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PART E

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PART E
CHANCELLOR'S 1988 PAPERS ON BANKING AND CITY ISSUES (NOT INCLUDING BANKING SUPERVISION)

Begins: 1/[illegible]/88
Ends: 30/12/88

DD: 25 years

[signature] 13/9/95

PO -CH /NL/0177
PART E

mg2.cc/Sheath/91g5.26.10

CONFIDENTIAL

FROM: R L SHEATH

DATE: 1 November 1988

1. MR GRICE JWG 1.11.88

2. ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mrs Lomax
Miss Noble
Mr O'Donnell
Miss O'Mara
Mr Bush
Mr Brooks
Mr Dickson
Mr Ritchie
Mr Hurst
Ms Ryding
Mr Wheatley

MAMC: B11

SECTORAL ANALYSIS OF BANK AND BUILDING SOCIETY DEPOSITS AND LENDING: Q3 1988

We now have available two useful analyses of recent bank and building society deposits and lending:

(i) a sectoral analysis of deposits and lending for the third calendar quarter; [includes July, a freak month]

(ii) the more detailed industrial analysis of bank lending for the quarter June-August. This difference in time period and also the different coverage of these data reduce their usefulness. However, the breakdown between, and within, lending to the financial and industrial and commercial sectors which they provide can be added to the M4 lending data to help clarify sectoral movements.

2. The main points are as follows:

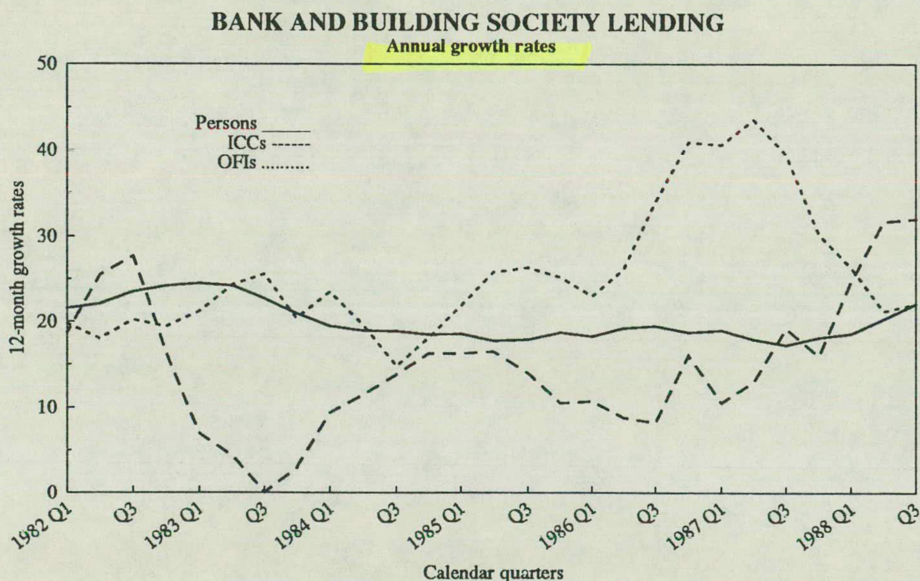
Lending

(i) **personal sector borrowing** continued to grow sharply. **Mortgage borrowing** grew at a record rate, as did lending **for consumption** on a 12-month basis;

(ii) **unincorporated business' sterling borrowing** continued to accelerate on a yearly basis. This coincides with rapid increases in industrial and commercial companies (ICCs) **borrowing**, which has risen by 32% over the past year. Within this, lending to **property companies** continued to increase strongly;

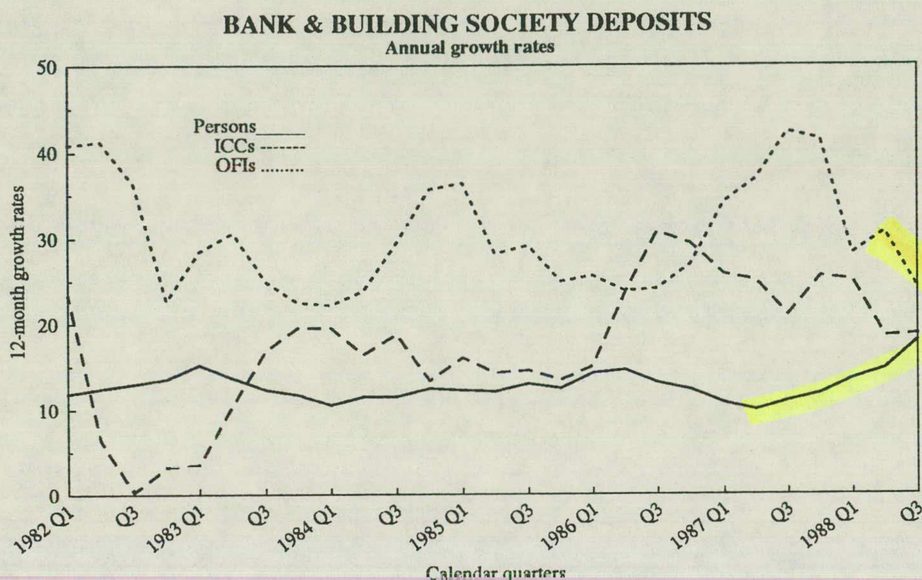
(iii) **financial sector** borrowing was mainly accounted for by mortgage finance vehicles. Otherwise it was sluggish.

(iv) The overall picture in recent quarters is brought out by the following chart. Growth in personal lending has remained steady at a high level for some years. Rapid growth in lending to financial companies has subsided but been replaced by an acceleration in lending to industry.



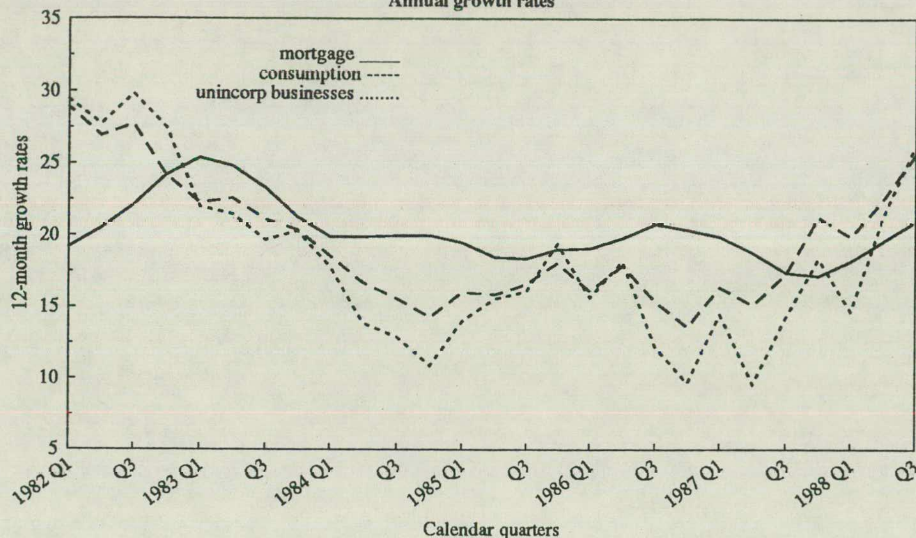
Deposits

Growth in personal deposits has accelerated. Growth in industrial and financial company deposits has tended to fall back but remains at a high level.



Detail

3. **Lending to the personal sector** rose by 22.1% in the year to Q3, and by 6% over the quarter (compared to 20.3% and 5.9% in the previous quarter). The increase of £14.5 billion would have been £0.6 billion higher had one bank not switched its mortgage lending to an OFI subsidiary. The increase was mainly due to **mortgage borrowing** which has risen by 21.1% over the past year. The third quarter increase of 5.8% (Q2 5.3%) was inflated by Budget effects. **Consumption borrowing** rose by £2.0 billion, as in the previous quarter, taking the 12-month growth rate to 23.0%; this will partly reflect consumption connected with house purchase. **Lending to unincorporated businesses** rose more slowly in Q3 (6.7%), but the yearly rate rose from 24.0% to 28.2%.



4. **Personal sector M4 deposits** rose by £11.3 billion, the annual growth rate increasing from 14.7% to a record 18.0%. Bank deposits rose much more rapidly than building society deposits, possibly reflecting the strengthening competitive position of the banks towards the end of the quarter.

5. **Industrial and commercial companies' sterling borrowing** continued to rise in 12-month terms, increasing from 31.7% to 32.0%. The quarterly increase was the lowest for a year however. This may reflect higher borrowing in Q2 to finance Budget tax rebates, this depressing the Q3 increase. The lending was more than accounted for by advances, with £0.5 billion of bill borrowing being repaid.

6. The industrial analysis for June-August shows continued heavy borrowing by **property companies**, which rose 13% over these months; it increased by 58% over the year to August. The £3.0 billion rise in lending to manufacturing industry was largely accounted for by £2.3 billion of lending to the **food, drink and tobacco industries**; much of this can be related to takeover activity as it includes loans of over £1.2 billion to one food manufacturer.

7. **ICCs' sterling deposits** rose by £5.0 billion, a sharp increase of 10.0% over the quarter; the 12-month growth rate

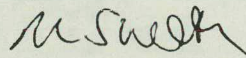
accelerated. As a result, ICCs net borrowing was flat (as in 1987).

8. **Other financial institutions' sterling borrowing** increased by £3.0 billion (6.6%) taking the 12-month growth rate from 21.2% to 22.1%. However, this figure is distorted upwards by £0.6 billion due to the switch mentioned above. Allowing for this, lending in Q3 was subdued, and the rapid deceleration in OFIs' borrowing from the heights of early 1987 continued.

9. The period June-August saw heavy lending to **mortgage companies** (£0.4 billion) and a single loan of £0.4 billion to a UK finance subsidiary. Lending to **securities dealers** fell by £0.7 billion.

10. In contrast to the other sectors, **OFI M4 deposits** rose slowly, increasing by only £1.4 billion (3.5%). This reversed the trend established by consistently large rises over the previous 12 months, and was half the corresponding figure in 1987. The 12-month growth rate fell from 30.7% to 24.6%.

11. **Foreign currency borrowing** rose sharply in Q3, £2.5 billion of the £3.2 billion (8.1%) increase being accounted for by **ICCs**. Currency lending to the company sector has increased by 36.9% over the past year. **OFIs** currency borrowing rose by £0.6 billion, after a total fall of £2.4 billion over the previous 12 months. Over the period June-August, **'food, drink and tobacco'** borrowed £0.6 billion, and **'other manufacturing'** £0.5 billion. Investment and unit trusts repaid £0.5 billion, 'other financial' also making repayments of £1.4 billion.



R L SHEATH

mom/pa.172

FROM: MISS M O'MARA

DATE: 3 November 1988

MR HUDSON

cc Sir P Middleton
Sir T Burns
Mr R I G Allen
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Grice
Mr Pickford
Ms Ryding
Mrs Chaplin
Mr Tyrie
Mr Call

FOREWORD TO THE TREASURER'S YEAR BOOK 1989

You asked for comments on Mr Cropper's draft, attached to your minute of 28 October. We have the following comments:

Page 1 paragraph 3 line 5: Replace "bond" with "capital"

Page 2 paragraph 1 second sentence: This repeats the common fallacy of equating a PSDR with repayment of the national debt. Redraft to read "This year we expect public sector to be £10 billion in surplus. In 1975-76, the Labour Government were borrowing £40 billion in today's terms" (strictly, we are referring to the same percentage of GDP but I think the formulation Mr Cropper used is acceptable in an article of this kind).

Page 2 paragraph 1 third sentence: This point is not for MG but we thought it difficult to argue that the change from PSBR to PSDR was "possibly the Government's greatest contribution to Britain's economic growth".

Page 2 paragraph 3 second sentence: Delete. This sounds far too apologetic. We suggest you might replace this sentence with a reference to the boom in investment, drawing figures from the Industry Act Forecast and pointing out that the CBI's October quarterly survey shows that investment intentions remain strong.

mom/pa.172

Page 2 paragraph 4 Delete. The first sentence implies that we raised rates as a consequence of the crash! The point we should making in the rest of the paragraph, if it remains at all, is that high interest rates are a price worth paying to secure lower inflation.

MOM

MISS M O'MARA

35/3/ea2/mr.25.4.11

FROM: MARTIN HURST
DATE: 4 November 1988

MR HUDSON

cc: Sir P Middleton
Sir T Burns
Mr Monck
Mr Lankester
Mr R I G Allen
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Gieve
Mr A C S Allan
Miss O'Mara
Mr Grice
Mrs Chaplin
Mr Tyrie
Mr Call

FOREWORD TO THE TREASURER'S YEARBOOK 1989

Mr Sedgwick has asked me to co-ordinate EA's comments on Mr Cropper's draft.

- Para 2. The profitability of non-North sea companies is running at the highest level for 18 years. Thus replace 'twenty years' by 'eighteen years' or 'almost two decades'.

- Para 3. Aggregate profits of British companies in 1987 were 2.71 times the 1979 level. Thus replace 'three times' by 'almost three times'.

- Para 4. We are worried by the reference to the expected repayment of the national debt, and the proposal to quantify this repayment. The national debt is a very precisely defined concept, which does not have a one for one relationship with the PSBR. Thus in 1987-88, PSBR was in surplus to the tune of £3½ bn, while the national debt rose by £11½bn. It is therefore dangerous to equate a published forecast for the PSBR with a similar change in the national debt outstanding. Given that the aim of this paragraph is to show the turn around in the Government's demands on the capital markets, we think that a simple reference to the size of the PSBR surplus, possibly coupled with a statement to the effect that this will mean net repayments of debt, would be a reasonable replacement for the current draft. This would tie in with the subsequent reference to the PSBR in the 1970s.

On the rest of the foreword, we think that some reference to the increasing sophistication of corporate treasurers departments, to the extent that some are now regarded as profit centres in their own right, might have been inserted. (This reflects in part the freeing of capital markets undertaken by this Government, and also the worldwide moves towards securitisation and globalisation).

Martin Hurst

MARTIN HURST

111476
MDHIAN 0302

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FM UKREP BRUSSELS
TO DESKBY 041330Z FCOLN
TELNO 3212
OF 041330Z NOVEMBER 88
INFO PRIORITY EUROPEAN COMMUNITY POSTS

FRAME ECONOMIC .

SECOND DRAFT BANKING COORDINATION DIRECTIVE:
OPINION BY BANKING ADVISORY COMMITTEE

SUMMARY

BAC OPINION CIRCULATED AT COREPER. CRITICISES SOME FEATURES OF COMMISSION'S PROPOSAL. RECIPROCITY AND COMITOLOGY AMONG THE SUBJECTS SINGLED OUT FOR ADVERSE COMMENT.

DETAIL

2. THE COUNCIL SECRETARIAT CIRCULATED IN COREPER TODAY AN OPINION ON THE DRAFT SECOND BANKING COORDINATION DIRECTIVE PREPARED BY THE BANKING ADVISORY COMMITTEE AND TRANSMITTED TO THE COUNCIL WITH A REQUEST FROM ITS CHAIRMAN (PADOA-SCHIOPPA) THAT IT REACH MINISTERS BEFORE MONDAY'S ECOFIN.

3. THE REPORT (MUFAXED TO KROLL, TREASURY AND FARRANT, BANK OF ENGLAND) EXPRESSES GENERAL SUPPORT FOR THE DRAFT DIRECTIVE BUT CONTAINS A NUMBER OF CRITICAL COMMENTS ON THE COMMISSION'S PROPOSAL: MAIN POINTS AS FOLLOWS:

A. THE OWN FUNDS AND SOLVENCY DIRECTIVES MUST BE IN FORCE BEFORE THE SINGLE BANKING LICENCE BEGINS TO OPERATE. (DIFFERENT VIEWS WITHIN THE COMMITTEE ARE REPORTED ON THE IMPORTANCE AND URGENCY OF COMMUNITY LEGISLATION ON LARGE EXPOSURES, DEPOSIT PROTECTION SCHEMES, LIQUIDITY, REORGANISATION AND WINDING UP, INTEREST AND EXCHANGE RATE RISKS AND COUNTRY RISK PROCEDURES.

B. THE DRAFT DIRECTIVE PERMITS HOST MEMBER STATES PENDING FURTHER COORDINATIONS TO REQUIRE BANKS ESTABLISHED IN ANOTHER MEMBER STATE TO MAKE PROVISIONS AGAINST MARKET RISK FROM OPERATIONS ON THE SECURITIES MARKET: MOST MEMBERS OF THE BAC OBJECTED TO THIS PROVISION.

C. A RANGE OF CRITICISMS OF THE IMPLICATIONS, FOR INSTITUTIONS ALREADY AUTHORISED, OF THE COMMISSION'S PROPOSAL FOR A MINIMUM

CAPITAL REQUIREMENT OF 5 MECU: WIDESPREAD DISSATISFACTION AT THE PROPOSAL THAT EXISTING INSTITUTIONS SHOULD HAVE UNTIL THE END OF 1996 TO REACH THE THRESHOLD.

D. RECIPROCITY: 'NEARLY ALL' MEMBERS OF THE BAC SAID TO THINK IT HIGHLY DESIRABLE TO OBTAIN RECIPROCAL TREATMENT FROM THIRD COUNTRIES. DIVIDED VIEWS ON THE ACCEPTABILITY OF THE COMMISSION'S PROPOSAL AS SUCH. A SOLUTION MIGHT BE FOUND BY CHANGING THE IMPLEMENTING ARRANGEMENTS PROPOSED.

E. IMPLEMENTING POWERS (COMITOLOGY)
A MEASURED REMINDER OF THE NEED FOR BANKING SUPERVISORS TO BE ACTIVELY INVOLVED IN THE DEVELOPMENT OF THE EC'S BANKING MARKET AND FOR THE BAC THUS TO HAVE A CENTRAL ROLE IN COMMUNITY BANKING LEGISLATION. THE COMITOLOGY PROVISIONS IN THE DRAFT DIRECTIVE (ARTICLE 20) SHOULD BE AMENDED TO SUBSTITUTE THE BAC FOR THE REGULATORY COMMITTEE PROPOSED BY THE COMMISSION, AND WITH ANY COMMISSION PROPOSAL LAPSING UNLESS IT OBTAINS A QM EITHER IN THE BAC OR IN THE COUNCIL.

COMMENT

4. THE BAC'S SUGGESTION THAT ANY IMPLEMENTING DECISION UNDER THE DIRECTIVE WHICH THE COMMITTEE HAS ITSELF TURNED DOWN SHOULD REQUIRE A QM IN THE COUNCIL CHIMES REASONABLY WELL WITH OUR OWN THINKING ABOUT RECIPROCITY AS DEVELOPED E.G. AT EQO LAST WEEK. BUT THE BAC'S OPINION MAY ALSO INADVERTENTLY LEND SUPPORT TO THE COMMISSION'S DEFENCE OF FEATURES OF ITS EXISTING PROPOSAL: FIRST, BECAUSE IT SUGGESTS THAT, PROVIDED THE BAC IS CONTENT, THE COMMISSION MAY TAKE IMPLEMENTING DECISIONS, INCLUDING ON RECIPROCITY: SECOND BECAUSE THE OPINION DOES LNOT CRITICISE EXPLICITLY THE REQUIREMENT IN ARTICLE 7 OF THE DRAFT PROPOSAL THAT EACH AND EVERY APPLICATION BY A THIRD COUNTRY SUBSIDIARY SHOULD BE POTENTIALLY AT RISK FROM THE RECIPROCITY PROCEDURE.

HANNAY

YYYY

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pvp

FROM: MRS R LOMAX
DATE: 7 NOVEMBER 1988

MR A C S ALLAN (Personal)

CHEQUERS AND THE CITY

I gather there was a Chequers meeting on the future of the City at the end of October, attended by various City luminaries and at least one person from this end of town.

2. Any chance of finding out what transpired? I would be very interested.

Rl.

RACHEL LOMAX

chex.md/j/3

⇒ Andrew-or

PNf

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

9 November 1988

Mrs J E Platford
The Treasurer
107/111 Fleet Street
London
EC4A 2AB

Dear Mrs Platford.

... Please find enclosed a black and white photograph of the Chancellor of the Exchequer, and a biographical note, which I have been asked to send you in association with the Treasurers' Year Book 1989.

Yours sincerely

Julie Thorpe.

MRS JULIE THORPE
Diary Secretary

C.

TREASURER'S YEARBOOK

1. This is the Foreword that Peter Cropper drafted, because you did it more or less at his insistence!

2. Rereading this proof, there's nothing about inflation. I have ~~put a sentence in~~ suggested a sentence, at the foot of the first page. OK? OK

3. They may omit the biographical note, on the grounds that everybody knows who you are. Failing that, it will be shortened along the lines marked.

Omit entire biog. nte & simply say "NL has bn C/X since June 1983."

8.12.

chex.md/ah/56

PWP
~~bf 1.12~~

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

14 November 1988

Mrs J E Platford
Managing Editor
"The Treasurer"
107/111 Fleet Street
London EC4A 2AB

cc Sir P Middleton
Sir T Burns
Mr Monck
Mr Lankester
Mr R I G Allen
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Gieve
Mr A C S Allan
Miss O'Mara
Mr Grice Mr Pickford
Mrs Chaplin
Mr Tyrie
Mr Call

Dear Mrs Platford,

FOREWORD FOR THE TREASURER'S YEAR BOOK 1989

... I attach the Chancellor's foreword to the 1989 Year Book. I look forward to seeing the proof copy, which you kindly offered to send. In the meantime, do get in touch if there are any queries - my direct line is 270-5021.

Yours sincerely,

Andrew Hudson

A P HUDSON

C.

2 further things.

(a) C. Fildes is a fellow-contributor, & believes this is the first time you & he have appeared between the same covers since the Spectator in the late '60s. Correct? If so, any objection to the Year Book saying so? NO

(b) They wd like a facsimile signature, as they had from Lord Carrington & the Prince of Wales. Pl. could you sign on a slip, with a black pen? Attached.

AH

chex.ps/ah/65

CHANCELLOR'S FOREWORD TO THE TREASURER'S YEARBOOK 1989

I am honoured to be invited to write this Foreword to the Treasurer's Yearbook 1989. It gives me a double opportunity: first to remind members of your Association of what the Government has done to improve the conditions for corporate finance, and then to congratulate companies and their treasurers on the successful manner in which they are seizing their opportunities. With freer capital markets, increasing globalisation, and the spread of securitisation, your own profession has had to change rapidly, and I commend you on the way you have adapted.

Since 1979, the financial position of the corporate sector has been transformed. Indeed, company profitability is running at the highest level for nearly twenty years. Out of record profits, companies are financing record levels of investment. Meanwhile dividends are flowing on an unprecedented scale into the country's pension funds and other savings institutions.

In 1987, the aggregate profits of British companies stood at £65 billion, close to three times their level in 1979. The flow of profits is the fuel of investment. It is also the security that enables companies to borrow on the world's capital markets.

The Government has also made room for companies to raise money in the domestic capital markets by cutting back its own demands. This year we expect the public sector to be in surplus by some £10 billion. By contrast, in 1975-76, government borrowing reached the equivalent of £40 billion in today's terms. This massive turn around in the Government's demands on the capital market is one of the Government's greatest contributions to Britain's economic transformation.

Meanwhile, the reform of company taxation, including a sharp reduction in the rates of corporation tax, has boosted the incentive to make a profit in the first place. The standard rate of corporation tax has come down from 52 per cent to 35 per cent. For small companies the fall is from 42 per cent to 25 per cent. These falls are just as striking as the cuts we have been able to introduce in the rates of personal tax. Moreover, by relating capital allowances more closely to the depreciation of assets, the reforms have contributed to a major improvement in the quality of investment in this country.

Today one sees, on all sides, the considerable benefits of freeing up the British economy from the restrictions of the sixties and seventies. Pay controls, price controls, dividend and exchange controls have all disappeared. And thanks to the outstanding response

from British businesses, the country has seen the longest period of steady growth most people can remember, the creation of a record number of new businesses, and the fastest fall in unemployment of any of the major nations. And although growth next year is likely to be below the exceptional rate of the past two years, it will remain at a healthy rate by historical standards. The upswing is going strong.

The need to cut red tape and make markets work more efficiently has also led the Government to work hard for the completion of the internal European market. By 1992, British industry will effectively have a domestic market of around 320 million people - nearly as many as in the United States and Japan put together. This represents both a challenge and an opportunity. The Government intends to make sure that British industry is among the best prepared in the Community to take advantage of the new business environment. But it must ultimately be for industry itself to respond by continuing to improve efficiency and investing to expand capacity, so as to win new markets and fight off competition from overseas producers.

The Government's aim is to provide the conditions for continuing growth in the private sector. By privatising the nationalised industries, including at least one of the massive loss-makers of the 1970s, we are removing

yet another drain on the successful private sector. We shall continue as we have started: water and electricity are due to be sold in the course of this Parliament; coal will follow in the next Parliament, and British Rail may go with it. Ministers and civil servants are working themselves rapidly out of jobs - jobs where they never belonged in the first place - and handing over to those who specialise in finance and management.

I suspect that the work of a Corporate Treasurer has something in common with the work of a Chancellor. Both have the responsibility of ensuring that finance is on an even keel, that money is there to pay the bills, and that balances are invested wisely when they are not wanted for current purposes. We are doing our job best when nobody has cause to notice that we are doing it. I have watched the growth of the profession of Corporate Treasurer with great interest and I wish your Association every success in the challenging years ahead.

est.ld/williams/Noble 01

1 Alex
2 pmp

FROM: JULIAN WILLIAMS
DATE: 15 November 1988

MISS G NOBLE

cc: PS/Chancellor
Mr Scholar
Mrs Lomax
Mr Kroll

SECOND BANKING CO-ORDINATION DIRECVTIVE : MEETING WITH BARONESS ELLES

The Economic Secretary has arranged to meet Baroness Elles on Thursday 24 November at 10.00am to discuss the Second Banking Co-ordination directive. He would be grateful if you would attend along with Mr kroll.

2. Please could you arrange for the necessary briefing for the meeting to arrive by close on Tuesday 22 November.

Julian Williams

JULIAN WILLIAMS
DIARY SECRETARY

est.ld/lilley/004

Treasury Chambers, Parliament Street, SW1P 3AG

Baroness Elles
House of Lords
LONDON
SE1

9 November 1988

Dear Diana

I understand that the European Parliament's Legal Affairs Committee, of which you are Chairman, is due to consider the Second Banking Co-ordination Directive in the near future. I would very much welcome the chance to have an informal discussion with you about the Directive. The Treasury are currently leading the negotiations on it in the Council Working Groups, and I would welcome the chance to explain some of the points on which we have expressed concern - most notably the proposed reciprocity provisions, which we regard as unacceptable and unworkable as they stand.

Yours ever

Peter

PETER LILLEY

RS137FST42

CC: PPS, CST, EST, PMG, Sir P. Middleton, Mr Scholar, Mrs Lomax, Mr Peretz, Miss Noble, Mr Ilett, Mr Chaplin, Mr Tyrie, Mr Neilson, Mr Jenkins (OPC), Mr Eccleshall - IR, Mr Sullivan - IR, PS/IR.

Treasury Chambers, Parliament Street, SW1P 3AG

R I L Allen, Esq.,
Chief Executive
Association for Payment Clearing Services
Mercury House
Triton Court
14 Finsbury Square
London EC2A 1BR

22 November 1988

Dear Mr Allen

Thank you for your letter of 7 November.

For the avoidance of doubt, perhaps I should emphasise that I have no difficulty with the proposition that it would be sensible to move to an electronic system for paying dividends and interest. And I certainly would not rule out making any legislative change by way of enabling powers plus secondary legislation. But before we can frame even enabling legislation, we do need to know much more about the precise details of the proposals you have put forward. We can then decide what would be the most appropriate way forward which satisfied both your and the Revenue's concerns. I understand that you are due to meet my officials shortly. It would be very useful if you could let them have details of your proposals in advance of the meeting, so that they can start working on them immediately.

I was interested to see your comments about the need to ensure that no interested party is deprived of essential requirements. And I was pleased to hear that you feel your proposals offer a good compromise plus improved economy overall. I look forward to hearing the outcome to your discussions.

Yours sincerely

Norman Lamont

NORMAN LAMONT

35a/g.fiml.ma/other/120

prp [weeded]

FROM: N J KROLL

DATE: 22 NOVEMBER 1988

1. MRS LOMAX RL 22/11

2. ECONOMIC SECRETARY

Ch seems OK AA

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mr R I G Allen
Mr Ilett
Mr Mortimer
Miss Noble or
Mr Bush
Ms Symes
Mr Segal

MONEY PROGRAMME - BANKING RECIPROCITY

The BBC's "Money Programme" is planning a short feature on banking reciprocity for transmission on 11 December, the day before next month's ECOFIN. They have asked for background guidance on four questions -

i. what is our attitude towards the way the Commission managed to include reciprocity in the Second Banking Directive and our general view of the Commission's policy?

ii. how are we going to tackle the issue?

iii. what is the UK definition of reciprocity? How does it differ from other countries' and is ours more liberal?

iv. do we feel it is better for individual countries to decide for themselves what the policy should be?

2. Draft answers to these questions are attached. If you are content with them, we shall pass them to the "Money Programme.

3. It is not yet clear whether we will be asked for an on-the-record line. If we are, we shall maintain our current position that in our view the Directive would be a better measure without the Commission's proposed reciprocity provisions, and that our participation in detailed consideration of these provisions is on a without prejudice basis.

NJKroll

N J KROLL

MONEY PROGRAMME - BANKING RECIPROCITY

i. What is our attitude towards the way the Commission managed to include reciprocity in the Directive and our general view of the Commission's policy?

The Commission inserted their reciprocity provisions into the draft Second Banking Directive shortly before it was submitted to the Council on 26 February 1988. We regret that there was no prior discussion in Commission working groups. The result is that the Commission's proposals are muddled and their intended effect is far from clear.

The UK believes that the Commission's proposals as drafted are unworkable and unacceptable, above all because they might be used to inhibit access to the single market. There are uncertainties about the definitions involved (for example it is not clear what the Commission mean by 'reciprocity') and who would be affected. Procedurally the proposals are extremely bureaucratic and appear open-ended. The proposals also seem inconsistent with the stance of the Commission's announcement of 19 October on external aspects of the single market. They raise legal doubts about compatibility both with Article 58 of the Treaty of Rome and the principle of equal treatment of established businesses, and with the EC's international obligations under the OECD Capital Movements Code.

ii. How are we going to tackle the issue?

We have made clear that in our view the Directive would be a better measure without these reciprocity provisions. Following ECOFIN on 7 November the Commission's proposals are to be subject to further detailed consideration, in which we are participating on a without prejudice basis.

iii. What is the UK definition of reciprocity? How does it differ from other countries and is ours more liberal?

UK reciprocity powers are clearly defined to mean that UK companies should be able to operate in a country on terms at least as favourable as those on which companies from the country in question operate in the UK. As Government Ministers made clear in the House during the passage of the Financial Services Act, our powers are permissive reserve powers which were designed as a negotiating weapon to open up third country markets as and when the Government judges it to be in the national interest; they have never in fact been used. By contrast, the Commission's proposals appear to apply an automatic reciprocity test to each and every application for a banking licence from an institution of non-EC parentage.

The Commission are investigating the existence and scope of reciprocity provisions in EC member states. Seven member states maintain a reciprocity reserve from the OECD Capital Movements Code, applying to at least some areas of financial services. France, Greece, Ireland, the Netherlands and the UK maintain general reciprocity reserves on banking while Germany and Italy have partial reserves relating only to branches.

iv. Do we feel it is better for individual countries to decide for themselves what the policy should be?

Clearly it is for member states to determine any Community policy in this area. We remain unconvinced that EC-wide provision is needed. We believe that Europe's banking industry will greatly benefit from liberalisation in the single market and that it will benefit even more to the extent that we can extend that liberalisation beyond the borders of the EC.

Goldman Sachs

S.1

Not for Publication Before 00.01 Hours on Wednesday 30 November 1988

A Plan for European Monetary Union

Gavyn Davies

23 November 1988

Ch
Not bad. (see X !)

A Plan for European Monetary Union

Goldman Sachs

SUMMARY

1. After recent sceptical or hostile pronouncements by many European luminaries, including Mrs. Thatcher and the heads of the central banks of both Germany and the UK, it may be thought that European Monetary Union (EMU) is some distance off. And indeed it is. But, if the final objective is thought desirable, there are sensible ways of moving in the right direction without immediately offending any politician's amour propre. This is no idle discussion: the EEC Heads of Government, at their Hanover meeting last June, established a Committee under Jacques Delors (comprising the 12 EEC central bank Governors, along with some outside experts) to recommend what concrete steps the Community should now take on the road to monetary union. This article looks at the case for and against EMU, and considers the progress made already in the spreading private sector use of the European Currency Unit (ECU). It ends by outlining a cautious long-term plan for EMU which could conceivably be embraced by the Delors Committee.

2. On the **desirability of EMU**, several arguments need to be considered. First, there is the question of central bank counter-inflation credibility. In the July/August issue of "The International Economics Analyst", we argued that the costs of disinflation in countries outside the EMS since 1979 had been rather less than those inside the EMS. Furthermore, we argued that any shift to a European Central Bank would risk reducing the counter-inflation credibility of the system, since such an institution could not be entirely dominated by the Bundesbank. These arguments still stand. But others may over time become more powerful. If the 1992 programme succeeds in creating a single European market, the EEC will move closer to being an optimal currency area. Furthermore, the semi-fixed EMS exchange rate system may not in the end prove consistent with freedom of capital flows; experience may prove that a credible fixed rate system is the only one compatible with the EECs intention to remove all capital controls (which is of course at the heart of the 1992 programme). This could be the consideration which eventually tips the scales in favour of EMU.

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3. In order to understand the debate on monetary union, it is necessary to understand how the ECU system works, since the fledging European currency will almost certainly play a key role in any future developments.

4. **The ECU:** The private sector ECU is a basket currency containing specified amounts of each of the major currencies in the EEC. It is created when commercial banks "bundle" and "unbundle" the composite national currencies to produce ECU-denominated deposits and loans. So far, the private ECU has played a small but growing role in the cross-border banking and bond markets of the EEC, and recently ECU-denominated bonds have been among the most actively traded in the Euromarkets. There is scope for the authorities to encourage this private sector activity further. In addition, **official ECU** are held by central banks. These are created when the central banks of the EEC receive ECU from the European Monetary Co-operation Fund in exchange for gold and dollar reserves in the form of 3-month revolving swaps. This is little more than a book-keeping mechanism, since **official ECU are not fungible with private ECU.**

5. **Developing the ECU:** Under the present system, the ECU can only exist if it is ultimately backed by the national currencies of the EEC. Because the process of ECU creation by the private sector needs to be "fuelled" by national currencies, it is in effect controlled by the "average" monetary policies of the European central banks. This is a useful attribute, since any further development of the ECU would tend to **force** European central banks to co-operate more in monetary policy setting. There are 3 distinct possibilities for developing the official ECU; two are interim stages, and the third represents a way of operating full EMU:

(i) **Interim Stage I:** The official ECU would be created by **permanent** f/x and gold swaps with the EMCF, and would become fungible with private ECU.

(ii) **Interim Stage II:** The official ECU would be created in exchange for EEC **national currencies** instead of f/x reserves.

(iii) **Final Stage:** The ECU would be created directly by a European Central Bank and would be the ultimate source of high-powered money in Europe. It would be issued to national central banks, which would be left with the residual authority to issue local currency against it. National currencies would basically cease to exist. The ECU would no longer be a basket currency, but would be an asset in its own right.

These three stages represent a gradual escalation from the present situation of partial national monetary autonomy to one of full control by a central European authority.

6. **Attitudes Towards EMU:** For Mrs. Thatcher, not in her lifetime. For Chancellor Kohl, inevitable before the end of the century. For the Dutch, the sooner the better. For the French, peut-etre. For the heads of the Bundesbank and the Bank of England, no for now; yes (on their own terms) later.

7. The Germans and the British, in their very different ways, represent the main stumbling blocs. The **Bundesbank** be-

lieves that the best route is to build on the successes of the ERM, widening the system where possible and decreasing the frequency of realignments. But the Bundesbank is not willing to encourage this process by making lending facilities more readily available to weak-currency countries, and is against encouraging the private sector use of the ECU. It is in favour of a European Central Bank as a very long-term goal, but only if it is independent, decentralised and charged with safeguarding the currency. In effect, Bundesbank President Poehl is saying that monetary union might be acceptable — as long as the DM becomes the European currency, and the Bundesbank becomes the European Central Bank. The **Bank of England** takes a profoundly different view. The Governor believes that the 1992 programme **can** succeed without creating a single currency; in fact, he argues that too much concentration on the latter objective could kill the former. He rules out sterling membership of the exchange rate mechanism (ERM) of the EMS for the time being, and sees the gradual development of the private ECU as a possible way forward.

8. **Some Principles:** The British and Germans agree: (i) that EMU might be a desirable long-term objective; (ii) that it cannot be forced too quickly on an unready Community of sovereign nations and (iii) that further economic convergence will be needed before EMU can be contemplated. They disagree, however, on the next practical steps to be taken. Somehow, the Delors Committee will need to tread a path through this minefield. This might look hopeless, but four guiding principles might be helpful:

(i) Set a leisurely timetable with plenty of practical steps. More haste, less speed should be the motto.

(ii) Do not rely on the developing the ERM as the sole instrument of early progress. Britain is unlikely to join for some years; and anyway the ERM in its present state may not be compatible with the removal of capital controls.

(iii) The ECU may be able to play a more useful role in promoting monetary union than the Germans, or even the British believe. Its developing role as an international currency can "grease the wheels" of the single market programme, and automatically force central banks to co-operate more in setting monetary policy. Progress in this direction will make the final step of full EMU much easier to take.

(iv) Any programme should be carefully phased so that the development of the ECU and the ERM occur in step with each other. By allowing the ECU to promote monetary policy "averaging", and by allowing the Bundesbank to retain a central role in the ERM, a happy medium might be achieved to keep most of the protagonists happy.

9. **A Programme:** Using these principles, the following programme spells out 3 separate phases of 2–3 years each which might conceivably take the EEC to full monetary union (the fourth phase) before the end of the Century:

— **Phase I.** No institutional changes. Official ECU stays non-fungible with private ECU. Governments and EEC bodies encourage the private use of the ECU as an international currency. Frequency and size of ERM realignments reduced.

— **Phase II.** Official ECU becomes fungible but is still created by swaps of f/x reserves. EEC countries set joint monetary targets as ERM is broadened, hopefully to include UK.

— **Phase III.** Official ECU now created by swaps for national currencies, not f/x reserves. EMCF to conduct Community f/x intervention. Internal exchange rates fixed. ECU to become legal tender in domestic economies.

— **Phase IV.** European Central Bank created. The ECU, now directly created as a liability of the European Central Bank, becomes an asset in its own right and ceases to be a basket currency. Monetary policy formed centrally with a residual implementation role for national central banks. Domestic currencies left to gradually wither away.

10. **Conclusion:** It is clear from the above programme that large hurdles still need to be cleared before the EEC can seriously contemplate full monetary union. So far, the member states have been intimidated by the difficulties and have fought shy of the whole process. But as the economies become more inextricably linked after 1992, the economic sovereignty which some members are so keen to protect could become increasingly trivial. Before too long, most of the crucial areas of economic management — trade policy, regional policy, industrial policy, the regulation of financial markets, take-over and monopoly policy, some aspects of tax policy, labour market policy etc. — will voluntarily have been ceded, in whole or part, to Community-level determination. And member governments may then find, as have the governments of many small open economies before them, that their supposed monetary sovereignty amounts to one thing only — the freedom to inflate more rapidly than their Community neighbours. In other words, if the 1992 programme works, it may inevitably carry greater monetary integration, and even monetary union, in its wake. The Delors Committee has much responsibility to map out a feasible path.

23 November 1988

INTRODUCTION

The special article in the July/August edition of "The International Economics Analyst" ("The Whys and Wherefores of European Monetary Union" by the present author) considered some of the implications of the creation of a single currency in the EEC. In particular, it explained that a single currency would inevitably involve (i) the end of national monetary autonomy for the member states, (ii) the eventual creation of a European central bank, (iii) a single bond market structure across the Community and (iv) powerful forces leading to harmonisation of fiscal policy among member states. It went on to examine the experience of the EMS since 1979, especially considering whether the macroeconomic performance of ERM (exchange rate mechanism) members has been superior to that of non-members this decade. The conclusion was not particularly supportive of the ERM, since it was found that the costs of disinflation for ERM members since 1979 had been somewhat greater than that for non-members. The implication was that any extra counter-inflation "credibility" bestowed on member states had not been particularly worthwhile, and did not make up for the loss of exchange rate flexibility which ERM membership involved.

Some useful mnemonics . . . .

ECU = European Currency Unit
EMU = European Monetary Union
ERM = Exchange Rate Mechanism of the . . .
EMS = European Monetary System
ECB = European Central Bank
EMCF= European Monetary Co-operation Fund

A further conclusion was that the case for the creation of a new European central bank suffered from a potential "Catch 22": if the bank were to be politically acceptable to the French, Italians and British, it would have to involve officials from these countries, and could not just be the Bundesbank "writ large"; but such an institution could not possibly carry the credibility of the Bundesbank, at least initially. Hence any institution which would be politically feasible would automatically involve a loss of counter-inflation credibility compared to the Bundesbank-dominated ERM. The implication of this particular argument was to leave well alone, moving towards European Monetary Union (EMU) only very cautiously. (Other arguments for and against EMU are considered below.)

THE DELORS COMMITTEE

The EEC Heads of Government have established the Delors Committee to spell out the next concrete steps towards EMU. Despite the hostility of some politicians and central bankers, there are sensible ways of moving in the right direction. This article looks at the options facing the Delors Committee and makes some recommendations.

The July/August article did not, however, consider the issue which is now being discussed in detail by a Committee comprising the 12 central bank governors of the Community, along with some outside experts. This Committee, which is under the Chairmanship of Jacques Delors is charged with spelling out the next concrete steps which should be taken by the Community on the road to monetary union. After recent sceptical or hostile pronouncements by many European luminaries, including Mrs. Thatcher, and the heads of the central banks of both Germany and the UK, it may be thought that EMU is some distance off, and indeed it is. But there are sensible ways of moving in the right direction without offending any politician's amour propre. This article looks at the options facing the Delors Committee, and makes some recommendations.

Broadly, the Committee is likely to be faced with a choice between two main routes. The first involves developing the present

ERM system, along with its German domination, into fully-fledged EMU. The second involves building on the European Community Unit (ECU) as a "parallel currency", without initially creating a European central bank. It will surprise no-one to learn that these options are being championed by the Germans and British respectively, with the French and Italians apparently undecided between them. The German position has been spelled out by none other than Bundesbank President Poehl himself, who took the unusual step of contributing a lengthy signed article to the "Wall Street Journal" on 20 July 1988. The British position is best represented in speeches by Bank of England Governor Leigh-Pemberton on 15 November and by Mr. Anthony Loehnis, an official at the Bank of England in Strasbourg on 15 June 1988. We will consider both positions in some detail, but before doing so it is worth summarising the recent history of this issue, explaining the main features of the ECU itself. This basket currency will play a key role in any sensible move towards monetary union.

The Delors Committee can . . . .
— build on the ERM, or
— expand the role of the ECU
. . . . or do both simultaneously.

(not exactly)

EMU AND ECU

There is nothing much new under the sun, and the EEC committed itself to full EMU as early as in the Hague Conference of 1969. There followed the publication of the Werner Report and the famous EEC Council Resolution of March 1971 which opined that EMU could be achieved prior to 1980. The oil crises of the mid and late 1970s created enough economic disruption to put paid to that objective, but when the EMS was created in 1979 the EEC again committed itself to creating a rather unspecific "final system" within two years. Nothing much happened, and the Single European Act of 1985 fell far short of making a commitment to full EMU. Nevertheless, many Europeans (apparently not including Mrs. Thatcher) do feel that the commitment to create a genuine single market in the Community, incorporated in the Single European Act, **does** involve a commitment to EMU.

*Several previous attempts at achieving EMU have failed. Nevertheless, many Europeans (apparently not including Mrs. Thatcher) feel that the Single European Act **does** involve a commitment to EMU.*

This short paragraph on past failures suggests that a large degree of cynicism might be appropriate when considering the chances of the latest initiative ending in full EMU. However, that does not mean that progress **towards** EMU is impossible. Indeed, important progress has already been made with the successful develop-

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Table 1: The ECU-Composition, Central Rates and Weights

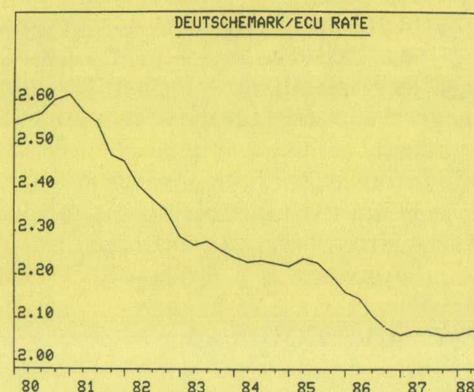
	Amount of National Currency in Basket	Central Exchange Rate Against ECU Since 12 Jan 1987	Weight of Currency in ECU*
DM	0.179	2.05853	34.93
Ffr	1.31	6.90403	18.97
Dfl	0.256	2.31943	11.04
Bfr	3.71	42.4582	9.07
Lfr	0.14	—	—
Lit	140	1483.58	9.44
Dkr	0.219	7.85212	2.79
£IR	0.00871	0.768411	1.13
£ST	0.0878	0.739615	11.87
Dra	1.15	150.792	0.76

*Based on existing central rates as of 12 January 1987.

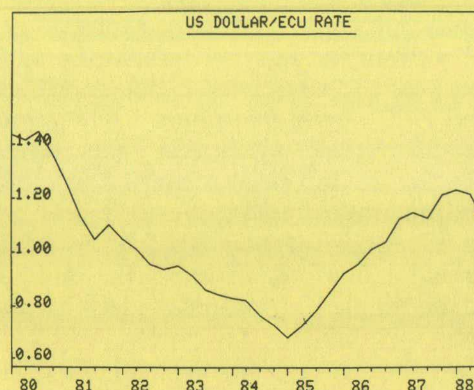
ment of the ECU as a "parallel" European currency in the past few years. The ECU fulfils several important roles in the EMS, and has many intrinsic attractions for private sector companies doing business in Europe. It is important to understand how the ECU basket works.

Readers who are already familiar with the workings of the private ECU may wish to skip to page S.11.

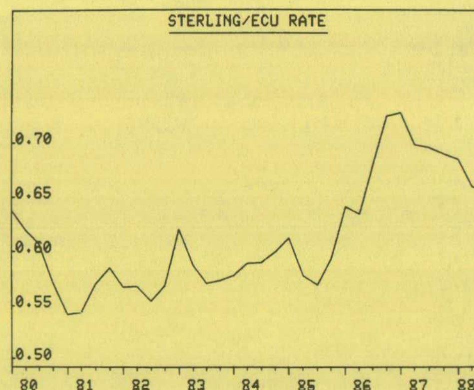
The ECU is defined as a basket containing **specified amounts** of each of the currencies in the EEC (excluding the peseta and escudo, which may well be included next year). The amounts of each currency included in the basket are shown in the left hand column of Table 1. The value of 1 ECU against any national currency — whether inside or outside the ECU itself — can be calculated at any given moment by translating each of the constituents in the ECU basket into the currency in question, using the exchange rates prevailing at the time. For example, translate each of the constituents in the ECU basket into dollars, and you have the value of 1 ECU in terms of dollars, or the $/ECU exchange rate. The weight of each of the constituent currencies in the basket varies with market exchange rates. If the DM appreciates against other constituent currencies, the value of 0.719 DM, measured in other currencies, rises so the DM appreciates against the ECU, and the weight of the DM in the basket increases at the same time.



The central rates for each of the EMS currencies within the ERM are defined against the ECU. The central rates following the last EMS realignment (on 12 January 1987) are shown in column 2 of Table 1. Bilateral rates can be obtained by dividing the central rates of each currency against the ECU; for example; the central rate for the F.fr/DM rate is obtained by dividing 6.90403 by 2.05853 to obtain F.fr/DM3.3539. Between realignments, the **bilateral** rates are allowed to deviate by no more than ±2.25% against their central rates (except the Lit, which has ±6% limits). Currencies are also (in theory, though not always in practice) prevented from deviating too much against the ECU itself[1]. Almost always, however, it is the bilateral cross-rates which trigger policy responses, not the deviations against the ECU.



Provided that all the member currencies keep within their EMS bands, the fluctuation of the ECU against any constituent currency should be rather small, and the weights of the currencies in the basket should not change very much. The weights, based on the latest central rates, are shown in column 3 of Table 1. They are intended to reflect the importance of each country in the economy of the EEC, taking into account both GNP and trade shares. However, the ECU is less stable against its constituent currencies than the Community originally intended, mainly because the £ sterling has stayed outside the ERM, and has in the past fluctuated a great deal against other European currencies. This fact, and the 6% permitted fluctuations of the Lit against the ECU, have increased the volatility of the DM/ECU, F.fr/ECU, B.fr/ECU rates etc., thus limiting the substitutability of the ECU for national currencies.



[1]The supposed limit, which should trigger policy action, is three-quarters of the maximum possible deviation of the currency from the ECU under conditions where the bilateral rates hold within their bands.

THE PRIVATE ECU

The EEC has created the ECU, and has given the markets certain commitments concerning its composition. The most important is that changes in the composition of the basket — for example, to include new currencies — shall not affect its external value on the day of the change. This helps achieve smooth market responses, which is crucial since all assets and liabilities denominated by the private sector in ECU are instantly re-defined in terms of the new basket whenever a change takes place. The alternative to this "open basket" would have been to keep all contracts defined according to the composition of the basket at the time the contract was made. But such a "closed basket" would have been disastrous to the private sector development of the ECU, since it would have led to a proliferation of different instruments based on different types of ECU. Uniformity is crucial if the ECU is to gain momentum as a currency in its own right.

The ECU is an "open basket". All contracts using the ECU adjust automatically when the composition of the basket changes. Changes in composition do not affect the external composition of the ECU on the day of the change.

But can the ECU be called a currency at all? Certainly, it has no bills or coins denominated in it, and is not legal tender in the EEC. However, it clearly does fulfil many of the bedrock characteristics of money, since it is used as a unit of account and medium of exchange through bank deposits and cheques denominated in ECU. It has "foreign currency" status in all EEC countries, and is used primarily for two purposes: (i) to denominate Euro-bond and other bond issues and (ii) to denominate bank deposits which can be used as a means of payment for international transactions.

Bond Issues: According to the latest OECD statistics shown in Table 2, ECU-denominated bonds have accounted for 5.5% of all international bond issues this year, which puts the ECU in 6th place among global currencies, having been practically non-existent as recently as 1981. At the end of last year, total ECU-denominated debt outstanding in the international markets amounted to $38.3bn (Table 3), which again placed the ECU 6th

Although it is not legal tender, the ECU fulfils many of the bedrock characteristics of an international currency. It has foreign currency status in all EEC countries and is primarily used in the Eurobond and banking markets.

Table 2: Denomination of International Bond Issues by Currency

($ billion)	1985	1986	1987	1988*	% Share in 1988
US$	96.8	118.1	56.7	71.8	38.6
Yen	6.6	18.5	23.1	19.0	10.2
DM	9.6	17.1	15.5	23.2	12.5
£	6.1	10.6	15.0	30.6	16.4
A$	3.1	3.4	9.0	8.2	4.4
ECU	**6.9**	**7.1**	**7.4**	**10.2**	**5.5**
C$	2.9	5.1	5.9	15.0	8.1
Ffr	1.1	3.5	1.9	2.4	1.3
NZ$	1.1	0.4	1.5	0.2	0.1
Dkr	0.5	1.2	1.4	1.4	0.8
Dfl	0.6	1.0	1.2	1.8	0.9
Other	1.3	1.7	1.9	2.4	1.2
Total	**136.6**	**187.7**	**140.5**	**186.2**	**100.0**

*First half at an annual rate.
Source: OECD Financial Market Trends, May 1988.

among global currencies with 3.9% of the total outstanding bond issue. The main issuers have tended to be government and international organisations within the EEC (Table 4), but more recently business issuers inside and outside the EEC have become more prominent. By nationality, the French and Italians have been the largest issuers (following the official EEC issuers themselves), but borrowers have now come from all the EEC countries, and from over a dozen countries outside the EEC. On the buying side, most of the final investors have come from within the Community, especially from Belgium and Luxembourg. Most types of bonds — fixed and floating rate, debt with warrants, convertibles, and zero coupons — have appeared in the ECU catalogue, though straight fixed-rate issues have tended to dominate. Swaps are a common feature.

Table 3: Debt Outstanding in International Bond Markets

($ billion)		End-1982	End-1987	Change
US$	– Euro	102.0	371.9	269.9
	– Foreign	42.0	51.9	9.9
Yen	– Euro	1.5	67.9	66.4
	– Foreign	15.0	53.8	38.8
Swfr		43.0	157.0	114.0
DM		31.0	98.5	67.5
Sterling		4.0	54.2	50.2
A$		0.1	16.5	16.4
ECU		2.0	38.3	36.3
Other		14.4	71.3	56.9
Total		**255.0**	**981.3**	**726.3**

Source: Bank For International Settlements, Annual Report, 1988.

Until recently, the ECU market was hampered by the lack of benchmark issues, and the lack of an active bill market. Both these omissions have now been partially rectified, with the ECU500m 6-year issue made by the EEC in June 1988, and by the more recent development of an ECU Treasury Bill market in the UK. When market conditions are right, these benchmark issues are expected to facilitate the rapid growth of the ECU market, and indeed there has been a surge of ECU issues in recent weeks. On some days, secondary market trading in ECU bonds (which has tended to be worryingly small in the past) has been more active than that in any other currency, including dollars.

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Bank Deposits: There is no central bank functioning in the ECU banking market, so there is no creator of "high powered" ECU, and no lender of the last resort. So how do bank deposits come into existence? In the final analysis, this is done by commercial banks "bundling" and "unbundling" the ECU from its component currencies in the Euro-markets. For example, if a customer asks for a loan to be denominated in ECU, the bank must either attract ECU deposits, borrow ECU in the inter-bank market, or acquire the component currencies to match the loan. The last of these methods represents the fundamental "creation" process for ECU

deposits. Once the component currencies have been translated into ECU in this way, further ECU can be created by the normal working of the bank credit multiplier in the Euromarkets, functioning in much the same way as Euro-dollars are "created" outside the US. However, there is a crucial difference, since there is no **domestic** market in ECU. If the Euromarkets become "short" of dollars (or other Euro-currencies such as DM, or F.fr etc.), they can always attract funds from the domestic markets of the currencies concerned. In the case of the ECU, the position is somewhat more complex, since the banks must attract component currencies from a large number of different markets. It is clear from this that the ECU market is a pyramid built on the money supply of each of the component central banks, with the central banks having an importance linked to the weights of their currencies in the ECU.

The ECU is created by commercial banks when they bundle and unbundle its component currencies in the Euro-markets. The ECU market is a pyramid built on the money supply of each of the component central banks, with the central banks having an importance linked to the weights of their currencies in the ECU.

From the point of view of the commercial banks which create the ECU from its component currencies, it is necessary to be confident that, in the final analysis, the component central banks will make available their national currencies in an emergency. The commitment to do this (which is analogous to the "last resort" function of a central bank in its own money markets) is, in effect, given by the assurance that EMS central banks will always intervene to an unlimited extent in the f/x markets to keep the parity grid intact if cross-rates reach their bilateral limits. Providing that this assurance is honoured, the commercial banks know that there will be unlimited "backing" for the ECU if there were to be a run on the banks. However, there are difficulties with this, since (a) sterling is not a member of the EMS and (b) there have been occasions on which EMS central banks have failed to honour their commitment to unlimited intervention. These and other complications involved in bundling and unbundling the ECU have undoubtedly hindered the development of the ECU banking market, but the larger the market becomes in "bundled" ECU, the less serious this will be. A further handicap until recently was the lack of a fully-fledged inter-bank clearing system for ECU, but this has now been rectified.

The use of the ECU in private banking markets has been handicapped by the lack of a clearing system (now rectified) and by problems with attracting "bundled" deposits.

Table 4: ECU Bond Issuers

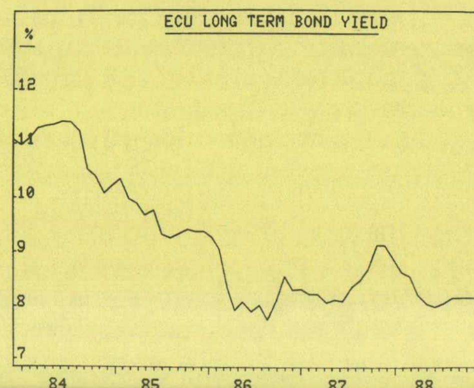
(ECU million)	1982	1985	1987
EEC Borrowers			
– Business	340	3454	2103
– Government	1230	3540	2000
– Institutions	202	1140	1345
Non EEC Borrowers			
– Business	65	3401	1930
– Government	0	200	453
– Intl. Organisations	55	560	350
Total	**1892**	**12295**	**8186**

Source: Eurostat ECU-EMS Information, June 1988.

Table 5: Currency Composition of Banks' Cross-Border Positions

($ billion)		Changes (Excl. Exchange rate effects)				Stocks At End-1987	
		Assets		Liabilities			
		1986	1987	1986	1987	Assets	Liabilities
US$	– Euro	188.8	186.4	210.1	196.1	1238.2	1377.9
	– External	43.2	13.5	63.1	63.4	458.2	477.4
DM	– Euro	1.1	33.8	28.7	43.1	297.7	338.8
	– External	26.4	4.0	2.3	4.4	147.9	80.7
Swfr	– Euro	7.8	–1.8	17.5	10.0	139.2	181.5
	– External	3.3	3.5	1.4	4.7	66.4	25.3
Yen	– Euro	20.9	30.9	21.2	23.9	147.8	137.2
	– External	43.9	92.6	29.4	89.9	288.6	223.8
£	– Euro	8.7	5.8	10.3	14.5	48.3	67.0
	– External	8.8	8.3	9.4	14.9	72.2	94.0
ECU	– Euro	7.4	9.9	4.2	8.7	78.5	69.4

Source: Bank for International Settlements Annual Report, 1988. Note that, since the ECU does not have a domestic market, there are no external positions in domestic currencies.

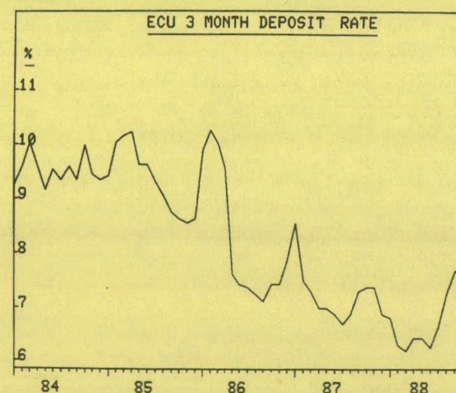


The development of the ECU banking market is summarised in Tables 5 and 6. Looking at bank assets (loans) in international markets (Table 5), the ECU sector has increased by about $17bn over the last two years, and at the end of 1987 there were $79bn of ECU-denominated cross-border banking positions. This represents 2.4% of the total of such positions. Table 6 shows the breakdown of these positions, including ECU positions which are not cross-border. It can be seen that total banking assets including non cross-border positions amount to $106bn, but the vast majority of these ($80bn) are **interbank** positions; only $26bn of bank loans are outstanding to the non-bank sectors.

Table 6: The Structure of the ECU Banking Market, End 1987

($ billion)	Assets	Liabilities	Net Position
Positions With Non Banks			
"Domestic"	11.1	4.2	6.9
Foreign inside EEC	8.6	2.6	6.0
Foreign outside EEC	2.9	0.9	2.0
Unallocated	3.6	1.1	2.5
Total	**26.2**	**8.8**	**17.4**
Positions With Other Banks			
"Domestic"	16.5	16.1	0.4
Foreign inside EEC	40.0	41.7	–1.7
Foreign outside EEC	13.1	14.8	–1.7
Unallocated	10.3	8.3	2.0
Total Interbank	**79.9**	**80.9**	**–1.0**
Overall Total	**106.1**	**89.7**	**16.4**

Source: As Table 5.



The ECU banking market has expanded less rapidly than the bond market. Perhaps the main reason for this has been a shortage of ECU-denominated deposits from the non-bank sectors. These amounted to only $9bn at the end of 1987, roughly one-third of the total of loans outside the banking sector denominated in ECU. National restrictions — for example, Germans have only recently been allowed to hold ECU deposits in Germany — is one reason given for the lack of deposits. Another factor is the absence of a domestic ECU market: in dollars, for example, there are US residents actively seeking the higher interest rates available in the Euro-market, so deposits of Euro-dollars can be attracted by shifting interest differentials a little. This does not happen in the ECU markets. A final reason is that the commercial use of the ECU to finance private sector trade flows is still very limited. It has been reported that ECU invoicing accounts for about 1% of all foreign trade in France and Italy (see "ECU Financial Activity", Bank of England Quarterly Bulletin, November 1988, pp509–516), but its use is almost unknown elsewhere. Only a handful of companies (among which the best known is the French company Saint-Gobain) use the ECU as their prime unit of account.

The commercial use of the ECU to finance private sector trade flows is very limited, as is its use as a prime unit of account.

THE OFFICIAL ECU

In addition to its expanding private sector role, especially in the bond and interbank markets, the ECU plays a rather strange role in the central bank sector. The public or official ECU, which is held exclusively by central banks, is defined in exactly the same way as the private ECU, **but the two different strains of the same currency are not fungible**. Official ECUs are obtained by the central banks of the European Community in the following way: they swap 20% of their dollar and gold reserves for ECUs created by the European Monetary Co-operation Fund (EMCF), the fund which administers the official accounting of the EMS.

The official ECU is not fungible with the private ECU. It is created when the EMCF makes 3-month revolving swaps for gold and $ reserves with EEC central banks. Since these official ECUs cannot be converted into private ECUs (for example by open market sales by central banks in the f/x market), they simply represent a rather arcane accounting mechanism within the EEC.

Official ECUs can only be used to settle transactions between central banks, and their main use at present is to settle loans between central banks made under the credit facilities of the exchange rate mechanism of the EMS. However, the key point to realise is that the official ECU is, in a sense, simply another name for gold and dollar reserves, since the ECU holdings of each central bank are automatically revalued to reflect changes in the ECU value of the gold and dollar reserves held at the EMCF. (This revaluation is conducted every three months.) Since these official ECUs cannot be converted into private ECUs (for example by open market sales by central banks in the f/x market), they simply represent a rather arcane accounting mechanism within the EEC.

This is an important point since, if central banks were allowed to sell ECUs for foreign exchange in the open markets, and if such official ECUs were initially created as liabilities of the EMCF, the whole process would represent direct creation of ECU by the EEC institutions. For example, if the Bank of England were to sell official ECU for dollars in the foreign exchange markets, it would be probable that the private sector's holdings of ECU

would increase, and this would increase the European money supply (assuming that ECU bank deposits were to be included in the definition of EEC "money").

THE OFFICIAL ECU AND MONETARY UNION

The above discussion on the official ECU has some very important implications which may be crucial if the EEC is ever to move towards full monetary union. If the official ECU were allowed to leak into the private sector, European "money" could potentially be created by the EMCF — which is precisely why the Germans in particular have been so keen to avoid any leakage of official ECU into private sector hands. In order to understand the full implications, we need to look further at the working of the ECU as it currently exists, and contrast this with the way the system would work if the official ECU were to be created by the EMCF as a new form of high powered money.

If the official ECU were allowed to leak into the private sector, European "money" could potentially be created by the EMCF — which is precisely why the Germans in particular have been so keen to avoid any leakage of official ECU into private sector hands.

The Present System: Under existing arrangements, there is, in effect, a fixed exchange rate between the ECU and the particular basket of European currencies which is defined to comprise 1 ECU. The private sector can hold as many ECUs as desired simply by presenting the required basket of currencies at a bank and asking for ECUs in exchange. In essence, the system is entirely demand-driven; the supply of ECUs is totally elastic at the fixed exchange rate which defines the basket. As in any other fixed rate system, the supply of the currency in question cannot be controlled if its price is fixed.[2] However, since the ECU can only exist if ultimately backed by the national currencies of the EEC, its elastic supply does not mean that the supply of money is outside the control of the central banks of the EEC. Because the process of ECU creation in the private sector needs to be "fuelled" by national currencies, it is in effect controlled by the "average" monetary policies of the central banks concerned.[3] No individual central bank can buck this by creating too much of its own currency, since this would lead to downward pressure on its exchange rate against the ECU and other currencies. The official ECU has no role whatever in this private sector process, since it is merely an accounting mechanism, and there is no leakage between the official and private ECUs.

These conclusions would be changed if the role of the official ECU were altered. It is possible to imagine several ways in which this could be done, and in particular there are three important distinct possibilities which would have differing impacts on the conduct of European monetary policy. Two of these are interim stages, and the third represents a way of operating full EMU.

It is possible to imagine several ways in which the role of the official ECU could be altered to promote monetary union. There are three important distinct possibilities which would have differing impacts on the conduct of European monetary policy. Two of these are interim stages, and the third represents a way of operating full EMU.

[2]Note that the ECU rate is fixed only against the **particular basket** of currencies which is defined to be equal to 1 ECU. The ECU rate is **not** fixed against any individual currency, either inside or outside the basket.

[3]This conclusion is not affected by the fact that ECU can be created by the operation of the bank credit multiplier in the Euro-markets. The whole process still needs to be ultimately fuelled by national currency creation, in much the same way as the creation of dollars in the Euro-markets is ultimately fuelled by the Federal Reserve.

Interim Stages: The first interim stage (which we shall call Interim Stage I), and the one which represents the smallest advance on the present system, would work as follows. Official ECU would continue to be created by swapping gold and dollars for ECU deposits at the EMCF, but these swaps would be made **permanent**, and the national central banks would be permitted to use the ECU so acquired freely for the purposes of f/x intervention. The impact of this change would be **relatively** limited, since the central banks concerned would otherwise be able to conduct exactly the same type of intervention, using their original dollar reserves instead of ECU.[4] However, the impact would be to leave ECU in private bank deposits instead of dollars after the f/x intervention had taken place, so the private use of the ECU would probably be boosted. This could create problems for the Germans, since the ECU which would reach private sector hands would of course contain a large DM weighting (roughly 35%). Unless the Germans were to attempt to offset this by tightening the supply of DM domestically, this would **increase** the effective supply of DM and would represent a potential easing in German monetary policy which would be outside the Bundesbank's control. (So far, the Germans have shown little enthusiasm for allowing this to happen.)

*Under Interim Stage I, the official ECU would become fungible with private ECUs, and would be created by **permanent** swaps of gold and $ reserves with the EMCF. This would be a first step in making monetary policy more "Communitaire".*

A further step forward (Interim Stage II)[5] would involve central banks creating ECU by swapping their **domestic** currencies, rather than their foreign exchange reserves, with the EMCF. Clearly, this process would have potentially greater effects than Interim Stage I, since it would not be limited by a shortage of gold or dollar reserves. All countries would subscribe their own currencies to the EMCF in exchange for ECU, and these ECU could then be used for f/x intervention purposes. This would have two effects. First, it would potentially **increase** the amount of intervention which weak-currency countries could conduct to hold the ERM parity grid together. Second, it would again result in a potential easing in German monetary policy, in much the same way as in Interim Stage I. (Because the net effect would be to hold the ERM together at the cost of loosening the discipline on weak currencies, the Germans may be implacably opposed to this at present.)

*A more important step would come in Interim Stage II. Central banks would receive ECU by swapping their **domestic** currencies, rather than their f/x reserves, with the EMCF. Clearly, this process would have potentially greater effects than Interim Stage I, since it would not be limited by a shortage of gold or $ reserves.*

Interim Stages I and II have several features in common. First, they would "mobilise" official ECU, instead of maintaining the

[4]Because the swaps of gold/dollars for ECU would be permanent, instead of revolving, the EMCF and the central banks would be taking more of an exchange rate risk than they do under the present system.

[5]This is proposed in a thoughtful article on the ECU by Professor Polly Reynolds Allen. (P. Reynolds Allen, "The ECU: Birth of a New Currency", Group of Thirty, New York, 1986.)

[6]In the final analysis, however, the Bundesbank would remain mostly in control, since it could choose to sterilise (i.e. offset) the disguised DM creation which would accompany ECU creation. If it did this, it would force the DM to appreciate in the f/x markets and eventually this would probably cause a tightening in monetary policy elsewhere in the EEC. Provided that the Bundesbank maintains the freedom to sterilise money creation in this way, any erosion of its monetary independence would be fairly limited.

rigid distinction between private and official ECU which exists at present. Second, they would continue to allow the creation of ECU to be basically determined by the average of the monetary policies of all the European central banks, though the grip of the Bundesbank would probably be weakened a little. [6] Third, the **definition** of the ECU as a basket currency would be unchanged, so there would be no new complications involved in the private use of the ECU.

The ECU could be developed further into the bedrock of full monetary union. The European Central Bank would be empowered to create ECU directly; these ECU could become the ultimate high powered money of the system. The national central banks would be permitted to issue local currency only against their holdings of ECU, which would be made available to them by the ECB in amounts consistent with the objectives of European monetary policy.

Full EMU: However, Interim Stages I and II would fall far short of full EMU: each nation would retain its own currency, and could ultimately decide to ease or tighten monetary policy, providing that it accepted the exchange rate consequences. Under a complete monetary union, this option would need to be eliminated and currencies would need to be irrevocably tied together. Even at this point, it would be possible to allow monetary policy to be conducted by the national central banks, but all of them would need to give up domestic policy objectives and aim interest rate policy solely at stabilising the exchange rates. The problem with this would be that such a system would lack a central counter-inflationary anchor. In the final analysis, all of the currencies could be stable against each other, but the inflation rate in the Community could be too high. Furthermore, the residual existence of "independent" central banks and of separate currency denominations in each member state would invite the f/x markets to speculate against the parity grid, and this could eventually prove fatal for the monetary union. **Given these risks, it would seem preferable to create irrevocably a single currency, and this in turn would probably involve the establishment of a single monetary authority in Europe.**

It would also seem natural at this stage to develop the ECU into the bed-rock of the full union. This could in fact be done fairly simply. The European Central Bank (ECB) would be empowered to create ECU directly (in the same way as national central banks now create high-powered money), instead of relying on a system of swapping ECU for dollars or domestic currencies. The resulting ECU could then become the ultimate high-powered money of the system, and the network of national central banks would only be permitted to issue local currency against their holdings of ECU. ECU would be made available to them by the ECB in amounts consistent with the objectives of European monetary policy, which would now be set centrally. The role of the national central banks would be of little importance and national currencies would cease to exist, except perhaps in the residual sense that Scottish banknotes exist today.[7]

The residual role of the national central banks would be unimportant, and national currencies would cease to exist, except in the sense that Scottish banknotes exist today.

One more point is worth making about this mechanism for full EMU. Under it, the ECU would no longer be a basket currency, but would be an asset in its own right, created as a liability of the ECB. Its value against the dollar and other world currencies

[7] Scottish banks can issue their own banknotes, but these must be backed by Bank of England notes on a one-for-one basis. The Bank of England therefore retains full control over the British note issue; the ECB would similarly retain full control over the European note issue under the above mechanism.

would be determined by the monetary policy, including f/x policy, of the ECB. No longer would monetary policy be an average of that set by national central banks: it would be set by a single European institution. That institution would have the sole power to intervene in f/x markets to influence exchange rates between the ECU and non-EEC currencies such as the dollar and yen; national "central" banks would lose that right. (N.B. In the US system, only the New York Fed. intervenes in the f/x market.)

The ECU would be an asset in its own right, not a basket currency. No longer would monetary policy be an average of that set by national central banks: it would be set by a single European institution. That institution would have the sole power to intervene in f/x markets to influence exchange rates between the ECU and non-EEC currencies such as the dollar and yen; national "central" banks would lose that right.

Stylised representations of the present system, Interim Stages I and II, and full EMU appear in the diagrams on the following pages.

A EUROPEAN GOLD STANDARD?

The system for full EMU described above would have some similarities to that which operated under the Gold Standard from 1876 until 1913. During those years, national central banks treated gold as the ultimate source of high powered money, and this was therefore the basic source of credit creation. Furthermore, there was complete monetary union between the major countries, with exchange rates absolutely fixed in terms of gold, and therefore (by implication) fixed against each other. As we have noted, it is possible to envisage a system of European monetary union operating in an exactly analogous fashion, with the ECU substituting for the central role of gold. But such a system would in fact be less haphazard than the Gold Standard, since it would rely on the European monetary authorities to generate a supply of the ultimate high powered money, instead of relying on the accidents of gold discoveries.

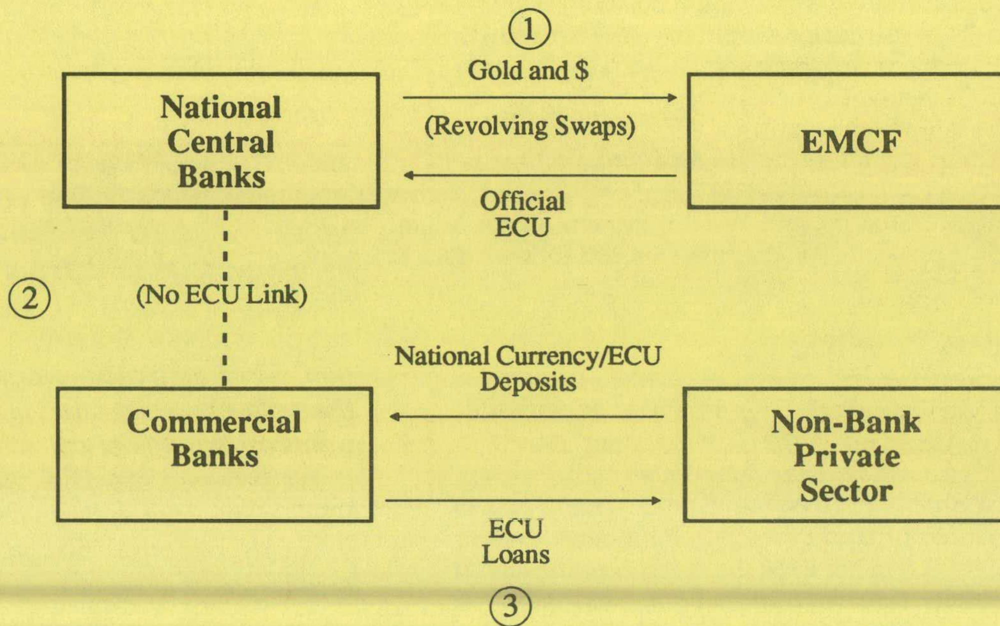
Such a system would be similar in some respects to the Gold Standard, except that the ECU would substitute for the central role of gold. But such a system would in fact be less haphazard than the Gold Standard, since it would rely on the European monetary authorities to generate a supply of the ultimate high powered money, instead of relying on the accidents of gold discoveries.

There are three other aspects of this "Gold Standard" form of European monetary union worth noting. First, the "central banks" of each nation state could continue to exist, as could national "currencies". But these central banks would have no monetary autonomy, since they would always be forced to change monetary policy as and when required to hold the fixed exchange rate between their domestic currencies and the ECU. As we have seen, this would in effect make all the national currencies in the system interchangeable (as are Scottish and English pound notes), so national currencies denominations would have no importance, except possibly to keep national electorates happy. A second fact worth noting is that the Gold Standard operated from 1876 to 1913 without being accompanied by any form of political union between the participating states. This shows that it is possible for independent nation states to pool their **monetary** sovereignty without pooling all forms of **political** sovereignty — something which Mrs. Thatcher seems to believe is impossible. The third feature worth noting concerns the behaviour of capital flows between countries under the Gold Standard. In the latter part of the nineteenth century, capital was allowed to move freely between countries, but exchange rates were permanently fixed against each other. Since capital flows were free to seek out the areas of the world offering investments with the highest rates of return, and since differences in rates of return tended to persist for prolonged periods, it was possible (indeed necessary) for current ac-

The ECU — Four Steps to Monetary Union

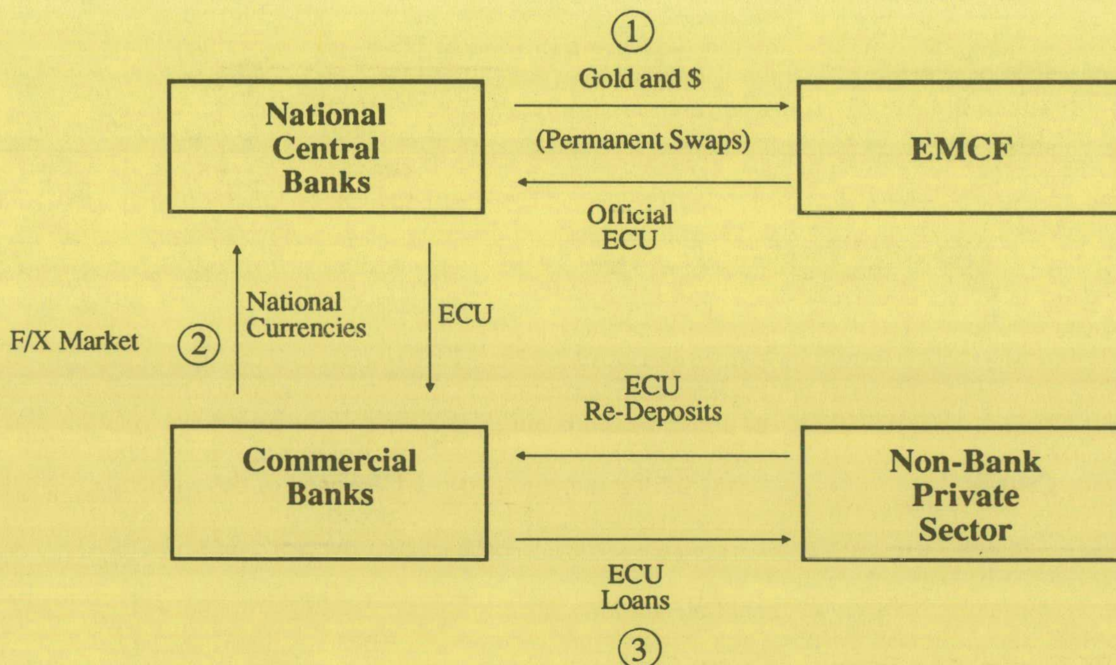
Goldman Sachs

1. THE PRESENT SYSTEM



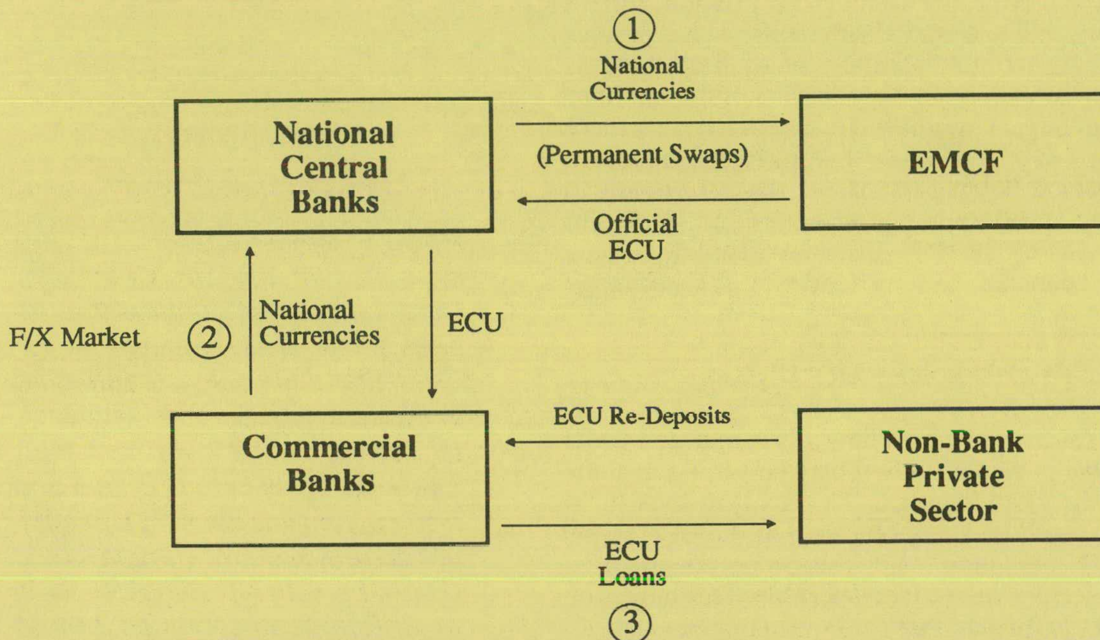
1. Creation of official ECU in exchange for gold and $ reserves in revolving swaps.
2. Official ECU only an accounting mechanism. No ECU link with commercial banks.
3. Private banks "create" ECU by exchanging them for national currencies.

2. INTERIM STAGE I



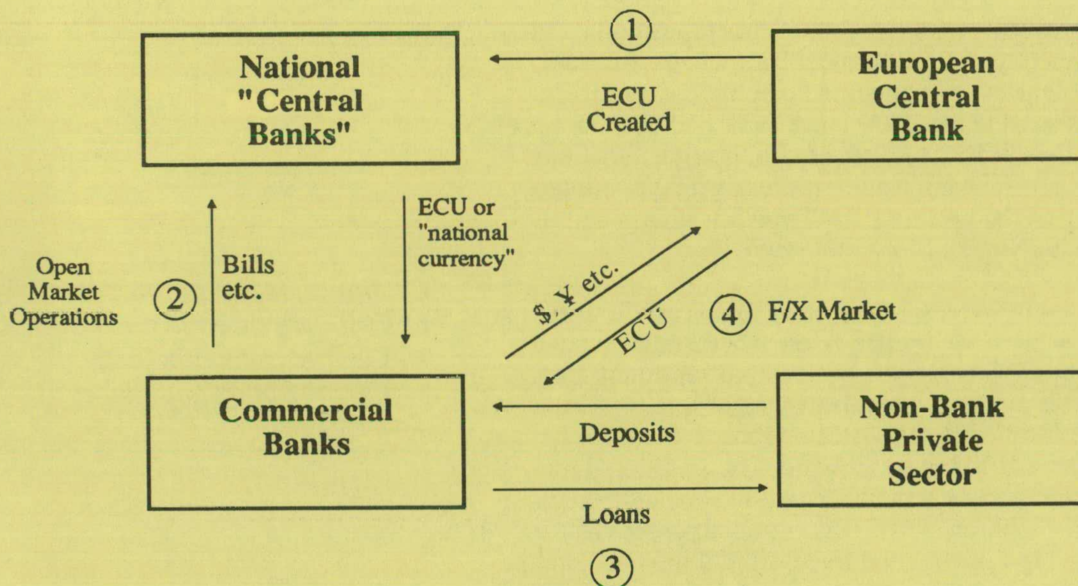
1. Creation of official ECU in exchange for gold and $ reserves in permanent swaps.
2. Central banks permitted to use official ECU to support currencies in f/x markets.
3. Commercial banks use ECU to make loans. This creates ECU re-deposits from non-bank private sector.

3. INTERIM STAGE II



1. Creation of official ECU **in exchange for national currencies**, not gold and $ reserves.
2. and 3. as in Interim Stage I.

4. FULL MONETARY UNION



1. High powered ECU created by European Central Bank.
2. National "central banks" conduct conventional open market operations for ECU or "national currency" which are wholly interchangeable at fixed rates.
3. Conventional banking operations in ECU or "national currencies".
4. European Central Bank has sole responsibility for f/x operations to influence ECU exchange rates with outside currencies ($, ¥, etc.)

count discrepancies also to persist for long periods as the offset to capital flows. By and large, persistent and substantial current account deficits were able to co-exist with stable exchange rates **without** leading (in general) to the imposition of direct controls over capital or trade flows. Recent close readers of the speeches of the UK Chancellor Nigel Lawson will realise that he sees these characteristics of the Gold Standard being resurrected in modern day Europe, with capital flowing out of low-return Germany to higher-return Britain and France, and this causing a persistent current account surplus for the Germans, with offsetting deficits in other European countries, **but no tendency for exchange rates to adjust.**

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THE DESIRABILITY OF MONETARY UNION

The last few pages have sketched out how a system of full EMU could work, and have explained how it may be similar in some respects to that of the Gold Standard. This analysis took it for granted that EMU would be a key objective of the EEC in the context of its "1992 revolution", but it made no comment on whether such an objective was in fact **desirable**. This hinges on several questions. In particular, three are worth mentioning:

(i) Would European monetary policy be more or less credible under EMU than it is now?

(ii) Is the EEC in fact an "optimal currency area"?

(iii) Is there a political case for EMU which would outweigh any perceived economic disadvantages?

Central Bank Credibility: On the first of these questions, our paper in July (referred to earlier) argued that the case for EMU was by no means clear-cut. It concluded that the costs of disinflation in countries outside the ERM since 1979 had been rather less than those inside the ERM. Furthermore, it argued that any shift to a European central bank would risk reducing the counter-inflation credibility of the present ERM, which is dominated by the Bundesbank. These conclusions still stand.

On the question of the desirability of EMU, we need to consider . . . .
— Central bank credibility
— Optimal currency theory
— Politics.

An Optimal Currency Area: Many economists would argue that the desirability of EMU depends on whether the twelve member states of the EEC constitute an "optimal" currency area. If so, there would be a case for binding together this particular group of currencies while allowing fluctuations to continue between the EEC bloc and the outside world. The traditional theory of optimal currency areas, which attempts to shed light on the question of which countries form such optimal groupings, is based on the following fundamental trade-off. On the one hand, a single currency reduces the transactions costs of doing business across the national borders of geographical areas such as the EEC, and reduces the uncertainty which f/x fluctuations bring to international trade. Since this promotes international trade and competition, it helps the law of comparative advantage to work, and would probably further the objectives of the 1992 programme. Obviously, all this constitutes a case for large currency

areas and would be the key **advantage** of EMU. On the other hand, there is an offsetting **disadvantage**. Exchange rate changes can be a useful way of eliminating the impact of country-specific economic shocks which frequently hit economic systems and it may be costly to suppress such exchange rate adjustments in a large currency area. For example, an oil discovery in one country of the EEC should lead to an appreciation in the **real** exchange rate of that country. This can be accomplished in one of two ways — by allowing the **nominal** exchange rate to rise, or by forcing prices and wages in the country concerned to adjust upwards while holding the nominal exchange rate constant. It is easy to see that the former option may be a lot less disruptive to the real economy than the latter.

The key advantage of EMU is that the costs and uncertainties associated with doing cross-border business in the EEC would be greatly reduced by the introduction of a single currency. The disadvantage would be that exchange rate adjustments could no longer be used to iron out economic shocks.

Optimal currency theory suggests that currency adjustments are particularly valuable in the following circumstances:

(i) where factors of production (labour and capital) are relatively immobile between countries, so that economic shocks cannot be ironed out by factor migration;

(ii) where economies are relatively closed and non-integrated, and where the share of tradeables in total output is low (so that changes in nominal exchange rates have a relatively good chance of being translated into **real** exchange rate changes, rather than being eroded by consequential changes in domestic inflation); and

(iii) where most economies in the union are characterised by a low degree of product diversification, so that exchange rate changes are needed to iron out commodity specific shocks (such as oil price changes).

Optimal currency theory suggests that currency adjustments are particularly valuable . . . .
— when labour and capital are immobile.
— when economies are not integrated.
— when product diversification is high.

In deciding whether the EEC is an optimal currency area, the importance of these factors needs to be taken into account. If there are serious impediments to the mobility of labour, capital and goods, so that economic shocks cannot be ironed out by such mobility, it can be important to retain the possibility of making exchange rate changes as a "shock absorber". (For more details, see N. Thygesen, "Is the EEC an Optimal Currency Area?", in R.M. Levich and A. Sommariva, "The ECU Market", Lexington Books, 1987.)

Recent Developments: The case in favour of treating the EEC as an optimum currency area rests on the belief that the existence of differing national currencies, and of volatility in f/x markets, greatly reduces trade flows between the countries concerned; that this causes associated welfare losses; and that these losses outweigh the benefits of using exchange rate changes to iron out shocks. **Recent changes in the international environment have cut both ways in this debate.** The development of increasingly sophisticated financial instruments for hedging currency risk has presumably reduced the uncertainties of doing international business in volatile f/x markets, so the costs of having more than one currency may have diminished. This argues against EMU. On the

other hand, certain aspects of the 1992 changes are likely to favour EMU. As the EEC approaches 1992, factors of production (especially capital) are likely to become more mobile between EEC members, and economies are likely to become more integrated. We have just noted that these changes tend to reduce the need for, and ability of, exchange rate changes to iron out economic shocks, so they increase the case in favour of the EEC being treated as an optimal currency area.

It is difficult to make an overall judgment on this issue (since none of the above arguments has been amenable to precise quantification by economists) but the importance of the opening up of EEC capital markets by 1992, with the complete abolition of capital controls, may prove to be a key factor in the outcome. As we shall see below, complete freedom of capital movements has tended to cause problems in flexible exchange rate systems, since the expectation of currency adjustments can lead to destabilising capital flows. On the other hand, in a credible fixed rate system, capital flows can be more stabilising, as indeed they tended to be in the years of the Gold Standard. As capital becomes more mobile in Europe, this consideration could eventually tip the scales in favour of EMU.

As 1992 approaches, labour and (especially) capital will become more mobile and economies will be more integrated. This reduces the need for, and ability of, exchange rate changes to iron out economic shocks, so they increase the case for a single currency.

Politics: There is no avoiding the fact that many observers see EMU as a stalking horse for political union. It has, for example, been noted that the monetary unification of Germany in the 1860s (based on a silver standard) was a crucial stage in the process which led to political unity. In the case of Germany, monetary unification **followed** economic integration (which had itself been largely created by the spread of the railway network) and **preceded** political unity. Some see the same process now occurring in the EEC, with the 1992 changes promoting economic integration, this creating the need for EMU, and this in turn making political unity inevitable. No wonder Mrs. Thatcher looks worried! (For a further analysis of the German and Italian precedents in creating a monetary union, see M. de Cecco and A. Giovannini, "A European Central Bank? Perspectives on Monetary Unification after Ten Years of the EMS", Cambridge University Press, to be published in 1989.)

Now we see the full significance of the Channel tunnel!

*In 19th Century Germany, monetary unification **followed** economic integration and **preceded** political unity. Some see the same process now occurring in the EEC, with the 1992 changes promoting economic integration, this creating the need for EMU, and this in turn making political unity inevitable. No wonder Mrs. Thatcher looks worried!*

ATTITUDES TOWARDS EMU

If the 1992 programme succeeds in creating a genuine common market in the EEC, and if the 12 national economies become increasingly inter-twined, the subject of monetary union will inevitably keep cropping up. Yet it is far from clear that Europe's political leaders, or even its central bankers, are yet ready to embrace it. Mrs. Thatcher has said that EMU will not occur in her lifetime, while Chancellor Kohl has sounded a little more optimistic, saying that EMU is inevitable before the end of this century. It is obvious that if the Delors Committee is to make proposals which stand any chance of political agreement, it will need to adopt a softly, softly, long-term approach. It will also need to take full account of the apparently polar positions taken by the German and British central banks on the next practical steps which can be taken towards EMU. Nevertheless, with an injection of

political sensitivity, the position for the Delors Committee is perhaps not quite as hopeless as it may seem.

The German View: Bundesbank President Poehl spelled out the Bundesbank's thinking in a very detailed article in the Wall Street Journal on 20 July 1988. He **started** by admitting that the EEC would be well on the way to economic union by 1992, and **concluded** with a very significant sentence: "European Monetary Union is a desirable political and economic goal." But in between these two progressive statements there were 2000 words designed to dampen enthusiasm. His basic position is that it would be disastrous to take premature steps towards EMU, since failure would probably lead to a collapse of the progress already made in the EMS. The recommended route, according to President Poehl, is to build gradually on the ERM, first by encouraging full ERM membership for all EEC currencies, and then by narrowing the permitted fluctuation bands for the Lit. But the Bundesbank is not willing to encourage this process by making the DM more freely available to intervene in currency markets when the parity grid is under threat. The German view is that the Basle and Nyborg agreements of 1987 have already extended "generous lending facilities" to countries such as France and Italy, enabling them to acquire DM when the F.fr and Lit are under pressure, but before these currencies have actually been forced down to their ERM bilateral exchange rate limits. This is as far as the Bundesbank is willing to go: anything further would take too much pressure off weak-currency countries to **tighten** monetary policy when their currencies are under threat, and would force the Germans to **ease** policy too much. This would remove the counter-inflationary bias in the system.

Bundesbank President Poehl believes . . . .
1. It would be disastrous to take premature steps towards EMU.
2. The EEC should build gradually on the successes of the EMS.
*3. Lending facilities from Germany to weak currency countries should **not** be eased further.*
4. The ECU should not be developed as a parallel currency.

Nor is the Bundesbank in favour of encouraging the ECU to develop as a parallel currency. This is essentially because the DM is included in the ECU with a one-third weight, and therefore any spread of the ECU automatically spreads the use of the DM. This can limit the Bundesbank's control over its own currency and domestic monetary policy, especially if the ECU becomes widely used within Germany itself. Furthermore, according to President Poehl, the ECU will only be widely used by the private sector in preference to strong currencies like the DM if it becomes domestic legal tender in member states, and if it is pegged firmly to national currencies. But this amounts to full EMU, so "why the expensive detour via the parallel currency?" Surely, he implies, it would be preferable to wait until all EEC currencies are able to keep pace with the DM in f/x markets, at which point the DM could in effect become the European currency.

If it comes, a European Central Bank should be . . . .
1. Independent.
2. Responsible for "safeguarding the currency".
3. Decentralised.
4. Responsible for f/x policy.

Finally, on the ECB, President Poehl spells out the type of institution needed. In particular, four characteristics would be required:

(i) It should be independent both from political influence and from the institutions of the EEC.

(ii) It should be charged with responsibility of "safeguarding the currency" (i.e. ensuring stable domestic prices).

(iii) It should have a decentralised constitution, similar to that of the US Federal Reserve System (or the Bundesbank).

(iv) It should administer f/x intervention policy for EEC member states, but should **not** aim for absolute currency stability between EEC currencies and outside currencies such as the dollar and yen. Internal, not external, currency stability should be the objective.

The similarity of these characteristics to those of the Bundesbank itself is clearly not wholly coincidental.

In effect, President Poehl seems to be saying that monetary union might be acceptable — as long as the DM becomes the European currency, and the Bundesbank becomes the European Central Bank!

Overall, President Poehl is saying that EMU might be an acceptable long-term goal, but that it is premature to take decisive new steps towards it. Instead, the EEC should build gradually on the successes of the ERM, widening it to include the UK, Spain, Portugal and Greece when possible, and not diluting its counter-inflationary bias, or the domination of the Bundesbank over the system. In effect, President Poehl seems to be saying that monetary union might be acceptable — as long as the DM becomes the European currency, and the Bundesbank becomes the European Central Bank!

The British View: Mrs. Thatcher is known to be a die-hard opponent of the EMS and EMU, but the view of the Bank of England (and the Treasury) has generally been more favourably disposed. However, a recent speech by Bank of England Governor Leigh-Pemberton[8] was decidedly Thatcherite in tone, and this must now be taken as the present position of the British government. The Governor's argument runs as follows. First, those who argue that the present ERM will break up when capital flows are liberalised — unless full EMU is achieved first — will be proved wrong; the successes of the ERM will be maintained **with** full capital liberalistion and **without** full EMU. This reduces the need for EMU. Second, the 1992 programme to create a single market can succeed without creating a single currency. Indeed, **flexible** currencies are needed in a Community where labour and product markets will remain highly segregated even after 1992. Third, the UK faces inflationary difficulties at present which require the authorities to use interest rates to disinflate the economy, even if this is not consistent with exchange rate stability. Hence, ERM membership for sterling is not currently on the agenda. Fourth, the development of the ECU can proceed without there being any commitment to full EMU, especially in the area of f/x intervention by EEC central banks.

Britain believes . . . .
1. The EMS will not break up when capital controls are removed.
2. The single market programme does not need a single currency.
3. The UK cannot join the ERM now.
4. The private use of the ECU can and should be developed.

The Bank of England attitude to the development of the ECU is spelled out in more detail in a speech given by an Executive Director of the Bank, Mr. Anthony Loehnis, on 15 June 1988.[9] He argues that the private use of the ECU should be encouraged by eliminating legal obstacles to its use, and by giving the currency "a benign push" in official government and EEC transactions. But

[8]At the Forex Club, Luxembourg, 15 November 1988.

[9]Reproduced in the Bank of England Quarterly Bulletin, August 1988, pp350–355.

he is concerned that this process should not be taken too far since, if the use of the ECU became too widespread, this could cause problems with EEC monetary policy (who would control the creation of ECU?). He therefore concludes that some fairly limited further development of the ECU might be advantageous, but that in the end it cannot provide an easy path towards EMU; in the final analysis, EEC economies will need to converge further before any form of monetary integration will be feasible, and the ECU cannot be a substitute for this economic convergence.

ASSESSMENT OF GERMAN AND BRITISH VIEWS

The British and Germans agree (i) that full EMU cannot be forced on an unready Community of sovereign nations, and (ii) that further convergence will be needed before EMU can be contemplated. They disagree, however, on the way forward. The Germans favour extending the EMS. The British oppose this, and see instead a (limited) role for the ECU in creating further convergence.

Both the German and British views outlined above are built on the supposition that full monetary union cannot be forced on an unready Community of sovereign nations. They also agree that further economic convergence between EEC members will be necessary before EMU can be contemplated. But they disagree on the next steps which can best promote such convergence. The Germans believe that the best way forward would be to widen the ERM while maintaining Bundesbank dominance over the monetary policy of the system's members. All would need to converge on the German Standard. The British, on the other hand, are unwilling to use the ERM as an instrument to promote convergence (in the way the French and Italians have done), preferring to wait until greater economic convergence has been achieved before allowing sterling to join the ERM. In the meantime, they see a limited role for the ECU in helping to create further convergence.

Somehow, the Delors Committee will need to find a path which is acceptable to the UK, Germany and other member states, many of whom are keen to proceed quickly to full EMU. This might look hopeless, but four guiding principles may be helpful . . . .

Somehow, the Delors Committee will need to find a way forward which is acceptable not only to Britain and Germany, but also to the other member states as well, many of whom (such as the Netherlands) are keen to proceed to full EMU with all possible speed. This might look a hopeless task, but some guiding principles may be helpful.

— First, it would be foolish to aim for a quick timetable taking the Community to full EMU, since this would not be acceptable to enough member states. It simply would not fly, and would threaten the remarkable harmony in the Community which currently exists on other aspects of the 1992 programme. But a gradual programme specifying clear steps towards EMU might just prove acceptable. (Everyone seems to be in favour of what Mrs. Thatcher calls "practical steps".)

— Second, there are dangers in adopting the German approach of relying solely on the ERM as the instrument of producing greater convergence between the 12 economies. Britain is unlikely to join the ERM for some years. Furthermore, despite the views of the Governor of the Bank of England, it may prove exceedingly difficult to combine freedom of capital movements in the EEC with the semi-fixed exchange rate mechanism now in place. Considerable economic evidence suggests that capital controls have been crucial to the successful working of

the EMS so far; and that destabilising capital flows are much less likely in wholly fixed exchange rate systems. It therefore would be wise to make the period in which free capital flows co-incide with semi-fixed exchange rates fairly short, rather than viewing it as a final destination.

— Third, the ECU may be able to play a more useful role in promoting monetary union than the Germans, or even the British, believe. The ECU has already shown itself to have considerable attractions for the private sector, especially in the bond markets. Although it is unlikely to win much of a role in transactions within any member state at present, it can play an increasingly important role as an international currency. This role should be encouraged, since the existence of such an international currency is a key step towards monetary union. It will reduce the costs and uncertainties of doing business across national borders, and therefore "grease the wheels" of the single market programme. Furthermore, because it is a basket currency made up of a mixture of national currencies, its spread will automatically force central banks to co-operate more closely in the setting of monetary policy. The more important the ECU becomes, the nearer European monetary policy will be to the average of the member states. Progress in this direction will make the final step to full EMU much easier to take.[10]

— Fourth, any plan designed to progress the Community towards full EMU would need to be carefully phased so that progress on the ECU front would proceed in step with progress on the ERM front. Both would move at a pace dictated by the degree of economic convergence being achieved by the member states. But the direction of causation here should not all be one way — the development of the ECU and the ERM can in themselves speed the process of economic convergence. The ECU can do this by forcing genuine co-operation between central banks in the "averaging" process just described. The ERM can do it by keeping the counter-inflationary discipline of the Bundesbank central to the process of integration. By allowing the ECU to promote monetary policy "averaging", and by allowing the Bundesbank to retain a special role in the ERM, a happy medium might be achieved to keep all the protagonists satisfied.

Four guiding principles . . . .
1. No quick timetable. Lots of "practical steps".
2. No sole reliance on the ERM to produce greater convergence.
3. The ECU can play a key role. Its spread will automatically force co-operation.
4. Careful phasing is necessary so that progress is made simultaneously on ECU and ERM fronts.

A PROGRAMME FOR MONETARY UNION

These four principles have been taken into account to produce

[10]One potential problem would be that no central bank would act as a lender of the last resort in the ECU market during any interim stage. Some have argued that this constitutes a great danger to the stability of the ECU market. But this is too pessimistic, since each of the main institutions which issue ECU (the European commercial banks) would continue to be regulated by their respective central banks, which would thus indirectly act as lenders of last resort to the institutions which issue ECU.

the suggested Programme for Monetary Union outlined on the next page. It also integrates the different stages for the development of the ECU discussed earlier. It suggests three separate phases, each of (ideally) 2–3 years in length, which could conceivably take the EEC from its present condition to full EMU before the end of the century.

Phase I: This would require the EEC to make **no** constitutional or institutional changes immediately. On the ECU front, the official ECU would be kept entirely separate from the private ECU, but the member states and the EEC institutions themselves would take further steps to encourage the private sector use of the ECU. More EEC transactions would be denominated in ECU; more government borrowing would be conducted in ECU; and (importantly) central banks would be allowed to use **private** ECU as ammunition in their f/x intervention (but would not be allowed to use official ECU for this purpose). All this would increase the private sector's need for ECU holdings, and could be accomplished if necessary without the active participation of the Germans. Meanwhile, the ERM would be gradually strengthened in much the same way as it has been over the past few years. The objective would be decrease the frequency and size of realignments and to develop closer co-ordination in the monetary and f/x policies of member states. (This would anyway be necessary if the private sector's use of the ECU was growing strongly.) More intra-marginal lending and f/x intervention may be needed to hold the parity grid together, especially at the end of Phase I, by when capital controls would have been eliminated in France and Italy. This gradual development of the ERM could, if necessary, be accomplished without the participation of the British. Hence, some progress could be made on both ECU and ERM fronts without the full agreement of all the member states. This would promote economic convergence in preparation for the second phase.

Phase I . . . .
1. *No institutional changes.*
2. *Official ECU non-fungible.*
3. *Encourage private ECU.*
4. *Decrease frequency of ERM realignments.*

Phase II: This phase would need more active agreement and co-operation from all members. It could only be started when economic convergence was sufficient to make both the British and Germans unafraid of further integration; if necessary Phase I would need to be lengthened until this were achieved. On the ECU front, the Community would embark on what we earlier labelled Interim Stage I. Under this, the official ECU would become fungible with private ECU, and would be created by the EMCF via permanent swaps of ECU in exchange for part of the gold and foreign currency reserves of member states. This would be the first tentative step on the road to ECU creation by a European monetary authority. Simultaneously, the ERM would need to be further strengthened. Only minimal changes would now be permitted in the parity grid, and only in extreme conditions. To emphasise the commitment of the monetary authorities to fixed exchange rates, national monetary targets would be set by the central banks **in concert** and announced jointly. This would be the optimal time for sterling to join the system. If the UK were still reluctant, the other EEC members would need to consider proceeding without Britain, even though this would probably involve expelling sterling from the ECU.

Phase II . . . .
1. *Official ECU fungible and . . .*
2. *. . . still created by f/x swaps.*
3. *Joint monetary targets.*
4. *UK to join ERM.*

Phase III: Again, this phase would require further active cooperation from all members, and could only be initiated when economic convergence permitted it. The main change in this phase would be that ECUs would now be created by the EMCF in exchange for **national currencies** (in agreed amounts), instead of in exchange for gold and dollar reserves. This would be a further step on the road to full ECU creation by the EMCF. In addition, the private sector's holdings of ECU would be included in national monetary definitions, and identical banks' reserve requirements would be set for both ECU and national currencies. The ECU would become legal tender in the member states. Turning to the ERM, internal exchange rates would now be fixed, so that the ECU would be freely interchangeable at unchanged parities with domestic currencies. The EMCF would be given an increasing role in conducting f/x transactions to influence the exchange rate of the ECU against outside currencies. This could be done by allowing the EMCF to utilise the f/x reserves and national currencies it had acquired under Phases II and III. Clearly, with the internal exchange rates fixed and the EMCF permitted to intervene in the f/x markets, the final step from there to full EMU would be a relatively small one.

Phase III . . . .

1. ECU created by swaps involving national currencies, not f/x reserves.

2. EMCF to conduct f/x intervention.

3. ECU to become legal tender.

4. Internal exchange rates fixed.

Phase IV: This would occur when the member states were ready to make permanent the monetary integration which would already have occurred (de facto) under Phases I to III. The EMCF would now be transformed into a European Central Bank. This institution would be independent from political control, and independent from other EEC institutions. It would have the sole right to create high-powered ECU, which would be acquired by the national central banks and used as high powered money in their own banking systems. Monetary policy would then be ultimately determined by the ECB, leaving only residual implementation powers for the national central banks. Although national "currencies" could still exist, this would be a fiction, since they could only be created in exchange for ECU at fixed rates. Meanwhile, on the exchange rate front, the situation would be simple. Bilateral exchange markets between member "currencies" would cease to exist, since all currencies would be freely interchangeable against each other, and against the ECU, at fixed rates. The ECB would now have the sole power to operate in the f/x markets for ECU against outside currencies, with the national central banks losing this right. European monetary union would be complete, and the fiction of banknotes denominated in the old domestic currencies would be allowed to wither over time.

Phase IV . . . .

1. European Central Bank created.

2. ECU a liability of the ECB.

3. Monetary policy formed centrally.

4. Domestic currencies to wither away.

CONCLUSION

Readers will have noticed from the last few paragraphs that many large hurdles need to be cleared before the European Community can seriously contemplate monetary union. However gentle the build-up, and however cautious the plan, there is no disguising the monumental nature of the changes which EMU would inevitably involve. So far, the member states have been intimidated by the size of the hurdles to be cleared, and have fought shy of this whole process. But as the economies become more inextricably linked after 1992, the economic sovereignty which some mem-

bers are so keen to protect could become increasingly trivial. Before too long, most of the crucial areas of economic management — trade policy, regional policy, industrial policy, the regulation of financial markets, take-over and monopoly policy, some aspects of tax policy, labour market policy etc. — will voluntarily have been ceded, in whole or in part, to Community-level determination. And member governments may then find, as have the governments of many small open economies before them, that their supposed monetary sovereignty amounts to one thing only — the freedom to inflate more rapidly than their Community neighbours. In other words, if the 1992 programme works, it may inevitably carry greater monetary integration, and even monetary union, in its wake. The Delors Committee has much responsibility to map out a feasible path.

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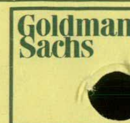
Programme For Monetary Union



	ECU/INSTITUTIONAL	EXCHANGE RATE/EMS
PHASE I 2–3 years	**Develop Use of Private ECU** More EEC transactions in ECU, more government borrowing in ECU, more f/x intervention in ECU, but official ECU still not fungible with private ECU.	**ERM/EMS Developed** Frequency of realignments decreased and capital controls removed. Development of co-ordinated monetary policy and f/x policies between central banks. More intra-marginal lending if needed to hold parity grid together.
PHASE II 2–3 years	**Interim Stage I** Official ECU becomes fungible with private ECU. Official ECU now created by EMCF through permanent swaps for gold and $.	**ERM/EMS Broadened** Encourage sterling to join ERM and reduce fluctuation bands for Lit. Only minimal changes permitted in parity grid. Monetary targets now set jointly by central banks.
PHASE III 2–3 years	**Interim Stage II** Official ECU now created by swaps for national currencies. ECU included in monetary definitions and made legal tender for domestic transactions. Banks' reserve requirements set for both ECU and national currencies.	**Fixed Rates** ERM rates now fixed. EMCF takes increasing role in conducting f/x transactions to influence ECU exchange rates against outside currencies.
PHASE IV Indefinite	**Full Monetary Union** Creation of European Central Bank. Monetary policy now determined by European Central Bank which has sole power to create high-powered ECU. Residual powers only for national "central" banks. ECU and national "currencies" become interchangeable at fixed rates.	**No Intra-EMS Exchange Rates** Exchange rates inside the ERM become notional only as all ERM currencies become interchangeable. European Central Bank has sole power to operate in f/x markets for ECU against outside currencies such as $ and ¥.

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BANK BRANCH ACCOUNTS DIRECTIVE

SUMMARY
1. REVISED COMMISSION PROPOSAL WITH TWO MINOR AMENDMENTS PRESENTED TO ATTACHES TODAY. PRESIDENCY INTEND TO TAKE THIS THIS TO COREPER NEXT WEEK TO ENABLE FINAL ADOPTION AT 12 DECEMBER ECOFIN (THEY HOPE AS AN 'A' POINT).

DETAIL
2. FOLLOWING A SECOND READING BY THE EP IN OCTOBER, A REVISED COMMISSION PROPOSAL WITH TWO MINOR AMENDMENTS (DOC 9772/88) WAS SUBMITTED TO ATTACHES TODAY WITHOUT WARNING. THERE WAS THEREFORE NO DISCUSSION.

3. THE PRESIDENCY INTEND AT MOST MINIMAL DISCUSSION AT COREPER NEXT WEEK, GIVEN THE INSIGNIFICANCE OF THE TWO AMENDMENTS, AND ARE AIMING FOR FINAL ADOPTION AT THE 12 DECEMBER ECOFIN COUNCIL AS AN 'A' POINT.

4. WE INDICATED THAT WE HAD NOT CHANGED OUR POSITION ON THIS PROPOSAL. WE HAD ABSTAINED AT THE JUNE INTERNAL MARKET COUNCIL AND WOULD WISH TO ENTER A UNILATERAL STATEMENT AGAIN IN THE MINUTES: WE HAD NOT YET DECIDED WHETHER WE ALSO WISHED TO MAKE AN ORAL STATEMENT AT ECOFIN, BUT WOULD INFORM THE COUNCIL SECRETARIAT IN DUE COURSE.

COMMENT
5. GRATEFUL FOR INSTRUCTIONS FOR NEXT WEEK'S COREPER. IF WE DECIDE TO RESTRICT OUR STATEMENT TO A WRITTEN ONE, THIS CAN SIMPLY BE FORWARDED IN ADVANCE OF ECOFIN TO THE COUNCIL SECRETARIAT.

6. THE DUTCH DELEGATION WAS NOT PRESENT BUT HAVING DISCUSSED TACTICS WITH THEM THIS AFTERNOON, THEY ARE LIKELY TO DO THE SAME. AS EXPECTED, GERMANY DOES NOT SEEM INCLINED TO JOIN IN FORMING A BLOCKING MINORITY.

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ADDITIONAL 1

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CONFIDENTIAL

FROM: N J ILETT
DATE: 22 DECEMBER 1988

PRINCIPAL PRIVATE SECRETARY

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Neilson
Mrs Ryding
Mr Sharples
Mrs Chaplin

Mr Corlett - IR
Mr O'Connor - IR
PS/IR

Ch/ an interim note - full note promised for early Jan

MPW

Thanks.

PS. I would want to include abolition of COBO in the Budget Speech.

ABOLITION OF COBO: TAX CONSEQUENCES FOR BONDS

This is to report where matters now stand.

2. The abolition of COBO will allow foreign sovereigns and parastatals to make deep discount issues in the UK for the first time. Unless the tax regime is changed, UK investors would have a fiscal incentive to buy these instruments. This could distort the market, and would reduce the UK's tax take to the benefit of the foreign issuer. This is the loophole which has to be blocked in the Budget when the abolition of COBO is announced.

3. The Revenue also propose tidying up the treatment of other types of deep discount bonds. The Revenue sent Treasury officials a draft submission earlier this month, setting out the options for the taxation of bonds in the new environment. MG and FIM have now discussed this with the Bank.

4. The basic issue is whether all low coupon and deep discount issues should have the same tax treatment, whether denominated in sterling or in foreign currency, and whether issued by the UK government (gilts), or foreign Governments, or by UK or foreign corporates. Treasury and Bank officials believe that this should be the objective as far as technically possible. This will be the main point for Ministerial decision. Decisions will be required

also on a number of transitional and technical points. These include:

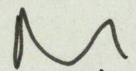
- Whether for practical, moral or legal reasons the tax treatment of existing gilts should be "grandfathered", either in the hands of their present holders only or until their maturity; and what the transitional arrangements for other extant deep discount bonds should be.

- Whether earnings from deep discount foreign currency bonds should be taxed entirely as income, because of the complexity of assessing a capital gains component where exchange rate movements are involved (there is also a read across here to the general question of tax treatment of foreign exchange gains and losses).

- How to shape the new regime so as to maintain the ability to issue new tranchettes of existing low coupon stock and of stock which was originally issued at par or at a "shallow" discount, but for which subsequent interest rate movements would cause the tranchette to be caught by the deep discount rules.

- To what extent it is technically possible for variable deep discount bonds (where the discount is subject to variation during the life of the bond) to be treated in the same way as more straightforward deep discount issues.

5. The Treasury and Bank's comments are on their way to the Revenue, and we would expect that the revised submission would reach Ministers very early next month. We do not anticipate that Ministers will need to spend much time on this subject.



N J ILETT

REVIEW COMMITTEE ON BANKING SERVICES LAW
80 Watling Street
London EC4M 9BX
01-601 3463

RBJ

~~29~~ 30th December 1988

The Right Honourable Nigel Lawson MP,
Chancellor of the Exchequer,
HM Treasury,
Treasury Chambers,
Parliament Street
London,
SW1P 3AG.

Dear Chancellor,

I write with reference to the supplement to our report contained in the letters addressed to you and the Governor on a confidential basis in regard to the need for changes in the law to cover possible default by a member of one of the clearing systems operated by the banks in the United Kingdom.

Since the Committee agreed its report in final form for submission to you a new Companies Bill has been introduced to the House of Lords on 21st December and published on 22nd December. This Bill contains provisions described in the explanatory and financial memorandum attached to the Bill as being designed "to safeguard the operation of certain financial markets in the event of the insolvency of a person (who is) party to transactions in the market". These provisions reflect (in the words of the DTI's consultative document of 16th December) a "basic approach" intended "to protect the default procedures of certain financial markets and related settlement systems by modifying insolvency law so that certain provisions will not apply in relation to action taken or transactions effected in connection with the operation of the default rules".

It does occur to us that, although the main bodies to be protected under the proposed new provisions are investment exchanges and clearing houses recognised under the Financial Services Act 1986, the general objective of protecting default procedures against challenge under insolvency law may (to a greater or lesser degree) have relevance to the clearing settlement arrangements which operate among banks. (This indeed is in line with our own thinking as reflected in the supplement to our report). We would expect, therefore, that the Treasury and the Bank of England would consider whether the modifications in insolvency law proposed in the Bill might usefully be adapted for application to the banks' clearing systems. For the reasons explained in our earlier letter, we are not ourselves in a position to give any view.

Yours sincerely,

R. B. Jack.

CONFIDENTIAL

REVIEW COMMITTEE ON BANKING SERVICES LAW
80 Watling Street
London EC4M 9BX
01-601 3463

Chairman - Professor R B Jack CBE

30 December 1988

The Right Honourable Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

Dear Chancellor,

PAYMENT SYSTEMS RISK

Although we have not addressed it in our Report, we consider the issue of payment systems risk, and in particular the possible consequences of the failure of a settlement bank to meet its clearing obligations, to fall clearly and unambiguously within our Terms of Reference, one of the provisions of which require us "to examine the law and its practical implications ..... in the availability, reliability, security and ..... effective operation of payment ..... services". We are aware, however, of the sensitivity of the subject, and in consequence accept that consultation with outside interests would be inappropriate, and that any findings and conclusions on the matter will not be suitable for publication. These circumstances place us in a dilemma, in that failure properly to address the issue would render us extremely vulnerable to public and parliamentary criticism if the unthinkable actually happened and a clearing member failed especially in the period immediately after the publication of our Report.

At the suggestion of the Treasury, we have sought guidance from the Bank of England who have assured us that a review of the relevant legal implications at this stage would be premature and counter-productive (quite apart from the risk of causing undue

alarm in the market, if its existence became known). As matters presently stand, the Bank is satisfied that its judgement in granting a settlement account, and its continuing supervision of clearing members' solvency and liquidity (including the recent provisions on large exposures) provide sufficient safeguards in ensuring the integrity of the system. There is, we are assured, in any case virtually no possibility of a sudden overnight failure whilst the present supervisory arrangements are in place. The Bank currently executes all clearing payments on request, even where this creates an (inadvertent) overdraft on the clearing member's account; this amounts for all practical purposes, to an assured payment system, tacitly underwritten by the Bank. Any difficulties, which it is thought would manifest themselves initially as a shortage of liquidity, leading to problems in raising money on the inter-bank market, would be detected sufficiently far ahead to encompass a period longer than the clearing cycle, which in the main does not exceed three days. Given that any impending difficulties would be signalled in advance, the Bank takes the view that there are no existing legal impediments to prevent it from taking the action necessary to ensure the continuing viability of the system, either by arranging the takeover of any beleaguered bank by another institution, or by itself buying in or lending against the assets of the clearing member involved. In the event of a risk of insolvency the Bank might order the closure of the clearer's settlement account and itself take over its clearing function to ensure the orderly run-down of the account.

Our reservations about the legal implications of these contingency plans fall broadly into two areas, where, we suggest, the present law is at best uncertain. First, does insolvency law properly ensure full redress for the Bank and other clearing members against a failed institution, or is there scope for providing a measure of preferential status to clearing debts? Secondly, might the law of set-off be amended so as to apply some force to netting arrangements by exempting the Bank or the institution which had taken over a failed clearer from gross payment obligations to other clearers, and instead to restrict liability to the net obligations which apply in normal clearing business?

If there is scope for clarification or improvement of the law of insolvency and set-off, our contribution would in any case be marginal, since detailed recommendations on such matters fall outside the Committee's Terms of Reference. In all these matters we must defer to the Bank of England's judgement: if the clearing system is extended to include institutions, like building societies, not subject to the Bank's supervision nor (as is possible after 1992) subject to any other UK regulator's supervision, there will be a corresponding increase in risks, but at present the integrity of the system is primarily dependent on institutions having the proper qualifications for membership, and their continued supervision thereafter. These are areas which continue to be matters of common concern for the Treasury and the Bank.

I have written in identical terms to the Governor of the Bank of England.

Yours sincerely,

R. B. Jones