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PART D

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PART D

CHANCELLOR'S PAPERS ON MISCELLANEOUS TREASURY AND CIVIL SERVICE COMMITTEE (TCSC) APPEARANCES AND ENQUIRIES

PO -CH /NL/0253

PART D

DD: 25 years

27/9/95

Begins: 12/6/89

Ends: 26/6/89

FROM: MISS M O'MARA (MG1)
DATE: 12 June 1989
X 4699

CHANCELLOR OF THE EXCHEQUER

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr H P Evans (IF)
Mr Peretz
Mr Gieve
Miss Simpson
Ms Symes
Mr N P Williams (MG1)

Thanks

Please minute

TCSC APPEARANCE ON THE DELORS COMMITTEE REPORT: ECU REWEIGHTING

Mr Wicks has suggested that you may need a line to take on the ecu reweighting, in case it is mentioned at today's hearing.

2. There was, of course, no hint of this in the questions but the attached report in today's 'Financial Times' may well bring it to the fore. The news has clearly, and very irritatingly, leaked from central bank governors meeting in Basle. As you know, the subject is on the agenda for next week's ECOFIN as an 'A' point (Mr Peretz' minute of 9 June) but we have deliberately not revealed that on grounds of market sensitivity. If questioned, we suggest you play a completely straight bat and say:

> "Under Article 2 of the Council Resolution of December 1978 which set up the EMS, the weights of the currencies in the ecu basket have to be re-examined every 5 years. The current 5 year period expires in September."

3. You will recall that the central bank governors recommended the two stage approach which ECOFIN is adopting, of announcing the new weights in advance of implementation in September. The group's recommendations have never been published but the Committee may pick the point up in the light of today's press reports. Should they do so, we suggest you simply say:

"The Council, of course, have this possibility in mind and I would not rule it out."

4. You are perhaps more likely to be asked whether sterling should have a lower (or nil) weight in the ecu in future because of our non-participation in the ERM, as the French have been arguing. On this, we suggest:

"Nonsense.

- The ecu is the Community's unit of account (eg it is used in the Community budget). So it has a wider importance than its role in the ERM.

- In fact, the removal of sterling would do more harm to the ecu than to the UK.

- In any case, the position under Community law is quite clear. Sterling can only be removed from the basket with the UK's agreement. Indeed, all revisions have to be mutually accepted.
  [**IF PRESSED:** If no agreement were reached, the current weighting would remain in force but I am confident we can come to a mutually acceptable solution.]"

5. If asked about any other details (eg the inclusion of the peseta and escudo from September), we suggest you simply decline to comment.

6. There is just one complication to which Mr Peretz has already alerted you. The Committee might ask you whether Parliament will have an opportunity to discuss the proposals for reweighting before Ministers take their final decision. This is likely to prove impossible on grounds of market sensitivity, as we propose to explain to the Scrutiny Committee after the event, unless others (eg the Danes) insist on placing a Parliamentary reserve. In that case we can do likewise. If this point comes up, you might simply say:

> "In such a market sensitive area, it may prove difficult to consult Parliament formally in advance but I shall certainly take due account of any views the Committee like to express to me now".

We have not yet been able to check our files thoroughly but we doubt whether there was any advance consultation of Parliament when the basket was reweighted in September 1984, since decisions were taken over a weekend and implemented the following Monday.

MOM

MISS M O'MARA

Iberian currencies to be included in the Ecu 'basket'

By **Peter Norman and Stephen Fidler** in Basle

EUROPEAN COMMUNITY member states have agreed to bring the Spanish peseta and Portuguese escudo into the European currency unit, making the Ecu a weighted basket of all 12 EC currencies.

Basic agreement on the move, which will involve a reweighting of the Ecu's existing constituent currencies, was reached late last week in a meeting of the EC Monetary Committee and discussed yesterday by European central bank officials who were in Basle for today's annual meeting of the Bank for International Settlements.

Final approval of the Ecu reweighting is expected at a meeting of EC economics and finance ministers next Monday with the new weights taking effect in September.

Changes in the Ecu have long been scheduled, because the currency unit, which was created in 1979 to be the "centre" of the European Monetary System, is subject to revision every five years.

However, this year's change has attracted more than usual interest. At one point, it was rumoured that France was pressing for Britain's exclusion from the Ecu as a penalty for it not joining the EMS exchange rate mechanism. This has not happened.

The inclusion of the two Iberian currencies as a delayed reaction to Spain and Portugal becoming EC members has also involved detailed negotiation about which other currencies should shed weight to make room for them.

The new weights are being kept secret until next week because they are regarded as market sensitive.

Although the Ecu will be worth just as much on the day after the reweighting as the day before, the changes in its constituents will affect those banks which have made a practice of creating Ecus from individual EC currencies to meet the demands of their clients.

Because the new Ecu will have to accommodate two new "soft" currencies, it is expected that Ecu interest rates will rise after the change. Central bank officials believe that financial markets are already discounting an increase of ¼-½ percentage points in Ecu rates from next September.

The early agreement on the reweighting is likely to be applauded by the Bank of England. It has played a pioneering role in issuing Ecu Treasury bills and an announcement of the new weights next week should remove any uncertainty surrounding trading in its three month bills.

The reweighting is based partly on economic criteria such as the role of a particular member state in intra-EC trade, its contribution to the Community budget and the weight of its economy in the EC. That leaves the D-Mark as the main currency in the Ecu. The final decision on the weighting is also subject to horse trading. However, officials say that the latest Ecu revision was agreed smoothly and without acrimony.

WORLD ECONOMIC INDICATORS

FOREIGN EXCHANGE RESERVES (US$m)

	Apr.'89	Mar.'89	Feb '89	Apr.'87
US	20,731	20,298	19,306	11,275
UK	39,097	38,771	40,746	38,364
W. Germany	51,370	50,157	50,660	68,177
Japan	93,471	92,739	91,981	80,366
Belgium	9,154	9,368	7,955	7,797
Netherlands	13,155	14,437	14,366	13,826
Italy	37,233	35,534	34,219	25,476
	Mar.'89	**Feb '89**	**Jan.'89**	**Mar '88**
France	22,572	22,104	22,117	28,052

Source: IMF

FROM: A A DIGHT
DATE: 13 June 1989

py

MISS M O'MARA (MG1)

TCSC APPEARANCE ON THE DELORS COMMITTEE REPORT: ECU REWEIGHTING

The Chancellor has seen and was grateful for your minute of 12 June, in which you kindly provided a line to take on the ecu reweighting, for his appearance before the TCSC yesterday.

Anthony Dight

A A DIGHT

108g/mg1.pa O'MARA(748)

FROM: MISS M O'MARA (MG1)
DATE: 13 June 1989
X 4699

CHANCELLOR OF THE EXCHEQUER

cc: Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen (EC)
Mr Peretz
Mr Riley
Mr Gieve
Ms Symes
Mr N P Williams (MG1)

BANK'S WRITTEN ANSWERS TO TCSC QUESTIONS

I attach a draft Private Secretary reply which Mr Allan might send to the Bank, commenting on the draft answers they have produced on the written questions set them by the TCSC.

2. The draft letter incorporates your own comments, as well as some additional points of our own but you may decide that on tactical grounds you want to cut down the number of points on which we ask the Bank to amend the text.

MOM

MISS M O'MARA

Ch
OK? (marked on attached copy)
AA

OK (one or 2 minor pts)

108g/mg1.pa O'MARA(747)

Please type for signature

DRAFT LETTER TO:

Paul Tucker Esq
Private Secretary to the Governor

TCSC QUESTIONS

The Chancellor was most grateful to you for sending us a copy of the written answers you had prepared to the list of questions the TCSC sent you after the Governor had given evidence. He ~~appreciates that the answers must be the Governor's own responsibility but~~ thinks it particularly important that the Governor and he should be seen to be speaking with one voice on the analysis which underlies the Government's response to the Delors Report. He would therefore like to suggest a number of amendments to the text to avoid clear inconsistencies between your own answers and those which he himself gave at ~~yesterday's~~ Monday's hearing.

<u>Question 1, line 6</u>: Redraft to read "...it is possible that large fiscal imbalances could make exchange rate policy harder to manage". This will avoid any awkward inferences being drawn about the UK's current budget surplus. The Delors Report is, of course, far more concerned about large budget <u>deficits</u> (eg paragraphs 30 and 34), as the first sentence of the answer implies.

<u>Question 1, third paragraph</u>: The Chancellor suggests that the whole of this paragraph should be deleted. ~~We do not want to give any hint that the larger Member States might be able to run large but "sustainable" budget deficits.~~ The impact of even a large fiscal deficit on interest rates and exchange rates is a controversial subject best avoided

Question 1, fourth paragraph: The Chancellor suggests redrafting the first line to read "Even though it would be possible.... it may be ea~~rl~~sier....". There is no doubt that a monetary union could be maintained without such formal constraints. He also found the reference to co-ordination of monetary policy in the fourth line odd: monetary union could not exist without it! He would prefer to replace "imposing" in the fifth line with "accepting".

Question 2(a): The Chancellor thinks it most important to acknowledge in this answer that the UK does not see the adoption of permanently fixed exchange rates as removing "an instrument of adjustment". As the Governor knows, his own firm view is that exchange rate adjustment ~~never~~ cannot of itself create~~s~~ additional resources. He has also questioned the statement that Member States cannot set their policies in isolation now. He feels this sentence is far too sweeping as it stands, although he accepts that closer economic integration is bound to place some constraints on Member States in practice.

Question 2(b): While appreciating that this question is largely factual, the Chancellor is again concerned that the first sentence should not imply there is some objective "recognition" that the adjustment mechanism would no longer be available, when the UK does not accept the basic premise. He feels there should also be a reference in this paragraph to the market adjustment mechanisms (wage flexibility and labour mobility) which are mentioned in paragraph 29 of the Report. To the extent that these mechanisms proved effective, the case for additional structural funds would be weakened further.

Question 3, line 3: The Chancellor suggests it would help the argument here to add at the end of the first sentence "and the levels at which the ERM ranges for that currency are set".

Question 3, line 8: Insert "possibly" before "initially". Some countries may offset the inflationary impact almost immediately.

Question 3, line 9 and 17: To parallel the reference to inward exchange controls above, amend to read "...which again might in principle be mitigated". In practice, the UK has no faith in exchange controls of any kind, which is why we abolished them in 1979.

Then better to omit references to both inward + outward exchange controls?

[illegible]

Question 4, second paragraph: The Chancellor has proposed that everything after the first sentence should be deleted on the grounds that relatively small changes in current account balances have no bearing at all on exchange rates and thus on the question of ERM membership.

Question 4, paragraph 4, line 7: Replace "the major difficulty" with "the key issue".

Question 5, second paragraph: The Chancellor would not want to give the impression that the UK advocates fine tuning. He would delete the whole of this paragraph and redraft the opening of the third paragraph to read "Monetary policy is the appropriate instrument for ensuring that demand in money terms follows the medium-term path consistent with the authorities' inflation objectives. If policy were achieving...".

The references to inward and outward exchange controls seem to imply that such controls might be effective. The Chancellor would prefer both references omitted.

Question 6, line 1: In practice, Member States rely almost exclusively on interest rates to influence monetary policy, as the answer makes clear elsewhere. The Chancellor therefore suggests the first sentence is redrafted to read: "Central banks have a variety of techniques they can use to set interest rates and hence influence monetary policy."

Question 7, paragraph 1, final sentence: Delete. In the UK context, we have consistently argued that in today's global market, it is increasingly difficult to distinguish short and long-term flows.

Question 8, second paragraph: Attention is likely to focus on this. The Chancellor feels strongly that the first two sentences should be deleted. As the Governor knows, he has argued that it is far too simplistic to assert that the current pick up in inflation should be attributed to the authorities' policy of shadowing the deutschemark and has pointed out that indeed some would suggest the source of the present inflation could be found in an earlier period. Similarly, he has asked that everything from "The circumstances of mid-1987" to the end of the paragraph should be deleted. He does not accept the argument here and thinks it quite inappropriate to attempt to explain in this context why we chose to adopt a policy we have never explicitly acknowledged we were following.

chex.ps/ds2/116

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mr Gieve
Miss O'Mara
Ms Symes
Mr N P Williams

Treasury Chambers, Parliament Street, SW1P
01-270 3000

14 June 1989

Paul Tucker Esq
PS/Governor
Bank of England
Threadneedle Street
LONDON
EC2R 8AH

Dear Paul,

TCSC QUESTIONS

The Chancellor was most grateful to you for sending us a copy of the written answers you had prepared to the list of questions the TCSC sent you after the Governor had given evidence. He thinks it particularly important that the Governor and he should be seen to be speaking with one voice on the analysis which underlies the Government's response to the Delors Report. He would therefore like to suggest a number of amendments to the text to avoid clear inconsistencies between your own answers and those which he himself gave at Monday's hearing.

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Yours
Alex

A C S ALLAN
Principal Private Secretary

Alex

The Clerk wants to think about this & consult TH. I suspect they may have made quite a lot of the point in their draft report - which we should see this p.m. (Mr Currie thinks that the proposed footnote doesn't sufficiently explain the point given that precedes it.)

Ratcliffe

(later)

Alex

The Clerk now thinks he would be minded to let us have our amendments, but he thinks, in the light of the Report, we might want either to expand or abandon them. We must let him know definitely on Monday morning what we want to do.

with you.

Ratcliffe

fn.vb/docs/wk12.6 28

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NBK @ tw.

FROM: N L WICKS
DATE: 15 June 1989
EXT : 4369

PPS

cc Economic Secretary
Sir P Middleton
Mr Lankester
Mr Peretz
Miss Simpson

CHANCELLOR OF THE EXCHEQUER EVIDENCE TO THE TCSC

As you know, I think we should try to secure the inclusion of a clarificatory footnote to the Chancellor's statement in his evidence to the TCSC that the preamble to the Single European Act ".... does not, in the opinion of the British Government, mean that the British Government is committed to monetary union."

2. This point is difficult to sustain since the preamble of the Act effectively brings the objective of the progressive realisation of EMU within the framework of the Treaty. To that extent it is a Treaty objective.

3. Moreover, our critics in the Community may seek to fasten on the statement so as to argue that we going back on agreed undertakings and hence to discredit our approach in the discussions on EMU, namely:

- ready to implement useful measures for stage 1, but

- while we are ready to discuss stages 2 and 3, were are not ready to accept Treaty amendment since EMU is not on the agenda for the foreseeable future.

To become embroiled in arguments about whether or not we adhered to earlier Community statements on EMU would simply make it more difficult to carry those in Community, like the Dutch and the

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Danes, who while seeming to favour EMU, are ready not to force the pace for the time being.

4. With these considerations in mind, I suggest that we should ask the Clerk to include a witness's note to the evidence. Two possibilities are:

X i. Further to this answer, the witness makes clear that the reference in the last sentence is to the ~~approval to~~ definition of monetary union set out in the Delors Report.

Given that a preamble or HoC motion

ii. Further to this answer, the witness draws attention to the preamble of the Single European Act, referred to earlier in his evidence; notes that the Government's views on the Delors Report were set out in his written answer of 21 April and in the Prime Minister's written answer of 2 May; points out that British Government is not committed to the approach in the Delors Report for achieving the objective of the progressive realisation of secure and monetary union; and says that his answer to the Committee should be read in the context of this last point, the Single European Act and the two written answers referred to above.

(i) is neater, but difficult to square with the answer to question 81. (ii) is sufficiently obfuscatory, but is rather long and if you wished, could be shortened eg by omitting the material after the last semi-colon.

5. I am attaching, for reference, the relevant extracts from the Chancellor's evidence and the two PQs referred to in the draft of the witness's note.

6. Finally, you should know that Miss Simpson tells me that any footnote must reach the Committee by Monday morning at the latest. Even then it would have to appear as a typed addition to the printed transcript which will be published (complete with printers errors) as soon as possible next week with a typewritten brief report. If we can get the footnote to the Clerk this week, there

is just a chance that it could be incorporated into the printers proof, although that cannot be guaranteed.

N.L.W.

N L WICKS

By all means Lawson go [illegible]
at getting the foreword @ X [illegible]
but it will be necessary also
to answer [illegible] 81 in para 4,
with more difficulty. Then together [illegible]
If this won't fly, then [illegible] rely on
[illegible] a foreword & [illegible] show
briefly along these lines the matter.
[illegible] [illegible] [illegible]

FROM : MISS J C SIMPSON (EB)
DATE : 16 JUNE 1989

PRINCIPAL PRIVATE SECRETARY

cc PS/EST
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr Peretz
Mrs M Brown
Miss O'Mara
Mr Gieve
Mr N P Williams
Mrs Chaplin

TCSC REPORT ON THE DELORS COMMITTEE

I attach a draft of the TCSC Report on the Delors Committee which the TCSC is due to discuss on Monday afternoon.

2. The convention is that these are shown to us in confidence for checking for factual accuracy. You will want to look with particular care at paragraph 10.

3. Any comments which we want taken into account when the Committee considers the report must reach the Clerk during the course of Monday morning.

JS

MISS J C SIMPSON

In confidence

16.6.89

TABLE OF CONTENTS

In confidence

TREASURY AND CIVIL SERVICE COMMITTEE

Chairman's draft Report

The Delors Report

INTRODUCTION

1. We and our predecessors have taken a continuing and keen interest in international monetary developments. We agreed our Report on International Monetary Coordination on 17 May,[1] as the latest in a series of studies of these developments. That Report concentrated primarily on efforts within the Group of Seven (G7) or Group of Five (G5) to cooperate, and even to coordinate, international monetary policy in the aftermath of the Plaza Agreement of September 1985 and the Louvre Accord of February 1987. In that Report[2] we deliberately left to one side the closely-related, but different range of issues raised by the publication in April of the Report of the Committee for the Study of Economic and Monetary Union. That Committee, chaired by the President of the European Commission, Mr Jacques Delors, had been set up by the European Community Heads of State or Government when they met in Hanover on 27-28 June 1988.

2. Following publication of the Report of the Committee chaired by Mr Delors (referred to hereafter as the Delors Report) we arranged meetings with the Governor of the Bank of England, Mr Robin Leigh-Pemberton, who, along with the Presidents or Governors of central banks of the other member

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[1]Third Report, 1988-89, HC384

[2]Much of the evidence in that inquiry both written and oral, is relevant to the present inquiry

states, was a member of the Committee in "a personal capacity"[3], and from the Chancellor of the Exchequer, Mr Nigel Lawson, who was accompanied by Sir Terence Burns and Mr Nigel Wicks. In order to give the House the benefit of studying the evidence we received from the Governor and the Chancellor before the European Council meeting on 26 June we have agreed this short Report drawing attention to what seem to us to be some of the salient issues.

3. We wish to express our thanks to our witnesses and also to Professor Brian Tew who has acted as our adviser on this inquiry as on previous similar inquiries and to whom we are again greatly indebted.

[3] Delors Report Annex 1 p39 and Q1 and 8

Background

4. The European Council when it met in Hanover in June 1988 recalled that "in adopting the Single European Act the Member States confirmed the objective of progressive realisation of economic and monetary union." The Heads of State or of Government gave the Delors Committee "the task of studying and proposing concrete stages leading towards this union".[4] There was, to our knowledge, no dissent expressed by **any** of the participants to this task being given to the Delors Committee.

5. The Report's contents are briefly summarised in the Treasury's explanatory memorandum a copy of which is annexed to this Report.

6. One of the Report's principal features was its proposal that there should be a three stage process leading to economic and monetary union. The Report emphasised that political decisions would be needed to move from one stage to the next, but also argued, much more controversially, that "the decision to enter upon the first stage should be a decision to embark on the entire process"[5]

7. Stages 2 and 3 of the Report would require amendment of the Treaties particularly in order to set up the proposed European System of Central Banks (ESCB). This led the Treasury to state:

> "The Government has said that there can be no question of further Treaty amendment as proposed by the Committee when the Treaty of

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[4]Delors Report, Foreword and Annex 1

[5]Delors Report, para 39

Rome has been so recently amended by the Single European Act"[6]

8. One of the most instantly controversial parts of the Delors Committee's Report related to the need for "binding rules" on fiscal policy to be the counter-part of monetary union.

9. In our evidence and in the paragraphs which follow we concentrated largely on the points referred to in the three previous paragraphs. We also used the opportunity provided by discussion of stage 1 to raise further questions about when it would be right for the UK to join the exchange rate mechanism (ERM) of the European Monetary System (EMS).

<u>The commitment to economic and monetary union</u>

10. We begin, however, by referring briefly to the manner in which the Delors Committee was set up and to its approach to its work. We asked the Chancellor how it was that given the Government's current view of the issues, it had come to endorse the terms of reference of the Delors Committee and in particular the reference to "proposing concrete stages leading towards [economic and monetary] union". The Chancellor's reply was that the series of references to economic and monetary union in European publications going back to 1972 did "not, in the opinion of the British Government, mean that the British Government is committed to monetary union"[7]. Later he based his defence of HMG's minimalist interpretation of the language on the fact that a Chapter heading in the Single European Act read "Cooperation in Economic and Monetary Policy (Economic and Monetary Union),[8] and the

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[6] T245, para 17

[7] Q78

[8] Q82

Subsequently expanded to make clear that
ref. to def. of EMU set out in Delors.
monetary union

text also spoke of cooperation.[9] We found this answer surprising since the interpretation put on the expression "economic and monetary union" by all the members of the Delors Committee seems to have been completely different. Although "economic" union is undoubtedly a somewhat imprecise concept,[9] the implications for sovereignty of any likely scheme of monetary union ought to have been clear to all the participants at the European Council meeting at Hanover in June 1988. While it is possible, in our view, to envisage "concrete stages" to something as firm as "union", we find it hard to believe that the Government would have thought it right to describe progress towards mere cooperation in such language. We are forced to the conclusion that ever since 1972 successive British Governments have gone along with the idea of economic and monetary union because it seemed unlikely to be a serious issue for some time. But the agreement at the Hanover Summit to the establishment of the Delors Committee and the publication of its report mean that we have reached the point when HMG's real doubts about the consequences of both economic and monetary union must be expressed. Unfortunately we suspect that under the pressure of events HMG may in the past have accepted far-reaching language too lightly. Having done so we fear that the strength of the Government's present negotiating position may have been undermined. **Despite that, it is important that the Government should make its position absolutely clear at the Madrid Summit and should not again go along with language whose full implications it does not accept. It is obviously dangerous for the Government to go on paying lip-service to ideas to which in reality it is fundamentally opposed.**

<u>The approach of the Delors Committee</u>

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[9] Q83

[9] see eg Q80-1

11. Having understood that its appointed task was to propose **how** union might be achieved the Delors Committee (we were told by the Governor) -

> "thought it therefore appropriate that the report should as far as possible be descriptive rather than prescriptive; that we should not seek to prescribe or recommend to heads of government but we should rather draw to their attention what we saw to be the essential parts of the concept of economic and monetary union, its definition and what that definition involved; that we should not shy away from the implications of that definition in terms of the effect on sovereignty; and we also felt that we were reasonably qualified to describe the practical steps towards the objective."[10]

The Governor's contention that the Delors Report was about "how" rather than "whether or when" economic and monetary union might be achieved was to some extent inconsistent with the view expressed by the Chancellor who argued that the Report was basically a "political document".[11]

Timing

12. Both the Governor[12] and the Report itself made plain that there was no deadline for completion of economic and monetary union. The Report said

> "The conditions for moving from stage to stage cannot be defined precisely in advance; nor is it possible to foresee today when these conditions will be realised. The setting of explicit deadlines is therefore not advisable."[13]

Nevertheless the Report also said

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[10] Q1

[11] Q80

[12] Q2

[13] Delors Report, para 43

> "there should be a clear indication of the timing of the first stage, which should start no later than 1 July 1990 when the Directive for the full liberalisation of capital movements comes into force."[14]

The Governor stressed the advantages of "level-headed pragmatic progress",[15] saying that most of the rest of the Committee, whom he contrasted with the "idealists", felt that

> "the Community is likely to make the most successful economic progress by natural organic growth, of which I would regard the things listed for stage one as the most typical"[16]

---

[14]Ibid

[15]Q49

[16]Q49

<u>A single process?</u>

13. One crucial issue relating to timing was the proposal in paragraph 39 of the Report that "the creation of an economic and monetary union must be viewed as a single process.". The Report went on to say

> "Although this process is set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process."

When the Governor was pressed on this, he said

> "I find it a very fundamental matter. We took it as very much part of what we were expected to study and report on to say that possible elements of the first stage are really hardly relevant unless they could be seen in the context of a longer term objective of economic and monetary union, which the heads of state have confirmed as an objective on two previous occasions. If you are going to say to me that that should never have been done, I might well provide you with my own comments but I would regard that as a highly political comment and not within my competence as Governor of the Bank of England. Having been given this mandate in the context of these resolutions, it seemed to us logical that the statement in paragraph 39 was perfectly justifiable if we were in fact to produce a coherent set of economic policies which would be of benefit to the Community if we are going to go down this road. A series of disassociated ad hoc moves probably would not be helpful to the Community and some countries would not be willing to undertake them unless they saw them in the context of this main ultimate objective."[17]

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[17] Q25

He had, however, earlier said

"First of all, the history of the matter made it not axiomatic but in the view of many members of the Committee somewhat natural that any steps taken should be seen in the context of a final objective to which the heads of state had really already committed themselves. The second point was that some countries took the view that it was necessary to have some idea of the nature of the destination. Some countries felt that even stage one was going to require of them adjustments, possibly even sacrifices, which might be worth taking only in the context of a gradual movement towards the final objective. We would all of us have agreed on the committee, had it been put to us at the time, that one would be entitled on the way to decide that the objective, if not the destination, could actually change as experience was gained. I do not feel that we are so certain about either the definition or the routes that any of us would have said that this sentence implies that there is no chance of deviation. The other point it is important to make is that even having said that, the Committee was emphatic that there should be no time deadline. Insofar as anybody may feel that this sentence implies a sort of pressure, I would like to plead that the paragraph which is headed **Calendar** relieves that pressure at least in terms of a timescale."[18]

The Chancellor emphasised his own "pragmatic and sensible" approach and his rejection of the notion of "in for a penny, in for a pound"[19]. It was important, he thought, that at ECOFIN in Spain in May they had "separated out the measures contained in stage 1, which aim to improve monetary cooperation within the context of the existing Treaty, from the questions of

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[18]Q2

[19]Q79

stages 2 and 3".[20]

Stage 1

14. Both the Governor and the Chancellor laid emphasis on the fact that the UK was not "dragging its feet" on stage 1. The Governor argued that

> "If you look at the performance of this country in terms of the liberalisation of capital movements, freedom from exchange rate controls, or our approach to the single market in 1992, you will see that we are in fact ahead of other Community countries. This is really why I like to put the emphasis on stage one because it is in stage one that I feel that the record of achievement of this country has not actually been properly recognised. I also think that it is a pity that a tremendous amount of the criticism or what has been said about this report, has been focused on the far distance, stage three, when really what the European Community should be concerned with is the successful conclusion of 1990, 1992 and the rest of stage one, where I believe we can achieve a great deal without formal and institutional change."[21]

The whole tenor of the Chancellor's evidence was to echo this approach, stressing what could be achieved within the existing Treaty. He maintained that "we should be devoting our energies" to the completion of the single market programme.[22] On this the UK had done much, had in some things gone further than most other countries,[23] and, apart from not yet joining the

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[20]Q79

[21]Q48

[22]Q105

[23]eg in development of the private ECU (Q105). The Chancellor also thought it was "a curious thing that some of those who are most vocal in their apparent desire for full economic and monetary union are extremely unwilling to remove

ERM, had done all that the Delors Report envisaged for stage 1. We consider later the issue of sterling joining the ERM. We welcome the fact that stage 1 also offers scope for intensified monetary cooperation along the G5/G7 model.[24]

5 national restrictions and controls of relatively minor kinds" (Q113).

[24]Q105 and 107

Stage 2

15. Stage 2 of the Delors Committee's proposals envisages the creation of a European System of Central Banks (ESCB). The Governor explained -

"We have spelt out in the report that the operation of a single monetary policy and the operation of a single currency within the Community would require a single central bank in order to be effective. You could just argue that in fact you might have all the central banks still independent of each other but operating on a working understanding. The chances of that being effective, both in terms of a single monetary policy and above all in terms of Community monetary relationships with third countries in the rest of the world, are probably very slender. It was our judgement that it would be necessary to have this European System of Central Banks."[25]

He recognised that to move from a central bank with a federal structure to a political federal structure was a "highly political and constitutional matter" and went on to say that the Committee had "felt that if a single monetary policy were to work properly, it would require a degree of central direction" from a body such as a federal central bank.[26]

16. The Governor pointed out that he had signed a report which said that "if the European Economic Community ever achieves economic and monetary union it will be necessary for that monetary union to have a single monetary policy and therefore to have a single central bank".[27] We note that this contrasts with what the Prime Minister had said to the House on her return from the European Council meeting in Hanover when she maintained that "progress

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[25]Q16

[26]Ibid

[27]Q11

towards [monetary union] would not necessarily involve a single currency or a European central bank".[28]

17. In explaining the contents of the Delors Report the Governor was at pains to argue throughout his evidence that he saw the Report as spelling out technically how economic and monetary union should be achieved, not whether it was politically desirable.[29] He insisted that he would "not have put on me that I am recommending economic and monetary union".[30] **The Chancellor made plain his political response to the Delors Report saying at the end of a most illuminating lengthy answer to one of our Chairman's opening questions "I reject the proposal for economic and monetary union".**[31]

18. We think it is important to stress the difference between "economic" and "monetary" union as the Chancellor did.[32] In fact the expression ought to be "monetary and economic" union since monetary union is obviously less comprehensive than complete economic union. It seems clear from the Chancellor's evidence that he is opposed to both. **The evidence we received as part of our major inquiry into international monetary coordination**[33] **suggests that monetary union would not require member states to abdicate control over fiscal policy, and the Delors Committee's assertion that it would, is really a device for seeking to achieve more European control of national Governments than is necessary for monetary union.** European control of fiscal policy would of course be necessary for the achievement of economic

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[28] Official Report, 30 June 1988, col 527

[29] see eg Q1 and para 11 above

[30] Q9

[31] Q80

[32] eg Q80

[33] Third Report HC(1988-89)384

union.

19. The Chancellor also firmly restated the Government's opposition to early Treaty amendment, which would be needed both in order to set up a new institution like the ESCB and also in order for member countries to commit some of their reserves to such a new central bank.[34] Asked whether the statement in the Treasury's explanatory memorandum about it being inappropriate for further Treaty amendment so soon after the Single European Act meant that after a reasonable interval such amendment would be possible, the Chancellor said that while he supposed "there could come a time when we were prepared to accept some amendment of the Treaty"[35], the Government had made no undertaking about any Treaty amendment and that the Government was not prepared to consider any amendment "at the present time or for the foreseeable future"[36]

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[34] see Q47 and Delors Report para 57

[35] Q109

[36] Q110

Stage 3

20. Perhaps the most controversial feature of the Delors Report was its linkage of monetary union with the need for "binding rules" on fiscal policy and on the role of regional policy. **The Chancellor argued that a common currency required neither control of budgetary and fiscal policies nor the great enlargement of regional policy.**[37] **We agree on the basis of the evidence we have received in previous inquiries.** To make monetary union work all that was required, in his view, was a simple rule that if a member country accumulated excessive debts, by borrowing too much, then there should be a clear understanding that it would not be bailed out.[38] He also thought that "if you accept the Delors framework, then in the run up to the process of monetary union you would need a further rule and that is that fiscal deficits cannot be financed by monetary means".[39] We found his second "rule" easier to understand than his first.

21. Although a member of the Delors Committee, the Governor seemed anxious to distance himself from some of the interpretations put on the need for binding rules. He sought to minimise their significance, for example,

- by emphasising that they were to deal with "highly profligate governments"[40];
- by emphasising that a very high proportion of the budget and expenditure would still be in the hands of individual governments[41],

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[37] Q80

[38] Q80

[39] Q80

[40] Q5

[41] Q18-19

and that the volume of the Community budget was still comparatively small[42]; and

- by saying that the rules ought to be in a "very wide and tolerant band"[43]

He also pointed out that the Committee had found it "impossible to name any sort of figure which would be a permissible and non-permissible range for budget deficits".[44] And he went on to say:

"a budget deficit for a country the size of Portugal of 10 per cent of GDP would probably be readily financable by the world markets in the new common currency. A similar proportional budget deficit for Germany or ourselves would be a very different proposition and would probably have a serious effect on both the interest rates that had to be paid in the common currency and on the monetary stability of the Community as a whole. It is within that range of considerations that we felt that there would have to be some understanding in one of these central economic bodies about what is a tolerable range of budget deficits for individual countries."[45]

22. **We wish to stress that, as we have noted in previous Reports, it is by no means clear what the impact of fiscal policy is on exchange rates.[46] Fiscal policy may affect demand, but its direct impact on exchange rates is ambiguous. Binding rules on fiscal policy seem to be unnecessary even in stage 3 of a monetary union.**

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[42]Q22

[43]Q75

[44]Q20

[45]Q20

[46]see eg Third Report, 1988-89. "International Monetary Coordination" para 26 (HC(1988-89)384)

23. The Chancellor, when asked whether a country such as the UK with a Government committed to a long-term balanced budget would have much to fear from rules designed to cope with countries with large budget deficits, turned the argument to constitutional issues[47] which we now consider.

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5 [47] Q102

The sovereignty argument

24. At the heart of the Government's objection to the proposals in Stages 2 and 3 of the Delors Report is the argument that they would involve an unacceptable loss of "sovereignty", even in relation to monetary union, let alone economic union.[48] The Chancellor had prepared the ground for this argument in a speech at the Royal Institute for International Affairs on 25 January 1989, almost three months before publication of the Delors Report. Then he contrasted full membership of the present EMS with Economic and Monetary Union saying that the difference between them could not be more fundamental. He said

> "The EMS is an agreement between independent sovereign states whose economic policies remain distinct and different. By close cooperation, they can achieve greater stability of exchange rates, and - as we have seen - reinforce their efforts to bring down inflation.
>
> Economic and monetary union, by contrast, is incompatible with independent sovereign states with control over their own fiscal and monetary policies."

And in his evidence to us on 12 June the Chancellor said that sovereignty would be involved both in handing over budgetary control and in abandoning a domestic currency. He spoke of the "dimension of irrevocability" in the process.[49]

25. He believed that the House was rightly concerned about the lack of "democratic accountability" in the Delors Committee's proposals for Stages 2

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[48]Q80

[49]Q80

and 3 in respect of both monetary and economic union.[50] The proposals in Stage 3 for binding fiscal rules implied a federal Europe. The abandonment of sovereignty was, he argued, "not the prospectus on which the British people and the British House of Commons ... quite rightly agreed to membership of the European Community in the first place".[51] Fundamental issues of accountability - "the whole question of political accountability [had] not been discussed at all" in what was a "report by central bankers".[52]

26. Arguments rage both inside and outside Parliament about the issue of sovereignty. Even if it be true that international treaties and other obligations and the impact of an increasingly interdependent world economy have **de facto** diminished the sovereignty of the United Kingdom Parliament that provides no justification for hasty action which would further limit the role of the UK Parliament and Government. The Report of the Delors Committee has shown **one** possible technical route towards economic and monetary union. If the "progressive realisation of economic and monetary union" is to be further discussed at meetings of the European Council the political dimension, the need for proper democratic accountability needs, in our view, to be given priority. So-called **technical** solutions ought not to drive a process which would lead to a diminished accountability for the people of all Community countries.

27. **The power of the House of Commons over the centuries has depended fundamentally on the control of money, both taxation and expenditure. This would be jeopardised by the form of monetary union proposed by the Delors Report which would involve central undemocratic direction from within Europe of domestic budgetary policies.** As the Chancellor put it,

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[50] Q80

[51] Q104

[52] Q112

"What is suggested in the Delors Report is that the individual Member countries of the Community would not have the budgetary or fiscal freedom which individual states of the United States have."[53]

We agree with the Chancellor that to press ahead with such proposals in a way that was "unacceptable to any Member State" would be "very damaging for Europe and very divisive".[54]

Membership of the present Exchange Rate Mechanism

28. We turn now from the somewhat speculative proposals of Stages 2 and 3 of the Delors Report to an issue which has immediate economic and political significance for the UK - the question of whether the time is right to join the ERM.

29. Our predecessor Committee reported on the EMS in its Thirteenth Report of Session 1984-85.[55] Its conclusion in October 1985 was

"While not ruling out eventual British participation in the long term, we consider that the difficulties of securing an appropriate valuation for sterling and the need to keep options open to pursue domestic policies in the national interest lead us to recommend a maintenance of the status quo in the short to medium term."[56]

Given the time that has elapsed since that Report on the EMS reappraisal of the arguments is clearly necessary.

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[53] Q80

[54] Q105 and see Q106, Q112

[55] HC(1984-85)57-IV

[56] Ibid, para 84

30. We asked the Governor for his assessment of the success of the ERM. He replied:

> "I think it has been a comparative success. In the ten years since it has been in existence after a difficult start, it has actually shown a very good performance for its member countries, certainly in the last four years in respect of exchange rate stability, counter-inflationary performance and the number of interest rate changes that have taken place. The growth throughout the Community on average has not been as good as ours. Unemployment rates have been probably on average a little worse than ours. It has achieved a great deal for countries like France, if you care to compare the major indicators of 1979 with now."[57]

The Chancellor echoed this assessment, saying

> "It has been successful in two ways, first of all in reducing exchange rate fluctuations within the European Community and, secondly, by assisting the various countries of the European Community to get their inflation rates down."[58]

He cited the decline in inflation rates in France (from 9.6% in 1983 to 3.6% in 1989) and in Italy (from 15.1% to 6.7% over the same period). While this was not wholly attributable to the EMS,[59] he argued that it could not have "prevented those countries getting their inflation rates down. It has provided a credible financial discipline which is adjusted for in the conduct of their

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[57]Q57

[58]Q116

[59]Non-members of the EMS were also successful in getting their inflation rates down.

monetary policy"[60]

31. From the evidence we received there would appear at present to be three major current arguments against UK membership of the ERM, viz:

a. the uncertain impact of the ending of remaining exchange controls in France and Italy in July 1990 and in other Member States thereafter;

b. the need for UK inflation and interest rates to be at appropriate levels; and

c. the need to choose a time when the current market value of sterling is near to the ERM official parity to which the UK Government is prepared to be committed (although we foresee that some adjustment might be needed at the moment we joined).

32. **As to the impact of the removal of exchange controls, the Governor thought that anxieties about the impact of the total liberalisation of capital movements were "ill-placed" since the level of restrictions in France and Italy was very modest.[61] The Chancellor, was more cautious on this point[62] (giving us perhaps the clearest clue yet as to when he thought the time might be right to join) saying "I do think it might be reasonable to wait to see the major countries remove their remaining exchange controls and then see how the EMS works out in those circumstances".[63]**

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[60]Q116

[61]Q58

[62]Perhaps because although the level of remaining restrictions may be modest, the administrative machinery for them still exists which may in turn affect market expectations

[63]Q140-1 and 147-8

33. The Chancellor made plain that he "would want to see our inflation rate again coming down"[64] before the time would be right to join, although he gave no indication as to what he thought its appropriate level would be.

34. As to the exchange rate, the Governor said

> "The difficulty for us is to choose the time when the exchange rate is right for us to go in so that we can both hold our place in the band and at the same time continue to operate a successful form of domestic monetary policy for counter-inflationary purposes."[65]

35. Both the Governor and Chancellor were clearly of the view that the time would come when it would be right to join the **present** form of ERM. We emphasise "present form" because a key difference between the ERM as it now is and the total fixity of rates proposed in stages 2 and 3 of the Delors Report is that realignment is still possible under present arrangements. The Governor thought it would be possible for the ERM to remain stable even with the inclusion in it of another major internationally traded currency such as sterling, although he thought there could be some initial strains.[66] Although there were a number of realignments in the ERM in the initial years there have been none for two years.[67]

36. One problem for UK policy makers with the ERM as at present relates to the possible conflict between the level of interest rates which is appropriate for domestic monetary policy on the one hand and the level which is appropriate for maintaining the external parity of the currency. The Chancellor's response to this was to argue that within the EMS for the last

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[64] Q142

[65] Q60

[66] Q65 and see Q121 and HC(1984-85)57-iv

[67] Q116

ten years, and particularly over the last five years, "periods of such conflict have been few and far between and on the whole there has been a compatibility between membership of the system and getting inflation rates down".[68] If he is right then on the very infrequent occasions when such a dilemma might occur a realignment could be sought. But that option would not be available under the irrevocable fixity of the proposed stage 3 arrangements.

37. We also sought to establish why membership of the ERM was thought preferable to "shadowing" the Deutschmark as in the period up to March 1988. The Governor said

> "The ERM itself does actually create a degree of protection of its own accord to a currency. The very fact that it is in the ERM makes it a less obvious and easy objective for speculation. While we are outside it, we do run the risk of being an isolated object of this nature in the way that the currencies that are in it are not. It is not to say that going in is an automatic magic of protection; by no means. It affords a degree of protection."[69]

The Chancellor endorsed what the Governor had said and added

> "there are three major differences. There is, as it were, the credibility that the exchange rate mechanism and EMS has acquired over the years which provides a helpful framework; there is the fact that as a result of that, the currency pressures to which one has to react tend to be less; and there is the third point [the Governor] perhaps did not mention but which is also true that, if you decide the pressure is such that you have to have a realignment you might have, say, a 5% upward realignment and that would have immediate market credibility,

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[68] Q136

[69] Q67

you would not have the tendency for the overshooting we see in the foreign exchange markets otherwise."[70]

38. One criticism of UK membership of the ERM at a time of relatively high inflation and interest rates has been that this would lead to perverse capital flows. The Chancellor did not think this was borne out by the experience of other countries and he cited the differential between Italian and German interest rates which had not led to an "enormous flood of money" out of Germany into Italy".[71] If such inflows were to occur sterilised intervention or ultimately an upward realignment would provide the answer.[72]

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[70]Q134

[71]Q124-6

[72]Q129

Conclusions

39. **Overall we conclude that it would not be right to join the ERM immediately. The determination to reduce UK inflation and the Chancellor's comments on waiting to see how in 1990 the abolition of exchange controls in France and Italy affects the ERM suggests an intention to join thereafter. We welcome the indications he gave that once the consequences of this were apparent the UK should join.** We recognise also that (although it may not be a decisive argument for membership) there would be important advantages for UK influence in the Community if "it were clear that we were going to be within the ERM within a reasonable period of time".[73]

40. **We welcome the fact that HMG has been setting the pace in much of what the Delors Committee envisaged for stage 1. The UK has not been dragging its feet. And on the outstanding issue of membership of the ERM on which HMG has been committed in principle to entry, we welcome the more positive commitment given during the evidence we received.** Other member states ought, we believe, to give credit to the UK for its attitude to stage 1. The UK's positive approach is important for another political reason: it maintains its credibility in European negotiations at a time when it is important for HMG to oppose, for both technical and constitutional reasons, the proposals for stages 2 and 3.

41. The Delors Committee's proposals for stages 2 and 3 are much more speculative than stage 1. They represent, it seems to us, one possible technical route to economic and monetary union. **They ought not to be inseparably linked to a commitment to fulfil stage 1. Unlike the Delors Committee we think it essential to distinguish between monetary and**

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[73] Q123

economic union, and progress on the first should not imply commitment to the second. Economic union would clearly involve national Governments surrendering ultimate control of budgetary and fiscal policy. Even monetary union as proposed by the Delors Committee would involve the creation of new institutions which would not be answerable in any way to national parliaments. For these reasons, and particularly because there has been no proper consideration of the implications for parliamentary accountability of the Delors Committee's solution to the task given to it, we think it was right for the Prime Minister to tell the House,[74] and the Chancellor to tell us, that they were not prepared to go along with stages 2 and 3. **HMG's enthusiasm for stage 1 and opposition to stages 2 and 3 should be made absolutely clear at the Madrid Summit on 26 and 27 June.**

Debate

42. We greatly regret that the Government has not accepted the recommendation of the European Legislation Committee[75] that there should be a debate on the Delors Committee's Report **before** the European Council meeting at Madrid on 26 and 27 June. **If the Government attaches significance to arguments about the sovereignty of Parliament it ought not to be selective in its attachment to them. The House must have an early opportunity to debate the far-reaching proposals of the Delors Committee before HMG adopts a position on them at high-level European meetings.**

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[74] eg Official Report 2 May 1989, cols 13-14

[75] Twenty-first Report, HC15-xxi (1988-89) pxii

CH/EXCHEQUER
REC. 20 JUN 1989 20/6
ACTION Sir P Middleton
COPIES TO Sir T Burns, Mr Wicks, Mr Lankester, Mr Scholar, Mr R I G Allen, Mr Peretz, Miss O'Mara, Mr Riley, Mr Gieve, Ms Symes, Mr N P Williams

BANK OF ENGLAND
LONDON EC2R 8AH

20 June 1989

A C S Allan Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Alex

Ahead of the Treasury Committee Report being published at lunchtime, I enclose our answers to the written questions they put to us.

Outrageous: What is their further justification? NL

Yours ever

Paul

P M W Tucker
Private Secretary
to the Governor

Ch
The Bank have taken on very few of your amendments — in particular they've retained X (which, apart from anything else, is clearly wrong). I've protested fiercely to (Rew) PS/Gov that he must not do this without letting me know & giving you a chance to press critical amendments on the Gov. AA

0163C

TCSC QUESTIONS

1 Given that a change in a country's fiscal balance has an ambiguous effect on the exchange rate, what justification is there for imposing constraints on national governments' fiscal balances in the pursuit of monetary union rather than relying on capital markets to assess the appropriate risk premium of a country's budgetary policy?

Neither economic theory nor empirical evidence suggests clearly whether an increase in the budget deficit will, other things being equal, lead to an appreciation or a depreciation of the exchange rate. But although links between fiscal imbalances and exchange rates are uncertain, and the effects therefore hard to predict, it is generally accepted that large fiscal deficits can in practice make exchange rate policy harder to manage, in part because of the uncertainty created about whether financing can continue without adverse effects on price stability.

Under monetary union it is possible that capital markets would impose a risk premium on borrowing by countries with weak fiscal positions through the emergence of higher interest rates on their borrowing. However, it is not clear that markets discriminate efficiently in this respect: countries might be able to borrow at normal rates whilst confidence was maintained then find that finance had dried up altogether when their creditworthiness was called in question. Moreover, market participants would be uncertain whether, in practice, market discipline would be allowed to take effect in the event that a member state found difficulties in servicing its debt; much would depend on whether markets believed that, in a crisis, the Community would underwrite the debt of its member states.

Even a sustainable deficit, if large in relation to the flow of savings within the union, could have an impact on monetary and exchange rate developments in the Community as a whole. If one or more of the larger member states were to run such a deficit, it would be likely to affect, for example, the level of interest rates in the Community as a whole and hence exchange rates vis-a-vis third countries. This is more likely to be true in the Community than in certain federal states since the fiscal policy of the Community would be almost entirely the net effect of the policy of the twelve member states; unlike existing federal systems, the central budget of the Community would be very small relative to the budgets of the member states.

Thus, even though it might be possible to maintain a monetary union without formal constraints on national budget imbalances, it might be easier to manage that union successfully if there were provisions for co-ordination of fiscal and monetary policy. While such co-ordination could in practice involve accepting certain constraints on member states' fiscal imbalances, those constraints do not necessarily have to be particularly tight; their purpose might only be to prevent major deviations from the collectively agreed fiscal policy. As the Delors Report itself notes, most fiscal decisions should remain the preserve of member states.

2 a <u>What consideration did the Delors Committee give to the disadvantages of total fixity of exchange rates</u>?

The purpose of the Committee was, of course, to consider <u>how</u> economic and monetary union could best be achieved rather than to draw up a balance sheet of its advantages and disadvantages.

However, the Committee stated that "the adoption of permanently fixed exchange rates would eliminate an important indicator of policy inconsistencies among Community countries and remove the exchange rate as an instrument of adjustment from the member countries' set of economic tools" [paragraph 14 of the Report]. The move towards economic and monetary union would therefore be a "quantum jump" and "greater convergence of economic performance" would be needed before it became feasible. At the same time the Committee noted that the achievement of the single market would speed up the process of growing economic interdependence between member states and therefore in itself "reduce the room for independent policy manoeuvre and amplify the cross-border effects of developments originating in each member state" [paragraph 10].

b <u>What consideration did the Delors Committee give to the possibility that regional policy (cn which much reliance is placed in a regime of totally fixed exchange rates) may prove as ineffective in a European context as it has sometimes appeared to be in a national context</u>?

The reference in the Report to regional policy arose from a perception that when exchange rate adjustment is no longer possible other ways of adjusting to disturbances that affect the relative position of different countries would have to be employed. The best mechanism would be market adjustments such as wage flexibility and labour mobility. Another possible instrument is that of fiscal transfers which, it should be noted, already exist in most countries through the progressivity of income tax and the transfers implicit in social security contributions and benefits. Whether such provision would need to be supplemented by a deliberate policy of transfers in favour of low-income regions is a question that, as the Report notes, would need to be considered in a move toward greater fixity of exchange rates. It is relevant to note that the Community already has a regional policy backed by structural funds; the point emphasised by the Delors Committee was that such funds should be employed effectively, not necessarily that they should be further augmented. The Report states that "the success of [regional and structural] policies will hinge not only on the size of the available financial resources but to a decisive extent also on their efficient use and on the private and social return on the investment programmes."

3 It has been argued (eg by Sir Alan Walters, Independent 14. 7.88) that in the absence of exchange controls, funds flow from the low inflation and low nominal interest rates currencies into the high inflation and high nominal interest rate currencies and that membership of the ERM would, therefore, lead to "perverse monetary movements".

a Do you think a country with relatively high inflation can remain a member of the ERM?

b If the UK were to join the ERM now or later but still with relatively high interest rates, would this be likely to lead to a major inflow of funds? And, if so, how would the authorities deal with it without changing exchange rates?

The argument that perverse monetary movements can disturb monetary policy objectives depends on there being periods in which the currency of even a high inflation country is confidently expected not to depreciate. Within the ERM there are two stages at which this might, but need not, occur.

If in a realignment such a currency's central rate is moved down so much that it is at (or tends to be above) the top of its new range there may indeed be inflows, downward pressure on nominal interest rates and intervention with initially expansionary monetary consequences. While these effects could, in principle, be prevented by inward exchange controls, there is no evidence of their having operated in this way in ERM countries.

Delay in seeking a realignment when such a currency has fallen to the bottom of its range can also create a period in which the exchange rate is temporarily locked; but uncertainty about its duration, and the possibility of a "one way bet" on devaluation, leads to capital outflows and upward pressure on interest rates - which may be mitigated by outward exchange controls.

The "perverse monetary movements" of the first case could be avoided if realignments did not involve moving central rates too far from market rates. However, even if the mechanism were operated so that between realignments there were to be an initial period in which the relatively inflationary currency was on its ceiling, followed by a movement through the band and a final phase on the floor, it is not clear that the overall effect would be very perverse as markets would be expecting a period of future stringency to offset any currently induced "laxity" and vice versa

More specifically:

a) at any one time the ERM will contain relatively high and low inflation countries. The question is what range of inflation rates is sustainable, which in turn depends on how damaging it might prove if one currency were to be known to be more prone to more frequent realignment. Experience provides very little basis for specifying any such limit.

b) entry would generate an inflow only if sterling were immediately at its ceiling, which is not necessary. The potential problem of inflows to relatively high inflation countries has not materialised among ERM members. The relatively high inflation countries have been able to reduce both their absolute and relative inflation rates without resorting to exchange controls to prevent perverse monetary movements.

4 <u>Sterling's status as an internationally traded currency (in competition with the D-mark) and as a 'petro-currency' were used by the Bank in 1985 as the two main reasons against its membership of the ERM. Are these valid reasons now?</u> <u>Does sterling have any other characteristics which might make it an unsuitable member of the ERM?</u> <u>What indicators would you use in making an assessment of the ripeness of the time to join</u>?

Anything that differentiates countries, in terms of economic structure, is potentially able to cause difficulties in maintaining a fixed exchange rate. In such circumstances, exogenous shocks can affect the countries differently and thus tend to cause movements in the exchange rate.

Sterling's status as a petro-currency is probably a less relevant factor than it was, since the share of oil production in GNP is now less, given the lower level of energy prices. Nevertheless, the oil price remains relatively volatile and is a factor that causes our real national wealth to be negatively correlated with that of our EC partners (except, perhaps, the Netherlands where the energy sector is of comparable size to that in the UK). Thus as long as the oil price is volatile, oil will be a factor (albeit diminishing) that is liable to affect sterling differently than other EC currencies. Small movements in the oil price could probably be managed; larger changes might still create significant tensions.

Sterling's status as an internationally traded currency may also be becoming less of a differentiating factor, particularly as capital movements throughout the Community are being liberalised. However, the fact that sterling is still relatively widely held means that if there were doubt about the sustainability of a particular exchange rate, pressure could build up more quickly and assume greater proportions. The presence of both sterling and the deutschemark in the ERM might therefore cause some complications, especially perhaps in the early stages of our participation.

Overall it is impossible to say categorically whether these factors are sufficiently important to make sterling's participation in the ERM particularly awkward. The system has shown itself to be reasonably robust. For the time being, however, the relatively high rate of UK inflation and interest rates would make participation problematic. Once inflation and interest rates have been brought down, the key issue will be choosing a time when the exchange rate is at a level that would permit the authorities both to maintain sterling within the band and to operate a successful domestic monetary policy in order to keep inflation down.

POLICY INSTRUMENTS

5 Since membership of the ERM obliges the authorities to use interest rate policy to manage the exchange rate, what instruments are governments expected to use in order to avoid overheating or depression within their national economies?

The interest rate is completely preempted by exchange rate management within the ERM only when a currency is at one or other of the limits of its band and realignment is precluded. More generally, internal and external objectives are unlikely to conflict if the partner countries are equally committed to price stability. An overheating economy is likely to be running inflation risks and finding its exchange rate under downward pressure against stable partners - higher interest rates would ease both problems and vice versa in a recessionary economy.

It may also be possible in principle to use fiscal policy to influence aggregate demand and activity - and, while this may affect the exchange rate as well, if the two instruments do so in different proportions it would be possible to respond to overheating and recession without sacrificing the exchange rate commitment.

To go far in this direction, however, would involve attempting to use policy to influence the breakdown of nominal GDP between its price and quantity elements, the scope for which is limited. If policy were achieving the desired path for nominal income and the exchange rate was approaching a limit of the band there would seem to be a case for realignment.

6 Para 24 of the Delors Report says, "The responsibility for the single monetary policy would have to be vested in a new institution in which centralised and collective decisions would be taken on the supply of money and credit as well as on other instruments of monetary policy, including interest rates". How will the ESCB simultaneously determine both the supply of money and interest rates? Is is likely that the

ESCB will wish to use direct credit controls or some other bank balance sheet restriction?

Central banks have a variety of techniques they can use to set interest rates and hence influence monetary policy. Although a number of ideas were discussed by the Committee, it was decided that it was not appropriate at this early stage to specify the instruments the ESCB would use to manage monetary policy. The Report therefore simply notes that "the policy instruments available to the system ... would be specified in its statutes" [paragraph 31].

In mentioning the taking of decisions on interest rates as well as the supply of money and credit, members of the Committee were unlikely to have been under any illusion that such decisions could be independent of one another. Many central banks - inside and outside the Community - set targets each year for the growth of some money or credit aggregate, and then during the course of the year vary interest rates to try to achieve the monetary or credit target. There is no necessary inconsistency in this procedure. It is a matter of one set of decisions being dependent on the other.

7 In 1988 the UK's trade deficit with Germany rose to $12.7 bn, a 33 per cent increase over 1987. In total Germany has a surplus of some $46 bn with other EC countries (also up over 32%). How should Germany's continuing trade surplus be adjusted? Is the D-mark undervalued within the ERM? If so, by how much? Ought such adjustments to be made before sterling joins the ERM?

From the point of view of the stability of the ERM, the German authorities have argued that the current account surplus is not necessarily a problem, since the counterpart to the surplus has been exports of long-term capital. This is indicative of growing German investment in the rest of the Community - a development that is quite natural, particularly in the context of the single market programme, and one that is compatible with the stability of the ERM.

It is difficult to specify a correct level for the deutschemark within the ERM, as it is for any other currency. However, it is worth noting that the ERM has been stable for the past two and half years without any need for a realignment of the deutschemark while interest rate differentials have narrowed. Of course, an assessment of the potential stability of the sterling/deutschemark rate would be an important element in any decision by the UK to join the ERM.

8 <u>If we had been a member of the ERM throughout the last three or four years, how would the performance of the UK economy have been different? In what respects would joining the ERM be an improvement on "shadowing" the D-mark, as in the 12 months up to March 1988? Has "shadowing" the D-mark been completely discredited by the UK's recent experience or should the experiment be repeated but with a more realistic parity</u>?

It is not possible to say with confidence what would have happened had the UK been in the ERM. Clearly this would have depended crucially on the exchange rate at which we participated. However, it seems likely that, even allowing for the possibility of sterling's rate having been realigned during the period, the exchange rate would have been more constrained than it was in practice. There would therefore have been some difference in UK policy and, presumably, in UK economic performance as well. There are times in the past three or four years when ERM participation would have led to a more restrictive monetary policy, and times when policy might have been easier.

However, it is important to note that the effects of ERM membership could well be different in the initial stages than when expectations had become more fully adapted to the constraints that membership implied. Several existing members encountered difficulties at first in staying within the band and at the same time maintaining a satisfactory level of economic activity. Over time, however, their performance improved and they have been able to secure a sustained reduction in inflation while achieving a significantly better growth record. Over the last several years, most participants in the ERM have had greater stability in their effective exchange rate than has the UK, and they have not experienced such wide swings in their interest rates. In fact they have generally changed their interest rates less frequently than the UK in this period.

It is true that, in hindsight, the so-called "shadowing" experience can be seen to have been associated with an undesirable inflow of liquidity. But one cannot draw from this firm inferences about the effects either of more formal pegging or of shadowing at a different rate. A firm peg, backed by a credible political commitment, would have a greater impact on market expectations than a policy of shadowing. Thus the interest differential required to counteract speculative pressure need not be so large. Even so, if a peg were to be adopted, it would clearly be of central importance to select an exchange rate that could be sustained consistently with the government's domestic economic priorities. The circumstances of mid-1987 would have made it difficult to select an appropriate rate. Although at that time the UK inflation rate was broadly similar to those of Community partners, there were important differences in cyclical positions. The United Kingdom was in the middle of a period of strong and sustained expansion, in which the demand for funds was acting as a powerful attraction for foreign capital; most continental European economies, by contrast, had a considerably greater margin of spare capacity and had not yet begun a period of faster growth. It would be easier (though of course still not easy) to select an appropriate exchange rate at which to peg when cyclical conditions, as well as inflation rates, were more closely in harmony across countries.

9 You have argued that "In foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances." (BEQB, Feb, 1989, p60). Is this argument compatible with stage 3 of the Delors Report?

The article quoted noted that the key point is that whether or not a fixed price is the right price depends very much on the circumstances. Where economies are fully integrated and the market mechanism is functioning properly, a variable exchange rate between two currencies should not be necessary to maintain equilibrium. Within countries, even where they are geographically large and economically diverse, as in the United States, separate currencies for different regions are not considered necessary. At the moment the economies of the member states of the Community are not sufficiently integrated for a single currency to be feasible and sensible - and the Report noted that it is not possible to predict when such integration might be achieved.

10 Paragraph 44 of the Delors Report says, "pending the full participation of all member countries - which is of prime importance - influence on the management of each set of arrangements would have to be related to the degree of participation by member states". What is the justification for this? What would be the implication for the UK if it were to defer formal membership of the ERM?

It is only natural that the countries participating in any set of arrangements should have more influence on their management than those who have not yet joined. This is already the case in the EMS. The UK is a member of the EMS and plays a full and useful role in determining the arrangements of the EMS in general. We also play a full part in the day-to-day management of those EMS arrangements not directly connected with the ERM. However because we are outside the mechanism we inevitably have less say over the day-to-day management of ERM arrangements. If the UK were to participate in the ERM its influence on any moves the Community may take towards economic and monetary union would inevitably become greater.

Mike
Pls Flack.

[Summary ...]

RESTRICTED

FROM: G SEGAL (IDT)
DATE: 20 JUNE 1989
X 5185

We will supply a summary of Labour MP's views soon

1.MR GIEVE JC

2. CHANCELLOR

cc Mr Peretz
Miss O'Mara
Mr N Williams
Mr Bush

TCSC REPORT ON THE DELORS REPORT: PRESS CONFERENCE

I attended this afternoon's TCSC press conference on the Delors Report.

2. Mr Higgins made the point that although the committee had only discussed the contents of their report last night they were anxious to publish their conclusions and the evidence well in advance of the Madrid Summit. In addition they were keen to see a debate on the subject. Mr Higgins made the point that in many ways the evidence was more important than the report.

3. In view of today's newspaper reports Mr Higgins was at pains to stress that most committee members were in agreement on the overall conclusions. The one area of disagreement concerned paragraph 28. Furthermore the committee was not, as suggested by the Independent, supporting European monetary union on the Delors report mould.

4. There then followed a ritual statement of position by committee members present most of which concerned para 28. Mr Budgen said the wording on this paragraph was very vague and that the obstacles to monetary union would become more and more apparent as time went on. In view of para 28 Mr Beaumont-Dark felt the Government should and would totally ignore the report. This view was also shared by Mr Watts and Mr Hamilton. Mr Beaumont-Dark said he dissociated himself from the report completely. He also disagreed with the chairman on the question of whether budgetary and fiscal policies would need to be controlled as a result of union. That Labour had succeeded in including para 28 was something Mr Watts said they would not be allowed to forget. At the same time,however, he was not sure whether the ERM would be as stable as it had been, after July 1990, if sterling joined and suggested that it would need a wider band than the other member currencies.

5. Summing up Mr Higgins said that he too felt the offending paragraph went too far and would not have supported it. However, the view was that the report was still worth publishing particularly because of the evidence given. Finally the chairman and Mr Beith both emphasised that the timetable on publication was exactly as expected, that full notice had been given to members about yesterday's discussion and that they were all keen to see the report published as soon as possible.

GREGORY SEGAL

File : EA/005

FROM : MISS J C SIMPSON (EB)
DATE : 23 JUNE 1989
Ext 5211

MR EVANS

cc PS/Chancellor 14/2
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Mountfield
Mr Peretz
Mr Walsh

FMP

TCSC HEARING ON INTERNATIONAL DEBT

I have heard from the Clerk with some of the likely lines of questioning for your hearing on Wednesday. These are attached. They expect to concentrate almost entirely on debt, although there may be a few questions about the US economy. The questions are more than usually tentative, as the Bank's promised memorandum has not yet arrived. He will let me know any further thoughts on Monday.

2. The hearing is at 4.30pm in Committee Room 18, which I think is on the Upper Committee Corridor. I will check this before next Wednesday.

JS

MISS J C SIMPSON

QUESTIONS FOR TCSC HEARING ON INTERNATIONAL DEBT

1. What are the main differences between the Brady and Baker debt plans?

2. Are any of the indebted countries to which these are directed better off now that they were 4-5 years ago?

3. To what extent have the Baker 15 received help from the IMF and the IBRD?

4. What prospect is there that heavily indebted countries will ever pay off the interest they owe, let alone the capital?

5. Why has no major debtor yet defaulted?

6. What progress has there been in implementing the Brady plan?

7. There may be some questions on the Sub-Saharan Africa initiative.

8. Are the commercial banks doing all that is needed in the way of provisioning?

9. HMT's memorandum suggests that "the risk of a systemic failure" of the banking system has been averted. Page 13 of the G10 deputies paper seems less certain of this. If one bank did collapse, what would be the consequences for the system?

10. One of the special advisers has suggested that the third world countries are cutting down on their imports in an attempt to improve their situation, and that this will have a knock-on effect on western growth and employment. What do we think of this?

11. To what extent should the taxpayer help out in the debt situation? Despite the Government's view that management of the existing debt problem is a matter for the banks, lending by the IFIs has increased over recent years, so in effect the taxpayer is presumably paying?

12. Why should we expect the banks to undertake new lending when past loans are trading in the secondary market at a big discount?

13. We frequently suggest that the debtor countries should put their own houses in order. But how can they do so in a time of high real interest rates worldwide?

14. Do the unresolved debt problems pose a greater threat to the world economic system than the other strains it is facing eg global imbalances, US deficit?

The last question may lead into some discussion of the US situation.

FROM: HUW EVANS
DATE: 26 JUNE 1989
EXT: 4430

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Mr Wicks
Mr Odling-Smee
Mr Mountfield
Mr Walsh
Miss J Simpson
Mr Tarkowski
Mr Tyrie

Ch / OK?

26/6

TCSC ON DEBT

Mr Mountfield, Mr Walsh and I are giving evidence on Wednesday. With the object of presenting the UK role as positive and constructive, I propose to take the following line:

(i) debt strategy continues to evolve as circumstances change, and as it becomes even clearer that for many countries getting back to creditworthiness is a long slow haul;

(ii) we support the strengthening of the debt strategy this year, by addition of IFI supported funds for debt reduction, as agreed by Fund and Bank boards in recent weeks. Any further proposals for more funds for debt reduction are counterproductive, because they discourage banks and debtors from concluding deals now; [if needed: that is why the UK pressed hard in the boards for resources to be clearly limited and conditions imposed].

(iii) negotiations on debt reduction are a matter between the commercial banks and the debtors. It is the policy of the Government <u>not</u> to put pressure on banks in these negotiations;

(iv) we are also pressing the case, now that the systemic threat to the banking system has been averted, for limiting the transfer of risk to the public sector;

(v) G7 economic performance since 1982 has been strong, and in many ways helpful to debtors. World interest rates are currently, in real terms, close to their 1984-88 average ie not excessive: reducing the US fiscal deficit would help to ease pressures.

2. The preliminary list of questions (attached to Miss Simpson's minute of 23 June to me) is familiar stuff. I attach draft answers to four questions, which you may like to see.

behind

3. Questions on banks' provisioning will be primarily for the Bank of England to answer. They are scheduled to appear a week after us, and are currently finalising a memorandum setting out their line on provisioning: that the matrix methodology can be applied to countries involved in debt reduction. The Bank will not give a view (nor will we) on whether the average level of provisioning (identified currently as about 35 per cent) is adequate.

4. I should be grateful for any comment on the line to take.

HPE.

H P EVANS

QUESTIONS FOR TCSC HEARING ON INTERNATIONAL DEBT

Q11. To what extent should the taxpayer help out in the debt situation? Despite the Government's view that management of the existing debt problem is a matter for the banks, lending by the IFIs has increased over recent years, so in effect the taxpayer is presumably paying?

A. Governments are already playing a substantial role in the debt situation:

- IMF
- World Bank
- Paris Club

all with the backing, implicit or explicit, of the taxpayer.

UK, and UK taxpayer, has interests in: avoiding systemic risks to the banking system; and promoting the economic development of debtor countries so that they can regain creditworthiness.

Management of debt problems is a matter for <u>all</u> the creditors and the debtors, not merely the commercial banks. But the majority of debt is owed to the banks; see table on page 9 of HMT memorandum. Now that the systemic threat to the banking system has been averted, there is no longer any systemic reason for the public sector to take a disproportionate share of lending.

Q. Will the Brady plan work?

A. This will depend mainly on the sustained implementation of economic reform plans in the debtor countries. Familiar requirements: cutting fiscal deficits, getting real interest rates positive, realistic exchange rates, structural reforms, including trade liberalisation, cutting public expenditure and state enterprises, encouraging private sector investment and saving.

Case by case; no quick solutions; but strengthened debt strategy is the best chance of getting countries back on the road to creditworthiness. G7 countries will continue to do what they can to promote strong, non inflationary growth in a context of open markets.

Q9. HMT's memorandum suggests that "the risk of a systemic failure" of the banking system has been averted. Page 13 of the G10 Deputies paper seems less certain of this. If one bank did collapse, what would be the consequences for the system?

A. The G10 report is conservative in its assessment that systemic risk has been "substantially reduced". Commercial banks' capital ratios and provisioning have been solidly reinforced since the onset of major debt problems in 1982. It would take a default by a number of debtors together to cause a major problem that might lead to the potential collapse of a US bank, although US banks have other possible sources of default as well as international debt. The collapse of a British bank for debt reasons is highly unlikely. (Further questions on this subject should be addressed to the Bank of England when they appear before the Committee next week).

Q12. Why should we expect the banks to undertake new lending when past loans are trading in the secondary market at a big discount?

A. Past loans to major debtors have been trading on the secondary market at a substantial discount for some time. But this has not prevented the banks making new money available to major debtors. The Brazilian commercial bank package of 1988 provided for $5.2 billion of new money when Brazilian debt was trading at slightly above 31 and the Mexican package of 1987 involved $5 billion when Mexican debt was trading at about 58. The broadening of the participants' menu has meant that banks have been able to participate in packages in a number of ways. Those with a continuing interest in a major debtor may well wish to provide new money to maintain a banking relationship as well as to protect existing exposure. Some banks have expressed the view in future that their new lending - outside trade lines will - largely take the form of project finance rather than balance of payments support.