PO-CH/116/0362 PART D

Part. D.

SECRET

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Begins: 27/9/88.
Ends: 28/9/88.

PO -CH /NL/0362
PART D

Chancellor's (Lawson) Papers:

PROPOSALS TO JOIN THE
EXCHANGE RATE MECHANISM

DD's: 25 Years.

24/11/95.

PO -CH /NL/0362
PART D

Thanks. Interesting but flawed. There is an implicit assumption either that severe/sudden pressure is significantly more likely to occur if we are in the ERM than if we are not, or that if it were to occur outside the ERM we would not need to raise interest rates (or we'd need to do so significantly less) — or possibly both. This is not demonstrated.

SECRET

FROM: F CASSELL
1 November 1985

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Sedgwick
Mr Peretz
Mr Fitchew
Mr Kelly
Mr H Davies

Ch

There is some interesting information here, of the sort you have been asking for. Background also to your breakfast meeting before the PM's Seminar. Not very jolly reading and at times overdrawn in places. (P. Sedgwick – the principal author – has at the discretion end of the spectrum; [illegible] of [illegible] ERM) KL 1/11

COPING WITH PRESSURES ON STERLING IN THE ERM

A few of us here, with help from the Bank, have been looking at some of the operational implications of managing sterling within the ERM. Given the sensitivity of the subject, we have not been able to consult very widely, and we will need to carry this work further when we can. However, I thought it might be useful to let you see at this stage the attached paper by FEU, which sets out the results of the work to date.

2. The paper looks first at the potential pressures that could be put on sterling, then at the experience of other countries within the ERM, and finally at how we might ourselves have to operate if sterling came under pressure.

3. I do not think the findings are in any way surprising. If sterling did come under pressure intervention would be of very limited use. The main action available to us would be to raise interest rates. If we found ourselves in a situation where the market thought that we would have to realign in the fairly near future the pressures that could be imposed on sterling would be so great that we would have to move interest rates very rapidly indeed. The Bank would have to adjust its bill dealing rates almost automatically, and the increases in money market rates would be reflected very quickly in bank base rates.

however, and I find it unconvincing.

N.

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If this can be done, it wd surely be done first

4. In some circumstances - for example if a substantial rise in base rates did not immediately relieve the pressures - there could be great attraction in concentrating a further rise on the very shortest rates, as some other ERM members seem to have achieved. The institutional arrangements of the London money market, however, make it unlikely that we could in fact confine the rise in rates in this way. In any case, the arithmetic calculations of what very short rates would need to be to neutralise the incentive to sell sterling at critical moments are probably much less important in practice than the symbolic effect of the change in interest rates. Allowing base rates to rise would be regarded in the markets as the test of the Government's resolve to do whatever is necessary to hold the parity.

5. If the doubts about sterling stemmed from worries about domestic policy, even a sharp rise in base rates might be seen merely as a holding operation, while a tightening of fiscal stance was brought about. In fact of course such a tightening would be difficult to implement - which underlines the main message of the paper that it would be essential to convince the markets from the start that the basic stance of our policies was right.

6. The analysis we have been able to do suggests that initially we would have to be prepared to use interest rates very vigorously indeed as part of the process of satisfying the markets of our resolve. The readiness to act in this way would be a condition for establishing the credibility that, in time, would enable us to secure lower interest rates than we would have outside the EMR. It also suggests that in this new regime the Bank would seek considerable latitude for their day-to-day market operations.

a clear downside risk

F CASSELL

COPING WITH EXCHANGE RATE PRESSURES WITHIN THE ERM

This note considers some potential operational implications of UK membership of the ERM, and in particular what response the UK authorities ought to, or could, make in periods (perhaps prolonged) of downward pressure on sterling. It does not directly consider the operational implications of significant upward pressure on sterling if it were in the ERM.

2. The note is divided into three sections. Section I sets out some relevant background information on the potential scope for flows out of sterling in the event of a loss of confidence. It then considers the likely effectiveness of exchange market intervention in the event of significant pressure on sterling. Section II briefly examines how the present ERM members have operated policy in the face of exchange market pressures. It summarises work we have carried out on exchange rate and interest rate behaviour in the main existing ERM countries. This work (which is described in greater detail in a separate note available on request) has concentrated on the pattern of events and the operation of policy during past exchange rate crises. Section III considers the potential implications of ERM membership for the operation of UK monetary policy - and in particular for interest rate policy - if there were to be significant downward pressure on the exchange rate.

I Potential flows out of sterling and the role of intervention

3. If sterling was in the ERM and came under severe selling pressure, the flows out of sterling that the UK authorities would be required to offset would be potentially vast. Under current arrangements with no controls on capital movements into or out of the UK, a large proportion of the stocks of sterling-denominated assets could potentially be sold, whether they were held by UK residents or non-residents, and whether

deposited inside or outside the UK. Table 1 gives data on the relevant sterling deposits. These sterling deposits, many of which could relatively quickly and easily be switched into another currency, have increased very significantly both in nominal and in real terms since sterling last operated under a fixed exchange rate regime - the Bretton Woods system up to 1971 and in the snake briefly in 1972. There could be substantial outflows in addition to those from switching of these balances; for instance as a result of leading and lagging of commercial payments. The scope for selling pressure against sterling is obviously great.

4. Some existing ERM members have had on occasions to cope with severe downward pressures on their ERM parities. Many of them have operated policy within a framework that included exchange controls. None of their currencies except the DM, and to a lesser extent the French franc, is traded internationally on any significant scale.

5. Reimposition of exchange controls is neither a desirable nor a feasible option for the UK. It would run directly counter to the UK government's general approach to economic policy of allowing markets to work freely. It would also run against the trend worldwide towards freer capital flows. (There have been recent moves to liberalise capital flows even in some existing ERM countries such as France and Italy. More recently EC Finance Ministers decided to allow free operation of unit trusts throughout the Community.) But most important of all, exchange controls would almost certainly have only a modest - and at the most very short-term - effect in staunching capital outflows in today's highly sophisticated and integrated financial markets.

6. Even to achieve this modest short-term effect exchange controls would have to be drawn wider than those the UK had in place up to 1979, which applied primarily to UK <u>residents</u>. As Table 1 shows, there is a very large stock of sterling balances held in London by <u>non-residents</u>. These balances are now much higher as a percentage of GDP than in the early 1970s

TABLE 1 : STERLING & FOREIGN CURRENCY LIABILITIES OF UK BANKS AND STERLING LIABILITIES HELD OFF-SHORE

	UK Banks'(1) £ and FC Liabilities				Off-shore Liabilities(2)
	To residents		To non-residents		
$ billion End period	£M3	Foreign Currency	Sterling	Foreign Currency	Total Sterling
1963	31	0.3	4.9	3.6	
1970	41	1.2	5.3	36.1	
1971	50	1.1	8.0	44.3	
1972	58	1.9	7.2	59.3	
1973	73	3.3	7.7	90.1	
1974	81	5.6	9.5	112.4	
1975	74	5.9	9.2	128.2	
1976	68	6.6	7.1	148.6	
1977	84	8.0	11.1	171.4	10.4
1978	103	10.2	11.9	213.4	11.4
1979	127	11.2	19.2	282.8	17.1
1980	162	14.3	27.7	347.6	27.0
1981	162	19.1	27.9	420.6	23.5
1982	149	21.1	30.9	455.9	19.4
1983	148	24.3	34.3	480.9	17.4
1984	130	24.8	34.8	496.7	19.0
1983 Q1	140	21.1	31.0	470.3	
Q2	150	21.1	32.9	465.7	
Q3	148	21.8	33.1	477.8	
Q4	148	24.3	34.3	480.9	
1984 Q1	148	25.5	36.3	498.8	
Q2	143	22.8	37.0	505.9	
Q3	135	22.2	36.0	495.4	
Q4	130	24.8	34.8	496.7	
1985 Q1	143	22.4	42.4	505.4	
Q2	153	25.9			

1. The UK monetary sector, comprising the UK offices of all recognised banks and LDTs, the National Girobank, the TSBs, the banking department of the Bank of England, and certain institutions in the Channel Islands and Isle of Man.

2. The data include sterling liabilities held within the BIS reporting system (excluding the UK). This includes seventeen major countries and seven 'off-shore' money centres. These liabilities are reported 'gross' ie they do not net out interbank deposits.

when the Bretton Woods fixed exchange rate system collapsed. Much of the increase in them has taken place since 1979. (They have more than doubled, as a proportion of GDP, since 1979.) Table 2 shows they are now on a scale not matched elsewhere in the major ERM countries*, even in Germany. This reflects London's importance as an international financial centre. If exchange controls extended to non-resident onshore deposits, this would of course lead to a major decline in the role of London as an international centre. Even this would not give comprehensive protection to the exchange rate. There are substantial gross stocks of sterling deposits held offshore in the Euro markets which could easily be mobilised in the event of a run on sterling. Reimposition of exchange controls in any form in order to strengthen the UK's ability to resist potential exchange rate pressures of the sort discussed in this note is therefore not an option.

7. There are clearly limits to the extent to which intervention could be used to resist major pressures. Our total foreign currency reserves at present stand at only the equivalent of $10½ billion (measured at current exchange rates) including ECUs. These reserves, it is true, would be buttressed by access to the Community support facilities. In certain circumstances we would be able to draw on the Very Short-Term Financing Facility (VSTF). Under the VSTF other European Central Banks would be obliged to provide us with unlimited credit facilities in their own currencies for settlement 45 days after the end of the month in which intervention took place. (The settlement date can be extended automatically by 3 months, subject to certain limitations and by another 3 months, subject to the agreement of the creditor Central Bank.) But this facility is only available for intervention <u>at the margin</u> of the permitted exchange rate fluctuations. In recent years most ERM intervention has taken place before the absolute margins are reached, in an attempt to nip any potentially harmful movements in the bud. So the VSTF has in practice been of relatively limited use.

8. To supplement our own reserves we would therefore probably

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*Some of the smaller countries also have significant non-resident deposits in relation to GDP but this may mainly reflect the particular openness of these economies.

TABLE 2 : DOMESTIC CURRENCY LIABILITIES TO NON-RESIDENTS OF BANKS IN:

	UK		GERMANY		FRANCE		ITALY		NETHERLANDS		BELGIUM		DENMARK		IRELAND		EMBOURG	
	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP	$bn	% of GNP
1973	6.2	3.6	9.1	2.7	4.5	1.9	1.8	1.2										
1974	7.7	3.9	11.3	2.6	3.7	1.3	1.3	0.8										
	9.5	4.6																
1975	9.2	4.3	13.6	3.5	4.4	1.4	1.6	0.9										
1976	7.1	3.3	17.4	3.7	3.8	1.1	1.4	0.8										
1977	11.1	4.0	24.3	4.3	4.2	1.1	1.5	0.7										
1978	12.0	3.5	40.2	5.7	5.7	1.2	2.0	0.8										
1979	19.2	4.4	54.3	6.8	6.6	1.1	2.9	0.9										
1980	27.7	5.1	50.7	6.7	8.6	1.3	2.9	0.7										
1981	26.9	5.6(a)	44.0	6.4	6.6	1.2	2.2	0.6	11.3	8.0	5.6	5.7	0.5	0.9	1.9	10.6	0.7	13.5
	27.9	5.8(b)																
1982	30.9	6.9	42.1	6.2	5.3	1.0	2.5	0.7	11.5	8.4	5.4	6.3	0.6	1.1	2.0	10.8	0.8	15.9
1983	34.3	7.8	36.4	5.9	5.9	1.1	2.3	0.6	8.9	6.7	4.8	5.9	0.6	1.1	1.7	9.4	0.8	17.0
1984	34.8	9.6	34.5	6.2	7.1	1.4	2.2	0.6	8.1	6.6	5.3	6.8	0.6	1.1	1.7	N/A	0.9	N/A
1985 Q1	42.4	10.7	33.5	5.9	7.0	1.4	2.6	0.7										

Source : BIS Various publications; latest data from "International Banking Developments - first quarter 1985" press release 31 July 1985.

(a) this figure and those for earlier years are for the old banking sector.

(b) this figure and those for subsequent years are for the new monetary sector.

(c) Break in UK series at March 1983 due to increased institutional coverage added $2.6 billion

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have to rely on the existing $3 billion swap facility with the New York Fed or on any new special bilateral facility it was possible to negotiate with the Bundesbank.

9. Furthermore, intervention cannot be seen as an alternative to raising interest rates. To be effective in countering selling pressure, it would have to be unsterilized, which means that it would induce sterling interest rates to rise almost immediately.* In practice therefore short term interest rate policy would be crucial in any attempt to resist downward pressure on ERM parities.

II Reactions of current ERM members to exchange rate pressures**

10. Analysis of previous periods of strain up to 1983 within the ERM reveals very diverse circumstances. Table 3 summarises the principal developments during these crises and in particular summarises the interest rate responses and the extent of intervention.

11. In some instances there was no response by the weak currency country to exchange rate pressures; in others there was both heavy intervention and significant rises in interest rates.

12. In most cases of exchange rate pressure foreign exchange intervention was usually undertaken, but on a very substantial scale only when the weak currency approached its lower divergence limit. On two occasions at least $5 billion was spent over a period of a month or so. In practice the main onus for intervention was placed squarely on the weak currency country; in only one case, in the early months of the ERM, did the strong currency country (Germany) intervene on a scale that came close to matching that by the weak currency country.

13. In some instances also interest rates were raised to protect ERM parities. In the first two years of the ERM, interest rate policy was restricted mainly to raising discount rates by a few percentage points. From mid-1981 onwards the emphasis

*Unsterilized intervention can be regarded as the combination of (i) sterilized intervention, and (ii) creation of a money market shortage that puts upward pressure on interest rates.

**The experience of existing ERM members during periods of significant pressure on parities are assessed in a separate note that is available on request.

TABLE 3 : EMS periods of strain(1) involving 5 major ERM countries

Bold entries indicate a realignment followed the period of strain.

Period	Country	Principal identified Source of strain	Intervention(2) ($ million)	Monetary policy	Offshore Interest rates(3) Max. level	'Normal' level
May-June 1979	Belgium	Continued lack of confidence	1200	DR (Discount rate) from 6% to 9%	10	5
Aug-Sept 1979	**Belgium**	**Capital inflows dry up**	**1150**	**DR from 9% to 10%**	**12**	**10**
Dec 1979 -Mar 1980	Belgium	Deficient capital inflow to finance current account deficit	2500	DR from 10% to 14%	16	12
Oct 1980	Germany	Weak current account and interest rates too low	1200	Slight tightening of credit market	9	8½
Feb 1981	Germany	Increased uncertainty about economic position; US interest rates surge	1700	Special Lombard rate; substantial tightening of policy	13	8¾
March 1981	**Belgium**	**DM firming**	**900 before 1500 after**	**DR from 12% to 16%**	**12½**	**8-11**
	Italy		**1900 before 1100 after**	**DR from 16½% to 19%**	**18**	**12**
May 1981	France	Presidential election	5900	Interest rate and exchange control measures	25	11½
Aug-Sept 1981	**France Belgium**	**DM rises against $ on improving external performance**	**3900 1900**		**57 14**	**18 13**
Nov 1981	Belgium	Negotiations for new govt. breakdown	800	DR from 13% to 15%	14	14
Feb 1982	**Belgium**	**Diminishing confidence in economy**	**500**		**14**	**14**
March 1982	France	Widening inflation differential with Germany	2200	Tightening monetary policy, exchange controls	50	14
May-June 1982	**France Belgium Italy**	**"The weekend syndrome": pressure late in the week on realignment rumours**	**3300 700 400**		**50 14½ 27**	**16 14 17**
Dec 1982 -Mar 1983	**France Belgium**	**Deteriorating trade balance, and inflation**	**8900 3100**	**Interest rate measures; emergency exchange controls**	**400 75**	**13 12**

(1) Adapted from Table 1 of IMF Occasional Paper No. 19

(2) Total intervention in all currencies ($ million equivalent) in the period of strain.

(3) 2-day Euro-currency rates. The 'normal' level is the average for a period of stability (usually two weeks) preceding the period of strain.

changed to action in the Euro-markets. France and Italy (and on one occasion Belgium) carried out 'bear squeezes' on off-shore speculators. Experience within the ERM during this period suggests that if the market believed there was a high probability of a devaluation in the coming days or weeks, very short term interest rates had to rise dramatically to maintain ERM parities. On one occasion, in the face of strong pressures in March 1983 the French found it necessary to drive very short Euro-franc interest rates above 1000 per cent for one day (and reports suggest at times during the day they rose as high as 5000 per cent). However, this instance is very much the exception. On a few other occasions, 2-day Euro-currency rates rose substantially. In some instances the interest rate rises were immediately followed by a realignment. In other instances the interest rate rises were enough to stave off immediate pressure, although usually the pressure reappeared a few months later. 2-day Euro-Belgian franc rates reached 75 per cent on one day in March 1983; Euro-lira rates hit 200 per cent at the same time, and 100 per cent in September 1981; and Euro-French franc and Euro-lira rates on four other occasions in 1981 and 1982 rose to around 50-70 per cent. But there is only the one instance of rates rising even close to 4-digits. On all occasions rates were only kept much higher than normal for a few days at most.

14. To put these interest rate levels into perspective, in recent years the highest level reached by UK domestic interest rates was 90 per cent for overnight rates in June 1980, and for 7-day rates 23 per cent in January 1980 due to acute money market shortages. These were isolated incidents.

15. In all the instances of large increases in Euro-market interest rates for ERM currencies the domestic authorities were able to insulate the onshore markets from these temporary pressures in the offshore markets. Movements in Euro-franc rates were not transmitted fully to domestic interest rates because exchange controls drove a temporary wedge* between the two markets. A number of ERM members have extensive exchange

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*It is likely that, if the French authorities had attempted to maintain a differential between the two markets on this scale for any length of time, francs on the domestic market would have somehow found their way into the offshore market.

controls and relatively smaller non-resident balances than the UK. Isolating the domestic and offshore markets in this way is not an option for the UK.

16. The experience of the present ERM countries when facing pressure on their parities cannot be a reliable guide to how sterling might fare in the ERM. There are important differences between these countries' financial markets and institutional arrangements, and Britain's. More importantly many of the exchange rate pressures arose because domestic macroeconomic policies were not tied in closely enough to those in Germany. It is notable that the Netherlands has successfully avoided serious exchange rate pressures within the ERM (despite its position as an energy producer) by adjusting its domestic policies accordingly. In the 6½ years of the EMS, it has realigned only twice against the DM, in both instances as part of an overall package, and in neither case as a result of serious pressure aimed specifically at the guilder.

III <u>The operation of domestic monetary policy</u>

17. The experience of the Netherlands suggests that if the UK joined the ERM it would be absolutely essential to run domestic policy so as to minimize the risk of sterling crises emerging. In particular it would be necessary to avoid giving any grounds for doubts about the UK authorities' policy stance.

18. But whether or not such 'crises' occurred would in part depend on the precise aims of policy. For instance if the aim were to maintain the £/DM rate for some time - say two years or so - the UK would be judged against Germany's very impressive counter-inflationary record. It would therefore be essential to assure financial markets that UK macroeconomic policy would be kept closely in line with that of Germany. In practice this could mean that interest rates along the short-term yield curve would be kept, for sustained periods, higher than those strictly necessary to meet our current aspirations on inflation or money GDP as set out, for example, in the 1985 MTFS. This would probably be necessary initially

This seems a bit strong — & implicitly argues that we <u>would</u> need to change our policy to stay with the DM for any length of time

This should be kept away from No 10!

to establish the credibility of our commitment to the ERM, though once that credibility had been established interest rates on average might be lower.

19. If, alternatively, the aim were to maintain broadly the same reduction in inflation as set out in recent MTFS's this could involve some divergence from German performance which in turn might entail some occasional depreciation against the DM - though probably not the ECU. Such 'adjustments' of ERM parities might not always come about at a time and in a manner of our choosing. Keeping in the ERM when such realignments were expected could involve some drastic - though probably temporary - measures until the required realignment conference with ERM partners took place.

20. Even if the authorities succeeded in avoiding domestically-generated shocks to confidence there could still be occasions (such as a fall in the oil price) when severe pressure against sterling could build up quickly. Sterling is likely to be more exposed to such shocks within the ERM than, for example, the Dutch guilder because of its position as an international currency. The UK authorities' response in these circumstances would depend in part on their assessment of the nature of the pressures on the exchange rate. If they were expected to be fairly long-lived, such as continued weakness in oil demand, the authorities might decide that the appropriate course was to realign. However, if it were thought possible that the pressures would be temporary or if a devaluation would run counter to the aims on inflation, the Government would presumably seek to maintain the existing ERM parity. They would then have little option but to engineer an immediate increase in interest rates. The hope would be that a sharp rise in rates, similar in size to past rises in the face of exchange rate pressures - say of 3-4 percentage points - would be sufficient to ease pressure on sterling.

21. Such action on interest rates would have to be prompt because the current option of taking some of the initial

pressure on the exchange rate would not be available in the ERM. The Bank of England would have to be very quick to raise its dealing rates in line with a rise in market rates - indeed the response would probably, in contrast to current practice, need to be more or less automatic - and to see this rise reflected in base rates. The Bank might also on occasion have to lead the market upwards in order to establish confidence, possibly by the most visible form of action - the temporary reinstatement of MLR. It would probably be the increases in base rates that would do most to reestablish confidence in sterling - because they would be taken as demonstrating that the Government was prepared to take whatever action was necessary in order to maintain the ERM parity. Since bank base rates are most strongly influenced by interbank rates in the 1-3 month maturity range, the authorities would have to be prepared to see higher rates spread sufficiently far along the short term yield curve.

22. There might be occasions when for a short period at least very short term interest rates might have to rise by more than envisaged in the preceding paragraphs. Such larger rises might be necessary <u>either</u> if the Government's policy measures (including a rise in interest rates on the scale discussed above) did not at first convince markets of its determination to hold the ERM parity and stronger measures (on a temporary basis) were needed to convince markets, <u>or</u> if the Government thought that a realignment was consistent with its inflation aims, but wished to prevent an exchange rate fall until one had been agreed at a realignment conference. These are of course two very different sets of circumstances, but for a limited period the behaviour of domestic interest rates could be similar.

23. In both circumstances speculators would be taking up positions against sterling. Selling pressure against sterling would be manifested in the domestic money markets by rises in short-term interest rates. If the market took the view that sterling might be devalued at some time over the next few weeks, this would put pressure on domestic interest rates some distance along the short-term yield curve - up to 1 month or beyond.

24. For technical reasons, however, overnight rates might not rise by much, if at all. Since spot foreign exchange transactions are normally for delivery two business days hence, speculators against sterling would not be seeking overnight loans: the main direct pressure would be concentrated at 3-days maturities. The yield curve might of course rise beyond that point especially if there was uncertainty in the market about the exact timing of the expected realignment.

25. The UK authorities would have to allow very short rates to rise if they wanted to maintain, even temporarily, the ERM parity. They might even have to take measures to raise very short term interest rates even higher in order to deter speculators from taking up positions against sterling. To do this they would have to under-assist the market. (If by chance there were no shortage on the day in question they would have to engineer one.) It is worth considering what would be the necessary scale of interest rate rises - of a purely temporary nature - in order to maintain ERM parities over an assumed few critical days of strain.

26. As a <u>purely mechanical</u> calculation, even if the market thought there was only a 10 per cent chance of a 5 per cent devaluation occurring over a particular weekend, very short domestic interest rates would have to rise by over 80 per cent* (at an annual rate) - eg from, say, 10 per cent to 90 per cent - to offset the incentive to sell sterling. In practice the very act of allowing domestic rates to rise further by a substantial amount would probably restore confidence, so that interest rates would not have to rise to anything like the levels indicated in this stylised calculation (though as pointed out in paragraph 14 such very short rates are not without precedent in the UK). Nevertheless some sharp increases could not be avoided. For the UK (unlike other ERM countries), however, these increases would not be confined to Euro-market interest rates. The high degree of integration of UK onshore and offshore markets would prevent the authorities from driving a temporary wedge between the two markets. The possible size of the interest rate increases necessary to counter selling pressure on sterling raise the immediate question of how far these are feasible.

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*If the market expected an overnight devaluation during the week, interest rates would have to rise by even more, because weekend interest rates implicitly incorporate interest payments for <u>three</u> days.

27. On past experience in the ERM, to staunch selling pressure against sterling, very short rates might have to rise to around the 50 per cent level observed on a few occasions (though certainly not to the exceptional heights of 1000 per cent experienced by Euro-franc rates). However, there is a real possibility that even temporary phases of rates at this level would have such adverse domestic consequences, particularly if base rates reacted quickly and by large amounts, that this course of action might not be open to us. It would only be possible to raise very short rates to these sorts of levels if we could ensure that intervention in domestic money markets primarily influenced very short term market rates, and therefore did not raise base rates to anything like the same degree. Operating procedures would probably have to be modified to try to limit the influence further out along the yield curve as far as possible.

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How?

28. However, it would certainly not be feasible to maintain even the very short rates at high levels for more than a few days without the effects spreading along the yield curve to the longer maturities. If the tactic of maintaining very high short-term interest rates during those days of very heavy exchange rate pressure was ruled out as too damaging, we would have in practice to bow to such pressures and either realign instantly or drop out of the ERM temporarily.

Conclusion

29. The experience of the ERM suggests that the prudent operation of policy, eg as in the Netherlands, can avoid major pressures. But for the reasons set out in paragraphs 20-22 it is not possible to rule out altogether the possibility that such pressures could arise in the UK. It seems likely that the UK authorities would have to be prepared to face these pressures at some stage if sterling joined the ERM.

FEU
1 NOVEMBER 1985

LR2.3 SECRET

pmp.

FROM: MRS R LOMAX
DATE: 4 November 1985

MR CASSELL

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Sedgwick
Mr Peretz
Mr Fitchew
Mr C Kelly
Mr H Davies

COPING WITH PRESSURES ON STERLING IN THE ERM

The Chancellor was grateful for your minute of 1 November and the attached paper by FEU. He found the analysis interesting but flawed. He has commented that there is an implicit assumption either that sudden severe pressure on sterling is significantly more likely to occur if we are in the ERM than if we are not, or that if it were to occur outside the ERM we would not need to raise interest rates (or would need to do so significantly less) - and probably both. He has noted that this is not demonstrated, and he finds it unconvincing. On your paragraph 4, he has also commented that if we can concentrate a further rise on very short term rates we should surely do this before a substantial rise in base rates, rather than after.

2. The Chancellor may want to discuss these points further at his briefing meeting on Friday afternoon.

RL.

RACHEL LOMAX

Ch.

You wanted to brief yourself & the Governor on "technical issues" before the PM's seminar.

Frank Cassell's note (& his reply to your comments on it) are a convenient peg. The note was not copied to the Bank, but it was produced after discussions with them.

RL 7/11

I accept Frank's 2nd pt (paras 6 & 7). But I remain wholly unconvinced by the first. The Bretton Woods analogy is false, since really big speculative movements involved the $, which was outside the system (hence no pair of any shares will take on DM/$ changes),

△ decline after 28 Jan (nor necessarily, & certainly until [illegible]) would not have been at [illegible] [illegible] within the ERM [illegible] have been no [illegible]

FROM: F CASSELL
6 November 1985

Ch/ a reply to your comment on Frank's earlier paper, which you haven't yet seen. RL 7/11

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr C Kelly
Mr H Davies

COPING WITH PRESSURES ON STERLING IN THE ERM

1. You commented on the FEU paper I sent you on 1 November that it implicity assumed that sudden severe pressure on sterling is more likely to occur if we are in the ERM than if we are not or that if it were to occur outside the ERM we would not need to raise interest rates (or would need to do so significantly less). The analysis in the paper was of course concerned with reactions _if_ sterling came under pressure; on the likelihood of such pressure occurring its general assumption seems to me in tune with the answer to Q11. of the questionnaire - that though joining ERM would probably not in itself generate turbulence, speculators would no doubt take an early opportunity to test the £/DM rate.

2. Obviously, sterling can come under pressure outside the ERM, and interest rates would have to be raised. The technical difference that the ERM makes is that it leaves little, if any, scope for taking part of the strain on the exchange rate.

3. Speculators will see themselves as having effectively a one-way option (as under Bretton Woods). This is likely both to increase the scale of speculation (until the Government has convinced the markets of its determination to hold the rate) and to make the rise in interest rates more immediate, and probably also sharper, than under the present system. The difference is one of degree, but significant.

4. In recent episodes of pressure on sterling the fall in the exchange rate has not always been immediately halted when interest rates rose. Last January, for example, short-term interest rates reached their peak on 28 January, but the sterling index did not reach its low point until 26 February. The decline over this period was not very great - 0.4 per cent - and did not seriously make us feel that we would have to raise interest rates further. If we had been in the ERM and sterling had already reached its lower limit we would have had to act to prevent the further decline in the rate.

Not so: it would not have fallen further.

5. The bull point for ERM membership is that by compelling interest rates to rise earlier it might have reduced (or even avoided) the acute pressures of January. It is far from clear, however, that the overall rise in interest rates would have been significantly less, or that we could subsequently have brought them down faster. The experience of other countries reported in the FEU paper is that higher interest rates generally have to be sustained for some time.

6. This bears on your second comment that "if we can concentrate a further rise on very short-term rates we should surely do this <u>before</u> a substantial rise in base rates, rather than after". I doubt whether in practice we would have this choice. In the circumstances envisaged the first requirement would be to establish the credibility of policy. Even if it were technically possible to raise very short rates to the sort of levels that made it unprofitable to sell sterling, it is difficult to believe that this would not quickly raise rates further along the yield curve and so raise bank base rates. If it were thought that our tactics were designed to avoid the rise in base rates then the problem of re-establishing credibility would be very difficult indeed.

That's the point

7. As I said in the covering note, allowing base rates to rise would be regarded in the markets as the test of the Government's resolve to do whatever is necessary to hold the

parity. Having done that, if the pressures on sterling were not immediately relieved, there could certainly be a case for seeking to push very short rates higher - but for this to be effective it would have to take place after, not before, a substantial rise in base rates.

F CASSELL

Permanent Secretary
H M TREASURY

Chancellor

EMS

Attached is

(a) a note from me which I hope will help you with your note for the meeting on Wednesday.

(b) a draft note by Mr Fitchew which could be annexed to it.

(c) a further note by Mr Fitchew on logistics

[illegible] 7/11.

156/25

SECRET

FROM: G E FITCHEW
DATE: 8 NOVEMBER 1985

1. SIR P MIDDLETON
2. MRS LOMAX

cc PS/Economic Secretary
Sir G Littler
Sir T Burns
Mr Cassell
Mr Sedgwick
Mr Peretz
Mr H Davies

ERM: DRAFT PAPER FOR OTHER MINISTERS

As requested, I attach a redraft of the paper to be circulated to other Ministers for the seminar. As I understand it this is to be in the form of an annex to a covering note by the Chancellor.

2. The redraft takes account of the Chancellor's comments on the earlier version. Mrs Lomax tells me that it is still not certain whether the questions and answers will be circulated to the other Ministers. The redraft therefore still assumes that ~~it~~ they will not be. If the questions and answers are circulated, the redraft could be cut down further by incorporating the gist of the "Recent Developments" section into the "Arguments in Favour" section.

3. Mr Sedgwick is checking to see what figures can be put into paragraph 23 for the unit labour costs comparison. But there may not be anything suitable for the Community average and the comparison may have to be with Germany instead.

G E FITCHEW

Of course if the Q+A is not circulated we need to add charts 2+3 from the Q+A to this document

Past UK Attitude

8. The public stance of the UK Government has consistently been that sterling would join the ERM when the time was right. Answering Dr Owen on 31 January this year in the House of Commons, the Prime Minister said :-

> "We have always said that we shall join the exchange rate mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

9. In the past the main reasons why ERM membership has been considered inappropriate are :-

- The market perception of sterling as a petro-currency - which meant that oil price changes would affect sterling in the opposite way to other ERM currencies;

- The risk of a substantial rise in the DM against sterling and other ERM currencies as the dollar falls;

- The gap between the UK performance and that of other ERM currencies on costs and inflation. (In the last quarter of 1979 consumer prices in the UK were rising at 15% per annum compared with 8% in ERM countries).

The concern has been that each of these three factors could give rise to large flows between sterling and the DM, since both currencies are widely held and traded and there are no barriers to capital movement between them.

10. Moreover, the Government's policy for reducing inflation has been centred on the framework of monetary targets set out in the Medium Term Financial Strategy. And it was widely argued, that,

given this framework, an explicit exchange rate target was unnecessary.

11. The following sections re-examine these issues in the light of recent developments, particularly in the evolution of monetary policy.

Recent Developments in Monetary Policy (Paras 14-16 need to be much changed to A to Q 21 in Q+A)

low and

12. Inflation in Britain is now falling again. The forecast is that the rate of increase in the consumer prices will be falling towards 5 per cent by the end of this year and by the middle of next year to 3¾ per cent, compared with 3 per cent for the average of other EMS countries (though % for Germany). There has thus been a considerable improvement in our comparative performance.

13. Over the past two years or so - despite some short-term volatility - there has been no downward trend in either the DM/£ or ECU/£ exchange rates (see chart attached). More recently, since the G5 agreement of 22 September, the pattern of our exchange rates has become more comfortable - some appreciation against the dollar being accompanied by an easing back against ERM currencies.

Over the past few years, however

14. In spite of these favourable developments there have been increasing difficulties over the operation and interpretation of the Government's financial strategy, in particular because the different target measures of the money supply are pointing in different directions. £M3 - the measure which in the public mind is most closely associated with the Medium Term Financial Strategy (MTFS) has been heavily affected by the far reaching liberalisation of financial markets and the rapid pace of innovation. In consequence its growth has been well above its target range. But none of the other aggregates now shown in the MTFS, such as MO, have proved satisfactory alternatives to £M3 as the main target aggregate. There can be no question of doing without the discipline of monetary targets. But the present money aggregates are now and prospectively

as a result of

which has affected £M3 in particular

a less reliable guide to the conduct of policy.

15. In these circumstances, increasing emphasis has had to be given to the exchange rate, (though this has always had an important role alongside other monetary indicators). While the exchange rate can be affected by external factors such as oil prices, in practice the ER it has had a good record of reflecting domestic monetary conditions in recent years. It has a direct impact on the price level and inflationary expectations, and sharp movements have generally coincided with changes in the market's perception of monetary ease or stringency.

Missing link: Effect of these developments on presentation of policy. Loss of clarity; Credibility problems. Consequences for interest rates

16. The Chancellor's Mansion House speech explained the difficulties in interpreting the monetary aggregates and why it was right not to seek to get the growth of £M3 back within the target range set in the Budget. The immediate market reaction to the speech has been good. But it has only provided a breathing space. The commentators continue to show a sense of unease that the framework for counter-inflationary policy established in the MTFS has been weakened by the absence of convincing and clearly defined targets for the monetary aggregates. They and the markets will be expecting more precise policy guidelines when the MTFS has to be updated at the time of the Budget. The arguments for and against ERM entry in this context have to be re-examined in this context.

Arguments in favour of ERM Membership

17. Given the developments described above, the arguments for joining the ERM now are that it :-

(take from annex to q 21 - end of (b) & beginning of (c))

- would reinforce the discipline of the MTFS and demonstrate to companies that they would not be bailed out from the effects of excessive wage increases by a depreciating exchange rate;

- would be a logical extension of our current financial strategy, but one which will enable the policy to be presented more clearly and convincingly;

- should in time, by the greater credibility it would give to the strategy, remove the premium built into current interest rate levels because of the uncertainties described in paragraphs 14-16 above.

18. Given the firmness of the exchange rate and the good prospects for inflation, we could now enter the ERM from a position of strength and with sufficient time before the next Election to secure understanding of the policy and establish our commitment to it.

Arguments Against

19. The main objection to entry is the doubt whether we can realistically expect to maintain our parity with the DM for the next two to three years - leastways without a tightening of policy that would increase unemployment. The three threats to our ability to do so are :-

- Flows out of sterling because of oil price weakness;

- Differential flows out of a declining dollar into the DM;

- the inflation differential between the UK and Germany and the relatively rapid growth in UK unit labour costs compared with the EC as a whole.

20. Sterling remains sensitive both to a further oil price weakening and in the longer-term to the decline of North Sea output. Market perception of sterling as a petro currency has always been exaggerated, however, and this is now being recognised. The real

oil price has already declined from its peak. The influence of oil price movements on sterling over the short-term has already diminished and will diminish further as oil production gradually declines. There may nonetheless be occasions when it will be appropriate to raise interest rates to resist short-term pressures on sterling away from the oil price factor. But this could happen whether sterling is within the ERM or outside.

21. Over the longer-run a gradual fall in the real exchange rate is likely to occur as part of the adjustment to lower oil output. The best way for this to come about would be through maintaining downward pressure on wage costs, which membership of the ERM would promote.

22. As noted in paragraph 12 above, the inflation differential between UK and the rest of the Community has been substantially reduced and should disappear by the middle of 1986. Matching German performance, which should be the objective in the long run, will be a stiff task. But this would not have to happen overnight. French experience since March 1983 suggests that a fixed parity with the DM can be sustained for a substantial period notwithstanding an inflation differential.

23. The rise in our unit labour costs (for manufacturing currently just over 6% pa in UK compared with a Community average of about 2 per cent) is a cause for serious concern because of the threat it presents to employment. The need to improve cost performance arises inside or outside the ERM. A main purpose of entry into the ERM would be to convince British wage bargainers of the need for this, by demonstrating that cost increases would not be accommodated into inflation through a depreciating exchange rate.

24. The main risk in joining the ERM arises not so much from the three factors described above in themselves as from the pressures that could be brought to bear on sterling in a very short time in a fixed exchange rate system, where the speculator believes he is presented with a one-way bet. The scale of potential outflows into and out of sterling is now very much larger than was the case in the early 1970s. Speculators must be expected to take an early

opportunity (such as a weakening of the oil price) to test the £/DM rate. Strong pressures on sterling could pose an unwelcome choice between :-

- devaluing;

- raising interest rates very sharply.

That choice, however, may in case have to be faced outside the ERM, particularly given the uncertainties surrounding the monetary aggregates. The difference is that within the ERM the choice would have a higher political profile. Moreover, the risks are ones which will continue for the foreseeable future, since the oil and dollar factors are unlikely to disappear in the short-term. The best defence against such risks is to run sound domestic policies aimed at bringing inflation down, which ERM membership would be intended to strengthen. The judgement to be made is therefore whether the longer-term risks are so fundamental as to offset the advantages of joining.

Adequacy of Reserves

25. We have recently strengthened our reserves substantially by borrowing $2.5 billion on the Euro-markets. But we still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. This should not, however, be regarded as a major objection to entry into the ERM. It would be a mistake to enter the ERM intending to rely heavily on intervention. That would risk repeating the experience of the French in late 1982 when they spent massively in defence of the indefensible. It would be necessary instead to recognise the need for policy change in good time and act on that.

Attitude of Other Member States

26. Other Member States will welcome our membership on broad political grounds. There is a possibility, however, that our joining will push the French into seeking a general realignment against the DM, because of the political uncertainties of the 1986 French

election. This will complicate the realignment meeting, but is not an objection against joining now.

Presentation of a Decision

27. A decision to join would be presented as a positive and natural evolution of our current financial strategy, in line with the arguments above. It would be essential to make it clear, as we have already done, that joining the ERM would not be a soft option and that on the contrary the aim would be to reinforce downward pressures on industrial costs and inflation. We would be able to point to the benefits from the removal of uncertainty and (in the case of the CBI) from meeting the desire for greater exchange rate stability. And we would naturally take credit for the decision in the context of our wider European policy.

CHART3: MOVEMENTS IN STERLING AGAINST THE DEUTSCHEMARK AND THE DOLLAR

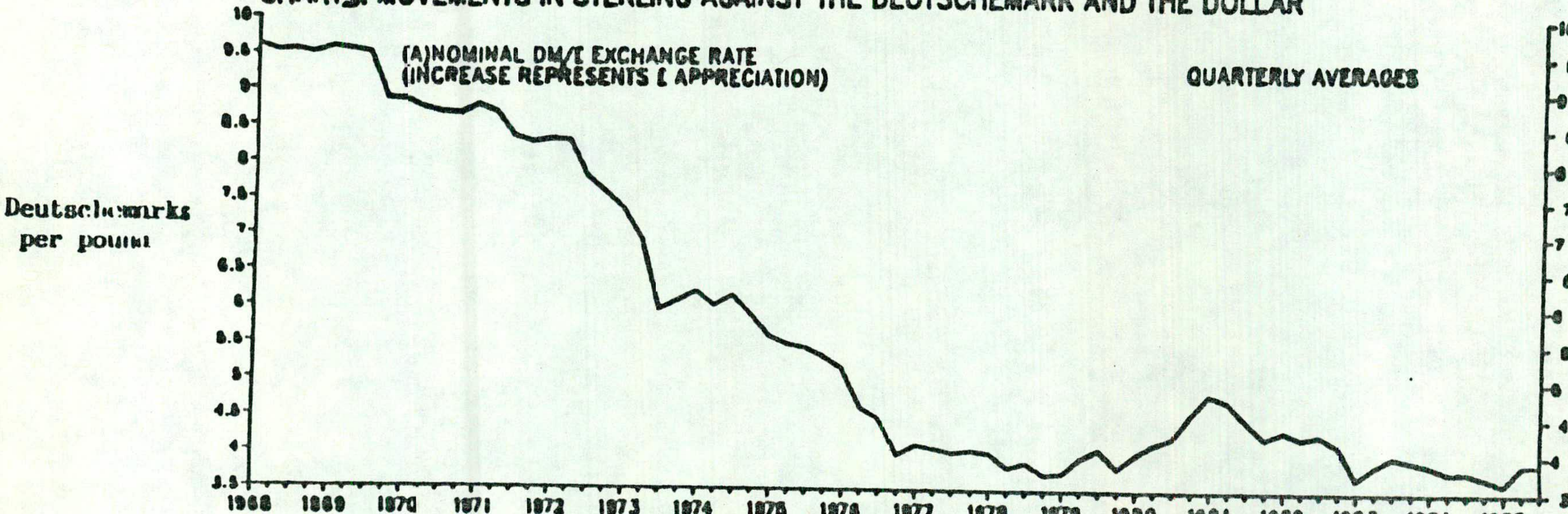
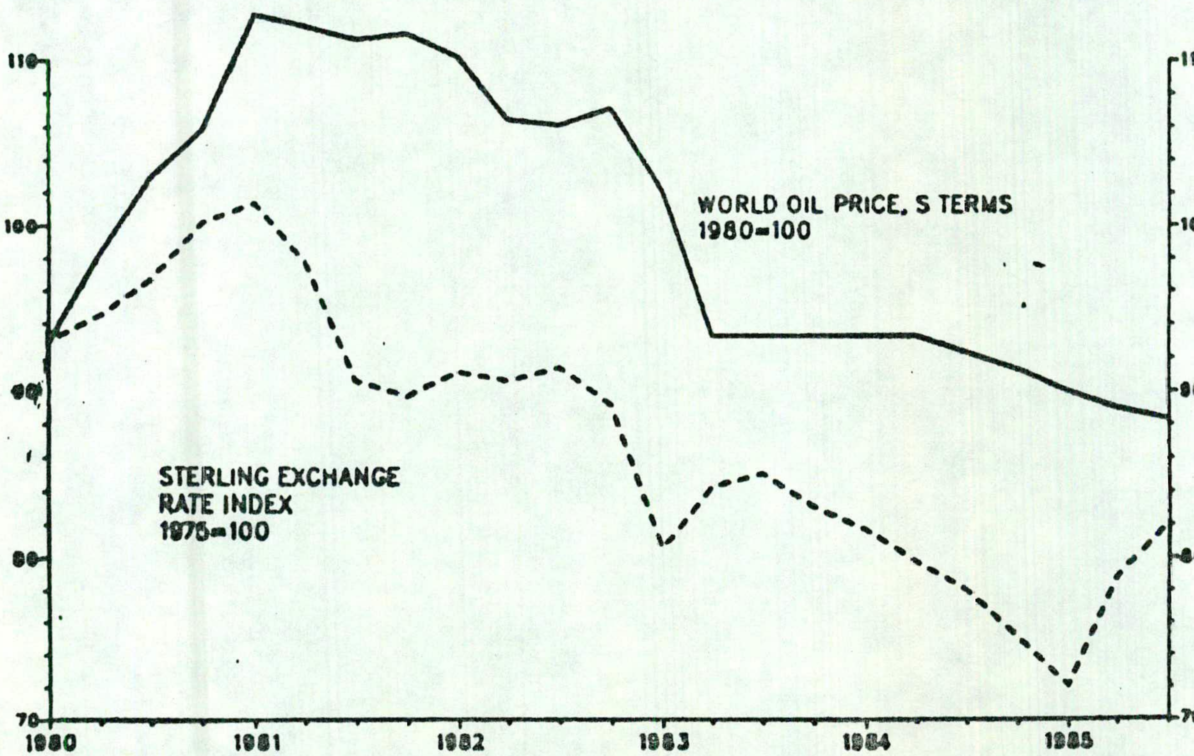


CHART 2: OIL PRICES AND THE EXCHANGE RATE



LRL.26 SECRET PMP

FROM: MRS R LOMAX
DATE: 11 November 1985

MR CASSELL

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr C Kelly
Mr H Davies

COPING WITH PRESSURES ON STERLING IN THE ERM

The Chancellor has seen your minute of 6 November. He accepts your second point - as any attempt to push very short term rates higher should take place after not before a substantial rise in base rates. However he remains wholly unconvinced by your first point. He thinks the Bretton Woods analogy is false, since really big speculation invariably involves the dollar, which is outside the system. This means that part of any strain will be taken by changes in the ecu/dollar rate. As for the point in your paragraph 4, which refers to events last January and February, he has commented that within the ERM there would have been no further decline after 28 January (nor incidentally, would we have waited until sterling was at the lower limit before acting).

RL.

RACHEL LOMAX

SECRET

FROM: F CASSELL
12 November 1985

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr C Kelly
Mr H Davies

COPING WITH PRESSURES ON STERLING IN THE ERM

You disagreed with the argument in my minute of 6 November that membership of ERM might increase the scale of speculation against sterling, because speculators might (if confidence was shaken) see themselves as having effectively a one-way option. In particular, you thought that the Bretton Woods analogy is false, since really big speculation invariably involves the dollar, which is outside the system.

The experience within the ERM does suggest that the periods of pressure often involve the dollar - but far from invariably. The attached note by FEU looks at the 13 episodes of strain within ERM reported in the earlier note against the background of what was happening to the dollar at the time. In six out of these thirteen episodes the dollar was not involved.

Comparisons of this sort of course can never be a reliable guide to what might happen in the future. The inclusion of sterling within ERM would probably increase the scope for internally-generated tension, though it would also promote earlier action to relieve the tension.

In any event, whether the strain is internal or external in origin you still have to cope with it. If you are a member of ERM you will generally have less freedom to take any of the strain on the exchange rate. That was the first point I was trying to make in the earlier minute.

F CASSELL

SECRET

THE ROLE OF THE DOLLAR IN EXCHANGE RATE CRISES

This note looks at the role played by the dollar in precipitating exchange rate strains both within the ERM and for sterling.

ERM periods of strain

2. Table 1, taken from the FEU note on the ERM*, summarises the principal developments during thirteen episodes when the ERM came under strain. Table 2 shows for the same periods the extent to which sharp movements in the dollar exchange rate coincided with these strains. It records how the deutschemark (the dominant currency within the ERM) moved against the dollar, and any policy response in the form of intervention or discount rate changes taken by the German authorities.

3. Table 2 reveals a diverse set of circumstances surrounding the periods of strain. The thirteen episodes can be divided into three categories:-

(i) periods of dollar strength. In periods (4) and (5) a rising dollar pushed the DM down against other ERM currencies and caused the German authorities to intervene to support the DM. There are two other instances ((3) and (7)) when ERM periods of strain coincided with dollar strength against the DM, although in these cases the DM was strong within the ERM. In the later of these two periods in particular the ERM strains emanated mainly from worries about the French Presidential elections in 1981, rather than from any influence exerted by the dollar.

(ii) periods of dollar weakness. Only two periods ((1) and (8)) conform exactly with the stylised view

---

*"Coping with pressures on sterling in the ERM", sent to the Chancellor under cover of Mr Cassell's minute of November 1.

TABLE 1 : EMS periods of strain(1) involving 5 major ERM countries

Bold entries indicate a realignment followed the period of strain.

	Period	Country	Principal identified Source of strain	Intervention(2) ($ million)	Monetary policy	Offshore Interest rates(3) Max. level	'Normal' level
1.	May-June 1979	Belgium	Continued lack of confidence	1200	DR (Discount rate) from 6% to 9%	10	5
2.	**Aug-Sept 1979**	**Belgium**	**Capital inflows dry up**	**1150**	**DR from 9% to 10%**	**12**	**10**
3.	Dec 1979 -Mar 1980	Belgium	Deficient capital inflow to finance current account deficit	2500	DR from 10% to 14%	16	12
4.	Oct 1980	Germany	Weak current account and interest rates too low	1200	Slight tightening of credit market	9	8½
5.	Feb 1981	Germany	Increased uncertainty about economic position; US interest rates surge	1700	Special Lombard rate; substantial tightening of policy	13	8¾
6.	**March 1981**	**Belgium** **Italy**	**DM firming**	**900 before** **1500 after** **1900 before** **1100 after**	**DR from 12% to 16%** **DR from 16½% to 19%**	**12½** **18**	**8-11** **12**
7.	May 1981	France	Presidential election	5900	Interest rate and exchange control measures	25	11½
8.	**Aug-Sept 1981**	**France** **Belgium**	**DM rises against $ on improving external performance**	**3900** **1900**		**57** **14**	**18** **13**
9.	Nov 1981	Belgium	Negotiations for new govt. breakdown	800	DR from 13% to 15%	14	14
10.	**Feb 1982**	**Belgium**	**Diminishing confidence in economy**	**500**		**14**	**14**
11.	March 1982	France	Widening inflation differential with Germany	2200	Tightening monetary policy, exchange controls	50	14
12.	**May-June 1982**	**France** **Belgium** **Italy**	**"The weekend syndrome": pressure late in the week on realignment rumours**	**3300** **700** **400**		**50** **14½** **27**	**16** **14** **17**
13.	**Dec 1982 -Mar 1983**	**France** **Belgium**	**Deteriorating trade balance, and inflation**	**8900** **3100**	**Interest rate measures; emergency exchange controls**	**400** **75**	**13** **12**

(1) Adapted from Table 1 of IMF Occasional Paper No. 19

(2) Total intervention in all currencies ($ million equivalent) in the period of strain.

(3) 2-day Euro-currency rates. The 'normal' level is the average for a period of stability (usually two weeks) preceding the period of strain.

DR = discount rate

TABLE 2 : PRESSURES ON THE DEUTSCHEMARK

Period	DM/$ rate (+ = DM appreciation)	German intervention ($ billion, + = selling dollars)	German discount rate (percentage point change)
1. May-June 1979	+5%	-1.1	+1
2. Aug-Sept 1979	**+1%**	**-0.3**	**-**
3. Dec 1979-Mar 1980	-7½%	+4.0	+1
4. Oct 1980	-5½%	+1.2	-
5. Feb 1981	-7½%, followed by +5½%	+1.6	-
6. Mar 1981	**-3%, followed by +5%**	**+0.2**	**-**
7. May 1981	-6½%	+0.8	-
8. Aug-Sept 1981	**+9½%**	**+1.3**	**-**
9. Nov 1981	-3%	+0.3	-
10. Feb 1982	**-2½%, followed by +2%**	**-**	**-**
11. Mar 1982	-2%	-	-
12. May-June 1982	**-4%**	**+0.2**	**-**
13. Dec 1982-Mar 1983	**+5½%, followed by -3%**	**-0.2**	**-1**

Bold entries indicate a realignment followed the period of strain.

that dollar weakness leads to strain within the ERM through the DM appreciating against other ERM currencies, although in period 6 also the DM's rise against the dollar in the latter part of the month probably contributed to strains within the ERM.

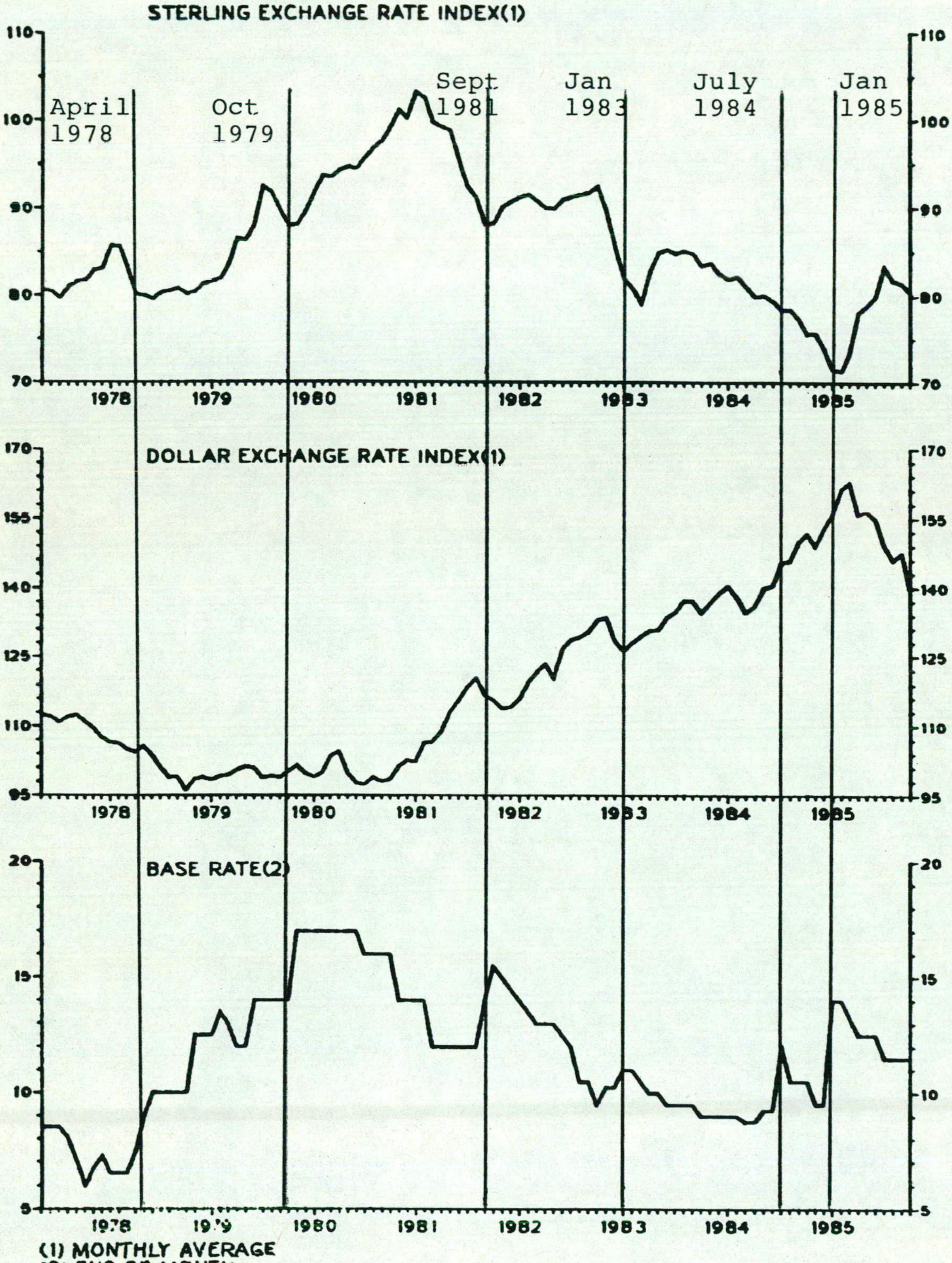
(iii) periods of strain with no obvious dollar influence. In all the other ERM periods of strain ((2), (9), (10), (11), (12), and (13)) it is difficult to detect any significant influence from the dollar. In all except the last period DM movements against the dollar were relatively small, and in the succession of crises in the end of 1981 and first half of 1982 the DM was generally falling against the dollar. In the last period, which culminated in the major realignment of March 1983, the dollar did show sizeable movements both up and down against the DM within the period of crisis, but the major reasons behind the realignment were much more to do with divergent trends in economic performance of the different ERM members.

Sterling crises

4. The attached chart is the familiar one showing movements in the sterling index and UK base rates. It includes also the dollar index. It is therefore possible to see the extent to which the sharp falls in sterling before base rate rises have coincided with strength of the dollar.

5. The influence of the dollar on sterling seems to have been stronger than its influence on the ERM currencies. Sterling's fall through 1981 coincided with prolonged dollar strength, though the dollar had begun to fall before the rise in base rates. The initial sharp fall in the sterling index during 1983 occurred at the same time as the dollar also was rising, but as in 1981 the dollar index had begun to fall some time before the slide in sterling was halted. The steady fall in sterling from early 1983 to January 1985 mirrored fairly well the dollar's rise, with the two base rate hikes following particularly fast dollar appreciation.

BASE RATES AND EXCHANGE RATES



(1) MONTHLY AVERAGE
(2) END OF MONTH

Conclusion

6. The experience of both ERM currencies and sterling support the view that exchange rate 'crises' have on a number of occasions coincided with periods when the dollar exchange rate index was changing. However, in about half of the periods of strain within the ERM surveyed in this note there was no obvious dollar influence and the exchange rate pressures were the result of other developments.

Bmp

FROM: MRS M HENSON
DATE: 13 November 1985

MR CASSELL

COPING WITH PRESSURES ON STERLING IN THE ERM

The Chancellor has seen and was grateful for your minute of 12 November.

Meena Henson
MEENA HENSON

156/23

FROM: C W KELLY
DATE: 18 NOVEMBER 1985

b/f 19/11 (Phil — in case Ch 'phones comments (I have sent him a copy of the attachment) T.

MR KUCZYS

cc Mr Fitchew
Mr Ilett

TCSC REPORT ON THE ERM: BRIEFING ON PM'S QUESTIONS

I attach a short note on the TCSC report. As you will see, this is a boiled down version of my note to Mr Culpin on the same subject, a copy of which you are sending separately to Mr Norgrove.

V. Roche

pp. C W KELLY

TCSC REPORT ON THE EXCHANGE RATE MECHANISM

The TCSC are publishing a report on the exchange rate mechanism at 12 noon on 19 November.

2. They conclude against UK membership at present, partly because of the belief that sterling is overvalued in relation to the deutschemark:

> "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 lead to keep options open to pursue domestic policies in the national interest need us to recommend the maintenance of the status quo in the short to medium-term".

3. The report breaks no new ground. The analysis is fairly superficial and on conventional grounds.

4. The evidence published with the report includes a written memorandum by the Treasury sent to the Committee in May this year. The Committee also took oral evidence from Treasury officials.

Line to take

1. The report has only just been published and I will read it with interest.

2. Our own position remains unchanged. On balance sterling participation in the mechanism would not at present be helpful. But the situation is kept under continual review.

156/23

Brief for PM's Questions

Pl: type for No 10 by 10am today

TCSC REPORT ON THE EXCHANGE RATE MECHANISM

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Line to take

1. The report has only just been published and I will read it with interest.

2. Our own position remains unchanged. On balance sterling participation in the mechanism would not at present be helpful. But the situation is kept under continual review.

/1765

Ch.

Minford's monetarism has never rested on much knowledge or understanding of monetary policy. He knows far more about exchange rates + was an early, fervent advocate of free floating. He became keen on MBC because he thinks it is the domestic monetary equivalent of free floating. Nothing very surprising here, but confuses some of the better points (eg about exchange controls) in a rather unhelpful way. Rh. 20/11

FROM: **S J PICKFORD**
DATE: 19 NOVEMBER 1985

1. Does Sir TB agree with X?
2. What are the facts re Y?
N.

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Lavelle
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr Culpin
Mr H Davies

PATRICK MINFORD ON THE EMS

Professor Patrick Minford (University of Liverpool) today gave a talk at a meeting organised by the Centre for Economic Policy Research, timed to coincide with publication of the TCSC report. His talk was entitled "why it would be a disaster for Britain to join the EMS".

Summary

2. Minford's talk was well-attended, with a sprinkling of journalists present. His central conclusion (press release attached) was that membership of the ERM would be worse than our current system of monetary control.

3. He began by discussing the TCSC report, which he characterised as getting its conclusions right, but for the wrong reasons. The TCSC report identified the main arguments for and against membership as being:

Against - that the pound is currently overvalued against the DM;

- that membership would act as a constraint on the conduct of domestic policy.

For - that membership would impose the discipline of matching German inflation performance and monetary policy stance;

- that inside the ERM sterling would have avoided the strong swings experienced in recent years.

4. Minford dismissed these arguments. He argued that concern over the 'correct' sterling/DM parity was misplaced, because the determination of the exchange rate level (at least in real terms) is essentially independent of the system of monetary control adopted. He characterised the Committee's arguments against membership on the basis of the damage to the UK's competitiveness of locking into too high a rate against the DM as "naked mercantilism". The argument that membership was beneficial because it imposed discipline was dismissed as not valid - any action which reduced the Government's set of possible outcomes would necessarily lead to a welfare loss.

how unworldly can you get.

5. He argued instead that the EMS should be evaluated on technical grounds as a monetary control mechanism. He concluded that, compared to the current system of monetary control, ERM membership would be "deficient" on a number of counts:

?

(i) The EMS system of 'fixed but adjustable pegs' allows, as did the Bretton Woods system, complete domestic policy independence. This enables countries to experience divergent price trends, thus necessitating periodic realignments. When a currency comes under pressure, the system sets up <u>one-way options</u> whereby speculators cannot lose by taking positions against the weak currency, but instead stand to gain large amounts if a realignment occurs - if the weak currency was expected, with 50 per cent probability, to be devalued by 10 per cent within 1 month, switching out of the currency would yield an annualised return of 80 per cent. Because of this, Minford argued the system was "fatally flawed".

(ii) EMS membership has changed the <u>statistical distribution</u> of exchange rate changes, because nominal parities remain unchanged for long periods and are followed by sharp step

? Not compared to Bretton Woods.

changes at realignments. But it is not clear that overall exchange rate volatility has been reduced by the ERM, even for nominal rates. (In this context he quoted, approvingly, the TCSC report and the Treasury evidence.) It would be surprising if the EMS had had any effect on real exchange rate volatility because real wages and the terms of trade are important determinants of the real rate, but are unlikely to be affected by the exchange rate regime. Minford presented charts which he interpreted as showing that the French franc and the lira had been no less volatile in real terms than had sterling; and he also claimed that formal tests confirmed that the generating process for the real exchange rate (white noise around a trend) was not altered by the existence of the ERM.

(iii) on the other hand, he argued the EMS does create greater monetary volatility (as measured by nominal domestic interest rates). Again he appealed to charts showing the experience of France, Italy and the UK to support this contention, arguing that large interest rate hikes were necessary when ERM limits were approached.

(iv) exchange controls were the norm within the ERM (except for Germany, which did not need them anyway). Exchange controls are damaging because they lead to inefficient international allocation of resources by driving a wedge between the domestic and world cost of capital (he argued that on plausible assumptions the welfare loss on this count could be as high as 15 per cent of GDP!); and because they prevent residents from achieving portfolio diversification necessary to reduce risk.

6. He concluded by arguing that if the aim of policy was (as in the MTFS framework) to stabilise nominal GDP, ERM membership must be a poor option because it generates monetary volatility. He argued that by contrast "current policy" (which he interpreted as monetary base control with an exchange rate override) had led to much more stability because growth of the monetary base (MO) had remained fairly constant in recent years, and MO was a very

good predictor of nominal GDP (with a mean lag of 2 quarters).

7. His parting shot was a plea for the Treasury not to move over to an informal exchange rate target, not only because it would be "guilty of downright discretionary policy" but also because MO was now undershooting, carrying with it the risk of a further contraction of GDP.

Discussion

8. There was a short discussion period (the first three interventions coming from ex-Treasury economists).

9. Steven Bell (Morgan Grenfell)

- criticised Minford's method of making assertions from the (ambiguous) evidence of charts;

- argued that the one-way option is not a real problem within the ERM because of its wide bands; and

- asked whether MO was a predictor of nominal GDP or merely a coincident indicator.

In reply Minford argued that

- formal tests confirmed the conclusions he had drawn from the charts;

- the one-way option still applies in the usual position when weak currencies are against their lower ERM limits; and

- because MO preceded nominal GDP by two quarters, causation ran in the same direction.

10. Bill Robinson (LBS)

- claimed that exchange rate volatility, at least in nominal terms, was reduced by the ERM;

- disputed Minford's claim that most ERM countries had exchange controls; and

- asked whether membership could not act as a useful discipline on future governments.

Minford argued that

- exchange rate volatility as measured by monthly changes might be lower because the operation of the ERM skewed the statistical distribution (see paragraph 5(ii))but this was not a reliable indicator;

meaning? - most of the important ERM currencies, except the DM, are protected by exchange controls; and | Y

- future governments cannot be bound by their predecessors.

11. Kenneth King (Rothschilds) commented that *ex post* returns on the French franc and the lira had been high in recent years because ERM membership had forced nominal interest rates to be kept up. He also argued that UK interest rates had been rather more volatile anyway than for ERM members, so membership might have actually reduced interest rate volatility.

12. Malcolm Crawford (Business International) started by saying he agreed with Minford but then argued that the Bretton Woods system had succeeded in stabilizing real exchange rates and concluded that the UK should go for an announced exchange rate target against a basket of currencies. Minford argued that even under Bretton Woods there were marked real exchange rate movements, and commented that Crawford's proposal ran foul of much the same problems as the ERM.

13. Finally, there was a short and inconclusive discussion of the circumstances under which the self-imposed external discipline of an exchange-rate band (graphically described as

lashing yourself to the mast in a storm) might be appropriate.

Comment

14. Neither the talk nor the subsequent discussion produced any radical new insights. The evidence presented by Minford, described as "casual empiricism" by one speaker, failed to convince many in the audience. And his conclusions were not particularly surprising. There was little in the talk, except Minford's name, that was very newsworthy.

Stephen Pickford

S J PICKFORD

FEU

Centre for Economic Policy Research

For release Tuesday, 19 November at 1:30 pm

EMS MEMBERSHIP DISASTROUS FOR BRITAIN
MINFORD ARGUES

It would be a disaster for Britain to join the European Monetary System (EMS), argued economist Professor **Patrick Minford** today. There were few clear benefits and important disadvantages to membership. In the past the EMS has encouraged the growth of distortionary barriers to capital mobility and of restrictions on free trade. It has also led to increased monetary volatility in member countries. Minford argued that present UK monetary policy is performing reasonably well. Why then embark upon an unknown sea of troubles?

?

Patrick Minford is Professor of Economics at the University of Liverpool and a Research Fellow in the International Macroeconomics programme of the Centre for Economic Policy Research (CEPR) in London. He spoke at a lunchtime meeting organised by the Centre, one of a regular series of meetings at which Research Fellows discuss policy-relevant research. They may also advance specific views on policy, but these views are their own and not those of CEPR, which takes no institutional policy positions.

Minford observed that the EMS is a system of "fixed-but-adjustable" parities between a number of European countries, each pursuing independent monetary policies. The key currency in the EMS is the Deutschmark (DM), and the monetary policy of the Bundesbank plays a key role in the behaviour of the EMS. There have inevitably been shifts of member currency parities against the DM, notably the Belgian and the French francs and the Italian lira. These parity shifts are generally foreseen well in advance, even if their timing is uncertain. They create a "one-way option" in the devaluing currency, of the kind familiar in the later years of the Bretton Woods agreement. The exchange market becomes unstable, and during these crises capital flows must be stemmed by means of exchange controls and abrupt shifts in monetary policy. A period of quiescence usually follows the devaluation, but in the absence of monetary policy alignment with the Bundesbank, the initial instability recurs. Hence, Minford argued, exchange controls become institutionalized, either through two-tier markets or physical controls. Controls on trade in services such as tourism and insurance also become necessary, because these are a potential route for avoiding capital controls; even barriers to trade in goods may be encouraged for the same reason. Monetary policy also becomes more volatile.

It is often claimed in defence of the EMS that it has reduced fluctuations in intra-European price competitiveness, but evidence for this is weak and

/more

6 Duke of York Street, London SW1Y 6LA. Tel: 930 2963

VR52

pwp

FROM: MRS LOMAX
DATE: 21 November 1985

MR PICKFORD

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Lavelle
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr Culpin
Mr H Davies

PATRICK MINFORD ON THE EMS

The Chancellor was grateful for your minute of 19 November. He has noted Patrick Minford's argument that most of the important ERM currencies, except the deutschemark, are protected by exchange controls; he would be grateful if you could let him have the facts.

2. He would also be grateful for Sir T Burns' views on Patrick Minford's assertion that M0 is a very good predictor of nominal GDP (with a mean lag of two-quarters).

RL.

RACHEL LOMAX

3/1770

Copied Annex A to DAV + extension to me 20/12

[4 No XC
2 ineffective 'XC' (2-tier XM)
4 Effective XC]

FROM: S J PICKFORD
DATE: 10 DECEMBER 1985

1. SIR T BURNS TB 12/12/85

2. CHANCELLOR ✓

Ch/ Annex A is interesting. However only is the position not as bullish, Minford et al claim, but the trend seems, if anything, to be towards liberalisation not tightening. RLu 19/12

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Lavelle
Mr Fitchew
Mr Peretz
Mr Sedgwick
Mr Culpin
Mr Kelly
Mr H Davies

PATRICK MINFORD ON THE EMS

Mrs Lomax's minute of 21 November asked for more information on two aspects of Professor Minford's talk, reported in my minute of 19 November:

Many thanks. V. interesting. Shd we comment to No 10 (only 4/10 in EC have proper XC) * PS/ cd I have these pre-Christmas

(i) the facts on the extent of exchange controls in ERM member countries;

(ii) Sir T Burns' views on the link between MO and nominal GDP.

Exchange controls in ERM member countries

2. The current position is:

(a) three countries - Germany, Netherlands, and Denmark - have no controls on capital movements at all. Germany does of course still have extensive domestic banking controls, but these do not appear to affect residents' ability to switch between currencies;

(b) Belgium and Luxembourg have no restrictions on capital movements apart from a two-tier foreign exchange market;

(c) the other ~~three~~ four members - France, Italy, Greece and Ireland - have in place wide-ranging exchange controls, although France and Italy have made some steps recently towards liberalisation.

More detail is given in Annex A, which has been assembled by EF1.

3. France, Italy, Greece and Ireland are the only ERM members with extensive exchange controls. It was therefore misleading of Minford to assert in his talk that exchange controls are the "norm" within the ERM. The qualification he made to his position, in response to a question from Bill Robinson, (paragraph 10 of my minute - attached at Annex B) is nearer the mark: the two most important ERM currencies after the DM - the French franc and the lira - are both still protected by exchange controls. However, it does not seem that ERM membership has in practice caused countries to operate a significantly different exchange control regime than they would otherwise. Of more relevance here is that EC membership should encourage countries to allow free movement of capital, at least within the Community.

MO and Nominal GDP

4. Professor Minford presented charts which seemed to show a clear relationship between MO growth and nominal GDP growth. This is reproduced at Chart 1, copies of which we have just received from Professor Minford. He also interpreted the chart as showing that the best relationship is between current nominal GDP growth and MO growth two quarters earlier, and that this established the causal process as running from MO to GDP.

5. His chart does show what appears to be an impressive correlation, but we doubt that the correlation is as good as Minford argues. On a very minor point, Professor Minford has not in our view made the best adjustment for the break in series in October 1981 (when the 1½ per cent bankers' balance requirement was replaced by ½ per cent cash ratio on eligible liabilities

for all recognised banks and some other monetary sector institutions). Chart 2 exactly replicates the data in Chart 1, except that it uses our own data for weekly-averaged M0 incorporating an internal adjustment for the 1981 break made by FEU. This, however, makes relatively little difference to the appearance of the chart.

6. More importantly, we believe that Professor Minford is overselling his case. Professor Minford has chosen the time period for his chart carefully to give the most flattering result. By starting the chart in 1979, the picture is dominated by the decline in both growth rates in 1980 and 1981. Chart 3 takes the comparison back rather further, to 1971. Over this extended period the correlation is much less convincing. There are clearly some periods when the two series coincide, but there are also important occasions when they do not.

7. It is always difficult and sometimes dangerous to adduce statistical relationships simply by examining charts. For example the strong link observed between £M3 and inflation in the early 1970s in retrospect seems to have been overly dominated by a single episode in the data. Recent statistical work on the information content of different monetary aggregates concluded that overall M0 has tended to be a better predictor of nominal GDP than have the broad aggregates. However, the ranking of the various aggregates in terms of their information content is very dependent on the time period examined, the length of lag assumed, and the exact definition of the inflation or GDP variable.

Stephen Pickford

S J PICKFORD
FEU

ANNEX A

EXCHANGE CONTROLS IN ERM MEMBER COUNTRIES

1. The current exchange control position of members of the ERM is:

Belgium and Luxembourg

No restrictions on capital movements apart from a two-tier foreign exchange market, dating back to 1954-55. This is technically an exchange control in our view, though it appears to have little effect at present.

Denmark

As a result of a series of liberalisations, there have since 1984 been only minor restrictions on capital movements.

France

Full set of exchange controls since 1939 apart from two periods between 1966 and 1968. Two periods of minor relaxation since the ERM began, in 1980-81 and from the end of 1983 to date, interrupted by restrictions in 1981-3.

Germany

No controls.

Ireland

Wide-ranging controls. Some relaxation in 1979 partly linked to Irish participation in the EMS, and some tightening in 1983. An incidental consequence of Irish participation was that parity between the Irish pound and the pound sterling was broken and UK residents became subject to the same controls as other non-residents.

Italy

Considerable restrictions on both portfolio and some direct investment - these were reinforced temporarily in 1981 and 1982 by an import deposit scheme. Since then, changes have mostly been in the direction of liberalisation, although some were forced on the Italians by European Court cases. A bill to introduce major reforms is before Parliament. (liberalisation).

Netherlands

No controls.

EXTRACT FROM MINUTE OF 19 NOVEMBER TO THE CHANCELLOR FROM MR PICKFORD: "PATRICK MINFORD ON THE EMS"

10. Bill Robinson (LBS)

- claimed that exchange rate volatility, at least in nominal terms, was reduced by the ERM;
- disputed Minford's claim that most ERM countries had exchange controls; and
- asked whether membership could not act as a useful discipline on future governments.

Minford argued that

- exchange rate volatility as measured by monthly changes might be lower because the operation of the ERM skewed the statistical distribution (see paragraph 5(ii))but this was not a reliable indicator;
- most of the important ERM currencies, except the DM, are protected by exchange controls; and
- future governments cannot be bound by their predecessors.

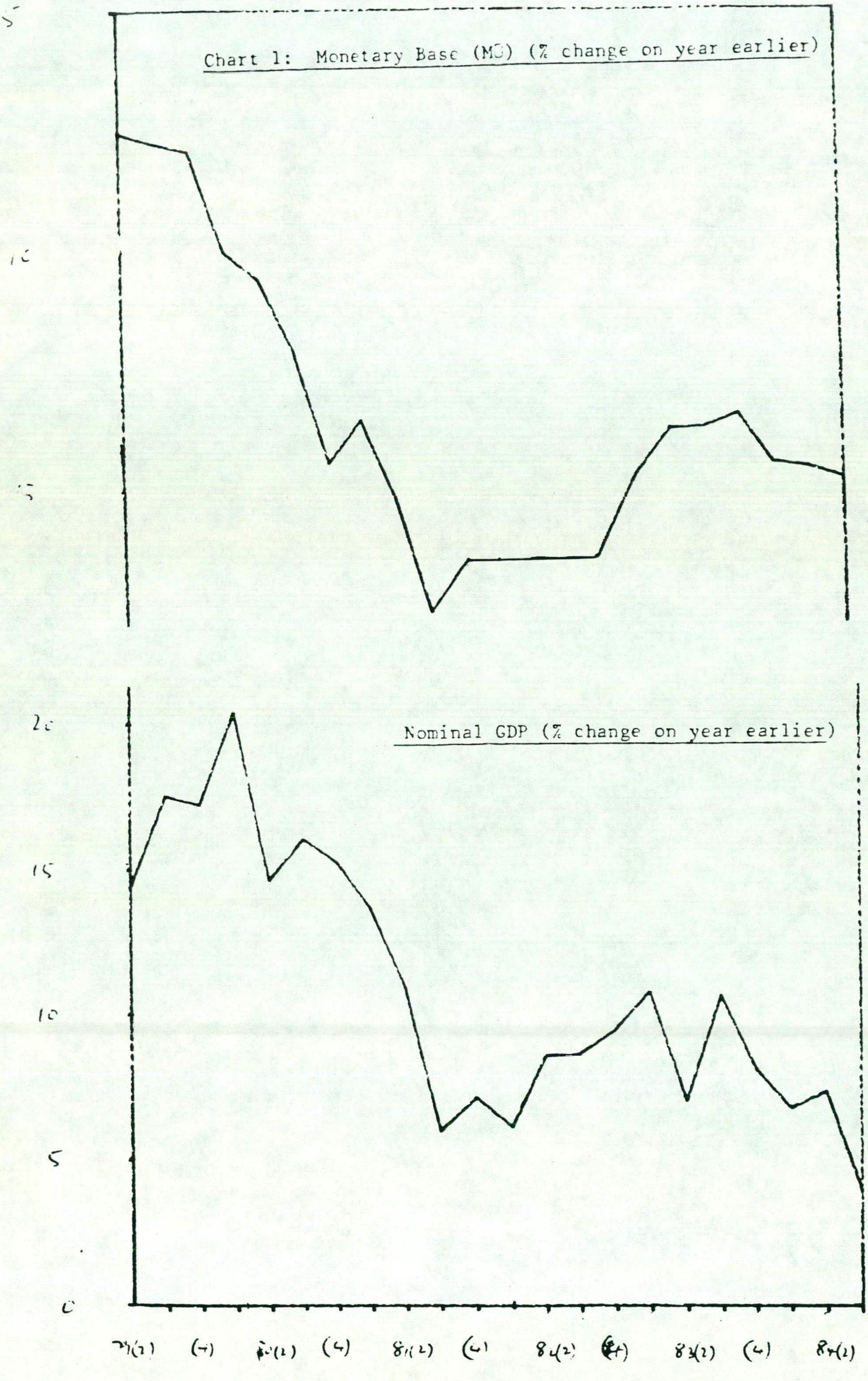


Chart 1: Monetary Base (M0) (% change on year earlier)
15
10
5
Nominal GDP (% change on year earlier)
20
15
10
5
0
79(2)
(4)
80(2)
(4)
81(2)
(4)
82(2)
(4)
83(2)
(4)
84(2)

CHART 2 : GROWTH OF NOMINAL GDP AND LAGGED MO

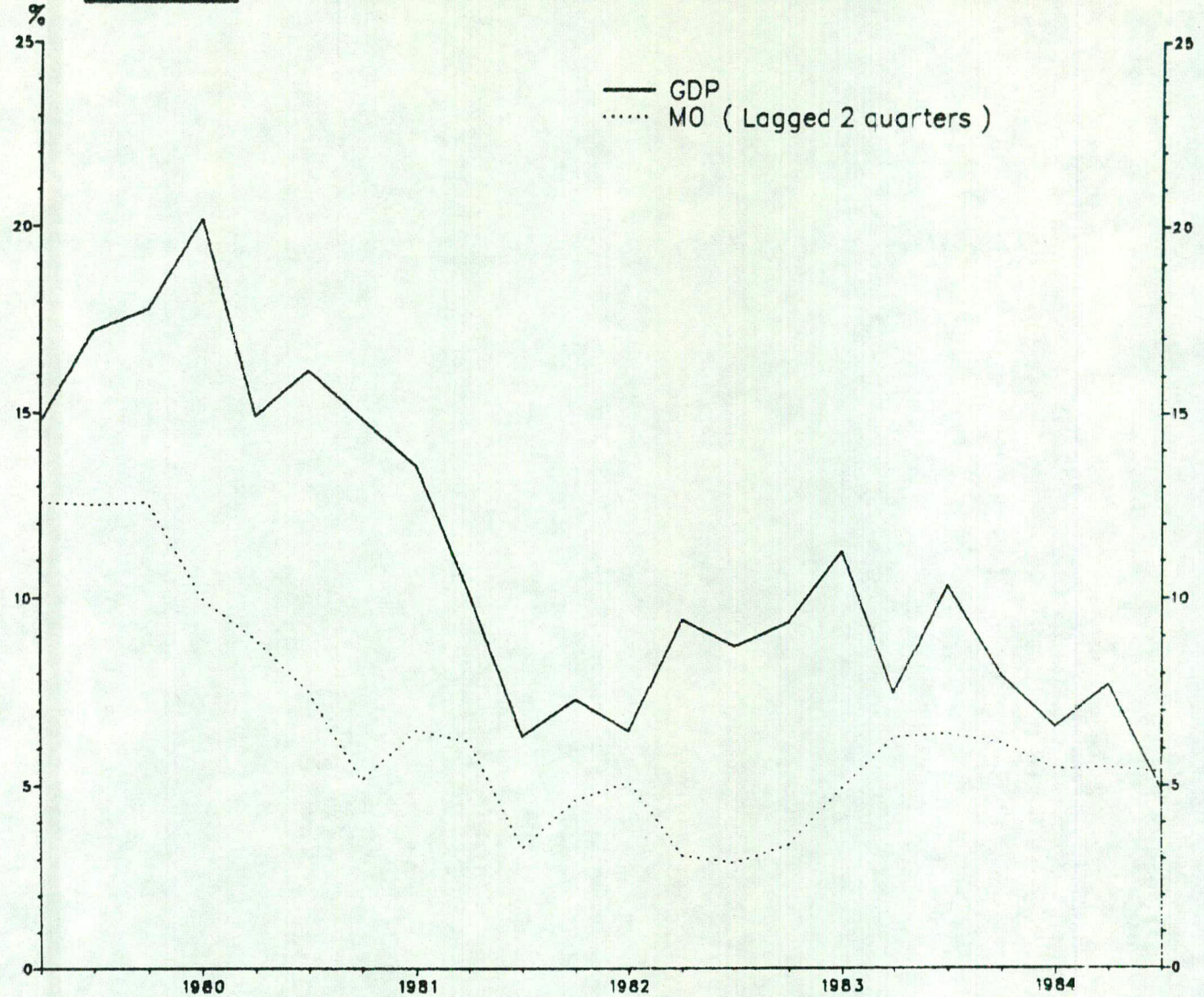
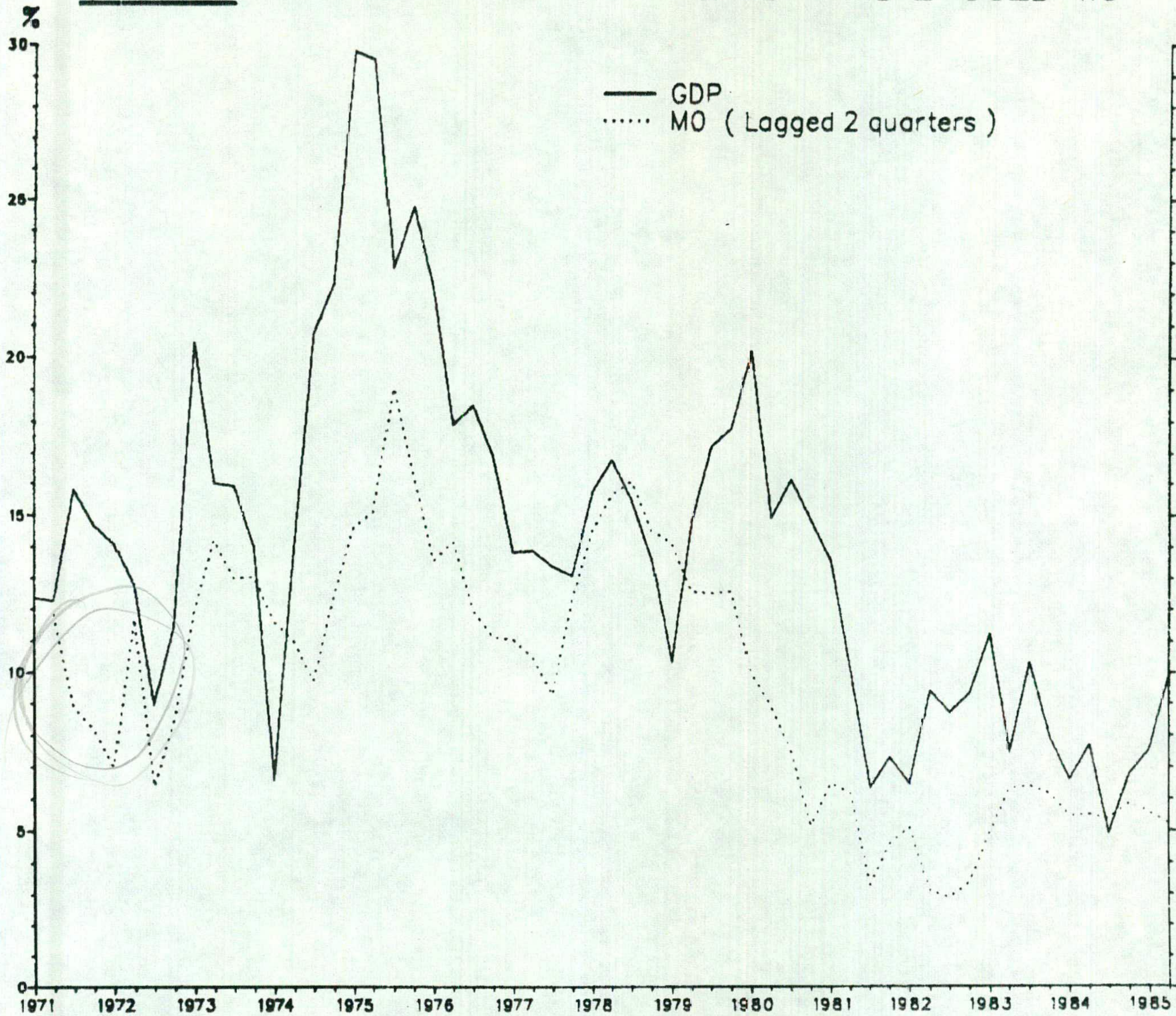


CHART 3 : GROWTH OF NOMINAL GDP AND LAGGED MO



pmp

P

FROM: MRS R LOMAX
DATE: 20 December 1985

MR PICKFORD

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Sedgwick

PATRICK MINFORD ON THE EMS

The Chancellor was most grateful for your minute of 10 December which he found very interesting - particularly the facts on the extent of exchange controls in the ERM member countries.

He would be grateful for Sir Terence Burns personal views on the link between MO and nominal GDP before Chevening.

RL.

RACHEL LOMAX

CHANCELLOR OF THE EXCHEQUER

For mtg with AA.

Ch

I have a copy & can discuss on Sunday

AA

Ch.

EC issues.

Jim Lankester may ask you, in the margins of this afternoon's meeting, how you got on with Sir GH yesterday in your talk about this paper.

I have deliberately feigned ignorance not only of the discussion at the meeting but also of any comments that you had on the paper (since you want to discuss with AA tomorrow).

23/5

SECRET

bf. to Alex 24/5

From: T P Lankester
Date: 19 May 1988

CHANCELLOR

cc

Sir P Middleton
Sir T Burns
Mr Wicks
Mr Peretz
Mr Scholar
Mr R I G Allen
Mrs M Brown
Ms O'Mara

EC ISSUES

I attach a draft of the paper which you and the Foreign Secretary asked John Kerr and me to prepare. This follows closely the outline which you gave us.

2. The draft is very much a first shot but I hope it is the sort of thing you were looking for. The ERM section has been, not surprisingly, drafted very much with the particular audience in mind. Hence, we have not tried to argue that ERM membership would be positively beneficial, but rather that it would not be inconsistent with our current economic strategy.

3. One other point I should mention is that we have heard from the Treasury Solicitor that there is a very slight risk that, if we joined, it would be illegal for us to leave. That certainly was not the view taken by the Attorney in 1987. However, we need to discuss this further with the Treasury Solicitor. In the meantime, the point is not mentioned in the draft.

R

T P LANKESTER

P.S. John Kerr is submitting this paper to the Foreign Secretary tonight also.

EC ISSUES

1. The prospects for the Madrid European Council and the subsequent French Presidency suggest that an unwelcome watershed in the Community could be close. We think it avoidable, if we get our Madrid line right. But we see serious risks of long term damage to UK interests if we get it wrong.

Background

2. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our opposition to witholding taxes on investment income, and our determination to maintain adequate frontier checks, our reasons are understood and command some support. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. Ensuring that the liberal thrust of the single market programme is not undercut by new socialist regulation may mean we have to break some china, starting in Madrid. But the watershed issue will certainly be attitudes to monetary cooperation.

3. Though the pragmatic step by step approach to Economic and Monetary Union, which is set out in the Delors Report,

and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS. The French will also argue, as will even the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. There is also a general concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).And the Delors Report exercise has created a general political expectation of likely advance: to disappoint it would strike most as unfortunate, and some as dangerous.

The Madrid European Council

4. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not only full capital liberalisation, labour mobility, wage and price flexibility, and unfettered intra-EC cross-frontier trade, but also genuine free competition, and convergent inflation, growth rates, and fiscal policies. Few could quickly swallow all that. The Report also claims - but with less justification - that a greatly increased official flow of resource transfers from richer to poorer member states would be essential. We shall not be alone is querying that proposition. Similarly, the Poehl-inspired proposition that in an EMU monetary policy decisions would be taken by operators independent of political control is likely to

prove less self-evident to most Ministers than it appears to have been to Central Bank Governors. A majority of Community governments tacitly accept our line that EMU is simply not on the current agenda.

5. We would however be in a minority of one if we went on to argue that EMU will <u>never</u> be conceivable, and that EMU as a long-term aim, last reaffirmed at Hanover, should therefore be dropped. Instead we should make plain, when rejecting - as we must - the Delors Report's assertion (para 39) that the "decision to enter upon the first stage should be a decision to embark on the entire process", that we do so because the timing and circumstances in which the latter stages of the process might take place, and the form of the arrangements which might then be made, are as yet wholly unclear. We don't sign blank cheques. On that basis, it should be possible, at Madrid, to have the para 39 "in for a penny ..." argument discounted.

6. Similarly, while we shall have to make clear in Madrid that we emphatically do <u>not</u> agree to the suggestion (para 66) that "preparatory work for the negotiations for the new Treaty would start immediately", we should <u>not</u> rule out cannot
Treaty amendment <u>ever</u>. In the Single European Act we secured confirmation that "insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236" (ie Treaty amendment, requiring unanimity) "shall be applicable". Our line at Madrid should be that even if there were agreement on the shape of eventual new institutional arrangements there could be no question of the UK Parliament agreeing now to ratify Treaty amendments transferring powers to such new institutions at an unknown, but distant, future date. Westminster does not sign undated cheques.

7. The risk that the Madrid European Council will nevertheless prove another Milan, with Gonzalez looking for

the six other votes necessary for a decision in favour of convening an Inter-Governmental Conference (IGC) does not at present seem high. But the line we take at Madrid may be decisive in determining whether, later in the year, the French go for such a decision (or, conceivably, set up a conference of 11 member states to prepare a separate Treaty, without us). It is our joint assessment that if the UK line at Madrid were seen as wholly dismissive of the Delors Report, or any other prescription for greater economic and monetary co-operation, the risk of the French subsequently taking the IGC route would be very high. That would be unwelcome: see paras 10 - 16 below.

8. Would other member states agree to play along with such French tactics? It is too soon to say with any certainty, but a large majority believe - with some justification - that while further monetary cooperation and economic convergence is not necessary to the Single Market, 1992 Europe would work better if they were secured. The political arguments - para 3 above - go in the same direction. Kohl would be unlikely to hold out against pressure from Mitterrand, and Poehl would mount no counter-pressure against the principle of Treaty amendment. The Spanish and Italians would probably support Mitterrand with some enthusiasm; the position of pragmatic gradualists like the Dutch and Danes, believers in the EMS model, and concerned that we should join the ERM, would probably depend on whether they believed that too we were ready for <u>some</u> pragmatic advance, including on ERM.

9. All one can say with certainty is that:

(a) all other member states would prefer to proceed on the basis of the Twelve acting together, accepting that the convoy will move at the speed of the slowest;

(b) but, if we seem unwilling to move at all, most and perhaps all the others would not be prepared to wait for us;

(c) and the French, if convinced that the UK would block the alternative of real practical progress, would probably go for an IGC decision later this year, and the grand gesture of new Treaty provisions with or without the UK.

10. Treaty amendments tabled at an IGC would not necessarily be confined to EMU-related institutional changes. Nor could we be confident that a UK veto would work: if the other Eleven agreed on a text, which we found unacceptable, there would be a risk of their choosing to consecrate it in a new Treaty, separate from the Treaty of Rome. Our status in the Community would then be rather different, and semi-detached.

[illegible]

Consequences of an IGC, and UK Isolation

11. Would this matter? Our joint assessment is that it would, both politically and economically.

12. The domestic political impact would undoubtedly be negative. Though we could point to deeper rifts below the surface of their EC policies, Labour are now in a position to exploit the friction inside the Conservative Party which would be inevitable. Our supporters in business would be uneasy, and the impact of our 1992 Awareness campaign blunted. In the City, concern about its position vis-a-vis Frankfurt and Paris would grow.

A bit feeble. Beef up? Need to stir up

[illegible]

13. Abroad, our negotiating position in other key current Community debates (para 2 above) would be weakened. We do best at Brussels when (as on frontiers or tax, or indeed CAP and budget reform) we build alliances. To isolate ourselves on the issue which is now seen as No 1 would scare off allies or potential allies on the rest of the Community agenda. And isolation in the monetary debate would be far more damaging than the isolation on "the social dimension"

which may be inevitable. The "social dimension" is a straight liberal/dirigiste, Right/Left issue, and our attitude, though unpopular with some, will be seen as consistent with our domestic policies, and validated by 3 successive elections here. We can argue with conviction that we believe new social regulation would be damaging to the Community, but we cannot say the same about greater monetary convergence. So outright UK opposition to monetary development would be seen as a UK v Community issue: our attitude would be assumed to reflect a new insularity: and this would in turn be assumed to determine our policies on other current EC issues, and so would reduce the chances of agreement to such policies.

14. Vulnerable areas in the Single market programme would be transport and telecommunications liberalisation, public procurement, technical standards and financial services. Loss of influence on budget decisions could rapidly have serious public expenditure consequences for the size of our net contribution. Our chances of using the Uruguay Round end-game to secure more liberal EC trade and agriculture policies would suffer, to the detriment of UK traders and consumers as well as tax payers. On all issues where majority voting applies, the others would be more inclined to vote us down rather than seek to accommodate us. Our links with other potential second tier states on the EC periphery would not necessarily weaken, but the Franco-German axis would increasingly become the drive-shaft of the Community. Vis-a-vis the external world, the consequence of third countries (eg the US and Japan) detecting a reduction in our influence on the Community's policies and development would probably be reduced reliance on us as a principal interlocuteur. And an obvious split in the Community, coming on top of strains in the Alliance, could further erode US commitment to European defence.

tenuous? no

15. Economically, the damage would primarily be to confidence, and could start relatively quickly. If

perceived as formally and indefinitely outside a currency area of increasing exchange rate stability, and more generally moving out of the Community mainstream, the UK would become relatively less attractive for new investment. Doubts, eg in Japan, about whether we would remain in the Community trading block, or would be able to retain our present influence on its trade policies, could cause the cancellation of current plans for manufacturing investment in the UK, in favour of continental sites. Non UK Banks and other financial institutions could similarly have a greater incentive to develop their continental bases rather than their London operations. Some domestic investment could similarly move offshore.

needs evidence to back this up: can we support this argument by saying that the recent flood of inward investment would not have taken place had UK been outside EC?

16. It follows that:

(a) since isolation on the monetary issue this year would have adverse short term consequences and could cause the UK serious long term damage; and

(b) since the damage could extend well beyond monetary issues;

(c) at and after Madrid we should, while dismissing the two plainly unacceptable elements of the short term prescription in the Delors Report (paras 39 and 66), put forward a credible alternative prescription, consistent with UK economic strategy and capable of securing majority EC support.

Alternative UK Prescription

17. Is it possible to construct such a prescription? Our joint view is that the task *is* feasible.

18. We would need to brush aside "advance commitment to the whole process" (para 5 above), and to point to some of the defects in Delors prescription for an eventual EMU (eg the professed requirement for massive resource transfers through the EC Budget). We would seek to discourage the

But about the British companies. CRITICAL

French, and the others, from the IGC route not only by making clear that Treaty amendment/ratification now is not on for us (para 6 above), but also by seeking to persuade them that we were ready to move some way in the direction charted by the Delors Group. We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, but that we favoured sensible step-by-step progress. But the ERM issue would inevitably arise.

19. The Delors Report suggests that all Community countries should become full ERM members by the end (undated) of stage 1. We can of course accept that: it is entirely consistent with our formula about joining when the time is ripe. But if others believe that our formula disguises a determination that the time will never be ripe, they would see agreement to a step-by-step approach in which nothing more happens until stage 1 (including UK ERM membership) is complete as in fact ensuring that nothing more ever happens. Even the Dutch would not settle for that.

20. So if we prescribe a step-by-step approach we are bound to be asked whether we can foresee circumstances in which we would be prepared to step into the ERM. Our answer will determine whether we can build support for our prescription. If what we say fails to carry credibility - and repeating the "when the time is ripe" formula would certainly fail, given that ERM is already ten years old - the odds must be that we shall fail to achieve the aim suggested at para 15(c) above, and are likely in consequence to face, later in the year, the crisis envisaged at para 9(c) above.

21. On the other hand, if what we say holds out the prospect of movement on ERM in the foreseeable future, the

French would probably prefer to build their Presidency package round that prospect, rather than the divisive pursuit, via an IGC, of Treaty change which would, at least for a time, be only symbolic. To succeed where Giscard failed, completing the composition of the ERM, would be politically attractive to Mitterrand. Evidence of UK intention to move would enable them to press Spain, Portugal and Greece to do the same. It might also be convenient for the French to have an excuse to press the Italians to reduce their divergence band and - more important - to press the Germans to allow a further stage of ERM reform (particularly on currency of intervention, where we agree with the French) along the lines of the Nyborg 1987 package. Moreover, while one cannot be wholly certain that a clear indication of a likely UK move on ERM would dissuade the French from exploring the IGC route as well, it seems certain to dissuade most other member-states from encouraging such explorations. So it would ensure that no IGC was in fact convened this year.

Spain will be in by Paris @ latest

Emphasis [illegible]

What about Spain

22. How precise would that indication have to be? We doubt if it will be necessary, though it could be advantageous, to name at Madrid a precise date before which we envisage ERM entry. But we do think it will be necessary to do so during the French Presidency. The obvious end-date would be 1 July 1990, the target date for completing the current stage of Capital Liberalisation: we would of course make clear that the exact date of entry would be of our choosing, reflecting our judgement of appropriate market conditions.

Needs to counter PM's assertion that any advance indication would cause speculation & market turmoil over a protracted period.

Fixed [illegible] dates [illegible] 1/7/90 & [illegible] not 1/1/93

23. Our joint view therefore is that the only sure way of killing the IGC risk for some years is for us to:

Will PM retort that ERM simply delays inevitable day when we have to cede more sovereignty or stand up for what she believes in?

(a) indicate by what we say before or at Madrid that we believe the time for ERM entry is now "ripening" or likely to ripen before too long; and

(b) be ready to confirm, before or at the December

?

European Council, that we envisage joining by 1 July next year.

ERM and Sovereignty

24. As you know, it already was our joint view, before the Delors Report crystallised the issue, that joining the ERM would not be inconsistent with our economic strategy. Nor do we believe it would involve unacceptable loss of sovereignty

25. Taking the sovereignty point first, there is far less to this than meets the eye. In sharp contrast to EMU, which would involve ~~a large pooling~~ an irrevocable loss of sovereignty, joining the ERM would mean a decision to link our currency to a European currency bloc as long as we wished to do so. From the standpoint of sovereignty the analogy is not with EMU but with ~~Bretton Woods~~ the gold standard or Bretton Woods, though the ERM allows more operating flexibility than Bretton Woods.

But new legal advice?

26. We would have large discretion over the sterling exchange rate. In the 11 ERM realignments so far it has been normal for major countries to achieve the full realignment sought, although there have often been extended arguments about the way in which realignments are expressed. Two exceptions were in October 1981 when the French achieved a devaluation of 8½ per cent compared with an initial request of 9½ per cent and in April 1986 when the devaluation agreed was 6 per cent compared with an initial request of 8-9 per cent. But these were small differences, and in any

case it seems almost inconceivable that we would ever be prevented from revaluing upwards to dampen down inflation.

ERM and UK Economic Strategy

27. Our economic strategy of course consists of two main aims: securing a significant and permanent reduction in inflation, and ensuring that the improvement of recent years in the productive performance of the economy is sustained.

28. In order to achieve our inflation objective, we have to conduct our financial policies - and particularly monetary policy - in such a way as to clearly bear down on inflation. Furthermore, we have to influence expectations so that the market firmly believes that we will stick to this approach. Joining the ERM, provided we were not wedded to defending a particular band, would not be inconsistent with either of these requirements.

29. Membership of the ERM certainly has not prevented other countries from reducing their inflation rates. As the chart at Annex A shows, inflation in France, Belgium, Ireland and Italy has fallen markedly since the early 1980s and there has been a convergence of inflation rates towards the German level.

30. Would joining the ERM prevent us from raising interest rates in order to combat inflation, as is sometimes argued? Certainly, if the markets firmly believed there was no prospect of a sterling devaluation, an interest rate rise could lead to large capital inflows. If the UK and other authorities intervened to protect the sterling rate and the intervention was unsterilised,

the interest rate rise might be aborted and sterling money supply would expand with obvious inflationary consequences. If the intervention was sterilised through larger gilt sales, then the higher interest rates would probably hold but it might then be impossible to avoid an upward realignment.

31. If this situation of capital inflows in response to higher sterling interest rates arose, it is the latter option - ie upward realignment - that we would go for. That said, the likelihood of this having to happen should not be exaggerated. Membership of the ERM can be consistent with quite large interest differentials. The 2¼ per cent margin allows for considerable currency movement. In the short run, interest differentials can thus be very wide indeed. For example, a 4 per cent interest differential is consistent with an expectation that the exchange rate will over a 3 month period depreciate by 1 per cent - ie well within the margin. Over longer periods, too, sizeable interest differentials have proved possible partly because of expectations of realignments. For example, the French had an interest differential of 3 to 4 per cent vis a vis the Germans in 1987 and 1988 while the Franc stayed within its 2¼ per cent band. And they achieved this after most of their capital controls had been abolished.

Short or long run (what have Delors asked for?) ([illegible])

32. Thus, if we needed to tighten monetary policy, we would raise interest rates and, if necessary, realign. It follows that there should be no significant risk of inflation being greater from joining the ERM.

33. It is frequently said that our experience with holding sterling at below DM 3 in the year up to March 1988 simply shows that inflation would be greater if we joined the ERM. Certainly in retrospect, we allowed monetary conditions to become too lax. In spite of the weakening of the dollar and the perceived worsening of investor and consumer confidence after the October 1987 crash, a sterling rate of DM 3 or just below turned out to be inconsistent with the counter-inflationary stance that we had intended.

34. Had we judged the stance of monetary demand more accurately, we should have raised interest rates earlier. Had we been in the ERM at around the DM 3 mark, we would probably have sought and obtained a realignment. Indeed, we would probably have come under pressure at a relatively early stage from other ERM members to realign: the Bundesbank, for example, would almost certainly have objected to intervention on the scale that took place. In short, we do not believe the experience of 1987/88 provides a valid rationale for our not joining. ie the 1987/88 experience points to the difficulty of interpreting monetary conditions (which would be the same within or outside ERM) not to inherent difficulties in the ERM concept itself

Improve

35. Another argument sometimes put forward is that, by not being able to devalue and by linking our monetary policy effectively to Germany monetary policy, the UK economy would have to grow too slowly.

36. ERM membership certainly would not slow down the introduction of supply side measures in the UK. Whether or not we are in the ERM we have to press ahead with these. Germany may

continue regrettably to go slow on structural reform, but there is no reason why - inside the ERM - we should go at their pace. Monetary policy over the medium to long term affects inflation not real growth. Therefore being tied to German monetary policy should not hold back the growth of the UK economy. Furthermore, we learned many years ago that exchange rate devaluation can only be a temporary panacea, if at all, to problems of output and unemployment.

37. There is still a theoretical risk that German monetary policy might be too tight for us. That would be the case if we felt that Germany's target for inflation was too low for us also (or possibly if their policy stance was too tight even relative to their inflation target).

38. Certainly, at present, there is no risk of German policy being too tight relative to their inflation target; ~~in fact, they probably need to tighten~~. As for Germany's inflation target of ~~zero or~~ near zero, there can be no question of this being too low for us. On the other hand, if we are to get inflation down to their level there will no doubt be an adjustment problem. If we were in the ERM, we might want to mitigate this at some stage by a downward realignment.

39. There is a further argument that sterling is inherently a more volatile currency than others, and that therefore attempts to hold sterling within its ERM margin would undermine our monetary policy. Although sterling is probably subject to greater

fluctuations on account of external factors than other ERM member currencies, this point is now much less important than it was because sterling is no longer a petro currency.

40. When we <u>were</u> a large net exporter of oil, big changes in the price of oil really would have caused us major problems had we been in the ERM. At its peak in 1985, we had an oil surplus valued at £8 billion; this fell to £2¼ billion in 1988 and is unlikely to increase. Our fiscal take from oil fell from £12 billion in 1984/85 to £3.2 billion in 1988/89. In those earlier years, even quite a small price change had a major impact on the exchange rate. With export and tax revenue from oil now so much reduced, and with the expectation of a relatively stable oil market over the next few years, the oil price is unlikely to be a significant influence on the exchange rate.

41. Finally, there is the question of whether greater exchange stability might be achieved at the expense of greater interest rate volatility. It is far from clear in fact that interest rates would be more volatile than they have been in recent years. Nonetheless, to the extent that there <u>was</u> greater interest rate variability, it seems that this is something industry would willingly trade, since, for most businesses, exchange rate changes have a far greater effect on cash flow than interest rate changes. Taking industry as a whole, short term assets and liabilities are roughly in balance, so that interest rate changes have little immediate effect.

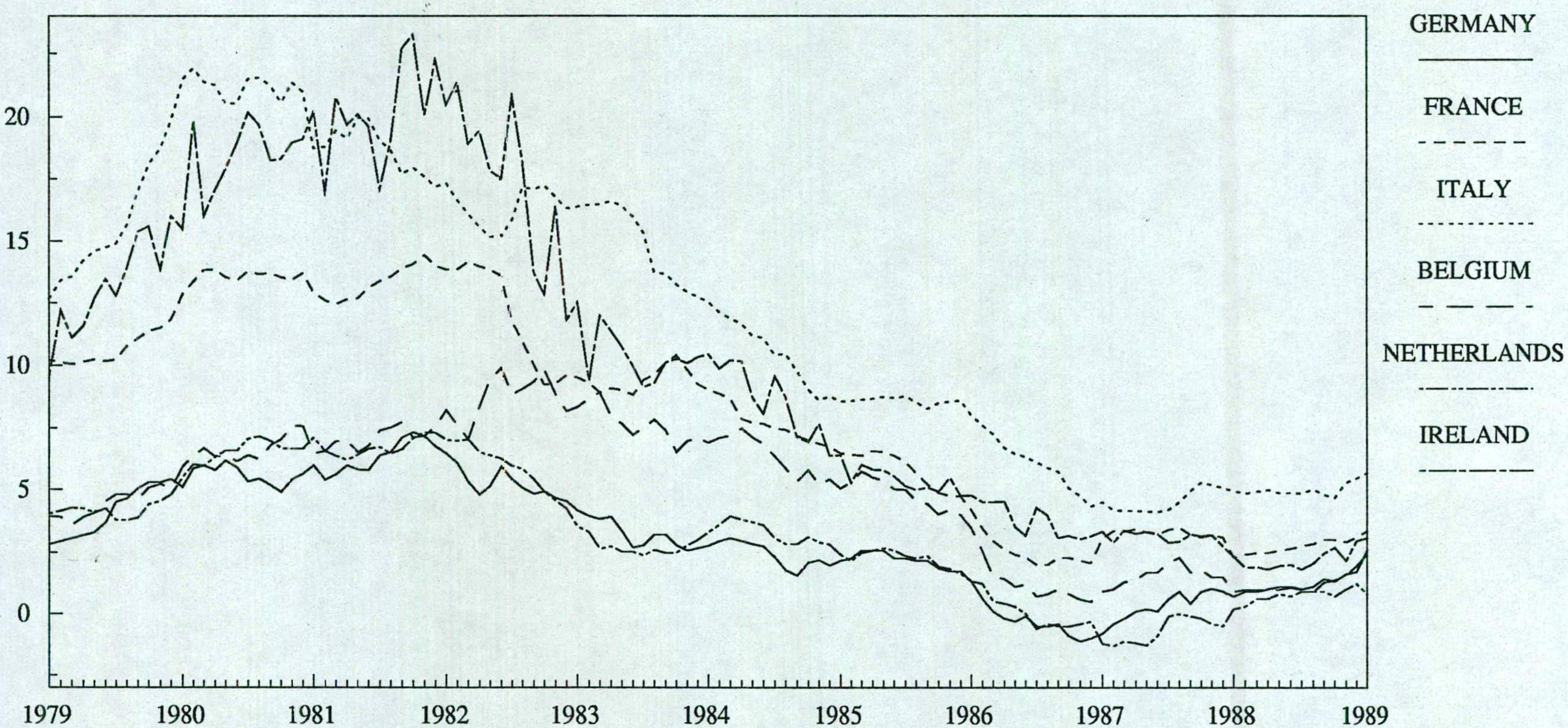
If this so, we surely ought to use it in our defensive briefing on interest rates.

Conclusions

42. In sum then, ERM membership if sensibly conducted would not hinder us in getting inflation down, and it might help. The possibility, and indeed desirability in some circumstances, of realignments would mean that our monetary policy would not become subservient to maintaining exchange rates stability. The greater exchange rate stability that would be likely to follow in due course should, if anything, improve the supply side performance of the economy. It follows that we believe circumstances have so evolved that ERM entry would no longer (as in the early 80s) conflict with UK economic strategy, but rather reinforce it. In the light of the EC risks our joint advice therefore is that the right course to follow now is as described in para 23, ie to indicate before or at Madrid that we believe the time for ERM entry is ripening, and to be ready to confirm in the Autumn that we envisage joining by next summer. We see no risk that such moves would be interpreted as any weakening of our objections to EMU as any more than a very long term aspiration . Indeed, since our move would be accompanied by EC acceptance of our prescription for handling the Delors Report, we would be seen to have defeated the "in for a penny....." approach. ERM would not be a slippery slope towards EMU, for ERM arrangements are inter-governmental, not supranational.

43. We would welcome an opportunity to discuss these issues with you, and consider what analytical work might be commissioned from officials, and what briefing might be useful before Madrid. Knowledge of this minute is being closely restricted by our offices, and no copies have gone to any of our colleagues.

SELECTED ERM COUNTRIES CONSUMER PRICE INFLATION RATE



COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS

OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

PG

THE CHAIRMAN

Basle, 27th September 1988

Confidential

The Rt. Hon. Nigel Lawson, P.C. M.P.
Chancellor of the Exchequer
Great George Street
London SW1

Dear Minister,

At its last meeting in September 1988 the Committee of Governors undertook its regular examination of recent developments in public finance and their implications for economic policy in the EEC countries. The discussion was based on a note drawn up by the group of experts chaired by M. Raymond. It was decided to bring this document to your attention together with certain observations made by the Governors in the course of their discussion.

The Committee noted that developments in 1987 as well as prospects for this and next year confirm a slight underlying improvement in the convergence of budgetary performances. This is due in large part to the fact that there has been greater differentiation in the fiscal policies implemented in the EEC countries in response to the different situations observed within the Community. However, the Committee considers that in a number of countries budgetary adjustment must be actively pursued. Strengthening of public finances seems all the more necessary as the liberalisation of capital movements and monetary integration within the Community progress.

Yours sincerely,

Godeaux

J. Godeaux

Enclosure

CH/EXCHEQUER

REC.	30 SEP 1988 ✓30/a
~~ACTION~~	
COPIES TO	PS/EST, SIR G LITTLER
	MR PERETZ
	MISS O'MARA
	MR N P WILLIAMS

COMMITTEE OF GOVERNORS OF THE

CENTRAL BANKS OF THE MEMBER STATES OF THE

EUROPEAN ECONOMIC COMMUNITY

GROUP OF EXPERTS UNDER THE

CHAIRMANSHIP OF M. RAYMOND

RECENT DEVELOPMENTS IN PUBLIC FINANCE

AND POLICY IMPLICATIONS

SEPTEMBER 1988

CONTENTS

INTRODUCTION

In accordance with the mandate given by the Committee of Governors, the group of experts under the chairmanship of M. Raymond has updated a selected number of statistics attached to its Special Reports on public sector deficit financing and public expenditure.[1] Analysis of these data present the following highlights:

- a further decline in the share of both public expenditure and deficits in GDP which, however, only partially reflected fiscal adjustment;
- a further rise in public debt ratios;
- increasing recourse by governments to domestic financial markets with somewhat more prominence given to short-term borrowing.

CHAPTER I CURRENT BUDGETARY TRENDS AND CONVERGENCE OF BUDGETARY POSITIONS

1. Developments in 1987

(a) Public expenditure, revenue and deficits

For the Community as a whole, general government deficits have continued to decrease in the period under review, mainly reflecting a similar-sized decline of public expenditure (see Table 5). This outcome, however, fell short of initial projections (which provided for more decisive

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1 Special Report on Public Sector Deficit Financing by EEC central banks, dated 28th October 1981, and Special Report on Public Expenditure and its Implications for Monetary Policy in EEC countries, dated 30th June 1982. Updatings of this kind were carried out in 1983, 1984, 1985, 1986 and 1987 (see the Group's notes on recent developments in public finance and policy implications, dated July 1983, 1984, 1985, 1986 and September 1987 respectively). It should be noted that following the revision of national accounts, back-data, especially for the Community, have been substantially revised.

fiscal adjustment) and concealed contrasting developments in individual EEC countries.

The main factors determining budgetary developments in 1987 were:

- varying priorities given by EEC countries to fiscal policies and differences in the strength of economic activity;
- the fall in interest rates which had a significant, albeit uneven, impact on public sector debt service.

With regard to fiscal policies in EEC countries,[2] some countries facing pronounced budgetary constraints (resulting from high government deficits and/or high public debt ratios) have continued their policies of reducing fiscal imbalances. This was the case in Belgium and Ireland which succeeded in cutting their deficits by about 2 percentage points of GDP through reductions in public expenditure combined with some modest increases in government revenue. In Spain, the general government deficit also declined by roughly 2 percentage points of GDP but this was largely the result of increased revenue (mainly reflecting the strength of economic activity) and the fall in interest expenditure. No underlying improvement of budgetary positions has been made in Greece, Italy and Portugal; in the two former countries the deficit net of interest payments remained virtually unchanged whereas in Portugal the considerable decline in interest payments in terms of GDP was fully offset by an increased deficit with respect to non-interest items. While in the case of Greece the depressed state of the real economy explains part of the failure to reduce the budget deficit, the results in Italy and Portugal have to be assessed against the background of relatively strong economic growth. The increase in the general government deficit in the Netherlands (which partly negated the efforts made in the preceding years to reduce the deficit) mainly reflected the decline in gas revenue which was offset only in part by fiscal adjustment measures.

Among EEC countries with no major budgetary constraints, the United Kingdom has continued its policy of gradually reducing the share of government in national income. This policy, in combination with the strength of economic activity, brought the budget into surplus for the first time since 1969/70. In France, the reduction of the general government deficit

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2 For details, see Annex I.

mainly reflected higher revenue whereas the share of public expenditure in GDP stabilised.

In Denmark, Luxembourg and Germany budgetary positions have deteriorated although remaining in surplus in the two former countries. In Germany the general government deficit rose by 1/2 percentage point to 2.5% of GDP; this was mainly due to shortfalls in revenues whereas public expenditure grew at the same rate as GDP. This deviation from the longer-term objective of a gradual reduction in the ratio of public expenditure to gross national product was accepted in order not to impede economic growth and external adjustment.

The development of interest expenditure (see Tables 2 and 5) has had a major effect on budgetary balances in several cases. Following the fall in interest rates in the past few years the effective cost of borrowing has declined significantly in countries where, government debt being short-term or at a floating interest rate, interest payments adjust promptly to changes in interest levels. This decline in the effective cost of borrowing more than offset the impact on interest expenditure of rising public sector debt. In some other countries the impact of falling interest rates was reduced by the rather inflexible long-term, fixed-rate structure of outstanding debt and in several cases it was offset to a large extent by the effect of rising debt ratios. Higher interest payments as a share of GDP in Greece reflected not only the further sharp rise in public debt but also the increase in the effective borrowing cost which allowed a larger part of the PSBR to be financed on the non-bank market.

(b) Outstanding public debt

The decrease in the Community's aggregate budgetary deficit has not prevented public debt ratios from rising further although in general the rate of growth has slowed (see Table 7). The reduction of deficits was insufficient to offset the effect of lower nominal GDP growth which resulted in turn from the fall in inflation and/or slower economic growth. In some countries, revaluation changes in foreign currency debt added to the rise in public debt ratios.

Public debt ratios rose especially strongly in countries with an existing high level of public debt outstanding. It rose also in Germany where the ratio had stabilised in the previous year. In France and the Netherlands, special financial transactions outside the budget (privatisation operations and repayments of public housing loans respectively) held the public debt ratio almost stable. Public debt ratios genuinely fell or were stable only in Denmark, Luxembourg and the United Kingdom, i.e. countries with budgets in balance or in surplus.

2. Prospects

Latest projections by the Commission of the European Communities suggest that the financial deficit for the Community as a whole will remain stable in 1988 and be reduced slightly to 4% of GDP in 1989. Both expenditure and revenue will also decline. These projections are based on national budgetary plans[3] which provide for some further tightening of budgetary policies in several countries but some relaxation in others.

Among the countries with more or less severe budgetary constraints, Ireland will continue its policy of fiscal adjustment whereas in Belgium the deficit is expected to stabilise around the level recorded in 1987. No major adjustment can be expected in Greece and Portugal whereas prospects remain uncertain in Italy. In the Netherlands the deficit is expected to decrease in 1988.

Elsewhere, prospects are for a gradual reduction of budget deficits in the case of Spain and France; in the latter country this will be achieved through cuts in non-interest expenditure. In the United Kingdom the authorities are aiming at a balanced budget over the next few years, while at the same time reducing public expenditure as a proportion of national income.

In the remaining countries, budgetary policies tend to be relaxed temporarily. This is particularly the case in Germany where the government will accept a further increase in the deficit of about 1/2 percentage point to approximately 3% of GDP in 1988 in order to give an impetus to domestic demand. However, the medium-term course of fiscal policy - the objective of which is a reduction in the tax burden and a curbing of the ratio of public expenditure to GDP - will be pursued. It has therefore been announced that the 1989 Federal Budget will provide for measures of fiscal retrenchment designed to reverse the rising trend of the budget deficit. The third and final stage of the tax reform will provide a further net tax relief of the order of about 1% of GDP.

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3 For details, see Annex I.

3. Convergence of budgetary positions

1987 saw some limited move towards more convergence of budgetary positions (in terms of GDP) and this trend appears likely to continue in the current year. Whereas some countries have taken structural measures in order to reduce unsustainable budgetary imbalances, some other countries which face no major budgetary restraint have accepted a deterioration of their budgetary position to the extent that this was in line with broader macro-economic aims.

Nevertheless, large divergences in budgetary balances remain. In Denmark, Luxembourg and, if one includes the proceeds of assets sales, the United Kingdom the general government is in surplus and in Germany, France and Spain deficits are below the Community average. The other countries run deficits well above the Community average, ranging from around 6% to more than 10%.

In line with the divergences of current budgetary deficits in EEC countries, the rate of growth of public debt also varies considerably. In the first group of EEC countries, debt ratios are either falling or increasing only slightly, in general from relatively modest levels. In other countries, they are growing strongly (at annual rates of up to 6%) and from generally much higher levels.

CHAPTER II GOVERNMENT DEBT POLICIES

1. Financing of general government borrowing requirements in 1987

Budgetary deficits were again covered to an increasing extent by sales of public debt on domestic financial markets although maturities of new government debt tended to shorten. Base money creation through government debt transactions was not very significant in any EEC country over the period under review but sometimes there were disturbances for money market control in the short run.

Recourse to central-bank financing and borrowing from abroad (see Table 6b, column (a) and Table 6a, column (f) respectively) was reduced in Greece, Ireland and Portugal to relatively small amounts; in Belgium government transactions with the central bank resulted in a net repayment of outstanding debt. In Spain, the general government deficit was basically financed through loans from the central bank in the first five months of

1987 as the Treasury was not willing to accept high nominal market interest rates. Subsequently, these loans were repaid when, following the relaxation of monetary policy and the creation of a new short-term debt instrument, the deficit was overfunded by market issues.

In Germany, the Netherlands and Belgium, public debt issued on domestic financial markets consisted mostly of medium and long-term borrowing (see Table 6a). In the latter country, this marked a reversal of the development recorded in 1986 when the authorities had reduced their recourse to the long-term financial markets in favour of issues of short-term debt instruments. In Portugal, the share of marketable medium and long-term instruments in government financing has continued to increase to about one third of the total in 1987. In Greece, too, issues of medium and long-term paper increased in importance but their share still only amounted to about 10% of government borrowing; the bulk of the shift from foreign borrowing to domestic financing was reflected in an increased volume of Treasury bill issues.

In contrast, in France, Ireland, Italy and Spain, much more reliance was made on short-term market financing. This development, which contrasted with the policies followed by these countries in previous years, had varying origins. In Ireland, there was the desire to take advantage of the yield structure whereas in Italy it became difficult to place long-term debt when inflationary expectations picked up in the second half of 1987. In France, the authorities responded to the increased preference of the public for short-term assets; the substantial decline in the volume of long-term funds raised by the State on financial markets was also linked to the privatisation operations, the proceeds of which were mostly used to repay long-term outstanding debt.

New public debt issued on domestic financial markets was mainly taken up by residents. In Germany, where in 1986 foreign investors had played a predominant part in financing the government deficit, net acquisition of government securities by non-residents dropped markedly in 1987; given a relatively stable dollar exchange rate and internationally strong interest rates, DM bonds became less attractive to those investors. In contrast, non-residents showed increased interest in government debt issued on the Danish, Irish and Dutch bond markets.

2. The structure of outstanding government debt

Except in Denmark, the share of marketable domestic debt instruments in total outstanding government debt has generally increased whereas that of outstanding foreign currency debt has fallen or stabilised. Outstanding loans from the central bank generally continued to decline, not only in per cent. of GDP, but sometimes also in absolute terms.

The move towards longer maturities of government debt continued in France (where it reflected a lengthening of the average maturity of newly-issued Treasury bills). In contrast, average maturities tended to shorten in several countries with relatively large shares of short-term debt. This was the case notably in Italy where the average residual life of outstanding securities fell by two months to 3 years and 7 months at end-1987.

CHAPTER III CONCLUSIONS AND POLICY IMPLICATIONS

Developments in 1987 and forecasts for the near future confirm the continuing move towards somewhat more convergent budgetary positions (budgetary balances in per cent. of GDP and growth rate of public debt ratios). This has been the result of fiscal policies responding in a more differentiated way to varying situations in EEC member countries.

Nevertheless, budgetary developments are only partially satisfactory. In some of the countries with severe budgetary constraints, there was virtually no fiscal adjustment, although temporary factors such as conjunctural developments and the fall of interest rates brought some temporary relief. As a result the strong underlying growth of existing high public debt will not be reduced; this in turn will make the eventual reduction of deficits even more difficult. In some other countries of the same group, fiscal adjustment is still incomplete despite significant progress made in 1987, and budgetary positions cannot yet be considered to be sustainable in the medium-run. On the other hand, those countries where budgetary positions are roughly balanced see little scope for fiscal relaxation. Either there are external constraints or countries are reluctant to take measures that could jeopardise the achievements made in recent years with regard to budgetary stability.

Financing of government deficits through funds raised on domestic financial markets has become a widely followed practice in EEC countries. Government debt policies avoiding base money creation have reduced direct conflicts between budgetary policies and monetary management. Nevertheless, heavier reliance on short-term borrowing might not be viewed as a favourable development from the standpoint of monetary policies. More important, however, are the indirect consequences of budgetary developments. Excessively high budgetary deficits tend to undermine the credibility of monetary policies designed to foster the disinflation process and thus impede the hoped-for decline in inflation-adjusted interest rates. In addition, divergences in budgetary positions are an obstacle to strengthened co-ordination of monetary policies.

BUDGETARY DEVELOPMENTS IN 1987 AND PROJECTIONS FROM 1988 ONWARDS

BELGIUM

The Belgian public sector financing requirement was considerably reduced in 1987 from 9% of GDP to 7%. This reflected a further tightening of the austerity policy in force since 1982.

All the main categories of public expenditure fell as a percentage of GDP in 1987. A fall in consumption and current transfers to individuals resulted particularly from the third withholding of 2% of the indexed increase of salaries and most social benefits and also from measures within the "Val-Duchesse" austerity plan. The latter has also restricted investment by the central government. In contrast investment by the local governments has been stimulated by the communal elections. For the first time since 1972, interest charges fell in 1987 as a percentage of GDP. This was mainly due to the decline in the effective borrowing cost resulting from lower interest rates, improved debt management and increased recourse to long-term borrowing which does not normally give rise to interest payments in the year of issue.

Public revenue rose, mainly because of an increase in indirect taxes and social security contributions. The former benefited, among other things, from an increase in VAT on residential building and a widening of the tax base following the strengthening of the secondary property market. Social security receipts were boosted, in particular, by the payment to the social security system of the proceeds of the 2% moderation of most earned income. Direct personal tax receipts, on the other hand, were reduced by this measure and by tax reductions prescribed in the four-year tax plan. Company tax receipts were more or less unchanged despite the reduction of the normal rate by 2 percentage points. Revenue deriving from the operations of the Banque Nationale de Belgique fell, partly due to lower interest rates, while the profit from the issue of the gold ECU coin was an extraordinary item of income which reduced capital expenditure.

Outstanding public debt rose further by 6% of GDP. This increase marked an acceleration in comparison with the two preceding years but the underlying trend is for some slowdown of public debt growth.

The Banque Nationale de Belgique estimates that the net financing requirements of the public authorities will stabilise at around 7% in 1988. Revenue is expected to grow more slowly than GNP, principally as a result of cuts in tax and civil servants social security contributions as well as lower transfers from the Banque Nationale de Belgique following the fall of interest rates. Expenditure will also slow in terms of GNP due to a continuation of lower debt service payments, reduced unemployment benefits, effects of the Val-Duchesse austerity plan and the fact that the indexation of salary and current transfers will take place only later in the year.

DENMARK

The Danish general government account, which had swung into a surplus of 3.1% of GDP in 1986, weakened somewhat in 1987 but nevertheless remained in surplus (by the equivalent of 2.1% of GDP). This deterioration was due to the effects of economic stagnation (GDP fell by 1%) and, in particular, falling real profits in the non-financial sector.

Expenditure increased in 1987, with public consumption increasing by 1.6% in fixed prices and transfers to households rising by almost 1% of GDP in real terms.

Revenue also rose, boosted in 1987 by various fiscal measures including an increase in excise taxes in 1986 which had its full effect in 1987, higher local government taxes, a less-than-full inflation adjustment of tax brackets and an increase in social security contributions. In addition the real interest tax on pension funds and life insurance companies grew strongly and tax receipts from banks and savings banks increased as a result of capital gains in the previous year.

External government debt increased by D.kr. 20 million in 1987, mainly due to external borrowing in the first quarter to replace private capital exports during the previous year. However, total public sector debt continued to shrink as a percentage of GDP, falling from 63% at end-1986 to 60% at end-1987.

The latest official forecasts for 1988 point to a further weakening of the budget surplus to 0.8% of GDP. Increasing unemployment and stagnating real incomes are expected to have a negative effect on revenue while, on the expenditure side, public consumption is forecast to rise by 1.5% and household transfers to increase in real terms by the equivalent of 0.5-1.0% of GDP. Since tax rates will be kept almost constant, this constitutes a relaxation of fiscal policy for the first time since 1980.

GERMANY

In 1987 the German central, regional and local authorities' budget deficits amounted to DM 51.5 billion and were thus DM 9 billion higher than in the preceding year, despite the fact that, following the income tax cut introduced in 1986, no further tax relief measures came into effect in 1987. The original plans, in contrast, had provided for some reduction in the deficits in 1987. Including the social insurance institutions, the public sector deficit last year, at DM 48 billion, was approximately DM 12 billion greater than in the preceding year; as a percentage of GNP, it rose from just under 2% to around 2.5%.

Public sector expenditure, grew at almost the same rate as GNP, with the result that there was no further progress towards the longer-term objective of a gradual reduction in the ratio of public expenditure to gross national product.

The major factor in the unfavorable trend in finances was, however, the slower-than-projected growth in the tax revenues of the central, regional and local authorities. At 3.5%, the increase was somewhat less than the rise in nominal GNP (which was just under 4%).

As a consequence of this development, public sector indebtedness again rose faster than the national product, having previously been kept stable in relation to GNP.

The second phase of income tax cuts agreed in 1985 came into effect at the beginning of 1988, having been increased to almost DM 14 billion in the course of last year by bringing forward part of the relief contained in the tax reform planned for 1990. This tax relief has already been taken into account in the budget estimates. However, the central, regional and local authorities' deficits are expected to widen further than planned with the Federal budget deficit likely to amount to around DM 40 billion, compared with a projected DM 30 billion. At the Land level, the current plans provide for a deficit of approximately the same size as last year's and a further increase is expected in the local authorities deficit. The central, regional and local authorities' budgets will thus provide a strong impetus to domestic demand.

The medium-term course of financial policy - the objective of which is to reduce the tax burden and curb the ratio of public expenditure to GNP, in order to strengthen the economy's productivity and improve long-term growth prospects - is, however, to be maintained. A further marked cut in the 1989 Federal Budget deficit is, therefore, projected. This is to be achieved by means of consistent retrenchment of expenditure, the removal of subsidies and the raising of specific indirect taxes. In 1990 the tax reform is scheduled to provide further net tax relief of the order of DM 20 billion.

GREECE

The Greek central government deficit widened to 10.3% of GDP in 1987 (on an accruals basis) compared with a forecast decline to 8.2%. On a cash basis the deficit increased to 11.6% of GDP from 10.4% in 1986. The general government deficit grew more slowly from 11.8% of GDP in 1986 to 12.2% in 1987 since part of the deficits of the social insurance fund and public transport companies were covered by transfers from the government budget.

Total central government expenditure increased to 38.1% of GDP in 1987 from 36.3% in 1986 with current expenditure boosted by large public debt service payments, transfers to public organisations and tax refunds. Capital expenditure fell as a proportion of GDP.

Central government revenue also rose to 27.8% of GDP in 1987 from 27% in 1986 but fell short of the budget forecast, due largely to the tight incomes policy pursued in 1987 for the second year running, the shortfall in revenue from tax arrears and the strike of public cashiers at the end of the year.

Outstanding government debt as a proportion of nominal GDP increased by a further 6 percentage points in 1987. About 1.5 percentage points of this increase were due to valuation adjustments of external debt. Higher interest rates offered on government paper allowed some substitution of domestic debt for foreign debt.

The Budget for 1988 implies a decrease of the central government deficit by approximately 1 percentage point of GDP. Both expenditure and revenue are expected to grow faster than GDP. Expenditure will be particularly influenced by large allocations to the Social Insurance Fund, public transport companies and local government as well as a rapid growth of interest payments. Revenue will be boosted by an expansion of the tax base following the introduction of a new personal income tax system at the beginning of 1988, renewed efforts to clear tax arrears and the increased rate of taxation of tobacco products.

SPAIN

The Spanish general government borrowing requirement decreased from 5.7% of GDP in 1986 to 3.6% in 1987 in terms of National Accounts. In terms of financial accounts, however, the reduction was less, the financing requirements falling to 4.3% of GDP from 5.9% in 1986.

Expenditure fell slightly in terms of GDP for the first time since 1975. This was mainly due to the drop in interest payments (which resulted not only from the decline in interest rates, but also from the introduction of a new accounting system). Public consumption grew by 0.5 percentage point of GDP due to an increase in the purchase of goods and services. Transfer payments decreased by 0.4 percentage point of GDP with social benefits falling sharply. Capital expenditure remained largely unchanged in terms of GDP.

As in the previous year, the decline in the public deficit in 1987 was mainly the result of a sharp increase in fiscal revenue which grew by 16.6% of GDP in 1987 and amounted to 38.6% of GDP compared with 37% in 1986. Receipts from direct personal and company tax increased very strongly due to the buoyant state of the Spanish economy. Indirect taxes grew more slowly, mainly due to a decline in income from the oil monopoly, while social security contributions continued to represent about 13% of GDP.

Outstanding public debt increased from 48% of GDP in 1986 to 48.5% in 1987 which continues the decelerating trend begun in 1985.

The net general government borrowing requirement is projected to decline in 1987 by almost 0.4 percentage point to around 3% of GDP.

FRANCE

The 1987 Budget resulted in a deficit which was Fr.fr. 21 billion smaller than in the previous year. The financing requirement of the public administrations fell to 2.4% of GDP from 2.9% in 1986 while the state financing requirements remained unchanged in terms of GDP at 2.3%.

Total public expenditure increased in line with GDP. A slight decrease in transfers to the personal sector and interest payments was offset by an increase in transfers to other sectors.

Public revenue increased faster than GDP in 1987. Tax receipts of the State were largely unchanged despite the beneficial effects of buoyant household consumption in 1987 and the improved financial position of enterprises in 1986. Local taxes continued to rise and social security contributions were increased.

Receipts from privatisation are outside the general budget. About one quarter was used for financing certain capital items which otherwise would have had to be financed out of the budget; another part was used for repayments of public debt. The public debt ratio thus stabilised in 1987 at around 25% of GDP.

The 1988 Finance Act budgets for a slight reduction (Fr.fr. 5 billion) in the deficit compared with the 1987 outturn. The State financing requirement will be reduced from 2.3% to 2% of GDP, largely through strict control over transfers and salary costs.

IRELAND

In 1987 both the Irish central government budget deficit at 6% of GDP and the Exchequer borrowing requirement at 9.1% of GDP were smaller than forecast. The general government borrowing requirement fell from 10.9% of GDP in 1986 to 8.5% in 1987.

This favourable outcome was largely due to lower-than-expected current expenditure resulting from falls in public consumption and transfers to the personal sector. There was also a substantial decline in capital expenditure as a percentage of GDP.

Government revenue on the other hand, increased slightly following increases in personal and other taxes, despite a decrease in indirect taxation.

Despite a significant reduction of the deficit in 1987, the debt ratio rose further by 3% of GDP; this, however, marked a substantial slow-down in comparison with preceding years.

The 1988 Budget forecasts a slight reduction of both the central government current budget deficit and the exchequer borrowing requirement, both in absolute terms and as a percentage of GDP. To achieve this, a sharp reduction of borrowing for capital purposes is proposed while a relatively smaller reduction in the current budget deficit is expected, largely through the maintenance of strict control over transfers and salary costs. Both capital and current expenditure is expected to decline, the latter largely due to a fall in public consumption. Government revenue is also expected to decline slightly as a result of lower personal tax receipts. The general government borrowing requirement is consequently expected to fall to 7.4% of GDP.

ITALY

The Italian public sector borrowing requirement considerably overshot its target but declined to 11.6% of GDP in 1987 from 12.2% in 1986 mainly as a result of lower interest payments.

Excluding interest payments general government expenditure fell in 1987 to 42.4% of GDP from 42.5% in 1986, despite the very high outlays resulting from the renewal of public sector labour contracts. Investment expenditure continued to expand less quickly than expected. Despite the strong growth of debt, interest payments declined to 8.2% of GDP in 1987 from 8.7% in 1986 due to the fall of interest rates in response to lower inflation. The lagged effect of the indexation of Treasury certificates, which represent half total government securities outstanding, meant that the substantial fall in rates in 1986 was the main factor in lowering interest payments last year.

The total revenue of the general government rose much more sharply than expected, to 40.0% of GDP in 1987 from 39.5% in 1986, largely due to tax measures taken in August 1987 which raised receipts in the second half of the year. Tax receipts were also boosted by the effects of the improved terms of trade. Indirect taxes were raised as international prices fell and direct tax receipts benefited from higher profits. In addition there was a considerable increase in revenue from the withholding tax charged on government securities.

Public sector debt rose to Lit. 910 trillion or 92.6% of GDP in 1987 from Lit. 793 trillion or 87.9% of GDP in 1986.

Budget forecasts for 1988 have been affected by political uncertainties. Towards the end of 1987 it was hoped to be able to reduce the 1988 State sector funding requirement to almost Lit. 100 trillion but many of the proposed expenditure cuts were opposed in Parliament and only because of the corrective measures taken in the summer was it possible to contain the borrowing requirement to Lit. 116 trillion.

LUXEMBOURG

The 1987 Luxembourg budget is expected to have been in surplus despite an initial forecast of a small deficit. This result is due to higher-than-planned revenue and was achieved despite the implementation of a major tax reduction plan amounting to 2.1% of GDP. Current expenditure fell somewhat as a percentage of GDP while capital expenditure remained stable.

Current revenue also fell a bit in terms of GDP while indirect taxation and social security contributions were unchanged.

NETHERLANDS

With revenues growing more slowly than expenditure, the Dutch general government financial deficit increased by 0.3 percentage point to a level of 6.6% of GDP in 1987. Mainly due to differences between cash basis and transactions basis, the borrowing requirement increased by 1.6 percentage points to 8.4% of GDP in 1987.

General government expenditure on a transactions basis increased in 1987 by 0.7 percentage point to a level of 59.8% of GDP. This was largely accounted for by a rise in income transfers to sectors other than the personal sector (0.8 percentage point). Upward pressure on these transfers was exerted by movements in cost-price reducing subsidies caused mainly by the marked increase in agricultural subsidies in 1987, due to a combination of lower world market prices and the dollar's decline. Transfers to the personal sector as well as public consumption and interest payments increased only slightly in terms of GDP. Capital expenditure decreased in 1987 by 0.6 percentage point of GDP as a result of lower transfers and credit supplied by the Government to the business sector. Investment expenditure as such was stable in 1987.

General government revenues also increased in 1987, rising by 0.4 percentage point to a level of 53.2% of GDP. Direct and indirect tax receipts grew as a result of relatively favourable economic developments, and social security contributions increased. These three categories of revenues increased by a total of 1.9 percentage points. Other current revenues declined by 1.5 percentage points of GDP, mainly because of the lower natural gas revenues resulting from the delayed impact of the sharp decrease of the dollar's exchange rate and the drop in oil prices. On a cash basis the decrease in national gas revenues was even more marked than on a transactions basis: natural gas royalties decreased by half, to 1.8% of GDP, while receipts from corporation tax levied on enterprises involved in natural gas exploitation declined by 0.7% of GDP.

The public sector debt ratio rose slightly to 73% of GDP; new borrowing to cover the current deficit was offset to a large extent by debt repayments following the anticipated unwinding by the private sector of public housing loans outside the budget.

Prospects for 1988 and later years will be influenced by an extensive package of proposals which include a restructuring and reduction of wage and income tax. In February 1988 it was decided, as part of this package, to reduce the base rate of the investment subsidy scheme from 12.5% to 0% and to use the Fl. 4 billion thus released to finance a reduction of the corporation tax rate to a level of 35% (40% for small profits) and a shift of family allowance contributions from the employees to the central government.

The financial deficit of the general government on a transactions basis is expected to decrease by 0.4 percentage point in 1988 as a result of a decrease in expenditure by approximately 1% and a decrease in revenues by 0.5%. On a cash basis the central government's financial deficit, after the usual adjustments for advance repayments and debudgeted expenditure, will decrease modestly in 1988 to around 6% of GDP. This is still a long way from the target set in the Government's policy programme to reduce the central government's deficit on a cash basis to 5.25% of net national income (equivalent to about 4.5% of GDP) by 1990. In the policy programme the local authorities' deficit is assumed to be 0.25% of national income, which is low taking into account the fact that the actual deficit in 1987 and 1988 is estimated to be about 1.5%

The limited reduction of the central government's deficit in 1988 can be ascribed to the fact that excess expenditure has not been wholly compensated for, while natural gas revenues continue to decrease.

PORTUGAL

The Portuguese general government deficit is estimated to have come down slightly to 7.9% of GDP in 1987 from 8.4% the previous year. However, excluding interest payments the balance shifted from a surplus of 0.8% of GDP to a deficit of 0.1%. The general government borrowing requirement increased from 10.2% of GDP in 1986 to 10.9% in 1987, due largely to the transfer of public entity debt to the Treasury and other loans and transfers to public enterprises.

Total general government expenditure fell by 1.4 percentage points to 44.4% of GDP in 1987, mainly as a result of reduced interest payments. Subsidies rose slightly in nominal terms but dropped sharply in real terms.

Public consumption increased by 1.7% and current transfers by 5.1% (the latter reflecting an increase in the value of pensions and changes in the age structure of the population). Public investments and capital transfers increased more than nominal GDP.

General government revenue also declined from 38.4% of GDP in 1986 to 36.5% in 1987 but in absolute terms it declined less than expenditure. Both direct and indirect tax receipts grew substantially less quickly than GDP and also less quickly than budgeted. This was mainly due to the effect of lower nominal interest rates on capital tax revenue and a shortfall in value added tax receipts.

Outstanding direct public debt increased by 2 percentage points to 72% of GDP in 1987, partly reflecting the transfer of public entity debt mentioned above. Outstanding external public debt fell slightly due to exchange rate developments.

Budgetary projections for 1988 point to a general government deficit of 8.5% of GDP (a 0.6 percentage point increase over the 1987 outturn) and a state deficit of 8% of GDP. The deterioration largely reflects higher interest payments as a result of the transfer of public entity debt. Public consumption and current transfers are forecast to increase in real terms and there will be a further cut in subsidies. On the other hand indirect revenue is expected to increase significantly, largely on account of a 1 percentage point rise in the general VAT rate to 17%. Taxation of civil servants was introduced in the fiscal year 1988 for the first time. The PSBR will again be boosted by transfers of public entity debt and the settlement of arrears.

UNITED KINGDOM

A fiscal surplus of £3.5 billion or 0.8% of GDP was recorded in the United Kingdom in the financial year 1987-88, the first surplus since 1969-70 and the third year in succession that the budget outturn was better than expected.

Although increasing in cash terms, general government expenditure fell as a percentage of GDP in 1987. The major contribution to this fall came from general government consumption and transfers to the personal sector (mainly social security payments); subsidies and debt interest were also lower as a percentage of GDP.

General government revenue increased strongly in cash terms, but also fell as a percentage of GDP, slightly more so than expenditure. Strong economic growth led to much higher than forecast tax receipts. Tax revenue on both income and expenditure was buoyant while high company profits led to high corporation tax receipts. North Sea Oil revenue was roughly unchanged from the previous year with the oil price exceeding the level assumed in last year's budget.

In the financial year 1988-89 a further budget surplus is forecast of broadly the same magnitude as the previous year, despite the tax reductions announced in the Budget. General government receipts, including interest and dividends, are forecast to rise by 6.5% following an estimated 8.5% increase in 1987-88. This is less than the rate of growth forecast for money GDP but without the budget measures it would have been more. Oil revenues are forecast to fall in 1988-89 as a result of both a lower average price and lower production whereas non-oil receipts are forecast to rise by 7%. General government expenditure is expected to rise by 6.5% in 1988-89 which represents a continuation of the falling trend in terms of GDP. Asset sales will continue to make a strong contribution. Over the medium-term the budget is projected to be roughly in balance.

EXPLANATORY NOTES ON STATISTICAL TABLES

Tables 1, 2, 3 and 4

Country figures are from national sources; they are not harmonised. Unless otherwise stated, they are on an accruals basis, i.e. on the basis of transactions.

Figures for the Community as a whole have been calculated on the basis of harmonised figures in conformity with the European System of Integrated Accounts (ESA). Aggregation has been done using purchasing power parities.

Because of differences in methodology, aggregated Community figures are not comparable with national figures.

Table 5

Data in columns (a) to (e) correspond to the figures in Tables 1 to 4 and are on an accruals basis unless otherwise stated.

Data in column (f) cover financial transactions and statistical adjustment; in the case of the Netherlands, data only consist of the financial balance of the social insurance system and items in transit. Conversely, in the case of Italy, the figures also include the balance of the non-state public sector.

Data in column (g) consist of the general government net borrowing requirement on a cash basis except for Italy (where they refer to the public sector net borrowing requirement), the Netherlands (balance of central and local government on a cash basis) and Spain (net change in financial liabilities less net change in financial assets).

Data in column (h) include, in addition to the net borrowing requirement, the refinancing requirement for maturing longer-term debt. In the case of Spain, figures correspond to the net change in financial liabilities.

Table 6a

Borrowing requirements as defined in this table cover the general government except in Denmark, France, Ireland (central government) and Italy (public sector).

Column (b) "Other direct loans" consists of the following items:

- Germany: loans against borrowers' note ("Schuldscheindarlehen") from banks and non-banks (including non-residents) of maturities up to 10 years;
- Italy: direct loans from banks;
- Netherlands: medium and long-term loans against borrowers' note from banks and non-banks;
- Spain: non-marketable Treasury debt subscribed to by the banking system.

Column (c) "Deposits and other short-term non-marketable debt" is made up of the following items:

- Belgium and Italy: Post Office funds;
- France: deposits with the Treasury and Post-Office, non-marketable Treasury and Post Office bills and short-term loans;
- Ireland: small savings;
- United Kingdom: National Savings Instruments, certificates of deposit and local authority short-term non-marketable debt.

In the case of Spain, column (c) includes the balance of Treasury notes compulsorily held according to the ratio applied since July 1984.

Column (f) "Foreign currency loans" consists of syndicated bank loans and issues of securities on foreign and international markets.

Funds raised with maturities of up to one year are considered short-term; medium and long-term funds are those with maturities of more than one year.

Table 6b

Borrowing requirements as defined in this table cover the general government except in Denmark, France, Ireland (central government) and Italy (public sector excluding foreign currency loans).

Column (b) "Banking system" includes the Post Office system in the cases of Germany, Greece, Spain, Ireland and the Netherlands.

Column (c) "Treasury and Post Office system" includes changes in Post Office call deposits, coins in circulation and deposits held by non-financial entities with the Treasury.

Column (d) "Domestic non-banks" includes the Post Office system in the case of the United Kingdom.

Column (f) "Non-residents" includes portfolio investments in domestic government bonds by non-residents except in Italy.

Table 7

Data relate to the general government except for Denmark, France, Ireland, Portugal (central government debt, not adjusted for central government financial claims), Italy (public sector debt), the Netherlands (debt by central government, provinces and municipalities) and the United Kingdom (public sector debt excluding holdings by the public sector). Figures for the Community relate to gross public sector debt.

Data are expressed as a percentage of nominal GDP except for Germany and Ireland where they are in terms of nominal GNP.

Table 8

Data concern the general government except for Denmark, France, Ireland, Portugal (central government debt, not adjusted for central government claims), Italy (public sector debt), the Netherlands (debt by central government, provinces and municipalities) and the United Kingdom (public sector debt excluding holdings by the public sector).

Data are expressed as a percentage of nominal GDP except for Germany and Ireland where they are in terms of nominal GNP.

Column (b) "Other direct loans" consist of the following items:

- Germany: loans against borrowers' note ("Schuldscheindarlehen") from banks and non-banks (including non-residents) of maturities up to 10 years;
- Italy: direct loans from banks;
- Netherlands: medium and long-term loans against borrowers' note from banks and non-banks;
- Spain: non-marketable Treasury debt subscribed to by the banking system.

Column (c) "Deposits and other short-term non-marketable debt" is made up of the following items:

- Belgium and Italy: Post Office funds;
- France: deposits with the Treasury and Post Office, non-marketable Treasury and Post office bills and short-term loans;
- Ireland: small savings;

- United Kingdom: National Savings Instruments, certificates of deposit and local authority short-term non-marketable debt.

In the case of Spain, column (c) includes the balance of Treasury notes compulsorily held according to the ratio applied since July 1984.

Column (f) "Foreign currency debt" consists of syndicated bank loans and issues of securities on foreign and international markets.

Column (g) "Other debt" consists of the following items:

- Germany: liabilities resulting from the Currency Reform in 1948;
- France: other medium and long-term non-marketable debt and Treasury bills subscribed to by international institutions.

Data on the average residual maturity in column (i) refer to the domestic marketable debt of the public sector in the case of Italy, domestic debt of the central government in Denmark and Portugal and total central government debt in the case of Belgium, France and the Netherlands.

Table 9

Data relate to the general government except for Denmark, France, Ireland and Portugal (central government debt, not adjusted for central government financial claims), Italy (public sector debt), the Netherlands (debt by central government provinces and municipalities) and the United Kingdom (public sector excluding holdings by the public sector).

Column (b) "Central bank" includes:

- in the case of Germany: equalisation claims resulting from the Currency Reform of 1948;
- in the case of the United Kingdom: holdings of public sector debt by both the Issue and Banking Departments of the Bank of England.

Table 10

The assumed tax rate on interest receipts in column (d) is defined as the nominal tax rate on households and enterprises' interest income, adjusted, where practical, for special allowances and fiscal evasion. Assumptions take into account the following factors:

- Belgium: interest received by financial intermediaries are not subject to the withholding tax of 25% and enterprises can deduct this tax from their income tax liability;

- Italy: Interest paid on government securities issued after 20th September 1986 is subject to a withholding tax. Initially the tax rate was 6.25% but was subsequently raised to 12.50% in respect of interest paid on government securities issued after 31st August 1987. The tax is due on a settlement basis for households, but can be deducted from firms' total tax liability. In 1987, revenue from this withholding tax was equal to 2% of total interest expenditure on government securities.
- Netherlands: pension funds are exempted from taxation.

ABBREVIATIONS

(a) Countries and country groups

BE	Belgium
CH	Switzerland
DK	Denmark
DE	Germany
ES	Spain
FR	France
GB	United Kingdom
GR	Greece
IE	Ireland
IT	Italy
JP	Japan
LU	Luxembourg
NL	Netherlands
PT	Portugal
US	United States
EC, EC12	European Communities (all present member countries)
EC10	European Communities excluding Spain and Portugal
EC9	European Communities excluding Greece, Spain and Portugal
EMS	Countries participating in the EMS exchange rate mechanism

(b) Other abbreviations

EMCF	European Monetary Co-operation Fund
EMS	European Monetary System
GDP	Gross national product
SOEC	Statistical Office of the European Communities

CONVENTIONAL SIGNS

%	per cent.
..	not available
-	nil or no transaction over the period
a	assumption
b	objective
e	estimated
f	forecast
n.s.a.	not seasonally adjusted
o	outturn
p	provisional
pe	partly estimated
r	revised
s.a.	seasonally adjusted
1/h	first half
2/h	second half

29.6.88

Table 1

LEVEL OF GENERAL GOVERNMENT EXPENDITURE (1)

(on a consolidated basis in per cent. of GDP at current prices)

	1972	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986o)	1987f)	1987o)	1988f)
	- National sources (on an accruals basis unless otherwise stated) -															
BE	42.4	48.2	49.0	50.7	51.8	53.4	54.6	59.7	59.5	59.4	58.3	57.4	56.2	..	54.9 p)	54.5
DK	42.9	48.6	48.3	49.5	51.2	53.8	56.9	60.3	61.7	62.2	60.9	59.5	56.3	..	58.5	59.8
DE	42.2	51.3	50.0	49.5	49.6	49.5	50.3	51.5	51.9	50.7	50.0	49.2	48.6	..	48.7	ca 48.5
GR (3)	22.3	26.1	26.7	27.1	27.0	26.6	26.3	32.7	31.8	33.3	34.0	36.9	36.3	38.2	38.1	41.2
ES	23.5	25.0	26.2	27.6	29.4	30.6	33.1 (7)	35.8	37.7	39.0	39.6	42.5p)	42.7 p)	43.3	42.2 p)	42.8
FR (2)	38.9	44.0	44.3	44.3	45.2	45.4	46.4	49.2	51.0	52.1	52.8	53.0	52.6	52.3	52.6	51.8
IE (2)	41.1	49.4	48.9	47.0	47.8	50.7	55.1	57.3	59.8	58.8	55.9	54.6	53.9	53.9	51.7 e)	49.7
IT (2)	39.0	43.4	42.6	43.1	46.3	45.9	41.9	45.9	48.4	50.0	50.0	51.1	51.0	..	50.5	
LU (4)	37.3	48.4	49.1	51.9	51.5	52.4	54.9	56.5	55.6	57.6	54.0	52.6	50.7	50.2	50.0	49.9
NL	46.9	52.8	53.2	53.5 (6)	55.2	57.7	59.3	60.7	62.4	63.2	62.1	61.1	59.1	..	59.8	58.9
PT (2)	27.8	32.1	36.9	35.8	39.7	37.8	41.0	44.0	44.8	46.1	45.8	45.2	46.8	46.0	44.4	45.6
GB (2)	38.5	44.7	45.0	42.1	42.1	41.6	43.6	45.0	45.3	45.8	46.4	45.1	44.0	..	42.2	..
	- Community sources (on a national accounts basis) (4) -															
EC (5)	38.0	43.7	43.5	43.5	44.5	44.7	45.5	46.9	48.3	48.7	49.0	49.1	48.4	47.5	47.9	47.8

(1) For details, see explanatory notes.
(2) On a cash basis.
(3) Only central government expenditure.
(4) 1972-1984: EUROSTAT figures; 1985-1988: Economic Budget of May-June 1988.
(5) 1972-1979: excluding Greece, Ireland and Portugal.
(6) Break in GDP series.
(7) Break in GDP series because of a revision of the national accounts: figure for 1980 on the old basis: 32.6.

STRUCTURE OF GENERAL GOVERNMENT EXPENDITURE (1)

Table 2

(on a consolidated basis in per cent. of GDP at current prices)

		Public consumption	Transfers to: Personal sector	Transfers to: Other sectors	Interest payments	Total current expenditure	Capital expenditure	Total expenditure
		- National sources (on an accruals basis unless otherwise stated) -						
BE	1972	14.1	15.4	3.6	3.3	36.4	6.0	42.4
	1983	16.5	24.1	4.9	9.4	54.9	4.5	59.4
	1984	16.0	23.9	4.6	9.9	54.4	3.9	58.3
	1985	15.9	23.3	4.2	10.5	53.9	3.5	57.4
	1986	15.2	22.9	4.1	11.0	53.2	3.0	56.2
	1987 p)	14.7	22.6	4.2	10.6	52.1	2.8	54.9
	1988 f)	..	..	..	..	..	..	54.5
DK	1972	21.3	11.4	3.6	1.3	37.6	5.3	42.9
	1983	27.4	17.8	5.2	8.1	58.4	3.8	62.2
	1984	25.9	17.0	5.2	9.6	57.7	3.3	60.9
	1985	25.1	16.2	4.9	9.8	56.0	3.4	59.5
	1986	24.0	15.5	5.2	8.8	53.5	2.8	56.3
	1987 p)	25.4	16.3	5.5	8.3	55.5	3.0	58.5
	1988 f)	25.7	17.4	5.5	8.2	56.8	3.0	59.8
DE	1972	19.3	14.7		1.1	35.1	7.1	42.2
	1983	22.5	19.7		3.1	45.3	5.3	50.7
	1984	22.4	19.4		3.1	44.8	5.2	50.0
	1985	22.2	18.9		3.0	44.2	5.0	49.2
	1986 pe)	22.0	18.6		3.0	43.6	5.0	48.6
	1987 pe)	22.0	18.9		2.9	43.8	4.9	48.7
	1988 f)	..	..		..	..	..	ca 48.5
GR(3)	1972	12.4	3.4		1.0	16.8	5.4	22.3
	1983	18.9	6.4		3.4	28.7	4.6	33.3
	1984	18.5	6.0		4.3	28.9	5.1	34.0
	1985	19.5	6.9		5.2	31.7	5.3	36.9
	1986	19.4	6.4		5.3	31.2	5.1	36.3
	1987	19.7	7.4		6.4	33.4	4.6	38.1
	1988 f)	21.3	8.6		6.5	36.3	4.9	41.2
ES(7)	1972	8.6	8.5	2.0	0.6	19.7	3.8	23.5
	1983	13.9	14.5	4.2	1.3	34.0	5.1	39.0
	1984	13.7	14.5	4.3	2.0	34.6	5.0	39.6
	1985 p)	14.0	14.9	4.4	3.2	36.5	6.0	42.5
	1986 p)	13.9	14.8	4.2	3.9	36.8	6.0	42.7
	1987 p)	14.4	14.6	4.0	3.4	36.4	5.9	42.2
	1988 f)	14.7	14.8	3.9	3.9	37.2	5.6	42.8
FR	1972	13.3	17.0	3.9	0.9	35.1	3.8	38.9
	1983	19.4	21.5	5.4	2.6	48.9	3.2	52.1
	1984	19.5	21.8	5.8	2.7	49.8	3.0	52.8
	1985	19.9	22.0	5.0	2.9	49.8	3.2	53.0
	1986	19.6	22.0	4.8	2.9	49.3	3.3	52.6
	1987	19.6	21.9	5.0	2.8	49.3	3.3	52.6
	1988 f)	19.8	22.0	4.1	2.9	48.8	3.0	51.8
IE(2)	1972	17.0	9.2	4.4	3.7	34.3	6.8	41.1
	1983	22.6	16.4	4.0	9.5	52.5	6.3	58.8
	1984	21.4	16.0	3.8	9.5	50.7	5.2	55.9
	1985	19.1	16.8	3.6	10.6	50.1	4.5	54.6
	1986	19.4	17.3	3.3	10.0	50.0	3.9	53.9
	1987	18.7	16.6	3.1	9.9	48.3	3.3	51.7
	1988 f)	17.9	16.8	2.8	9.9	47.4	2.3	49.7
IT(2)	1972	16.1	13.9	1.9	2.3	35.0	4.0	39.0
	1983	16.3	17.3	2.9	7.5	44.9	5.1	50.0
	1984	16.2	16.7	3.0	8.0	45.0	5.0	50.0
	1985	16.3	17.1	2.8	8.0	45.2	5.9	51.1
	1986	16.1	17.2	3.0	8.5	45.8	5.2	51.0
	1987	16.7	17.0	2.6	8.1	45.4	5.1	50.5
	1988 f)	..	..	..	..	..	..	..
LU(5)	1972	11.8	18.9		1.1	31.8	5.5	37.3
	1983	17.3	32.3		1.0	50.6	10.2	60.8
	1984	16.1	29.8		1.1	47.0	8.2	55.2
	1985	15.2	28.8		1.3	45.3	7.4	52.7
	1986	14.8	27.7		1.3	43.8	6.9	50.7
	1987	14.9 e)	27.3 e)		1.2	43.4 e)	6.6 e)	50.0
	1988 f)	15.0	27.1		1.1	43.2	6.7	49.9
NL(4)	1972	15.3	13.4	7.9	2.7	39.3	7.6	46.9
	1983	16.9	21.5	12.4	5.7	56.5	6.7	63.2
	1984	16.0	20.5	12.4	5.9	54.9	7.2	62.1
	1985	15.6	19.9	12.5	6.3	54.4	6.8	61.1
	1986	15.3	19.7	12.4	6.0	53.4	5.8	59.1
	1987	15.4	19.9	13.2	6.1	54.6	5.2	59.8
	1988 f)	15.2	19.8	13.4	6.3	54.6	4.3	58.9
PT(2)	1972	13.6	5.1	1.3	0.6	20.6	7.2	27.8
	1983	14.6	13.6	4.9	6.4	39.6	6.5	46.1
	1984	14.5	13.7	5.0	7.1	40.2	5.6	45.8
	1985 p)	14.4	13.4	4.3	7.9	40.0	5.2	45.2
	1986 p)	13.6	15.0	3.1	9.2	40.9	5.9	46.8
	1987 p)	13.2	14.9	2.6	7.9	38.6	5.8	44.4
	1988 f)	14.0	15.2	2.2	8.2	39.6	6.0	45.6
GB(2)	1972	20.1	9.0	0.3	3.5	33.0	5.5	38.5
	1983	24.1	13.2	0.6	4.8	42.6	3.2	45.8
	1984	24.3	13.3	0.6	5.0	43.2	3.2	46.4
	1985	22.9	13.2	0.9	5.1	42.2	3.0	45.1
	1986	22.6	13.4	0.6	4.6	41.2	2.7	44.0
	1987	22.0	12.7	0.8	4.4	39.8	2.4	42.2
	1988 f)	..	..	..	..	..	..	..
		- Community sources (on a national accounts basis) (5) -						
EEC(6)	1972	..	..		..	..	..	38.0
	1983	18.9	21.6		4.5	44.8	3.8	48.7
	1984	18.8	21.7		4.8	45.1	3.9	49.0
	1985	18.7	21.5		5.0	45.1	3.9	49.0
	1986	18.5	21.2		5.0	44.7	3.6	48.3
	1987	18.5	21.1		4.8	44.5	3.5	47.9
	1988 f)	18.5	21.0		4.8	44.4	3.5	47.8

(1) For details see explanatory notes. Disrepancies in totals are due to rounding. (2) On a cash basis. (3) Only central government. (4) Break in GDP series because of a revision of the national accounts system in 1977. (5) 1972-1984: EUROSTAT figures: 1985-1988: Economic Budget of May-June 1988. (6) 1972: excluding Greece, Ireland and Portugal.

23.6.88

Table 3

LEVEL OF GENERAL GOVERNMENT REVENUE (1)

(on a consolidated basis in per cent. of GDP at current prices)

	1972	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986o)	1987f)	1987o)	1988f)
	- National sources (on an accruals basis unless otherwise stated) -															
BE	37.6	42.8	42.8	44.4	45.2	46.0	45.4	46.2	48.1	47.6	48.6	48.7	47.2	..	47.8 p)	47.5
DK	46.8	47.3	48.1	48.9	50.9	52.1	53.6	53.4	52.6	55.0	56.8	57.4	59.4	..	60.6	60.6
DE	41.3	44.8	45.7	46.6	46.4	46.2	46.7	47.0	47.8	47.3	47.2	47.2	46.8	..	46.3	ca 45.5
GR (3)	19.2	20.6	21.2	21.8	21.5	22.0	21.0	21.0	23.1	24.1	24.7	24.3	27.0	30.0	27.8	30.4
ES	23.8	25.0	25.9	27.0	27.7	29.0	30.5 (7)	31.9	32.1	34.2	34.1	35.5 p)	37.0 p)	38.3	38.6 p)	39.4
FR (2)	39.7	41.8	43.8	43.5	43.3	44.7	46.7	47.4	48.2	49.0	50.1	50.2	49.7	49.8	50.2	48.5
IE (2)	35.9	35.8	39.3	38.2	36.9	37.9	41.0	42.3	44.3	46.8	46.2	43.1	43.0	44.4	43.2 e)	42.3
IT (2)	31.9	32.1	33.9	35.5	36.8	36.4	33.4	34.6	37.2	39.4	38.4	38.7	39.5	..	40.0	
LU (4)	39.3	49.3	50.5	54.8	55.9	53.2	54.1	53.4	54.1	57.0	55.6	56.8	54.5	52.8	52.4	51.8
NL	45.0	48.8	49.6	50.5 (6)	50.4	52.0	52.6	53.2	53.7	55.1	54.6	55.1	52.8	..	53.2	52.7
PT (2)	25.3	28.2	30.7	30.7	29.7	29.9	31.7	33.3	33.8	37.7	35.0	33.8	38.4	36.9	36.5	37.1
GB (2)	37.1	40.7	40.1	39.2	37.4	37.6	40.4	42.8	44.2	43.5	43.9	43.9	42.6	..	40.5	..
	- Community sources (on a national accounts basis) (4) -															
EC (5)	35.6	37.9	38.8	39.4	39.5	40.0	40.9	41.8	42.8	43.4	43.6	43.9	43.6	43.3	43.8	43.7

(1) For details, see explanatory notes.
(2) On a cash basis.
(3) Only central government revenue.
(4) 1972-1984: EUROSTAT figures; 1985-1987: Economic Budget of May-June 1988.
(5) 1972-1979: excluding Greece, Ireland and Portugal.
(6) Break in GDP series.
(7) Break in GDP series because of a revision of the national accounts: figure for 1980 on the old basis: 30.6.

STRUCTURE OF GENERAL GOVERNMENT REVENUE (1)

Table 4

(on a consolidated basis in per cent. of GDP at current prices)

		Direct taxation			Social security contributions	Indirect taxation	Other taxes and revenue	Total revenue
		Corporate	Personal	Total				
		- National sources (on an accruals basis unless otherwise stated) -						
BE	1972	2.7	9.7	12.4	11.5	12.2	1.5	37.6
	1983	2.7	15.9	18.6	13.9	12.8	2.3	47.6
	1984	3.0	16.2	19.2	14.7	12.4	2.3	48.6
	1985	3.1	15.9	19.0	15.1	12.3	2.3	48.7
	1986	3.1	15.3	18.4	15.1	11.8	1.9	47.2
	1987 p)	3.1	15.2	18.3	15.5	12.3	1.7	47.8
	1988 f)	..	..	..	..	..	..	47.5
DK	1972	1.0	22.6	23.6	2.5	17.4	3.3	46.8
	1983	1.4	25.3	26.7	2.9	17.8	7.7	55.0
	1984	2.5	24.9	27.4	2.9	18.1	8.4	56.8
	1985	2.4	26.0	28.4	2.8	18.2	8.1	57.4
	1986	3.1	26.0	29.1	2.5	19.6	8.2	59.4
	1987	2.3	27.8	30.1	2.8	19.6	8.2	60.6
	1988 f)	2.2	29.0	31.2	1.7	19.7	8.1	60.6
DE	1972	..	..	10.9	12.4	13.0	5.0	41.3
	1983	..	..	11.5	16.0	12.2	7.6	47.3
	1984	..	..	11.4	16.0	12.2	7.6	47.2
	1985	..	..	12.0	16.0	11.8	7.4	47.2
	1986 pe)	..	..	11.8	16.0	11.5	7.4	46.8
	1987 pe)	..	..	11.5	16.1	11.8	6.9	46.3
	1988 f)	..	..	..	..	..	..	..
GR (3)	1972	0.8	1.9	2.7	-	13.2	3.3	19.2
	1983	0.6	3.9	4.5	-	15.5	4.2	24.1
	1984	0.7	4.1	4.8	-	15.6	4.3	24.7
	1985	0.8	4.3	5.1	-	15.6	3.6	24.3
	1986	1.1	4.1	5.2	-	17.5	4.3	27.0
	1987	1.6	4.1	5.7	-	18.2	3.8	27.8
	1988 f)	1.9	4.7	6.6	-	19.1	4.8	30.4
ES	1972	2.3	1.7	4.0	9.0	7.7	3.1	23.8
	1983	2.0	5.9	7.9	13.7	8.6	4.1	34.2
	1984	1.9	6.4	8.3	13.1	9.1	3.7	34.1
	1985	2.1	6.5	8.6	13.2	9.6	4.2	35.5
	1986 p)	2.0	6.4	8.4	13.1	11.1	4.4	37.0
	1987 p)	2.5	7.9	10.4	13.1	10.9	4.3	38.7
	1988 f)	2.6	8.1	10.7	13.2	11.0	4.5	39.8
FR (2)	1972	1.9	4.9	6.8	13.2	13.1	6.6	39.7
	1983	1.8	7.2	9.0	18.9	12.1	9.1	49.0
	1984	1.7	7.4	9.1	19.2	12.2	9.6	50.1
	1985 p)	..	..	9.3	19.2	21.7		50.2
	1986 p)	..	..	9.5	18.9	21.3		49.7
	1987 p)	..	..	9.5	19.1	21.6		50.2
	1988 f)	..	..	9.5	19.4	20.6		49.5
IE (2)	1972	0.9	8.3	9.2	2.8	18.5	5.4	35.9
	1983	1.5	12.6	14.1	5.8	17.8	9.1	46.8
	1984	1.3	13.5	14.8	5.7	17.7	8.0	46.2
	1985	1.3	13.5	14.8	5.8	17.4	5.1	43.1
	1986	1.4	14.3	15.7	5.7	17.4	4.2	43.0
	1987 e)	1.3	14.8	16.1	5.6	16.8	4.6	43.2
	1988 f)	1.4	13.9	15.3	5.7	16.5	4.6	42.3
IT (2) (6)	1972	1.4	4.9	6.3	12.4 (11.1)	10.1	2.9	31.9 (8)
	1983	..	..	12.4	14.0 (12.5)	9.2	3.8	39.4 (8)
	1984	..	..	12.6	13.5 (11.9)	9.2	3.0	38.4 (8)
	1985	..	..	12.9	13.5 (11.9)	8.9	3.3	38.7 (8)
	1986	..	..	12.8	13.8 (12.3)	9.1	3.9	39.5 (8)
	1987	..	..	13.3	13.9 (12.4)	9.5	3.3	40.0 (8)
	1988 f)	..	..	..	..	..	..	..
LU (4)	1972	..	..	12.7	10.8	11.1	4.7	39.3
	1983	..	..	20.9	15.8	16.6	7.6	60.9
	1984	..	..	19.2	14.6	15.7	7.1	56.6
	1985	..	..	19.9	13.5	15.1	8.2	56.8
	1986	..	..	18.6	13.2	14.7	8.0	54.5
	1987 e)	..	..	17.1	13.3	14.6	7.5	52.4
	1988 f)	..	..	16.3	13.3	14.7	7.5	51.8
NL	1972	..	..	15.5	14.8	11.4	3.3	45.0
	1983	..	..	13.7	21.9	11.6	7.9	55.1
	1984	..	..	13.3	20.7	11.8	8.5	54.4
	1985	..	..	13.2	20.6	12.0	9.2	55.1
	1986	..	..	13.6	19.6	12.3	7.3	52.8
	1987	..	..	14.1	20.3	13.0	5.8	53.2
	1988 f)	..	..	14.1	20.4	13.0	5.2	52.7
PT (2) (7) (9)	1972	1.8	3.5	5.3	6.2	11.1	2.6	25.2
	1983	1.8	6.8	8.6	10.0	15.7	3.3	37.7
	1984	1.8	6.5	8.3	9.4	15.2	2.1	35.0
	1985 p)	1.6	6.8	8.4	9.2	14.2	2.0	33.8
	1986 p)	1.3	5.1	6.4	10.6	16.5	4.9	38.4
	1987 p)	1.5	4.4	5.9	10.5	15.3	4.8	36.5
	1988 f)	1.6	5.3	6.9	10.1	15.2	4.9	37.1
GB (2)	1972	2.3	10.4	12.7	5.1	14.2	5.1	37.1
	1983	4.0	11.8	15.8	7.0	16.2	4.5	43.5
	1984	1.8	6.5	8.3	9.4	15.2	2.1	35.0
	1985	4.7	11.5	16.2	6.9	16.1	4.6	43.9
	1986	3.8	11.6	15.4	6.9	16.4	3.9	42.6
	1987	3.7	10.6	14.3	6.9	16.4	2.9	40.5
	1988 f)	..	..		..	..	..	..
		- Community sources (on a national accounts basis) (5) -						
EEC (5)	1972	..	..	..	..	..	..	35.6
	1983	..	..	12.0	14.7	12.9	3.8	43.4
	1984	..	..	12.2	14.6	13.1	3.8	43.6
	1985	..	..	12.4	14.6	12.9	4.0	43.9
	1986	..	..	12.2	14.6	13.1	3.8	43.6
	1987	..	..	12.5	14.6	13.2	3.4	43.8
	1988 f)	..	..	..	..	..	..	43.7

(1) For details see explanatory notes Disrepancies in totals are due to rounding. (2) On a cash basis. (3) Only central government. (4) 1972-1984: EUROSTAT figures: 1985-1988: Economic Budget of May-June 1988. (5) 1972: excluding Greece, Ireland and Portugal. (6) In brackets, figures net of imputed social security contributions. (7) In 1986 social security contributions increased partially due to the inclusion of Unemployment Fund Taxation which, in previous years, was included in direct and indirect taxation. (8) It includes imputed social security contributions. (9) Including arrears of social security contributions.

GENERAL GOVERNMENT DEFICITS AND BORROWING REQUIREMENTS (1)

Table 5

(In per cent. of GDP at current prices)

		Total revenue	Expenditure (excluding interest payments)	Surplus (+) Deficit (-) excluding interest payments	Interest payments	Surplus (+) Deficit (-)	Other items (2)	Borrowing requirements (-) (2)	
								Net	Gross
		(a)	(b)	(c) = (a) - (b)	(d)	(e) = (c) - (d)	(f)	(g) = (e) + (f)	(h)
				- National sources (on an accruals basis unless otherwise stated) -					
BE	1972	37.6	39.1	-1.5	3.3	-4.8	-1.1	-5.9	-7.2
	1983	47.6	50.0	-2.4	9.4	-11.8	-2.6	-14.4	-19.1
	1984	48.6	48.4	0.2	9.9	-9.7	-1.4	-11.1	-15.6
	1985	48.7	46.9	1.8	10.5	-8.7	-3.3	-12.0	-16.7
	1986	47.2	45.2	2.0	11.0	-9.0	-2.4	-11.4	-14.5
	1987 p)	47.8	44.3	3.5	10.6	-7.1	-2.6	-9.7	-14.4
	1988 f)	47.5	44.0	3.5	10.5	-7.0	..	..	..
DK	1972	46.8	41.6	5.2	1.3	3.9	-1.0	2.9	1.2
	1983	55.0	54.1	0.9	8.1	-7.2	-1.1	-8.3	-22.4
	1984	56.8	51.3	5.5	9.6	-4.1	-0.5	-4.6	-25.5
	1985	57.4	49.7	7.8	9.8	-2.2	-1.7	-3.9	-22.2
	1986	59.4	47.6	11.9	8.8	3.1	-1.2	1.9	-15.8
	1987	60.6	50.2	10.4	8.3	2.1	-1.4	0.7	-12.9
	1988 f)	60.6	51.6	9.0	8.2	0.8	-0.5	0.3	-16.2
DE	1972	41.3	41.1	0.2	1.1	-0.9	-0.9	-1.8	..
	1983	47.3	47.6	-0.3	3.1	-3.4	0.0	-3.4	..
	1984	47.2	46.9	0.3	3.1	-2.8	0.2	-2.6	..
	1985 pe)	47.2	46.2	1.0	3.0	-2.0	-0.3	-2.3	..
	1986 pe)	46.8	45.6	1.1	3.0	-1.9	-0.2	-2.1	..
	1987 pe)	46.3	45.8	0.5	2.9	-2.4	-0.0	-2.4	..
	1988 f)	..	..	..	..	a good -3	..	a good -3	..
GR (3)	1972	19.2	21.3	-2.1	1.0	-3.1	1.0	-2.1	..
	1983	24.1	29.9	-5.8	3.4	-9.2	-0.5	-9.7	..
	1984	24.7	29.7	-4.9	4.3	-9.2	-3.4	-12.6	..
	1985	24.3	31.7	-7.4	5.2	-12.6	-0.8	-14.4	..
	1986	27.0	30.9	-4.0	5.3	-9.3	-1.1	-10.4	..
	1987	27.8	31.7	-3.9	6.4	-10.3	-1.3	-11.6	..
	1988 f)	30.4	34.7	-4.4	6.5	-10.8	0.0	-10.8	..
ES	1972	23.8	22.9	0.9	0.6	0.3	-0.2	0.1	-1.2
	1983	34.2	37.7	-3.5	1.3	-4.8	-0.4	-5.2	-9.4
	1984	34.1	37.6	-3.5	2.0	-5.5	-0.9	-6.4	-10.5
	1985 p)	35.5	39.3	-3.8	3.2	-7.0	-0.4	-7.4	-9.7
	1986 p)	37.0	38.9	-1.9	3.9	-5.7	-0.2	-5.9	-7.2
	1987 p)	38.7	38.9	-0.2	3.4	-3.6	-0.9	-4.5	-5.4
	1988 f)	39.4	38.9	0.5	3.9	-3.4	..	..	..
FR (2)	1972	39.7	38.0	1.7	0.9	0.8	-	0.8	..
	1983	49.0	49.5	-0.5	2.6	-3.1	-	-3.1	..
	1984	50.1	50.1	-	2.7	-2.7	-	-2.7	..
	1985 p)	50.2	50.1	0.1	2.9	-2.8	-	-2.8	..
	1986 p)	49.7	49.7	-	2.9	-2.9	-	-2.9	..
	1987 p)	50.2	49.8	0.4	2.8	-2.4	-	-2.4	..
	1988 f)	49.5	48.9	0.6	2.9	-2.3	-	-2.3	..
IE (2)	1972	35.9	37.4	-1.5	3.7	-5.2	-0.9	-6.1	..
	1983	46.8	49.3	-2.5	9.5	-12.0	-0.1	-12.1	..
	1984	46.2	46.4	-0.2	9.5	-9.7	-1.5	-11.2	..
	1985	43.1	44.0	-0.9	10.6	-11.5	-	-11.5	..
	1986	43.0	43.9	-0.9	10.0	-10.9	-	-10.9	..
	1987 e)	43.2	41.8	1.4	9.9	-8.5	-	-8.5	..
	1988 f)	42.3	39.8	2.5	9.9	-7.4	-	-7.4	..
IT (2)	1972	31.9	36.7	-4.8	2.3	-7.1	-3.0	-10.2	..
	1983	39.4	42.5	-3.1	7.5	-10.6	-3.7	-14.3	..
	1984	38.4	42.0	-3.6	8.0	-11.5	-2.5	-14.0	..
	1985	38.7	43.1	-4.4	8.0	-12.5	-2.1	-14.6	..
	1986	39.5	42.5	-3.0	8.5	-11.4	-0.8	-12.2	..
	1987	40.0	42.4	-2.4	8.1	-10.5	-1.1	-11.6	..
	1988 f)	..	..	..	..	..	..	..	..
LU	1972	39.3	36.2	3.1	1.1	2.0	..	..	..
	1983	57.0	56.6	0.4	1.0	-0.6	..	..	..
	1984	55.6	52.9	2.7	1.1	1.6	..	..	..
	1985	56.8	51.3	5.5	1.3	4.2	..	..	..
	1986	56.0	50.0	6.0	1.3	4.7	..	..	..
	1987	52.4	50.0	2.4	1.2	1.2	..	..	..
	1988 f)	51.8	49.9	1.9	1.1	0.8	..	..	..
NL	1972	45.0	44.2	0.8	2.7	-1.9	0.2	-1.8	-3.2
	1983	55.1	57.5	-2.4	5.7	-8.1	-0.3	-8.4	-10.6
	1984	54.6	56.1	-1.6	5.9	-7.5	-0.3	-7.8	-10.9
	1985	55.1	54.9	0.2	6.3	-6.1	-0.7	-6.8	-10.8
	1986	52.8	53.1	-0.3	6.0	-6.3	-0.5	-6.8	-12.1
	1987	53.2	53.7	-0.5	6.1	-6.6	-1.8	-8.4	-14.2
	1988 f)	52.7	52.6	0.1	6.3	-6.2	-	-6.2	..
PT (2)	1972	25.3	27.2	-1.9	0.6	-2.5	0.2	-2.3	-2.7
	1983	37.7	39.7	-2.0	6.4	-8.4	-1.3	-9.7	-12.5
	1984	35.0	38.7	-3.7	7.1	-10.8	-0.1	-10.9	-14.6
	1985 p)	33.8	37.2	-3.5	7.9	-11.4	0.2	-11.2	-15.7
	1986 p)	38.4	37.6	0.8	9.2	-8.4	-1.8	-10.2	..
	1987 p)	36.5	36.6	-0.1	7.8	-7.9	-3.0	-10.9	..
	1988 f)	37.1	37.4	-0.3	8.2	-8.5	-5.1	-13.6	..
GB (2)	1972	37.1	35.0	2.1	3.5	-1.4	-1.8	-3.2	-5.6
	1983	43.5	41.0	2.5	4.8	-2.3	-1.7	-4.0	-5.5
	1984	43.9	41.4	2.5	5.0	-2.5	-0.5	-3.0	-4.5
	1985	43.9	40.0	3.9	5.1	-1.2	-1.2	-2.4	-4.0
	1986	42.6	39.3	3.3	4.6	-1.4	0.5	-0.9	-2.8
	1987	40.5	37.8	2.6	4.4	-1.8	1.9	0.1	-1.9
	1988 f)	..	..	..	..	..	..	..	..
				- Community sources (on a national accounts basis) (4) -					
EEC (5)	1972	35.6	..			-2.4	..	..	..
	1983	43.4	44.2	-0.8	4.5	-5.3	..	..	..
	1984	43.6	44.2	-0.6	4.8	-5.4	..	..	..
	1985	43.9	44.1	-0.2	5.0	-5.2	..	..	..
	1986	43.6	43.4	0.2	5.0	-4.8	..	..	..
	1987 e)	43.8	43.1	0.7	4.8	-4.1	..	..	..
	1988 f)	43.7	43.0	0.7	4.8	-4.1	..	..	..
	1989 f)	43.6	42.8	0.8	4.8	-4.0	..	..	..

(1) For details see explanatory notes Disrepancies in totals are due to rounding. (2) On a cash basis. (3) Only central government. (4) 1972,1980-84: EUROSTAT figures: 1985-87: Economic Budget of May-June 1988. (5) 1972: excluding Greece, Ireland and Portugal.

COVERAGE OF GOVERNMENT BORROWING REQUIREMENTS (1)
ANALYSED BY DEBT INSTRUMENTS

Table 6a

(In per cent. of GDP at current prices)

		Non-marketable debt instruments			Domestic market issues		Foreign currency loans	Other financing means	Total net borrowing requirement	Of which: medium and long-term funds
		Loans from central bank	Other direct loans	Deposits and other short-term non-marketable debt	Treasury bills and other short-term debt	Medium-term and long-term bonds				
		(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
BE	1972	-	-	0.6	-1.2	7.5	-1.0	-	5.9	4.8
	1981	2.0	-	0.1	4.8	3.1	6.1	-	16.1	6.1
	1982	0.8	-	-	4.2	3.6	6.1	-	14.7	8.1
	1983	0.2	-	-0.1	2.0	9.1	3.2	-	14.4	11.8
	1984	0.3	-	-0.3	0.4	7.3	3.4	-	11.1	11.7
	1985	-0.4	-	0.3	-0.2	11.6	0.7	-	12.0	10.1
	1986	0.5	-	0.2	5.1	4.4	1.2	-	11.4	2.8
	1987	-1.9	-	-0.1	3.8	7.3	0.6	-	9.7	7.1
DK	1972	-0.7	..	..	-	-0.2	0.5	-1.0	-1.4	..
	1981	1.8	..	..	2.3	4.8	1.2	-0.1	10.1	..
	1982	-0.6	..	..	0.2	9.4	3.4	-1.2	11.3	..
	1983	-2.1	..	..	0.6	9.7	2.0	0.3	10.6	..
	1984	1.2	..	..	-0.6	8.7	-2.2		7.0	..
	1985	-0.6	..	..	-1.6	5.4	0.8	0.9	4.9	..
	1986	-5.3	..	..	-0.2	-1.3	4.7	1.0	-1.1	..
	1987	-1.1	..	..	2.2	-3.3	2.0	-0.7	-0.8	..
DE	1972	-0.2	1.5	-	-	0.6	-	-0.1	1.8	..
	1981	0.1	4.9	-	0.4	-0.3	-	-	5.0	..
	1982	-0.2	2.6	-	0.4	1.5	-	-	4.3	..
	1983	-	1.4	-	-	2.0	-	-	3.4	..
	1984	0.1	0.9	-	-0.3	2.0	-	-	2.6	..
	1985	-0.1	0.4	-	-	2.1	-	-	2.3	..
	1986pe)	0.1	-0.5	-	-0.1	2.6	-	-	2.1	..
	1987pe)	-0.1	0.1	-	-0.1	2.5	-	-	2.4	..
GR	1972	..	..	..	..	..	..	..	..	..
	1981	11.0	-2.4	-	2.1	-0.1	1.3	..	11.8	..
	1982	10.9	-3.2	-	1.7	-	1.3	..	10.6	..
	1983	-3.0	2.6	-	6.4	-	2.5	..	8.5	..
	1984	3.8	0.3	-	5.4	-	3.3	..	12.7	..
	1985	2.0	0.6	-	7.6	-	4.9	..	15.1	..
	1986	1.2	2.4	-	4.2	0.4	3.6	..	11.8	..
	1987	0.1	2.4	-	6.9	1.4	1.5	..	12.2	..
ES	1972	-0.6	0.9	-	-	0.3	-	0.6	1.2	1.2
	1981	3.2	0.7	-	0.2	0.8	0.3	1.1	6.3	6.1
	1982	4.1	0.7	-	0.4	1.4	0.4	1.0	8.0	7.7
	1983	0.6	0.6	-	5.4	0.5	0.6	1.7	9.4	4.1
	1984	-2.6	2.4	8.1	1.3	0.5	0.5	0.2	10.5	1.1
	1985	1.8	0.3	-0.1	5.2	1.3	0.1	1.0	9.7	4.6
	1986	-1.9	-0.1	0.4	2.3	6.2	-0.5	0.8	7.2	4.5
	1987	-0.9	-0.4	0.6	4.7	0.9	-0.2	0.8	5.4	0.1
FR	1972	-0.5	-	0.8	-0.9	-0.1	-	0.3	-0.4	-0.1
	1981	-0.6	-	0.4	1.7	0.7	-	-0.3	1.9	0.7
	1982	-1.0	-	0.5	2.4	0.5	-	-0.1	2.3	0.5
	1983	0.6	-	0.4	1.0	1.2	-0.1	0.6	3.7	1.5
	1984	-0.3	-	0.7	1.1	1.8	-	-	3.3	1.8
	1985	0.5	-	0.5	0.5	1.9	0.1	-0.1	3.4	1.9
	1986	-0.1	-	-0.1	0.6	2.3	-	-	2.7	2.0
	1987	-0.9	-	0.7	1.1	0.3	-	0.7	1.9	..
IE	1972	-	-	1.1	-	4.3	1.0	-	6.4	5.3
	1981	0.6	-	0.7	0.5	2.1	11.3	-	15.2	13.4
	1982	-0.1	-	0.6	-0.1	5.5	8.6	-	14.5	14.1
	1983	-0.2	-	1.0	-	5.8	5.4	-	12.0	11.2
	1984	0.6	-	1.0	1.4	4.2	4.0	-	11.2	8.2
	1985	-1.0	-	2.1	-0.9	6.7	4.7	-	11.6	11.4
	1986	-0.5	-	1.4	1.1	5.3	4.5	-	11.8	9.8
	1987	-1.3	-	0.9	1.1	5.4	3.0	-	9.1	7.4
IT	1972	1.0	2.4	2.3	0.9	3.5	..	..	10.1	3.7
	1981	1.4	0.2	0.6	7.2	1.5	0.5	-	11.5	1.7
	1982	1.6	1.0	0.7	6.1	4.2	0.5	-	14.1	5.5
	1983	-0.2	0.9	0.8	1.7	10.9	0.2	-	14.3	11.6
	1984	1.8	1.2	0.9	1.2	8.6	0.3	-	14.0	8.9
	1985	0.5	-0.3	1.1	1.6	11.3	0.4	-	14.6	10.7
	1986	0.2	0.2	1.2	1.1	9.4	0.1	-	12.2	8.8
	1987	1.0	0.3	1.3	2.8	5.5	0.6	-	11.6	6.2
NL	1972	-	3.6	-	-1.3	0.6	-	-1.2	1.8	4.3
	1981	-	4.6	-	0.2	2.5	-	0.1	7.3	7.1
	1982	-	4.2	-	-0.5	4.4	-	-0.2	7.8	8.6
	1983	-	3.5	-	-0.2	5.4	-	-0.3	8.4	8.9
	1984	-	2.5	-	-0.6	5.4	-	0.4	7.8	7.9
	1985	-	3.6	-	-	3.5	-	-0.6	6.6	7.1
	1986	-	3.2	-	0.7	1.8	-	-0.5	5.2	5.0
	1987	-	4.3	-	-0.7	2.8	-	0.7	7.1	7.1
PT (3)	1972	..	..	..	..	..	..	..	..	..
	1981	6.7	2.6	0.8	-	0.1	3.2	2.6	16.0	15.2
	1982	6.2	1.8	0.1	-	0.4	6.2	-1.3	13.4	13.3
	1983	6.2	1.1	0.2	-0.1	0.4	8.7	-0.4	16.1	16.0
	1984	8.6	-0.1	0.1	-	0.3	7.5	-0.1	16.3	16.2
	1985	7.2	-0.2	-0.2	5.7	2.4	2.7	3.0	20.6	15.1
	1986	3.1	0.1	0.5	7.6	2.0	0.1	-0.5	12.9	4.8
	1987	1.1	-0.4	1.1	6.1	3.7	0.9	0.3	12.8	5.6
GB (2)	1972	..	..	0.8	-1.4	0.7	0.1	-0.6	-0.4	-
	1981	..	..	1.7	0.5	1.7	-0.3	-0.7	2.9	-
	1982	..	..	0.8	0.7	1.5	0.1	-0.2	2.9	-
	1983	..	..	0.9	2.5	1.6	-	-0.4	4.6	-
	1984	..	..	1.1	2.2	1.4	0.1	-	4.8	-
	1985	..	..	0.2	0.1	2.2	0.3	-0.4	2.4	-
	1986	..	..	0.2	-0.6	2.0	0.6	0.2	2.4	-
	1987	..	..	..	..	..	..	..	..	..

1) For details, see explanatory notes. Discrepancies in totals are due to rounding. - = absorption of surplus through repayment of outstanding debt or accumulation of cash holdings. 2) Financial year starting 1st April of the current year and ending 31st March of the following year . 3) For 1985, 1986 and 1987; including settlement of arrears.

29.6.88

Table 6b

CHANGES IN HOLDINGS OF GOVERNMENT DEBT BY THE DIFFERENT SECTORS OF THE ECONOMY (1)

(in per cent. of GDP at current prices)

		Central Bank	Banking System	Treasury and Post office system	Domestic non-banks	Sub-total	Non-residents	Total
		(a)	(b)	(c)	(d)	(e)	(f)	(g)
BE	1972	-0.1	5.2	0.6	1.2	6.9	-1.0	5.9
	1981	2.0	6.5	0.1	1.1	9.7	6.4	16.1
	1982	0.8	6.9	-		7.7	7.0	14.7
	1983	0.2	9.4	-0.1	0.8	10.3	4.1	14.4
	1984	0.3	6.4	-0.3	0.6	7.0	4.1	11.1
	1985	-0.4	8.6	0.3	1.5	10.0	2.0	12.0
	1986	0.6	7.0	0.2	0.5	8.3	3.1	11.4
	1987	-1.5	7.2	-0.1	1.5	7.1	2.6	9.7
DK	1972	-0.7	-		-	-0.7	0.5	-0.2
	1981	1.7	2.4	0.6	4.6	9.4	1.0	10.4
	1982	-0.4	2.4	2.0	5.3	9.2	3.3	12.5
	1983	-2.1	5.6	1.4	2.9	7.8	2.5	10.3
	1984	1.3	1.1	1.4	4.1	8.0	-0.9	7.1
	1985	-0.8	2.0	0.6	-0.7	1.1	3.0	4.1
	1986	-4.9	-1.7	0.4	-0.9	-7.1	5.0	-2.1
	1987	-1.3	-2.0	-0.5	-0.5	-4.2	4.1	-0.1
DE(2)	1975	0.3	4.7	-	1.1	6.0	0.2	6.2
	1981	0.2	3.2	-	-	3.4	1.6	5.0
	1982	-0.1	2.6	-	1.1	3.5	0.8	4.3
	1983	0.1	1.1	-	1.3	2.5	0.9	3.4
	1984	-	1.3	-	0.8	2.0	0.6	2.6
	1985	-0.1	1.1	-	0.4	1.4	1.0	2.3
	1986	0.2	-0.0	--	0.1	0.2	1.9	2.1
	1987	-0.1	1.3	-	0.3	1.5	0.9	2.4
GR	1972	..	..	-	..	..	..	..
	1981	8.0	2.6	-	-0.1	10.6	1.3	11.8
	1982	5.8	3.5	-	-	9.3	1.3	10.6
	1983	-0.3	6.3	-	-	6.0	2.5	8.5
	1984	2.3	7.2	-	-	9.5	3.3	12.7
	1985	2.0	7.9	-	0.2	10.2	4.9	15.1
	1986	1.3	6.4	-	0.4	8.2	3.6	11.8
	1987	0.9	7.6	-	2.2	10.7	1.5	12.2
ES	1972	0.6	1.1	-	-0.6	1.2	-	1.2
	1981	3.3	1.4	-	1.3	6.0	0.3	6.3
	1982	4.3	2.0	-	1.4	7.7	0.4	8.1
	1983	4.2	1.8	-	2.9	8.8	0.6	9.4
	1984	-3.6	13.2	-	0.4	10.0	0.5	10.5
	1985	1.8	5.5	-	2.2	9.6	0.1	9.7
	1986	-1.4	7.0	-	2.2	7.7	-0.5	7.2
	1987	1.2	2.4	-	2.0	5.6	-0.2	5.4
FR	1972	-0.5	-0.7	0.7	0.1	-0.4	-	0.4
	1981	-0.9	2.0	0.3	0.5	1.9	-	1.9
	1982	-	1.5	0.4	0.4	2.3	-	2.3
	1983	1.0	0.7	0.4	1.7	3.8	-0.1	3.7
	1984	-0.1	1.0	0.5	1.9	3.3	-	3.3
	1985	-0.2	1.3	0.4	1.8	3.3	0.1	3.4
	1986	-0.5	0.4	0.2	2.6	2.7	-	2.7
	1987	-0.9	0.5	0.4	1.8	1.8	0.1	1.9
IE	1972	-	2.3	-	3.1	5.4	1.0	6.4
	1981	0.6	1.1	-	2.5	4.2	11.0	15.2
	1982	-0.1	1.8	-	4.4	6.1	8.4	14.5
	1983	-0.2	1.5	-	5.0	6.3	5.7	12.0
	1984	0.6	2.6	-	3.3	6.5	4.7	11.2
	1985	-1.0	1.4	-	6.1	6.5	5.1	11.6
	1986	-0.5	0.1	-	6.4	6.0	5.8	11.8
	1987	-1.3	0.4	-	4.6	3.7	5.4	9.1
IT	1972	2.1	5.6	2.3	0.2	10.2	..	10.2
	1981	2.8	1.2	0.6	6.2	11.0	-	11.0
	1982	2.3	6.9	0.7	3.7	13.6	-	13.6
	1983	0.2	5.3	0.8	7.8	14.1	-	14.1
	1984	1.9	2.4	0.9	8.6	13.7	-	13.7
	1985	3.4	1.3	1.1	8.2	14.0	0.3	14.3
	1986	1.2	0.8	1.3	8.4	11.6	0.4	12.1
	1987	0.7	0.7	1.3	8.3	11.0	-	11.0
NL	1972	-0.9	1.4	-	..	..	..	2.6
	1981	-0.1	0.9	-	4.9	5.8	0.7	6.5
	1982	-	1.2	-	5.5	6.7	0.7	7.4
	1983	0.2	1.6	-	5.8	7.6	0.5	8.1
	1984	0.3	1.1	-	5.1	6.5	0.6	7.1
	1985	-	2.0	-	3.8	5.8	0.6	6.4
	1986	-0.2	2.4	-	1.0	3.3	-	3.3
	1987	-0.1	-0.4	-	2.6	2.1	2.0	4.0
PT	1972	0.8	2.0	-	-0.5	2.3	-	2.3
	1981	6.0	3.5	-	0.1	9.6	2.4	11.9
	1982	7.5	1.7	-	-0.2	9.0	2.9	11.9
	1983	4.6	2.0	-	-0.3	6.2	3.5	9.7
	1984	8.1	-0.1	-	-0.3	8.2	2.7	10.9
	1985	4.2	1.4	-	3.5	9.1	2.2	11.2
	1986	3.2	0.8	-	6.4	10.4	-0.2	10.2
	1987	-1.6	6.9	-	4.5	9.8	1.1	10.9
GB (3)	1972	..	-1.3	-	3.0 (4)	1.7	0.5	2.2
	1981	..	1.8	-	2.5 (4)	4.3	0.2	4.5
	1982	-	-1.0	-	4.0	3.0	0.2	3.2
	1983	-	-0.2	-	4.4	4.2	1.0	5.2
	1984	-	0.4	-	4.5	4.9	0.2	5.1
	1985	-	-0.4	-	2.1	1.7	0.7	2.4
	1986	-	-0.2	-	1.3	1.0	0.8	1.8
	1987	..	..	..	..	..	..	..

1) For details, see explanatory notes.- = absorption of surplus through repayment of outstanding debt or accumulation of cash holdings. Discrepancies in totals are due to rounding. 2) No data available for 1972, 1973 and 1974 3) Financial year ending 31st March of the following year. 4) Includes changes in holdings of public sector debt by the Bank of England (Banking Department).

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Table 7

DEVELOPMENT OF OUTSTANDING PUBLIC SECTOR DEBT (1) AS A PERCENTAGE OF GDP/GNP AT CURRENT PRICES

(end-year figures on a cash basis)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988f)
BE	54	52	49	51	52	55	57	62	69	84	93	104	109	113	116	122	..
DK (2)	-2	-4	-2	5	8	13	18	25	34	47	60	70	74	70	63	60	58
DE	19	19	20	25	26	27	29	30	32	35	38	40	41	41	41	42 pe)	44
GR	18	16	18	21	20	21	24	24	26	34	39	44	51	61	63	69	..
ES	15	13	13	13	14	15	15	17	19 (5)	23	28	35	42	47	48	49	49
FR	18	17	16	17	16	16	17	17	17	17	19	22	24	25	25	24	..
IE	63	60	65	75	78	74	76	83	84	80	86	97	103	107	122	125	126
IT	56	58	58	66	65	65	71	71	58	61	66	72	77	84	88	93	..
LU (3)	..	..	..	18	17	17	15	14	14	14	14	15	15	15	14	14	14
NL	46	42	41	41	40	38 (4)	40	41	45	49	55	60	65	69	72	73 p)	..
PT	19	18	18	26	32	34	38	42	39 (6)	48	51	57	63	67	70	72	..
GB (2)	69	68	63	63	63	62	57	53	55	54	53	55	55	53	53	..	..
EC (3)	..	..	39	38	36	39	38	40	43	43	48	51	54	57	58	60	62

(1) For details, see explanatory notes.
(2) 31st March of the following year. For Denmark, 1972-1977.
(3) Community sources.
(4) Start of new series for GDP.
(5) Start of new series for GDP; figure for 1980 on the old basis was: 18.58, on the new basis: 18.55.
(6) Decrease due to the cancelation of part of the public debt held by the Banco de Portugal against capital gains derived from the revaluation of gold reserves.

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OUTSTANDING PUBLIC SECTOR DEBT (1) ANALYSED BY DEBT INSTRUMENTS

Table 8

(end-of-year figures in per cent. of GDP/GNP of current prices) (2)

		Non-marketable debt			Domestic market debt		Foreign currency debt	Other debt	Total	Average residual maturity (Years)
		Loans from central bank	Other direct loans	Deposits and other short-term non-marketable debt	Treasury bills and other short-term debt	Medium-term and long-term bonds				
		(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
BE	1972	2.2	-	4.2	1.5	45.2	0.8	-	53.9	9.1
	1982	6.4	-	2.2	13.1	53.8	17.2	-	92.7	3.2
	1983	6.2	-	2.0	15.2	59.9	20.6	-	103.9	3.4
	1984	6.1	-	1.5	14.8	62.9	23.5	-	108.8	3.7
	1985	5.3	-	1.7	13.8	70.4	21.3	-	112.5	4.2
	1986	5.5	-	1.8	17.8	70.6	20.4	-	116.1	3.8
	1987	3.4	-	1.7	21.1	75.8	20.2	-	122.2	3.6
DK	1972	-7.4	-	-	-	1.9	4.1	-0.2	-1.6	..
	1982	-1.6	-	-	7.8	36.1	17.0	-0.3	59.0	4.1
	1983	-3.7	-	-	7.9	45.2	20.0	-0.1	69.3	4.3
	1984	-2.4	-	-	6.7	51.9	17.4	-0.1	73.5	4.3
	1985	-3.0	-	-	4.6	53.4	15.0	0.0.	70.0	4.2
	1986	-7.5	-	-	4.1	48.5	18.0	0.0	63.1	4.0
	1987	-8.2	-	-	6.3	43.4	18.4	-0.3	59.6	3.6
DE	1972	0.1	12.6	-	0.2	3.3	-	2.8	18.9	..
	1982	0.1	28.5	-	1.0	7.9	-	1.0	38.5	..
	1983	0.1	28.6	-	0.9	9.6	-	1.0	40.1	..
	1984	0.1	28.1	-	0.6	11.1	-	0.9	40.9	..
	1985	-	27.2	-	0.5	12.7	-	0.8	41.3	..
	1986	0.2	25.3	-	0.4	14.7	-	0.8	41.3	..
	1987pe)	0.0	24.5	-	0.3	16.6	-	0.7	42.2	..
GR	1972	-1.9	2.7	-	8.4	2.1	6.4	-	17.7	..
	1982	16.8	-	-	13.0	0.5	9.1	-	39.4	..
	1983	13.8	-0.1	-	17.2	0.4	12.6	-	43.8	..
	1984	12.6	2.1	-	19.0	0.3	16.4	-	50.3	..
	1985	12.4	2.4	-	23.3	0.2	22.3	-	60.6	..
	1986	11.5	4.4	-	23.5	0.6	23.1	-	63.3	..
	1987	10.1	6.2	-	27.3	2.2	23.1	-	69.0	..
ES	1972	0.3	7.6	-	-	4.4	0.7	2.3	15.3	..
	1982	11.2	6.2	-	0.6	4.0	1.9	4.5	28.4	..
	1983	10.5	6.1	-	5.9	4.1	2.6	5.9	35.0	..
	1984	6.6	7.8	8.1	6.5	4.1	3.1	5.5	41.7	..
	1985	7.8	7.4	6.6	11.7	5.0	2.6	5.9	47.0	..
	1986	5.0	6.4	6.1	12.5	10.5	1.5	6.0	48.0	..
	1987	3.5	5.3	6.1	16.0	10.3	1.2	6.1	48.5	..
FR	1972	0.6	-	12.7	2.1	1.2	0.8	0.3	17.7	..
	1982	-2.3	-	6.8	6.2	5.7	1.0	1.4	18.8	..
	1983	-1.1	-	6.4	6.6	6.4	2.3	1.4	22.2	..
	1984	-1.3	-	6.6	7.2	7.6	2.4	1.4	23.9	2.4
	1985	-1.2	-	6.9	7.2	8.7	1.7	1.3	24.6	2.9
	1986	-0.8	-	6.2	7.4	10.5	0.8	0.8	24.9	3.5
	1987	-1.3	-	6.6	8.2	9.9	0.8	0.3	24.5	4.0
IE	1972	-	-	..	5.0	41.0	..	-	63.0	..
	1982	0.4	-	2.6	1.5	41.9	39.5	-	85.9	..
	1983	0.5	-	3.0	1.3	44.3	47.8	-	96.9	..
	1984	0.3	-	3.4	2.6	47.7	48.6	-	102.6	..
	1985	-	-	4.4	1.6	52.0	48.7	-	106.7	..
	1986	-	-	6.0	2.6	60.1	53.5	-	122.2	..
	1987 e)	-	-	6.4	4.5	64.2	49.4	-	124.5	..
IT	1972	5.4	10.7	11.6	5.3	21.0	1.0	0.9	55.9	6.4
	1982	6.9	4.3	7.2	25.6	20.1	1.8	0.4	66.3	1.2
	1983	5.8	4.6	7.0	23.7	28.4	2.0	0.3	71.9	1.6
	1984	6.8	5.2	7.0	22.0	33.5	2.2	0.3	77.1	2.5
	1985	6.6	4.4	7.3	21.1	41.6	2.2	0.3	83.7	3.4
	1986	6.1	4.2	7.9	20.2	47.3	2.0	0.3	87.9	3.7
	1987	6.7	4.2	8.5	21.4	49.2	2.3	0.3	92.6	3.5
NL (3)	1972	-	27.9	-	2.8	9.2	-	5.8	45.7	..
	1982	-	33.0	-	5.0	14.9	-	2.3	55.1	7.3 (e)
	1983	-	33.9	-	4.7	19.5	-	2.1	60.2	6.5 (e)
	1984	-	34.4	-	4.3	24.4	-	1.7	64.8	5.4 (e)
	1985	-	36.0	-	4.0	27.3	-	1.6	68.9	5.4 (e)
	1986	-	36.9	-	3.7	29.2	-	2.3	72.0	5.6 (e)
	1987	-	36.8	-	3.0	31.0	-	2.1	72.9	5.9 (e)
PT (4)	1972	0.1	-	0.2	-	-	4.8	11.5	16.6	..
	1982	21.5	3.9	0.8	0.5	3.3	15.2	6.6	51.8	..
	1983	23.6	4.3	0.9	0.3	3.1	21.0	4.9	58.1	..
	1984	27.8	3.4	0.8	0.3	2.8	24.6	3.9	63.6	..
	1985	27.1	2.5	0.4	4.3	4.7	22.3	6.1	67.4	..
	1986	26.5	2.1	0.8	11.3	7.0	17.9	4.3	69.6	..
	1987	23.7	1.4	1.8	15.7	9.4	16.2	4.0	72.2	9.2 (e)
GB (2)	1972	-	-	9.9	10.1	22.2	2.9	12.3	47.3	..
	1982	-	-	8.5	9.2	23.0	1.0	6.6	48.3	..
	1983	-	-	8.7	11.1	22.9	1.0	5.6	49.2	..
	1984	-	-	9.2	12.5	22.7	1.0	5.2	50.7	..
	1985	-	-	8.6	11.5	22.9	1.2	4.4	48.7	..
	1986	-	-	8.2	10.2	23.5	1.7	4.4	48.0	..
	1987	..	..	..	..	..	..	..	..	..

1) For details, see explanatory notes. Discrepancies in totals are due to rounding 2) 31st March of the following year. 3) Start of new series for GDP in 1977. 4) In 1980 part of the public debt held by the Banco de Portugal was cancelled against capital gains derived from the revaluation of gold reserves.

OUTSTANDING PUBLIC SECTOR DEBT ANALYSED BY SECTOR OF HOLDERS (1)

(in per cent. of total outstanding debt at end-year)

Table 9

		Monetary institutions			Domestic non-banks	Domestic sectors	Non-residents
		Total (a)	Central Bank (b)	Banks (c)	(d)	(e) = (a) + (d)	(f)
BE	1972	64	4	60	34	98	2
	1982	64	7	57	12	76	24
	1983	63	6	57	11	74	26
	1984	63	6	57	10	73	27
	1985	64	5	59	10	74	26
	1986	65	5	60	10	75	25
	1987	64	3	61	11	75	25
DK	1976	-37	-95	58	14	-23	123
	1982	21	-3	24	45	66	34
	1983	23	-5	28	46	69	31
	1984	23	-3	26	48	72	28
	1985	23	-4	27	50	74	26
	1986	15	-11	26	50	65	35
	1987	10	-13	23	49	59	41
DE	1972	69	6	63	29	98	2
	1982	68	2	66	19	87	13
	1983	65	2	63	21	86	14
	1984	64	2	62	21	85	15
	1985	63	2	62	21	84	16
	1986	60	2	58	20	80	20
	1987	60	1	58	19	79	21
GR	1972	57	-	57	1	58	42
	1982	76	43	33	1	77	23
	1983	71	32	39	-	71	29
	1984	67	25	42	-	67	33
	1985	62	20	42	1	63	37
	1986	62	18	44	1	63	37
	1987	62	16	46	5	67	33
ES	1972	71	3	68	25	95	5
	1982	72	41	30	22	93	7
	1983	69	42	27	24	93	8
	1984	74	22	52	19	93	7
	1985	75	22	53	20	94	6
	1986	76	16	60	21	97	3
	1987	74	16	58	23	97	3
FR	1972	21	7	14	75	96	4
	1982	32	-7	39	63	95	5
	1983	35	-2	37	55	90	10
	1984	36	-	36	54	90	10
	1985	37	-1	38	56	93	7
	1986	35	-2	37	62	97	3
	1987	30	-5	35	67	97	3
IE	1972	26	6	20	65	91	9
	1982	16	3	13	35	51	49
	1983	14	2	12	34	48	52
	1984	15	3	12	35	50	50
	1985	15	2	13	35	50	50
	1986	13	2	11	38	51	49
	1987	22	1	21	31	53	47
IT	1973	86	23	63	12	98	2
	1982	68	22	46	29	97	3
	1983	63	17	45	35	97	3
	1984	58	17	41	39	97	3
	1985	54	18	36	43	97	3
	1986	50	16	34	48	98	2
	1987	47	15	32	50	97	3
NL	1972	28	1	27	72 (2)	..	..
	1982	30	1	29	64	93	7 (3)
	1983	29	1	28	65	93	7 (3)
	1984	28	1	27	65	93	7 (3)
	1985	28	1	27	65	93	7 (3)
	1986	30	1	29	63	93	7 (3)
	1987	28	1	27	63	91	9 (3)
PT (6)	1972	31	3	28	45	76	24
	1982	57	43	14	14	70	30
	1983	53	41	12	10	63	37
	1984	53	45	8	8	61	39
	1985	55	41	14	12	67	34
	1986	54	39	15	20	74	26
	1987	53	31	22	24	77	23
GB (4)	1972	20	8	12	66	86	14
	1982	12	3	9	80	92	8
	1983	9	1	8	82	91	9
	1984	9	1	8	83	92	8
	1985	8	1	7	83	91	9
	1986	8	2	6	83	91	9
	1987	..	..	..	..	..	..

(1) For details, see explanatory notes. Discrepancies in totals are due to rounding.
(2) Including non-residents.
(3) Approximate portfolio investment in State bonds by non-residents.
(4) 31st March of the following year.
(5) Including Special Credit Institutions.
(6) In 1980 part of the public debt held by the Banco de Portugal was cancelled against capital gains derived from the revaluation of gold reserves.

GENERAL GOVERNMENT NET INTEREST EXPENDITURE (1)

(in per cent. of GDP at current prices)

	Period	Gross interest payments by general government			Assumed tax rates on interest receipts (3)	Post-tax interest payments e) a-(cxd)	Memorandum items			
		Total	Abroad	Domestic			Interest receipts by general government	Net interest expenditure a-f	Net post-tax interest expenditure	
									e-f	Adjusted (4)
		(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
BE	1985	10.5	1.8	8.7	0.05	10.1	1.2	9.3	8.9	..
	1986	11.0	1.4	9.6	0.05	10.5	1.0	10.0	9.5	..
	1987 p)	10.6	1.2	9.4	0.05	10.1	0.9	9.7	9.2	..
DK	1985	9.8	2.4	7.4	0.40	6.9	3.9	6.0	3.0	4.6
	1986	8.8	3.3	5.5	0.40	6.6	3.9	4.9	2.7	4.3
	1987	8.3	2.4	5.9	0.40	6.0	3.9	4.5	2.1	3.7
DE	1985	3.0	0.5	2.5	..	..	0.5	2.5	..	..
	1986	3.0	0.6	2.4	..	..	0.5	2.5	..	..
	1987 p)	2.9	0.6	2.3	..	..	0.5	2.4	..	..
GR (1)	1985	5.2	1.6	3.6	..	..	..	..	..	..
	1986	5.3	1.6	3.7	..	..	..	..	..	..
	1987	6.4	1.5	4.9	..	..	..	..	..	..
ES	1985	3.2	0.2	3.0	0.08	3.0	0.9	2.3	2.1	..
	1986	3.9	0.2	3.7	0.09	3.6	0.9	3.0	2.7	..
	1987	3.4	0.1	3.3	0.13	3.0	0.9	2.5	2.1	..
FR	1985	2.9	0.3	2.6	0.35	2.0	1.0 (5)	1.9	1.0	..
	1986	2.9	0.1	2.8	0.32	2.0	1.0 (5)	1.9	1.0	..
	1987 p)	2.8	0.1	2.7	0.32	1.9	1.0 (5)	1.8	0.9	..
IE	1985	10.6	4.8	5.8	0.4	8.3	2.1	8.5	6.2	..
	1986	10.0	3.9	6.1	0.4	7.6	2.2	7.8	5.4	..
	1987 e)	9.9	3.9	6.0	0.4	7.5	2.2 e)	7.7	5.3	
IT	1985	8.0	-	..	..	..	0.6	7.4	..	..
	1986	8.5	-	..	0.004	8.5	0.7	7.8	7.8	..
	1987	8.1	..	..	0.022	7.9	0.7	7.4	7.2	..
NL	1985	6.3	0.4	5.8	0.2	5.1	1.5	4.8	3.6	..
	1986	6.0	0.4	5.6	0.2	5.0	1.6	4.4	3.4	..
	1987	6.1	0.6	5.6	0.2	5.1	1.2	4.9	3.9	..
PT	1985	7.5	1.9	5.6	0.04	7.3	-	7.9	7.3	..
	1986	8.1	1.4	6.7	0.03	7.9	-	8.1	7.9	..
	1987	7.5	1.0	6.5	0.02	7.4	-	7.5	7.4	..
GB	1985	4.9	0.4	4.5	0.30	3.5	1.5	3.4	2.0	..
	1986	4.5	0.4	4.1	0.29	3.3	1.4	3.1	1.9	..
	1987	4.2	0.5	3.7	0.27	3.2	1.3	2.9	1.9	..
EC (6)	1985	5.0	0.6 e)	4.4 e)	..	..	..	..	..	..
	1986	5.0	0.5 e)	4.5 e)	..	..	..	..	..	..
	1987	4.8	0.4 e)	4.4 e)						

(1) For details, see explanatory notes. (2) Central government only. (3) Defined as the nominal tax rate on households' and enterprises' interest income, adjusted, where practical, for special allowances and fiscal evasion. (4) Estimated net of tax value of interest deductions. (5) Including dividends received. (6) Community sources.

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JOINING THE EUROPEAN EXCHANGE RATE MECHANISM

This note reviews, in summary form, the arguments for and against joining the exchange rate mechanism of the EMS.

2. The main arguments in the past have been:-

(i) Membership of the ERM would reduce the Government's room for manoeuvre. With large and open capital markets and relatively small reserves we have recognised that it would put more strain on interest rates, which might have to move more sharply. There would be much less scope for taking part of the impact of external stocks in the exchange rate. Moreover linking sterling to the deutschemark might require a faster speed of adjustment towards German inflation rates.

(ii) The counterpoint to (i) is that membership of the ERM provides a clear external discipline for the operation of financial policy. Difficulties in interpreting monetary aggregates have led to uncertainties about the operation of policy which may in turn have added an "uncertainty premium" to the average level of interest rates needed to deliver a given inflation path.

(iii) Sterling is particularly vulnerable to external pressures; with its international status, large money and capital markets, absence of exchange controls. Petro-currency factors have added further to the currency's variability. Moreover the UK status as a net oil exporter means that if the price of oil moves substantially then some corresponding movement in sterling is both necessary and desirable. In some circumstances membership of the ERM might serve to reduce potential speculative pressures; but in other circumstances defending particular margins for sterling could be difficult, particularly against the DM which shares sterling's status as a major internationally traded currency.

(iv) The variability in sterling has been a factor affecting investor and industrial confidence. It may itself have added to the uncertainty premium on sterling interest rates. As to industrial confidence, although forward markets and other hedging devices can help reduce uncertainties, most firms are much more concerned about the impact of exchange rate variability than movements in interest rates. In 1980 the economy needed shock treatment, and a sharp rise in sterling helped deliver that. With inflation now much lower, and on a downward track, more weight can be given to the impact of exchange rate stability on industrial confidence.

(v) Sterling's membership of the ERM would be seen by many as an important step in the development of the EC. As time goes by it becomes harder to sustain the argument that we intend to join in due course, but not yet.

3. The balance of argument has shifted over the years, and is affected by recent developments:-

(a) The Government has successfully managed a move to a more complex exposition of policy, placing less emphasis on monetary targets, without losing the market's confidence. This has been achieved in large part by giving increased emphasis to the exchange rate in the operation of policy.

(b) G5 and G7 moves towards achieving a period of wider exchange rate stability (including the yen and dollar as well as European currencies) have affected the substance and presentation of policy. We have laid stress on the need for a period of stability in the exchange rate. And this has been widely interpreted - not without a little help from the authorities - as meaning stability primarily in relation to the DM rate. If we continue to operate, in effect, alongside the ERM within the G7 framework it may become increasingly difficult to explain to EC partners why we do not wish to join. And we deny ourselves some of the benefits of membership without any compensating advantages if we continue this approach to the exchange rate.

(c) There are a number of developments that suggest sterling might be less subject to speculative strains within the ERM in the future, than might have been the case in the past. First, the petro-currency factor is reduced with the 1986 fall in the oil price, and the prospect of greater stability in oil prices for the period ahead. Second, convergence between inflation rates in EC countries should mean that general strains within the ERM will be less than in the past. Third, the dismantling of exchange controls in other EC countries should reduce the degree to which any speculation within the ERM is likely to concentrate on the sterling-deutschemark rate. We were also particularly concerned about the prospect of joining when a period of pre-election market uncertainty was ahead of us. The market can now see the prospect of four or five years of settled Government policy ahead.

(d) The sharp rise in the level of the reserves during 1987 (they now stand at a level of $41.7 billion spot and forward) means we are much better placed than in the recent past to intervene to see us through periods of temporary pressure within the ERM.

(e) We shall in any case need to consider the way in which we have operated our monetary policy, and the implications for funding. Membership of the ERM would provide a much simpler basis for this.

4. In general the balance of arguments has shifted in favour of joining the ERM, with many of the difficulties seen in the past somewhat reduced. Whenever we join, some risks will remain; but with the election behind us these risks now look as low as they are ever likely to be. We are of course already gaining some of the benefits previously seen from ERM membership, from participation in the G7 arrangements to promote greater worldwide currency stability. By the same token a move to an explicit exchange rate target within the ERM is now a smaller step than it would have been in the past.

26/3070E

JOINING THE ERM : TIMING

This note discusses possible dates for joining the ERM over the next few months. It is assumed that there would need to be a full meeting of EC Finance Ministers, and that this would take place over a weekend, when the markets are closed. Apart from the constraints discussed below, timing could also be affected by a view about the correct rate at which to join (see separate paper); and it may be sensible to allow the markets some time to settle down after the election.

2. The main factors are as follows:-

(a) Parliament. We have assumed hitherto that Parliament should be in a position to debate a decision to join within a few days (normally not later than the following Tuesday). If we joined when Parliament was in recess it might be difficult to resist pressure for early recall . No proper business can be done before the Queen's Speech now scheduled for 25 June. The first week of the new Parliament is for swearing in etc. This rules out the weekend 13/14 June and effectively also 20/21 June - since we could not wait till Thursday or Friday to make a statement. There is likely to be an economic debate - in which the Chancellor will speak - on ~~31 June~~ 2 July. It also rules out August, September and October up to 17/18. (It would in any event no doubt be difficult to arrange a meeting of EC Finance Ministers in August).

(b) Cabinet could be told of the decision on the Thursday preceding realignment. Given the risk of leaks this assumption may need further consideration. In any event it is not a real constraint since Cabinet always meets when Parliament is sitting except when the Prime Minister is away.

(c) On present thinking the Autumn Statement is likely to be in the first half of November. Last year it was on 7 November. Joining the ERM immediately after the AS looks unattractive because of the difficulties of explaining the change of course immediately after a major policy Statement. There might also be problems of inconsistency between the Industry Act Forecasts and the chosen ERM central rate. Joining the ERM on the weekend immediately before the AS has obvious presentational attractions and would provide the focal point of the AS itself. But the strains both on the Chancellor and on the Treasury machine in preparing for, and handling, both simultaneously - with the ERM decision known only to a handful of people - would be very considerable. The Chancellor would have to attend the EC Finance Ministers' meeting the weekend immediately preceeding the Autumn Statement. If we wanted to leave open the possibility of joining the ERM early in November, one possibility would be to decide fairly soon to have the Autumn Statement late this year - though there are public expenditure arguments against this.

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(d) Privatisations raise implications for disclosure, if the decision were taken but not announced before publication of the prospectus or pathfinder. These are difficult for the layman to judge, and we would need legal advice. Moreover the timing of the announcement could well bear on the pricing of an issue. Any market uncertainty resulting from the announcement, and particularly any short term adverse effect, could make pricing an issue more difficult or, if the decision were during the offer period, jeopardise the response to the offered price. And, if it were around the time dealings started, there would be criticism if the opening price suffered.

The main dates for the BAA sale are pathfinder 22 June; Impact Day 8 July; offer closes 16 July; allocations announced 20 or 21 July; dealings start 28 or 29 July. This suggests that 27/28 June might be a possible weekend to join if it were thought that markets would have settled sufficiently before 8 July and there were no pathfinder/prospectus difficulties. But 4/5 July would be very close to Impact Day; and the remaining weekends in July either in the offer period or before dealings started.

The main dates for the BP sale are the following (or one week later): pathfinder 21 September; Impact Day 8 October; 21 October UK fixed price offer closes and international tender bids received; 23 October tender striking price fixed and dealings start (unless Stock Exchange insist that dealings cannot start until 3 November). On this timetable a decision on 24/25 October would be straight after dealings had started on 23 October. But 31 October/1 November could be before dealings started if the Stock Exchange are difficult on the timing. 7/8 November would be after dealings had opened on either assumption (unless the whole BP sale were one week later than assumed here).

Summary

3. So the prospects look like this:-

	Weekends	Difficult because of:-	No difficulties
	13/14 June	Parliament	
	20/21 June	Parliament (?)	
poss too soon	27/28 June		No difficulty
	4/ 5 July	BAA	
	11/12 July	BAA	
	18/19 July	BAA	
	25/26 July	BAA(?)	
	August- 17/18 October	Parliament	
	24/25 October	BP (?)	
poss better one	31/ 1 November	AS (?)	Probably OK if AS were delayed until mid November
	7/8 November	AS (?)	OK if AS were delayed until late November.
	14/15 November	AS (?)	

DMARK/STERLING EXCHANGE RATE AND THE ERM

This note considers the exchange rate at which it might be desirable for sterling to join the exchange rate mechanism of the EMS, if a choice were available. It does so in three ways:

(a) It considers the behaviour of the "real" DM/£ exchange rate over time;

(b) It looks at the exchange rate which, by implication, we have felt over the last year or so has been more or less appropriate for keeping monetary conditions on track for meeting the inflation objectives;

(c) It examines the exchange rate assumptions made in the Budget forecast, taking into account the balance of payments outlook and discusses subsequent changes in our views.

2. It is likely to be impossible to identify a single "appropriate" level at which sterling should join the ERM. But the above approaches may help to shed some light on the matter. They are discussed in turn. Most of the arguments point to a band no lower than one centred around DM3.00.

a. <u>The Real Exchange Rate</u>

3. Experience suggests that over long periods of time exchange rates tend to adjust in accordance with relative inflation rates. Consequently, although other factors affect exchange rate movements in the short and medium term, it is useful to consider the inflation-adjusted or "real" exchange rate. Chart IA shows the actual DM/£ exchange rate since 1970. Sterling's trend depreciation is not very surprising in the light of the faster inflation rates in

the UK as compared to Germany, shown in Chart IB. The implicit real exchange rate is then shown as in Chart IIA.

4. The question was last looked at in September 1985. Taking 1980 as equalling 100, sterling's real exchange rate against the mark then stood at 110, some 20 per cent above its average level of the last 17 years. The following factors were then thought to be relevant in assessing an appropriate rate for sterling to join the ERM:

(i) at that time, it would be natural for the real exchange rate against the mark to be somewhat above average because of the petro-currency premium which sterling enjoyed. This must be expected to persist for some time; it might, therefore, be unwise to attempt to reduce sterling's rate against the mark by the full 20 per cent needed to reduce the real rate to its average level;

(ii) the UK's inflation rate was still appreciably above the inflation rate in Germany. Again, this was likely to persist for some while. Over time, this meant that the mark must be expected to rise against sterling, pointing in the direction of joining sterling on the low side initially to counteract this effect;

(iii) against this, the very need to eliminate the gap between British and German inflation rates required a period when the real effective rate index was sufficiently high to maintain steady downward pressure on inflation (Chart IIIB displays the real effective rate index over time). The dollar was a complicating factor here. Although the dollar had begun to depreciate against the mark, its real exchange rate was some 40 per cent higher than the average of the last 17 years. Unless the dollar declined further, a "high" sterling rate against the mark was needed to give a satisfactory effective rate index from the point of view of monetary conditions.

5. These considerations pointed in different directions. But on balance the conclusion was that a parity against the mark perhaps 10 per cent lower than the market rate in September 1985 might be appropriate - with a central rate of somewhere between DM3.65 and DM3.75. This would provide continued anti-inflationary pressure and the chance of maintaining the parity for some time to come.

6. Since 1985, there have been material changes in the circumstances:

(a) the sharp fall in oil prices in the Spring of 1986 has reduced any petro-currency premium that attaches to sterling. Arguments for suggesting that the real exchange rate ought on this account to be above average are therefore weakened;

(b) there has been a general appreciation of the D-mark. The dollar's real exchange rate against it - in September 1985 some 40 per cent above average - is now 10 per cent or a little more below its historical average. Sterling's real exchange rate against the mark has fallen by around 25 per cent over the same period to stand about 5 per cent below its average.

7. One factor which has not changed, however, is the relative inflation rates in Germany and the United Kingdom: UK inflation remains about 4 per cent higher.

8. These considerations make it hard to argue for sterling joining the exchange rate mechanism at a rate much lower than the current prevailing rate. Further depreciation of sterling against the mark could lead to insuffcient downward

pressure on money GDP.

9. On these grounds there might be a case for sterling joining the ERM at a slightly higher rate than the present market rate. The main argument against would rest on the continued adverse inflation differential compared to Germany. Since this must be expected to persist for some time, and the market recognises this, joining at a higher rate than the current market rate obviously increases the risk of its proving unsustainable, neccessitating an early realignment.

b. <u>The Rate appropriate for maintaining downward pressure on inflation</u>

10. The preceding discussion questioned whether joining the ERM at a rate below the present one would be sufficient to maintain adequate downward pressure on inflation. In principle, there can be no clear answer to this question. The exchange rate is only one of the factors which has to be taken into account in assessing monetary conditions. A low exchange rate could be offset so far as the overall stance of policy is concerned by higher domestic interest rates or by a more restrictive fiscal policy. Nevertheless, the exchange rate is of self-evident importance.

11. One way to explore the issue further is to examine the exchange rates which have obtained at the times of the monthly monetary assessments over the last year. Since these assessments record whether monetary conditions were considered satisfactory or otherwise, they are instructive in demonstrating what exchange rates have been judged to be appropriate.

12. Table 1 shows in summary form this information. Broadly speaking, the period since May 1986 falls into 3 parts:

(i) from May to July, there was some feeling that the exchange rate was probably higher than would

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Table 1

		Exchange Rates			
		ERI	£/$	£/DM	Monthly Monetary Assessment
1986	May	76.1	1.52	3.39	Lower exchange rate desirable on structural grounds. (Base rates fell ½ per cent, 27 May.)
	June	75.9	1.51	3.37	
	July	74.0	1.51	3.24	Exchange rate higher than expected given fall in oil prices
	August	71.4	1.49	3.07	Exchange rate broadly neutral on inflation at this level.
	September	70.4	1.47	3.00	Fall in exchange rate disturbing, given firmer oil prices.
	October	67.8	1.43	2.86	Higher interest rates required to offset exchange rate weakness. (Base rates rose ½ per cent, 14 October.)
	November	68.5	1.43	2.88	Monetary conditions remain loose. Case for a further rise in interest rates.
	December	68.5	1.44	2.86	No case for reducing interest rates unless, for example, exchange rate strengthens.
1987	January	68.9	1.51	2.80	
	February	69.0	1.53	2.78	Exchange rate stability on falling oil prices heartening. But no case for reducing interest rates, unless, for example, exchange rate strengthens further.
	March	71.9	1.59	2.92	(Base rates fell ½ per cent, 10 and 19 March.)
	April	73.2	1.66	2.98	(Base rates fell ½ per cent, 28 April.) Strength of exchange rate justified falls in interest rates.
	May 27	72.1	1.62	2.94	(Base rate fell ½ per cent, 8 May.)

be ideal; either it was placing too much downward pressure on inflation too quickly or that the pressure was occuring in an unbalanced way;

(ii) from August through to January, there was concern at, first, the rapid slide in sterling's effective rate index and then its stability at the lower level. It was felt that this required us to maintain the higher interest rates after October. At times a case was seen for further increases in interest rates to keep monetary conditions on track;

(iii) after February as the exchange rate began to firm, the prevailing view was that a gentle decline in interest rates could be countenanced without forcing monetary conditions off course.

13. There are many complications in interpreting monetary conditions and the level of the exchange rate. Other factors apart from interest rates - the fiscal stance, for example, and the position of the world economy - also have to be taken into account. Nevertheless the overriding impression from the monthly assessments is that we have been comfortable with an effective rate index between about 72 and 74. Lower rates than that have been felt to require higher interest rates to produce the required degree of downward pressure on inflation: higher exchange rates have been viewed as harmful to industrial confidence.

14. There has been no single sterling - mark exchange rate corresponding to this corridor for the effective rate index. As the mark has appreciated against most other currencies, a lower sterling exchange rate against the mark has been consistent with an unchanged effective rate index. But given the mark's current exchange rate against other currencies, maintaining sterling in an effective rate index band of 72-74 would imply an exchange rate against the mark of around DM 3.05 - 2.95. Should there be a further

substantial appreciation of the mark against the dollar, despite the Louvre Agreement, then a lower sterling/mark rate would be consistent with an ERI in this range. But the circumstances of dollar depreciation would have to be considered carefully. If it were to take place accompanied by renewed inflationary pressures in the world as a whole, then a higher sterling ERI might be required to maintain downward pressure on domestic inflation.

c. The Balance of Payments Outlook

15. A further factor bearing on the choice of rate at which sterling might join the ERM is the consequences for the balance of payments. Nearly a half of UK trade is with countries who are members of the ERM, a slightly higher proportion of imports and a lower proportion of exports.

16. At Budget time the current account balance was projected as in the following table. The table also shows the pattern of exchange rates with which these projections were taken to occur.

UK Current Account: FSBR Projections

		Current Surplus (£bn)	Exchange Rates		
			ERI	£/$	£/DM
1987	Q1	-0.8	69.6	1.54	2.78
	Q2	-0.6	70.5	1.57	2.79
	Q3	-0.5	70.5	1.57	2.78
	Q4	-0.8	70.5	1.57	2.77
1987		-2.7	70.3	1.56	2.78
1988		-1.5	69.3	1.62	2.67
1989		-0.4	67.3	1.69	2.52
1990		0.9	65.4	1.72	2.43

17. The current account position projected in the Budget forecast is not an unfavourable one. Whilst there is an assumed current account deficit of £2¾ billion in 1987 (about 0.7 per cent of GDP), this is projected to improve in successive years so that by 1990, there would be surplus of about £1 billion. Two factors underpin this predicted improvement:

(i) in 1987 demand in the UK is liable to grow more quickly than in trading partner countries, producing an appreciable deficit. But in later years, the reverse is the case leading to better trading performance;

(ii) the effects of improved UK competitiveness which became apparent in late 1985 and throughout 1986 increasingly work through to improved net exports, as time progresses.

18. But it should be noted that this satisfactory trade performance is predicated upon an exchange rate substantially below that which has occurred in 1987 to date. In the second quarter, for example, the effective rate index has so far been on average some three percentage points higher than

in the FSBR projections. The exchange rate against the mark has been about 6-7 per cent higher than assumed. Moreover, the FSBR projections incorporate a steady decline in both the effective rate and the rate against the mark after 1987. Clearly, other things being equal, a higher exchange rate must mean a poorer trade position.

19. On the other hand, there are some grounds for thinking that the current account position may remain in a satisfactory state, even with a higher exchange rate path than in the FSBR projections. In the first four months of 1987 imports have been markedly lower than anticipated. Though short run movements are always difficult to interpret, on balance the evidence suggests that the supply response of the economy may be turning out a little better than the Budget projection assumed. So the economy may be able to support a higher exchange rate without an unacceptable current account position.

20. The main conclusion to be drawn, perhaps, is that joining the ERM at rates close to current market rates would probably not give an unduly uncomfortable ride on the current account. Though such rates would be appreciably above those assumed in the FSBR projections, somewhat less favourable trade outcomes than that incorporated in the projections would presumably still be acceptable. Moreover, the basic trade performance may turn out to be better than then expected. But clearly joining the ERM at rates appreciably above those now in the market would increase the danger of a quite unacceptable current account position emerging.

Conclusion

21. There is likely to be no single correct answer to the question of the rate at which sterling should join the ERM. But the three sets of issues considered in this Annex point broadly in the same direction:

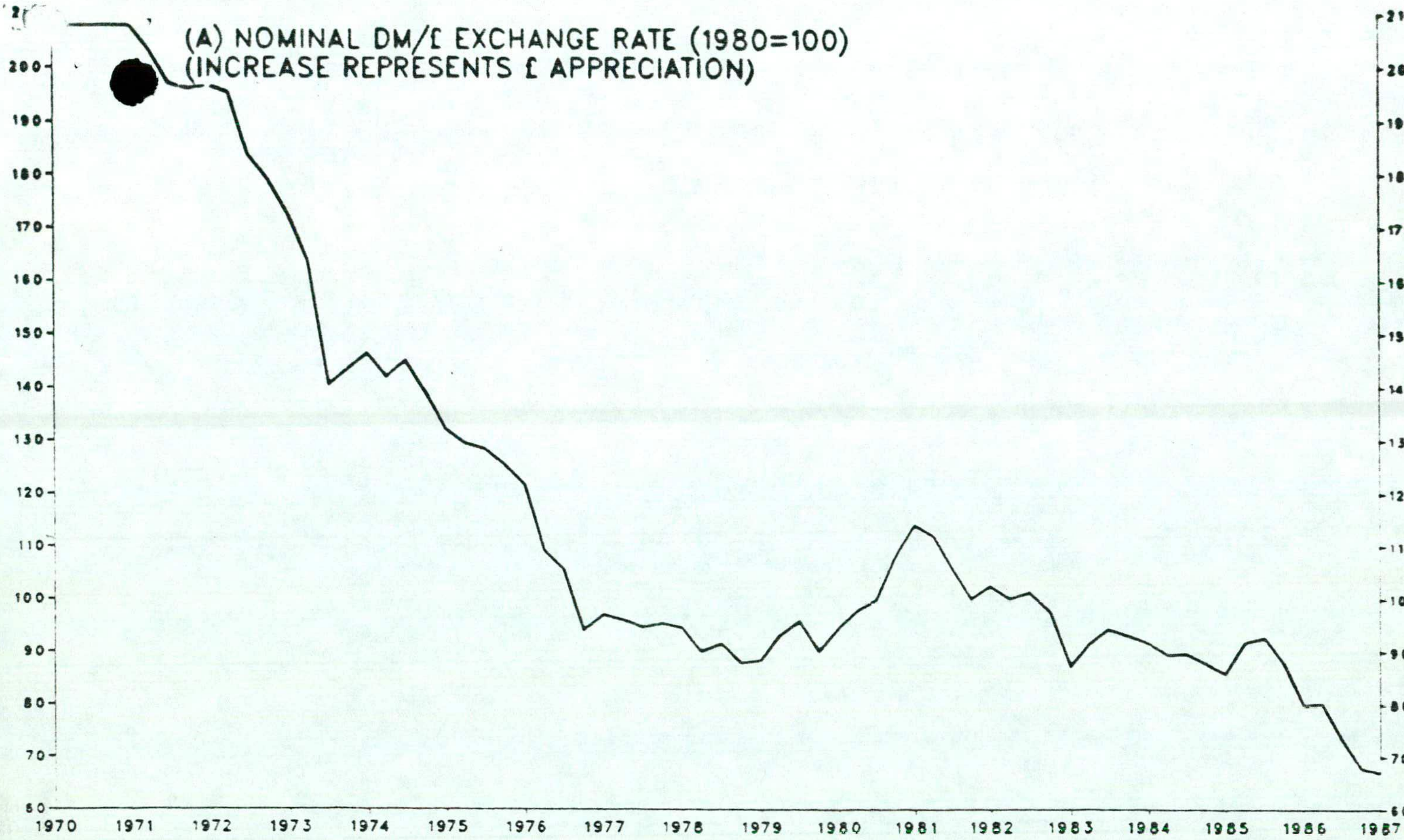
(i) the movements in both sterling's real effective rate index and the real rate against the mark, in relation to their historical averages, suggest that there it would be wrong to look for a substantially lower rate than current market rates for sterling to join the ERM.

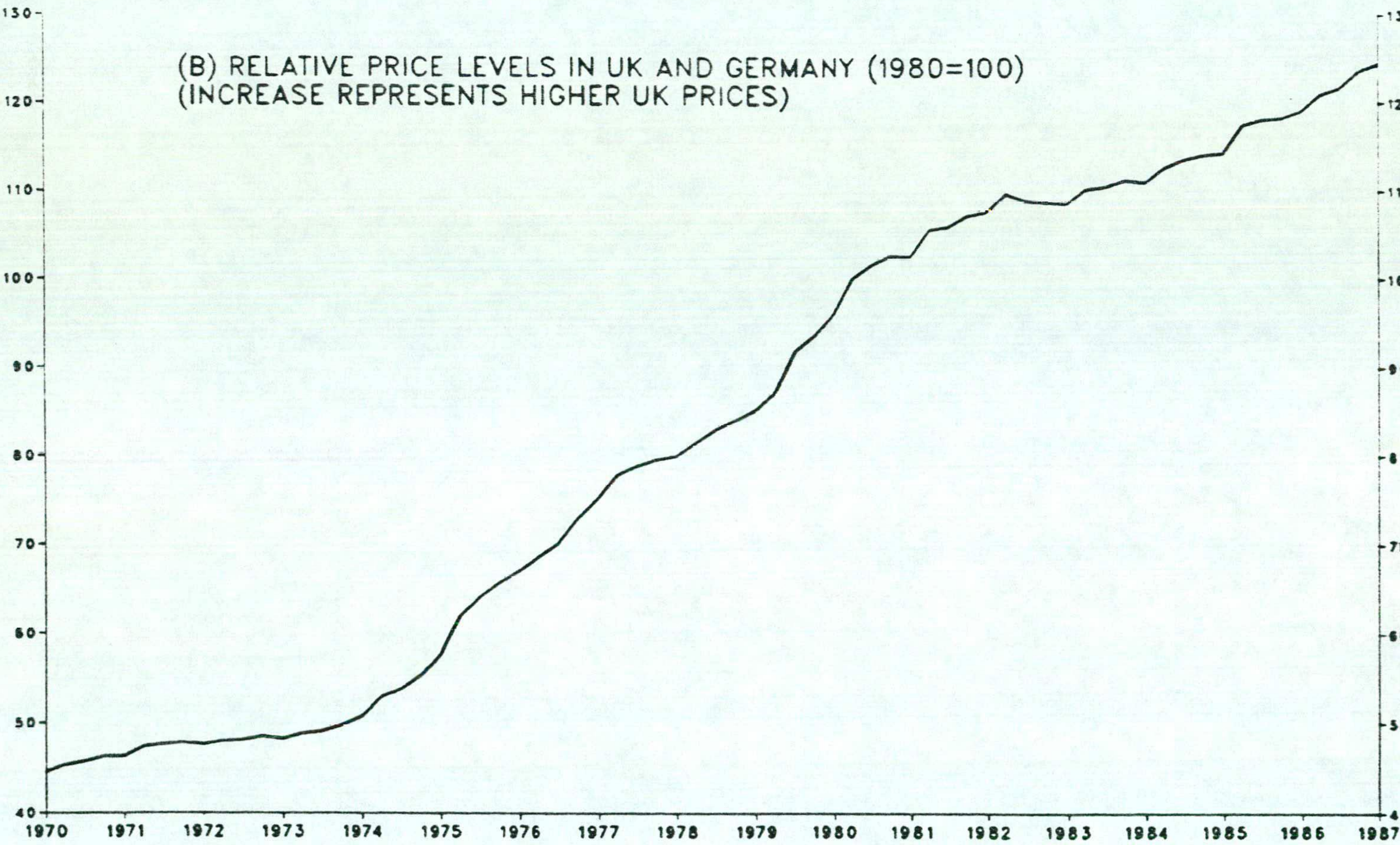
(ii) were sterling to join the ERM at a rate of around DM 3.05 - 2.95, that would appear consistent with the overall exchange rate level which in the last few months has appeared compatible with keeping monetary conditions on track. The situation would have to be reassessed if the mark appreciated further against the dollar and other currencies, in the light of the circumstances accompanying its appreciation.

(iii) joining the ERM at rates close to present market ones would probably not be incompatible with a satisfactory trade performance at least for a reasonable period of time.

22. By contrast, joining at rates appreciably higher or lower than ~~from~~ present market levels would be subject to some dangers. A significantly lower rate would run the risk of allowing a loosening in monetary conditions which would have to be offset by other policy changes if inflation were not to be re-fuelled. But equally joining at a rate much above current market rates would also be risky. There would be an increasing danger of a serious trade deterioration and, with the market perceiving this in advance, the possibility that a high rate for sterling would not be sustainable.

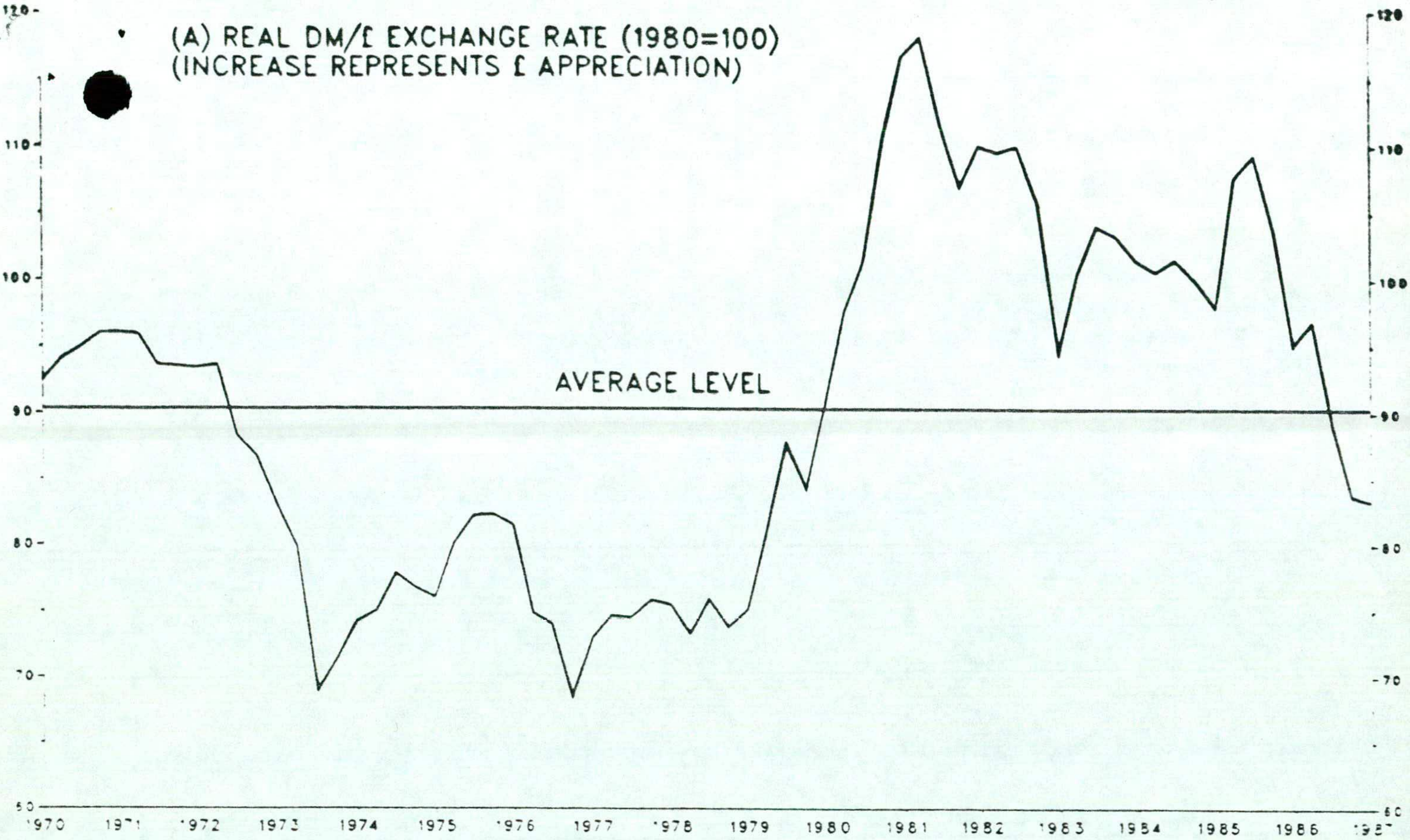
CHART I:

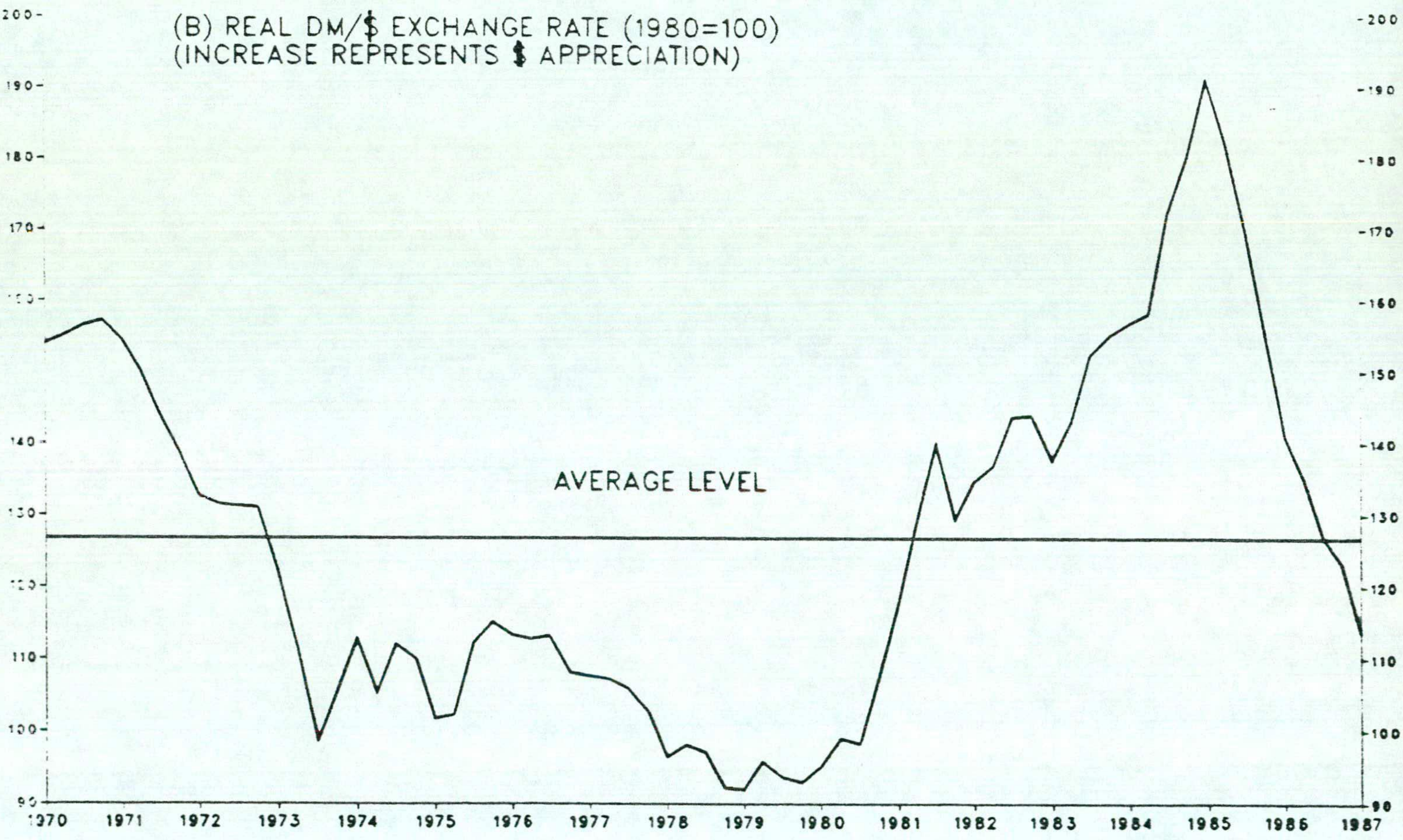




THE PRICE DATA RELATE TO CONSUMER PRICES.

CHART II: REAL DM EXCHANGE RATES AGAINST £ AND $

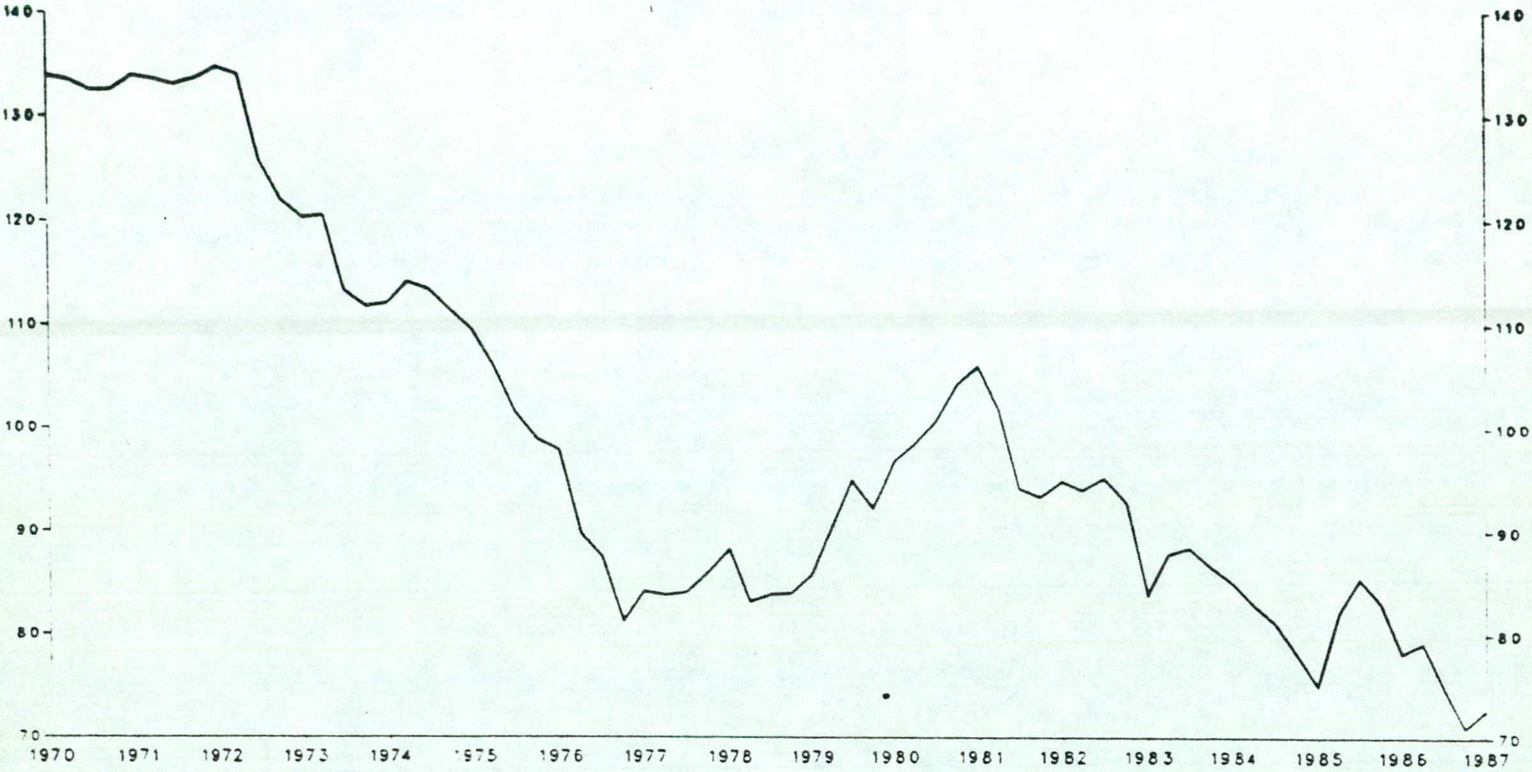


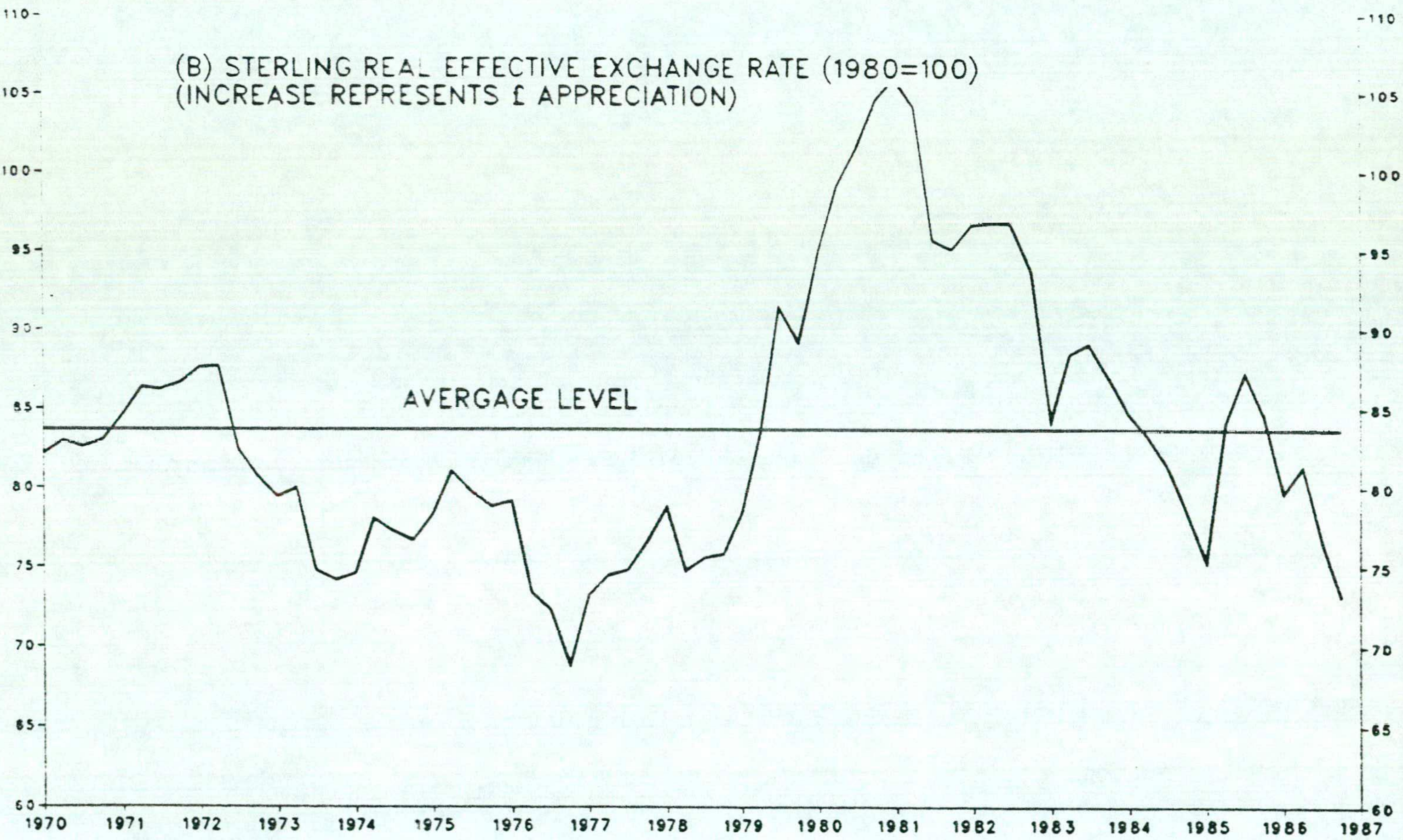


REAL EXCHANGE RATES ARE CALCULATED ON THE BASIS OF
RELATIVE MOVEMENTS IN CONSUMER PRICES

CHART III: STERLING'S NOMINAL AND REAL EFFECTIVE EXCHANGE RATE

(A) STERLING NOMINAL EFFECTIVE EXCHANGE RATE (1980=100)
(INCREASE REPRESENTS STERLING APPRECIATION)





REAL EXCHANGE RATES ARE CALCULATED ON THE BASIS OF
RELATIVE MOVEMENTS IN CONSUMER PRICES

SECRET AND PERSONAL

THE ERM: LEGAL POSITION

We have never had any doubt about the legality of joining the Exchange Rate Mechanism, should you choose to do so. But there is in existence some advice from the then Attorney General in 1978 - which, unlike other Ministerial papers is available to subsequent administrations - the burden of which is to cast doubt on the propriety of undertaking a major new continuing commitment of this type without specific legislative cover.

2. It is not out of the question to conceive of taking a robust line towards this, and to ignore it. Views about constitutional propriety are necessarily subjective. But it would be difficult to do so and potentially embarrassing if it ever came out.

3. A more natural course might be to check first whether the Law Officers share the view of their predecessors. Miss Wheldon's advice is that it is by no means inevitable that they will.

4. Legislation, if that were thought to be necessary, could be relatively simple. Nor, since we are concerned with propriety and not legality, would it necessarily be essential to have it in place before entry was affected. This is, however, on the assumption that joining would not be irrevocable. The EMS texts are silent on this point and, if we did get into this area, it would be prudent to check the position first with the FCO lawyers who are the experts on international law.

5. This is a sensitive area. We could, if you preferred leave the point to be resolved if and when it ceases to be academic. But on balance we think it would be helpful to clear it out of the way ahead of the heat of any decision. The approach to the Law Officer's department would be made through Treasury Solicitor, and we would propose to draft the question in such a way that the Attorney General was not only asked to take a view on the constitutional proprieties but also to endorse Mr Silkin's advice that participation in the ERM would not raise any legal, as oppose to constitutional, problems.

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[For a rather different message, see Bonn tel., behind]

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Rather: he changes his tune to suit his audience!

FRAME GENERAL

DELORS INTERVIEW IN LE SOIR

SUMMARY

1. FIRST OF TWO PART INTERVIEW BY DELORS IN LE SOIR THE BELGIAN DAILY, COVERING ROLE OF MEMBER STATES, SOVEREIGNTY, AND PROSPECTS FOR INTERNAL MARKET. FIRM REFUSAL TO GET DRAWN INTO BATTLE WITH PRIME MINISTER, DESPITE CRUDE ATTEMPTS ON PART OF INTERVIEWERS. CLARIFICATION OF HIS ''80 PERCENT OF ECONOMIC POLICY'' PREDICTION. OVERALL, A VERY CAUTIOUS PERFORMANCE. TEXT ALREADY FAXED TO ARTHUR, ECD I.

2. SECOND PART IN NEXT FEW DAYS TO COVER DETAILED ISSUES INCLUDING TAX, MONETARY AND SOCIAL POLICY AS WELL AS PROTECTIONISM AND FRONTIER CONTROLS.

DETAIL

3. FOLLOWING ARE THE MAIN POINTS OF DELORS' REPLIES:

(A) IT WAS NOT HIS ROLE TO ENGAGE IN POLEMICS WITH A HEAD OF GOVERNMNET. IT WAS UP TO HEADS OF GOVERNMENT THEMSELVES TO DISCUSS ISSUES AFFECTING THE CONSTRUCTION OF EUROPE. HE CONFIRMED HIS LINE AFTER THE PRIME MINISTER'S BRUGES SPEECH: '' WHAT UNITES US IS MORE IMPORTANT THAN WHAT DIVIDES US''.

(B) WOULD MRS THATCHER'S ATTITUDE HAVE A BRAKING EFFECT? HE RECALLED THE DIVERGENCES AMONG THE SIX BOTH BEFORE THE TREATY OF ROME AND BEFORE THE UK'S ACCESSION WHICH HAD APPEARED INSURMOUNTABLE TO SOME. ''THAT IS NO LONGER THE CASE''. THE COMMUNITY SPIRIT AMONG MEMBER STATES HAD BEEN CONSIDZGXPVW HC CR QMILQAT TORONTO AND HANOVER.

(C) REFERRING TO HIS PREDICTION TO THE EP IN JULY THAT IN TEN YEARS 80 PERCENT OF THE ECONOMIC LEGISLATION WOULD BE OF COMMUNITY ORIGIN, DELORS SAID: ''YOU WILL NOTE THAT I DID NOT SAY I WISHED 80 PERCENT... I WAS ONLY DRAWING THE LESSONS FROM WHAT IS CONTAINED IN ESSENCE IN THE SINGLE ACT. I MADE A DISTINCTION BETWEEN ECONOMIC AND FISCAL BECAUSE I KNOW HOW COMPLEX THE FISCAL DIMENSION OF THE SINGLE MARKET IS AND HOW IT POSES DIFFICULT PROBLEMS FOR MEMBER STATES''.

HE EMPHASISED THAT WHILE A LARGE NUMBER OF DECISIONS COULD BE TAKEN AT COMMUNITY LEVEL, THEY WOULD BE TAKEN BY REPRESENTATIVES OF THE TWELVE GOVERNMENTS, NOT BY THE COMMISSION. TO ATTACK THE BRUSSELS BUREAUCRACY OR USE IT AS A SCAPEGOAT WOULD NOT ABSOLVE GOVERNMENTS FROM ADDRESSING THE KEY QUESTIONS OF IMPLEMENTING THE SINGLE ACT.

(D) WAS THE SINGLE ACT BEING CALLED INTO QUESTION? ''I DO NOT THINK SO''. SUPPOSING MRS THATCHER HAD NOT MADE HER STATEMENTS, ''IF YOU ASKED ME TODAY'' SO YOU CAN BE EUPHORIC? - ''I WOULD HAVE BEEN THE FIRST TO PLAY THE ACTIVE PESSIMIST''.

(E) THE SINGLE MARKET. GIVEN THE RISK OF NOT MEETING THE 1992 DEADLINE, WAS THE ABSENCE OF ANY SANCTIONS ON MEMBER STATES SERIOUS? THE POLITICAL UNDERTAKING AT THE LUXEMBOURG EUROPEAN COUNCIL HAD BEEN CLEAR, BUT SEVERAL MEMBER STATES HAD DEMANDED THAT THE DATE SHOULD NOT HAVE AUTOMATICITY. THE COMMISSION COULD ONLY WORK ACCORDING TO THE PRINCIPLES ESTABLISHED BY MONNET AND PROVEN BY EXPERIENCE, NAMELY ON THE BASIS OF CONSENSUS. HE NOTED THAT THERE WOULD BE DIFFICULT DEBATES AHEAD IN FOUR MAIN AREAS: FISCAL, SOCIAL, EXTERNAL ECONOMIC AND MONETARY. HE ADMITTED THAT THE FINE WEATHER FORECASTS IN JUNE HAD BEEN TOO EUPHORIC. ''BUT TO PROCLAIM A STORMY OUTLOOK NOW SEEMS TO ME VERY EXCESSIVE''.

(F) THE ROLE OF INDIVIDUAL MEMBER STATES: DELORS SAID ONE COULD BE PROUD OF BEING BELGIAN WHILE AT THE SAME TIME BEING PROUD OF BEING EUROPEAN. HE HAD NEVER THOUGHT THAT INDIVIDUAL NATIONS WOULD DISAPPEAR AND DID NOT WISH THIS TO HAPPEN. QUESTIONS OF INTERNAL AND EXTERNAL SECURITY WOULD REMAIN ESSENTIALLY IN THE HANDS OF MEMEBR STATES. THE MAIN DEBATE WAS ON THE ROLE OF THE STATE IN OVERALL ECONOMIC, FINANCIAL AND SOCIAL POLICY. THERE WAS NOT A SINGLE MEMBER STATE, EVEN AMONG THE MOST LIBERAL, WHICH BELIEVED THESE COULD BE ENTIRELY REGULATED BY MARKET FORCES. THE QUESTION WAS WHETHER IN THE CONTEXT OF A SINGLE MARKET THERE SHOULD ALSO BE COOPERATION/NEGOTIATION AT A EUROPEAN LEVEL BETWEEN SOCIAL PARTNERS, AS WELL AS COMMUNITY MEASURES PERMITTING THE NECESSARY MINIMUM OF COOPERATION ON MACROECONOMIC AND MONETARY POLICY. THE ANSWER FOR DELORS WAS A MATTER OF COMMON SENSE.

(G) ON SOVEREIGNTY, DELORS NOTED, FIRST, THAT ALL EUROPEAN STATES WERE INCREASINGLY INTERDEPENDENT IN FACE OF COMPETITION FROM THE REST OF THE WORLD: AND, SECOND, THAT THERE WAS ALREADY COMMON EXERCISE OF SOVEREIGNTY AMONG MEMBER STATES IN THE CONTEXT OF THE IMF/IBRD. ''EUROPE IS ONE OF THOSE COLLECTIVE ADVENTURES, PERHAPS THE ONLY ONE WHICH UNITES US BEYOND OUR DOCTRINAL DIFFERENCES, AND WITH RESPECT, I REPEAT, FOR OUR OLD NATIONS WITH THEIR TRADITIONS, PERSONALITY AND CONTINUITY''.

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FRAME ECONOMIC

SPEECH BY DELORS TO GERMAN TRADE UNIONISTS ON THE SOCIAL DIMENSION OF THE SINGLE MARKET, 23 SEPTEMBER

SUMMARY
1. SPEECH BY DELORS TO GERMAN TRADE UNIONISTS AND INDUSTRIALISTS IN COLOGNE ON 23 SEPTEMBER SEEN AS A RIPOSTE TO THE PRIME MINISTERS'S SPEECH IN BRUGES.

DETAIL
2. ADDRESSING TRADE UNIONISTS AND BUSINESSMEN IN COLOGNE ON 23 SEPTEMBER AT A SYMPOSIUM ORGANISED BY THE GERMAN TRADE UNION FEDERATION AND THE COMMISSION ON THE SOCIAL DIMENSION OF THE SINGLE MARKET, DELORS RESPONDED TO THE PRIME MINISTER'S VIEWS ON THE FUTURE DEVELOPMENT OF EUROPE BY CALLING FOR A EUROPE BASED ON QUOTE FRATERNITY AND SOLIDARITY UNQUOTE, ANCHORED IN CO-OPERATION AND DIALOGUE BETWEEN EMPLOYERS AND TRADE UNIONS.

3. PAYING TRIBUTE TO THE SOCIAL CONSENSUS-BASED GERMAN MODEL, DELORS POINTED OUT THAT 11 OF THE 12 MEMBER STATES HAD ACCEPTED THE IDEA OF A EUROPEAN MODEL OR EUROPEAN PERSONALITY AT THE HANOVER COUNCIL. ALLUDING TO THE MISGIVINGS EXPRESSED BY THE PRIME MINISTER IN HER BRUGES SPEECH ABOUT SUBMERGING NATIONAL IDENTITIES IN AN IDENTIKIT EUROPEAN PERSONALITY, DELORS FIRMLY RULED OUT ANY QUESTION OF WANTING TO BUILD EUROPE ON A SINGLE MODEL. RESPECT FOR DIVERSITY WAS ONE OF THE KEY PRINCIPLES UNDERLYING PLANS FOR DEVELOPING THE COMMUNITY. NATIONAL DIVERSITY SERVED TO ENRICH EUROPE.

4. OTHER KEY PRINCIPLES INCLUDED THE IMPORTANCE OF TAKING AS MANY DECISIONS AS POSSIBLE AT LOCAL RATHER THAN NATIONAL OR EUORPEAN LEVEL, THE NEED TO RETAIN A MINIMUM OF REGULATION EVEN WHEN TRADE BARRIERS WERE LOWERED AND THE IMPORTANCE OF INCREASED CO-OPERATION IN ORDER TO ACHIEVE THE BENEFITS OF GREATER COMPETITION. THIS PRINCIPLE APPLIED IN MANY AREAS, INCLUDING CO-OPERATION BETWEEN

CENTRAL BANKS OVER MONETARY POLICY. INDEED IT WAS VIRTUALLY THE QUOTE MARRIAGE CONTRACT UNQUOTE OF THE TWELVE WHICH BY IMPLICATION THE UK WAS TRYING TO UNDO.

5. WITHOUT MENTIONING MRS THATCHER BY NAME, DELORS ARGUED THAT DESPITE THE CLAIMS MADE BY THOSE ADVOCATING EXAGGERATED DEREGULATION, ECONOMIC PROSPERITY AND SOCIAL COHESION WERE INEXTRICABLY MIXED. THIS POINT NEEDED TO BE MADE AGAIN BECAUSE THE DEBATE OVER WHETHER EUROPE WAS SIMPLY A FREE TRADE ZONE OR A COMMON ECONOMIC AND SOCIAL SPACE HAD NOW BEEN STIRRED UP ONCE MORE, DESPITE THE COMMITMENTS WHICH ALL 12 GOVERNMENTS HAD GIVEN.

6. DELORS' ADDRESS WAS ALSO AIMED AT ALLYING THE FEARS OF WEST GERMAN TRADE UNIONS THAT HIGH GERMAN WAGES, JOB PROTECTION AND EMPLOYEE PARTICIPATION COULD BE ERODED BY PLANS FOR 1992, AND THAT THE SINGLE MARKET WOULD LEAD TO COMPANIES SITING JOBS AND INVESTMENT IN LOWER-COST, LESS REGULATED COUNTRIES THAN THE FRG. DELORS ARGUED THAT COMPANIES' INVESTMENT DECISIONS WOULD CONTINUE TO BE INFLUENCED BY FACTORS OTHER THAN LABOUR COSTS AND THAT SOME INDUSTRIAL RE-LOCATION WAS BOUND TO HAPPEN ANYWAY WITH OR WITHOUT THE SINGLE MARKET. COMPLETION OF THE SINGLE MARKET WOULD NOT REDUCE THE LEVEL OF SOCIAL PROTECTION OR EMPLOYEE PARTICIPATION ALREADY ACHIEVED IN MEMBER STATES. THE EUROPEAN COMPANY STATUTE WOULD NOT JEOPARDISE THE GERMAN SYSTEM OF CO-DETERMINATION. WHERE HEALTH AND SAFETY IN THE WORKPLACE WERE CONCERNED, THE AIM WAS TO RAISE STANDARS, NOT TO LOWER THEM. THE NATIONAL AUTONOMY OF THE TRADE UNIONS IN WAGE BARGAINING WOULD NOT BE UNDERMINED BY THE SINGLE MARKET BUT WOULD BE USEFULLY COMPLEMENTED BY A SOCIAL DIALOGUE BETWEEN EMPLOYERS AND TRADE UNIONS AT EUROPEAN LEVEL. WHILE PRAISING THE GERMAN MODEL, DELORS ALSO WARNED GERMAN TRADE UNIONISTS AND EMPLOYERS NOT TO BLAME ALL THEIR PROBLEMS ON THE SINGLE MARKET. STEPS TO ADJUST THE GERMAN ECONOMY WOULD NEED TO BE TAKEN ANYWAY BECAUSE OF CHANGES IN THE WORLD ECONOMY. COMPLETION OF THE SINGLE MARKET DID NOT OFFER A MIRACLE CURE BUT WOULD HELP EUROPE TO MEET EXTERNAL CHALLENGES.

8. FULL TRANSLATION FAXED TO ARTHUR (FCO) AND GILBERTSON (DTI). UNUSALLY DELORS SPOKE IN GERMAN.

MALLABY

FCO PLSE PASS SAVING

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OTHER EC POSTS

NNNN

Foreign and Commonwealth Office
London SW1A 2AH

13 April 1989

[not, of course, on agenda!]

Dear Alex

The Foreign Secretary has asked me to send you the
/ attached checklist of points which he looks forward to discussing with the Chancellor tomorrow.

Yours,
Stephen
(J S Wall)
Private Secretary

Alex Allan Esq
PS/Chancellor of the Exchequer

[Work on Walters – or is he lost cause?]

[PM – at present – has asymmetrical view: fine to defend ↓ £, highly inflationary to try to stop ↑ £. Can this be turned to advantage – especially since she's worried about BoP]

SECRET AND PERSONAL

ERM: POSSIBLE QUESTIONS

1. Is there a risk that reports of the Delors Group's unanimous recommendation that all Community currencies become full ERM participants during "Stage I" will lead to No 10 painting itself more firmly into a corner? If so,

Yes.

- should one use minutes/meetings about the Delors Group outcome to advise No 10 that dumping on this aspect of the Delors Group report would demolish the "when the time is right" line, and so lose us potential allies (eg FRG, Netherlands) on other issues in the post-Delors report debate?

- should one go further and aim to convince the Prime Minister this month of the merits of appearing open-minded on ERM when she sees da Mita (28 April), the Dutch (29 April) and Kohl (30 April)?

2. Would it make sense to aim to use the Dutch visit to Chequers to address the substance of the ERM issue? If so,

How much weight does Lubbers carry?

- should Ruding (margins of 17 April ECOFIN) and Vanden Broek (margins of informal FAC 15/16 April) be nudged to use the arguments most likely to have impact?

- are these arguments:

  (a) the case for seeing ERM membership as a reinforcement to, rather than a distraction from, the primary counter-inflationary aim; and

  (a) is better

  (b) the potential value of ERM entry in contriving a "soft landing"?

3. Is it worth considering any similar nudging of the Germans before the 30 April encounter? (NB riskier; for the Prime Minister and Kohl will not be accompanied).

- if so, since Genscher would clearly <u>not</u> be the right interlocutor, would a word with Stoltenberg on 17 April be the right step?

Not now!

4. When the issue is first re-opened internally with No 10, would the job best be done (a) by the Chancellor and Foreign Secretary alone or (b) with potentially sympathetic Cabinet colleagues around?

- if (a) were thought best for a first step, what would be the right peg? Not, presumably, the Delors report, since the Brittan argument that ERM movement is the only way of derailing EMU clap-trap will, though valid, cut no ice in No 10 and risks implying that ERM entry is a <u>price</u> we might have to pay, a concession to the foreigners, rather than what the UK interest requires.

- might the right peg be something which the Dutch said at Chequers?

none of these, but possibly downward pressure on £

- or is an endogenous peg likely to arise from the inflation/trade/money figures, and Treasury forecasts, in the near term?

5. Should the aim of the first round be to commission rapid and restricted papers/seminars, covering likely Prime Ministerial objections?

- if so, would the right subjects be:-

no - underestimated strength of world economy. But the hardest issue.

(a) does the experience of "shadowing" the DM invalidate the case for ERM entry?

in present circs sh'd be seen as underpinning

(b) would ERM entry be seen by the market as an underpinning for, or a distraction from, counter-inflationary pressure?

yes

(c) has the force of the "petro-currency" argument against ERM diminished?

doubt it's true, but could be useful argument vis a vis No10.

(d) is the greater volatility of Sterling (c.f. other EC currencies) against the DM a factor in the current growth of the deficit in UK/FRG trade in goods and services? If so, would ERM entry remove/reduce a 1992 handicap to UK business?

[(e) in contriving a "soft landing", <u>when</u> this year might ERM entry have maximum beneficial impact?]

6. When other Cabinet colleagues are brought in, who should be approached?

[Hurd	[Ridley
Wakeham	Young
Rifkind	Clarke
MacGregor	Parkinson
Major	King]
Younger]	

Could be useful if Young was persuaded by Euro/trade arguments, but he's dangerous.

7. Meanwhile, radio silence?

Is there much to study?

- should any "studies" be done in a <u>very</u> restricted group?

- should press speculation (eg P Jenkins: Independent: 12 April) be met with flat denials?

[watch out for July reshuffle!].

J.M.12.89

PERSONAL AND SECRET

From: T P Lankester
Date: 8 June 1989

CHANCELLOR

cc

Sir P Middleton
Mr N Wicks

PM

DELORS, ERM AND MADRID

You asked me to redraft the Madrid paper with John Kerr on the basis that:

i. The section arguing the case for sterling joining the ERM should be taken out altogether - you said we should come back to this after Madrid.

ii. The Prime Minister should be advised to play it long at Madrid and say the minimum necessary about Delors and the ERM to avoid provoking the French into working for an IGC under their Presidency.

You also had some suggestions on what might be the consequences of an IGC and UK isolation.

2. I now attach a revised draft reflecting these points. You will want to look particularly closely at paragraphs 23 to the end and especially at the line proposed in paragraph 33. John Kerr and I believe that the latter is the absolute minimum that is needed to avoid a move to an IGC under the French Presidency. We cannot be certain of this, however; it could be that we would have to sign up to conclusions in Madrid which would commit us to joining by 1992. But at this stage I do not think it likely that the Prime Minister would be prepared to accept such a formulation, and there is certainly a reasonable chance that the formulation we have suggested would have the desired effect. If the Prime Minister could be persuaded in discussion with you and Sir Geoffrey Howe that she could accept a target date, that would of course be preferable and would reduce the risks; but we thought it best not to go for this in the paper itself.

PERSONAL AND SECRET

3. You should be aware that the Spanish Foreign Minister this morning told Sir Geoffrey Howe that they were planning that the Madrid Conclusions should roughly follow the conclusions at S'Agaro but with two variations. First, they would be looking to include a 1992 target date for ERM membership for the three outsiders. Secondly, though they were determined not to hold a vote on an IGC or include a date for it in the Conclusions, it would probably be necessary to say a little bit more about the possibility and prospects of an IGC in order to satisfy the French.

4. On handling, the Foreign Secretary would very much like to get this paper to the Prime Minister over the weekend. This is because he thinks it is vital for you and he to have your discussion with her before she sees Gonzalez on the 19th. For what she says to Gonzalez will, in his view, virtually determine the position she takes in Madrid.

5. I think this is probably right, though if necessary the paper could perhaps wait until early next week.

T P LANKESTER

macro-economic policy co-ordination at the international level is concerned, the Community as such is currently represented only at the summit meetings of the major industrial countries. In order to make full use of its position in the world economy and to exert influence on the functioning of the international economic system, the Community would have to be able to speak with one voice. This emphasises the need for an effective mechanism for macro-economic policy co-ordination within the economic and monetary union.

III. Steps towards economic and monetary union

39. After defining the main features of an economic and monetary union, the Committee has undertaken the "task of studying and proposing concrete stages leading towards this union". The Committee agreed that the creation of an economic and monetary union must be viewed as a single process. 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.

V bad

A clear political commitment to the final stage, as described in Part II of this Report, would lend credibility to the intention that the measures which constitute stage one should represent not just a useful end in themselves but a firm first step on the road towards economic and monetary union. It would be a strong expression of such a commitment if all members of the Community became full members of the EMS in the course of stage one and undertook the obligation to formulate a convergent economic policy within the existing institutions.

bils A Gov
o Hoffmeyer

Given that background, commitment by the political authorities to enter into negotiations on a new Treaty would ensure the continuity of the process. Preparatory work for these negotiations would start immediately. At the end of this Report suggestions are made regarding the procedures to be followed for the further development of economic and monetary union.

We may be able to make something of

Back papers.

PUP

[Not to be shown to anyone without consulting these]

OUTLINE OF EC ISSUES PAPER

EMU will be a major topic at Madrid, and subsequently.

We have already staked out our position clearly.

But will not be able to kill it off, and will need to consider our line carefully as the debate develops.

Raises wider issues of our relationships with EC partners.

Been doing quite well by taking tough line on EC issues:

- Budget
- Witholding taxes
- Frontiers
- Tax approximation

But now fighting on several fronts

- social dimension - vital to supply side etc that we win
- EMU - where very strong political pressures, from French in particular, for move forward

Informal Ecofin went reasonably well

Unlikely to be show-down at Madrid

But can't be sure - foreign ministers and heads of government may less sympathetic to UK arguments

And ~~In~~ any discussion at Madrid important as background to action in French presidency.

NO

[Kerr stuff on can't rubbish concept of EMU since we've signed up to it; and can't say never any Treaty change]

Keep talking - prepared to discuss (not least democratic dimension)
- play long (past French presidency)

Risk of others going it alone if they believe no chance of

securing any progress with our cooperation

Would this matter?

Beefed-up section on two-tier Europe, bringing out

political problems/isolation

US attitude

loss of influence on other issues/ others would see less need to try to reach an accommodation with us

risk of being out-voted on issues like extra regional spending, size of budget etc

damage to UK's economic interests as firms saw UK as no longer part of mainstream Europe

None of this should arise at Madrid

Line there should be to build on Ecofin:

more study of implications - political as well as economic

acceptance of Stage I with no commitment to timescale or to later Stages

But clear that there are real dangers ahead

Need to consider carefully what best solution for UK is

More work in light of Madrid

Happy to discuss

Tuesday, May 23, 1989

Supporters of Economic and Monetary Union in Europe fail to see the obvious: that it is quite unnecessary to the strengthening of political and social ties. It is time they took their heads out of the sand, says CHRISTOPHER MONCKTON

IN THE past month the black [illegible] of No 10 has been opening and shutting even more frequently than the usual 700 times a day. Ambassadors and academics from Europe have been dropping in to try to persuade Sir Alan Walters, Mrs Thatcher's newly returned economic adviser, to drop objections to Britain's membership of the European Monetary System.

They have had little effect. Alan Walters takes the view that present inflation arose because Nigel Lawson tried to get us into the EMS by the back door early last year by forcing interest rates down to 7.5 per cent in the hope of pegging the pound to the German mark. If interest rates are too low, inflation results. Inflation resulted.

At the moment, HMG is at odds with Europe on several issues but the most serious dispute, and the only one on which there is real division within the Cabinet, is about the economic future of Britain in Europe.

Most European currencies (but not sterling) are linked in the exchange rate mechanism of the European Monetary System (EMS), an informal arrangement between central banks. Nigel Lawson wants the pound to join the EMS. The Prime Minister does not. In No 10, EMS is pronounced "E-Mess".

Inflation

Those who argue sterling should join E-Mess—such as Michael Heseltine and Arthur Cockfield, Britain's former EC Commissioner—claim it has benefited the European economy in various ways.

But inflation rates within E-Mess have fallen more slowly than in other developed countries both in Europe and elsewhere. Furthermore, since 1979 all the original members of the EC have larger growth rates in trade with non E-Mess than with E-Mess countries.

Investment levels have fallen inside E-Mess but have grown outside it. Finally, overall growth in gross domestic product has been slower for countries within E-Mess than for countries outside it.

After E-Mess comes Emu (Economic and Monetary Union). Emu, pronounced like Rod Hull's pet bird, is a formal proposal by a committee under M Delors, crotchety President of the European Commission, that Europe should proceed to full union of economic, fiscal, monetary and budgetary systems.

The main Delors proposals are:

- Every member state, including Britain, should join E-Mess. Then the exchange rates between EC currencies, which are now loosely linked, would be permanently "locked". Eventually, they would be compulsorily scrapped and replaced by a single European currency, the Ecu.
- The fixing of interest rates and (to a large extent) taxes in each member state would be done by a massive, central bureaucracy called the European System of Central Banks, which would have extensive regulatory powers to supervise all banks in the EC and set interest rates.
- The ESCB would have an unelected council and an unelected board with security of tenure. It would not be subject to control by any elected parliament in the EC. Even the European Parliament would have no say—indeed, it is scarcely mentioned throughout the 40-page document.
- No member state would be allowed to run a budget deficit without permission from the bureaucracy, which would have the power to set upper limits on the deficit and influence overall budgetary policy.
- All major economic decisions would be taken by the ESCB, and the Commission would enforce compliance. "For the Community institutions, it will mean a substantial addition to their executive and policing functions."

The Emu report is the Commission's bid for near-absolute power throughout the Community. The Commission is seeking the power to form an anti-democratic, corporatist, neo-Fascist cartel of invisible, immensely powerful, near-totally unaccountable, bureaucratic institutions.

The real argument, therefore, is not about whether Britain should be in Europe, or about whether the Prime Minister is keen enough about the Community: it is about whether Europe after Delors will remain recognisably democratic at all.

Leapfrog

How, then, should the Prime Minister respond to Delors? Merely to condemn the report at the Madrid summit in June would be dismissed by her opponents as evidence of a churlish and negative approach to the Community.

In the run-up to the European elections, Margaret Thatcher has a golden opportunity to leapfrog Delors and show that, far from being in the brake van of Europe, she is in the engine driver's seat. She should say just two things:

1. Britain will join the E-Mess one year after the other member states have carried out their obligation under the European Single Act to liberalise and deregulate their financial markets.

Britain, ahead of the EC, has the most free financial markets in Europe. But West Germany still has exchange controls exercised through restrictions on the financial institutions; and it savagely regulates the insurance market.

France has exchange controls for individual travellers, and strictly rations credit. Italy has exchange controls and a mortgage cartel. These are just a few of the major restrictions which will have to go by 1992.

When they have gone, the free and fast flows of capital which will then become possible will make the E-Mess exchange rate mechanism, in its present, objectionable form, unworkable. E-Mess will simply be unable to stand the strain of all that freedom.

This leads to the second thing the PM should say:

2. We want the Ecu, and we want it now. The common currency of Europe should be available at once, in coins, bank notes, cheques and financial instruments of every kind.

Hideous

But the Ecu would not replace the existing currencies of Europe: it would exist in competition with them. The free decisions of free people, not the directives of a new and hideous oligarchy, will then decide how rapidly and completely economic and monetary union will come about.

The truth is that economic union is unnecessary. For instance, Little Europeans like Michael Heseltine, prone to look narrowly at Europe without thinking about the wider world, have not advocated economic and monetary union for Canada and the U.S.

Canada and the U.S. do more trade with each other than any other two countries. They have, in effect, free movement of labour, capital and goods just like the EC. But they have no Emu because there is simply no need.

Nor is there the slightest need for an Emu in Europe. The nations of the EC can grow together economically, politically and socially without it.

But I'll bet you 10 Ecu to one that without the Prime Minister's vigilance the whole thing would have gone through on the nod.

Alan Walters: standing firm against the Europeans

11/27

Thursday May 25 1989

...ardian

...opean partners say sterling ...sis could force UK into EMS //

John Palmer in Strasbourg and Mark Milner in London

BRITAIN'S European Community partners believe that if yesterday's interest rate increase fails to halt the slide in the value of sterling the Government may be left with no alternative but to peg sterling within the exchange rate mechanism of the European Monetary System.

Some European bankers are even convinced that an EMS decision could be forced on London in the next few weeks.

"If the latest UK interest rate increase does the job, well and good. But if the slide in sterling gathers pace what alternative will be left if inflation is to be halted except to bring sterling fully into the EMS?" one senior Commission official asked yesterday.

Another official said that the Chancellor might "try to buy time before taking the fateful step into the exchange rate mechanism by sanctioning one last further interest rate hike."

Even before the latest sterling slide some EEC governments detected signs that the Chancellor was renewing pressure within the government for a change of policy on the EMS.

After the weekend meeting of EEC finance ministers at S'Agaro in southern Spain, some of his fellow ministers thought Mr Lawson was willing to trade hardline opposition to European monetary union for a decision to enter the EMS exchange rate mechanism.

Speaking to journalists, the Chancellor highlighted his differences of approach over the EMS with Mrs Thatcher by saying that the issue was "not whether, but when" Britain pegged sterling in the EMS.

It was recognised on European foreign exchange markets yesterday that Mrs Thatcher might see the pressure on sterling as a further reason for not trying to fix sterling in the system.

"Most other people hope the British will draw a completely different conclusion," one West German banker said yesterday. "The risk of not fixing sterling at the right rate against the West German mark does exist. But it surely cannot be greater than the risks of losing control of inflation as sterling continues to lose ground on the world's currency markets."

However some foreign exchange dealers worry that, if Britain were a member of the EMS, the kind of divergence between sterling and the mark seen over the last two days would put an intolerable strain on the system.

They argue that the strength of the pressure on sterling — coupled with the Bundesbank's public questioning of foreign exchange intervention — would have meant either a disruptive realignment of the EMS or a rise in interest rates such as the UK was forced into yesterday.

The UK's cool stance on full EMS membership was underlined by the governor of the Bank of England, Mr Robin Leigh Pemberton, in the Bank's annual report published yesterday. He welcomed the conclusions of the Delors committee, (of which he was a member), noting that it recognised "the internal market programme, the 1992 initiative, for all its great importance to European business life, was in no sense predicated upon progress towards monetary union."

The Governor yesterday said the EMS had proved a "comparative success" over the past 10 years. Giving evidence to the Treasury and Civil Service select committee examining the Delors Report, he said there had been a "very good performance" for EMS countries in terms of exchange rate stability, counter-inflation performance, and numbers of interest rate changes. But growth performance and the unemployment record had not been as good as in Britain.

There would be "possible advantages" in joining. It was the Government's policy to join when the time was right. "One of these days, in my view, that day will come."

FINANCIAL TIME[S]

A timetable for EMS membership

26
SB

Mrs Thatcher has thrown down the gauntlet, saying that she knows of "no one" who thinks that Britain should join the exchange rate mechanism of the European Monetary System until the inflation rate has been brought down. Here then are the thoughts of no one.

It would indeed be less than ideal to join the mechanism tomorrow with the standard $2\frac{1}{4}$ per cent exchange rate margin for fluctuation around the central parity.

Here are, however, three possible approaches which embody the substance of the British Government's commitment to join when the time is ripe (not incidentally "right", which must be a typographical error which has crept in to recent drafts.)

- Following the PM's own cue, the Government could undertake to join when inflation was down to a certain level – for example the Community or EMS average.
- There could be an undertaking to join by 1992 when the Single Market is supposed to be established or in relation to some other timetable.
- Britain could join with a wider margin.

Italy has a 6 per cent margin, which if used to the full gives a 12 per cent band of possible fluctuation. But in the British case it should be allied with a commitment to move to the general Community margin in the not-too-distant future.

Indeed the Italian and Spanish Finance Ministers have already been discussing arguments for a $3\frac{1}{2}$ per cent margin for everyone. I had better not say which other Finance Minister they thought was listening to their discussions with interest.

Each of the versions comes in varying degrees of hardness. The inflation rate at which Britain would join could be defined in advance or left vague. The exchange rate for joining could be set now (which would help on the inflation front) or left unspecified.

My own favourite option is the wider margin one. Indeed I suggested it as early as 1979 when the Callaghan Government was still in office, only to be told that the EMS could never be sold to the Labour Party. But the Bank of England to its discredit then rejected with contempt any arrangement which put Britain on a level with Italy. A senior Bank of England official with shining prospects also took it upon himself the other day to pour cold water on EMS membership on a semi-public occasion.

Nevertheless it is partly as a result of the skilful negotiation of membership with a wider margin for Italy, by the former Bank of Italy governor, Mr Paolo Baffi, that Italy has achieved a lower rate of inflation than Britain and a higher growth rate – despite an horrendous budget deficit approaching 10 per cent of gross domestic product.

Which of the three options outlined for Britain is followed is less important than that one of them is. Any of them would be sufficient for the UK Government to be in on the follow-up discussions to the Delors Report which would, in practice, enable it to put a single currency Europe on to the back burner so long as it misguidedly wishes to do so.

But if all these compromise ideas are shunned, we will see a two-speed Community. The other members will then go ahead on their own to establish a union much more along the lines of the Delors vision. It will be a fate which the British Government will richly deserve, not only the Prime Minister but her colleagues who let her get away with it.

3/3.

DEPARTMENT OF THE TREASURY
Washington

Some liking of these political
impracticality of dollars; but
some movement on more
co-operative exchange.

chex.ps/aa2/89 **PERSONAL AND SECRET**

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

13 June 1989

J S Wall Esq LVO
PPS/Foreign Secretary
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

Dear Stephen

EUROPEAN ISSUES

... I attach a copy of the draft paper by Tim Lankester and John Kerr, with the Chancellor's amendments marked. The Chancellor has asked me to emphasise that it is for discussion at this stage: he has not yet decided whether he would wish this to be sent now.

Yours,
Alex

A C S ALLAN

Ch
Sir G Howe is content subject to reinstating old para 17 (☒)

AA

EC ISSUES, AND MADRID

Insert (X) below

1. [The prospects for the Madrid European Council and the subsequent French Presidency suggest that an unwelcome watershed in the Community could be close. We think it avoidable, if we get our Madrid line right. But we see serious risks of long term damage to UK interests if we get it wrong.]

Background

3. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, to drop the proposed withholding tax on savings income, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our [~~opposition to witholding taxes on investment income, and our~~] determination to maintain adequate frontier checks, our reasons are understood and command some support.

4. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. We shall have to fight hard to ensure that the liberal thrust of the single market programme is not undercut by new socialist regulation.

X

It is now clear that the Spanish have ambitions to make progress on several very contentious issues at Madrid. The main items on the agenda are EMU and the Social Charter, and the Spanish are seeking substantive progress, rather than just an exchange of views before action in the French presidency. They are also trying to get agreement to an initiative on international debt.

2. Our basic line on these issues is clear. But we need to think carefully about our tactics for Madrid: if we are seen to be unremittingly hostile to any progress in the Community we may set the scene for a dangerous confrontation during the French Presidency. This note analyses the risks of this, and what might be done at Madrid to head it off.

This makes our tactics on EMU all the more important.

5. [~~But the watershed issue will certainly be attitudes to monetary cooperation.~~] Though the step by step approach to Economic and Monetary Union, which is set out in the Delors Report, and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS.

6. The French will also argue, as will ~~even~~ the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. In addition, the French have an interest in involving us in closer co-operation on economic and monetary issues, on which they see us as an ally against the Germans. ~~6. And the Delors Report exercise has created a general political expectation of likely advance: to disappoint it would strike most as unfortunate, and some as dangerous.~~ There is also a general - and understandable - concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).

7. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not only full capital liberalisation, labour mobility, wage and

price flexibility, and unfettered intra-EC cross-frontier trade, but also genuine free competition, and convergent inflation, growth rates, and fiscal policies. Few could in practice quickly swallow all that.

8. The Report also claims - but with less justification - that a greatly increased official flow of resource transfers from richer to poorer member states would be essential. We shall not be alone in querying that proposition. ~~Similarly, the Poehl-inspired proposition that in an EMU monetary policy decisions would be taken by operators independent of political control is likely to prove less self-evident to most Ministers than it appears to have been to Central Bank Governors.~~ Similarly, there are real problems about the democratic accountability of the proposed arrangements, which will worry many others too.

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UK Line at Madrid

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22. Partly it will be a matter of tone of voice. As already mentioned we would do well not to ~~be downright dismissive of~~ the Delors Report, though we ~~might need to~~ should certainly point to some of the defects in its prescription for an eventual EMU - eg the professed requirement for massive resource transfers through the EC Budget, like the unwarranted assertion of the need for central control of fiscal policy) and the question of non-accountability (para 8 above). But we also need to make clear that we are ready to move some way in the direction of closer monetary cooperation as set out in stage 1 of the Delors report. ~~charted by the Delors Group~~. We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a European Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, and that ~~while~~ more analysis and debate is needed to clarify what Stage 3 might entail, and especially its political implications, which are barely touched on in the Report. ~~we would give strong support to sensible step-by-step progress~~

23. There are two important tactical traps to avoid.

24. First, we would be in a minority of one if we ~~appeared~~ sought to argue at Madrid ~~that EMU will never be conceivable, and~~ that EMU as a long-term aim, last reaffirmed at Hanover, should ~~therefore~~ now be dropped. Instead we should make plain, when rejecting - as we must - the Delors Report's assertion (para 39) that the "decision to enter upon the first stage should be a decision to embark on the entire process", that we do so because ~~the timing and circumstances in which the latter stages of the process might take place are as yet wholly unclear.~~ it is wholly unnecessary, needlessly divisive, and hopelessly premature. How could it be acceptable to the House of Commons. The political debate on the form of the arrangements which ~~might then be made~~ full monetary union implies has yet to start; and we don't sign blank cheques. On the basis, it should be possible, at Madrid, to have the para 39 "in for a penny ..." argument discounted, as the Spanish appear ready to accept.

We need to play this long.

25. Secondly, we should not appear to rule out Treaty amendment ever. In the Single European Act we secured confirmation that "insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236" (ie Treaty amendment, requiring unanimity) "shall be applicable". Our line at Madrid should be that there could be no question of the UK Parliament agreeing now to ratify Treaty amendments transferring powers to new institutions at an unknown, but distant, future date. Westminster does not sign updated cheques. The institutional question is, as S'Agaro recognised, one to be addressed in due course, in the light of further work on Delors's Stages 2 and 3.

26. The real difficulty however is that the ERM issue will inevitably arise at Madrid, for the Delors Report suggests that all Community countries should become full ERM members by the end (undated) of stage 1, and the Spanish have announced that they hope to join by the stage 1 start-date (1 July 1990). ~~We can expect them to seek~~ As we mentioned earlier, they are likely to seek Conclusions language setting a target date, probably of 1 July 1992, for the other ERM non-members (ourselves, the Greeks and the Portuguese).

27. We can of course accept the ERM reference in the Delors Report: it is entirely consistent with our formula about joining when the time is ripe. But - although you repudiated this pretty explicitly at the 22 May Manifesto launch - many in the Community believe that our formula disguises a determination that the time will never be ripe. If what we say in Madrid, eg about the idea of setting a target-date, appears to slam the door on UK entry and so reinforces that belief, they would see agreement to a step-by-step approach in which nothing more happens until stage 1 (including UK ERM membership) is complete as in fact ensuring that nothing beyond Stage 1 ever happens. Even the Dutch would not settle for that.

28 ~~30~~. So if we prescribe a step-by-step approach, following the S'Agaro priorities, we are bound to be asked whether we can foresee circumstances in which we would be prepared to step into the ERM. Our answer will determine whether we can in the rest of the year build support for concentrating on S'Agaro priority one - ie Stage 1 measures, and so ensure that the French do indeed leave the IGC issue to be addressed "in due course". If what we say fails to carry credibility - and simply repeating the "when the time is ripe" formula would certainly fail, given that the ERM is already ten years old - the odds must be that, even if we deal satisfactorily with the problem of Conclusions language at Madrid, we shall face later in the year the crisis envisaged at para 13(c) above.

29 ~~31~~. Our judgement is that, if what we say holds out the prospect of movement on ERM in the foreseeable future, the French would probably prefer to build their Presidency package round that prospect, rather than the divisive pursuit, via an IGC, of Treaty change which would, at least, for a time, be only symbolic. To succeed where Giscard failed, completing the composition of the ERM, would be politically attractive to Mitterrand. ~~(They would no doubt take the opportunity to press the Germans to allow a further stage of ERM reform (particularly on currency of intervention, where we agree with the French) along the lines of the Nyborg 1987 package.)~~ Conversely, there have been hints from Paris that, "the question of institutional change, if necessary in a small group, would force itself onto the agenda" in the absence of any sign of UK movement on ERM. Moreover, while one cannot be wholly certain that a clear indication of a likely UK move on ERM would dissuade the French from exploring the IGC route as well, it seems certain to dissuade most other member-states from encouraging such explorations.

INSERT (Z)

32. How precise would that indication have to be? We doubt if it will be necessary, though it could be advantageous, to accept Conclusions language at Madrid which set a precise date before which we would envisage UK entry. (We believe that the Spanish may consider a range of possible end-dates, including 1 July 1990, the target date chosen by them for the peseta, and the target date for completing the current stage of Capital Liberalisation; or more likely 1992). But if we decided to reject a target date, we would need to do so in terms which did not cast doubt on the good faith of our formula about joining when the time is ripe.

33. In our view the right line might be that:-

(a) we fully support to work programme on Stage 1, and would like to get ahead with it;

(b) the question of sterling and the ERM is of course for decision by the UK alone;

(c) in our judgement, circumstances may be so evolving that ERM entry would no longer (as in the early 80's) conflict with UK economic strategy;

(d) in particular, the petro-currency issue, which would have caused us major problems if sterling had been in the ERM as late as the mid 80's (in 1985 we had a £8 billion oil surplus), is no longer relevant;

(e) so the time for UK entry may be "ripening", or likely to ripen before too long;

(f) but a decision on the exact date of entry would also be one for the UK alone, reflecting our judgement of appropriate market conditions.

Z

30 How precise would that indication have to be? As mentioned above, we doubt very much that it would be enough simply to restate the line that we will join when the time is ripe, without going any further on by when we think the time will be ripe, or in what circumstances. The indications are that the Spanish Presidency will propose language in the form of a non-legally binding reference to all currencies joining by 1 July 1992 (perhaps in the form "it is important that..."). We do not propose that we should accept that as it stands. But we believe we could accept that sort of approach, which would not present us with any difficulties in the financial markets, providing certain conditions were attached. These would include a condition that all the major member states had completely abolished all exchange controls well before that date - as is provided for in the Capital Liberalisation Directive. And, perhaps, an understanding that the pound would enter with wider margins, as the Spaniards have themselves stipulated for the peseta. We would also of course want to ensure that our inflation rate is on the way down again; but that is a matter for us, and something we are determined to achieve anyway.

31 Setting a non-legally binding timetable for joining the ERM - say by 31 December rather than 1 July 1992 - would represent a change in policy. But setting a date over three years in the future, and with certain conditions attached, is conceding very little. And seeing off the - potentially very damaging - debate over EMU for an even longer time would be a major prize.

~~(While you will recognise that (c) above is our joint view, we see no need to trouble you now on the substance of the issue, as distinct from the question of Madrid handling.)~~

~~34. Taking such a line might enable us to secure Conclusions language merely noting that existing ERM member states urge others to join as soon as they think fit, while ensuring that we avoid the trap of convincing our partners that for us that means the Greek Kalends.~~ We see no risk

32. that taking such a line would be interpreted as any weakening of our objection to EMU, ~~as any more than a very long term aspiration.~~ Indeed, if we succeed in securing Madrid acceptance of the S'Agaro priorities we would be seen to have defeated the Delors' "in for a penny ..." approach. And ERM would not be a slippery slope towards EMU, for ERM arrangements are inter-governmental, not supranational.

33. In short, we believe that the Madrid discussion will be difficult, and may settle the course of the French Presidency. There is a way through the minefield, provided we avoid outright rejection of the Delors Report, and convince the others that our call - first things first - for concentration on Stage 1 is made in good faith, not just as a tactical manoeuvre. But it is our joint view that we would maximise, and perhaps precipitate, the IGC risks (paras 14 and 20 above) if at Madrid we said less than is suggested at para 30 above.

34. Could we discuss this with you?

GH NL

EC ISSUES, AND MADRID

Insert (X) below

1. ~~The prospects for the Madrid European Council and the subsequent French Presidency suggest that an unwelcome watershed in the Community could be close. We think it avoidable, if we get our Madrid line right. But we see serious risks of long term damage to UK interests if we get it wrong.~~

to drop the proposed withholding tax on savings income,

Background

3 ~~2~~. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our ~~opposition to witholding taxes on investment income, and our~~ determination to maintain adequate frontier checks, our reasons are understood and command some support.

4 ~~3~~. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. We shall have to fight hard to ensure that the liberal thrust of the single market programme is not undercut by new socialist regulation.

X

It is now clear that the Spanish have ambitions to make progress on several very contentious issues at Madrid. The main items on the agenda are EMU and the Social Charter, and the Spanish are seeking substantive progress, rather than just an exchange of views before action in the French presidency. They are also trying to get agreement to an initiative on international debt.

2. Our basic line on these issues is clear. But we need to think carefully about our tactics for Madrid: if we are seen to be unremittingly hostile to any progress in the Community we may set the scene for a dangerous confrontation during the French Presidency. This note analyses the risks of this, and what might be done at Madrid to head it off.

This makes our tactics on EMU all the more important,

~~4.~~ 5. [~~But the watershed issue will certainly be attitudes to monetary cooperation.~~] Though the step by step approach to Economic and Monetary Union, which is set out in the Delors Report, and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS.

~~5.~~ 6. The French will also argue, as will ~~even~~ the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. In addition, the French have an interest in involving us in closer co-operation on economic and monetary issues, on which they see us as an ally against the Germans.
~~6. And the Delors Report exercise has created a general political expectation of likely advance: to disappoint it would strike most as unfortunate, and some as dangerous.~~
There is also a general - and understandable - concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).

7. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not only full capital liberalisation, labour mobility, wage and

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24. Partly it will be a matter of tone of voice. As already mentioned we would do well not to ~~be downright dismissive of~~ the Delors Report, though we ~~might need to~~ should certainly point to some of the defects in its prescription for an eventual EMU - eg the professed requirement for massive resource transfers through the EC Budget, the unwarranted assertion of the need for central control of fiscal policy) and the question of non-accountability (para 8 above). But we also need to make clear that we are ready to move some way in the direction of closer monetary cooperation, as set out in stage 1 of the Delors report. ~~charted by the Delors Group~~. We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a European Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, and that~~, while~~ more analysis and debate is needed to clarify what Stage 3 might entail, and especially its political implications, which are barely touched on in the Report. ~~we would give strong support to sensible step-by-step progress.~~

25. There are two important tactical traps to avoid.

26. First, we would be in a minority of one if we ~~appeared~~ sought to argue at Madrid ~~that EMU will never be conceivable, and~~ that EMU as a long-term aim, last reaffirmed at Hanover, should ~~therefore~~ now be dropped. Instead we should make plain, when rejecting - as we must - the Delors Report's assertion (para 39) that the "decision to enter upon the first stage should be a decision to embark on the entire process", that we do so because ~~the timing and circumstances in which the latter stages of the process might take place are as yet wholly unclear.~~ it is wholly unnecessary, needlessly divisive, and hopelessly premature. Nor would it be acceptable to the House of Commons. The political debate on the form of the arrangements which full monetary union implies ~~might then be made~~ has yet to start; and we don't sign blank cheques. On the basis, it should be possible, at Madrid, to have the para 39 "in for a penny ..." argument discounted, as the Spanish appear ready to accept.

We need to play this long!

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28. The real difficulty however is that the ERM issue will inevitably arise at Madrid, for the Delors Report suggests that all Community countries should become full ERM members by the end (undated) of stage 1, and the Spanish have announced that they hope to join by the stage 1 start-date (1 July 1990). ~~We can expect them to seek~~ As we mentioned earlier, they are likely to seek Conclusions language setting a target date , probably of 1 July 1992, for the other ERM non-members (ourselves, the Greeks and the Portuguese).

29. We can of course accept the ERM reference in the Delors Report: it is entirely consistent with our formula about joining when the time is ripe. But - although you repudiated this pretty explicitly at the 22 May Manifesto launch - many in the Community believe that our formula disguises a determination that the time will <u>never</u> be ripe. If what we say in Madrid, eg about the idea of setting a target-date, appears to slam the door on UK entry and so reinforces that belief, they would see agreement to a step-by-step approach in which nothing more happens until stage 1 (including UK ERM membership) is complete as in fact ensuring that nothing beyond Stage 1 <u>ever</u> happens. Even the Dutch would not settle for that.

28
~~30~~. So if we prescribe a step-by-step approach, following the S'Agaro priorities, we are bound to be asked whether we can foresee circumstances in which we would be prepared to step into the ERM. Our answer will determine whether we can in the rest of the year build support for concentrating on S'Agaro priority one - ie Stage 1 measures, and so ensure that the French do indeed leave the IGC issue to be addressed "in due course". If what we say fails to carry credibility - and simply repeating the "when the time is ripe" formula would certainly fail, given that the ERM is already ten years old - the odds must be that, even if we deal satisfactorily with the problem of Conclusions language at Madrid, we shall face later in the year the crisis envisaged at para 13(c) above.

29
~~31~~. Our judgement is that, if what we say holds out the prospect of movement on ERM in the foreseeable future, the French would probably prefer to build their Presidency package round that prospect, rather than the divisive pursuit, via an IGC, of Treaty change which would, at least, for a time, be only symbolic. To succeed where Giscard failed, completing the composition of the ERM, would be politically attractive to Mitterrand. [~~(They would no doubt take the opportunity to press the Germans to allow a further stage of ERM reform (particularly on currency of intervention, where we agree with the French) along the lines of the Nyborg 1987 package.)~~] Conversely, there have been hints from Paris that, "the question of institutional change, if necessary in a small group, would force itself onto the agenda" in the absence of any sign of UK movement on ERM. Moreover, while one cannot be wholly certain that a clear indication of a likely UK move on ERM would dissuade the French from exploring the IGC route as well, it seems certain to dissuade most other member-states from encouraging such explorations.

INSERT (Z)

32. How precise would that indication have to be? We doubt if it will be necessary, though it could be advantageous, to accept Conclusions language at Madrid which set a precise date before which we would envisage UK entry. (We believe that the Spanish may consider a range of possible end-dates, including 1 July 1990, the target date chosen by them for the peseta, and the target date for completing the current stage of Capital Liberalisation; or more likely 1992). But if we decided to reject a target date, we would need to do so in terms which did not cast doubt on the good faith of our formula about joining when the time is ripe.

33. In our view the right line might be that:-

(a) we fully support to work programme on Stage 1, and would like to get ahead with it;

(b) the question of sterling and the ERM is of course for decision by the UK alone;

(c) in our judgement, circumstances may be so evolving that ERM entry would no longer (as in the early 80's) conflict with UK economic strategy;

(d) in particular, the petro-currency issue, which would have caused us major problems if sterling had been in the ERM as late as the mid 80's (in 1985 we had a £8 billion oil surplus), is no longer relevant;

(e) so the time for UK entry may be "ripening", or likely to ripen before too long;

(f) but a decision on the exact date of entry would also be one for the UK alone, reflecting our judgement of appropriate market conditions.

Z

30 How precise would that indication have to be? As mentioned above, we doubt very much that it would be enough simply to restate the line that we will join when the time is ripe, without going any further on by when we think the time will be ripe, or in what circumstances. The indications are that the Spanish Presidency will propose language in the form of a non-legally binding reference to all currencies joining by 1 July 1992 (perhaps in the form "it is important that..."). We do not propose that we should accept that as it stands. But we believe we could accept that sort of approach, which would not present us with any difficulties in the financial markets, providing certain conditions were attached. These would include a condition that <u>all</u> the major member states had completely abolished all exchange controls well before that date - as is provided for in the Capital Liberalisation Directive. And, perhaps, an understanding that the pound would enter with wider margins, as the Spaniards have themselves stipulated for the peseta. We would also of course want to ensure that our inflation rate is on the way down again; but that is a matter for us, and something we are determined to achieve anyway.

31 Setting a non-legally binding timetable for joining the ERM - say by 31 December rather than 1 July 1992 - would represent a change in policy. But setting a date over three years in the future, and with certain conditions attached, is conceding very little. And seeing off the - potentially very damaging - debate over EMU for an even longer time would be a major prize.

~~(While you will recognise that (c) above is our joint view, we see no need to trouble you now on the substance of the issue, as distinct from the question of Madrid handling.)~~

~~34. Taking such a line might enable us to secure Conclusions language merely noting that existing ERM member states urge others to join as soon as they think fit, while ensuring that we avoid the trap of convincing our partners that for us that means the Greek Kalends.~~ We see no risk
32. that taking such a line would be interpreted as any weakening of our objection to EMU, ~~as any more than a very long term aspiration.~~ Indeed, if we succeed in securing Madrid acceptance of the S'Agaro priorities we would be seen to have defeated the Delors' "in for a penny ..." approach. And ERM would not be a slippery slope towards EMU, for ERM arrangements are inter-governmental, not supranational.

35. In short, we believe that the Madrid discussion will be difficult, and may settle the course of the French Presidency. There is a way through the minefield, provided we avoid outright rejection of the Delors Report, and convince the others that our call - first things first - for concentration on Stage 1 is made in good faith, not just as a tactical manoeuvre. But it is our joint view that we would maximise, and perhaps precipitate, the IGC risks (paras 13 and 22 above) if at Madrid we said less than is suggested at para 33 above.

36. Could we discuss this with you?

GH NL

Addition on fiscal policy to (old) para 8

It also claims that central control over fiscal deficits ~~and their financing~~ are an essential element in monetary union; this is a false analysis - but its inclusion no doubt reflects Delors' desire to arrogate as much power as possible to the centre.

Strengtheneing what's left of (old) para 19

[I don't see that this is necessary]

Addition on fiscal policy for (old) para 24

... the unwarranted assertion of the need for central control over fiscal policy, ...

Ch

These are the three ~~[illegible]~~ remaining bits needed for your redraft of the paper for the PM. Sir G Howe is v keen to read on aeroplane tomorrow (he leaves about 10.00) - I'll stress that it's for discussion only!

AA

OK W
w/snr.

MM

I have made a number of changes, based on your reading; but have retyped it for discussion with Sir G.H. NB: the paras were for discussion. I am not sure ~~[illegible]~~ at this stage. N.

Ch
These are Howe/Kerr suggestions to shorten since Howe thought it was too long
AA

EC ISSUES, AND MADRID

1. The prospects for the Madrid European Council and the subsequent French Presidency suggest that an unwelcome watershed in the Community could be close. We think it avoidable, if we get our Madrid line right. But we see serious risks of long term damage to UK interests if we get it wrong.

Use AA wording

Background

2. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our ~~opposition to witholding taxes on investment income, and our~~ determination to maintain adequate frontier checks, our reasons are understood and command some support.

to drop the proposed withholding tax on savings income,

3. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. We shall have to fight hard to ensure that the liberal thrust of the single market programme is not undercut by new socialist regulation.

This makes our tactics on EMU all the more important.

4. ~~But the watershed issue will certainly be attitudes to monetary cooperation~~. Though the step by step approach to Economic and Monetary Union, which is set out in the Delors Report, and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS.

5. The French will also argue, as will ~~even~~ the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. In addition, the French have an interest in involving us in closer co-operation on economic and monetary issues, on which they see us as an ally against the Germans.

~~6. And the Delors Report exercise has created a general political expectation of likely advance: to disappoint it would strike most as unfortunate, and some as dangerous.~~ There is also a general - and understandable - concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).

6 ~~7~~. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not only full capital liberalisation, labour mobility, wage and

price flexibility, and unfettered intra-EC cross-frontier trade, but also genuine free competition, and convergent inflation, growth rates, and fiscal policies. Few could <u>in practice</u> quickly swallow all that.

(7) ~~8~~. The Report also claims - but with less justification - that a greatly increased official flow of resource transfers from richer to poorer member states would be essential. We shall not be alone is querying that proposition. ~~Similarly, the Poehl-inspired proposition that in an EMU monetary policy decisions would be taken by operators independent of political control is likely to prove less self-evident to most Ministers than it appears to have been to Central Bank Governors.~~

Insert (a) sentences re fiscal balances & (b) AA replacement

(8) ~~9~~. The need for much greater discussion of such issues was brought out at the informal ECOFIN meeting at S'Agaro on 19-21 May. The general view then was that while work on launching the measures set out in Stage 1 of the Report should go ahead as a matter of urgency, work on stages 2 and 3 should have a lower priority. And it was accepted that the question of convening an inter-governmental conference to consider Treaty change should be considered <u>in due course</u>, in the light of this further work.

(9) ~~10~~. ~~This is satisfactory, for the moment. But it does not follow that we are out of the wood on the IGC issue, for European Councils are more unpredictable than ECOFIN meetings. The risk that Madrid will prove another Milan, with Gonzalez looking for the six other votes necessary for a decision to convene an IGC does not at present seem high. But the line we take at Madrid may be decisive in determining whether the French, later in the year go for such a decision (or, conceivably, set up a conference of 11 member states to prepare a separate Treaty, without us).~~

AA redraft

10 ~~11~~. It is of course too soon to say with any certainty that other member states would in the end ~~agree to~~ play along with such French tactics. But a large majority believe that while further monetary cooperation and economic convergence is not necessary to the Single Market, 1992 Europe would work better if they were secured. The political arguments - paras 4-6 above - go in the same direction. Kohl would be unlikely to hold out against pressure from Mitterrand, and Poehl would mount no counter-pressure against the principle of Treaty amendment. The Spanish and Italians would probably support Mitterrand with some enthusiasm; the position of pragmatic gradualists like the Dutch and Danes, believers in the EMS model, and concerned that we should join the ERM, would probably depend on whether they believed that we were ready for <u>some</u> pragmatic advance, including on ERM.

11 ~~12~~. It is our joint assessment that if the UK line at Madrid were seen as wholly dismissive of the Delors Report, especially its recommendations for Stage 1, the risk of the French at Paris seeking, and securing, the votes necessary for an IGC, would be high.

12 ~~13~~. All one can say with certainty now is that:

(a) all other member states would prefer to proceed on the basis of the Twelve acting together, accepting that the convoy will move at the speed of the slowest;

(b) ~~but,~~ if we seem unwilling to move at all, most and perhaps all the others would not be prepared to wait for us;

(c) ~~and~~ the French, if convinced that the UK would block the alternative of real practical progress, would probably go for an IGC decision later this year; ~~and the grand gesture of new Treaty provisions with or without the UK.~~

~~14. Treaty amendments tabled at an IGC would not necessarily be confined to EMU-related institutional changes. Nor could we be confident that~~ a UK veto would not necessarily work: if the other Eleven agreed on a text, which we found unacceptable, there would be a risk of their choosing to consecrate it in a new Treaty, separate from the Treaty of Rome. If this happens, our status in the Community would then be rather different, and semi-detached.

(leading to a Treaty of Eleven

<u>Consequences of an IGC, ~~and UK Isolation~~</u> (the evolution of a two-tier Europe

13 ~~15~~. Would this matter? Our joint assessment is that ~~it~~ <u>would</u> matter, both politically and economically.

14 ~~16~~. The domestic political impact would undoubtedly be negative. Though we could point to deeper rifts below the surface of their EC policies, Labour are now in a position to exploit the friction inside the Conservative Party which would be inevitable. Our supporters in business would be uneasy, and the impact of our 1992 Awareness campaign blunted. In the City, concern about its position vis-a-vis Frankfurt and Paris would grow.

15 ~~17~~. Abroad, our negotiating position in other key current Community debates (para 2 above) would be weakened. We do best at Brussels when (as on frontiers or tax, or indeed CAP and budget reform) we build alliances, and the increase in QM voting introduced by the Single European Act makes this all the more important. But to isolate ourselves on the issue which is now seen as No 1 would scare off allies or potential allies on the rest of the Community agenda.

?

16 18. Isolation in the monetary debate would be far more damaging than the isolation on "the social dimension" which may be inevitable. The "social dimension" is a straight liberal/dirigiste, Right/Left issue, and our attitude, though unpopular with some, will be seen as consistent with our domestic policies, and validated by 3 successive elections here. We can argue with conviction that we

believe new social regulation would be damaging to the Community, but we cannot say the same about greater monetary convergence. So outright UK opposition to monetary development would be seen as a UK v Community issue: our attitude would be assumed to reflect a new insularity: and this would in turn be assumed to determine our policies on other current EC issues, and so would reduce the chances of agreement to such policies.

the number of which has been greatly enlarged by the Single Act,

(16) ~~19.~~ ~~Immediately vulnerable areas in the Single market~~ programme would be transport and telecommunications liberalisation, public procurement, technical standards and financial services. Loss of influence on budget decisions could rapidly have serious public expenditure consequences for the size of our net contribution. Our chances of using the Uruguay Round end-game to secure more liberal EC trade ~~and agriculture policies would suffer, to the detriment of UK traders and consumers as well as tax payers.~~ On all issues where majority voting applies, the others would be more inclined to vote us down rather than seek to accommodate us. ~~Our links with other potential second tier states on the EC periphery would not necessarily weaken, but the Franco-German axis would increasingly become the drive-shaft of the Community.~~

? strengthen

budget, the market might [illegible]

(17) ~~20.~~ Vis-a-vis the external world, the consequence of third countries (eg the US, Japan, ~~Australia~~) detecting a reduction in our influence on the Community's policies and development would probably be reduced reliance on us as a principal interlocuteur. In particular we could expect to have much less influence on the Bush Administration if we were seen to have less influence ~~in Brussels. And an obvious split in the Community, coming on top of strains in the Alliance, could further erode US commitment to European defence.~~

within the Community.

(18) ~~21~~. Economically, the damage would primarily be to confidence, and could start relatively quickly. If perceived as formally and indefinitely outside a currency area of increasing exchange rate stability, and more generally moving out of the Community mainstream, the UK would become relatively less attractive for new investment. But it is true that we would remain within the single market, and that is important. Doubts, eg in Japan, about whether we would ~~remain in the~~ indefinitely remain within the Community trading block, or would be able to retain our present influence on its trade policies, could ~~cause the~~ be expecting to lead the Japanese and others to reckon the course of prudence was to site their European ~~cancellation of current plans for~~ manufacturing investment ~~in the UK, in favour of~~ at continental sites rather than the UK; and the flow of new inward investment (geared to 1992) ~~plans could~~ would tend to dry up. Non UK Banks and other financial institutions could similarly have a greater incentive to develop their continental bases rather than their London operations. Some domestic investment could similarly transfer to the EC mainland.

(19) ~~22~~. It follows that:

(a) since complete isolation on the monetary issue this year would have adverse short term consequences and could cause the UK serious long term damage; and

(b) since the damage could extend well beyond monetary issues;

(c) at and after Madrid we should, while dismissing the two plainly unacceptable elements of the short term prescription in the Delors Report (paras 39 and 66), aim to convince our EC partners that we are genuinely interested in greater economic ~~convergence~~ and monetary cooperation, and willing to make progress.

UK Line at Madrid

(20) ~~23~~. We have been considering how this can best be done, first at Madrid.

(21) ~~24~~. Partly it will be a matter of tone of voice. As already mentioned we would do well not to condemn ~~be downright dismissive of~~ the Delors Report, though we ~~might need to~~ Should Certainly point to some of the defects in its prescription for an eventual EMU - eg the professed requirement for massive resource transfers through the EC Budget (budgetary fallacy) and the question of non-accountability (para 8 above). But we also need to make clear that we are ready to move some way in the direction of closer monetary cooperation, as set out in Stage 1 of the Delors Report. ~~charted by the Delors Group.~~ We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a European Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, and that~~, while~~ more analysis and debate is needed to clarify what Stage 3 might entail, and especially its political implications, which are barely touched on in the Report. ~~we would give strong support to sensible step-by-step progress.~~

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AA

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(f) but a decision on the exact date of entry would also be one for the UK alone, reflecting our judgement of appropriate market conditions.

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Use AA wording [illegible] on

~~(While you will recognise that (c) above is our joint view, we see no need to trouble you now on the substance of the issue, as distinct from the question of Madrid handling.)~~

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33 ~~36~~. Could we discuss this with you?

GH NL

CHANCELLOR OF THE EXCHEQUER

This is one good question. I will read over w/E, & try & fix a bilateral with the For Sec. this week.

Ch

Immediate operational decision is do you go along with For Sec's desire to get this to PM over the w/e? I presume the answer is "no", in which case you can work on it over the weekend.

You need to read my comments (and redrafted paras attached at end) in the light of Hannay's very interesting note at the bottom of the string.

Shall we fix another bilateral with the Foreign Secretary on Monday — or perhaps better //

on Tuesday, ~~[illegible]~~ giving him a chance to see a redraft on Monday?

AA

AA

CK

This is version with your amendments added — and with para 17 reinstated. I've checked against original. One typo — para 25 AA

[was not circulated within Tsy, but I showed a copy to Tim]

EC ISSUES, AND MADRID

1. It is now clear that the Spanish have ambitions to make progress on several very contentious issues at Madrid. The main items on the agenda are EMU and the Social Charter, and the Spanish are seeking substantive progress, rather than just an exchange of views before action in the French Presidency. They are also trying to get agreement to an initiative on international debt.

2. Our basic line on these issues is clear. But we need to think carefully about our tactics for Madrid: if we are seen to be unremittingly hostile to any progress in the Community we may set the scene for a dangerous confrontation during the French Presidency. This note analyses the risk of this, and what might be done at Madrid to head it off.

Background

3. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, to drop the proposed withholding tax on savings income, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our determination to maintain adequate frontier checks, our reasons are understood and command some support.

4. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. We shall have to fight hard to ensure that the liberal thrust of the single market programme is not undercut by new socialist regulation.

5. This makes our tactics on EMU all the more important. Though the step by step approach to Economic and Monetary Union, which is set out in the Delors Report, and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS.

6. The French will also argue, as will the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. In addition, the French have an interest in involving us in closer co-operation on economic and monetary issues, on which they see us as an ally against the Germans. There is also a general - and understandable - concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).

7. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not

only full capital liberalisation, labour mobility, wage and price flexibility, and unfettered intra-EC cross-frontier trade, but also genuine free competition, and convergent inflation, growth rates, and fiscal policies. Few could in practice quickly swallow all that.

8. The Report also claims - but with less justification - that a greatly increased official flow of resource transfers from richer to poorer member states would be essential. We shall not be alone in querying that proposition. It also claims that central control over fiscal deficits are an essential element in monetary union; this is a false analysis - but its inclusion no doubt reflects Delors' desire to arrogate as much power as possible to the centre. Similarly, there are real problems about the democratic accountability of the proposed arrangements, which will worry many others too.

9. The need for much greater discussion of such issues was brought out at the informal ECOFIN meeting at S'Agaro on 19-21 May. The general view then was that while work on launching the measures set out in Stage 1 of the Report should go ahead as a matter of urgency, work on stages 2 and 3 should have a lower priority. And it was accepted that the question of convening an inter-governmental conference (IGC) to consider Treaty change should be considered in due course, in the light of this further work.

10. The indications are that the Spanish Presidency will want to build on this approach at Madrid. In particular, they are proposing that Stage 1 should start on 1 July 1990, but without any commitment to the timing of a move to Stage 2, nor on precisely what measures would be included in Stages 2 or 3, nor even - and this is particularly welcome - that a decision to embark on Stage 1 should be a decision to embark on the entire process. They are proposing that the European Council should review progress in mid-1993, and by

implication that no decision on an IGC would be taken before then. The main difficulty for us - which we discuss below - is that they propose that there should be a reference, albeit of a non-legally binding kind, to all EC currencies being brought within the exchange rate mechanism by 1 July 1992.

11. The Spanish objective is to pull off the trick of getting the whole follow-up procedure to Delors agreed at Madrid and not left over to the French Presidency. This is an astute tactic, which will not be altogether to the French liking, but very difficult for them to oppose too directly. But, conversely, it will be very easy for the French to argue, if there were a confrontational debate at Madrid, that clearly everyone needed more time to think about the matter and it could all be taken up again at Paris. That would greatly increase the chances of the French then pressing for a decision to convene an early IGC (or, conceivably, setting up a conference of 11 member states to prepare a separate Treaty without us).

12. It is of course too soon to say with any certainty that other member states would in the end play along with such French tactics. But a large majority believe that while further monetary cooperation and economic convergence is not necessary to the Single Market, 1992 Europe would work better if they were secured. The political arguments - para 6 above - go in the same direction. Kohl would be unlikely to hold out against pressure from Mitterrand, and Poehl would mount no counter-pressure against the principle of Treaty amendment. The Spanish and Italians would probably support Mitterrand with some enthusiasm; the position of pragmatic gradualists like the Dutch and Danes, believers in the EMS model, and concerned that we should join the ERM, would probably depend on whether they believed that we were ready for <u>some</u> pragmatic advance, including on ERM.

13. It is our joint assessment that if the UK line at Madrid were seen as wholly dismissive of any progress on this issue, and rejected the Presidency compromise outright, then the risk of the French at Paris seeking, and securing, the votes necessary for an IGC, would be high.

14. All one can say with certainty now is that:

(a) all other member states would prefer to proceed on the basis of the Twelve acting together, accepting that the convoy will move at the speed of the slowest;

(b) if we seem unwilling to move at all, most and perhaps all the others would not be prepared to wait for us;

(c) the French, if convinced that the UK would block the alternative of real practical progress, would probably go for an IGC decision later this year, and the grand gesture of new Treaty provisions with or without the UK;

(d) a UK veto would not necessarily work: if the other Eleven agreed on a text, which we found unacceptable, there would be a risk of their choosing to consecrate it in a new Treaty, separate from the Treaty of Rome. If this happens, our status in the Community would then be rather different, and semi-detached.

<u>Consequences of an IGC leading to a Treaty of Eleven</u>

15. Would this matter? Our joint assessment is that the evolution of a two-tier Europe <u>would</u> matter, both politically and economically.

16. The domestic political impact would undoubtedly be negative. Though we could point to deeper rifts below the surface of their EC policies, Labour are now in a position to exploit the friction inside the Conservative Party which would be inevitable. Our supporters in business would be

uneasy, and the impact of our 1992 Awareness campaign blunted. In the City, concern about its position vis-a-vis Frankfurt and Paris would grow.

17. Abroad, our negotiating position in other key current Community debates (paras 3 and 4 above) would be weakened. We do best at Brussels when (as on frontiers or tax, or indeed CAP and budget reform) we build alliances. But to isolate ourselves on the issue which is now seen as No 1 would scare off allies or potential allies on the rest of the Community agenda.

18. Isolation in the monetary debate would be far more damaging than the isolation on "the social dimension" which may be inevitable. The "social dimension" is a straight liberal/dirigiste, Right/Left issue, and our attitude, though unpopular with some, will be seen as consistent with our domestic policies, and validated by 3 successive elections here. We can argue with conviction that we believe new social regulation would be damaging to <u>the Community</u>, but we cannot say the same about greater monetary convergence. So outright UK opposition to monetary development would be seen as a UK v Community issue: our attitude would be assumed to reflect a new insularity: and this would in turn be assumed to determine our policies on other current EC issues, and so would reduce the chances of agreement to such policies. On all issues where majority voting applies, the number of which has been greatly enlarged by the Single Act, the others would be more inclined to vote us down rather than seek to accommodate us.

19. Vis-a-vis the external world, the consequence of third countries (eg the US, Japan) detecting a reduction in our influence on the Community's policies and development would probably be reduced reliance on us as a principal interlocuteur. In particular we could expect to have less influence on the Bush Administration if we were seen to have less influence within the Community.

20. Economically, the damage would primarily be to confidence, and could start relatively quickly. If perceived as formally and indefinitely outside a currency area of increasing exchange rate stability, and more generally moving out of the Community mainstream, the UK would become relatively less attractive for new investment. It is true that we would remain within the single market, and that is important. But doubts, eg in Japan, about whether we would indefinitely remain within the Community trading block, or would be able to retain our present influence on its trade policies, could be expected to lead the Japanese and others to reckon the course of prudence was to direct their European manufacturing investment to continental sites rather than to the UK; and the flow of new inward investment geared to 1992 would tend to dry up. Non UK Banks and other financial institutions could similarly have a greater incentive to develop their continental bases rather than their London operations. Some domestic investment could similarly transfer to the EC mainland.

21. It follows that:

(a) since complete isolation on the monetary issue this year could have adverse short term consequences and could cause the UK serious long term damage; and

(b) since the damage could extend well beyond monetary issues;

(c) at and after Madrid we should, while dismissing the two plainly unacceptable elements of the short term prescription in the Delors Report (paras 39 and 66), aim to convince our EC partners that we are <u>genuinely</u> interested in greater economic and monetary cooperation, and willing to make progress.

UK Line at Madrid

22. We have been considering how this can best be done, first at Madrid.

23. Partly it will be a matter of tone of voice. As already mentioned we would do well not to condemn every aspect of the Delors Report, though we should certainly point to some of the defects in its prescription for an eventual EMU - eg the professed requirement for massive resource transfers through the EC Budget, the unwarranted assertion of the need for central control of fiscal policy, and the question of non-accountability (para 8 above). But we also need to make clear that we are ready to move some way in the direction of closer monetary cooperation as set out in Stage 1 of the Delors Report. We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a European Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, and that more analysis and debate is needed to clarify what Stage 3 might entail, and especially its political implications, which are barely touched on in the Report.

24. There are two important tactical traps to avoid.

25. First, we would be in a minority of one if we sought to argue at Madrid that EMU as a long-term aim, last reaffirmed at Hanover, should now be dropped. Instead we should make plain, when rejecting - as we must - the Delors Report's assertion (para 39) that the "decision to enter upon the first stage should be a decision to embark on the entire process", that we do so because it is wholly unnecessary, needlessly divisive, and hoplessly premature. Nor would it be acceptable to the House of Commons. The political debate

on the form of the arrangements which full monetary union implies has yet to start; and we don't sign blank cheques. On that basis, it should be possible, at Madrid, to have the para 39 "in for a penny ..." argument discounted, as the Spanish appear ready to accept.

26. Secondly, we should not appear to rule out Treaty amendment evcr. We need to play this long. In the Single European Act we secured confirmation that "insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236" (ie Treaty amendment, requiring unanimity) "shall be applicable". Our line at Madrid should be that there could be no question of the UK Parliament agreeing now to ratify Treaty amendments transferring powers to new institutions at an unknown, but distant, future date. Westminster does not sign undated cheques. The institutional question is, as S'Agaro recognised, one to be addressed in due course, in the light of further work on Delors's Stages 2 and 3.

27. The real difficulty however is that the ERM issue will inevitably arise at Madrid, for the Delors Report suggests that all Community countries should become full ERM members by the end (undated) of stage 1, and the Spanish have announced that they hope to join by the stage 1 start-date (1 July 1990). As we mentioned earlier (para 10), they are likely to seek Conclusions language setting a target date, probably of 1 July 1992, for the other ERM non-members (ourselves, the Greeks and the Portuguese).

28. We can of course accept the ERM reference in the Delors Report: it is entirely consistent with our formula about joining when the time is ripe. But - although you repudiated this pretty explicitly at the 22 May Manifesto launch - many in the Community believe that our formula disguises a determination that the time will never be ripe. If what we say in Madrid, eg about the idea of setting a

target-date, appears to slam the door on UK entry and so reinforces that belief, they would see agreement to a step-by-step approach in which nothing more happens until stage 1 (including UK ERM membership) is complete as in fact ensuring that nothing beyond Stage 1 <u>ever</u> happens. Even the Dutch would not settle for that.

29. So if we prescribe a step-by-step approach, following the S'Agaro priorities, we are bound to be asked whether we can foresee circumstances in which we would be prepared to step into the ERM. Our answer will determine whether we can in the rest of the year build support for concentrating on S'Agaro priority one - ie Stage 1 measures, and so ensure that the French do indeed leave the IGC issue to be addressed "in due course". If what we say fails to carry credibility - and simply repeating the "when the time is ripe" formula would certainly fail, given that the ERM is already ten years old - the odds must be that, even if we deal satisfactorily with the problem of Conclusions language at Madrid, we shall face later in the year the crisis envisaged at para 14(c) above.

30. Our judgement is that, if what we say holds out the prospect of movement on ERM in the foreseeable future, the French would probably <u>prefer</u> to build their Presidency package round that prospect, rather than the divisive pursuit, via an IGC, of Treaty change which would, at least, for a time, be only symbolic. To succeed where Giscard failed, completing the composition of the ERM, would be politically attractive to Mitterrand. Conversely, there have been hints from Paris that, "the question of institutional change, if necessary in a small group, would force itself onto the agenda" in the absence of any sign of UK movement on ERM. Moreover, while one cannot be wholly certain that a clear indication of a likely UK move on ERM would dissuade the French from exploring the IGC route as well, it seems certain to dissuade most other member-states from encouraging such explorations.

31. How precise would that indication have to be? As mentioned above, we doubt very much that it would be enough simply to restate the line that we will join when the time is ripe, without going on to suggest by when we think the time will be ripe, or in what circumstances. The indications are that the Spanish Presidency will propose language in the form of a non-legally binding reference to all currencies joining by 1 July 1992 (perhaps in the form "it is important that..."). We do not propose that we should accept that as it stands. But we believe we could accept that sort of approach, which would not present us with any difficulties in the financial markets, providing certain conditions were attached. These would include a condition that <u>all</u> the major member states had completely abolished all exchange controls well before that date - as is provided for in the Capital Liberalisation Directive. And, perhaps, an understanding that the pound would enter with wider margins, as the Spaniards have themselves stipulated for the peseta. We would also of course want to ensure that our inflation rate was on the way down again; but that is a matter for us, and something we are determined to achieve anyway.

32. Setting a non-legally binding timetable for joining the ERM - say by 31 December rather than 1 July 1992 - would represent a change in policy. But setting a date over three years in the future, and with certain conditions attached, is conceding very little. And seeing off the - potentially very damaging - debate over EMU for an even longer time would be a major prize.

33. We see no risk that taking such a line would be interpreted as any weakening of our objection to EMU. Indeed, if we succeed in securing Madrid acceptance of the S'Agaro priorities we would be seen to have defeated the Delors' "in for a penny ..." approach. And ERM would <u>not</u> be a slippery slope towards EMU, for ERM arrangements are inter-governmental, not supranational.

34. In short, we believe that the Madrid discussion will be difficult, and may settle the course of the French Presidency. There is a way through the minefield, provided we avoid outright rejection of the Delors Report, and convince the others that our call - first things first - for concentration on Stage 1 is made in good faith, not just as a tactical manoeuvre. But it is our joint view that we would maximise, and perhaps precipitate, the IGC risks (paras 14 and 21 above) if at Madrid we said less than is suggested at para 31 above.

35. Could we discuss this with you?

GH NL

AA's bits of redrafting

Redraft of introduction

It is now clear that the Spanish have ambitions to make progress on several very contentious issues at Madrid. The main items on the agenda are EMU and the Social Charter, and the Spanish are seeking substantive progress, rather than just an exchange of views before action in the French presidency. ~~[And~~ They are also trying to get agreement to an initiative on international debt. ~~too.]~~

Our basic line on these issues is clear. But we need to think carefully about our tactics for Madrid: if we are seen to be unremittingly hostile to any progress in the Community we may set the scene for a dangerous confrontation during the French Presidency. This note analyses the risks of this, and what might be done at Madrid to head it off.

[Then continue with 'Background' section]

Redraft of para 10

The indications are that the Spanish presidency will want to build on this approach at Madrid. In particular, they are proposing that Stage 1 should start on 1 July 1990, but without any commitment to the timing of a move to Stage 2, nor on what [precise] measures would be included in Stages 2 or 3, nor even - and this is particularly welcome - that a decision to embark on Stage 1 should be a decision to embark on the entire process. They are proposing that the European Council should review progress in mid-1993, and by implication that no decision on an IGC would be taken before then. [The main difficulty for us - which we discuss below - is that they propose that there should be a reference, albeit of a non legally-binding kind, to all EC currencies being brought within the exchange rate mechanism by 1 July 1992.]

The Spanish objective is to pull off the trick of getting the whole follow-up procedure to Delors agreed at Madrid and not left over to the French Presidency. This is ~~a clever~~ an astute tactic, which will not be altogether to the French liking, but very difficult for them to oppose too directly. But, conversely, it will be very easy for the French to argue, if there were a confrontational debate at Madrid, that clearly everyone needed more time to think about the matter and it could all be taken up again at Paris. That would greatly increase the chances of the French pressing for a decision to convene an early IGC (or, conceivably, setting up a conference of 11 member states to prepare a separate Treaty, without us).

Redraft of paras 32 to 34

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~~[mention wider margins?]~~

Setting a (non-legally binding) timetable for joining the ERM (we say by 31 December rather than 1 July 1992 —) would represent a change in policy. But setting a date over three years in the future, and with certain conditions attached ~~and perhaps with an escape clause, too~~, is conceding very little. And seeing off the - potentially very ~~difficult~~ damaging - debate over EMU for an even longer time would be a ~~great~~ major prize.

[then continue from middle of existing para 34: "We see no risk that..."]