

PO-CH/NL/715

ECONOMIC AND MONETARY
UNION
(EMU)

PO/CH/NL/715

NI PTA

Begins: 24/10/89

Ends: 25/10/89

NOT
NO



FROM: JOHN GIEVE
 DATE: 24 OCTOBER 1989

MR ODLING-SMEE

cc PS/Financial Secretary
 PS/Paymaster General
 Sir P Middleton
 Sir T Burns
 Mr Wicks
 Mr H Evans
 Mr Scholar
 Mr R I G Allen
 Mr Peretz
 Mr Riley
 Mr Walsh
 Mrs Brown
 Mr Davies
 Mr Grice
 Mr O'Donnell
 Miss O'Mara
 Mr Kroll
 Mr White
 Mrs Chaplin
 Mr Tyrie

Deputy Governor (B/E)
 Mr Crockett (B/E)
 Mr George (B/E)
 Mr Flemming (B/E)

Mr Kerr FCO

EMU: CHANCELLOR'S PAPER FOR ECOFIN

The Chancellor was grateful for the revised version of the paper. He has commented that this is well drafted even if the content is still a bit on the thin side. We need to flesh out our alternative for the press, and in particular paras 20 and 21. He believes that the paper must also address the question of legal tender since he is bound to be asked about it in any event. There seem to be three possibilities:

- (a) to abolish the concept of legal tender altogether (do we really need it?),
- (b) to have a rule that a person must accept settlement of a debt in at least one Community currency, or



- (c) to retain the existing tender law amended to enable the creditor to specify a different Community currency should he wish to do so.
2. He has commented that we will also need to decide the trickier questions on company accounts and tax liabilities. He would be grateful for urgent advice on these two questions.
3. He has also made a few minor drafting changes which are as follows:

Para 14 insert ", which is the most important single measure of all." after "exchanges controls"

Para 20 delete "free" in line 5.

Para 23 replace "however" by "strictly speaking" in line 9, and insert "but it is clearly desirable" at the end of the penultimate sentence. In the final sentence insert "Budget" before "deficits"

Para 32 replace "and with it" by "and thus" in the penultimate sentence and redraft the final sentence to read as follows "there is no agreement among the Member States or their peoples on the desirability of making so fundamental and irreversible a constitutional change".

JL

JOHN GIEVE

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FM BONN

TO DESKBY 241730Z FCO

TELNO 1012

OF 241704Z OCTOBER 89

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FRAME ECONOMIC

FEDERAL GERMAN VIEWS ON ECONOMIC AND MONETARY UNION (EMU)

PART I OF II

SUMMARY

1. THE FEDERAL GOVERNMENT HAS YET TO AGREE A CLEAR LINE WHEN AND UNDER WHAT CONDITIONS AGREEMENT SHOULD BE GIVEN TO AN INTER-GOVERNMENTAL CONFERENCE. DESPITE INTENSIVE CONSULTATION BETWEEN FEDERAL MINISTRIES AND THE BUNDESBANK TO COORDINATE THE GERMAN POSITION IN THE HIGH LEVEL GROUP, ARGUMENTS CONTINUE ABOUT THE PACE OF PROGRESS TOWARDS EMU. GENSCHER, THE ADVOCATE OF SPEED, APPEARS TO HOLD THE UPPER HAND WHILE WAIGEL, MUCH MORE CAUTIOUS, NEGOTIATES DETAIL WITH THE BUNDESBANK. KOHL IS KEEPING HIS OPTIONS OPEN, AND MAY DO SO FOR SOME TIME.

DETAIL

2. AFTER CALLS BY MY STAFF ON THE FEDERAL CHANCELLERY, AUSWAERTIGES AMT, FINANCE MINISTRY AND BUNDESBANK, I ASSESS THE POSITION HERE AS FOLLOWS:

- THE POLITICAL AND TECHNICAL SIDES OF THE DEBATE REMAIN LARGELY UNTOUCHED BY ONE ANOTHER, AND THE GOVERNMENT HAS YET TO SEEK A BALANCE BETWEEN THEM,
- THE POLITICAL ARGUMENTS FOR EMU AS THE GOAL AND THE DELORS REPORT AS THE METHOD ARE WIDELY KNOWN AND APPROVED. THEIR ECONOMIC SIGNIFICANCE FOR GERMANY AND THE CHANGES THEY WOULD BRING ARE LITTLE UNDERSTOOD AND LARGELY IGNORED.
- THERE IS NO COHERENT PLAN IN THE GOVERNMENT OR THE BUNDESBANK ABOUT GERMAN PRE-CONDITIONS FOR THE CONVENING OF AN INTER-GOVERNMENTAL CONFERENCE, LET ALONE A DECISION ON A TARGET DATE FOR A CONFERENCE.

THE POLITICAL CONTEXT

3. GENSCHER, WHO HAS CAPTURED THE ROLE OF FRONT RUNNER, ARGUES SIMPLY THAT THE TIME HAS COME FOR A FURTHER BIG STEP TOWARDS EUROPEAN UNION AND THAT THE SINGLE MARKET NEEDS EMU FOR ITS FULL REALISATION. THIS VIEW HAS WIDE, IF SUPERFICIAL, APPEAL. GENSCHER'S SENSE OF URGENCY HAS BEEN INCREASED BY EVENTS IN EASTERN EUROPE. HE SEES FURTHER INTEGRATION AS STRENGTHENING THE MAGNETIC INFLUENCE OF THE EC FOR REFORM IN EASTERN EUROPE AND AS COMPATIBLE WITH FUTURE MEMBERSHIP FOR EAST EUROPEAN COUNTRIES THAT BECOME DEMOCRATIC. THIS PRESSURE ON THE ACCELERATOR IS CAUSING THE FINANCIAL AND BUSINESS SECTORS AT LAST TO EXPRESS THEIR LONG-STANDING FEARS. THEY SEE EMU AS MEANING THE TRANSFER OF THE BUNDESBANK SYSTEM TO THE EUROPEAN LEVEL, BUT ARE SCEPTICAL THAT IT WILL WORK SO WELL, EG. THAT DISCIPLINE COULD BE ENFORCED ON THE UNRULY. THEY FEAR THAT HASTE WILL COMPOUND THE DANGERS BY INCREASING THE RISK OF COMPROMISE ON ASPECTS OF THE BUNDESBANK SYSTEM. THIS ARGUMENT, WHICH BOILS DOWN TO SAYING THAT THE FLESH IS TOO WEAK, IS A FORM OF REALISM THAT HAS DIFFICULTY IN MAKING AN IMPACT AGAINST THE IDEALISM OF EUROPEAN UNION. THE SENSE OF WELL BEING IS SO STRONG THAT THERE IS LITTLE APPREHENSION OF THE THREAT THAT EMU COULD POSE TO STABLE PRICES OR THE VALUE OF THE MARK. EVEN THE BUNDESBANK IS RELUCTANT TO USE THIS HIGHLY CONTROVERSIAL ARGUMENT AND NO-ONE YET KNOWS HOW SOON OR HOW FORCEFULLY WAIGEL MIGHT ENGAGE IN THIS KIND OF DEBATE OR HOW KOHL WILL PLAY HIS HAND. HE IS SHOWING CAUTION. THIS TAKES THE PUBLIC FORM OF BEING SILENT ABOUT DETAIL. SITTING BESIDE ANDREOTTI AT A PRESS CONFERENCE LAST WEEK, HE PASSED UP THE OPPORTUNITY TO AGREE THAT AN IGC SHOULD BE CONVENED IN THE SECOND HALF OF 1990.

MALLABY

YYYY

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PART II OF II

DISCUSSION BETWEEN GOVERNMENT AND BUNDESBANK

4. THE INTER-DEPARTMENTAL GROUP SET UP IN THE SUMMER AT UNDER SECRETARY LEVEL, WHICH INCLUDES THE FINANCE, ECONOMICS AND FOREIGN MINISTRIES, THE CHANCELLERY AND THE BUNDESBANK, HAS ATTRACTED NO PUBLIC ATTENTION. BEYOND COORDINATING GERMAN POSITIONS IN THE HIGH LEVEL GROUP, IT HAS NOT DONE MUCH: THE PARTICIPANTS ARE STILL KEEPING THEIR POWDER DRY. IN THE SHORT RUN, THIS SITUATION WILL NOT CHANGE. DESPITE THE GREAT IMPORTANCE OF THE ISSUES TO THEM, THE GERMANS ARE LIKELY TO REACT TO EVENTS IN BRUSSELS RATHER THAN TO SHAPE OR LEAD THEM. THE HANDLING WITHIN GOVERNMENT SO FAR OF THE IGC EXEMPLIFIES THIS. THE BUNDESBANK HAS PRE-CONDITIONS FOR AGREEING TO ONE, WHICH INCLUDE THE RIGHT QUESTIONS BEING ASKED BY THE HIGH LEVEL GROUP AND SATISFACTORY ANSWERS BEING GIVEN. BUT THERE IS STILL NO INTER-DEPARTMENTAL VIEW AS TO WHETHER THE FRG WILL INSIST ON CONDITONS FOR AN IGC. THERE IS FATALISM IN THE FINANCE MINISTRY THAT GENSCHER WILL 'WIN'.

5. THE STATE OF DEBATE ON THE SUBSTANTIVE ISSUES IS:

- STATUS OF A EUROPEAN CENTRAL BANK. THE INDEPENDENCE OF A EUROPEAN CENTRAL BANK IS A GERMAN RALLYING CRY. BUT NOT MUCH MORE. THE AUSWAERTIGES AMT IS SAID BY THE BUNDESBANK TO BE PRESSING FOR WEIGHTED VOTING WITHIN IT. THIS HORRIFIES THE BANK, SINCE IT IMPLIES DELEGATED MEMBERSHIP RATHER THAN TRUE INDEPENDENCE OF BANK GOVERNORS. THE BUNDESBANK'S CRITERIA ARE THAT THERE SHOULD BE NO NATIONAL (OR OTHER) INSTRUCTIONS TO GOVERNORS, THAT THEIR APPOINTMENT SHOULD BE PROTECTED LIKE THAT OF JUDGES, AND THAT THEY SHOULD HAVE SUFFICIENT POWERS TO DO THE JOB WHICH MUST BE WRITTEN DOWN.

- FEDERALISM, SUBSIDIARITY ETC. THE BUNDESBANK ENVISAGES MONETARY POLICY OPERATING BY INSTRUCTION FROM A EUROPEAN CENTRAL BANK

DOWNWARDS TO MEMBER STATES WHERE THE NATIONAL CENTRAL BANKS WOULD EXECUTE POLICY AS AGENTS. IN THE NAME OF STABLE MONEY, MONETARY FINANCING OF DEFICITS WOULD BE FORBIDDEN. BUT FISCAL POLICY IN LINE WITH SUBSIDIARITY WOULD OPERATE FROM BOTTOM UP, WITHIN CLEAR RULES WHICH WOULD CONSTRAIN NATIONAL (OR LOCAL) AUTHORITIES ON SUCH MATTERS AS BORROWING. THE WAY OF RESOLVING CONFLICTS BETWEEN THESE TWO STREAMS OF POWER, FLOWING IN OPPOSITE DIRECTIONS, IS NOT EXPLAINED. THE FINANCE MINISTRY IS KEENER ON BUDGETARY/FISCAL CONTROL BEING EXERCISED CENTRALLY IN BRUSSELS WITHIN RULES OVER WHICH THOSE IMPLEMENTING THEM (NOT THE COMMISSION) WOULD HAVE CONSIDERABLE CONTROL. BUT THE NATURE OF THE RULES GOVERNING FISCAL POLICY IS AN IMPORTANT UNRESOLVED ISSUE AND IS LINKED TO

- ACCOUNTABILITY. WHILE SAYING LOUDLY THAT A EUROPEAN CENTRAL BANK MUST BE INDEPENDENT, AN INCREASING NUMBER OF GERMANS WILL WHISPER THAT THEY RECOGNISE THAT THE EUROPEAN SYSTEM CANNOT BE QUITE THE SAME AS THE GERMAN ONE. THE BUNDESBANK IS PREPARED TO CONCEDE A (VERY LIGHT) FORM OF ACCOUNTABILITY IN THE FORM OF REPORTING TO THE EUROPEAN PARLIAMENT AND/OR THE COUNCIL OF MINISTERS. THE FINANCE MINISTRY WANTS A MORE TRADITIONAL (AND NATIONAL) APPROACH, WITH ACCOUNTABILITY TOWARDS THE MINISTRY AND THE BUNDESTAG.

- TRANSFERS AND THE LENGTH OF STAGE 1 OF DELORS. THE ECONOMICS MINISTRY HAS PUBLISHED A PAPER POURING COLD WATER ON THE DELORS REPORT'S APPARENT ATTACHMENT TO TRANSFERS AS BEING BOTH EXPENSIVE AND ECONOMICALLY INEFFICIENT (MY TELNO 798). THE BUNDESBANK REGRETS THE MENTION OF TRANSFERS IN THE DELORS REPORT, REGARDS THEM AS POLITICALLY UNAVOIDABLE AND WANTS TO MINIMISE THEIR SIZE. THE PROSPECT OF BIG TRANSFERS IN STAGE 2 IS ONE FACTOR WHICH REINFORCES THE BUNDESBANK'S INSISTENCE THAT STAGE 1 MUST BE OF VERY LONG DURATION. THE FINANCE MINISTRY MAKES THE SAME POINT IN A DIFFERENT WAY: ONLY WHEN A HIGH DEGREE OF CONVERGENCE HAS BEEN ATTAINED (MAKING BIG TRANSFERS UNNECESSARY) WILL STAGE 1 BE CONSIDERED ACCOMPLISHED. THIS IMPLIES THAT IT COULD CONTINUE LONG AFTER AN IGC HAD MET OR THE TREATY BEEN AMENDED. THE CHANCELLERY KNOWS, HOWEVER, THAT PRESSURE TO MOVE TO STAGE 2, OR ACCEPT ELEMENTS OF IT, WOULD BE STRONG IN THE WAKE OF TREATY AMENDMENT.

- A SINGLE CURRENCY. DISCUSSION HERE OF HOW TO MOVE TO A COMMON CURRENCY HAS AN ACADEMIC AIR. THE BUNDESBANK'S STRONG PREFERENCE IS THAT IT BE A DISTANT FINAL STAGE. THEY DISLIKE THE NOTION OF COMPETING CURRENCIES FOR POLITICAL REASONS. THEY DO NOT BELIEVE THAT ANY GOVERNMENT WOULD ALLOW ITS NATIONAL CURRENCY TO BE DRIVEN OFF THE MARKET WHILE OTHERS WERE NOT. THEY WOULD PREFER TO THIS TO MOVE

AT AN EARLY STAGE TO THE DISCIPLINES AND BENEFITS OF A COMMON CURRENCY. THE MINISTRIES ARE MORE OPEN MINDED. THEY ARE PREPARED TO LISTEN TO THE ARGUMENT THAT GOVERNMENTS WOULD EXERT DISCIPLINE AT THE NATIONAL LEVEL TO AVOID BEING DRIVEN OUT OF THE SYSTEM

CONCLUSIONS

6. GENSCHER SEES HIS BROAD GOAL CLEARLY AND SEEMS CONFIDENT THAT HE CAN PUSH TOWARDS IT. THE DISAGREEMENT AMONG THE FINANCIAL PRACTITIONERS ON SOME ISSUES WEAKENS WAIGEL'S HAND AND GIVES GENSCHER OPPORTUNITIES. THE BUNDESBANK FEARS THAT KOHL WHO SHARES GENSCHER'S POLITICAL ASSESSMENT BUT DOES NOT WANT TO OVERRULE THE BUNDESBANK, WILL DELAY DECISIONS, PERHAPS UNTIL THE IGC ITSELF.

7. FCO PLEASE ADVANCE TO PS/SOFS, KERR, ARTHUR ECD(I), PS NO 10, PS/ CHANCELLOR OF THE EXCHEQUER, EVANS TREASURY.

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YYYY

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MR M. MERCER, TRSY
PERMANENT SEC/MAFF
MR P KENT HM CUSTOMS
RESIDENT CLERK

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PUT



FROM: JOHN GIEVE
DATE: 24 OCTOBER 1989

SIR P MIDDLETON

cc PS/Financial Secretary
Mr Wicks
Mr H P Evans
Mr Monck
Mr Odling-Smee
Mr R I G Allen
Mr Peretz
Miss O'Mara
Mrs M E Brown
Mr White

CBI REPORT ON EUROPEAN MONETARY UNION

The Chancellor has written to John Banham following Mrs Brown's submission of 23 October. He agrees with Mrs Brown that it would be desirable for the CBI to delay publication until after ECOFIN on 13 November and he would be grateful if you would take this up with them.

JG

JOHN GIEVE

PO/CH/NL



FROM: JOHN GIEVE *JMG*
DATE: 24 OCTOBER 1989

MR H P EVANS

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Odling-Smee
Mr R I G Allen
Mr Peretz
Mr Riley
Mrs M E Brown
Mr O'Donnell
Miss O'Mara
Mr Grice
Ms Wallace
Mr Flanagan
Mr A E W White
Mrs Chaplin
Mr Tyrie

EMU: PROFESSOR NEUMAN AND THE BOARD OF ACADEMIC ADVISERS

The Chancellor has seen the Financial Secretary's comment (Mr Flanagan's minute of 23 October to me). He agrees. Would Mr Tyrie and Mr O'Donnell please take this forward.

JG

JOHN GIEVE

POP



FROM: JOHN GIEVE
DATE: 24 OCTOBER 1989

MR D L C PERETZ (MG)

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Riley
Mr O'Donnell
Mr Grice
Miss O'Mara

MINFORD ON EMU AND 1992

The Chancellor was grateful for your note of 23 October. He agreed with paragraph 4 of your minute and commented that the argument about nominal interests becoming identical was similarly flawed except in the very long run.

Jc

JOHN GIEVE



PLG

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

24 October 1989

John M M Banham Esq
Director-General
Confederation of British
Industry
Centre Point
103 New Oxford Street
LONDON
WC1A 1DU

cc PS/Financial Secretary
Sir P Middleton
Mr Wicks
Mr H P Evans
Mr Monck
Mr Odling-Smee
Mr R I G Allen
Mr Peretz
Miss O'Mara
Mrs M E Brown
Mr White

A handwritten signature in black ink, appearing to be 'John M M Banham'.

Thank you for send me an advance copy of your Council's report on European Monetary Union.

I very much hope that when your report is published you will be able to stress that the CBI believes in making step-by-step progress towards economic and monetary integration in Europe, and that (in particular) it would not be desirable to rush into controversial and difficult institutional changes until we have absorbed and learnt the lessons of the massive changes implicit in Stage 1 of EMU.

A handwritten signature in black ink, appearing to be 'Nigel Lawson'.

NIGEL LAWSON

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PLP

FROM: N L WICKS
DATE: 25 OCTOBER 1989
Ext : 4369

CHANCELLOR OF THE EXCHEQUER

cc PMG
FST
Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mrs M E Brown (EC1)
Miss O'Mara (MG1)
Mr A E W White (EC1)
Mrs Chaplin (CX)
Mr Tyrie (FST)

Not advised

EMU: YOUR PAPER FOR ECOFIN

I understand that there are indications that the Prime Minister may wish to see a reference in our paper to the UK's conditions for joining the ERM.

✓ 2. Clearly, it would be preferable to omit such material. The paper is drafted to look well beyond Stage 1 and to be written in a "Community-wide" context, rather than addressing itself to particular countries' positions. Nonetheless, it will be difficult to resist such an addition if the Prime Minister presses for it (and particularly if it is the only change suggested!). If a passage needs to be included, I suggest that it goes at the end of paragraph 4 (not indented) and is on the following lines:

"Regarding the inclusion of all currencies in the ERM on equal terms, the UK Government has stated that the decision when to join the mechanism will have to be judged against progress in a number of areas. In particular, when the level of United Kingdom inflation is significantly lower, there is capital liberalisation in the Community and real progress has been made towards the completion of the Single Market, freedom of financial services and strengthened competition policy."

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This material draws on the Prime Minister's answer in the House, OR vol 165 No 142, col 518-519. An alternative formulation based on your speech at the Mansion House would be:

"Regarding the inclusion of all currencies in the ERM on equal terms, as the UK Government made clear after the Madrid European Council earlier this year, once UK inflation has come down and progress has been made with the abolition of exchange controls and other key aspects of the Single Market, the way will be clear for sterling to participate fully in the EMS."

N.L.W.

N L WICKS

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No
No latter, unless
Bus. Man-
just wr not face
to say & split!

EMU Debate

I have told the LSip's Office that you see attractions in a debate on the adjournment (subject to squaring Speering on para 2a below) (So that you would like to know the Chief LSip's & LD President's views.

If this doesn't work, I think we might try to restrict the motion to eg 'takes note of documents x, y, z & the Government's approach to EMU' and get Murdoch to avoid the extra 1 1/2 hours. Any views?

The question is whether this
should be 'of' or 'endorses'. I wd prefer
JC

MP



FROM: MISS M P WALLACE
DATE: 25 OCTOBER 1989

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Peretz
Mrs M E Brown
Mrs Chaplin

EMU DEBATE

I gather it is now virtually certain that this Debate will take place next Thursday, 2 November. We now need to consider the form of the Motion, and what should be said at tomorrow's Business Statement.

2. There are a number of constraints:

- (i) we have a collection of European documents which the Scrutiny Committee has recommended for debate. So a "take note" Motion would seem to be appropriate for these; but
- (ii) a pure "take note" Motion on EC matters apparently carries with it the convention that an extra 1½ hours of debate should be allowed after 10 o'clock, and I assume you would want to avoid this;
- (iii) there is the additional difficulty that you will not wish to identify your ECOFIN paper as one of the relevant documents until it has been released next Tuesday.
- (iv) any Government motion is open to amendment.



2a. I gather the Opposition may favour a debate on the adjournment, and that is being discussed by the Business Managers. Although that may have some attractions, it has disadvantages too. Mr Dyer has pointed out that a debate on the adjournment may well not satisfy the Scrutiny Committee's demand for a debate on the 4 EC documents they have already processed - so we could end up with pressure for a further, separate debate on them. In addition, since a motion for the adjournment gives us no way of "tagging" the relevant documents until the order paper for the day itself, there could be complaints that we hadn't allowed Members enough time to read them.

3. If this option falls, for whatever reason, we will need a Government motion. After discussion with Mr Dyer and Mrs Brown, a hybrid option has emerged. This would entail an announcement at the Business Statement tomorrow that there will be a Debate next Thursday in Government time on economic and monetary union and that the relevant EC documents will be listed in the official report. (This list would consist of the four documents already recommended for debate - not your paper.)

4. Then, next Tuesday when you release your paper we would put it before the House by means of an arranged PQ - tabled on Monday 30th for answer the next day - saying that copies (some 200) will be available in the Vote Office and in libraries of both Houses. This would then be drawn into the scope of Thursday's Debate when you put down your Motion (again this should be done on Tuesday afternoon) which could be along the following lines:

"This House takes note of: an unnumbered explanatory memorandum of May 1989 on the Delors report; two unnumbered memoranda of 20 October 1989 on proposed Decisions on economic convergence and



cooperation between central banks; and of EC document No 7550/89 relating to the value of the European Currency Unit; and endorses the Government's view, set out in the Chancellor's paper, that monetary union should be achieved through an evolutionary approach, and in a manner that maintains full accountability to national parliaments."

5. Brian Dyer has taken very informal soundings with the Whips Office, and thinks this procedure should be acceptable to them. It appears that it will get us out of the extra 1½ hours of debate we would have on a pure "take note" Motion. If you are content with this, then if the need for a Government motion arises, we would clear this wording quickly with the Foreign Office tomorrow, and then put it to the Whips.

6. You also asked whether there was any need for your paper itself to be sent to the Scrutiny Committee. We have established that the rules do not require this. And looking at precedent, your Ecofin paper on indirect tax harmonisation was simply sent over at official level, to the Clerk, for information, and the Committee itself did not discuss it.

MOIRA WALLACE

FROM: R I G ALLEN (EC)
DATE: 25 OCTOBER 1989

PPS

cc: Mr H P Evans
Mrs Brown

BRIEFING ON EMU

I attach a preliminary draft of some defensive Q/A briefing on the Chancellor's paper: this is still being checked and cleared with officials. But the Chancellor might like to glance at it on the plane tomorrow before his meeting with Herr Waigel.

2. I shall be submitting a full package of draft briefing tomorrow night which will include, in addition to the enclosed documentation, a draft press release and background material.

RIG

R I G ALLEN

Some suggestions marked. In addition to this I think we need to prepare some knocking copy against the paper Chastyle is preparing for Delors on the economic advantages of a single currency.

JC

Draft of 24 October 1989

CHANCELLOR'S PAPER ON EMU: DEFENSIVE QUESTIONS/ANSWERS

A. General: Strategic/tactical/procedural questions

Q1. *How can the UK sign up to the principle of EMU but reject practical steps (ie Delors Stages 1 and 2) to achieve it?*

A. UK accepts the progressive realisation of EMU, as made clear in Madrid. What we reject is the approach laid down in Stages 2 and 3 of Delors Report: a centralist and bureaucratic agenda posing great threats to political accountability. We favour a gradualist, evolutionary route.

Q2. *If there is no timetable and no specific guidelines (ie a new Treaty), will not progress towards EMU be undisciplined and haphazard?*

A. Certainly not. Community has already agreed on major new steps to be taken, and the first part of a timetable. Stage 1 will begin on 1 July 1990. But Community not ready to lay down firm guidelines for later stages now. Much better to allow for evolutionary approach, in which decisions are informed by experience.

Q3. *UK out of line with most of Europe once again?*

A. No. Other countries share many of our reservations on the Delors route. On many other aspects of EC

Credible?

Possibly - Only a few countries will press ahead
repeal with Stages 2 & 3. Often
skin our reservations

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policy, UK runs with the pack or ahead of it (eg on completion of the single market).

Q4. *UK paper just a blocking device to prevent setting up an IGC?*

A. No. Paper a genuine contribution to an important debate. Quite wrong to think that Delors Report is the only possible solution, as Madrid Council recognised.

Q5. *Other countries will simply reject UK approach?*

A. Wait and see. UK approach is logical extension of Stage 1. Already clear that others in the Community are concerned that French Presidency are seeking to press too hard, too fast for early decisions. Important to fulfil Madrid agreement that there is full and adequate preparation before an IGC is convened.

Q6. *But surely an IGC in 1990 H2 is already a foregone conclusion?*

A. Certainly not. No decision to hold an IGC has yet been taken. Much more preparatory work needed before this issue is addressed.

Delete - it is possibly unavoidable.

Q7. *Would the UK block an IGC?*

A. IGC can be convened by simple majority. The Prime Minister has said that we would not adopt an empty chair posture. To call an IGC before full and adequate provision would be a waste of everyone's

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time. Of course, any new Treaty which emerged could only be adopted by unanimity.

Q8. *Will UK be preparing further detailed proposals on what needs to be done beyond Stage 1?*

A. No. Ideas in paper intended to stimulate discussion. Would be for Commission to bring forward new proposals.

Q9. *Don't we need, as Delors says, a clear idea of where we are going?*

A. Of course. We know what our objectives are and we have signed up to the massive undertaking of Stage 1. There is no need at all to spell out now the institutional changes which may or may not be needed beyond Stage 1.

Q10. *Isn't the paper simply a charade to hide the intense dislike by the Prime Minister of giving up any sovereignty in this area?*

A. No. Study the arguments in the paper. Most decisions in the Community are taken at a national level on the widely accepted principle of subsidiarity.

Q11. *CBI favours early entry to ERM and subsequent move to single currency and ESCB?*

A. Prime Minister has made clear that UK will join ERM during Stage 1. Important to note that CBI agrees that progress beyond Stage 1 should be gradual. No need for rush.

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Q12. What about Sir Alan Walters' position (article in "Observer", 22 October) on UK membership of ERM (".....arguments have never attained even a minimum level of credibility"); and on EMU (".....not opposed, at least on economic grounds, to the development of a proper European currency administered by a European Central Bank")?

A. These views are clearly not those of HMG, on either issue, as Chancellor made clear in 24 October Commons debate on economy.

B. UK paper: general questions

Q13. What is the UK definition of monetary union?

A. The principal objectives of monetary union are: price and currency stability; lower costs of financial transactions, especially across borders; and equal access to financial instruments and services by all citizens and other borrowers and lenders within the Community. The mechanisms through which these objectives would be achieved include the progressive alignment, through competitive forces, of member states' monetary policies; and increasing interchangeability of all Community currencies. The UK approach would not be mandatory, but permissive. And it would involve no major constitutional change.

This is the correct answer to a different question ie what are the aims of MU?
We need also a succinct definition on the lines you proposed -

equal status for all currencies within the Community + monetary policies united towards a commonly agreed end.

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Q14. UK "alternative approach" is no alternative at all: in effect, goes no further than Stage 1?

A. Yes it does, as paragraphs [16-20] of the paper make quite clear. Important to realise what a major step Stage 1 is. UK approach envisages considerable evolution beyond that, involving further Government measures. Cannot say in advance where system will end up. The bureaucratic nature of Delors' approach implies that it is necessarily a blueprint. In contrast, the UK approach - with its emphasis on evolution, learning by doing, market forces - cannot be a blueprint. Indeed, that is its great strength.

Q15. What's the attraction of UK version of EMU for the man in the street?

A. Consumers will get increased choice, lower prices, greater opportunities for living and working elsewhere in the Community, less delay at frontiers, ~~more~~ stable currencies and lower transactions costs. More generally, lower inflation and more stable exchange rates throughout the Community will provide the basis for a strong and growing EC economy.

Q16. The idea of competing national currencies would surely lead to chaos and confuse the consumer?

A. As Chancellor said in Mansion House speech, not a question of requiring the village shopkeeper in Much-Binding-in-the-Marsh to accept payment in drachma. The nub of the Chancellor's proposal is that there should be competition between the monetary policies of member states. This - not a centralised monetary policy under a non-accountable central bank - is way to ensure that inflation in Community

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unnecessarily

converges on the best, rather than on the average. Stimulus to competition will come from removing all unnecessary barriers to use of national currencies, so that EC residents have choice between them.

Q17. *Won't a competing currencies regime simply drive out all EC currencies apart from the DM?*

A. No. Competition does not usually give rise to monopolies. There would be pressures on all national governments to maintain the value of their currencies by conducting sound (ie non-inflationary) economic policies.

'Alternative anchor' concept.

Q18. *UK approach claims to produce, over time, most of the characteristics of full-blown EMU (a "practical monetary union" - see paragraph [19]). Why not take the final step of going to a single currency/ESCB?*

A. Possible that Community may eventually decide to move further, eg to establish irrevocably linked exchange rates. But Community simply not far enough down the road to take such decisions now. And setting up an ESCB would mean passing control of monetary policy to an independent, non-accountable body.

Q19. *But surely the UK approach will put huge strains on ability of Community to coordinate their monetary/economic policies? Will the existing arrangements for coordination need to be strengthened?*

A. The arrangements for coordinating monetary/economic policies are being strengthened as part of Stage 1. Much too soon to know whether further changes may be

needed. An important part of UK's approach is that market disciplines will cause policies to converge.

Q20. *What does paper mean by removing all "unnecessary" restrictions on use of Community currencies (paragraph [16])? What is "unnecessary" in this context?*

A. We do not know what restrictions exist in detail in other countries, but it is important for the Commission to carry out appropriate studies. As for the UK, there are probably few restrictions which need to be removed that have much of an effect in quantitative terms.

Q21. *Would Government transactions be included in the list of "unnecessary" restrictions? What about restrictions imposed by the tax system? Are the arrangements for company accounts satisfactory?*

A. Questions illustrate how fundamental a change we are considering. These are some of the issues we shall need to consider in detail as Stage 1 proceeds.

Q22. *Are we proposing that legal tender rules should be changed? What about the Truck Acts?*

A. Legal tender rules - which strictly apply only to the use of notes and coin - do not prevent parties from agreeing to use currencies other than sterling. Probably not necessary therefore to change existing legal tender rules. But certainly prepared to consider this in the context of an EC-wide liberalisation. Truck Acts do not prevent payment of wages in foreign currency and, if an employer had a good reason to pay wages other than in sterling,

*This is too
weak we need
some examples*

Will this do? →

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likely that employees' interests would be similar. In any case, open to employer to buy out employees' right to sterling payments.

Q23. *What about FRG argument - reflected in Delors Report - that economic union must go in parallel with monetary union?*

A. That is exactly what the UK approach entails. The aim is to create a competitive European economy in the monetary sphere and financial markets, just as in other markets. In contrast, the Delors approach combines increased competition in some areas with a bureaucratic and centralised approach to monetary policy.

Q24. *What about other models (eg gold standard) reportedly considered by the Treasury? Have these been rejected?*

A. Present proposal is the only one which UK is putting forward.

Q25. *Why is UK proposing further measures beyond Stage 1? Surely both the single market and single financial area - see paragraph 52 of Delors Report - are due to be completed during Stage 1?*

A. No inconsistency. Stage 1 provides a framework. But much more will need to be done, especially in individual member states to make the single market and single financial area a reality. Scale of these changes should not be under-estimated.

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Q26. *Any evidence of support for Chancellor's views in other countries?*

A. Yes, for example in a recent paper written by the German Board of Academic Advisers.

Q27. *What is the Governor's attitude to the UK paper - since he was a signatory to the Delors Report, he must presumably disagree with some of it?*

A. For the Governor/Bank of England to comment. Chancellor has of course consulted the Governor, and taken his views into account, in the preparation of the paper. Governor has set out his views both to TCSC (on 24 May) and in IEA lecture in July. Worth pointing out that the IEA lecture specifically recognised the advantages of alternative, evolutionary approaches, as compared with the Delors model.

C. UK paper: monetary policy questions

Q28. *How do we reconcile our enthusiasm for Stage 1 with our reluctance to contemplate ERM membership for so long?*

A. No inconsistency. UK always made it plain that we shall join mechanism. Progress toward completion of single market one of main factors influencing decision on timing, and also an essential element in Stage 1.

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Q29. *Doesn't a market-based approach imply floating exchange rates. Inconsistent to join ERM?*

A. No inconsistency. Closer coordination of exchange rate policy part of the gradual integration of the Community economy. But great difference between ERM - which leaves control of monetary policy in national hands - and irrevocably linked currencies with monetary policy controlled by a non-accountable central bank.

Q30. *Why should Stage 1 bring about a convergence of inflation rates at a low level?*

A. Removal of all exchange controls will mean any country pursuing an inflationary policy would run out of reserves quickly and face possibility of devaluation within the ERM. Experience shows Governments are strongly averse to devaluations because they damage credibility of economic policies and involve loss of national prestige. There will thus be strong pressures for convergence on low inflation.

Q31. *What is the evidence for the alleged asymmetry in the system which will tend to bring about convergence on the lowest inflation rate?*

A. Experience of ERM to date provides ample evidence of convergence on low inflation rates. What Stage 1 will do is to sharpen still further the competitive forces which have brought this about.

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Q32. *What are the risks that the EMS will break up because the discipline proves to be excessive for some countries?*

A. Clearly a theoretical possibility. But EMS has survived major developments in financial environment over last ten years. Has shown willingness to adapt to change and demonstrated increasing readiness of its members to cooperate and consult. No reason why it should not continue to evolve successfully in new context.

Q33. *Why has there been so little use of each other's currencies in the three countries which have had virtually no exchange controls for 10 or more years (FRG, Netherlands, UK)?*

A. There are already substantial holdings of foreign currencies in UK and Netherlands. Residents' foreign currency bank deposits in the UK are now some 16% of sterling bank deposits. In Netherlands, corresponding figure is 10%. By contrast, holdings in FRG are negligible partly because of restrictions on residents' foreign currency, but mainly because of excellent perceived quality of DM.

Q34. *In a world of competing national monetary policies, surely Bundesbank will dominate, as it already does in practice? So concept of "independent" national monetary policies really an illusion?*

A. National monetary authorities would be entirely free to run their monetary policies as they saw fit. Provided their citizens continued to find their own national currencies attractive, issue of "Bundesbank domination" would not arise. If, alternatively, authorities behaved in an inflationary way, so that

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perceived quality of their national currencies deteriorated, citizens would be free to switch to DM or other higher quality currencies. But this would not be "Bundesbank domination" in any real sense.

Q35. *Don't recent moves in interest rates by most EC countries show that sovereignty is largely a myth?*

A. Of course not. Just because monetary decisions are closely linked, and because some decisions are rightly taken at Community level, does not mean that all other decisions should be.

Q36. *Delors Report (paragraph 24) asserts that "once permanently fixed exchange rates have been adopted, there would be a need for a common monetary policy". Does HMG reject this view, endorsed by all central Bank governors?*

A. UK approach does not envisage permanently fixed exchange rates - at least not in foreseeable future.

Q37. *Surely there are some advantages in moving from UK model of EMU to a single currency?*

A. Certainly, eg a single currency would make transactions easier and cheaper. But the costs would substantially outweigh the benefits. In particular, single currency would be likely to lead to higher overall inflation than either present (DM dominated) arrangements or UK alternative approach. Moreover, single currency would inevitably involve loss of existing national responsibilities for monetary policy, with ensuing loss of political accountability.

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D. UK paper: fiscal/regional policy questions

Q38. *Why does UK reject Delors proposals for binding fiscal policy rules?*

A. Quite unnecessary to have such rules. But, as paper makes clear sound monetary policies will impose their own constraints on national budgetary policies. To reinforce discipline of free foreign exchange and capital markets, would be beneficial to have Community agreement that it would not bail out Governments which ran excessive deficits - though this not essential while realignments remain a possibility. Also desirable to have explicit understanding that deficits would not be financed by monetary financing.

Q39. *Would such "agreements" and "understandings" require legislative backing?*

A. This is a matter for further discussion.

Q40. *The Delors Report says that market forces will not generate adequate constraints on fiscal policy. Does HMG disagree?*

A. Yes. But market discipline could be reinforced by appropriate no bailing out/no monetary financing arrangements, as well as by the improved procedures for mutual surveillance to be established under Stage 1.

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Q41. Surely EMU will worsen the position of poorer countries who will need to be compensated?

A. No need for such compensation. As paper explains, strengthened market forces should provide a satisfactory balance of economic development throughout the Community. Transfers from the EC budget through the new structural funds regime are already substantial, and will increase rapidly over the next few years.

Q42. EMU will reduce countries' options for responding to shocks, necessitating bigger transfers within the Community?

A. There is no reason why this should be so. The UK approach, like the single market programme, involves strengthening market forces and enhancing competition. It also provides a powerful stimulus to achieve low inflation. Countries should therefore become more responsive to shocks, not less.

Q43. Under EMU, the Community budget will surely need to be bigger to perform a macro-economic stabilisation role?

A. No: a large EC budget would be a recipe for wasteful expenditure, as history (eg CAP structural funds) demonstrates. In any event, fiscal policy should be directed primarily to medium-term objectives. Role of short-term macro-economic stabilisation is best achieved by monetary policy, though automatic fiscal stabilisers will continue to operate at national level.

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Q44. *What about Delors' argument that market disciplines on fiscal policy would be inadequate?*

A. Delors Report offers no evidence for this assertion. Plenty of evidence however, that market ratings of sovereign debtors respond to changes in fiscal position well before crisis develops, eg downgradings of Australia and New Zealand in 1986. Range of ratings currently applied to EC member states.

Q45. *Budget deficits need to be coordinated: otherwise they will undermine monetary policy?*

A. Previous fixed exchange rate regimes (eg Gold Standard) survived perfectly well without budgetary coordination. Delors Report does not consider enormous practical difficulties of trying to monitor implementation of centrally determined fiscal policy decisions; nor how variations in fiscal positions across countries would be agreed. (There could be no question of simple rules, eg that all countries run the same budget deficit as a proportion of GNP, giving acceptable economic outcomes).

Q46. *Chancellor used to agree that a single Community monetary policy would require central control over size of budget deficits (eg Chatham House speech, January 1989)? Why this apparent volte face?*

A. Much expert academic debate over these issues this year; has led to the role of fiscal policy in EMU being analysed much more fully than before. Clear that weight of argument has shifted strongly in favour of the line now taken in Chancellor's paper, namely that fiscal coordination in form proposed by Delors not needed.

Q47. *Why would a "no bailing out" agreement be required?*

A. Main reason why markets might fail to provide discipline was if they thought individual countries' debt guaranteed by other ERM members ran the risk of default. This would mean irresponsible members borrowing too cheaply, and give general incentive for excessive fiscal expansion. Essential therefore to make clear to markets that defaulters would not be bailed out, and to put strict limits on countries' access to the Community Financing Mechanisms.

Q48. *What about the rule of "no monetary financing of deficits".*

A. Delors Report was probably right to call for exclusion of monetary financing of government deficits. Availability of monetary financing could weaken market discipline on countries' fiscal policies, at the expense ultimately of exchange rate stability. Helpful reassurance to markets to know that this would not be allowed to happen.

Q49. *EMU will surely worsen position of poorer countries?*

A. Delors Report (paragraph 29) argues that peripheral/low productivity regions will suffer as a result of alleged "centripetal" forces such as transport costs and economies of scale. Highly questionable however, whether these will outweigh "centrifugal" forces - especially outward investment to low-labour cost areas - which will help the poorer regions to catch up with the richer ones. Worth noting that, in US, regional GNP per head now much more evenly distributed than in individual European countries. And relative income disparities between

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Ireland, Spain and rest of Europe have also reduced following accession of these countries to EC.

Q50. *Poorer countries will need transfers to compensate for loss of ability to adjust by depreciating their currencies?*

A. Fallacy to think that depreciation helps convergence of real living standards. What is needed is faster productivity growth in poorer countries. Often goes with real appreciation not depreciation - witness Japan throughout post-war period as a whole.

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PLP

FROM: S J FLANAGAN
DATE: 25 October 1989
Ext 4340

PS/CHANCELLOR

cc PS/Paymaster General
 Sir P Middleton
 Sir T Burns
 Mr Wicks
 Mr H Evans
 Mr Scholar
 Mr R I G Allen
 Mr Peretz
 Mr Riley
 Mr Walsh
 Mrs Brown
 Mr Davies
 Mr Grice
 Mr O'Donnell
 Miss O'Mara
 Mr Kroll
 Mr A E W White
 Mrs Chaplin
 Mr Tyrie

Deputy Governor - BoE
 Mr Crockett - BoE
 Mr George - BoE
 Mr Flemming - BoE
 Mr Kerr - FCO

EMU: CHANCELLOR'S PAPER FOR ECOFIN

The Financial Secretary has seen Mr Odling-Smee's note and revised draft dated 23 October.

2. He has doubts about the last sentence of para 23. He thinks there is bound to be some expansion of domestic money supplies generating seigniorage which finances part of the government deficit.

3. The Financial Secretary would also be sad to lose the reference to seigniorage mentioned at (c) in Mr Odling-Smee's cover note. We are comparing

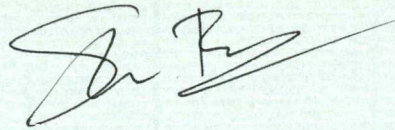
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i. a situation where the government can retain most of the seigniorage (it may tolerate x per cent inflation to gain fy of seigniorage), with

ii. a situation where it can retain less of the seigniorage - especially if it runs an inflationary policy (so x per cent inflation yields less than fy).

So under (ii) the government will tend to inflate less (this assumes that normal declining utilities apply).



S J FLANAGAN

Private Secretary

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PLP

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	26 OCT 1989
ACTION	MRS BROWN
COPIES TO	FST Sir P. Middelton Sir T. Burns, Mr Wicks Mr H. P. Evans, Mr Odling-Smee Mr Scholar, Mr R. G. Allen Mr Perez, Mr Riley Mrs Brown, Mr W. White Mrs Chaplin, Mr Tyrie

26/10

25 October 1989

Dear John,

EMU

The Prime Minister held a meeting this afternoon with the Chancellor, the Foreign Secretary and the Trade and Industry Secretary to discuss the paper which the Chancellor proposes to circulate to ECOFIN on European Monetary Union. It was agreed that the purpose of the paper was primarily tactical: to fulfil our undertaking to put forward an alternative to the Delors Report and to slow down discussion of EMU within the Community. There would then be at least two options on the table at the European Council in Strasbourg, and the need for our proposals to be properly considered could be adduced as an additional reason for delaying an IGC. It was suggested that the paper's title should be amended to read: **The Evolutionary Approach to EMU**. The point was also made that we needed to be more active, both in spelling out the implications of Delors and in publicising our views on the alternatives, especially in Germany. This could be achieved by stepping up the number of Ministerial speeches and interviews.

It was agreed that the Chancellor's paper should be finalised by the end of the week on this basis, with any detailed amendments to be sent to the Treasury in the course of 26 October. The Prime Minister noted that the conditions for sterling's membership of the ERM should be stated in the paper in the precise terms which she had used at the European Council in Madrid.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and Neil Thornton (Department of Trade and Industry).

CHARLES POWELL

John Gieve Esq
HM Treasury