PO/CH/NL/727
Part.C

ECONOMIC AND MONETARY UNIONS
(EMU)

Starts: 21/7/89
Ends: 4/8/89

Ch / You may like to discuss at Int. issues meeting. 2/.

The inflationary impact of these swaps has been much exaggerated. But when domestic interest rates are very high in real terms, then converting external debt into internal debt is expensive. D/e swaps in conjunction with privatisation are highly desirable.

HPE 21/7

21/7

FROM: A KILPATRICK (IF1)
DATE: 21 July 1989
x 4504

1. ~~MR EVANS~~
2. CHANCELLOR

cc Economic Secretary
Mr Wicks
Mr Mountfield
Mr Pickering
Mr Bottrill
Mr Lazar
Mr Tarkowski
Mr Tyrie

Mr Cassell UKDEL

Thanks. I agree with that conclusion. There must be few cases where real interest rates are significantly higher than, say, the UK?

DEBT/EQUITY SWAPS

This note seeks your approval for the line we propose to take in the IMF and World Bank Boards on debt/equity swaps and reports on their role in the Mexican package.

2. In the current Mexican negotiations, the banks are pressing for a debt/equity conversion facility of $1bn per year over 4 years. The proposal involves (i) investment in privatised public sector bodies or infrastructure projects and (ii) a conversion rate no greater than the face amount of discount bonds or 65 per cent of par bonds or new money. The Mexicans have not yet reacted to this proposal but have generally been resisting a resumption of debt/equity exchanges (save perhaps for privatisation operations).

3. Debt/equity swaps have been the main driving force behind debt reduction so far. The bulk have taken place in Chile, Mexico and Brazil. But four questions have now been raised on: deadweight, net resource transfer, the potential inflationary impact and the fiscal cost.

Deadweight

4. An incentive to the foreign investor to swap debt for equity is provided by the offer of local currency in amounts greater than the local currency equivalent of the secondary market price. Subsidies can however be distortionary and may involve a serious risk of deadweight loss. It is often difficult to tell how far investments would have taken place anyway. Recent research by the IFC into swap programmes in Argentina, Chile, Brazil and Mexico

tends to confirm that, while investments by banks were wholly additional, those by multinational companies (the larger proportion of the total) were additional in only 1/3 of the cases examined (although another 10 per cent of investments were made sooner or for larger projects than otherwise).

5. Debt/equity schemes are of limited size and the amount of local currency available on favourable terms is often rationed. After schemes are sold out, the prospect of future debt/equity programmes, and the expected subsidy for the foreign investor, can have the adverse effect of causing inward investment to be **delayed** until a subsidy is once again available.

Net Resource Transfer

6. The reduction in foreign debt does not necessarily mean net outflows of resources will be reduced. In fact, equity stakes under free exchange rates will in the long run usually mean larger outflows than debt because of the risk factor. But risk-sharing carries advantages and successful new investment can bring significant dynamic benefits, eg from technology transfer, which may outweigh any net additional outflows. The balance of advantage in terms of flows will depend on a comparison of the expected flows connected with the equity and those that were likely to occur from the servicing the debt itself. (To ensure the comparison is favourable countries often restrict the timing of outflows, sometimes delaying them for several years).

Inflationary Impact

7. Where debt/equity swaps involve conversion of private sector debt into private sector equity or the exchange of public sector assets for public sector external liabilities there is no direct monetary impact: existing liquidity is transferred from the debtor to the new equity holder without intermediation by the banking system and without domestic credit expansion or pressure on the domestic capital market. But many debt/equity swaps involve central bank or government liabilities being exchanged for local currency provided by the authorities which is then used for private investment. There will thus be domestic financial effects.

8. The size of these effects depends first of all on the extent to which the investment is 'additional'. If the investment would have taken place anyway, the possible inflationary effect of the debt/equity programme is limited. But equally this means the programme is ineffective and foreign exchange is forgone. Where investment is 'additional' the monetary impact of swaps depends on how they are domestically financed. If they are simply financed through the banking system there will be an increase in the growth of monetary aggregates.

9. Given weak monetary and fiscal policies (as in Brazil) any inflationary consequences of debt/equity programmes are likely to be small in relation to the overall problem, although large in relation to the growth of narrow money. This is because the size of external bank debt relative to the narrow money supply can be large enough to imply a significant monetary impact of debt/equity swaps even where these cover only a small percentage of the debt stock. Table 1 below illustrates the potential problem for the monetary authorities: for example an unsterilised annual programme of $1½bn in Mexico could increase money supply growth by some 22 per cent.

10. Inclusion of quasi-money however makes a big difference: as the Table shows the impact on the broader definition of money supply in the Mexican example is much lower, around 4 per cent. Ultimately the size of the problem depends on the extent to which additional liquidity feeds through into prices; and this is likely to vary from case to case.

Table 1: Potential Monetary Impact of Unsterilised Debt/Equity Swaps, Major Debtors 1988

	Debt to Banks	Money Supply		Potential Effect on Money Supply of 2% conversion	
		M1	M1 + Quasi money		
	(1)	(2)	(3)	(4) = 0.02x(1)/(2)	(5) = 0.02x(1)/(3)
	$bn	$bn	$bn	%	%
Argentina	34.4	4.3	18.2	16	4
Brazil†	72.2	14.5	201.8	10	1
Chile	9.6	1.5	5.4	13	4
Mexico†	68.8	6.4	37.1	22	4
Venezuela	24.5	10.8	22.5	5	2

† 1987 figures

Source: IIF data

Fiscal Cost

11. One approach to curb adverse monetary effects of swaps is to make compensating reductions in public expenditure (and/or by raising tax revenues). But for countries already pursing a tight fiscal policy, further squeezing may be difficult. The alternative is to sterilise the monetary impact through the issue of public bonds to the private sector. But there are two problems:

i. Because of the limited size of domestic capital markets in most debtor countries, absorption of substantial amounts of public debt can cause difficulties. This may be especially so where, as in Brazil, funding of public debt is already concentrated in short-term instruments. Sterilisation can put upward pressure on interest rates and this may cause some crowding-out of private investment. It may also exacerbate the debtor's fiscal problem by raising the cost of funding.

ii. Even if interest rates are not pushed up there may be disadvantages for the debtor where real domestic interest rates are high. The sterilised swap involves substitution of domestic debt for foreign currency debt. Where domestic interest rates (after allowing for inflation and anticipated currency depreciation) exceed external rates the operation is expensive.

12. Some debtors, particularly Mexico, have argued the fiscal costs involved in sterilising debt/equity programmes outweigh the advantages. Real interest rates in Mexico are currently running at around 40 per cent. This partly reflects the shift from high to low inflation and the need to compensate for expected devaluation and to establish policy credibility. A further factor is the burden of domestic debt itself: nearly 60 per cent of planned government expenditure is now taken up by interest payments, approximately 3/4 of which is interest on domestic debt. While high real interest rates persist, a debt/equity programme (other than one linked to privatisation) is expensive (if sterilised) or may run against the objectives of monetary policy (if unsterilised).

Table 2: Very Approximate Real Short-Term Interest Rates, Major Debtors (late 1988/early 1989), % per annum

Argentina	-11
Brazil	+15
Chile	+10
Mexico	+35
Venezuela	-20

Source: estimates based on IMF REDs.

13. Among Baker 15 countries the behaviour of real interest rates is mixed, with a very volatile pattern in some countries as they move between high and low inflation rates. Where real interest rates are strongly negative, for example in Argentina or Peru, sterilising debt/equity programmes might not be an expensive fiscal operation initially. But the overriding objective ought to be proper macroeconomic management. In the process of achieving

this, real interest rates can be expected to become positive, possibly staying at very high levels for some time until inflation and fiscal policy are brought under control, on a sustainable basis. Where a debt/equity programme is associated with credible policies, the investment inflow can help meet some of the additional demand for real money balances resulting from lower inflation expectations. In these circumstances, the monetary impact of the programme need not be critical: and it may help to avoid very high real interest rates during the adjustment period.

14. In Chile, where a credible macroeconomic framework has been in place, real interest rates have remained close to those abroad. Together with careful management of swaps, this has enabled the debt/equity programme to be highly successful in achieving debt reduction without jeopardising other objectives.

Conclusions

15.

a **Deadweight and Net Resource Transfer** A subsidy element in debt/equity swaps can be justified where it results in additional and successful investment, with attendant dynamic advantages to the debtor's economy.

b (i) **Inflation** The inflationary impact of debt/equity swaps has been much exaggerated. The Chilean example of roughly 40 per cent reduction in private sector claims (largely through debt/equity) without adverse inflationary consequences demonstrates what can be achieved if macroeconomic policy and the debt/equity programme are managed properly.

(ii) There are clear benefits of linking debt/equity swaps to privatisation and no serious disadvantages.

c **Fiscal (Interest) Cost** Some debtors undertaking policy reforms designed to bring about macroeconomic credibility have for a time a high level of real domestic interest rates - much higher than external rates. In these circumstances, we should not insist on a general debt/equity programme.

Line to Take

16. The conclusion that debt/equity swaps can be advantageous to the debtor, particularly when linked to privatisation, is consistent with our existing line. Looking carefully at the balance of advantage of introducing or continuing a debt/equity programme when real domestic interest rates are much higher than those abroad would be a refinement of this approach. Where there are genuine disadvantages we would want to argue even more strongly for specific actions by debtors to improve the climate for inward investment and a requirement to link debt/equity programmes with privatisation.

AK.

A KILPATRICK

cc: Mr Miles BoE
Mr Sharpe FCO

ec1.bk/meb/21.7.11 **UNCLASSIFIED**

ECONOMIC SECRETARY

* Mrs Brown [illegible] on this issue. N

This is v. good stuff. I have confined myself to cosmetic changes.

Ch,
You will want to see.
JG
20/7

FROM: MRS M E BROWN (EC1)
DATE: 21 JULY 1989
x 4709

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Riley
Mr Gieve
Miss O'Mara
Mr S J Davies
Ms Symes
Mrs Chaplin
Mr Tyrie

DELORS REPORT: EVIDENCE TO HOUSE OF LORDS SELECT COMMITTEE

1. I attach briefing for your appearance before Sub-Committee A on Tuesday 25 July. It is based on the list of questions sent by the Clerk. We have added supplementaries where necessary and a separate section on the ERM.

2. Mr Wicks, Miss O'Mara and I will accompany you to the hearing.

3. A number of the questions are very tricky. You will no doubt be pressed strongly on whether the UK accepts the Delors version of EMU, whether we reject it entirely, and whether we have workable alternatives to offer. Work is in hand within the Treasury on these questions, and we do not yet have firm answers. We suggest that at this stage you do not lead the Committee to expect that an alternative UK prescription will definitely emerge in the near future.

4. You may therefore want to adopt the tactic of giving detailed and technical answers where possible, in order to take up time. We have accordingly provided quite voluminous material for you to draw on.

. In addition to the Q&A material, I attach notes on:

- UK commitments to EMU
- procedures for calling an inter-governmental conference
- the constitutional position of certain central banks.

Mary Brown

MRS M E BROWN

CHANCELLOR

I'm sorry this is so bulky.

The briefing for Antibes comes in three folders – (a) EMU papers

(b) EMU background

(c) other subjects.

(a) includes the Commission/French 10 questions & the Trichet paper on the 1974 decision – these are new as are the revised commentaries & the legal opinion.

(b) includes a Pöhl dossier which is fairly full but I have highlighted the key statements. 26/1 and 8/6 and 21/6 are useful but there is as much on the other side.

You will also wish to

review Nigel's comments - in

the telegrams.

I have included your minute to

the PM & the Powell note. Nigel

recommends leaving these behind because

- in his experience - the French security

services always examine all delegations'

papers!

JC

ECOFIN BRIEFING -EMU

LE MINISTRE D'ÉTAT,
MINISTRE DE L'ÉCONOMIE, DES FINANCES
ET DU BUDGET

-:-:-

RÉPUBLIQUE FRANÇAISE

-:-:-

PARIS, le 21 juillet 1989

Mon cher Collègue,

J'ai l'honneur de vous confirmer que la prochaine réunion informelle ECOFIN aura lieu vendredi 8, samedi 9 et dimanche 10 septembre 1989 à l'Hôtel du Cap Eden-Roc à Antibes.

Les invités seront attendus vendredi dans l'après-midi ou en début de soirée. La réunion aura lieu le samedi et une visite touristique à Saint-Paul de Vence est prévue dimanche matin avant le repas de clôture. Comme pour les réunions informelles précédentes, les Ministres des pays membres peuvent se faire accompagner du Gouverneur de leur banque centrale et d'un conseiller.

Les épouses des Ministres et des Gouverneurs sont cordialement invitées. Un programme à leur intention sera prévu pour le samedi 9 septembre.

Je vous prie de bien vouloir trouver ci-joint un programme détaillé de ces trois journées ainsi qu'une fiche pratique contenant différents renseignements d'ordre matériel.

Je vous serais reconnaisant de me faire savoir dans les meilleurs délais possibles la composition exacte de votre délégation. Chaque membre de celle-ci aura à répondre à un questionnaire que je vous adresse également ci-joint.

Je me réjouis de vous revoir bientôt à Antibes et vous prie d'agréer, mon cher Collègue, l'expression de mes meilleurs sentiments.

A vous,

P Bérégovoy

Pierre BÉRÉGOVOY

CH/EXCHEQUER	
REC.	26 JUL 1989
ACTION	
COPIES TO	

Monsieur Nigel LAWSON
Chancelier de l'Echiquier
du Royaume-Uni

PROGRAMME
-:-

REUNION INFORMELLE ECOFIN

8 - 9 - 10 septembre 1989

EDEN-ROC (Antibes)

Vendredi 8 septembre 1989

	Dans l'après-midi et la soirée, accueil des délégations à l'aéroport de Nice-Côte-d'Azur par le Chef de Cabinet de M. Pierre BEREGOVOY, Ministre d'Etat, Ministre de l'Economie, des Finances et du Budget.
	Départ en voiture pour l'Hôtel Eden-Roc.
	Installation des délégations.
- 20 H 30	Accueil par M. et Mme Pierre BEREGOVOY à Eden-Roc. Dîner-buffet servi sur place.

Samedi 9 septembre 1989

- 8 H 30 - 9 H 30	Petit déjeuner.
- 9 H 30 - 13 H 00	Réunion de travail.
- 13 H 00 - 14 H 30	Déjeuners de travail (Ministres seuls dans un salon, Gouverneurs et autres membres des délégations dans un autre salon).
- 14 H 30 - 17 H 30	Suite et fin de la réunion de travail.
- 18 H 00	Conférence de presse
- 19 H 00	Départ pour Mougins. Dîner au restaurant "Le Moulin de Mougins".

.../...

<u>Dimanche 10 septembre 1989</u>

- 8 H 30 - 9 H 30	Petit déjeuner.
- 10 H 00	Départ pour Saint-Paul de Vence.
- 10 H 30	Visite de la Fondation Maeght et de l'exposition "l'oeuvre ultime, de Cézanne à Dubuffet" sous la conduite de J.-L. PRAT, Directeur de la Fondation.
- 11 H 30	Visite à pied de Saint-Paul de Vence.
- vers 12 H 30	Déjeuner au restaurant de la "Colombe d'Or" à Saint-Paul de Vence.
	A l'issue du déjeuner, départ des délégations.

PROGRAMME des DAMES

-:-

Samedi 9 septembre 1989

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10 H 00	Départ pour la roseraie Meilland, à Antibes. Puis visite des verreries de Biot.
11 H 30	Départ pour Nice. Visite à pied de la vieille ville et du marché aux fleurs.
vers 13 H	Déjeuner au restaurant "Maximin" à Nice.
vers 15 H	Retour à l'Hôtel Eden-Roc. Après-midi libre.

20/07/1989

Renseignements pratiques

-:-:-

- Trois voitures avec chauffeurs seront mises à la disposition de chaque délégation depuis l'arrivée à l'aéroport de Nice-Côte d'Azur vendredi 8 septembre jusqu'au départ dimanche 10 septembre.

  Les transports samedi soir et dimanche matin s'effectueront en autobus (de même que l'excursion des dames le samedi matin).

- Les coordonnées de l'Hôtel du Cap-Eden-Roc sont les suivantes :

  Boulevard Kennedy B.P. n° 1202, 06602 ANTIBES CEDEX

Téléphone	: (33)	93 61 39 01
Télécopie	: (33)	93 67 76 04
Télex	:	470 763

- La réunion de travail s'effectuera avec interprétation simultanée (français, anglais, allemand)

- La température estivale sera vraisemblablement encore chaude en cette saison et les bains encore très agréables mais les soirées pourront être plus fraîches au bord de la mer.

- Des courts de tennis seront disponibles dans l'enceinte du parc de l'hôtel.

- Un secrétariat commun sera installé à côté de la salle de conférences avec lignes téléphoniques internationales et télécopies, dont les numéros seront ultérieurement précisés.

- Des étiquettes pour les bagages vous seront prochainement adressées.

ANTIBES: PHONE NUMBERS

Hotel du Cap Eden-Roc, Antibes

Switchboard: 010 33 93 61 39 01

Telex: 470 763

Fax: 010 33 93 67 76 04

Chancellor (Room 647): 010 33 93 67 07 47

Governor (Room 612): via switchboard

Nigel Wicks (Room 127): via switchboard

FROM: A C S ALLAN
DATE: 24 July 1989

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr H P Evans

SALOMON BROTHERS ON EMU

The Chancellor saw Graham Bishop's letter of 19 July to the Paymaster General. He thought that the points marked on the attached copy of the first page were relevant to the exercise on alternatives to Delors.

A C S ALLAN

Salomon Brothers

July 18, 1989

Graham Bishop
721-3921 (London)

The Madrid Summit — European Monetary Union IS Coming

The monetary landscape of Europe is changing irreversibly. In June 1988, the European Community (EC) Heads of State agreed to abolish exchange controls. They also set up a committee chaired by EC President Jacques Delors to study "concrete steps leading towards the progressive realisation of economic and monetary union" (EMU). The Heads of State considered the resulting "Delors Report" at the Madrid Summit on June 28/29, 1989, and agreed to the following agenda:

- The first stage of Economic and Monetary Union will begin on July 1, 1990;

- The preparatory work will be undertaken for an intergovernmental conference to lay the ground for subsequent stages, which would meet after the first stage had begun in 1990.

On July 10, just ten days into the six-month French presidency of the European Council, the EC finance ministers agreed on an aggressive timetable for the preparatory work.

This report analyses these developments from the perspective of the business opportunities that will open up for the financial services industries. Genuine liberalisation of these industries is likely to lead to such a degree of financial integration that monetary union will, effectively, be created by market forces.

The Council has requested the adoption of the "provisions necessary for the launch of the first stage" (see text of communiqué on page 5). The Delors Report names the creation of a Single Financial Area as a key step in Stage One, and much work has already been achieved towards this end, but there are shortcomings in some of the measures and proposals. Current political commitment provides an excellent opportunity to ensure that the "provisions necessary" do, in practice, create a genuinely liberal financial market. This, in turn, will develop a powerful market discipline that should obviate the need for complex and bureaucratic budgetary coordination policies and minimise any functions that need to be delegated to a European System of Central Banks.

On balance, remarkable strides have been made towards achieving the Single Financial Area that will realise the European Council's decision in Madrid. Given a continuation of that degree of political commitment, the remaining problems can be overcome, permitting progress towards monetary union.

Principal Stage One Steps

The Delors Report describes Stage One as "the initiation of the process" of creating EMU. For practical business purposes, the key steps are as follows:

- "In the economic field ...firstly, there would be a complete removal of physical, technical and fiscal barriers The completion of the internal market would be accompanied by a **strengthening of Community competition policy.**"

● **"In the monetary field the focus would be on removing all obstacles to financial integration... Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented."**

The first statement merely reaffirms the principles of the 1992 programme. However, the second statement comprises a remarkably powerful and clear definition of the liberalised financial services market that we should now expect to unfold. **The Heads of State, in accepting Stage One of the Delors Report, have implicitly set a "quality standard" for the directives.** as well as the areas to be covered.

Impact of financial innovation

There is an implicit timetable: Stage One requires not only the approval and enforcement of the directives, but also their "*full implementation.*" The importance of this point may have been overlooked: it implies the enactment of enabling legislation in each of the 12 member states. Only then — and probably after a considerable time lag — will the full consequences of liberalisation unfold as financial intermediaries offer new products. The willingness of consumers to purchase these products will determine the degree of permanent and substantial financial innovation that will exist in the Community.

The Delors Report states that "account would also have to be taken of the continued impact of financial innovation on monetary control techniques (which are at present undergoing radical changes in most industrial countries)." The "preparatory work" to develop the "provisions necessary" for the new EC institutions, such as the European System of Central Banks, will certainly need to analyse these "monetary control techniques." The analysis will be difficult in the absence of practical evidence of liberalisation in the markets — and even more difficult if the legislative programme has not even been agreed.

To proceed beyond Stage One to the "subsequent stages" of monetary union requires revision of the Treaty of Rome by an intergovernmental conference. Currently, it seems probable that this conference will be called by majority vote at the earliest possible opportunity — shortly after July 1, 1990. However, because conference decisions require *unanimous* voting, such an early date could be premature: Stage One will have only just started and if any major parts of the Single Financial Area have not even been approved — including agreement on strengthening competition policy — it would be hard to feel that there was enthusiastic, unanimous support for the more difficult stages ahead.

The Single Financial Area — Can The EC Achieve Its Target?

The genuinely liberalised financial markets envisaged by the Delors Report are a quantum leap from the status quo, but progress seems to be accelerating. The French Presidency of the EC could be crucial in creating a climate where the Single Financial Area appears a realistic probability.

The following actions highlight the progress made to date:

Abolition of exchange controls

This historic and far-reaching measure was agreed in June 1988. The major EC countries have agreed to abolish the few remaining controls by July 1, 1990. The most visible exchange controls have, effectively, been abolished already, and the European Monetary System (EMS) has survived remarkably well at a time of sharp dollar fluctuations. The only remaining controls are those preventing individuals from holding foreign currency bank deposits. Evidence, particularly from the UK, indicates that individuals do not diversify their transaction balances — only their savings — so freeing liquid balances should not create a crisis.

Overall, the agreement to abolish visible exchange controls was *the* change that has probably made the drive towards some form of monetary union irreversible, because of the need to remove the risk of destabilising capital flows. Under *current* scenarios, there seem few reasons to expect abolition of the remaining visible exchange controls in the EC to destabilise the EMS.

However, there is still an array of restrictions on the investment policies of many financial institutions, which has a similar economic effect to exchange controls. These restrictions are analogous to the "nontariff" barriers that have always bedevilled liberalisation of trade in physical goods, and they amount to invisible exchange controls.

Mutual funds

On October 1, 1989, the directive on Undertakings for Collective Investment in Transferable Securities (UCITS) — the first liberalisation — comes into effect. This directive permits qualifying mutual funds to be sold freely throughout the EC. Tested against the Heads of State "quality standard," the directive falls short, because money market funds are not permitted. However, the principal opponent of such funds — West Germany — is about to permit its own mutual funds to have up to 49% of their assets in money market instruments. Bundesbank President Pöhl recently accepted the likelihood of further changes in West Germany.

Banking

The Spanish Presidency succeeded in obtaining the Council's agreement on a common position — the vital hurdle — on the Second Banking Directive and the Solvency Ratio Directive. The Second Banking Directive permits an EC bank to offer — in any EC country — the services for which it is authorised in its home country. The Solvency Ratio Directive is the measure that implements the risk-weighted capital adequacy standards proposed by the Cooke Committee of the Bank for International Settlements. Together, these measures seem to go a long way towards meeting the quality standard for banking services (including mortgages). This freedom is expected to be extended fully to foreign banks' services.

Investment services

The proposed Investment Services Directive would give nonbanks and financial intermediaries the same freedoms as those given to banks by the Second Banking Directive. Progress on this "EC passport" for investment banks seems to be lagging, because, in general, it is only UK-based entities that are affected. In the capital markets, an uneven playing field for banks and nonbanks would not be compatible with the "quality standard."

Insurance

The directives already approved and proposals made so far do not, realistically, begin to measure up to the Heads of State "quality standard." The problem stems from the European Court of Justice 1986 rulings on whether there was sufficient harmonisation of EC law to give consumers adequate protection. As a result, the current proposals have avoided the individual consumer and, certainly for the nonlife risks, concentrated on freeing insurance for medium- to larger-sized companies. This focus avoids the very area where the European consumer — who is also the elector — hopes to see tangible benefits from enhanced international competition. However, the Commission plans to address this problem in 1990.

If they are to be prudently and efficiently managed in the liberalised market, insurance companies' assets must reflect properly the type of liabilities undertaken to the public. Thus, foreign assets would not be appropriate where the premiums are likely to be paid out again as claims in a short period. At the other end of the spectrum, a life insurance policy that participates in profits is essentially a savings vehicle with attached insurance against death. That savings element should be free to be invested in an internationally diversified, profit-maximising portfolio.

Life insurance companies play a key role in the EC's capital markets: as the repository of much of the Community's long-term savings, they are major buyers of long-term Government bonds. With a choice of assets constrained only by prudence, the capital markets will have the genuine freedom, not only to judge the budgetary position of member states, but also to exert discipline by moving assets accordingly. The same principles should apply to pension funds.

Unless liberalisation of insurance — both assets and liabilities — meets the Heads of State "quality standard," a vital component of the Single Financial Area will be missing.

Securities issuance

The Prospectus Directive goes some way towards harmonising conditions for issuing securities by requiring member states to recognise a prospectus published in another member state. However, many member states continue to impose conditions that restrict issuance — originally for the proper purpose of ensuring an orderly market. Typically, conditions comprise the nationality of the lead-manager, nationality of the applicable law, physical location of the securities, and nationality of the paying agent. Even the most liberal country — the UK — requires the lead-manager of sterling issues to have a full UK presence. Although the original purpose of these regulations remains necessary, the current regulations have the effect of discriminating against lead-managers outside the member state. If issuance is restricted, then free circulation of financial instruments is effectively limited — contrary to the spirit of the "quality standard." "Mutual recognition" of other member states' standards is necessary.

Competition policy

UK Prime Minister Thatcher has emphasised, particularly, that the European Council had accepted the need for strengthening the Community's competition policy — as specified in Stage One of the Delors Report.

Competition policy potentially covers a wide area, but the current principal topic is the proposed merger regulation. This regulation would give the European Commission power to review "large mergers." The raising of the definition of "large" — perhaps to an annual turnover of ECU5 billion, declining over a period to ECU2 billion — has overcome many objections. There seems to be a reasonable chance that this measure could be approved later this year. However, Prime Minister Thatcher may have broadened the requirement of an acceptable competition policy by highlighting the Delors Report's call for a reduction in state aid.

It seems quite feasible that the EC can meet the "strengthening of Community competition policy" condition set for Stage One.

* * *

Appendix

Extracts from **Presidency Conclusions — European Council**
Madrid, 26 and 27 June 1989

"The European Council, meeting in Madrid, reviewed the situation and the prospects for progress towards European Union.

"...The completion of the Internal Market and the strengthening of economic and social cohesion were the priority objectives of this new chapter in the history of the Community.

"...The European Council noted that the forward thrust in achievement of the Internal Market was making an ever-increasing contribution to expansion and improvement in the employment situation. This thrust had hitherto resulted mainly from the decisions taken to remove technical barriers to trade. It was now necessary to make similar progress towards the elimination of physical and fiscal obstacles with a view to achieving an area without internal frontiers by 31 December 1992 in accordance with the provisions of Article 8a of the Single Act.

"The growing rate at which decisions were being taken meant that well over half the measures listed in the White Paper had been adopted. The Council recalled certain priority fields identified at its meetings in Hanover and Rhodes, and welcomed the fact that important decisions had been taken in the areas of public contracts, banking and financial services, the approximation of technical standards and transport. However, it noted that there were still decisions to be taken in these priority fields, including transport, in particular cabotage, and asked the Council to intensify its work in these sectors.

"The European Council invited the Commission to submit to the Council the remaining proposals provided for in the White Paper at the earliest opportunity, and expected the Council to finalise adoption, as quickly as possible, of the instruments that would permit the completion of the Internal Market.

Economic and Monetary Union

"The European Council restated its determination progressively to achieve Economic and Monetary Union as provided for in the Single Act and confirmed at the European Council meeting in Hanover. Economic and Monetary Union must be seen in the perspective of the completion of the Internal Market and in the context of economic and social cohesion.

"The European Council considered that the report by the committee chaired by Jacques Delors, which defines a process designed to lead by stages to Economic and Monetary Union, fulfilled the mandate given in Hanover and provided a good basis for further work. The European Council felt that its realization would have to take account of the parallelism between economic and monetary aspects, respect the principle of "subsidiarity" and allow for the diversity of specific situations.

"The European Council decided that the first stage of the realization of Economic and Monetary Union would begin on 1 July 1990.

"The European Council asked the competent bodies (the ECOFIN and General Affairs Councils, the Commission, the Committee of Central Bank Governors and the Monetary Committee):

"(a) to adopt the provisions necessary for the launch of the first stage on 1 July 1990;

"(b) to carry out the preparatory work for the organization of an intergovernmental conference to lay down the subsequent stages; that conference would meet once the first stage had begun and would be preceded by full and adequate preparation."

Other Titles in the "1992 and Beyond" Series

Fortress Europe, Graham Bishop, Salomon Brothers Inc, October 1988.

Banking — Will Liberalisation Itself Lead to a Common Currency?, Graham Bishop, Salomon Brothers Inc, February 1989.

The Long March to European Monetary Union — Two Practical Steps, Graham Bishop, Salomon Brothers Inc, May 1989.

European Banking Integration in 1992 — The Competitive Challenges Facing U.S. Multinational Banks, Thomas H. Hanley *et al*, Salomon Brothers Inc, June 1989.

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FROM: J M G TAYLOR
DATE: 24 July 1989

PS/ECONOMIC SECRETARY

Moira You wanted to see
Sarah.

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Riley
Mr Gieve
Miss O'Mara
Mrs M E Brown
Mr S J Davies
Ms Symes
Mrs Chaplin
Mr Tyrie

DELORS REPORT: EVIDENCE TO HOUSE OF LORDS SELECT COMMITTEE

The Chancellor has seen the briefing enclosed with Mrs Brown's note of 21 July.

2. He has made the following amendments:

Question 4: What benefits would full monetary union confer that ERM membership would not?

Delete existing answer. Replace with: "A good question. If ERM membership were to bring about the maintenance of a high degree of exchange stability among the currencies concerned, then it is difficult to see what significant additional economic benefits monetary union would confer. If, however, ERM membership were to prove unable to bring about a high degree of exchange rate stability, then the case for monetary union would clearly be stronger.

Indeed, the Delors Report and the debate about EMU could be portrayed as an attempt to solve the admitted problem of what to do about exchange rates between independent sovereign states by deciding to abolish independent sovereign states. And proposing to do so without, so far, any serious discussion of the vital question of democratic accountability. Yet this is a matter of the most fundamental importance that can never - dare never - be taken for granted".

Question 5: What would be the disadvantages to member states of being "left out" of a community monetary union?

Line 3 - delete "for the shorter term". Replace with "in the meantime, ...".

Question 5 (a)

Line 3 - delete "am sure", replace with "believe".

Question 6

Line 6 - delete "economic", replace with "fiscal".

Question 8: Can a country which uses the sharp tightening of monetary policy to discipline inflation afford the monetary straitjacket of ERM/EMU?

First para to read: "First, the ERM is not a straitjacket since a) fluctuations are permitted within margins and b) realignments are possible. Under full EMU, of course, exchange rates would be irrevocably fixed".

Question 8: "If pressed". To read: "It is certainly true that, with the benefit of hindsight, monetary policy was too loose at the end of 1987 and the beginning of 1988. But this represented ...".

Question 14: How would the Central Bank be financed?

To read: "That is clearly a matter for discussion if and when it is decided that a European Central Bank is necessary".

Question 18, Supplementaries: Do you want the European Central Bank in London?

To read: "We have not yet agreed that it would be sensible to have a European Central Bank at all. So the question of where it should be situated does not arise".

But the Deputy Governor put in a bid for London. Delete third sentence of reply.

Question 19.

Line 3, delete "any new".

Question 19, Supplementary (ii).

First line to read: "The logical implication of the Delors prescription may well be ..."

ERM; Supplementaries; What are the conditions on which the UK will join the ERM?

Second indent to read: "There must be capital liberalisation in the Community".

Prime Minister's "conditions" are a delaying tactic.

Answer to read: "No. UK inflation apart, these conditions are all part of stage 1 of the Delors process.

Time table for sterling's entry.

Answer to read: "We are not commi'ted to any particular date, but it will clearly be within the course of the so called stage 1 of Delors, which starts on 1 July 1990".

J M G TAYLOR

ec1.bk/meb/21.7.11 **UNCLASSIFIED**

Pmp

ECONOMIC SECRETARY

FROM: MRS M E BROWN (EC1)
DATE: 24 JULY 1989
x 4709

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Riley
Mr Gieve
Miss O'Mara
Mr S J Davies
Ms Symes
Mrs Chaplin
Mr Tyrie

DELORS REPORT: EVIDENCE TO HOUSE OF LORDS SELECT COMMITTEE

1. I attach revised sections of your briefing, incorporating the Chancellor's amendments and the changes agreed at your briefing meeting this afternoon.

2. MG Division will submit separately a note on the powers of the Bundesbank on exchange market interventions, and on the legal tender laws. Ms Symes is letting you have a note on the evidence given by Lord Cockfield and Charles Goodhart.

Mary Brown

MRS M E BROWN

EUROPEAN COMMUNITIES COMMITTEE: SUB-COMMITTEE A

ECONOMIC SECRETARY'S EVIDENCE, TUESDAY 25 JULY 1989

Q1. How would you define the "Economic and Monetary Union" which the Government is committed to implement (most recently in the Madrid Communique)?

This is one of the key questions which the further work agreed on at Madrid will need to cover. The Delors Report gave one definition. We and our fellow member states need to examine the elements of the Delors approach very carefully, and to consider alternatives.

SUPPLEMENTARIES

(a) But you are committed to some form of EMU?

The UK is a signatory to the Single European Act. The preamble to that Act referred to the 1972 Conference at which Heads of State approved the objective of the progressive realisation of Economic and Monetary Union. But the Act itself does not specify any arrangements for implementing EMU, or a timetable. [If pressed: indeed it is worth noting that chapter one of that Act is headed "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". The Act itself certainly does not suggest that EMU must involve centralised, rather than cooperative, arrangements.]

[List of UK commitments - attached].

(b) Do you agree that monetary union involves a common currency and a single central bank?

The Delors report (in paragraph 22) defines a monetary union as a "currency area in which policies are managed jointly with a view to attaining common macro-economic objectives." It recalls that the Werner report of 1970 laid down 3 conditions for a monetary union. Two have already been met or are in the process of being met, through the single market programme. They are

- the total convertibility of currencies;

- the complete liberalisation of capital transactions and full integration of financial markets.

The third is a decision to lock exchange rates irrevocably, so that national currencies became "increasingly close substitutes".

The Delors report goes on to say (in paragraph 23) that the interlocking of exchange rates would not necessarily mark the end of the process of monetary unification in the Community. It argues that there would be advantages in moving to a single currency. But it states that this would not be "strictly necessary for the creation of a monetary union".

I do not think EMU necessarily requires an independent central bank, though this is of course one of the questions to be looked at. Some coordinating questions would no doubt be needed, but past experience does not suggest that a central bank on the Delors model is necessarily required.

(c) <u>The Chancellor told the TCSC (Q80) that monetary union "is a single currency ... a single monetary policy ... and a single central bank". The Prime Minister told the House of Commons on 29 June that "The fixed exchange rate ... would come under considerable criticism and people could not do it". Who is right?</u>

The Chancellor was referring to what Delors means by monetary union. As he said, it is quite clear that Delors' concept of full EMU involves interlocked exchange rates, probably a common currency and an independent central bank. But both the Prime Minister and the Chancellor have stressed that the Government has fundamental concerns about the surrender of sovereignty that would be involved in the Delors prescription. That is one of the questions to be examined further. I simply cannot say at this stage what the end point may be.

(e) <u>The Governor said Delors was "the right model"?</u>

But I believe he also said Delors was not the only model.

(f) <u>The Prime Minister has said others share her doubts about the Delors prescription for stages 2 and 3. Who are they?</u>

All member states agreed at Madrid that further work was needed. The communique made that clear.

The Governor of the Bundesbank, Herr Pohl, said in a speech on 22 June (the PM quoted this in another place on 29 June):

> "I myself doubt whether the time has come for such a comprehensive renunciation of sovereignty, namely the transfer of monetary powers to supra-national institutions. I can only repeat what I said a little while ago. Neither a single currency nor a European Central Bank is necessary for an economic and monetary union to function. What is more important is that the member states pursue a consistent policy."

Q2. When would you expect preparations to be complete for the inter-Governmental conference? When does the Government expect to publish its alternative proposals for monetary union?

i. No date has been agreed. The Madrid European Council concluded that such a conference "would be preceded by full and adequate preparation", and that it would meet only once the first stage had begun (ie. not before 1 July 1990). Finance Ministers will begin discussing the issues involved in the autumn, but a great deal of work to do thereafter.

ii. As the Prime Minister said in her statement to the House of Commons on 29 June after the Madrid Council, we shall be working out alternative proposals, and hope that other people will do so too. Too early to say how and when we will produce our ideas. But the informal meeting in Antibes on 9-10 September will provide an opportunity for discussion.

SUPPLEMENTARIES

(a) Why did UK agree to inter-governmental conference?

The UK agreed to preparatory work for a Conference, which would meet "once the first stage had begun and would be preceded by full and adequate preparation". There has not yet been a formal decision to call an Inter-Governmental Conference. [Article 236 of the Treaty of Rome provides that such a decision must be preceded by a proposal from any government or the Commission. The Council, after consulting the European Parliament and the Commission, would then vote by single majority for or against calling a conference of representatives of the Governments of member states. If the Council were in favour, a conference would be convened by the President of the Council.]
[Copy of Article 136 attached.]

Article 236

The Government of any Member State or the Commission may submit to the Council proposals for the amendment of this Treaty.

If the Council after consulting the European Parliament and, where appropriate, the Commission, delivers an opinion in favour of calling a conference of representatives of the Governments of the Member States, the conference shall be convened by the President of the Council for the purpose of determining by common accord the amendments to be made to this Treaty.

The amendments shall enter into force after being ratified by all the Member States in accordance with their respective constitutional requirements.

(b) <u>Would UK refuse to attend an IGC?</u>

No. There is no question of an empty chair policy as the Prime Minister made clear in Madrid. We would want to play a full part in any discussions on when and whether to hold an inter-governmental conference, and to influence discussions at such a conference. The Treaty makes clear that any amendments to the Treaty have to be agreed unanimously and ratified by all member states in accordance with their constitutional requirements (ie. in the UK by Parliament).

(c) <u>Might not talk of 'alternatives' be seen as entirely negative?</u>

Far from it. We want to make progress on the steps in Stage 1 as fast as we can, and we have endorsed the recommendation that stage 1 should begin on 1 July 1990. In several areas (eg. exchange control abolition) we are already ahead of many other member states. And we want to see action during Stage 1 on some points the Delors Report did not cover at all: active promotion of the private ecu, increased holding of private ecu in official reserves and their greater use in intervention. But it was clear from the discussions in Madrid and subsequently that we are by no means alone in questioning whether the proposals on longer term developments put forward in the Delors Report are the best route forward.

Q3. <u>How would you interpret the conference's mandate to "lay down the subsequent stages"?</u>

Article 236 of the Treaty of Rome states that an Inter-Governmental Conference "shall be convened ... for the purpose of determining by common accord the amendments to be made to this Treaty". There is no more precise guidance at present, but any Conference would follow extensive preparatory work.

[The Madrid conclusions do not imply that the Council endorsed Stages 2 and 3 of the Delors report. Finance Ministers will need to assess the report's findings in their further work.]

Q4. <u>Is the Government convinced of the economic benefits of monetary union?</u>

All depends on what form of monetary union is envisaged. Currency stability throughout the Community obviously brings savings in transaction costs for industry and travellers. But it would be important that the process did not give rise to unacceptable costs in other areas (eg an expansion of the Community's structural funds or centralisation of budgetary policy). The possible economic benefits have to be weighed against the loss of sovereignty to the UK involved in the Delors prescription for economic and monetary union.
[See also Q6 and Q12].

<u>What benefits would full monetary union confer that ERM membership would not?</u>

A good question. If ERM membership were to bring about the maintenance of a high degree of exchange rate stability among the currencies concerned, then it is difficult to see what additional economic benefits monetary union would confer. If, however, ERM membership were to prove unable to bring about a high degree of exchange rate stability, then the case for monetary union would clearly be stronger. Indeed, the Delors Report and the debate about EMU could be portrayed as an attempt to solve the admitted problem of what to do about exchange rates between independent sovereign states by deciding to abolish independent sovereign states. And proposing to do so without, so far, any serious discussion of the vital question of democratic accountability. Yet this is a matter of the most fundamental importance that can never - dare never - be taken for granted.

Q5. What would be the disadvantages to member states of being "left out" of a Community monetary union?

There is no question at the moment of anyone being "left out" of developments in the Community. Any Treaty change would have to be agreed unanimously by the 12 member states. In the meantime, the Prime Minister has made clear that the UK fully supports the implementation of stage 1 on 1 July 1990. She has also made clear that we would participate in an Inter-Governmental Conference.

SUPPLEMENTARIES

(a) What if the 11 decided to proceed with stages 2 and 3 without the UK?

The UK is one of the major economies of Europe. I do not believe that proceeding without us would be in the interests of the Community as a whole, and I believe that is the view of our partners.

(b) The Delors Report envisages "a degree of flexibility" concerning the date and conditions of joining certain arrangements. The UK might avail itself of that?

[Delors Report paragraph 44 to be attached].

We have to discuss in much more detail all the arrangements recommended in the Delors Report, including those suggested in paragraph 44.

[Not for use: the Report said "Influence on the management of each set of arrangements would have to be related to the degree of participation by member states". Important to avoid any suggestion that UK would accept such '2 tier' arrangements.]

Q6. <u>Why did the Madrid communique emphasise the "parallelism between economic and monetary aspects"?</u>

Member states obviously need to examine how far cooperation in economic matters needs to progress in parallel with developments in monetary arrangements. As the Chancellor made clear in a recent speech to the Institute of Directors, we do not think the Delors report gets anywhere near sustaining the case for tight <u>fiscal</u> coordination in order to make a joint monetary policy sustainable.

The Madrid communique also said that further work should respect the principle of "subsidiarity" and allow for diversity of specific situations. Those are equally important points, and highlight the need to cede no more functions to the central institutions of the Community than are strictly necessary.
[See also Q12.]

Q7. Other than membership of the ERM by all member states, what should "Stage 1" consist of? How long might this stage take to complete? Would there not be pressures to develop full monetary union more quickly if the removal of capital controls jeopardised the current working of thc ERM?

(i) Stage 1 measures are set out in some detail in paragraphs 51-52 of the Delors report, although here too there will have to be more work on precisely what needs to be done. The main elements of Stage I will include: completion of the internal market, in particular the single financial area, and a strengthening of competition policy (which we see as requiring removal of barriers to takeovers and reduction in subsidies); implementation of the agreement to reform the structural funds; revision of both the 1964 Council Decision which established the Committee of Central Bankers and the 1974 Council Decision on economic convergence; and removal of impediments to the private use of the ecu.

[For use as necessary: On the 1964 and 1974 Decisions, we will be seeking to ensure that these texts reflect the free-market approach of this Government, and include more emphasis on medium-term and structural adjustment policies (rather than fine tuning). At the same time we must not overload the Brussels Committee structure.

We will be stressing the need for genuine completion of the single market in financial services and Community wide capital liberalisation:

- progress being made in some areas: welcome agreement on 2nd Banking Directive. But need to move faster in others, notably life assurance and investment;

- also important to ensure that unnecessary restrictions on market access are lifted, including excessive regulation of what financial services can be offered in particular markets and the way they are to be sold, which can amount to hidden barriers to trade;

- full capital liberalisation due by 1 July 1990 for eight major EC countries. Essential for single market. Must include: removal of all remaining controls by Italy and France; rapid progress by remaining four member states (Ireland, Greece, Spain, Portugal) towards removal of controls;' and complete integration of banking and other financial markets..

(ii) The second part of the question is entirely hypothetical. We in the UK are putting our efforts into ensuring that Stage I <u>does</u> work. There are different views about the extent to which full-scale capital liberalisation might undermine the ERM. Personally, I would not want to exaggerate the likely consequences.

Q8. <u>Can a country which uses the sharp tightening of monetary policy to discipline inflation afford the monetary straightjacket of ERM/EMU?</u>

First, the ERM is not a straightjacket since (a) fluctuations are permitted within margins (b) realignments are possible. Under full EMU, of course, exchange rates <u>would</u> be irrevocably fixed.

However, if you look at what has actually happened in practice, conflicts between domestic and external policy have been few and far between, since the countries within the ERM have shared the objective of reducing inflation. Thus France has seen its inflation rate fall from 10.7 per cent in 1979 to 3.7 per cent in May this year and Italy's inflation rate has more than halved from nearly 16 per cent in 1979 to 7 per cent last month. The EMS certainly did not prevent those countries from reducing their inflation rates: it provided a credible financial discipline which <u>helped</u> them in the conduct of their monetary policy.

<u>Capping sterling at DM3 has been responsible for subsequent inflationary pressures</u>?

That is far too simplistic an analysis. The increase in UK inflation is part of a worldwide phenomenon.

[**IF PRESSED:** It is certainly true that, with the benefit of hindsight, monetary policy was too loose at the end of 1987 and the beginning of 1988. But this represented the authorities' response to the stock market crash of October 1987 which not only we in the UK, but other countries too, thought could have provoked a severe loss of confidence, had steps not been taken to inject more liquidity into the economy. On the balance of risks as we then judged them, I am sure we were right to act as we did. Since then, inflation has picked up worldwide and other countries have responded as we have by raising their interest rates.]

[For further detail, you might draw on your CPS speech.]

Q9. <u>Other than the power to devalue, exactly what powers would be given up by Member States in "Stage 3"?</u>

Under the Delors prescription, member states would lose very considerable control over fiscal policy, and complete control over monetary policy.

In the economic field:

- the Council could impose constraints on national budgets
- and make discretionary changes in Community resources
- and "a new form of representation in arrangements for international policy coordination and in international monetary negotiations would be adopted".

In The monetary field:

- the responsibility for the formulation and implementation of monetary policy in the Community would be transferred to the European System of Central Banks
- decisions on exchange market interventions in third countries would be the sole responsibility of the ESCB Council
- official reserves would be pooled and managed by the ESCB.

Q10. <u>Various alternatives have been suggested to the form of monetary union suggested in the Delors Report. Could all member states' currencies become legal tender throughout the Community, in the hope that the "good money" would become the most frequently used?</u>

(i) I have indeed seen a number of alternative suggestions. For instance, the Treasury and Civil Service Select Committee in its recent report said that "Binding rules on fiscal policy seem to be unnecessary even in stage 3 of a monetary union". There has been discussion of the possibility of a parallel currency, a gold standard approach, or of allowing currencies to compete (the 'Hayekian model'). Delors' proposals on increased regional subsidies have also been challenged by a number of commentators. These are all things to be examined in the Community's further work.

(ii) I have seen suggestions about the currency option you describe. I have also seen it suggested that a single Community currency (usually assumed to be the ecu, although in that case, it could no longer be a basket currency as at present) could be introduced in parallel to the individual Community currencies, with the intention that it would gradually displace them. Another suggestion is that the existing Community currencies might be maintained but at irrevocably fixed rates.

Q11. The Chancellor has said that he would be "perfectly happy" with the "quasi-monetary union" of the gold standard system. What would be the advantages and disadvantages of such a system?

The gold standard offered a system which operated under defined rules. At the same time, as the Chancellor pointed out to the TCSC, it did not involve an irrevocable transfer of sovereignty: members could depart from it at any time. Moreover, it operated without any centralisation of national fiscal policy and without an international regional policy - two elements which the Delors Committee suggested should be incorporated within full EMU but which the UK disputes would be necessary.

How are circumstances different today?

i. Gold no longer backs the note issue.

ii. With the increasing internationalisation of financial markets, capital flows now dominate current transactions. The scale of capital flows across the exchanges is vastly greater. Even in 1986, foreign exchange market turnover in London was $90 billion a day and was several times this in the world as a whole. Today the figure would be larger still.

iii. The proportion of those flows represented by individual countries' official holdings of gold is trivial.

Could an alternative to gold be found?

Some have suggested commodities might replace the role of gold in such a system. But clearly a great deal of further work would be needed before any solution of this kind could be discussed in detail.

Q12. <u>What was the logic behind the report's proposal for limits on fiscal and budgetary policy?</u>

The Delors report has essentially two arguments. Firstly, that uncoordinated policies will lead to imbalances between member states in terms of their trading balances, and levels of inflation. Secondly, that without coordination of national budgetary policies "it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for internal balance" (paragraph 30 of the Delors Report).

But in our view, while some degree of coordination is necessary or desirable, this does not imply the setting of rigid limits or guidelines. As the Chancellor said in his recent speech to the Institute of Directors, there would need to be a credible rule that if any member country got excessively into debt, there would be no bail-out. But since individual states would not have access to monetary financing if a central bank were in operation, there seems no reason why the Community, rather than the member state's own government should not control the size of the budget. There is scarcely a single federal nation in the world that has control of the size of individual states' fiscal deficits or the nature of budgetary policies.

Q13. If the fear was that irresponsible Member States might jeopardise the system by running large budget deficits, would it not suffice to write into the system a rule that such states would not be bailed out? To what extent will the influence of financial markets act as a discipline?

It would certainly be very important to convince markets that member states who get into trouble as a result of irresponsible policies will not be bailed out by the rest of the Community. Otherwise countries that do pursue irresponsible policies may not experience the market discipline of a rising risk premium on their borrowing at an early enough stage for them to take action to avoid insolvency. Moreover the costs of irresponsibility will be reduced and the temptation to fiscal expansion will be greater, leading to higher interest rates throughout the Community. This is one of the questions we need to consider with our European partners.

Q14. <u>Will monetary union require an increase in Community expenditure?</u>

I see no reason why it should.

We certainly do not accept the suggestion in the report that there would have to be further large increases in structural fund spending to secure greater cohesion between the more and less advanced regions of the Community. The important priority must be to complete the internal market and ensure that both capital and labour can move freely. Market-driven adjustments, not massive injections of public money, are the way to reduce disparities in economic performance.

<u>How would the central bank be financed?</u>

That is clearly a matter for discussion if and when it is decided that a central bank is necessary.

[**IF PRESSED:** Clearly one possibility would be that the running costs of the central bank could be met from seignorage. We should in any case need to decide where the benefits of seignorage should accrue - the Community budget should certainly not be increased on the back of them. But discussing such issues now puts the cart in front of the horse.]

Q15. <u>Could national fiscal policy be used to help depressed areas in a monetary union, rather than increasing the Structural Funds?</u>

Fiscal policy should be left to national governments to determine. But [as I have said] fiscal policies should be used when necessary to exert discipline on public spending, not to provide massive subsidies. The priority is to complete the single market programme , so that capital and labour can move freely to all parts of the Community.

[I certainly would not endorse encouraging national governments to increase budget deficits in order to subsidise regional spending].

Q16. <u>Will not member states in a monetary union be unwilling to lose the power to give state aids to depressed industries, undermining the Community's competition policy?</u>

Some may. I believe that such subsidies are not appropriate, now or in any future Community arrangements.

Q17. <u>Are there valid arguments for having a common currency rather than irrevocably fixed exchange rates?</u>

The main argument adduced in favour of a common currency is that while separate currencies continue to exist, realignment always remains a possibility - in other words, there is no way of ensuring that exchange rates are fixed irrevocably in practice. Adoption of a common currency would also avoid any transactions costs incurred in exchanging one Community currency for another

Q18. <u>How important is independence for the credibility of central banks?</u>

The constitutional position of central banks differs widely, reflecting different historical backgrounds. Some have considerably more independence than others. We will want to examine different approaches as part of the further work that has been agreed, [always bearing in mind the need to protect UK national sovereignty].
[<u>Note</u>: you may wish to draw on the supplementary material we have provided on the constitutional position of central banks.]

<u>Supplementaries</u>

<u>What would the statutes of the European central bank be? Would they follow those of the European Reserve Fund in paragraph 53 of the Delors Report?</u>

As paragraph 54 made clear, a number of members of the Committee, including the Governor of the Bank of England, thought the creation of an ERF during Stage 1 would not be opportune. We need more experience of the way in which the Community is going to develop before we create new institutions. For the same reason, it would be quite inappropriate to attempt to define now what the statutes of such an institution might be.

<u>Do you want the European central bank in London?</u>

We have not agreed that it would be sensible to have a European central bank at all. So the question of where it should be situated does not arise.

<u>But the Deputy Governor put in a bid for London</u>

He is well placed to appreciate the advantages of London as a financial centre. But location is a second order issue.

Q19. What degree of political accountability would be required in a monetary union? Would Community monetary policy have to be more accountable than other Community policies currently determined by the Council of Ministers?

The Government is quite clear that a high degree of political accountability to national democratic bodies must be retained in economic and monetary arrangements. The Delors proposals for an independent central bank, answerable day by day only to an independent board and submitting annual reports to the European Council, give us cause for concern in this respect.

SUPPLEMENTARIES

(i) Why not oversight by the Council, as for other policies?

Monetary policy is implemented day by day, unlike many activities undertaken at Community level. But Finance Ministers will want to examine all this thoroughly in their further work.

(ii) Would accountability be provided by strengthening the European Parliament?

The logical implication of the Delors prescription may well be a fully democratic European Parliament and European Government. I do not think that is what the majority of members of either House of Parliament would wish to see.

EXCHANGE RATE MECHANISM

When will the UK enter the ERM?

As the Prime Minister made clear in a written answer on 12 July (OR Vol 156 No 142 Col 518):

> "The decision when to join the exchange rate 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".

Supplementaries

[Note: you may wish to decline to put any gloss on the above. But if necessary you could draw on the following].

What are the conditions on which the UK will join the ERM?

The decision when to join will have to be judged against progress in a number of areas. In particular:

- UK inflation will need to be significantly lower;
- there must be capital liberalisation in the Community;
- real progress must have been made towards the completion of the single market, freedom of financial services and strengthened competition policy.

Prime Minister's "conditions" are a delaying tactic

No. UK inflation apart, these conditions are all part of Stage 1 of the Delors process.

How far does inflation need to come down? To the Community average?

The Prime Minister made the Government's position perfectly plain. We must get inflation "well down".

Has the Government changed its position?

No. We have always made it plain we shall join when the time is right.

Timetable for sterling's entry

We are not committed to any particular date, but it will clearly be within the course of the so-called Stage 1 of Delors, which starts on 1 July 1990.

With what band will the UK enter? 2¼ per cent or 6 per cent like the Spanish?

Wait and see. It is too soon to be talking about such details as the band within which we will operate or the central rate we will adopt.

Has the entry of Spain into the ERM made any difference to the UK position?

No. The Spanish decision was one for the Spanish Government, just as the decision on sterling's entry is the responsibility of the UK Government.

Policy of shadowing the deutschemark caused present inflationary pressures?

That is far too simplistic an analysis. The increase in UK inflation is part of a worldwide phenomenon.

Should those who participate in the ERM adopt progressively narrower bands?

That would clearly be one way of making the transition between the present situation and full monetary union. But it is not the only way. This is just one of the issues we need to thrash out together over the coming months.

Should non-EC members be allowed to participate in the ERM?

The 1978 Council Resolution setting up the EMS states in Article 5.2 "European countries with particularly close economic and financial ties with the European Communities may participate in the exchange rate and intervention mechanisms." We have received no proposals for participation from non-EC members. If and when we do, the response will be a matter for the Community as a whole to decide.

NOTE FOR THE RECORD

Pl cc PPS/Chancellor to note X.

1. Mr Evans

2. Mr RIG Allan

3. Mr Peretz.

To note

N.C.J 25.7

cc : J O Kerr Esq CMG, FCO
N Wicks Esq, HM Treasury
D Hadley Esq, Cab Off
M Jay Esq, PARIS
Mr de Fonblanque
Mr Bostock
Mr Elliott

EMU

1. When I spoke to the President of the Commission's Chef de Cabinet on 25 July about another matter, I asked him how he and Delors were getting on identifying a couple of speaking engagements in the UK between now and Christmas in parallel with which he might be able to have informal contact with our Ministers on EMU (my Note for the Record of 5 July refers). I added that there seemed to have been some contact in the margins of the Paris Economic Summit between the Prime Minister and Delors which the former had found useful. Lamy said Delors too had felt that these contacts had been useful.

2. Lamy said that he was still working to identify speaking engagements The only one which he had so far earmarked was a bit late (a Financial Times Conference on 1 December), although Delors would probably accept that and it fell usefully close to the run-up to the Strasbourg European Council. But a much earlier date was also desirable for an informal contact and he was currently trying to identify a speaking engagement about mid-October. He said he would be in touch with me or whoever was in charge here as soon as the plan had shaped up a bit further. He would handle all this through UKRep and not through Mr Drew at the Commission's London Office.

3. I asked Lamy what Delors had thought of the French suggestion, made at last week's Foreign Affairs Council, to set up a high level group to deal with EMU. Lamy said Delors was, to put it mildly, "deeply reserved" about this idea. I said I was glad to hear this. The suggestion seemed to us to have nothing to commend it. Not only

/did

did it seem to reflect a desire to accelerate quite unrealistically the work of preparing an IGC but, by bringing in Foreign Ministries and institutional specialists, it seemed only too likely to confuse and jeopardise the process of preparation agreed in Madrid. In any case Delors could be sure that we would oppose such ideas. Lamy said that he would keep in close touch with us on this issue with which he believed we would continue to see eye to eye.

D H A Hannay

25 July 1989

ec.jn/Brown/26.7.1

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Mr A Allan,
For information
Mary Brown
27/7.

You may like to see.

File

EMU(W)(89)1ST METING
26 JULY 1989

HER MAJESTY'S TREASURY

CO-ORDINATING GROUP ON ECONOMIC
AND MONETARY UNION

MINUTES OF A MEETING HELD AT 11.30AM ON
MONDAY 24 JULY IN ROOM 113/2, TREASURY CHAMBERS

Those present:

Mr N L Wicks (Chairman)
Mr H Evans
Mr J Odling-Smee
Mr R I G Allen
Mr C Riley
Mr R Bonney
Miss O'Mara
Mr A Tyrie

Mr D Hadley - Cabinet Office
Sir D Hannay - UKREP
Mr J Kerr - Foreign Office
Mr A Crockett - Bank
Mr J Arrowsmith - Bank
Miss J Wheldon - Treasury Solicitors

Secretary: Mrs M E Brown

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1. Mr Wicks said that the Group's main tasks were set out in his letter of 20 July to Mr Hadley. Stage 1 was the immediate priority. Other work was also in hand elsewhere in the Treasury and would need to be taken into account as necessary.

2. Three initial points were addressed:

(i) High Level Group

Sir David Hannay said that the idea of setting up a high level Community group on EMU had come from the French at the Foreign Affairs Council. Delors, however, had shown no interest, and indicated that he wanted to spend the Autumn talking in a more open way to the main participants. In the end there had been no agreement at the Council on either a high level group or on the attempt to put the FAC in the lead on EMU. The Group agreed that a suitable opportunity should be taken to emphasise to Trichet the UK's opposition to a high level group. Mr Kerr would also make the point to de Boissieu (Foreign Ministry). Mr Kerr would consider asking posts to lobby on this: the best time might be in the week before Antibes, when there would probably other points for them to raise too.

(ii) Revision of 1964 Decision on Cooperation between the Central Banks of the Member States

Mr Crockett said that at the meeting of alternates of Central Bank Governors on 19 July the UK had secured improvements to the Bundesbank draft, though some points were unresolved. A re-draft would be considered by Central Bank Governors in the current week. It would then be sent to the Commission who were expected to submit it for discussion at the informal ECOFIN in September. It would probably be an informal proposal at that stage, but would have to be adopted formally before a Council Decision could be taken in December. Sir David Hannay said that all the revised legal texts would have to go to the European Parliament for an Opinion, which made the Presidency's timetable look very tight.

(iii) Legal Base of Revised Texts

Miss Wheldon referred to the 6 texts listed in Mr Bostock's letter of 18 July to Mr Allen about legislation for Stage 1. A revision of the 1974 Convergence Decision would require unanimity. The Directive of 18 February 1974 on stability, growth and full employment would require a qualified majority (because it was an "implementing directive" under Article 103 of the Treaty). The three Decisions on monetary matters (64/300, 64/301 and 71/142) all cited Article 105, and the two 1964 Decisions also cited Article 145(1). If these Articles were a sufficient base for legislation, amendments could be made by simple majority. However, it was arguable that those Articles were not a sufficient legal base because they did not provide for the Council to take Decisions. In that case Article 235, requiring unanimity, would apply. But there was no guarantee that the European Court would accept such a line of argument. Mr Arrowsmith said he had heard that the Commission would want to proceed by unanimity, and was considering citing Article 102(a). They might see this as a way of augmenting their own role in the monetary field.

The Group agreed that the UK's stance for the time being should be to assume that Stage 1 legislation would require unanimity. The position could be reviewed in about October, when questions of substance would be clearer. Meanwhile nothing should be said which conceded that simple or qualified majority was the appropriate voting method. The Group also agreed that UKREP should investigate informally the Commission's thinking on the appropriate legal base for the texts, and how and why it might use Article 102(a). Mr Wicks stressed the importance of ensuring that the Commission did not extend its competence in monetary matters, and that it continued to have no part in the arrangements for running the ERM.

3. The Group's future work was then discussed. Sir David Hannay thought it necessary to divide the work on negotiating tactics, institutions and accountability into two distinct parts: Stage 1 and the longer term. Work on accountability had to be closely linked to our thinking on institutional options. All work on longer term matters needed to be related to Delors' "6 questions" about EMU. [The telegram reporting these is attached]. Mr Wicks said the Chancellor would need speaking notes on each question for Antibes and would want to be able to show that any more general points he made related back to Delors' questions.

4. On Stage 1, Sir David Hannay said it was important to differentiate between the things which had to happen before Stage 1 started - notably the revision of legal texts; and those which had to have happened before Stage 1 finished. Mr Wicks agreed, but said we might want to reserve the possibility of objecting to the passage of the paving legislation if progress on, for instance, single market measures was not fast enough. The Group recognised that it was probably unrealistic to expect to delay the start of Stage 1. But the UK could certainly insist that all capital liberalisation scheduled for 1 July 1990 was fully implemented before Stage 1 started. And it might want to use the negotiations on legislation as a means of putting pressure on other member states on certain specific items, especially in the financial area.

5. The Group commissioned the following items of work:

(i) Mr Kerr to send Mr Wicks a note before the end of August distinguishing between accountability to Community institutions on the one hand, and to national political institutions on the other. It was important to ensure that UK statements about the need for political accountability were not misinterpreted as a call for Community institutions to be strengthened;

(ii) Mrs Brown (consulting other members of the Group and FIM Division, Treasury) to prepare a checklist of the items which needed to be implemented during Stage 1. This should cover all remaining items in the Commission's Single Market programme, together with any other items which the UK would regard as essential to Stage 1, especially relating to financial services, competition and free movement of capital.

(iv) Miss O'Mara would provide a note on possible additional elements relating to private development of the ecu, consulting UKREP on Commission thinking in this area. (However, the Group did not think the UK should press for major additional items in Stage 1, such as reviving the idea of a European Reserve Fund);

(v) EC Division, consulting other members of the Group, to provide a critique of the Commission's proposals for revising the Convergence Decision. UKREP would try obtain these as soon as possible, and the critique should be available by end-August if possible.

6. Mr Wicks asked whether there was any possibility of President Mitterand trying to get a decision in December on calling an IGC, even though it could not meet until July 1990. Sir David Hannay and Mr Kerr said that this was always possible, and German attitudes (which would be influenced by the Federal elections in December 1989) would be influential. On the whole, however, they thought the French would stick to getting decisions on Stage 1 in their Presidency.

7. It was agreed that the next meeting would be held, if possible, on 4 or 5 September. [A meeting notice will be circulated as soon as possible].

HM TREASURY
26 July 1989

Copies to: those present

PS/Sir P Middleton
Mr Scholar
Mr Peretz (or)
Ms Symes
Mrs Chaplin
Mr Bostock - UKREP

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FRAME ECONOMIC

FOREIGN AFFAIRS COUNCIL: 17 JULY 1989
FOLLOW UP TO EUROPEAN COUNCIL

SUMMARY

1. A LENGTHY TOUR DE TABLE ON FUTURE WORK ON EMU. SOME PRESSURE FOR A STRONG COORDINATING ROLE FOR THE FOREIGN AFFAIRS COUNCIL (FAC). FRANCE ANXIOUS FOR RAPID PROGRESS. THE PRESIDENCY PROMISED PROCEDURAL PROPOSALS, POSSIBLY INVOLVING THE SETTING UP OF A HIGH LEVEL GROUP.

DETAIL

2. DELORS (COMMISSION) RECALLED THE DISCUSSION AT THE ECOFIN COUNCIL. THE WHOLE OF THE 9/10 SEPTEMBER INFORMAL MEETING WAS TO BE DEVOTED TO STAGE I. THEY WOULD NEED TO CONSIDER IN PARTICULAR THE STRENGTHENING OF THE ROLE OF THE COMMITTEE OF GOVERNORS OF CENTRAL BANKS. AS FOR LATER STAGES (HE WOULD NOT CALL THEM STAGES II AND III SINCE THE DELORS REPORT HAD NOT BEEN ADOPTED AS SUCH), THERE WERE SIX QUESTIONS FOR THE FOREIGN AFFAIRS COMMITTEE TO CONSIDER:

(A) SHOULD THERE BE GREATER CENTRALISATION FOR MONETARY THAN FOR ECONOMIC POLICIES AS HIS REPORT HAD SUGGESTED, IN VIEW OF THE SMALL PROPORTION OF PUBLIC EXPENDITURE WHICH WOULD BE CENTRALISED COMPARED WITH TYPICAL FEDERAL STATES?

(B) WHAT BINDING RULES SHOULD THERE BE ON MEMBER STATES AND CENTRAL BANKS? SHOULD THESE FOCUS ON DEFICITS AND THEIR FINANCING?

? (C) HOW MUCH COHESION WAS NEEDED?

(D) WAS THE NEW FEDERAL CENTRAL BANK PROPOSED IN HIS REPORT ACCEPTABLE?

(E) SHOULD THE EUROPEAN CENTRAL BANK BE ACCOUNTABLE TO THE EUROPEAN PARLIAMENT AND EUROPEAN COUNCIL?

(F) SHOULD THERE BE SOME DEMOCRATIC QUID PRO QUO FOR THE GROWING ROLE OF THE SYSTEM?

3. DUMAS (PRESIDENCY) NOTED THAT THE MADRID CONCLUSIONS INCLUDED THE FOREIGN AFFAIRS COUNCIL AMONG THE BODIES WHO WERE TO DO FOLLOW UP WORK. ITS ROLE SHOULD BE ONE OF OVERALL COORDINATION AND THE PRESIDENCY WOULD PUT FORWARD SPECIFIC PROPOSALS. EYSKENS (BELGIUM) THOUGHT THE FOREIGN AFFAIRS COUNCIL SHOULD HAVE A CREATIVE ROLE PARTICULARLY ON INSTITUTINAL ISSUES, IN ADDITION TO ITS COORDINATING ROLE. SOLBES (SPAIN) SAID THE FAC'S ROLE WAS MORE ONE OF PROCEDURE THAN OF SUBSTANCE. MADAME CRESSON (FRANCE) EMPHASISED THE NEED FOR SPEED. THE COMMISSION SHOULD SUBMIT ITS IDEAS AS SOON AS POSSIBLE SO THAT THE TIMETABLE COULD BE ADHERED TO.

4. GENSCHER (GERMANY) SAID IT WAS FOR THE PRESIDENCY TO DECIDE ON THE PRECISE ROLE OF THE FAC WHICH SHOULD COMBINE COORDINATION WITH MAKING ITS OWN CONTRIBUTION. MRS CHALKER REFERRED TO THE CONCLUSIONS OF ECOFIN ON 10 JULY, EMPHASISING THAT THE ECOFIN COUNCIL SHOULD TAKE THE LEAD ON THE BASIS OF THE WORK PROGRAMME WHICH THEY HAD DISCUSSED. THE SIX QUESTIONS POSED BY DELORS WERE NOT EXHAUSTIVE AND WE SHOULD ''HASTEN SLOWLY''. CALAMIA (ITALY) AND MOLLER (DENMARK) ALSO SUPPORTED THE NEED FOR A SUBSTANTIAL ROLE FOR THE FOREIGN AFFAIRS COUNCIL.

5. POOS (LUXEMBOURG) SUPPORTED THE TIMETABLE PROPOSED BY THE COMMISSION AND PRESIDENCY AT ECOFIN. THE FAC SHOULD HAVE ITS NORMAL COORDINATING ROLE AND SHOULD HAVE EMU PERMANENTLY ON ITS AGENDA. PAPOULIAS (GREECE) EMPHASISED THE IMPORTANCE OF STRUCTURAL POLICY AS PART OF STAGE I AND AGREED WITH THE 10 JULY ECOFIN CONCLUSIONS. COLLINS (IRELAND) AGREED WITH THE PRESIDENCY PROPOSALS FOR THE TIMETABLE. PINEIRO (PORTUGAL) SAID IT WAS IMPORTANT TO AVOID CLASHES WITH ECOFIN AND TO DEFINE CAREFULLY THE RESPECTIVE ROLES OF THE TWO COUNCILS. NIEMAN (NETHERLANDS) SAID IT WAS FOR THE PRESIDENCY TO DECIDE HOW TO SPLIT UP THE WORK BETWEEN THE FAC AND ECOFIN.

6. CHRISTOFFERSEN (COMMISSION) SAID THE COUNCIL AND COMMISSION HAD AGREED ON THE TIMETABLE PRESENTED TO ECOFIN. ECOFIN'S ROLE WAS TO DEAL WITH THE SUBSTANCE OF STAGE I AND THE MACROECONOMIC ELEMENTS OF STAGES II AND III. THE FAC'S ROLE WAS TO MONITOR THE WORK, TO PREPARE FOR THE EUROPEAN COUNCIL, TO DEAL WITH INSTITUTIONAL QUESTIONS AND SOME ASSOCIATED POLICIES AND TO PREPARE FOR THE IGC. THE TIMETABLE AGREED AT ECOFIN WAS A TIGHT ONE. STAGE I MUST BE PREPARED DURING THE FRENCH PRESIDENCY, WITH AGREEMENT IN PRINCIPLE AT THE NOVEMBER ECOFIN SO THAT THE STRASBOURG EUROPEAN COUNCIL COULD

TAKE STOCK OF THE WORK ON STAGE I.

7. DUMAS SAID THAT AT STRASBOURG IT MUST BE POSSIBLE TO SHOW DEFINITIVE PROGRESS ON STAGE I AND USEFUL PROGRESS ON STAGES II AND III. TO MAKE THIS POSSIBLE THE COMMISSION'S PAPER SHOULD BE READY IN THE FIRST HALF OF SEPTEMBER NOT THE SECOND. HE ALSO SUGGESTED THAT ONE WAY OF IMPROVING COORDINATION WOULD BE TO SET UP A HIGH LEVEL GROUP OF PERSONAL REPRESENTATIVES, LIKE THE DONDELINGER GROUP SET UP IN CONNECTION WITH THE SINGLE EUROPEAN ACT. THE PRESIDENCY WERE THINKING OF PUTTING FORWARD PROPOSALS ON THESE LINES.

8. DELORS SAID A PAPER COULD BE PRODUCED BY MID SEPTEMBER BUT IT WOULD BE A PAPER SETTING OUT THE PROBLEMS, NOT GIVING FINAL ANSWERS. THE COMMISSION NEEDED MORE TIME FOR REFLECTION AND TO LISTEN TO MEMBER STATE'S VIEWS.

9. MRS CHALKER SAID ANY PAPER SHOULD BE PREPARD FOR THE SEPTEMBER INFORMAL ECOFIN, RATHER THAN FOR THE FAC. WE WERE DOUBTFUL ABOUT THE IDEA OF A HIGH LEVEL GROUP: THE DONDELINGER GROUP HAD BEEN SET UP AFTER THE CONVOCATION OF THE IGC ON THE SEA. POOS AND NIEMAN SAID THEY WERE NOT KEEN ON A HIGH LEVEL GROUP. GENSCHER SAID HE WAS.

10. DUMAS CONCLUDED THAT THE COMMISSION HAD ACCEPTED HIS PROPOSAL TO PRODUCE A DOCUMENT BY 15 SEPTEMBER AND THAT THE PRESIDENCY WOULD SUBMIT CONCRETE PROPOSALS ABOUT THE FAC'S COORDINATING ROLE.

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EMU(PM)(89) 1
27 July 1989

PWP

HER MAJESTY'S TREASURY

SIR PETER MIDDLETON'S CO-ORDINATING GROUP ON ECONOMIC AND MONETARY UNION

Note by the Secretaries

1. The attached paper by Mr Odling-Smee is circulated for discussion at the meeting of the Group on Friday 28 July. In the time available it has not been possible to edit the annexes to remove some overlap with the main text. Mr Odling-Smee apologises for the physical appearance of the paper, caused by a word processor failure on 27 July.

2. A telegram reporting President Delors' speech to the European Parliament on 26 July is also attached for information. Paragraph 6 refers to EMU.

Mrs M E Brown)
Miss M O'Mara) Secretaries

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OF 261810Z JULY 89
INFO ROUTINE EUROPEAN COMMUNITY POSTS, STRASBOURG, VIENNA

FRAME GENERAL

EUROPEAN PARLIAMENT PLENARY, STRASBOURG, 26 JULY 1989:
SOLBES AND DELORS ON THE MADRID EUROPEAN COUNCIL

SUMMARY

1. STANDARD REPORT BY THE SPANISH PRESIDENCY ON THEIR SIX MONTHS AND THE MADRID EUROPEAN COUNCIL IN WHICH SOLBES PREDICTED THAT THE INTER-GOVERNMENTAL CONFERENCE ON ECONOMIC AND MONETARY UNION WOULD MEET AS SOON AS STAGE ONE OF EMU BEGAN: JULY 1990. DELORS SPOKE IN TERMS OF VEILED DISAPOINTMENT OF THE OUTCOME OF THE MADRID EUROPEAN COUNCIL, DESCRIBED THE CONCLUSIONS ON EMU OBJECTIVELY, AND REGRETTED THE IDEOLOGICAL NATURE OF THE DISCUSSION ON SOCIAL AFFAIRS.

DETAIL

SPANISH PRESIDENCY REPORT

2. THE SPANISH MINISTER OF STATE AT THE FOREIGN MINISTER, SOLBES, STOOD IN FOR THE CONVALESCENT FERNANDEZ ORDONEZ AND SPOKE AT LENGTH ON THE SPANISH PRESIDENCY AND MADRID (TEXT BY BAG TO ECD(I) AND MADRID). ON INSTITUTIONAL RELATIONS HE PLEASED HIS AUDIENCE BY EMPHASING THE INEVITABLE PROGRESS TOWARDS EUROPEAN INTEGRATION - BUT SAID NOTHING CONTROVERSIAL. ON THE SINGLE MARKET, THE SPANISH PRESIDENCY HAD ACHIEVED A COMMON POSITION OR ADOPTION OF SEVEN REGULATIONS, 45 DIRECTIVES AND 10 DECISIONS. ON THE SOCIAL DIMENSION IT WAS NOT POSSIBLE IN THE SPANISH PRESIDENCY TO SECURE APPROVAL FOR THE SOCIAL CHARTER, PARTLY FOR POLITICAL REASONS CONCERNING ONE MEMBER STATE AND PARTLY ON ACCOUNT OF THE TIMETABLE. SOLBES MAJORED ON THOSE SOCIAL CONCLUSIONS AT MADRID AGREED UNANIMOUSLY. HE CHRONICLED PRESIDENCY ACHIEVEMENTS ON THE ENVIRONMENT, NOTING THAT MADRID HAD ''RESPONDED POSITIVELY TO THE IDEA OF A EUROPEAN ENVIRONMENTAL AGENCY'' WHICH THE COUNCIL WOULD STUDY. HE BEMOMOANED LACK OF PROGRESS ON PEOPLE'S EUROPE, NOTABLY THE RIGHT OF RESIDENCE AND PARTICIPATION IN LOCAL ELECTIONS. ON EMU, HE SPELLED OUT THE MADRID CONCLUSIONS IN SEVEN POINTS, THE SEVENTH BEING ''THIS CONFERENCE (IGC) WILL MEET AS SOON AS THE FIRST STAGE HAS BEGUN - IE AS OF 1 JULY 1990''. SOLBES DESCRIBED THE MADRID OUTCOME AS AN AGREEMENT ON WHAT WAS POSSIBLE - IMPORTANT BOTH FOR THE DECISIONS THEMSELVES AND BECAUSE A RUPTURE IN THE EC WAS

AVOIDED.

3. SOLBES SPOKE REMARKABLY ON EXTERNAL RELATIONS AND EUROPEAN POLITICAL CO-OPERATION, COVERING EC/EFTA, EC/US AND EAST/WEST. HE DWELT ON LATIN AMERICA AND DEBT. HE RECALLED SPAIN'S PROPOSAL FOR A EUROPEAN GUARANTEE FUND FOR THE DEEPLY INDEBTED STATES, TO BE EXAMINED BY ECOFIN. AFTER MENTIONING THE MIDDLE EAST, SOLBES RECALLED THE TWELVE'S STRONG CONDEMNATION OF IRAN'S INTOLERABLE DEATH SENTENCE ON RUSHDIE.

DELORS

4. DELORS CAME NEXT, SPEAKING IN FAIRLY MUTED TONES. HE PRAISED THE SPANISH PRESIDENCY AND FELIPE GONZALEZ FOR HIS SPIRIT OF COMPROMISE IN MAKING THE POLITICAL CHOICE TO AVOID CONFRONTATION LEADING TO RUPTURE. MADRID HAD DONE THREE THINGS:
(A) REAFFIRM THE COHERENCE OF THE SINGLE EUROPEAN ACT AS A WHOLE
(B) ENHANCE THE EC'S EXTERNAL PROFILE AND
(C) REACH CONCLUSIONS ON EMU.

5. NOTING THAT THE EP HAD LONG ARGUED THAT COHESION WAS A PRE-CONDITION FOR EMU , DELORS STRESSED THE IMPORTANCE THE COMMISSION ATTACHED TO THE STRUCTURAL FUNDS AND TO THE NEW RESEARCH AND DEVELOPMENT FRAMEWORK PROGRAMME (AS AN INSTRUMENT OF INDUSTRIAL POLICY).

ECONOMIC AND MONETARY

6. ON EMU, HE DREW THREE CONCLUSIONS FROM MADRID:
(A) THE CENTRAL PROPOSITION OF THE DELORS COMMITTEE (PARA 39) DID NOT COMMAND UNANIMOUS AGREEMENT OF THE MEMBER STATES
(B) THERE HAD BEEN AGREEMENT ON PHASE ONE, WITH SOME RELECTION ON THE NEXT STAGES
(C) INSTITUTIONAL PROBLEMS OF EMU WERE ON THE TABLE.

THE SITUATION WAS NOT OF 11-1: IT WAS MUCH MORE COMPLICATED. THERE HAD BEEN A CHOICE BETWEN CRISIS AND A COMPROMISE TO GO FORWARD. THE LATTER WAS CHOSEN. HE NOTED THE SPEED WITH WHICH THE IGC LEADING TO THE SINGLE EUROPEAN ACT HAD COMPLETED ITS WORK. BY 1990 (1 JULY) THE 1964 AND 1974 MEASURES NEEDED TO BE REVISED. THE DELORS REPORT WAS A GOOD BASIS FOR WORK, BUT NOT THE BASIS. THERE NEEDED TO BE RESPECT FOR SUBSIDIARITY: A TRANSITIONAL PERIOD FOR SOME MEMBER STATES: AND PARALLEL PROGRESS ON MONETARY AND ECONOMIC UNION. HE PREDICTED THAT COUNTER-PRPOSALS ON MONETARY UNION ONLY WOULD SEE THE LIGHT OF DAY IN THE AUTUMN, IF THEY DID NOT TACKLE ECONOMIC UNION, THEY WOULD NOT DO. THE EP WOULD TAKE PART IN THE COLLECTIVE CONSIDERATION ON EMU. DELORS WANTED TO ILLUSTRATE THE POSITIVE ASPECTS. THE SINGLE MARKET ALONE COULD NOT DO EVERYTHING. AS TO SOVEREIGNTY, THE POLITICAL ARGUMENT WAS THAT A COMMON EXPRESSION OF SOVEREIGNTY, SHARING RESPONSIBILITIES, WAS NEEDED. WHAT WAS THE MARGIN OF NATIONAL

SOVEREIGNTY ON THSE ISSUES IN EACH MEMBER STATE TODAY? FINALLY, THERE WAS A NEED TO REINFORCE THE DEMOCRATIC COUNTER-WEIGHT OF EMU THROUGH REPRESENTATIVE COMMUNITY INSTITUTIONS RESPONDING TO PUBLIC OPINION.

SOCIAL AFFAIRS

7. ON THE SOCIAL DIMENSION, DELORS NOTED THAT DEBATE TENDED TO BE TOO IDEOLOGICAL. THE COMMISSION ACTED ACCORDING TO THE PRINCIPLES OF SUBSIDIARITY AND RESPECT FOR NATIONAL TRADITIONS (HENCE THE DIFFERENT MODELS FOR WORKER PARTICIPATION IN THE EUROPEAN COMPANY STATUTE). THE COMMUNITY'S TRACK RECORD WAS NOT BAD. JOBS WERE BEING CREATED ON A LARGE SCALE. THE SOCIAL DIALOGUE WAS IMPERATIVE. ON THE SOCIAL CHARTER, HE HAD SOUGHT AGREEMENT BY SPELLING OUT ITS EXTENT AND ITS LIMITATIONS AS AN AFFIRMATION TO THE OUTSIDE WORLD OF COMMUNITY VALUES. ONE MEMBER STATE WAS AGAINST, SO HE HAD TRIED TO DISTINGUISH BETWEEN A SIMPLE, SOLEMN DECLARATION AND AN IMPLEMENTING PROGRAMME WITHIN THE EC TREATY. BUT IN VAIN. HE INVITED HIS LISTENERS TO JUDGE FROM THIS CHARACTER OF THAT OPPOSITION. THE COMMISSION WOULD MAKE PROPOSALS WITHIN THE TREATY, USING ALL ITS ASPECTS.

OTHER ISSUESS

8. ON THE ENVIRONMENT, HE DESCRIBED TTHE PROPOSED ENVIRONMENTAL AGENCY AS PROVIDING A PERMANENT CHECK-UP ON THE PLANET EARTH, SCIENTIFIC EVIDENCE MUST BE GARNERED BEFORE PROPOSALS FOR SOLUTIONS WERE TABLED. EFTA AND OTHER EUROPEAN COUNTRIES COULD JOIN. IF THE AGENCY TURNED INTO AN INTERNATIONAL BODY, SO MUCH THE BETTER.

9. SPEAKING IN STANDARD TERMS ON THE SINGLE MARKET, FREE MOVEMENT OF PEOPLE ETC, DELORS STRONGLY DEFENDED THE COMMISSION'S ATTITUDE TO THE DRAFT BROADCASTING DIRECTIVE, WHICH REPRESENTED THE ONLY REASONABLE COMPROMISE AVAILABLE.

10. ON EXTERNAL ISSUES, HE REPEATED THE VIEWS HE EXPRESSED TO THE EP IN JANUARY ON THE NEED FOR A THIRD WAY FORWARD ON EC/EFTA (NOT ACCESSION, NOR THE STATUS QUO). EC ENLARGEMENT WAS IN PRACTICE NOT POSSIBLE FOR NOW. THE AUSTRIAN APPLICATION WOULD BE EXAMINED CLOSLEY IN AN OPEN SPIRIT, BUT THIS IN NO WAY CHANGED THE NEED TO FIND THE THIRD WAY IN RELATIONS WITH EFTA. AFTER MENTIONING EASTERN EUROPE AND LOME IV (INCLUDING STRUCTURAL ADJUSTMENT) HE CAME TO CENTRAL/LATIN AMERICA AND COMMUNITY ACTION ON DEBT. THE COMMISSION FORMALLY SUPPORTED THE SPANISH PRESIDENCY'S PROPOSED EUROPEAN GUARANTEE FUND. AFTER THE RECENT DEAL BETWEEN MEXICO AND THE BANKS, HE HOPED THE CLIMATE FOR THE SP&ANISH PROPOSAL WOULD BE BETTER.

11. RESPONDING TO A LONG DEBATE, DELORS COMPLIMENTED THE SPANISH PRESIDENCY FOR ITS VALIANT EFFORTS IN COUNCIL ON INSTITUTIONAL QUESTIONS (''TRYING TO MAKE THE DEAF HEAR AND THE DUMB SPEAK''). THE PROBLEM OF EMU AS THE NEXT WAY TO APPROACH

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INSTITUTIONAL DEVELOPMENT. HE RECALLED (BELATEDLY) THAT HIS REPORT ON EMU HAD BEEN AGREED UNANIMOUSLY BY CENTRAL BANK GOVERNORS. THE CRISIS AVERTED AT MADRID HAD BEEN A CRISIS OF ABSENCE OF DECISION. ON THE SOCIAL DIMENSION, HE RECALLED THAT THE MADRID CONCLUSIONS HAD ANNEXED TO THEM CONCLUSIONS FROM THE SOCIAL AFFAIRS COUNCIL. HE WOULD BE HAPPY TO SEE THE EP PREPARE AND CONDUCT A DEBATE ON THE SOCIAL DIMENSION COVERING WHAT HAD BEEN DONE UNDER THE TREATY SINCE 1957 SEMICOLON WHERE TO GO ON UNIFORMITY SEMICOLON AND WHAT THE EP THOUGHT OF THE EUROPEAN COMPANY STATUTE AND SOCIAL DIALOGUE. HE STRESSED THE NEED FOR SUBSIDIARITY, DIVERSITY AND PROGRESSIVITY. SOME MEMBER STATES LEFT IT TO THE SOCIAL PARTNERS TO WORK OUT THE TERMS OF THEIR RELATIONS. WAS THE EP REALLY AGAINST SUCH AUTONOMY? THE DEBATE WAS WORTH HAVING, BUT NEEDED PREPARATION.

HANNAY

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ADDITIONAL 1

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MODELS OF ECONOMIC AND MONETARY UNION

Introduction

Monetary policies

Extending the ERM
(i) Narrower bands
(ii) Incorporation of non-EC members in ERM
(iii) Common dollar/yen policy
Competing currencies
The gold standard and related models
The sterling area
Delors' Stage 3
Loose Delors

Other policies

Fiscal policy
Regional policy

Conclusions

Economic aspects
Institutions and accountability
Sustainability
Definitions of monetary union
Acceptability to EC partners
Overall assessment of monetary models
Fiscal and regional policies

CONFIDENTIAL

MODELS OF ECONOMIC AND MONETARY UNION

INTRODUCTION

1. This paper discusses alternative models of economic and monetary union, with emphasis on monetary union. The main models considered are:

- strengthening the exchange rate mechanism by:

  - having narrower margins;
  - incorporating non-EC members;
  - a common dollar/yen policy.

- competing currencies:

- the gold standard, or more generally a commodity standard (a weighted average of commodities might in practice be more suitable, although for convenience the discussion is mainly in terms of the gold standard);

- the sterling area, or at least an area in which one currency and one monetary authority is dominant - in practice these will probably be the deutschemark and the German;

- "loose" Delors, namely an arrangement whereby national monetary authorities continue to make monetary policy decisions but in a framework of greater co-ordination and consultation at the Community level. Alternatively this could be thought of as a permanent Delors Stage 2.

For completion and as a basis for comparison Delors Stage 3 is discussed, fairly briefly in the main text and more fully in Annex 3.

2. The first four models and, to some extent, the fifth do not necessarily involve any European central monetary authority or decision-making capacity. They can therefore be contrasted with full Delors (Stage 3) which obviously does.

3. The implicit basis of comparison for the alternative models is Delors Stage 1. In other words, it is assumed that all currencies are in the ERM with margins of 2¼ per cent, there are free capital flows, and a single market in banking.

4. Much of the argument is at a fairly high level of generality. Details can be filled in at the next stage when one or more of the models is subject to more careful analysis.

5. As mentioned above, the main emphasis is on monetary policy which accounts for the bulk of the paper. There are brief sections on fiscal and regional policies and a concluding section which picks out the main points. Further details on three of the models are in the annexes.

MONETARY POLICIES

~~Strengthening~~ Extending the ERM

6. Three ways of ~~strengthening~~ extending the ERM are considered: narrower bands, the incorporation of non-EC members and a common dollar/yen policy.

(i) <u>Narrower bands</u>

7. The Delors Report recommends that in Stage 1 all Community currencies should be included in the ERM on the same rules. This implies that the possibility of operating with a wider 6 per cent band would be removed. In line with this, when the Monetary Committee discussed the entry of the peseta into the ERM, the subsequent communique noted "The Ministers and Governors agreed to review the issue of the currencies currently availing themselves of wide fluctuation margins with a view to having such margins reduced as soon as economic conditions permit".

8. During Stage 2, the Delors Report proposes that not only should realignments become less frequent but "as circumstances permitted and in the light of progress made in the process of economic convergence, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero".

9. In practice, the adoption of narrower bands should probably be a two stage process with a move to a single 2¼ per cent band during Stage 1 and a subsequent change to, say, 1 per cent. Smaller and more frequent changes would add complication, without offering significantly greater flexibility.

10. **Monetary policy and targets would** continue to be set, as now, at the domestic level. There would be no need for a Community monetary policy or Community monetary targets. But as the scope for exchange rate fluctuation was reduced, the need for prior consultation about interest rate changes would correspondingly increase.

11. It is sometimes argued that with narrower bands, and exposure to large capital flows on full liberalisation, the ERM would become unstable and eventually break up. In fact, most capital controls have already been abolished in the major member states, yet the ERM has not experienced a realignment since January 1987. On the other hand, the situation remains one in which the deutschemark is the only serious investment currency within the system. What the situation will be when, for example, the French franc has acquired investment currency status - which seems inevitable when the full effects of the removal of exchange controls become apparent - remains to be seen. Certainly, narrowing the bands would reduce the monetary authorities' freedom of tactical action to some degree. They would be less able to "punish" speculators by allowing within-the-band variation of the exchange rate.

12. There would also be implications for the "Walters Critique". There are two separate strands to this argument:

a) immediately after a realignment there will be a period of time during which markets will be entirely confident that no further change in parity will take place. Over this period, nominal short term interest rates - those relating to shorter periods than the anticipated period without a realignment - will have to be the same in the countries involved, at least in those countries where money and financial markets are reasonably well developed. If they were not, profitable speculation possibilities would arise and the resulting transactions would bring about the equality of interest rates. However, if inflation is higher in one country than the others, the real interest rate in that country will be lower than elsewhere - quite the opposite of what is wanted to generate convergence on a common low inflation rate.

b) if inflation differentials persist, then as the time since the last realignment lengthens markets will come to expect one. They will demand a premium on interest rates of currencies which are expected to depreciate sufficient to offset the effects of the depreciation. But since markets will not know when realignments will occur, or how hard national monetary authorities will resist, or how big they will eventually be, the degree of uncertainty will be substantial. Consequently, there are liable to be gyrations in short-term interest rates. Even though longer rates may be unaffected, these gyrations may be disruptive and potentially damaging to the economies concerned.

13. As criticisms of the existing ERM, these arguments are blunted by the fact that it is not a fixed exchange rate system but one with bands wide enough to allow considerable movements in the exchange rate without triggering a realignment. But if the bands were narrowed, then the criticisms would come to have increased force. On the other hand, even a 1 per cent band would permit a maximum of 2 per cent movement in one currency against another without a realignment, and so allow - for example - a

4 per cent differential in three month interest rates, consistent with a market expectation of a 1 per cent depreciation of one currency against the other over the following three months. Clearly, though, the flexibility would not be limitless.

14. There would be no need for any change in the institutional arrangements on which the EMS was based if narrower bands were adopted (although it would be necessary to amend some of the supporting legal documents which refer explicitly to 2¼ per cent fluctuation margins eg the Council resolution of 5 December 1978 and the central bank agreement of 13 May 1979).

(ii) Incorporation of non-EC members in ERM

15. Article 5.2 of the Council Resolution of 5 December 1978 establishing the EMS states:

> "European countries with particularly close economic and financial ties with the European Communities may participate in the exchange rate and intervention mechanism."

In practice, none has applied to do so, although Norway, for one, has shown signs of interest from time to time.

16. The perceived advantages and disadvantages of increased membership may differ according to viewpoint:

a) a greater area of currency stability would have, in principle, some economic benefits. But in practice the size of the candidate economies is relatively small;

b) procedurally, having more members of the ERM would make changes more difficult to agree. On one interpretation, that could slow down movement towards monetary union. But alternatively, it could increase the tensions sufficiently to generate two - or multi - speed movements by different groupings within the enlarged ERM.

17. Expansion of the ERM to non-EC members could, in principle, be coupled with a narrowing of the ERM bands, although it would almost certainly have to precede a decision to adopt, say, a 1 per cent band for ERM participants. It would also not rule out the pursuit of a common dollar/yen policy. However. it would be difficult, although not impossible, to integrate it with some of the associated institutional changes discussed under those options.

18. To the extent that the inclusion of non-EC members would be seen to make it harder, rather than easier, to achieve full economic and monetary union on a <u>Community</u> basis (if defined to include, inter-alia, the setting of monetary policy for the Community as a whole and perhaps centralised budgetary decisions), those most enthusiastic for this form of EMU would probably find this option unattractive and could turn to more radical solutions.

19. There would be no need to change the existing monetary arrangements. Monetary targets and policies would continue to be set at the national level.

20. There are no significant institutional implications.

(iii) <u>Common dollar/yen policy</u>

20. This could be an alternative or compliment to a policy of narrower bands.

21. At the minimum, it might simply reflect a concern to ensure that when individual member states intervened vis a vis the dollar or yen, they did so consistently and that the market impact of one country's action was not immediately offset by the action of another ERM member. Incidents of mutually inconsistent market intervention by major countries have occurred in the past but have not usually involved two ERM members since they have a common interest in ensuring a consistent action. This suggests that informal understandings already exist within the Mechanism on intervention against third currencies. By definition, we in the

UK, as non-ERM participants, do not know for certain that understandings of this kind exist, or the form they take. But if they are already in place and working quite effectively, we cannot offer their introduction as an alternative to a more full-blooded version of monetary union.

22. On the other hand, a common dollar/yen policy could take the form of agreement at Community level on ranges to be adopted towards major third currencies. That would require, at the least, an intensification of the informal cooperation and coordination which existed among the major Community countries under the Plaza and Louvre agreements. But given the scope for differing interpretation and tactical judgement, it would probably be necessary to formalise the arrangements. In this case, the dollar and yen ranges would have to be set (perhaps framed only in terms of the deutschemark and sterling), in consultation with the US and Japan, however grey around the edges and subject to review, and there would have to be some burden-sharing agreement on intervention.

23. Monetary targets would continue to be set at national level, with no need for targets for the Community as a whole. However, advance consultation on interest rate moves would again be required because of their implications for third currencies as well as within the Community.

24. In theory, such a policy would not require any adaptation of the existing institutional arrangements. However, in practice, it is difficult to see how individual member states could be required to meet their obligations without some form of monitoring, or even sanction. It would be important to ensure that there was some political input, as in the G7 context: coordination could not be left to central banks alone. The formulation of strategic guidelines and monitoring could take place at regular, say

monthly, intervals and might perhaps be based on the monthly meetings of the Monetary Committee. It would be more difficult to agree how tactical decisions should be taken in the light of intervening market developments, particularly since individual member states or central banks might well disagree over the appropriate response to be made.

25. For this reason, there would no doubt be pressure from the French and others to review the (disputed) proposals contained in the Delors Report under Stage 1 for the creation of a European Reserve Fund, headed by Central Bank Governors, which would have access to a proportion of each member state's foreign currency reserves and would intervene on their behalf against third currencies. Such a development would be resisted by the UK, not least because of the transfer of sovereignty it would entail. We might have to accept in consequence that a common policy towards the dollar and yen would not amount in practice to much more than a revamped Louvre agreement which might be honoured more in the breach than in the observance. While this might well prove acceptable to the UK, its lack of substance might make it less attractive to some other member states.

26. Nevertheless, it might prove to be necessary to <u>require</u> member states to consult in advance of changing their interest rates (although they should not be bound by the outcome) and to set this out in a Community legal document. Given the shortage of time and the different constitutional position of member states, any such consultation would probably have to take place between central banks. The implications for eg the Bundesbank would be greater than for the UK, provided consultation was not regarded as binding.

27. At the same time, it would also be necessary to decide how consultation should take place with the US and Japan. Ideally, the present G7 arrangements would continue undisturbed but the smaller member states would probably object to their lack of representation and might insist that, at the least, the Presidency

and Chairman of the EC Central Bank Governors were also invited to attend, where otherwise excluded. The UK could live with this but the US and Japan might react adversely.

The Hayek Competing Currencies Model

28. Hayek proposed a system of competing national currencies each controlled by its own national monetary authority.* The currencies would be competing in the sense that transactions throughout the Community would be free to use whichever of the available currencies they wanted. National monetary authorities would then compete to make their currency the most attractive and thus the most widely used.

29. This proposal was in fact made quite specifically in a European context by Hayek in 1976 as a replacement for the monetary systems in place at the time. Hayek called this his "practical proposal". But underlying this proposal was one closer to Hayek's heart - his "generalised proposition" - which in fact takes up most of the pamphlet. This proposition was that any agent that wished should be allowed to issue his own currency, again competing freely so as to make his product widely and profitably acceptable. The generalised proposition is discussed in Annex 1 which also looks at the more restricted, specifically European, proposal.

30. Hayek formulated his concrete suggestion within a specifically European context as follows:

> "the countries of the Common Market, preferably with the neutral countries of Europe (and possibly later the countries of North America) mutually bind themselves by formal treaty not to place any obstacles in the way of free dealings throughout their territories in one another's

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* F A Hayek: "The Denationalisation of Money" IEA Hobart Paper 70, 1976.

currencies (including gold coins) or of a similar free exercise of the banking business by any institution legally established in any of their territories."

So although national governments would retain monopolies on issue of their particular currencies, competition throughout the EEC between national governments would bring many of the disciplinary benefits of the generalised proposal.

31. Many of Hayek's conditions have already largely been achieved or will be implemented within the foreseeable future:

(a) the Capital Liberalisation Directive will ensure freedom of capital movements within the Community from 1 July 1990 for all member states other than Spain, Ireland, Greece and Portugal who have a more extended timetable for meeting its requirements;

(b) the Second Banking Coordination Directive, scheduled to take effect from the beginning of 1993, will provide any bank with authorisation in its own country with a passport to open branches in any other part of the Community.

32. Together these measures will provide a good approximation to the conditions which Hayek called for in 1976. That would provide the basis for a competitive currency regime throughout the Community. However, even within the UK, some obstacles to the free use of Community currencies would remain in practice.

i. <u>Legal tender</u>: Where no contractual provision exists for repayment, debts have to be settled in legal tender, ie. sterling - if there is a dispute. If we were to remove all obstacles, we should therefore have to extend the definition of legal tender to cover all Community currencies. But one can imagine the outcry if creditors were forced to accept settlement of debt in any Community currency the debtor chose, particularly since, if the debt were incurred in sterling, it would presumably be up to the courts to determine the exchange rate at which settlement had to be made. (There would, by definition, be no contract which laid this down.) In principle, we could move in the opposite direction and abolish legal tender entirely. But that would mean that any contract - even ones usually left as implicit - would have to state explicitly what currencies both parties would then be prepared to accept for the purposes of the transaction;

This is important not only in itself but also because the accounting currency will often make a difference to the total tax liability.

ii. Company accounts: The position in UK law is unclear and has never been tested. However, in practice, wherever a company can reasonably argue that it would be appropriate to draw up its accounts in any currency other than sterling, it has been allowed to do so (eg. the oil companies are allowed to draw up their accounts in dollars). Presumably, if a company decided it wanted to denominate its accounts in another Community currency, it would be extending its use of that currency more generally, and so could meet this requirement. A draft SEMs directive, currently scheduled to come into force on 1 January 1990 but unlikely to be agreed for a couple of years or so, provides for companies in the Community to draw up their accounts in ecu (but not other Community currencies) as well as domestic currency.

iii. Truck Act effects: The Truck Acts themselves were superseded by the 1986 Wages Act which came into force at the beginning of 1987. But that does not override any pre-existing contractual agreement for payment to be made in cash. Section 1 of the 1831 Truck Act provides for employees to be paid in "current coin of the realm" ie. sterling. There is no legal bar to employees being paid in a currency other than sterling, provided both parties agree. But employees can insist on being paid in sterling even if employers would not choose sterling as one of its currencies.

33. The obstacles to perfectly free competition in currencies listed above in the case of the UK would doubtless be matched by similar other obstacles in each of the other countries. A comprehensive study would need to go through each country, identify what the relevant obstacles are and consider the prospects for breaking them down.

34. The extent of competition between currencies will also depend on the behaviour of governments. They can be expected to encourage the use of their own currencies to maximise the seignorage. On the other hand they may be reluctant to have too much currency held by other EC residents because of a perception that such holdings would be relatively volatile and so monetary policy more difficult to operate. National governments may themselves have a preference for using their own currencies. There is little doubt, for example, that in its own transactions the UK Government displays a marked preference for sterling:

(i) so far as the payments are concerned, although there is no requirement in tax law to pay tax due in sterling, the legal basis for requiring payment in sterling comes from the general law about debts having to be settled in legal tender. Customs apparently already accept payment in foreign currency in limited circumstances (eg. when it is the only sensible way of collecting the tax from an incoming passenger). But they are currently considering revising this practice because of the Exchequer risk and administrative costs (checking the foreign currency paid to match the sterling bill; keeping separate records for all the currencies until they are converted into sterling etc.) involved;

(ii) we have also fought very hard so far to ensure that payments to and from the Community budget are made in sterling, so that we can retain control of the flows within the Treasury and so that we can deposit any excess sterling overnight with the PGO.

No doubt, other Community countries display similar preferences for their own currencies.

35. Should everyone, including governments, be required to accept any currency in payment? The answer is no, because:

(i) competition between currencies will be enhanced by allowing creditors to choose the currency in which they will be paid:

(ii) it would put an extra cost of currency conversion ~~on~~ or risk onto the creditor, assuming that the debtor always paid in the cheapest possible way for him;

(iii) if the situation in (ii) were avoided by specifying in all contracts the currency of payment, transactions (including legal) costs would be high.

However, to prevent governments acting in protectionist ways by insisting on all payments to them being made in their own currencies, there might have to be some rules analogous to the EC public purchasing regulations.

Implications of European Competitive Currencies

36. It seems clear that one of the advantages of the competitive currency route would be that minimal <u>institutional</u> or <u>structural</u> changes would be required. The essence of the system would be that national monetary authorities would continue to administer their currencies just as at present save that their policies would be severally subject to the additional competitive discipline of making sure that their currencies continued to be widely used and accepted. So there would be no need for extra administrative machinery or institutions.

37. Indeed, arguably, the approach should lead to some dismantling of the existing cooperative framework - not least the Exchange Rate Mechanism. If competition between currencies is the driving force of this regime:

(a) cooperation between governments could be positively harmful. It would be harmful if it took the form of collusion between the monetary authorities to over-issue currency as a group and settle for a common positive level of inflation;

(b) the ERM - fixing the exchange rate between the individual currencies for the relatively long periods of time between realignments - could also help blunt the required competition. For an extended period of time after a realignment had taken place, potential users of currencies would regard them as largely interchangeable with no great pressure to prefer one to another, regardless of longer term considerations.

38. A further question which needs to be explored is what the implications of a competitive currency system would be for the eventual pattern and scale of currency usage in Europe. Although this is necessarily an exercise in prediction, experience to date gives some guide:

(a) one of the difficulties with the generalised competitive currency model is that transactors need to acquire a great deal of information to operate with multiple currencies. That means that if their "domestic" currency is reasonably well behaved, they are likely to stick with it even if some other currency is in principle a better one; related to this,

(b) currencies with a big initial presence have a substantial in-built advantage. Since there are large numbers of other potential transactors who know and understand them, these currencies will be attractive unless their monetary authorities render them very inconvenient;

(c) in practice, despite the fact that some European currencies have been clearly more inflationary than others and in those situations where it has been permitted, there has been no great observed tendency towards cross-holdings of currencies. For example, although it has been freely permitted since the abolition of exchange controls in 1979, UK residents' holdings of foreign currency are still less than one-tenth of their sterling deposits;

(d) "cocktail" currencies, such as the ecu, have so far not flourished as transactions currencies, though the ecu has done slightly better as an investment currency. There has been little or no pressure for private cocktails based on privately agreed weighting of existing currencies, even though there would be no constraint on transactions in such form if people wanted to make them.

39. There are probably two reasons why competition has not so far eroded established patterns of currency use to any marked degree:

(i) the inertia in the system is strong: French residents stay with francs ~~when~~ even if there are strong reasons to the contrary; and

(ii) there has not been a great deal to choose between the major currencies in terms of their "goodness". Hayek supposed that low inflation currencies - the mark and guilder for example - would be preferred to more inflationary ones such as the lira and franc. But account also needs to be taken of the fact that most ~~currency~~ transacting balances nowadays ~~is~~ are interest bearing and holders of the inflationary currencies have tended to be compensated by receiving higher interest rates (indeed even the real interest rates may have been higher although taxation and exchange gains and losses complicate the comparison). Even in common currency terms, there has not been much to choose between the major currencies either in their total return or the volatility over time.

40. Whilst it is true that full competitive pressures cannot yet play freely within Europe, there is sufficient freedom to suggest that experience to date will prove a good guide to the future. The implication must be that unless individual major national monetary authorities behave much more irresponsibly than they have so far, then those major currencies will continue to be used predominantly in their domestic geographical domains for a long time to come.

41. But even if the competitive pressures did result in a dominant single currency, and the above analysis suggests it would not, this would not be a permanent state of affairs. Other currencies might re-emerge as their relative quality changed over time. This would only not happen if the competitive process was suspended when a winner had emerged and the winning central bank was perhaps converted to a Community institution. There is an underlying tension between:

a) competing currencies acting as a competitive discipline on national monetary authorities to ensure they behave responsibly;

b) competing currencies as a precursor to a single currency, Community-wide, when by definition competition would have ceased.

42. Competing currencies would probably not be very acceptable to other EC countries. First, it would not satisfy the demand that EMU be promoted - it would merely be being permitted and might not happen at all. Secondly, if it did, what emerged could be a <u>Community</u> currency controlled by a <u>national</u> central bank which, to the extent it was democratically accountable, would be accountable to a <u>national</u> government and parliament. That prospect would be

viewed differently by different parties, much depending upon the identity of the winning currency and central bank.

The gold standard and related models

43. The presentation in this section is mainly in terms of gold, although in practice a broader commodity standard would probably be better.

44. An EMS gold standard would presumably share the following key features with the pre-first world war gold standard:

- the monetary unit of all participating currencies would have prescribed limits to its price in terms of gold, with the central bank in each country (or other authority responsible for intervention) buying or selling gold to keep the currency within the prescribed limits

- freedom of imports and exports of gold, and unrestricted rights ~~in~~ of citizens of each participant country to sell gold to or buy gold from ~~the~~ its central bank.

The established academic view is that unfettered trade in gold was not a universal characteristic of the pre-first world war international gold standard. While the UK certainly put no restraints on imports and exports of gold until the beginning of the first world war, some participants did have means of restraining gold exports when it suited them. But we can take it that, following complete abolition of capital controls in 1990, an EMS gold standard would provide for unfettered trade in gold both between EMS participants and with the rest of the world.

45. An EMS gold standard would obviously require the determination of gold parities (plus bands) for each EMS currency at the outset. All participants in an EMS gold standard would hold reserves of gold sufficient to meet the requirements of purchasers within the agreed bands. However, unless specifically prohibited from doing so, central banks would certainly choose to diversify their portfolios, ie to hold (interest-bearing) currency reserves as well. Faced with a would-be purchaser of gold, a central bank would in this case have the choice of either selling gold directly from its reserves or using currency reserves to buy more gold on the open market and satisfy its customer that way. If currency reserves were held on a large scale the system would be closer to what is normally described as a "gold exchange standard" - such as existed for a few years between the two world

wars - rather than the pure gold standard. (Even before the first world war, some currency reserves were held by participants in the international gold standard.)

46. One well known feature of the gold standard as it operated in the United Kingdom in the nineteenth century was that the Bank of England maintained gold backing, pound for pound, for all outstanding Bank of England notes beyond a defined "fiduciary issue"; the latter was set at £14 million in 1844 but increased occasionally in the second half of the century, reaching about £16½ million by the early 1890s. A rule of this sort, requiring central banks' holdings of gold to be some predetermined proportion of their note issue, would act as a form of automatic monetary stabiliser. If a country experienced a sharp increase in real demand or inflationary pressure there would be an increased transactions demand for notes at given interest rates. The constraint on the note issue would mean that the authorities would not be able to satisfy this demand without an inflow of gold. With less than perfect capital mobility, this would require an increase in interest rates and tend to check the demand or inflationary pressure.

47. However a gold backing rule of this sort is not an essential feature of a gold standard, and there would be practical difficulties in instituting such a rule now. Some countries (including the UK) currently hold a relatively small part of their reserves in the form of gold, and there would have to be an increase or at least a substantial reallocation of gold reserves within Europe if a common EMS-wide backing ratio were to be adopted. The essential ingredient would be a clear commitment that exchange rate parities against gold would ultimately be defended, if tested, by variations in interest rates. Provided the EMS gold parities were fixed irrevocably, the external discipline on domestic monetary policy would mean that the private sector would not have to worry about government reneging on its commitment to reduce inflation. There would be no impediment to optimal policies from "time inconsistency".

48. The international gold standard operated successfully for about 35 years before the first world war without any central institution for the system as a whole, and an EMS gold standard would have no need for a European Central Bank or for any new institution to coordinate the activities of the national monetary authorities. It is possible that some institutional details would be determined centrally (eg. the extent to which national central banks were required to back their note issue with gold), and the initial parities would have to be agreed at the Community level, as would any subsequent parity changes either for individual currencies or for the EMS group as a whole. But there is no reason why these sort of issues should not be settled by ad hoc meetings of Finance Ministers and Central Bank Governors. There would be no need for regular coordination or centralised decisions on the conduct of national monetary policy. Nor would the aggregate monetary conditions of the EMS bloc as a whole be something that would require centralised or coordinated policies. Monetary conditions within individual EMS countries and for the bloc as a whole would be determined by events outside the bloc (such as the rate of production of gold), rather than by discretionary policy.

49. It is assumed that what is for discussion is a European reform, not a world wide monetary reform; so that what is at issue here is not a gold standard covering all the major industrial countries in the world, including the United States and Japan, but a purely domestic EC arrangement. The yen and dollar would continue to float freely against gold; so all the EMS currencies would float with gold against the dollar and the yen. This means that if the gold price were to rise in dollar terms, the EMS currencies would appreciate against the dollar: shocks to the gold price would be transmitted to the competitiveness of EMS currencies. A South African miners' strike or a reduction in Russian gold exports would cause an appreciation of European currencies against the dollar and a consequent loss of European competitiveness.

50. It might also be difficult to decide at what level to set the EMS gold parities initially: the world gold price would not necessarily be invariant to the institution of an EMS gold standard. If the parities were set too high, there could be an extended period of uncompetitiveness against the dollar until European price levels adjusted downwards to increase the real price of gold in Europe. If parities were set too low initially (the price of gold in Europe too high) there would be a period of inflation.

51. The problem of volatility in competitiveness would also arise in the case of a **multi-commodity standard** but might be much less serious. Under such a standard the value of unit of a currency would be defined as equal to so many ounces of commodity X plus so many ounces of commodity Y plus so many ounces of commodity Z, and so on; rather than equal to just a certain number of ounces of one commodity (gold). The selection of commodities for inclusion in the basket and the choice of weights for these commodities would be made so as to achieve some objective such as minimising the expected impact of commodity price disturbances on the domestic European price level. The basket would inevitably include oil, of which the UK has particularly large reserve by European standards.

52. The volatility of the total dollar value of the unit should be reduced as compared with the pure gold standard case. There should particularly be a reduction in volatility arising from supply conditions: so that fluctuations in the dollar value of the unit would reflect mainly world demand conditions. In this case the EMS currencies would tend to appreciate against the dollar when world demand was high and depreciate when world demand was low: this would help to stabilise activity and prices in the European economies but destabilise the United States.

53. A further possible advantage of a multi-commodity standard as compared with a gold standard is that there is less danger of destabilising private sector speculation. The relatively high cost of storage would probably reduce the scale of private sector

hoarding of commodities in periods of currency crises: with a gold standard fluctuations in private sector hoarding might be rather large in periods of crisis.

54. To summarise, the advantages of a gold (or multi-commodity) standard are:

- it provides a nominal anchor for the system;

- because the nominal anchor is external (unlike, say, a monetary target) the private sector does not have to worry about governments reneging on previous commitments;

- monetary conditions would move in a stabilising way in Europe in response to world demand shocks.

The disadvantages are:

- commodity supply shocks would affect European competitiveness;

- the response of EMS currencies to world demand shocks would destabilise other countries and might cause international friction.

55. An alternative variant on the gold standard - and a particular form of gold exchange standard - is the Bretton Woods model: one currency tied to gold while the other currencies have a fixed central parity (with bands) against the first currency. In the present context this would presumably mean the deutschemark on a gold standard and the rest of the EMS on a deutschemark standard. This would have both the advantages and disadvantages of the simple gold standard model, and the problem of fluctuations of the EMS currencies against the dollar would remain. The point of the Bretton Woods arrangements was that they helped to insulate the world economy from the conditions of gold supply. A European "Bretton Woods" would not achieve this. However, the question of a deutschemark area is considered more fully in the next section.

The sterling area model

56. According to the Treasury's 1958 evidence to the Radcliffe Committee, the Sterling Area originated in the early nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which prevailed in most of the colonies. Each local currency was statutorily regulated as a local version of the pound, printed or stamped with local symbols, but all representing the sovereign (or a fraction of it) and all backed with some obligatory holding of sovereigns or gold. Thus the sterling area at that time was essentially a special case within the gold standard. What distinguished these countries was the closeness of their trading ties, their common use of the London capital markets, and in particular the use of sterling as the currency for their external transactions. The gravitation of foreign exchange income of the whole area to London was a natural consequence of normal business and banking practices. Effectively London acted as a clearing centre for the external transactions of the whole area, enabling economies to be achieved in lesser resort to physical gold shipments and eventually in the total holdings of external reserves for the countries of the area.

57. There were no special arrangements to ensure that local monetary and other policies were consistent with the maintenance of exchange parities. In this sense the sterling area was no different from the wider group of countries on the gold standard. However the closeness of trading ties and the common use of London's money and capital markets meant that policy changes in the UK were transmitted through the rest of the area relatively quickly. Because of unambitious economic policies of the overseas civil servants running the colonies, any thought of varying parties rarely occurred and in any case a change would have required legislation. In other words, the idea that the colonies would do other than accept the consequences of UK economic developments and policy (such as it was) did not really arise.

58. After World War II the advantage to the overseas sterling area countries of membership of the sterling area diminished and signs of resentment at having to follow UK monetary policies grew. Although they valued access to the London capital market, they would have liked to have spread their reserves more widely than they did and the tightening of monetary policy which was imposed on them when the UK tightened was unwelcome. Sterling's devaluation in 1967 represented a major turning point when a number of countries did not devalue in line. It was followed by a diversification of reserves out of sterling. Meanwhile some developing country members of the sterling area had been imposing exchange controls on money flows to London. The sterling area eventually broke down when the UK imposed its own exchange controls against the overseas sterling area in 1972.

59. If the sterling area is taken as a model for a European monetary arrangement,* the arrangement would have to be based on a strong national currency and the willingness of the rest of the Community to accept the monetary policy of the monetary authorities in that country. The Treasury cited four fundamental features of the sterling area in 1958; if we paraphrase these by giving the deutschemark rather than sterling the central role in a European arrangement, these four features are:

(a) the members use deutschemarks as the normal means of external settlement;

(b) they hold the major part of their reserves in deutschemark;

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* Other monetary unions and currency systems are discussed in Annex 2.

(c) they look to the Federal Republic as a major source of external capital;

(d) they co-operate to maintain the strength of the deutschemark.

60. This would be one possible form of evolution from the present situation in which the policies of the Bundesbank already play a leading role in setting ERM interest rates. To some extent (d) applies already, and (c) would not be relevant with today's highly developed world capital markets. Some countries (and academics) see considerable advantages in the present situation which allows others to borrow the Bundesbank's reputation for monetary rectitude.

61. If (a) and (b) have not yet occurred so far within the ERM, that has been in part due to Bundesbank resistance. The difficulties the UK experienced with the sterling balances - and also the transition from dollar shortage to dollar glut in the final years of Bretton Woods - are reminders of the extra constraints that a reserve currency can face. Moreover, rather than completely surrendering sovereignty to West Germany, other member states would want to have some influence on policies that determine the supply of deutschemarks if a deutschemark area became more generally established. In spite of this, however, a deutschemark area might have some attractions for Germany as an alternative to ceding the determination of German inflation to a European Central Bank. Thus this model could possibly emerge as a compromise between those Germans who want to retain maximum Bundesbank control, and others (both Germans and other Europeans) who want a European Central Bank. But this seems unlikely.

Delors' Stage 3

62. The Delors report defines achievement of monetary union as the irrevocable locking of exchange rates and the completion of the transition to a single monetary policy. The change-over to a single currency comes <u>after</u> completion of a monetary union: it is

seen as the icing on the cake rather than an essential ingredient. There must be some question, however, whether locking of exchange rates can be absolutely irrevocable while separate currencies continue to exist.

63. The European System of Central Banks (ESCB) as recommended by the Committee would be responsible for the formulation of monetary policy and, with the help of the national central banks, for the implementation of this policy. It would also be responsible for exchange rate and reserve management. An ESCB Council, composed of the Chairman, an unspecified number of Board members plus the national Central Bank Governors, would take the policy decisions. The ESCB would be independent of instructions from national governments and Community authorities.

64. The proposed independence is clearly designed to satisfy the Germans. For the great majority of countries, including of course France and the UK, this could be a radical departure. The Federal Reserve in the US and Bundesbank owe their independence partly to special historical factors. It is highly doubtful whether, in modern circumstances, many EC countries would be willing to offer the same. Handing over to an independent body the management of the exchange rate and the reserves would be especially sensitive (which no doubt explains why the US Treasury have held onto this), and would run counter to the fact that exchange rate agreements are made government to government. The recommended independence would only make any real sense if one took the view (as did the Germans and Americans earlier in their history) that the political authorities could not be trusted to run a sensible monetary policy.

65. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions and which could no doubt be studied for years. For example, what monetary aggregates would be targeted? In the period before transition to a single currency, would as near as possible identical aggregates be targeted in each country or would existing national traditions be respected? How would allowance be made for differences in velocity trends and potential growth rates in

allocating national monetary targets? Would the ESCB target bank reserves, would it go further and operate a monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

66. A more detailed discussion of Delors is at Annex 3.

Loose Delors

67. An alternative to full Delors that is worth considering is one that involves some evolution from the first stage of Delors' process but stops short of the binding rules of Stage 3. It would involve a greater degree of co-ordination of monetary policy than in Stage 1, but the final decisions would remain at the national level. There would be full consultation even before monetary (and probably budgetary) decisions were taken, and the aggregate implications of individual countries' policies monitored, but nothing beyond that. The model can be thought of as a perpetual Stage 2 of Delors.

68. There would not necessarily be a role for the ESCB in this model: the ESCB is set up in Delors' Stage 2 but partly to get into training for its central role in Stage 3. If a new body were to be set up to assist in the co-ordination and monitoring of policies, it would be for consideration how independent it should be of existing institutions, and the balance of membership between central banks and Finance Ministers. The creation of a new institution would at least give the impression of a significant step forward, even if its work could equally be done by beefed up versions of existing Community institutions.

69. One problem with a "perpetual Stage 2" is likely to be in establishing a proper nominal anchor for the system as a whole. In the absence of any external anchor, there needs to be some way of ensuring that when exchange rate tensions develop, the adjustment is carried out by these countries whose policies are most inconsistent with the inflation objectives for the EC as a whole.

70. A further point that needs to be borne in mind is the possibility that making arrangements for more systematic monitoring of member countries' economic performance and creating a new institution might increase the momentum towards something further: the new institution might lobby for more power, complain that its expertise was not being fully exploited etc. Thus there is a risk that this alternative to Delors' Stage 3 might actually intensify pressures to achieve Stage 3.

OTHER POLICIES

Fiscal policy

71. Delors' proposals for co-ordination of fiscal policy are discussed in Annex 3, which notes various difficulties about imposing mandatory budgetary guidelines in practice, even if one accepts the case that co-ordination may in principle yield a superior outcome to uncoordinated policies.

72. If there is some room for scepticism over the need for mandatory central controls on national budgetary policies in the context of the Delors model of monetary union, there is less of a case for mandatory central co-ordination in the alternative decentralised models considered earlier in this paper. All the models will involve some form of constraint being put on national budgetary policies by the exchange rate regime itself. Providing a dominant group of countries follows responsible budgetary policies, exchange markets will exert pressure on the other countries to adopt responsible policies as well.

Regional policy

73. The Delors report takes as read a need to increase regional and structural assistance in order to make EMU a success. It seems to have in mind both a permanent increase in such spending after the planned doubling by 1992, and also temporary official assistance "to reduce adjustment burdens temporarily" (paragraph 29). A related argument that is sometimes made (eg in the MacDougall Report of 1976) is that the size of the central

budget should be substantially increased to introduce the sort of automatic stabilisers between countries that tax and benefit systems currently give rise to between regions of each country.

74. There are two distinct strands to the argument:

- that regional imbalances must be reduced or at least not made worse if EMU is to be viable, and that larger official flows will help to achieve this;

- that official flows are needed to compensate for the fact that countries would no longer have the exchange rate as an instrument of adjustment.

Similar arguments could be made in respect of any of the alternative monetary models considered in this paper, as they all remove the exchange rate as an instrument of adjustment.

75. These arguments are not convincing, for the reasons set out in Annex 3. The only obvious reason (which of course the report does not mention) for expanding regional flows would be if the richer countries were determined to press ahead with EMU; the poorer countries needed to be bribed into participating; and the richer countries thought it worth the cost. By arguing the case for extra regional flows so strongly and on largely spurious grounds, the report will increase the pressure on this from the poorer countries.

CONCLUSIONS

76. Having described the alternative models separately, it may be helpful to attempt to compare them directly under a number of different heads. Taking monetary policy first, they can be considered from the point of view of: economic aspects; institutions and accountability; sustainability; whether they can be said to approximate to monetary union; and acceptability to our EC partners. The implicit baseline against which the alternative models are being compared is the system at the end of Delors Stage 1.

Economic aspects

77. The key economic question is how successful each model is likely to be in controlling inflation and providing a stable monetary framework. Recent history suggests that those models in which the German monetary authorities would have a central role would be relatively successful for the foreseeable future, although not necessarily for ever. This applies especially to the extended ERM models and the sterling area. It also applies to a lesser extent to loose Delors, although the more that German monetary policy is watered down by compromises with other EC countries, the less this argument holds. Full Delors, even with a wholly independent central bank, would probably produce a more inflationary outcome than a German dominated system, assuming that there would be political influences on the central bank (and that German rectitude continued).

78. Under competing currencies the inflationary outcome depends on the degree of competition in practice and the strength of people's preferences for a sound currency. If the competitive forces were relatively weak, perhaps because of national preferences for national currencies or high transactions costs, the process whereby sound currencies drive out unsound ones may take a very long time during which inflation could be significant.

79. The gold standard may be relatively non-inflationary, although it could be exposed to inflationary bursts in periods when the supply of the commodities on which it was based increased rapidly.

80. The models also differ according to the fixity of exchange rates. Delors Stage 3 is totally fixed. The competing currencies model is likely to involve the most fluctuating exchange rates. Realignments could be expected in all other cases: extended ERM, gold standard and sterling area. The size and frequency of the realignments would depend more on the degree of commitment to exchange rate stability and the rules of the game than on the objective characteristics of the particular system

81. Each model also has a number of specific economic implications of which the following are the more important:

- narrower bands within the ERM would increase the risk that interest rates could settle at inappropriate levels and fluctuate widely on occasions;

- an agreed commitment to stable rates for EMS currencies against the dollar and the yen would leave the Community more exposed to monetary shocks (for example changes in interest rates) elsewhere and would lead to greater exchange rate stability vis-a-vis the dollar and the yen;

- instability would be introduced into a gold standard world by fluctuations in commodity prices, and the response of the Community could lead to friction with the US and other countries.

Institutions and accountability

82. The institutional changes that are necessary range from creating new European institutions in the case of Delors and, possible, loose Delors, through agreeing new rules in the case of competing currencies, the gold standard and the sterling area, to

relatively little institutional change in the case of an extended ERM. Any new institutions in the loose Delors case could be watered down versions of the Stage 3 ESCB (eg an ESCB subject to control by national monetary authorities), or beefed up versions of existing arrangements, such as the Monetary Committee, or something similar. The paper does not consider important questions relating to the accountability of new central institutions with respect to either national Parliaments or the European Parliament.

83. Under some models, especially the extended ERM ones and the sterling area, the Bundesbank would develop into a kind of European central bank. Issues of accountability would also arise in these cases.

Sustainability

84. It is difficult to speculate about the sustainability of alternative models, since much depends on the degree of political commitment which would change over time with changing economic and political circumstances. Those models which involve major institutional changes, such as Delors, may be relatively more sustainable because reversing institutional change is a difficult process which would be resisted by most people

85. On the other hand, those models, such as the gold standard and the sterling area, which rely on a commitment to a set of rules, may be relatively less sustainable. Certainly history suggests that pressures can easily arise to cause systems like these to fall apart. In the case of the sterling area there is the added destabilising factor that countries which hold their reserves in deutschemarks would have an increased incentive to devalue their currencies.

86. Competing currencies may be fairly sustainable once a number of currencies are circulating side by side. But there will always be a threat that countries whose currencies are being displaced will withdraw from the system.

87. The extended ERM models have similar sustainability characteristics to Delors Stage 1.

Definitions of monetary union

88. The three forms of extended ERM represent very little more monetary union than in Delors Stage 1. The introduction of non-EC members into the ERM could even lead to less monetary co-operation, although there is the alternative possibility that it causes a sub-group of the 12 to press ahead towards a Delors-type union.

89. Loose Delors could just about be presented as monetary union.

90. The other three models may or may not look like monetary union at the end of the day depending on how they develop.

91. While it is possible to assert that competing currencies will eventually lead to a single official currency, this paper argues that this is unlikely. It will be difficult to present this model as monetary union with much conviction.

92. Strictly speaking, the gold standard does not represent monetary union. However, there is an element of unity in the common acceptance of the rules of the game. Moreover, as time progresses and all countries' monetary authorities react in identical ways to shocks, it might be a trivial step to lodge authority for monetary policy in a central EC institution which then issues a single currency.

93. The sterling area model, assuming that the deutschemark was the key currency, would be somewhat closer to monetary union than Delors Stage 1. But, as with the gold standard, there would need to be a formal transfer of authority to a single body (in this case a German one) before union was explicit.

Acceptability to EC partners

94. Other governments are more likely to find acceptable those models which do not represent sharp changes from Delors Stage 1. The extended ERM models, the sterling area, and full and loose Delors models fulfil this description.

95. Competing currencies represent quite a sharp change, especially since this model would work best if exchange rates were less fixed than in Delors Stage 1. The gold standard also represents a fairly sharp change, although the fact that previous French governments have flirted with this idea may make it more saleable.

96. Other countries may also favour models which show some resemblance to Delors Stage 3. Again this points to loose Delors. Competing currencies, the gold standard and the sterling area are so different, especially in not having any central institutional machinery, that they will not be attractive in this respect. Extended ERM models show too little advance on Stage 1 to have much support.

97. Models which strengthen the leading role of Germany will be unpopular among many countries. This applies to the stronger ERM options, the sterling area and, in the long run, competing currencies. It does not apply to the gold standard and full or loose Delors. While in some respects Germany (and perhaps one or two others such as the Netherlands which are close to Germany) will take the opposite view, they may not act as an effective counter-weight because:

(a) they may not wish to see the leading role of the deutschemark challenged by competing currencies, even if the expectation is that it will win out in the end;

(b) they may be reluctant to create a formal deutschemark area - they have not encouraged other EC countries to hold deutschemarks in their reserves;

(c) for foreign policy reasons they have supported Delors even though it may not be in their best economic interests.

Taking all these points into account, the easiest to sell to our partners as an alternative to Delors is loose Delors. The extended ERM models and the gold standard are possibilities.

Overall assessment of monetary models

98. In terms of the UK's broad objectives of retaining independent monetary policies, minimising institutional change and controlling inflation, the most acceptable alternative models are the extended ERM options, competing currencies and the gold standard. The extended ERM models do not look much like monetary union and competing currencies are unlikely to be acceptable to our partners. It may be possible to present the gold standard as a form of monetary union and it could possibly be acceptable to our EC partners. But in the end it may be necessary to fall back on loose Delors as a compromise between full Delors and the kind of full independence of monetary policy which we are seeking.

Fiscal and regional policies

99. Neither the mandatory central controls over national budgetary policies nor the extra official flows to poorer countries that are proposed by Delors are, in economic terms, a necessary part of full Delors. There may, of course, be other reasons for wishing to see a larger transfer of funds to the poorer countries - for example, a need to bribe them to accept the full package.

100. If this is true of full Delors, it is still more true of the alternatives to Delors. All the monetary models discussed here, including full Delors, could operate perfectly well without much central co-ordination of fiscal policies or enhanced regional flows.

ANNEX 1: THE HAYEK COMPETING CURRENCIES MODEL

The starting point for Hayek's thesis is the observation that there is no necessary linkage between monetary issue and public finance. Governments began their monetary careers by restricting themselves to stamping lumps of gold and other precious material to certify their quality and weight. That was a harmless activity and even, provided the stamps were regarded as authoritative, a socially useful activity. But governments quite soon learnt that they could go farther than this, to their own advantage. By issuing these stamps, quite detached from the original certification purpose, as notes or coin, they were able conveniently to finance an excess of expenditure over revenue.

2. In order to carry off this trick, governments needed to ensure the continuing demand for their use of notes and coin - that people were prepared to provide goods and services to government in return for these notes and coin. To this end, governments generally stipulated that their issue of notes and coin were legal tender, that they had to be accepted as payment for goods and services. In order further to enhance the demand for their notes and coin, and thus facilitate a larger budget deficit, governments also took steps to ensure that they were the monopoly supplier of money. <u>Only</u> governments were therefore allowed to issue currency: others who did so would be branded as counterfeiters and subject to criminal punishment.

3. It was not the fact that someone was providing money which worried Hayek. On the contrary, the provision of money is a major underpinning of civilisation itself, allowing the elevation of economy from one based on barter to one based on transactions. But it was the monopoly position of the supplier which was disturbing, bringing with it the same disadvantages as attend monopoly generally. Now there is a superficial paradox here. Usually, a monopolist restricts the supply of his product to a point less than the quantity which would be supplied if there were free competition. In return, he obtains a more than

proportionately higher price and thus maximises his profits. But a government's temptation is to use its monopoly to supply more money than people want to hold. However, the paradox is only superficial and is easily resolved. The government's action has the further effect of raising prices and, in fact, because the money supplied now has the disadvantage of depreciating in purchasing power over time, less of it in real terms will be demanded. Thus, the situation is exactly the same as in a normal monopoly: a lower real quantity supplied at a higher price since the currency is depreciating.

4. Hayek's worry about government's monopoly supply of money was not a new one. It is, for example, a constant theme in the writings of Milton Friedman* from the early 1950's onwards. Friedman's view, however, was that this was a natural monopoly that governments held and that the answer was for them to be bound by rule to supply the optimal amount of money that people wanted. Friedman's solution was that the supply should be restricted such that it appreciated over time, bearing in mind that it was non-interest bearing, so the total return to holding it was the same as the interest rate in the economy. That would not rule out that the nominal quantity supplied would increase since the real demand for money would be increasing as the economy grew.

5. Hayek's proposal is the alternative one, not of regulating the monopolist but of breaking up the monopoly and allowing as many people as want to provide the service of supplying money. He supposes, reasonably enough, that it would be a subgroup of banks, "issue banks", who would want to compete for the business of supplying currency. It would be an important part of the scheme that each issuing bank would not supply pounds or dollars or some common currency but its own proprietary currency. (See paragraph 10.) NatWest might issue Boardmans; Midland would issue McMahons; Lloyds, Morses; and so on. Each would be defined by reference to its unit purchasing power in terms of a defined basket of goods and services.

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* Hayek was, of course, Friedman's colleague at the University of Chicago between 1950 and 1962.

6. Each issuing bank would have an incentive to maximise the demand for its own note issue because it could use the proceeds for profitable investment. But that would not mean that they would issue notes without limit. In principle, Hayek notes, people might freely choose to have either appreciating or depreciating currency but, in practice, the majority preference is likely to be for currency stable in value against the basket of goods people generally buy. So the issuing bank, in its own interests, will restrict its issue to the quantity which will preserve the value of each of its notes against the basket. If NatWest, for example, were to exceed this, then it would know that the Boardmans would depreciate against the Morses and the McMahons and be acceptable for only a part of the basket it was suppose to purchase. Assuming people wanted a stable currency, preferences would turn against the Boardmans in favour of stable Morses and McMahons and Natwest would be punished for its profligacy by finding it could keep only fewer, not more, of its notes in circulation.

7. It is a vital part of this scheme, that issuing banks are not allowed to issue a common currency so as to reverse the normal thrust of Gresham's low. If a profligate bank were allowed to issue notes fixed by law as equal in value to any other banks' notes, then the profligate bank's money - bad money - would drive out the other banks', good, money. Since everyone would know that the profligate bank's money was in reality worth less than the other money - despite what the law claimed - everyone would hang on to the good money but pay for goods and services received with the bad money. In this way, only the bad money would finish up in circulation - Gresham's Law, the bad money having driven out the good. By contrast, under the Hayek proposal, the reverse would happen. It would be the good money which stayed in circulation by virtue of the mechanism described in paras 8-9.

Some Difficulties

8. As it stands, Hayek's proposal is not without its difficulties. Some of the main ones that come to mind are discussed below.

9. First, it needs to be clear what kind of worry it is that is under discussion. On the one hand, Hayek is clear that the distinguishing feature of money is that it is used as the medium of exchange. (Other attributes - store of value, unit of account, means of deferred payment - he regards either as derivative or as non-essential.) On the other hand, it is equally clear that he is thinking of a commodity supplied by the government, and only by the government, and in the form of a non-interest bearing liquidity. That means he must have in mind notes and coin. Yet in a modern economy the main medium of exchange is not notes and coin but sight deposits at banks (or building societies). In the UK, for example, notes and coin total only £17 billion whilst sight deposits, for transaction purposes, at banks alone come to seven or eight times as much.

10. This is important because historically the greatest part of the inflation tax has not accrued to the government but to the banking system in the form of the "endowment profit" on their current accounts. More recently, however, the endowment profit has been eaten away. Competition, both between banks and with other financial institutions, has meant that an increasing - and probably by now the greater part - of transactions balances are interest bearing. But once money is allowed to bear interest, the nature of the competitive equilibrium may be quite different. In terms of the example used previously, people may still be prepared to demand depreciating Boardmans provided that Natwest were prepared to pay a good rate of interest upon them (or, at least, upon current account Boardman deposits). The outcome may therefore not necessarily be currency in circulation with a stable value against goods and services.

11. A second difficulty is that the banks and the public would have to work out how to value each of the note issues that were made. One problem would be to define the standard basket of goods and services against which the currencies were to be defined. But assuming that such a basket would be universally agreed upon, there would still be difficulties. Even if the management of bank X had decided that it wanted to keep its issue of notes at a stable value, it would be faced with a difficult technical calculation each day in deciding how money notes to print and to issue. The complication would arise from the fact that the demand for its issue would be in the first instance unobservable. If the issuing bank under-estimated this demand, then its issue would appreciate in terms of the basket: if the demand had been over-estimated, its issue would depreciate. The banks might try to error correct, modifying its issue in the light of observed appreciation/depreciation over time. But it could be a period of weeks or months before such information became available. So there would be a possibility of prolonged periods of fluctuating values for a currency whose issuer wanted to avoid that.

12. Hayek supposes that this would not happen because the financial press would perform and publish each day the required purchasing power calculation for each currency in issue. But it is hard to see why the press would be any more able to carry out the calculation than the individual banks could. An alternative source of information could come from the currency exchanges where Boardmans would trade against Morses and McMahons. Generally, over time, the issues of profligate banks would depreciate in exchange rate against other issues. But experience of the foreign exchanges suggest that the observed exchange rate could, in the short term, prove to be information worse than useless.

13. What would be needed to reach Hayek's objectives is that the currency exchanges established exchange rates consistent with the relative purchasing power parity for each pair. Yet in the foreign exchanges this happens only, if at all, in the longest term. Over shorter periods, the rates would be affected by factors such as the believed state of banks' loan books, predicted changes in management structures leading issuing banks in future

to be more or less prudent than was currently the case. Morses might appreciate this week because traders had perceived they had risen in previous weeks and were therefore bidding them up, and so on.

14. A third set of questions relates to the numbers of issuing banks which would be likely to result, or for that matter be desirable, under such a system. From the points of view of making the system manageable, one might be looking for a smallish number. Hayek supposes, for example, that all shopkeepers would need to price their goods in at least the main available currencies. Because of the changing exchange rates, prices would have to be re-posted at least once a day and consumers would need at least a broad idea of what the pattern of exchange rates was so as to be able to check that they were not being faced with unfair relative prices. Households would need to budget and account separately for at least those of the available currencies that each chose to hold. Company treasurers would have to extend their foreign currency exposure control techniques to purely domestic transactions as well.

15. All this sounds rather complicated and it seems unlikely that more than a few issue currencies would survive. In fact, in Hayek's own illustration there are just seven currencies which circulate. But from the point of view of making the systems fully competitive, this looks like too small a number. Such a small group of issuing banks would quickly come to understand that their group profits could be appreciably higher if they were to stop competing fiercely and exercise a degree of collusion instead. That would mean reconstructing at least an approximation to the monopoly position that the competitive system of issue was supposed to avoid. No doubt the group of issuing banks would justify the collusion, both to themselves and to the public, as an exercise in standardisation designed to increase their customers' wellbeing. But the result would be just the over-issue in nominal terms, and consequent under-provision in real terms, of money that the scheme is supposed to avoid.

16. The final difficulties would stem from the fact that all of the currency under the Hayek plan would be the liability of private companies. Notes and coin issued by the government are at least secured on the taxing power. Hayek does not discuss what would happen if one of his issuing banks were to fail, as a result, for example, of its using the proceeds of the issue for unwise investments or, for that matter, because of fraud on the part of the management. People choosing which currency issues to hold would evidently need to take a view about the soundness of each bank's assets as well as their relative intentions about the size of their note issues.

17. Not all of the difficulties discussed above are necessarily insuperable. But the issues would need to be worked in a great deal more detail before there would be the semblance of a viable system at national level. As the Chancellor has publicly noted, no government has so far been prepared to experiment along Hayekian lines.*

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* "This is not a form of privatisation that Britain, as for that matter, any other country, has so far espoused, and this Government has therefore accepted its responsibilities for the value as well as for the creation of the currency. We have accepted that the state has a clear responsibility to maintain the internal value of the currency - that is to say, to avoid domestic inflation - and, within that context, to maintain the external value of the currency - the exchange rate" (Nigel Lawson: "The State of the Market" Institute of Economic Affairs Occasional Paper 80, 1988).

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ANNEX 2: STERLING AND OTHER CURRENCY AREAS

The Sterling Area

1 According to the Treasury's 1958 evidence to the Radcliffe committee, the Sterling Area was far from being a term with a precise meaning. The system originated in the early nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which prevailed in most of the colonies. Each local currency was statutorily regulated as a local version of the pound, printed or stamped with local symbols, but all representing the sovereign (or a fraction of it) and all backed with some obligatory holding of sovereigns or gold. Thus the sterling area at that time was essentially a special case within the gold standard. What distinguished these countries was the closeness of their trading ties, their common use of the London capital markets, and in particular the use of sterling as the currency for their external transactions. The gravitation of foreign exchange income of the whole area to London was a natural consequence of normal business and banking practices. Effectively London acted as a clearing centre for the external transactions of the whole area, enabling economies to be achieved in lesser resort to physical gold shipments and eventually in the total holdings of external reserves for the countries of the area.

2 There were no special arrangements to ensure that local monetary and other policies were consistent with the maintenance of exchange parities. In this sense the sterling area was no different from the wider group of countries on the gold standard. However the closeness of trading ties and the common use of London's money and capital markets meant that policy changes in the UK were transmitted through the rest of the area relatively quickly. Because of unambitious economic policies of

the overseas civil servants running the colonies, any thought of varying parties rarely occurred and in any case a change would have required legislation. In other words, the idea that the colonies would do other than accept the consequences of UK economic developments and policy (such as it was) did not really arise.

3 Although some of the largest colonies had been granted independence before sterling left the gold standard in 1931, all Commonwealth countries apart from Canada decided to remain pegged to sterling. In the period to 1939, there were no new formal monetary arrangements but the sterling area did provide a sort of "zone of (internal) monetary stability" in a world of growing protectionism and "beggar my neighbour" devaluations. After 1939 the arrangements were formalised with trade restrictions, payments and capital controls imposed vis-a-vis the rest of the world, and the agreement of the overseas sterling area (OSA) that any increases in their external reserves would normally be held in sterling.

4 After the War these arrangements remained acceptable to the OSA as they enjoyed the benefits of Commonwealth trade preferences and access to London capital markets in exchange for being willing to pool their reserves and maintain their parity with sterling. All except Pakistan devalued with sterling in 1949, and they followed later. But as world trade and payments arrangements were steadily liberalised under the GATT and IMF, and stock markets developed for commodity exports, the advantage to the OSA countries of membership of the sterling area diminished and signs of resentment at having to follow UK policies grew.

5 Memoranda submitted by several OSA central banks to the Radcliffe Committee stress that the sterling area is a voluntary association which is not subject to formal rules and obligations but based on considerations of mutual interest. The Commonwealth Bank of Australia said that in general, the arrangements to hold reserves in sterling <u>had</u> been convenient, but went on to spell out the advantages of spreading their reserves over different forms of holdings. They noted that members of the sterling area had had from time to time to take measures to protect the gold and dollar

reserves of the area as a whole and indicated that their willingness to remain within the area rested on their need to have access to the London capital market. The Reserve Bank of New Zealand grumbled more specifically about the rise in UK Bank Rate to 7% in 1957, spelling out the adverse effects it had had on the New Zealand economy. "These changes came at a time when we could ill afford them." The South African Reserve Bank complained that the credit squeeze in the UK had had "unfavourable repercussions" on South Africa's balance of payments, and dwelt at length on how they had been forced to follow a succession of "drastic measures" which had been of "material assistance from the UK's point of view" but had imposed "an excessive strain upon South Africa and other countries of the area".

6 Other central banks called more explicitly for greater symmetry in policy-setting. After deprecating unilateral actions by the UK, the Central Bank of Ceylon said "a stronger sense of the need for internal discipline among all members must prevail if unevenness in the sharing of benefits and burdens is to be avoided". The Reserve Bank of India saw "undoubted advantage in organising more frequent discussions on the working of monetary policies, exchange controls and related questions of trade and economic policy among the countries of the sterling system". However the central banks were cautious about instituting more formal arrangements for policy co-ordination; it seems that they were reluctant to be thought to be ceding any sovereignty back to the UK by subscribing to new regulations, and preferred to maintain the status quo whereby the UK in practice, but not by treaty, determined the monetary policy of the sterling area. That said, the Governor of the Bank of Rhodesia and Nyasaland stressed that Federation's freedom to act independently by pointing out that "the Governor-General is fully empowered to determine the value of the Rhodesian pound" and "any change in the external value of sterling would immediately raise a difficult question of policy for the Federation".

7 Despite this awareness that the sterling area arrangement gave OSA countries little choice but to follow the UK's lead in monetary policy, sterling's devaluation in 1967 represented a major turning point, when a number of member countries either

decided against moving their currencies with sterling (Australia, Hong Kong and Bahamas), or did change and then set about diversifying their reserves against a possible future decision to go in their own directions. There then followed a period of instability, with the sterling reserves under pressure from diversification but the speed of deterioration moderated by various "sterling agreements" negotiated with members to maintain "minimum sterling proportions'. It was only when the UK imposed exchange controls vis-a-vis the OSA in 1972 that the area finally broke up. In 1958 the Treasury had seen the arrangements to be beneficial because UK citizens "could use their own currency over a large part of the world" and were "saved the inconveniences of operating in foreign currencies", and because of the profitable business the sterling system created for the City of London. But the Treasury also believed that the "cohesion and viability of the sterling area depend above all on the strength of sterling", to which "a current account surplus in the UK balance of payments is of fundamental importance". In the end these conditions were not met and the sterling area came to an end. The reserve role of sterling was ended as a condition of the UK's entry into the EEC.

8 However, the UK-originated problems for sterling were not the only reason for the breakdown. The movement towards political independence (and not only by colonies, as other countries also had political dependence on the UK) had parallel economic consequences. Countries such as India and Ghana set out to achieve ambitious national goals, often spending along the way large sterling balances accumulated during the war. They imposed their own exchange controls on money flows to London as their balance of payments deteriorated, often because of indifferent economic management resulting from a deep lack of understanding of the economic consequences of political and social policies. The present day debt problems of many African and some other countries can be traced directly back to such influences.

9 If the sterling area is taken as a model for a European monetary arrangement, the arrangement would have to be based on a strong national currency and the willingness of the rest of the Community to accept the monetary policy of the monetary authorities in that country. The Treasury cited four fundamental

features of the sterling area in 1958; if we paraphrase these by giving the deutschemark rather than sterling the central role in a European arrangement, these four features are:

(a) the members use deutschemarks as the normal means of external settlement;

(b) they hold the major part of their reserves in deutschemark;

(c) they look to the Federal Republic as a major source of external capital;

(d) they co-operate to maintain the strength of the deutschemark.

10 Unless other members of the Community were willing to accept that monetary policy would be determined in Frankfurt, just as sterling area members accepted London's dominance in determining policy, then the system would fail. But to suggest that a national currency be adopted as the central pillar of the system raises the same issues as would the emergence of a dominant national currency through competition (see section on competing currencies). Rather than completely surrendering sovereignty to West Germany, other member states would surely insist on formal procedures whereby they had some say in the policies determining the supply of deutschemark. But such "interference" in German monetary policy would be unlikely to be acceptable to the Bundesbank unless other states' influence were very minor. Adoption of a system paralleling the arrangements for the sterling area does not resolve the inherent conflicts within any attempt to seek closer co-ordination of member states' monetary policies.

Other monetary unions and currency systems

11 Although the sterling area has broken up, a number of other arrangements - notably in the French franc zone - survive. Do these offer any more possibilities?

12 The franc zone is a centralised concept in origin, depending on a fixed exchange rate relationship between the French franc and the subsidiary currencies. Within the system there are various individual and regional arrangements ranging from near-currency boards, where local currency is issued against French franc assets and managed by the Institut d'Emission d'Outre-Mer in Paris, to

the large regional central bank zones in West and Central Africa with autonomous local management. It may be tempting to see similarities between the BCEAO and BEAC and a European central bank in that several countries have to sink their differences and reach consensus on monetary policies. However, the essential feature of the French African central banks is the continuing role played by France. In effect, it provides the equivalent of a gold standard, and individual countries' policies have to follow from that. But it is an external constraint, not one established and maintained by the member countries themselves. France still has directors on the boards of the African central banks and France is the dominant country economically as well as politically with a GNP 20 times that of all the African member states taken together.

13 The members of the franc zone each agree to hold at least 65% of their reserves with the French Treasury. Often they place more there, as the terms offered (SDR exchange guarantee and Bank of France's intervention rate for interest) are attractive. The regional central banks each have an operations account with the French Treasury (as do other countries and zones participating in the franc zone arrangements). All transactions with France pass through this account, which may be in surplus or deficit, but if the latter subject to an increasing disincentive in the shape of interest rate bands. The same principle applies within the regional central banking zones - individual governments may have a surplus or deficit with the central bank, as do commercial banks. However the Statutes of the central banks restrict their advances to the African Treasuries to 20% of the previous year's budgetary receipts when the operations account with the French Treasury is in deficit.

14 One of the features of the French overseas system, as of the metropolitan system, is the rediscount and even the medium-term rediscount, which links monetary policy into financing of agriculture, industry and commerce. However, rediscount policies are liberal and liquidity tends to be uncontained for some time after external receipts fall - good for confidence and stability, but not for adjustment.

15 Throughout the system, provided an individual, company, bank or government has local currency it has access to foreign exchange at the fixed rate under what the French proudly refer to as "le garanti francais". The rate against the French franc has been set at FF1 (100 old francs) to CFAF50 since 1948.

16 The two African regions are currently in bad shape and last year produced for the first time an overall deficit by both zones in their operations accounts. Usually, the different economies have tended to balance each other but the oil price fall has brought down the oil producers of Central Africa while soft tropical commodities have remained weak. In West Africa, the big change has been in the Cote d'Ivoire which has been hit particularly hard by lower oil prices and falls in coffee and cocoa prices and has not adapted domestic policies accordingly. Another features has been, until last year, the fall of the dollar against European currencies including the franc at the same time as commodity prices weakened in dollar terms. There is a clear case for a devaluation of the CFA franc but the difficulty in reaching agreement and perceptions of cost increases have prevented these proposals coming to the surface. Also, France has vested interests in maintaining confidence and French investment in these zones and in keeping exports from France cheap. However, France is effectively giving a foreign exchange subsidy to the system at present. Meanwhile, countries like the Cote d'Ivoire are having difficulty in moving exports and maintaining producer prices and have acute budgetary difficulties. Interest rate policy is not within their control and, unable to devalue, their only weapon is budgetary. A massive deflation is about to take place as producer prices are cut and salaries are held in inflationary conditions.

17 There have from time to time been regional currency and monetary arrangements within the sterling area. The Eastern Caribbean Central Bank (previously East Caribbean Monetary Authority) with a varying membership of small islands, and before that the British Caribbean Currency Board, which included the larger Caribbean territories, is an example. It cannot be said ever to have worked well, the problem being the absence of agreement between governments generally and at times of crisis.

The lack of consensus has, however, had the advantage of restraining the central authorities from moving exchange rates except when forced by external circumstances (eg, the collapse of the sterling arrangements) from doing so. Some kind of price stability has therefore been maintained but slow economic growth, poverty and social unrest have been the norm.

18 Other regional arrangements which emerged from the sterling area system were the Common Monetary Area (previously the Rand Monetary Area) centred on south Africa, the East African Currency Board (Kenya, Tanzania and Uganda) and various forms of Central African federal arrangements including under the Bank of Rhodesia and Nyasaland.

19 Of these systems, the most successful in terms of unified policy has been the South African rand area, no doubt because of positive, centrally controlled policy and stable political conditions. However, despite the relatively generous facilities offered by South Africa to its constituent members, independence has inevitably tended to lead towards disintegration, with Botswana withdrawing totally and Swaziland loosening the links.

20 The old East African federal arrangements, which survived independence, were very comprehensive, covering railways, harbours, posts, airline and marketing arrangement as well as currency. Significantly, as political differences emerged, it was the currency and financial arrangements which took the strain first. Almost the first split was from a single currency board to three separate central banks, each with its own currency. A common exchange rate was even then maintained for a number of years but collapsed in the face of divergent economic and political policies.

21 In the Central African Federation, which perhaps was more unified as Southern Rhodesia was far more developed than the other members, the split followed a similar pattern although there seems to have been no attempt to unify the exchange rate arrangements after separation.

22 It is probably inappropriate to draw too close parallels between somewhat primitive currency and exchange arrangements in colonial and newly independent countries with those in developed, industrialised ones. However, if there is a lesson to be drawn it is that attempts at monetary unity where it does not exist on the political and administrative planes tend to disintegrate. Where regional currency systems have worked successfully for any length of time, there seems to have been a consistent pattern of control or domination by a single country. On the other hand, federal economic arrangements have tended to break up where the dominant member was unable or unwilling to devise adequate compensation arrangements to offset the advantages felt by those at the fringes. There also seem to be strong links between national pride, sovereignty, common aspirations and the currency. Experience with currency boards suggests that emotional local identification with the currency is often one of the most difficult matters to deal with. Once that has been settled, the technical side can fall into place relatively easily.

ANNEX 3: DELORS PROPOSALS FOR ECONOMIC AND MONETARY UNION

This section offers a critique of the form of Economic and Monetary Union proposed by Delors (the destination reached in Delors' "third stage").

2. The main features of completion of **monetary union** would involve irrevocably locked exchange rates between EMU participants, and eventually a single currency. Responsibility for monetary policy (including exchange rate policy and management of reserves) would be transferred to the proposed "European System of Central Banks". Key monetary policy decisions would be taken by the Council of the ESCB, which would be independent of both national governments and Community authorities, and would be composed of Governors of the Central banks plus board members appointed by the European Council on contracts whose terms ensured their independence from national political pressures.

3. **Economic union** would involve not just the completion of the internal market programme, increased convergence of the European economies, improved factor mobility etc, but also enhanced structural and regional policies and new powers for the Council of Ministers to impose constraints on national budgets.

(i) Economic union

4. The Delors report does not set out very clearly the reasoning behind its proposals in the fields of budgetary and regional policy. Indeed there is some ambiguity over the degree of central intervention in national budgetary policy that is envisaged. Paragraph 33 of the report - which covers institutional arrangements in the economic field - says:

> "it would seem necessary to develop both binding rules and procedures for budgetary policy, involving respectively effective upper limits on budget deficits of individual

member countries [and]... the definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance."

Later on in the report, in discussing the steps to be taken in stage three, fiscal arrangements are described as follows:

"the Council of Ministers... would have the authority to take directly enforceable decisions, ie to impose constraints on national budgets to the extent to which this was necessary to prevent imbalances that might threaten monetary stability".

5. The tone of these two quotations is quite different, even if what they say is formally consistent. The first quotation gives very much the idea of an appropriate overall fiscal position being decided centrally and then budget objectives being allocated to member countries to achieve this overall position. The second quotation might involve no more than intervention in extreme cases where national policies had clearly got out of hand (eg Greece at present).

6. There is no doubt that a theoretical case can be made that uncoordinated fiscal policies may be inferior to a coordinated outcome. But we would need a lot of convincing that the externalities of national fiscal policies were such as to warrant Delors' proposals. Previous fixed exchange rates regimes survived without fiscal coordination, while the experience of many countries in recent years suggests, at least at first sight, that fiscal policy measures have a very limited impact.

7. There would also be practical difficulties with any attempts to coordinate fiscal policy. There would, for example be accounting problems: countries may have scope for switching items on or off budget so that a given measured deficit position would be consistent with a range of fiscal impacts. More fundamentally, various aspects of fiscal impact are not reflected in conventionally measured deficits at all (eg unfunded pension liabilities). Again, policies on assets sales or other

compositional issues will affect the impact economic impact of a given deficit. Would restrictions be set in terms of a more sophisticated measure of fiscal impact than the crude fiscal deficit (eg the Blanchard index used in the recent Monetary Committee paper on the UK)?

8. There would also be control problems. Forecasts of many components of public deficits are subject to considerable margins of error; with the best will in the world, no country is going to meet budget guidelines exactly. There will be some scope for countries that want to exceed guidelines for the deficit to make overoptimistic projections of revenue ex ante; it would not always be easy to distinguish genuine forecast error from deliberate flouting of Community directions.

9. A further aspect of budgetary policy that the Delors report does not go into is the extent to which it should take account of the differences in private sector saving and investment behaviour in member states*. If a total Community budgetary balance is to be parcelled out among the member states it is hard to see how the allocation could avoid making allowance for differences in private sector behaviour; but at the same time agreeing on the appropriate allowance is going to be a disputatious procedure, to say the least.

10. As well as the limits on budget deficits, the Delors report calls for the exclusion of access to monetary financing and limits on borrowing in non-Community currencies. The prohibition on monetary financing is a necessary consequence of the particular model of monetary union adopted by Delors in which the monetary growth for EMU region as a whole is determined centrally. Other models, in which monetary policy in each country was determined independently subject to the constraint of maintaining a fixed exchange rate would not require a rule on monetary financing.

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* There is what may be a cryptic reference to this question in paragraph 30 of the report: "although in setting these limits [sc. on budget deficits] the situation of each member country might have to be taken into consideration".

11. The need for limits on borrowing in non-Community currencies is questionable even with the context of the Delors model. No restriction on private sector borrowing in foreign currency seems to be proposed, and it is not clear why a distinction should be made between the private and public sector. Nor is it clear why national governments should be prevented from borrowing in what they believe to be the lowest cost way or arranging their portfolio of liabilities in the way they believe to be optimal.

12. The report is littered with references to the possible or probable need to increase regional and structural assistance in order to make EMU a success. It seems to have in mind both a permanent increase in such spending after the planned doubling by 1992, and also temporary official assistance "to reduce adjustment burdens temporarily" (paragraph 29).

13. There are two distinct strands to the argument:

- that regional imbalances must be reduced or at least not made worse if EMU is to be viable, and that larger official flows will help to achieve this;

- that official flows are needed to compensate for the fact that countries would no longer have the exchange rate as an instrument of adjustment.

14. The key question in relation to the first point is whether countries on the periphery would be worse off with EMU. The report says that "historical experience suggests that, in the absence of countervailing policies, the overall impact on peripheral regions could be negative" (paragraph 29). Within Europe in recent years growing intergration has actually been associated with <u>faster</u> growth in the periphery than in the geographic core of the EC. During the 1980s, the UK, Spain, Portugal and Italy have grown on average ½ per cent per annum faster than the average for Germany, France and Benelux. And within individual countries, there have been some striking recoveries in their regions. It also is of interest in this

context that the United States has seen an enormous reduction in regional inequalities during the course of this century, and particularly since the second world war.

15. In short, it is much less evident than the report implies that the peripheral countries would suffer. At the very least, it should have kept an open mind on this. Even if the periphery were to be worse off as a result of EMU, it does not follow that there should be greater regional flows. Experience with regional policy suggests that it may not have much effect in reducing regional imbalances: it may even aggravate them by postponing necessary changes in competitiveness and movements of labour and capital.

16. Nor over the medium term are official flows necessary to finance current account deficits. It could be that, as happened under the Gold Standard, the faster growing regions or regions at a lower level of development will run current account deficits over a number of years. But these can and should be financed by voluntary capital flows. If they cannot be financed voluntarily, that would suggest that resources would be better used elsewhere in the Community.

17. The key question in relation to the loss of the exchange rate as an instrument of adjustment is whether European countries are at present able to achieve significant and reasonably durable competitiveness changes through exchange rate changes. It seems most unlikely to us that there is now the degree of "money illusion" in European economies that is required for this to be so.

18. On the whole, then, the case for extra official flows in conjunction with EMU is a lot weaker than the report suggests. The only obvious reason (which of course the report does not mention) for expanding regional flows would be if the richer countries were determined to press ahead with EMU; the poorer countries needed to be bribed into participating; and the richer countries thought it worth the cost. By arguing the case for

extra regional flows so strongly and on largely spurious grounds, the report will increase the pressure on this from the poorer countries.

19. There are no other substantial proposals in the non-monetary sections of the report. Although the report argues that "strong divergences in wage levels and developments, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion", there is no support for price and wage controls to encourage convergence. Nothing more than talk is proposed in this area: "efforts would have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity".

(ii) Monetary union

20. The Delors report defines achievement of monetary union as the irrevocable locking of exchange rates and the completion of transition to a single monetary policy. The change-over to a single currency comes <u>after</u> completion of a monetary union: it is seen as the icing on the cake rather than an essential ingredient. There must be some question, however, whether locking of exchange rates can be absolutely irrevocable while separate currencies continue to exist.

21. The European System of Central Banks (ESCB) as recommended by the Committee would be responsible for the formulation of monetary policy and, with the help of the national central banks, for the implementation of this policy. It would also be responsible for exchange rate and reserve management. An ESCB Council, composed of the Chairman, an unspecified number of Board members plus the national Central Bank Governors, would take the policy decisions. The ESCB would be independent of instructions from national governments and Community authorities.

22. Numerous questions arise which are barely addressed in the report - in particular:

- Would it be sensible or politically feasible for the ESCB's policy-making to be independent of governments, the EC authorities and Parliaments?

- What sort of monetary policy would the ESCB pursue and what instruments would it use?

23. The proposed independence is clearly designed to satisfy the Germans. For the great majority of countries, including of course France and the UK, this could be a radical departure. The Federal Reserve in the US and Bundesbank owe their independence partly to special historical factors. It is highly doubtful whether, in modern circumstances, many EC countries would be willing to offer the same. Handing over to an independent body the management of the exchange rate and the reserves would be especially sensitive (which no doubt explains why the US Treasury have held onto this), and would run counter to the fact that exchange rate agreements are made government to government. The recommended independence would only make any real sense if one took the view (as did the Germans and Americans earlier in their history) that the political authorities could not be trusted to run a sensible monetary policy.

24. As for the type of policy, it is worth remembering that one of the motives that some current ERM members have in wanting to move to EMU is the hope that this would lead to a "better monetary policy in Europe than exists at present - ie predominantly, a German monetary policy. Representation on the ESCB would give them some influence to bring this about.

25. So much of course would depend upon the monetary views of EC countries when and if we ever get to EMU. From the UK's standpoint, there are two ways of looking at it. On the one hand, when we join the ERM, we might not be altogether happy to have our monetary policy dictated to by the Germans; in that sense,

movement to an ESCB run policy would have advantages. On the other hand, the influence in the ESCB of countries wanting to run a looser policy than us might be a danger.

26. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions and which could no doubt be studied for years. For example, what monetary aggregates would be targeted? Would the ESCB target bank reserves, would it go further and operate a monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

27. The Committee correctly reject a parallel currency strategy. The creation of ECUs by national and central banks would be quite different from the use of official ECU in intervention (which we favour), since official ECU are derived from countries' foreign exchange reserves. It would all too likely be in effect a licence for central banks to print the currencies in other countries, especially the DM and other more important components of the ECU. It is not surprising that the Germans vigorously oppose this.

28. It is just about conceivable that national monetary authorities could collectively agree on issues of ECU through each of their central banks in proportion to their currencies' weighting and <u>in place</u> of own currency issue. But this would be extraordinarily difficult to agree and the effort would greatly complicate whatever steps <u>are</u> taken to strengthen ERM and beyond. Instead, the ECU should continue to develop mainly through the spontaneous "bundling" of currencies by the private sector.

Alternatives to a European Central Bank

29. The Delors report argues that EMU requires centralisation of responsibility for monetary policies: coordination of national monetary would not be sufficient. Hence the proposal for an ESCB and for Community monetary policy being set at the centre by the ESCB Council.

30. It is certainly not enough to ensure that all national monetary policies are consistent with each other: some device is needed to ensure that they are also consistent with an acceptable outcome for inflation, ie the system as a whole needs an appropriate nominal anchor. But these are ways of achieving this that do not involve the centralisation proposed by Delors.

31. One type of solution is to select a nominal anchor that is external to the EMU system - eg gold or the dollar - and for all currencies within EMU to peg to that nominal anchor. This type of solution was discussed earlier in the "gold standard model". Another type of solution would be for one participant to peg to some nominal anchor - which could again be the dollar or gold, but could also be a domestic monetary aggregate or nominal income - and for other participants to conduct monetary policy so as to fix their exchange rates to the leading currency. In this way the nominal anchor in the leading currency would function as a nominal anchor for the whole system. Neither of these solutions would involve a European Central Bank, though the second might require some forum in which other members of the Community could discuss and perhaps exercise pressure on the leading country's monetary policy.

(1)

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STRENGTHENING OF ECONOMIC POLICY COORDINATION

DURING STAGE ONE OF THE ECONOMIC AND MONETARY UNION

(REVISION OF THE 1974 CONVERGENCE DECISION)

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PART 1: PROMOTING ECONOMIC CONVERGENCE

A. THE RATIONALE FOR A NEW CONVERGENCE DECISION

1. The European Council in Madrid decided that the first stage of the process towards Economic and Monetary Union (EMU) should begin on 1 July 1990. It also stated that preparatory work for the organisation on the Intergovernmental Conference (IGC) to lay down the subsequent stages, should begin immediately.

Progress towards the monetary construction of Europe requires a greater convergence of economic performance and, as a means to it, stronger policy coordination. However, a greater degree of common economic policy-making is not only required in view of the future of Europe, with EMU prominent in it. It is also necessary in order to strengthen existing major building blocks of the Community. For example:

- the internal market which, by linking national economies more closely, will reduce the room for independent policy;

- the EMS which, with free capital movements and fully integrated financial markets, will translate incompatible national policies into exchange rate tensions even more quickly than thus far.

2. The 1974 Council Decision on Economic Convergence (74/120/EEC) and its associated Directive on Stability, Growth and Full Employment (74/121/EEC) have not worked satisfactorily because of:

- an excessive reliance on a single strand of economic thought (cyclical stabilisation via demand management);

- a misplaced overcentralisation in decision-making (disregarding even the most elementary form of subsidiarity);

- an overbureaucratic mechanism of implementation (with unrealistic sequencing of economic consultations).

Furthermore, these two 1974 texts predate the creation of the EMS, the internal market programme and the Single European Act, and since the Basle/Nyborg agreement the procedures for multilateral surveillance have been strengthened. Recently the exercises have been conducted at a Ministerial level.

3. In view of the above, the Commission proposes to replace the two 1974 acts with a new Council Decision to strengthen economic policy coordination during Stage One of EMU on the basis of a surveillance process. This new Decision will:

- learn from the weaknesses of the 1974 legal texts;

- be consistent with the importance now attached to the supply orientation of policy, and the ongoing structural adjustment of the Community economy;

(4)

(II) Subsidiarity and reciprocal commitments

7. The principle that the Community should only seek to act where national governments cannot be expected to do so satisfactorily, is already widely reflected in areas of internal market and micro-economic policies. It should also be applied to the macro-economic area as the Community progresses towards Economic and Monetary Union. This was not the case with the 1974 Convergence Decision: a shortcoming to be redressed.

In full respect of subsidiarity, the present proposal sets up a procedure of reciprocal commitments leading to self-enforced policy coordination from within the Council. This implies a new modus operandi of the Economics and Finance Council, already successfully tested on July 10 and to be strengthened. Thus, in addition to the normal legislative responsibility discharged by the Council (the legislative mode), Ministers will be called for a periodic, in depth, confidential, common assessment of economic prospects - inclusive of the consequences of policy and their consistency within and among countries. In this capacity (the multilateral surveillance mode), the Council will review policy behaviours, examine individual members' policy commitments and agree on Community-wide recommendations aimed at achieving a more effective economic convergence. The Commission will prepare the discussions on the basis on analytical work and the necessary contacts with Member States.

(III) Learning-by-doing, in a dynamic process

8. Stage One aims at a greater convergence of economic performance through the strengthening of policy coordination within the existing institutions. Given the fact that institutions (the Treaty itself) will have to be changed as the monetary union process goes on, the self-policing of economic policy will have to gain in depth, breadth and scope in the course of Stage One.

9. This carries two consequences:

First, the process of surveillance itself cannot be prescribed in any definite form, lest it will be either premature (at first) or obsolete (later on).

Second, and this is the key point, policy coordination will have to be implicit at the start of Stage One. However, an experience with the process accumulates, it will eventually become explicit, resulting in commonly agreed recommendations and commitments, with growing influence on the formation of national policies.

It is on the basis of this adequate apprenticeship in policy coordination and economic convergence, that the subsequent stages of EMU will be launched.

(3)

- respond to the growing interdependence of policies as a consequence of the Internal Market and of the EMS discipline;

- foster multilateral surveillance, in the context of the EMS not only in monetary policy, but also in areas of national economic management affecting supply conditions, market regimes, aggregate demand, budgetary policy, prices and costs of production, and the unemployment situation.

4. There is also need for parallel revision of the texts governing the cooperation between central banks (notably Council Decision 64/300/CEE of 8.5.1964 and other texts(1)). The Commission, after consultations with the Committee of Governors of Central Banks, will soon present its proposals on these texts.

B. MULTILATERAL SURVEILLANCE WITHIN THE COMMUNITY

5. Three main principles will support the process of policy coordination during the Stage One of EMU:

(i) consensus on economic policy objectives;
(ii) subsidiarity and reciprocal commitments;
(iii) learning-by-doing, in a dynamic process.

(i) Consensus on economic policy objectives

6. Member States agree on the objective of job-creating and non-inflationary growth with stability; on the framing of policy in the medium-term; and on the need to accompany good macroeconomic management with structural reforms, taking into consideration the economic and social cohesion in the Community. This, in turn, requires a double coherence in policy:

- within Member States. Lax budgetary policy, for example, when combined with stability-oriented monetary policy, eventually undermines stability and/or crowds-out private investment.

- between Member States. For monetary policy, in an integrated financial area, incoherence is immediately felt, and sharply. For budgetary policy interdependence may be slower acting. Yet, experience shows that major budgetary divergences, especially within the EMS, have important negative consequences.

Consensus on economic policy objectives is a necessary - but not a sufficient - condition for the type of enhanced multilateral surveillance required under Stage One of EMU. Other principles are required.

(1) Council decision 64/301/EEC of 8.5.1964, Council Decision 71/142/EEC of 22.3.1971, and rules of Procedure of the Committee of Governors of the Central Banks of the member States.

(5)

C. MAIN FEATURES OF THE PROPOSED SURVEILLANCE SYSTEM

10. The new Decision would be based on Art. 103 and 145 of the Treaty. It would refer to Art. 102A, inserting the surveillance process at the very heart of the EMS, the Internal Market and the progress towards EMU.

11. Three main objectives of economic policy coordination are proposed:

    1. achievement of the Community's objectives;
    2. improvement of Member States' economic performance and convergence;
    3. betterment of the Community's ability to influence or withstand world economic developments.

    Correspondingly, three main forms of coordination are put forward: multilateral surveillance, country-specific consultations; and concertation in the case of major outside disturbances.

12. The task of economic policy coordination is the primary responsibility of the Concil of Economic and Finance Ministers (ECOFIN) together with the Commission and supported by the relevant committees. Due account will be taken of the views of the Committee of Governors of Central Banks.

13. General multilateral surveillance would be based on indicators of economic performance, country reports on national policies and an Annual Report on the economic situation of the Community. It would provide a comprehensive framework for the assessment of the consequences, and consistency of the overall policies of Member States. Specific national commitments may result together with Community-wide recommendations. The ECOFIN may aim at the examination of budgetary policies, ahead of national budgetary planning.

14. Where the performance of individual Member States were collectively judged detrimental to common objectives, the Concil may engage in country-specific policy consultations.

15. Joint concertation to face outside disturbances would take place when the performance of the Community economy is considered to be threatened. Such a search for a Community response may occur, in particular, in the case of sudden international financial tensions.

(6)

PART 2: DRAFT OUTLINE OF COUNCIL DECISION ON THE STRENGTHENING OF ECONOMIC POLICY COORDINATION DURING STAGE ONE OF ECONOMIC AND MONETARY UNION*

1. Legal base: Art. 103 and 145 with reference in the preambles to Art. 102a.

2. Justifications:

   - completion of the internal market will increase the degree of economic integration and amplify the cross-border effects of policy.

   - the stability of the EMS requires more intensive and effective policy coordination;

   - incompatible national policies with free capital movements from 1 July 1990 and integrated financial markets would quickly distort flows of savings and translate into exchange rate tensions.

   - in order to facilitate progress towards EMU, greater convergence of economic performance is needed in the face of persisting internal and external disequilibria.

   - achieving the full potential benefits of the internal market requires a strengthened competition policy and the common policies given in the Single European Act.

3. The Objectives of Economic Policy Coordination:

   - contributing to the achievement of Community objectives, in particular convergence at a high level of economic performance in the framework of monetary stability and enhanced economic cohesion;

   - ameliorating Member States' economic performance with regard to price stability, growth, employment and internal and external equilibria;

   - increasing the social and economic cohesion in the Community;

   - contributing to the efficiency of European financial markets,

   - improving the Community's ability to influence world economic developments;

4. Policy Coordination should focus on:

   - multilateral surveillance issues;

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* (To replace the Council Decision 74/120/EEC and Directive 74/121/EEC of 18.2.74).

(7)

- country-specific policy issues;

- joint concertation to face outside disturbances.

5. Multilateral Surveillance should be mainly concerned with:

- the economic situation of the Community and in Member States;

- macro-economic, micro-economic and structural policies and conditions;

- the consistency of policies within Member States and in the Community at large;

- coordination of policies vis-à-vis the exterior.

5.1 The surveillance should be the primary responsibility of the Council of Economic and Finance Ministers (ECOFIN) together with the Commission and supported by the relevant committees. For this ECOFIN would meet on a regular basis. To ensure the consistency between monetary and economic policies, the Chairman of the Committee of Central Bank Governors would attend these meetings.

5.2 Multilateral surveillance should take place on the basis of Commission analyses having the form of:

- indicators of economic performance concerning monetary and budgetary policies, supply and demand trends, price and cost development, unemployment, financial markets, external and internal imbalances.

- country reports on national policies and their adequacy in view of the completion of the internal market and of economic and social cohesion.

- an annual report on the economic situation of the Community and of Member States.

In the above context, the ECOFIN will examine all aspects of economic policy. It should also consider annually reviewing budget policies, ahead of national budgetary planning. In due course, as more experience is gained in this domain, the coordination procedure may include the setting of medium-term budgetary orientations as well as initiating concerted budgetary actions by Member Countries.

5.3 The Annual Economic Report would be submitted to the European Parliament and the Economic and Social Committee.

5.4 The Council's multilateral surveillance should consist of in-depth examination of particular issues of national and Community concern.

(8)

It should increasingly result in agreed policy commitments by each Member State and in Community-wide recommendations aimed at achieving a high degree of economic convergence. As experience grows this should become an effective way of ensuring self-enforced coordination.

The Chairman of the ECOFIN and the Commission should periodically report to the European Parliament on the results of multilateral surveillance. The Council may also decide that, when suitable, its deliberations be summarised in "surveillance conclusions" to be made public.

6. Country-specific policy consultation would take place in the case of potential or manifested economic conditions threatening the interests of the Community, and incompatible with the general policy orientations adopted by the Community.

Such consultation can imply the formulation of recommendations with a view to promoting the necessary policy corrections in the country in question and, if necessary, by other Member States. The progressive implementation of this consultation should enhance the cooperative approach to national policy-making.

7. Joint Concertation to face outside disturbances would take place in the ECOFIN in the case of:

- the emergence of international economic and financial tensions likely to produce negative consequences for the Community economy;

- other unforeseen events threatening the Community economy.

This procedure may be developed to ensure that the Community coordinates its economic policy vis-à-vis the rest of the world. In conjunction with the Committee of Governors, exchange rate policy vis-à-vis third currencies may be coordinated.

8. Monitoring

There cannot be multilateral surveillance without appropriate monitoring of the follow-up to agreed upon commitments. This applies equally to concerted economic policy actions, to the country-specific policy consultation and to the joint concertation. As appropriate, the Commission may be asked to keep matters under review and report back to the Council.

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EMU(PM)89 2nd Meeting
1 August 1989

PLP

HER MAJESTY'S TREASURY
SIR PETER MIDDLETON'S CO-ORDINATING GROUP
ON ECONOMIC AND MONETARY UNION

Minutes of a meeting held at 9.45am on Friday 28 July in Room 78A/2 Treasury Chambers.

Those present:

Sir P Middleton (in the chair)

Sir T Burns)		Mr Crockett)	
Mr Wicks)		Mr Coleby)	Bank of England
Mr H P Evans)		Mr Price)	
Mr Odling-Smee)	Treasury		
Mr Scholar)		Mr Kerr	FCO
Mrs Chaplin)		Professor Griffiths	No.10

Secretaries: Mrs M E Brown) Treasury
Miss M O'Mara)

1. Reporting briefly on developments in Europe, Mr Kerr noted that the interview by President Mitterrand, which had just been reported in the press, had in fact been given on 7 July, well before his discussion with the Prime Minister at the Economic Summit. M. Dumas' speech at Strasbourg the previous day was of more concern, since it had been interpreted by the press as indicating agreement had been reached on the French proposal that a high level group of Ministers and officials should be set up to co-ordinate work on Treaty amendment. In fact, no agreement had been reached on this proposal when Dumas had mooted it at the Foreign Affairs Council on 17 July. The FCO would ensure that overseas posts lobbied their contacts before the Informal ECOFIN at Antibes to ensure this was fully understood. Mr Kerr added that the new Foreign Secretary was likely to make a speech on Europe in New York just after the Informal ECOFIN.

2. Sir Peter Middleton explained that EMU(PM)89(1) represented the draft of a preliminary report on alternative models of EMU which he would like to put to the Chancellor. Once he had the Chancellor's initial reactions to its conclusions, it would be possible to narrow down the options on which further work would be required. Mr Odling-Smee explained that given the shortage of time, there were one or two obvious gaps in the paper, of which he cited the absence of any discussion of the private ecu as a notable example.

3. In an extended discussion, the following points were made:

Introduction

i. It might be made clear that the paper discussed models which could be presented as genuine forms of monetary union, rather than different forms of monetary co-operation. It should also be made clear at the outset that Delors covered both monetary and economic union but that this paper deliberately did not discuss economic union which was not necessary for the Delors model of monetary union, let alone others. The paper therefore did not cover fiscal policy in any detail.

ii. It was suggested that it would be helpful if the criteria against which the models should be judged were set out at the beginning of the paper.

iii. It could also be useful to indicate precisely what commitments to EMU the UK had already entered.

Extending the ERM

(a) Narrower bands

i. It was noted that the argument in paragraph 13 depended on the size of the interest rate differential, the inflation differential and the width of the band. In practice, this option would not be adopted until the inflation differential had narrowed. If it were to be consistent with a decreasing frequency of realignments, economies would have to converge faster than the bands narrowed.

ii. This option might be difficult to present as an end point in the process of EMU.

(b) Incorporation of non-EC members in ERM

i. Although several members of the group questioned the value of including this option, it was agreed it should continue to be discussed briefly in this first paper but it should be made clear that some would regard any attempt to advance it as a wrecking amendment.

(c) Common dollar/yen policy

i. This section might usefully distinguish between improvement of the current intervention arrangements; establishing an agreed view of the implications for the Community of movements in the dollar and yen and the appropriate response; and setting specific exchange rate ranges, as in the Plaza and Louvre agreements.

ii. The section should not reject the concept of a European Reserve Fund and should include material from the de Larosiere paper on the subject circulated to the Delors Committee.

iii. It would be difficult to decide under this option how the Community should be represented in discussions with the US and Japan.

(d) Competing currencies

i. The main body of the paper currently dealt only with official currencies; the discussion should be extended to cover the private currency model, at present in an annex.

ii. After some discussion, it was agreed on balance that this model was probably not consistent with maintaining the ERM.

iii. It was questioned whether good currencies would in fact drive out bad, if "bad" currencies paid higher interest. However, it was generally concluded this should happen in time on the grounds that higher interest rates would not be a sufficient incentive to offset the greater risk inherent in holding bad currencies. A distinction might be drawn between currencies used for local trade, which were likely to be retained for this purpose, whatever their characteristics, and those which would increasingly be favoured for intra-EC trade and for savings.

iv. It was pointed out that even when the capital liberalisation Directive came into force for most EC countries on 1 July 1990, it would still be possible to maintain some controls for prudential and tax reasons.

v. It might be more helpful to couch the discussion of obstacles in terms of the practical conditions which would need to be put in place in order to create the environment in which currencies could genuinely compete, followed by a passage on other issues which would also arise. The overriding condition might be that the law should not prevent willing parties from using whatever currency they wished.

(e) Gold standard

i. It was suggested that participating central banks would not have to hold large stocks of gold, provided they were prepared to adjust interest rates sufficiently swiftly and sharply to ensure private sector demand matched supply. The money stock in individual countries would not need to be backed by gold. But some gold stocks would have to be held, probably at Community level, to foster credibility in the system.

ii. In discussion of the related commodity standard model, it was noted that the price of commodities fluctuated a great deal. If this option were pursued, more work would need to be done on whether a commodity standard could in fact deliver price stability. Some reference might be made to the Chancellor's proposals for a commodity price indicator made at the IMF meetings in September 1987.

(f) Sterling area

i. It was noted that unless this model contained special features, such as a requirement that members should hold the major part of their reserves in deutschemarks, it looked little different from the ERM. The Germans would, however, oppose suggestions that member states should hold more deutschemarks on familiar reserve currency grounds.

ii. This section should state explicitly that sterling was unlikely to become the dominant currency.

(g) Loose Delors

i. It would be difficult to present this option as an end point, so it should not be offered as an alternative model. It might, however, be an outcome the UK could accept in subsequent negotiation. It should not in any case be presented as a watered-down version of Stage 2.

ii. One form of "loose Delors" might be the creation of a weak co-ordinating committee, rather than some form of central bank, to establish monetary rules, with all monetary operations conducted through individual central banks and no centralised fiscal policy.

iii. This section might usefully distinguish between the Fed's Open Market Committee and the ESCB model.

iv. The discussion of "loose Delors" would more naturally follow the section of the paper on extending the ERM.

(h) Conclusions

i. This part of the paper should contain a separate section on sovereignty. That might refer to the degree of sovereignty surrendered under earlier arrangements and note that further work would need to be done on this aspect when the choice of options had been refined.

4. Summing up, Sir Peter Middleton concluded that the most promising options appeared to be an enhanced ERM/loose Delors, the competing currencies model and the gold standard. He asked Mr Odling-Smee to revise his paper in the light of discussion and recirculate it to members of the group for final comments during the course of the following week. He would then submit the paper to the Chancellor, making it clear that it simply sought to examine the merits of each option and not how they might ultimately be presented. The paper might serve as source material for a list of questions the Chancellor could pose at Antibes.

HM Treasury

1 August 1989

Copies to:

Those present
Mr A C S Allan
Mr R I G Allen
Mr Peretz
Mr Riley
Mr S J Davies
Mr Grice
Ms Symes

Miss J Wheldon (T.Sol)

M207

FROM: C MELLISS (IF2)
DATE: 3rd August 1989
X4700

CHANCELLOR

cc Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr A Allan o/a
Mr R I G Allen
Mr Peretz
Mr Riley
Mr Sedgwick
Mrs Brown (EC1)
Mr S Davies (MP1)
Mr O'Donnell (IDT)
Miss O'Mara (MG1)
Mr Edmonds
Mr Hanks
Mr Tyrie

THE FRENCH ECONOMY: RECENT DEVELOPMENTS AND POLICY

1. The attached paper by Stephen Hanks examines the macroeconomic performance and structural adjustment of France. Our aim in producing this paper is two-fold. Firstly, we need to develop a coherent view about French economic policy to help you, ministerial colleagues and senior officials in your various bilateral and international meetings which involve questions about France. Secondly, we need to have an up-to-date and reasonably comprehensive source for briefing on France. The paper has been approved by Sir Terence Burns, and an earlier version was seen by the Bank, FCO and the Paris Embassy, all of whom provided invaluable comments.

2. Perceptions of French economic performance have shifted somewhat over the last two years. Over the period 1981-1987 French growth had averaged a little less than 1¾ per cent a year, well down on the average of the 1970s. The 1983 policy reversal, involving a strong disinflationary strategy linked to exchange rate stability within the ERM had succeeded in reducing inflation. Inflation fell from over 10 per cent in 1982 to less than 3 per cent in 1986. The inflation differential with Germany, 6½ percentage points in 1983, had been reduced to less than 3 per cent and it is now ½ per cent (CPI figures). But this

disinflation had been achieved at a high price in terms of low output growth and high unemployment. Questions were being raised as to whether ERM membership was not contributing to this low growth - low inflation outcome.

3. French economic performance improved markedly in 1988 and this has continued through this year. The strengthening of other European economies and the world-wide investment and export boom has undoubtedly contributed to this. But there is evidence that some of the improvement, particularly the acceleration in investment since early 1988 aided by higher profitability, has been the result of mainly French factors. The paper, in common with recent assessments by the IMF and OECD, takes the view that France, over the medium term, should be able to continue to have higher rates of growth consistent with productive potential of about 2½-3 per cent. At the same time most forecasters see only a very modest rise in French inflation.

4. It is too early to say whether or not there has been a decisive improvement in the French output inflation trade-off. But it is worth noting that the French themselves see the linkage of the franc to the deutschemark as the key to the credibility of their monetary policy. There seems little doubt that this policy has contributed to the near convergence of French and German inflation rates.

5. French interest rates remain above those in Germany, although the differential has declined significantly since the mid 1980s - chart 1 of the paper illustrates this. Nevertheless the French are concerned about the high overall level of interest rates, while at the same time being concerned about the decline in household saving.

6. Despite the good overall performance of the French economy since the beginning of 1988 some important problems remain. Unemployment remains at about 10 per cent, the second highest level among G7 economies, and no early significant reduction is expected. The paper ascribes much of this to labour market rigidities, especially factors which inhibit appropriate

adjustment in the structure of wages. Associated with this is a structure of taxation and social security which has disincentive effects. This is coupled with a high overall burden. The high level of employers' national insurance contributions is a particular feature which by raising the tax wedge contributes to labour market inefficiency.

7. The general government budget deficit fell in 1988, mainly as a result of the cyclical buoyancy of revenues. The 1989 and 1990 budgets have shown that the government has a preference for expenditure increases rather than tax reduction. This tendency may require difficult choices to be made as the economy slows, with pressure on the budget deficit.

8. The Government has withdrawn significantly from industry over the last five years, and there have been few signs of the present administration reversing the disengagement started by the Chirac Government between 1986 and 1988. Trade liberalisation is an area where the record is less good. As the paper shows there is serious - and to us excessive - concern in France that any widening of the current account deficit could undermine the strong Franc policy. This is probably one reason why a protectionist approach to trade policy issues persists. France for example has a VRA for Japanese motor cars which allows a 3 per cent market share for Japan. France is also one of those countries resisting liberalisation of the MFA for textiles.

9. Recipients of the version of this paper circulated on 27th July will wish to use the corrected version of the paper attached.

CM

C MELLISS

cc Mr A Crockett - BoE
Mr S Broadbent - ERD FCO
Mr M Jay - Paris Embassy

THE FRENCH ECONOMY: RECENT DEVELOPMENTS AND POLICY

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S HANKS

IF2 DIVISION

HM Treasury

July 1989

THE FRENCH ECONOMY: RECENT DEVELOPMENTS AND POLICY

1. SUMMARY

Macro-developments

1. Since 1983 France has pursued a disinflationary strategy with some success. Inflation has been cut from a rate double the G7 average in 1983 to below that average in 1988. Growth has, however, been sluggish in the 1980s, well below the G7 average. Recently output growth has accelerated mainly due to rising world trade, which benefited French exports, and strong business investment which reflects improved demand conditions and a recovery in profits. Most current projections foresee a continuation in this improvement in French performance.

Fiscal and Monetary Policy

2. In the period since the reflation of 1981-83 French fiscal policy has been restrictive. The central government budget deficit has been reduced from 3.4% of GDP in 1984 to 1.4% in 1988. The government is aiming to stabilise the public debt-GDP ratio, estimated to be 27% in 1988, by the end of 1992. This target requires cuts in the deficit of F15 billion or 0.3% of 1987 GDP, per annum over the period 1989-92. The Rocard administration has, however, taken advantage of buoyant tax revenues to raise public expenditure in priority areas such as education, culture, research and employment. The initial budget plans for 1990 also involve a further strong increase in public expenditure.

3. The main element of French monetary policy is a fixed parity of the franc in the ERM, the "hard currency" policy, which is seen as necessary to reinforce disinflationary expectations. The policy is advanced primarily through the use of interest rates but wages policy and limiting the size of the current account deficit are also seen as important elements. There is governmental concern about the impact of such a strategy on the level of nominal interest rates, which have been high in both historical and relative terms, but monetary policy has remained non-accommodating.

4. 1988 and 1989 provided, however, a benign test of the viability of the hard currency policy. The weakness of the deutschemark and the boost given to French exports by the strength of world trade both aided the stability of the franc. The credibility of French policies, the narrowing of the inflation and short term interest differentials with Germany and the fact that France had already removed all its major exchange controls, suggests that the policy would be viable in less favourable circumstances.

Public Finance

5. At an estimated 51% in 1988, France has the highest public expenditure-GDP ratio amongst the G7 countries. Since 1984 fiscal rectitude has put the ratio into gentle decline, but it is still over 10 percentage points higher than the G7 average. In the long term the major upward pressure on public expenditure comes from pensions. An increase in the old age dependency ratio and the fact that pensions are earnings related have started to push the social security budget into deficit.

6. The counterpart of high public expenditure is the highest tax burden in the G7. The two main sources of tax revenue are employers' social security contributions, significantly higher than those of France's major competitors, and indirect taxes. Tax reform since 1986 has reduced employers' social security contributions, indirect taxes, corporation tax and marginal rates of direct taxes.

Structural Policies

a. Industrial Policy

7. Since 1983 France has reoriented its industrial policy, moving away from government intervention and subsidy towards a more laissez faire stance. State aid to industry has been cut by a third, as a percentage of GDP, since 1983. F80 billion was raised from a privatisation programme, which has now been abandoned. Price controls were abolished. Nationalised industries were encouraged to improve their efficiency.

8. Recently the performance of industry has improved significantly. The rate of return on capital has returned to levels close to those of the early seventies. Business investment has picked up from averaging 0.8% growth 1975-85 to 5.8% in the last three years. The nationalised industries, as a group, have moved to a position of profit.

b. Labour market

9. France has the second highest level of unemployment in the G7, after Italy. It was the only G7 country to experience a contraction of employment over the period 1984-1987. The government has responded to the problem with youth employment

schemes and liberalisation of employment regulations. Three major labour market rigidities remain: a large 'tax wedge', which is the difference between employers' effective labour costs and employees' net wages, the minimum wage (SMIC) and the relative homogeneity of wage settlements.

10. A key element of the governments labour market strategy is a wages policy. In the public sector this is mandatory with wage increases being linked to government inflation forecasts. Exhortation and the credibility of the disinflationary policies are the weapons used in the private sector. With unit labour costs currently falling the policy is perceived as having played a significant role in the success of the battle against inflation.

c. **Finance**

11. The French financial system has been partly deregulated in a bid to turn Paris into a major financial centre. Regulations governing financial institutions have been harmonised, fixed brokers commissions ended, restrictions on the ownership of brokers eased and credit controls eliminated. In addition all exchange controls, except for a ban on non-enterprise foreign bank accounts, have been lifted.

d. **Trade**

12. French trade policy remains relatively protectionist. Within the EC the French have opposed moves towards a more liberal trade policy. France also accounts for the largest proportion of export credits extended by OECD countries and these credits have, in some cases, effectively been export subsidies.

Personal Sector

13. OECD projections suggest that France will become the most populous nation in the EC by 2020, and that the old age dependency ratio will rise by a half to around 30%. In the short term such a trend may lead to a reversal of the recent secular decline in the household savings ratio.

External performance

14. France's trading performance has been poor since the late 1970s with loss of export market share and a rise in the propensity to import. This decline in performance is not explicable, however, in terms of a loss of cost and price competitiveness. In this context the French government is right to be concerned about non-price factors. The current account deficit though is only ½% of GDP and France has no major external debt burden.

2. CONCLUSIONS AND PROSPECTS

15. 1983 was a turning point in post-war French economic history. At the level of macro-economic policy it represented the point when fiscal and monetary retrenchment became a part of the political consensus. The socialist government came to accept that France was inextricably integrated into the global economy and had to design policies to meet this reality. Since 1987 this acceptance of macro-economic stringency has evolved into the commitment to the hard currency policy.

16. At the level of micro-economic policy it represented the point where the primacy of market forces was recognised. The government no longer believed that it's intervention could successfully guide the development of industry.

17. The performance of the economy in 1988 highlighted the advances made in the last five years. Growth outstripped inflation, investment was the strongest component of demand, the foreign balance was stable, unit labour costs fell and employment grew whilst unemployment fell.

18. The short term prospects for the continuation of this recovery are good. So far in 1989 French growth has shown no significant signs of slowing down. Industrial production, domestic and foreign orders and business confidence are all running at high levels. Investment is expected to remain buoyant as French industry prepares for the single market. The latest international forecasts suggest that growth in 1989-90 will be in the range 2¾-3½ per cent, which is at the top end of the range of estimates of productive potential. The continuing firmness of monetary policy should mean that inflation peaks this year and then resumes its earlier downward path.

19. The most significant risk for the French economy is if domestic demand expands faster than expected. In these circumstances, with a current account

deficit rising rapidly, the hard currency policy could come under severe pressure. If the government remained as committed to the strong franc as it appears to be at present, there would have to be a tightening of fiscal policy in order to rein in domestic demand. In turn a tighter fiscal policy would require higher taxes or public expenditure cuts, neither of which are attractive options for the government.

20. The balance of probabilities suggests, though, that France will avoid such problems. Whilst the trade deficit may widen in 1989, largely due to an adverse movement in the terms of trade, this should be largely offset by an improvement in the invisibles balance. Despite the virtual elimination of capital controls the franc has remained stable within the ERM. Monetary policy is tight, which should help to slow domestic demand by the end of the year.

21. Unemployment is a symbol of the problems that remain with the French economy. The labour market suffers from rigidities which have pushed up the NAIRU, and the current level of unemployment is largely a structural problem. Its solution requires further structural reform. The government, however, seems reluctant to take the initiative in such areas as labour market reform and the opening up of domestic markets. This reluctance could have an adverse impact on the French economy in the medium term.

3. SUMMARY DATA

Table 1: Population and employment 1988*

		France	Germany	United Kingdom	Italy
Population (millions)		56	61	57	57
Total Civilian employment (millions)		21.0	25.5	25.4	20.9
% employed in	- Agriculture	7.1	5.1	2.3	10.0
	- Industry	30.8	40.4	29.5	32.4
	- Services	62.1	54.6	68.2	57.6

* Estimates
Source: OECD

Table 2: National income 1988

	France	Germany	United Kingdom	Italy
GDP (Francs bn)*	4,545	5,188	4,569	4,527
GDP per capita (Francs)*	81,705	84,842	80,313	78,963
Private consumption per capita (Francs)*	49,793	46,565	54,446	53,302
Total investment (as % of GDP)+	19.4	19.4	17.4	19.9
Gross savings ratio+ (as % of GDP)	19.6	23.9	17.2	20.9

+ Figures refer to 1987
*Converted into common currency using PPPs.
Source: OECD

Table 3: Government finance (1987)

(all as % of GDP)

	France	Germany	United Kingdom	Italy
Current revenues	47.6	44.9	40.0	39.8
Current expenditure	51.8	46.6	41.3	50.3
Net public debt	26.6	23.0	43.4	89.1
Gen Government financial balance	- 2.0	- 1.7	- 1.4	- 10.5

Source: OECD

Table 4: External position 1988

	France	Germany	United Kingdom	Italy
Export of goods (Francs bn)	948	1,841	849	763
(as % of GDP)	(16.9)	(25.6)	(20.1)	(15.4)
Imports of goods (Francs bn)	995	1,371	1,067	766
(as % of GDP)	(17.8)	(19.1)	(25.2)	(15.5)
Net Overseas assets (Francs bn)*	- 6	84	144	- 36
Current account (as % of GDP)	- ½	4	- 3¾	- ½

* Figures refer to 1987
Source: OECD

Table 5: Major Events

1979-March	:	EMS established and the Franc enters the ERM
1981-May	:	Francois Mitterrand elected to the Presidency
1981-June	:	Socialists win a majority in the National Assembly
1981-October	:	Franc devalued by 8.5% against the Deutsche mark
1982-June	:	France devalued by 10% against the Deutsche mark. The government introduces a six month pay and price freeze
1983-March	:	Franc devalued by 8% against the Deutsche mark. The government embarks on a disinflationary strategy
1984-July	:	L Fabius replaces P Mauroy as Prime Minister
1986-March	:	Right wing victory in legislative elections leads to J Chirac being appointed Prime Minister
1986-April	:	The Franc is devalued by 6% against the Deutsche mark
1988-April	:	Francois Mitterrand wins a second term as President
1988-May	:	Right wing majority overturned in National Assembly
1989-July	:	France celebrates the 200th anniversary of the revolution with a stylish display of public expenditure.

4. MACRO DEVELOPMENTS

22. Following the Socialist initiated reflation of 1981-1983, French macro-economic policy has been reoriented towards disinflation. Fiscal policy was tightened, and an accommodating monetary policy was replaced by a strong commitment to the stability of the franc within the ERM. Since January 1987 there has been no realignment of the franc-deutschemark rate as against the five devaluations of the franc in the period 1981-87.

23. The immediate benefit of the new strategy was a sharp fall in inflation. Since 1983 inflation has been reduced to a rate close to the average of other major countries.

Table 6: France's relative inflation performance

	Annual percentage change					
Consumer price inflation	**1970-82**	**1982-88**	**1984**	**1986**	**1988**	**May 1989**
France	10.1	5.2	7.4	2.7	2.7	3.7
Germany	5.2	1.2	2.4	-0.2	1.2	3.1
Major Seven countries	8.6	3.5	4.5	2.0	3.1	4.7

Source OECD

Table 7: France's relative nominal interest rates

Short term interest rates	**1970-82**	**1982-88**	**1984**	**1986**	**1988**	**June 89**
France	9.8	10.4	11.7	7.8	7.9	9.0
Germany	7.6	5.6	6.0	4.6	4.3	7.0
Differential	2.2	4.8	5.7	3.2	3.6	2.0

Chart 1: French relative to German money market rate

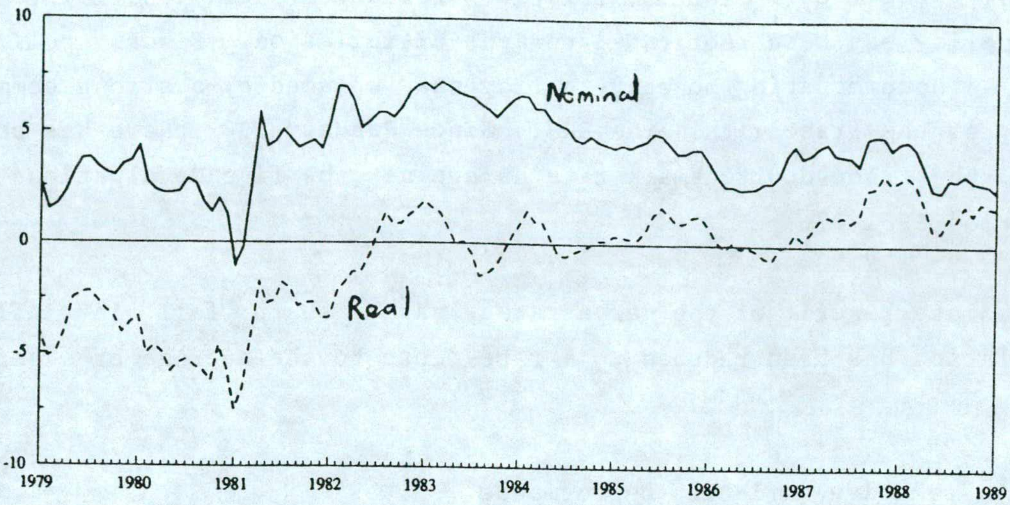
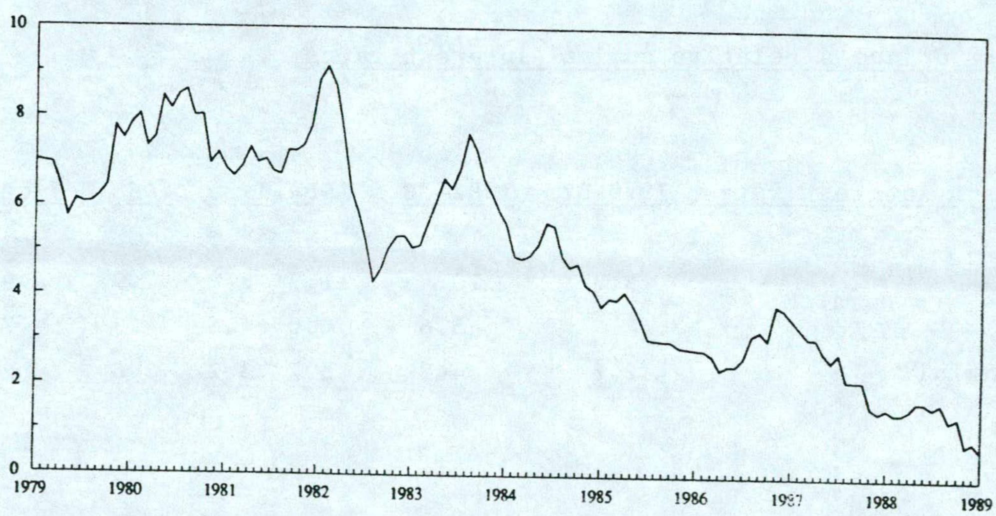


Chart 2: Franco-German inflation differential



24. Over 1983-1987 economic growth was consistently sluggish, both by international standards and by France's own historical standards. Since the second quarter of 1987, however, growth has quickened markedly.

Table 7: France's relative growth performance

	Annual percentage change				
Growth of real GDP	**1970-82**	**1982-1988**	**1984**	**1986**	**1988**
France	3.0	1.9	1.3	2.1	3.5
Germany	2.2	2.4	3.3	2.3	3.4
Major Seven Countries	2.7	3.5	5.1	2.7	4.2

25. The acceleration in growth was mainly due to two factors. First, strong growth in world trade, which benefited French exports. Second, a surge in business investment, reflecting improved demand prospects and a recovery in profits. Profit margins have risen mainly due to real wage restraint, and the 1986 oil price fall, but also as a result of the lifting of price controls in 1986-87 and corporation tax cuts in 1987-88.

5. MONETARY POLICY

26. Monetary policy has been non-accommodating since 1983. The domestic monetary objective has been to control the growth of money and credit. Targets have been set for M2, although M3 was added in 1986 and 1987. The external monetary objective has been to maintain the stability of the franc within the EMS. Increasingly the domestic objective has become subordinated to the external objective with interest rates being determined by developments on the foreign exchange markets.

Table 11: Monetary targets and interest rates

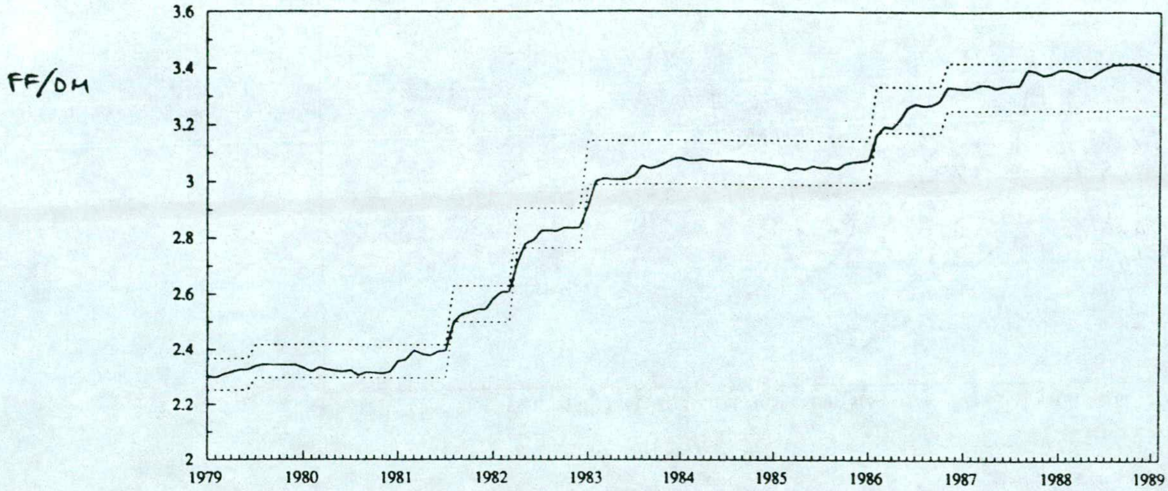
Percentage change on previous year

	M2 Target	Outturn	M3 Target	Outturn	Short interest rates	Long interest rates
1981	10	11.4			15.5	15.8
1982	12½-13½	11.5			14.7	15.7
1983	9	10.2			12.5	13.6
1984	5½-6½	7.6			11.7	12.5
1985	4-6	6.9			10	10.9
1986			3-5	4.5	7.8	8.4
1987	4-6	4.0	3-5	9.1	8.2	9.4
1988	4-6	3.8			7.9	9.6

Source: IMF

27. The adoption of the "hard currency" option has become central to the authorities macro economic strategy. Since January 1987 there has been no realignment of the franc-deutschemark exchange rate. The government has adopted this commitment to exchange rate stability to give credibility to its disinflationary strategy. Maintaining parity with the deutschemark forces the authorities to adopt stringent monetary and fiscal policies. The advantage of establishing credibility is that it should alter agents expectations and improve the efficiency of macro-economic policy. The foreign exchange markets could expect a diminished risk attached to holding francs.

Chart 3: Nominal exchange rate and limits of franc against the deutschemark



28. The exchange rate policy does appear to have played an important role in the recent improvement in the French economy. First, wage inflation has declined to the point where unit labour costs are actually falling. Wage bargainers believe that the government is committed to disinflation. Second, the Franco-German interest rate differential has narrowed as confidence in the franc has increased. Third, the increased confidence of industry about the future has been reflected in steady growth of investment since 1985.

29. In pursuing their exchange rate objective the French have probably had to endure higher interest rates than would otherwise have been the case. The French authorities have expressed the concern that the dominance of the deutschemark in the ERM imparts too great a deflationary bias to the system. The fact that the exchange rate link means that French monetary policy has to follow that of the Bundesbank, however, helps to underpin its anti-inflationary credentials.

Chart 4: Nominal interest rates

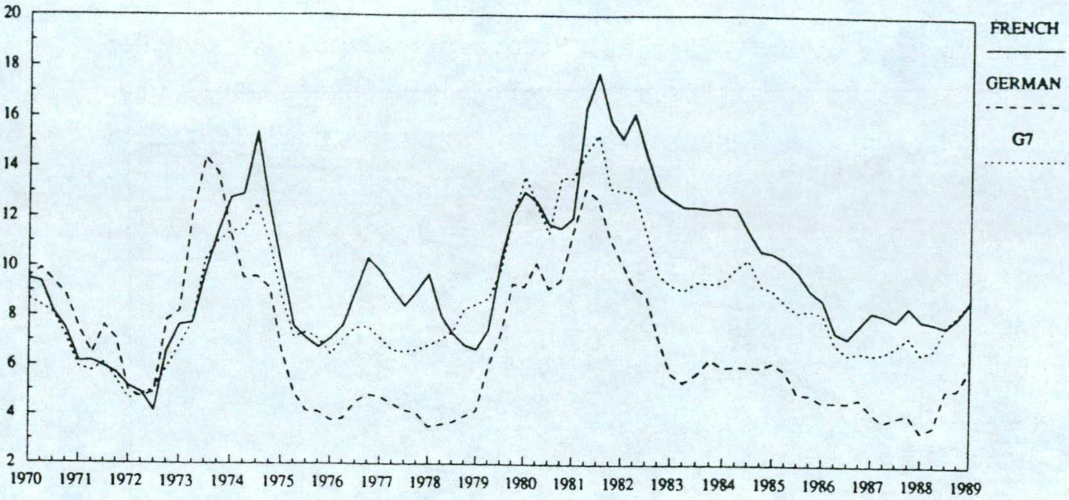
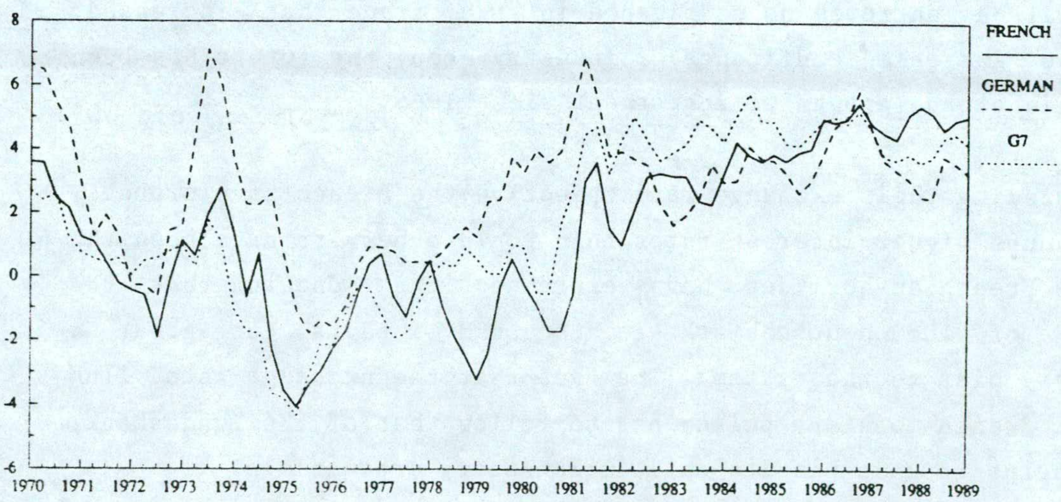


Chart 5: Real interest rates



6. FISCAL POLICY

30. In contrast to most other countries, French fiscal policy avoided large budget deficits in the 1970s. However, beginning in 1981, when most other European countries were starting to reduce deficits, the socialist government embarked on a expansionary fiscal programme. The general government budget deficit rose rapidly between 1980 and 1984, but even at its peak it was well below the G7 average.

Table 8: General government financial balances

	Percentages of GDP				
	1980	1982	1984	1986	1988*
France	0.1	- 2.8	- 2.8	- 2.7	- 1.3
Germany	- 2.9	- 3.3	- 1.9	- 1.3	- 2.0
United Kingdom	- 3.4	- 2.4	- 3.9	- 2.4	0.8
Italy	- 8.5	- 11.4	- 11.6	- 11.5	- 10.5
G7	- 2.7	- 4.0	- 3.4	- 3.2	- 1.6

*Estimates

Source: OECD

31. Rising inflation and a deteriorating current account led to strong speculative attacks on the franc, placing a severe strain on the ERM. In the period up to March 1983 the government was forced to accept three devaluations of the currency. After the third devaluation the government reversed its expansionary policies. It was accepted that continuing membership of the ERM required a commitment to policies compatible with a greater degree of exchange rate stability. For the remainder of its period in office the socialist government sought to hold the central government budget deficit constant as a proportion of GDP. In the event, there was a small decline.

Table 9: Central government financial balance

Percentage of GDP

	1983	1985	1987	1988
France	- 3.0	- 2.9	- 2.3	- 1.4

Source: OECD

32. The 1986-88 Chirac government strengthened this reorientation of fiscal policy. Initially its aim was to eliminate the central government primary deficit, something which was achieved last year. In the 1988 budget the target of stabilising the public debt-GDP ratio, by the end of 1992, was adopted. This new target requires cuts in the deficit of F15 billion or 0.3% of GDP, per annum, over the period 1989-1992.

Table 10: Net public debt

Percentage of GDP

	1982	1984	1986	1988*
France	17.8	21.1	25.3	26.6
Germany	19.8	21.6	22.1	23.8
United Kingdom	45.9	47.6	45.9	39.1
Italy	63.4	74.2	85.6	92.0

* Estimates
Source: OECD

33. The French have had considerable success in reducing the central government budget deficit, and the Rocard government is committed to continuing the process. The 1988 conservative budget was left unamended. The socialist's 1989 budget set a deficit target F15 billion below the estimated 1988 deficit outturn. The preliminary deficit target for 1990 is F90 billion which represents a further F10 billion reduction.

34. The restrictive stance of fiscal policy has, however, eased slightly in the last year. In an adjustment to the 1988 budget the Rocard administration used higher than expected tax receipts to raise public expenditure rather than to further reduce the budget deficit. The real increase in public expenditure planned for 1989 and 1990 is not being constrained, as was the case in previous years, to a level

below real GDP growth. Extra money is being spent on education, culture, research, aid, employment, transport and overseas territories.

35. In the medium term budgetary decisions are set to become tougher. Tax revenue will to grow more slowly due to slower output growth and the costs of reforming taxes on savings and companies. At the same time the government is committed to reducing the deficit and increased public expenditure. It is not clear how these conflicting pressures will be resolved. The most likely outcome is that the pace of deficit reduction may slacken.

7. PUBLIC FINANCE

36. The failure to control public expenditure in France in the early 1980s led to France having the highest public expenditure to GDP ratio of the G7 countries. This was a reflection of the socialists expansionary policies in 1981-1983. Fiscal consolidation has, however put the ratio into gentle decline, but public expenditure remains at a very high level.

Table 12: Public expenditure

	Expenditure as % of GDP 1987				French public expenditure				
	France	Germany	U.K.	Italy	1980	1982	1984	1986	1988
Government Consumption	19.0	19.7	20.7	16.7	46.1	50.3	52.1	51.8	50.8
Government Consumption	3.5	3.6	1.4	5.1					
Transfers	26.6	20.5	14.9	20.3					
Debt Interest	2.8	2.9	4.3	8.1					
	51.8	46.6	41.3	41.3					

37. The recent success in curbing public expenditure has been achieved largely through control of public sector wages and employment. Little progress, however, can be expected in this area in the near future. Under the Rocard administration central government expenditure is now rising in line with GDP.

38. The major problem area of public expenditure is social security. Social security spending is under upward pressure mainly from high unemployment and rising pensions. Emergency increases in employee social security contributions have been imposed to deal with the problem in the short term and recently strong output growth

and lower unemployment have also helped. In the medium term, however, social security expenditure is expected to rise at 3% a year in real terms. Reform will be required if the contribution burden is not to rise inexorably.

39. The counterpart of the high levels of public expenditure in France is a higher tax burden than most of its major competitors. In addition the structure of French taxation is less than ideal. The direct tax base is narrow, indirect taxes are extensive, employers face a heavy burden of social security contributions and the system of taxing investment income is complex.

Table 13: Composition of tax revenue

	% of GDP			
	France	Germany	United Kingdom	Italy
Individual	6	11	10	8
Corporate	2	2	4	2
Employees NICs	5	6	3	2
Employers NICs	12	7	4	9
Property	2	1	5	1
Consumption	13	10	12	9
Other	4	1	0	5
	45	38	38	36

40. The Conservative government of 1986-1988 carried through a series of tax reforms designed to reduce the tax burden and encourage individual enterprise. The top rate of direct tax was cut from 72.4% to 56.8%, tax allowances were raised to help the low paid and the wealth tax was eliminated. For enterprises corporation tax was reduced from 50 to 42% and the payroll tax was cut by 16%. VAT rates on certain goods were lowered. In total, taxes were cut by F 63 billion in two years. The Rocard administration continued this policy with tax cuts of F 24.6 billion in the 1989 budget. Two VAT rates, 33.3% and 7% have been abolished, the rate of corporation tax has been cut again and companies created in 1989 will qualify for corporation tax breaks. A wealth tax, expected to raise F 4 billion, has however been reintroduced.

Table 14: Average rates of income tax: Single person*

Income (£)	France	Germany	United Kingdom	Italy
15,000	28	37	30	30
30,000	34	44	32	36

*Tax and social security contributions as a percentage of gross income. The figures refer to 1989 (France and Germany) 1988-89 (UK) and 1988 (Italy)

Source: Inland Revenue

Table 15: Marginal rates of tax*: Single person

	Income tax threshold£	Starting tax rate	Marginal rate at £15,000	Marginal rate at £30,000	Max Marginal Rate
France	4567	34	48	67	65
Germany	1926	40	56	56	56
UK	2605	34	34	40	40
Italy	2550	41	42	41	62

* Marginal rates of tax and social security on employment income. The threshold was calculated using PPP's. The figures refer to 1989 (France and Germany) 1988-89 (UK) and 1988 (Italy).

Source: Inland Revenue

Table 16: Corporation tax rates: 1988

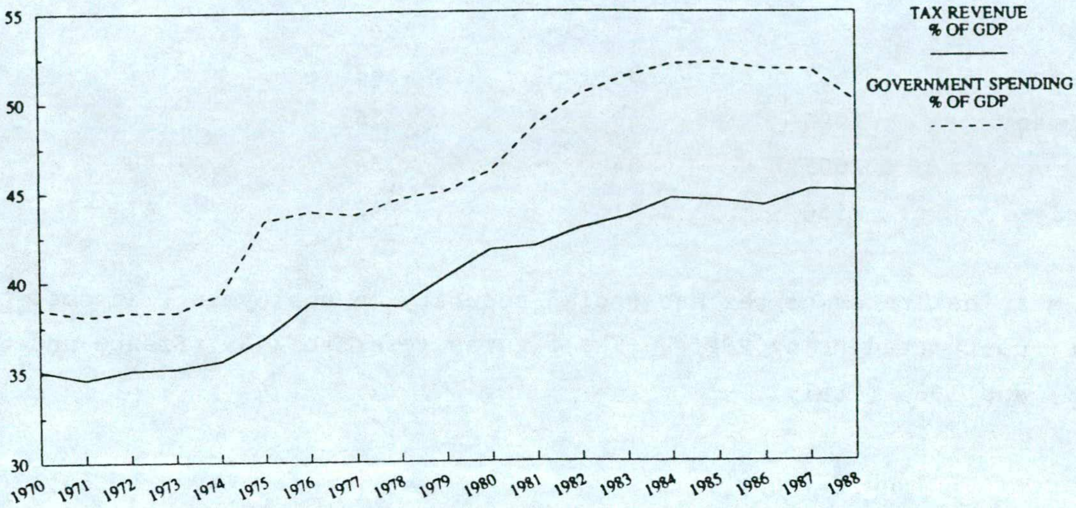
	Central Government	Local Government	Total
France	42	0	42
Germany	56	6-10	62-66
United Kingdom	35	0	35+

+ A reduced rate applies for small enterprises
Source: Inland Revenue

41. The creation of the EC single market in 1992 is putting the French under pressure to introduce further reforms of their tax system. This pressure comes from market forces as well as Commission proposals. France's taxes on expenditure and investment income are amongst the highest in the community. Since the collapse of the Commission proposals on a common withholding tax the French have decided to give priority to reform of taxes on savings.

42. The preliminary 1990 budget involves a further cut in the deficit together with a strong rise in expenditure. Whether there will be tax cuts depends on the strength of tax revenues which have been buoyant in 1988 and 1989 due to the strength of output. Under the Rocard administration the emphasis appears to be switching away from tax cuts towards expenditure rises.

Chart 6: Government expenditure and tax revenue as % of GDP



8. STRUCTURAL POLICIES

a. Industry

43. In post war France there has been a political consensus about the desirability of an interventionist industrial strategy. This consensus has been based on a widespread belief in the efficacy of government guidance of the economy, together with persistent concerns about the balance of trade in manufactured goods, a desire to develop a lead in high technology industries and a streak of economic nationalism. The three main elements of the interventionist strategy have been public ownership, indicative planning and state aid for private industry.

44. French nationalisation took place in three waves: in the late 1930s under the 'Popular Front', in the immediate post war era and in the early 1980s following Mitterrand's accession to the Presidency. After the last wave industrial state owned companies represented 8% of GDP and the financial sector was almost exclusively state owned. In addition the state has holdings in a variety of enterprises arising out of the commercial activities of nationalised industries. Governments have not been afraid to utilise the influence over investment, purchasing and prices that the public sector provides. Examples of this include the vast telecommunications and electro-nuclear programme of the 1970s.

45. Indicative planning started off by bringing together government business and the unions under the auspices of the Commisariat du Plan to decide upon basic economic priorities and then to draw up sectoral plans in accordance with these priorities. The first plan (1946-51) channelled Marshall aid into the priority sectors of transport, infrastructure, electricity, coal, iron and steel, cement and farm machinery. Subsequent plans were however frequently undermined by shocks such as the Algerian war, the events of May 1968 and the first OPEC oil price rise. By the start of the 1980s the plan had been reduced to a document expressing vague political aspirations.

46. State aid for industry has taken various forms including grants, preferential loans, tax allowances, interest subsidies and equity participation. The users to which the funds have been put has also varied and can be divided into four main categories: regional aid, sectoral aid, horizontal aid and export aid.

Table 17: Industrial subsidies (1986)

	Total aid (1)	Direct subsidies'	Industry and regional aid (2)
France	2.2	2.4	3.8
Germany	2.5	2.2	2.7
United Kingdom	1.3	1.4	2.6
Italy	5.6	2.6	16.8

(1.) As a percentage of GDP.

(2.) As a percentage of gross value added in industry.

Source: columns 1 + 3 EC, column 2 OECD

47. The government set up DATAR (Delegation Generale a l'amenagement du Territoire) in 1963 to co-ordinate economic discentralisation and to channel funds into regional development. DATAR's own resources are modest and serve mainly to encourage investment from other sources. Regional spending on company and job creation is less important than spending on the development of infrastructures. Recently emphasis has been given to boosting economic activity in regions hardest hit by the decline in traditional industries, and a number of enterprise zones have been set up, drawing on the UK example, in former shipbuilding areas.

48. Traditionally sectoral support has concentrated on funds for R&D in high technology areas. This money have been highly concentrated in the civil aeronautics, electronics, space and telecommunications sectors, however, sectoral support also involved a large diversion of aid into ailing industries. The main recipients of this money were coal, steel, shipbuilding, chemicals, paper and machine tools in the late seventies and early eighties.

49. Horizontal support, that is funds available to firms across the range of industrial sectors, has been aimed at small and medium sized enterprises. The spending in this area is relatively modest compared to sectoral support and is aimed at improving efficiency and competitiveness in the French economy. Some of the schemes involve the provisions of consultancy services, modernisation of plant, encouraged of research and support for collaborative ventures.

50. Despite the high level of support, the performance of French industry, as in other industrial countries, was weak between the mid-70s and mid-80s. Profit rates fell consistently following the first oil price shock. The rate of growth of business investment was very sluggish. The trade balance stubbornly remained in deficit and the size of the deficit rose.

Table 18: Rate of return in the business sector

	Pre 74	1974-79
France	21.5	18.1
Germany	20.3	17.2
United Kingdom	14.1	11.2
Italy	23.2	18.1

Source: OECD

Table 19: Business investment

	1975-85
France	0.8
Germany	3.3
United Kingdom	4.7
Italy	1.8

Source: OECD

51. Not only was the general condition of industry weak, but specific policies seemed to be failing. Many of the nationalised industries started to run up losses and debts, spending on subsidies escalated as a result but this served only to postpone rather than prevent restructuring and large scale job losses. Despite the R&D funds flowing into the electronics industry it failed to produce a trade surplus.

52. In 1983 there was a shift in industrial policy. The socialist government cut back on aid to industry as part of its general curb on public expenditure. Greatest progress was made in the area of subsidised credit with sharp cutbacks in the volume of subsidised loans and the element of subsidy. The Chirac government, with its ideological commitment to the free market, took the process further. It sought to reduce the influence of the state in industry by removing price controls abandoning indicative planning, and introducing a programme of privatisation.

Table 20: Aid to industry

	1981	1982	1983	1984	1985	1986
Total aid as % of GDP	2.8	2.7	2.9	2.8	2.8	2.2

Source: EC

53. Price controls which have been used in France since 1945, were gradually lifted. Initially the liberalisation process covered the prices of industrial goods but it was later external to trading margins and the prices of services. The government retains the power to fix power to fix prices by decree for a six month period in the face of market disruption.

54. A privatisation programme, which aimed to cover the full five year period of a French Parliament and raise F200 billion, was embarked upon. In the event F80 billion was raised by selling 29 enterprises employing 500,000 workers, mainly in the financial sector. Protection against hostile takeovers during the first five years after privatisation was provided by allocating 20-30% of shares to industrialists and financiers, French and foreign, committed to retaining them during that period. At the time of the 1987 stock market crash, when the privatisation programme was brought to a halt, the public sector was still larger than it had been prior to the nationalisations of 1981-2.

55. The fall of the Chirac government has not led to a major reversal of industrial policy. The socialists accept the primacy of the market and the need to cut aid to industry. There has however been a change of emphasis. Privatisation has been banished from the political agenda, public expenditure is being increased in priority areas and a new plan has been drafted. The latter is however a document filled with vague political aspirations, rather than being the basis for a serious return to indicative planning.

56. The shift in industrial policy in 1983 together with the recent stability of macro policy has started to generate significant benefits. Profits have begun to recover, aided by wage restraint, lower oil prices and the lifting of price controls. In turn the level of business investment has surged since 1985. The economy has started to create jobs in the last 18 months. The losses of nationalised industries have virtually disappeared.

Table 21: Profits

a. Rate of return in the business sector

	1980-86	1985	1988
France	16.2	16.4	18.1
Germany	16.5	17.1	18.1
United Kingdom	11.6	13.0	13.0
Italy	20.2	21.1	22.9

Source: OECD

b. Ratio of gross operating surplus to value added

	1970	1979	1983	1985	1987
France	45.4	39.6	38.0	39.5	42.0

Table 22: Business investment

	1986	1987	1988
France	3.9	4.4	9.2
Germany	4.4	3.3	7.2
United Kingdom	0.6	14.7	17.2
Italy	2.5	9.4	7.2

Source: OECD

Table 23: Nationalised industry profits

	1982	1984	1986	1988
Francs billions	-13.3	-20.4	-13.6	27.8

Source: Le Monde

b, Labour markets

57. Despite the supply side initiatives pursued since 1983, little progress has been made with respect to unemployment. France has the highest rate of unemployment, with the exception of Italy, amongst the G7 nations, and was the only G7 member to experience a contraction of employment over the period 1984-1987.

Table 24: Standardised unemployment

	1980	1982	1984	1986	1988	April 1989
France	6.3	8.1	9.7	10.4	10.1	10.1
Germany	3.0	6.1	7.1	6.4	6.2	5.6
United Kingdom	6.4	11.3	11.7	11.2	8.3	6.6
Italy	7.5	8.4	9.9	10.9	11.8	n/a

Table 25: Growth of employment

	1980	1982	1984	1986	1988
France	0.2	0.3	-1.0	-0.1	0.8
Germany	1.1	-1.7	0.1	1.0	0.5
United Kingdom	-1.0	-1.9	2.2	0.7	3 2
Italy	0.8	0.6	0.4	0.8	1.4

Source: OECD

58. The government's attempts to deal with unemployment can be divided into two categories. First youth employment measures. Prominent amongst these are a Community Work Programme (TUC) and a Company Sandwich Course Scheme (SWP). The schemes involve subsidies for training, exemptions from employer social security contributions and the ability to circumvent the minimum wage. Second, an assault on labour market rigidities was made under the Chirac administration. Enterprises were freed from the requirement to give prior administrative approval for dismissals and restrictions on the use of fixed term contracts and part time work were removed. Regulations governing shift work, female employment and overtime were eased. Price controls were abolished.

59. The continuing high level of unemployment appears to reflect problems with the structure of wages rather than their average value. There is evidence that capital-labour substitutability is low in France. During the disinflationary process labour's share of income has declined as profit margins have been restored. Despite this France's employment record has been poor. There are several reasons for believing that the wage structure is inappropriate.

60. First, due to the high level of social security contributions, the gap between the labour costs faced by employers, and employees take home pay, is higher in France than in its major competitors. This means that the consumption wage is below the product wage and hence employment is lower than it would otherwise be.

61. Second, the minimum wage (SMIC). This places a floor under real wages thereby increasing labour force adjustment at the expense of price adjustment in the face of labour market shocks. Between 1980 and 1988 the SMIC rose by an average of 12.3% a year against an average of 8.8% for the hourly wages of unskilled workers, thereby raising the floor under real wages.

Table 26: Worker remuneration

	1980	1983	1987	1988
Annual value (Francs thousands) of minimum wage	28.7	43.6	56.0	57.5
Average compensation (Francs thousands) per worker	73.9	106.9	131.5	139.7
Row 1 as % of row 2	39	41	43	41

Source: INSEE

62. Third, the relative homogeneity of pay awards. The government has restricted pay rises in the public sector to forecast rates of inflation and has had considerable success in persuading the private sector to follow suit. This could thwart appropriate movements in relative wage costs.

63. The French, however, believe that their interventionist pay policies have been a success contributing in an important way to the anti inflation strategy. Unit labour cost growth during 1980-82 averaged around 13% but during 1986-88 was actually negative. Over the same period the inflation differential with Germany was much reduced. Government policy certainly played a role in these events. It froze wages for six months in 1982 and replaced the freeze with a public sector incomes policy which linked wage rises to forecast inflation. Youth employment schemes allowed employers to undercut the minimum wage. The government was, however, aided by falling import prices. This led to undershooting of regulation forecasts thereby increasing the acceptability of the public sector pay policy and giving credibility to the forecasts as a basis for private sector pay negotiations. Unemployment also probably moderated wage pressures. The perceived success of pay policy ensures that it will continue to be pursued.

c. **Financial Reforms**

64. Prior to the 1980s the French had a poorly developed financial system. Bank intermediation was predominant, and itself dominated by four main banks. The authorities used quantitative credit controls to regulate bank activity and also regulated interest rates. Financial markets were highly compartmentalised. The current aim is to turn Paris into a major world financial centre.

65. The 1984 Banking Act was the first major government reform. This harmonised the solvency, liquidity and risk sharing rules for financial institutions and brought them under the authority of the competition commission. Other moves to strengthen competition have included the ending of fixed commissions for brokers and bond issues, auctioning of government securities, and the gradual lifting of restrictions on the ownership of brokers.

66. Since 1985 several steps have been taken to hasten the development of a unified financial system. Banks are now able to issue Certificates of Deposit, rather than relying excessively on the Central Bank to relieve liquidity shortages. The minimum and maximum length of deposits have been lowered and raised respectively. Financial institutions can now issue long term securities, quoted on the Stock Exchange to finance mortgage lending. Enterprises can now issue commercial paper on the money markets as an alternative to bank finance. A financial futures market was established in 1986. The process has also been aided by financial innovations such as venture capital companies and diversified bond market products.

67. Quantitative controls on bank lending in France took the form of monthly norms which, if exceeded, led to supplementary deposits at the Bank of France. To cope with the distortions this system caused, norms varied for types of credit and unused lending was marketable. Quantitative controls were however abolished at the start of 1987, as the authorities moved over to using interest rates as the main instrument of monetary policy.

68. The French have also liberalised exchange controls since 1986. A ban on personal sector foreign bank accounts is the only remaining capital control and this is expected to be abolished in June 1990.

d. Trade

69. Trade policy is the area where the recent liberal orientation of micro-economic policy is least pronounced. The IMF estimated, in 1986, that France's non tariff barriers in manufacturing were more extensive than those of the UK but less extensive than those of Germany. These figures do not however distinguish between the severity of barriers. In particular the more restrictive a measure the lower the weight it receives because it produces a larger cut in imports.

Table 28: Non tariff trade barriers

Proportion of manufactured imports facing non tariff barriers (1986)

France	15.4
United States	17.9
Japan	10.2
Germany	17.9
United Kingdom	12.8

Source: IMF

70. Trade policy is, of course, an area where EC competence applies. But some autonomy is allowed to member states, and there is evidence that France exploits that autonomy to respond to domestic pressure for protection. For example, France has a bilateral arrangement with Japan that restricts the share of Japanese car exports to 3% of the French market. This is less restrictive than similar Spanish and Italian arrangements, but more restrictive than the UK (11%) or German (15%) arrangements.

71. Where EC competence applies, member states remain able to argue in Brussels for the policies that they favour. The French have opposed moves towards a more liberal EC trade policy, particularly in the areas of agriculture. French resistance to a flexible EC position on reducing agricultural support and protection in the Uruguay Round has been very strong indeed. They have consistently opposed moves which seek to reduce the degree of protection afforded EC farmers by the CAP.

72. The French also offer large scale export credits. This export aid is concentrated on buyers in developing countries and is often linked to "tied aid". No attempt is made to ensure that prices invoiced reflect market prices. Loan repayments are also frequently not made on time, which lead to further loans.

Table 29: French Exports Credits (1985)

	US $ million	As % of total credits extended by OECD countries
Developing Countries		
- Middle Income	656.1	73
- Low Income	19.8	23
NIES	35.3	28
EC	9.6	100
Centrally Planned	8.0	47
OECD minus EC	7.0	50
Total	735.7	64

Source: OECD

73. A few faltering steps have been taken towards the reform of export credits. Since 1985 the rescheduling of loans has tended to replace new loans. The losses of the official export credit guarantee agency (COFACE) are now part of the budget deficit and are therefore more visible. Banks now have to bear the interest risk on loans. Despite this, interest relief on export credit is still virtually automatic and the government consistently seems content to underwrite the losses of COFACE.

9. PERSONAL SECTOR

74. France has the fourth largest population in Western Europe, but only the tenth highest level of people per square kilometre. Average annual population growth has declined consistently since the 1960s but continues to outstrip that in Germany, Italy and the United Kingdom. The current age distribution of the French population is almost exactly the average in the OECD area.

75. OECD projections suggest that by 2020 France will be the most populous nation in the EC and there will have been a rise in the age dependency ratio. These projections are based on three key assumptions. First, between 1995 and 2050 the fertility rate will converge to replacement level. Second, life expectancy will rise by 2 years in the period up to 2030 but will be stable thereafter. Finally, net migration will continue at recent rates.

Table 30: Average annual population growth rates (%)

Country	1980-1990	2010-2020	Ratio of projected population in 2020 to 1980 level
Canada	1.01	0.6	1.40
France	0.37	0	1.07
Germany	-0.10	-0.69	0.79
Italy	0.01	-0.4	0.89
Japan	0.48	-0.23	1.05
United Kingdom	0.08	0.13	1.04
United States	0.88	0.48	1.33
Average of above	0.39	-0.02	1.13

Source: OECD

Table 31: Old age dependency ratios in OECD countries: population 65 & over/ population 15-64

Country	1980	2000	2020
United States	17.1	18.3	35.0
Japan	13.4	22.4	33.7
Germany	23.4	25.1	33.2
France	21.9	23.1	30.5
United Kingdom	23.3	22.3	25.6
Italy	20.8	22.9	28.7
Canada	14.1%	19.0%	29.0%

Source: OECD

76. The main implication of such projections relates to spending on pensions. France is already having problems in meeting social security expenditure out of current contributions. A rise in the number of pensioners relative to the population of working age will exacerbate the problem. Such trends will increase pressure for fundamental reform of the pensions system.

77. Of the G7 countries only the UK has a lower household savings ratio than France. The household savings ratio has declined since the early 1980s. This decline can be attributed to two main factors. First, the success and credibility of the disinflationary process. The level of nominal savings required to achieve a

given level of real savings has diminished. Second, financial innovation and liberalisation. The ability to finance expenditure via credit rather than through savings has increased.

Table 32: Net household savings ratio

% of disposable household income

	1981	1983	1985	1987	1988*
France	18.0	15.9	13.8	12.1	12
Germany†	13.5	10.8	11.4	12.2	13.3
United Kingdom	12.8	10.4	9.5	5.4	3.8
Italy	26.7	24.5	23.4	21.9	21.3

*Estimates
†Gross household savings

Source: OECD

Table 33: Consumer price inflation

	1981	1983	1985	1987	1988
France	13.4	9.6	5.8	3.1	2.7
Germany	6.3	3.3	2.2	0.2	1.2
United Kingdom	11.9	4.6	6.1	4.2	4.9
Italy	18.7	15.0	8.6	4.6	5.3

Source OECD

Table 34: Debt/income ratios*

% household nominal disposable income

	1981	1983	1985	1987
France	n/a	58	59	68
Germany	15	16	16	17
United Kingdom	60	73	86	104
Italy	7	7	8	10

*Defined as total liabilities/income.

Source: OECD

78. The life cycle theory of savings suggests that an aging population could affect a country's savings ratio. In the short term the savings ratio may rise as the increased number of future pensioners save for their retirement. In the long term, however, the savings ratio may be expected to fall as increasing numbers of

people actually become pensioners and start to draw on their earlier savings. The OECD population projections seem therefore, to point to potential further downward pressure on the French savings ratio in the first two decades of the next century.

10. EXTERNAL PERFORMANCE

79. Trading performance is of obvious importance to the French economy - which, in terms of ratios of exports and imports to GDP, is more open than the average of the major seven countries, though rather less open than Germany or the UK.

Table 35: Exports and Imports of goods and services 1988

	Percentage of GDP	
	Exports	Imports
France	22	21
Germany	32	27
United Kingdom	24	28
Italy	24	27
Major Seven	15	16

Source: OECD

80. France's trading performance has gradually deteriorated since the late 1970s and this trend has been particularly pronounced post 1982. The French share of world trade, in volume terms, has declined on average by 2% a year.

Chart 7: French share of world trade volume expressed as an index with 1970=100

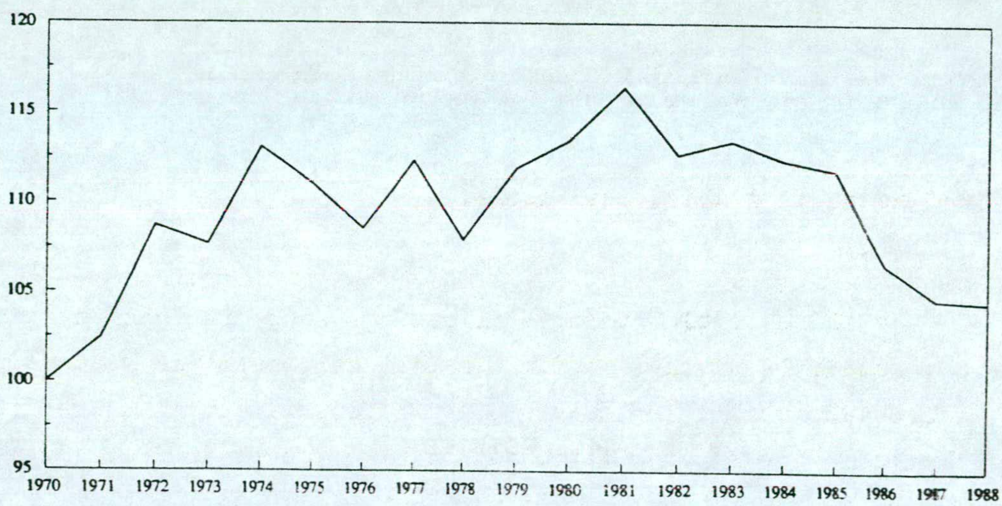


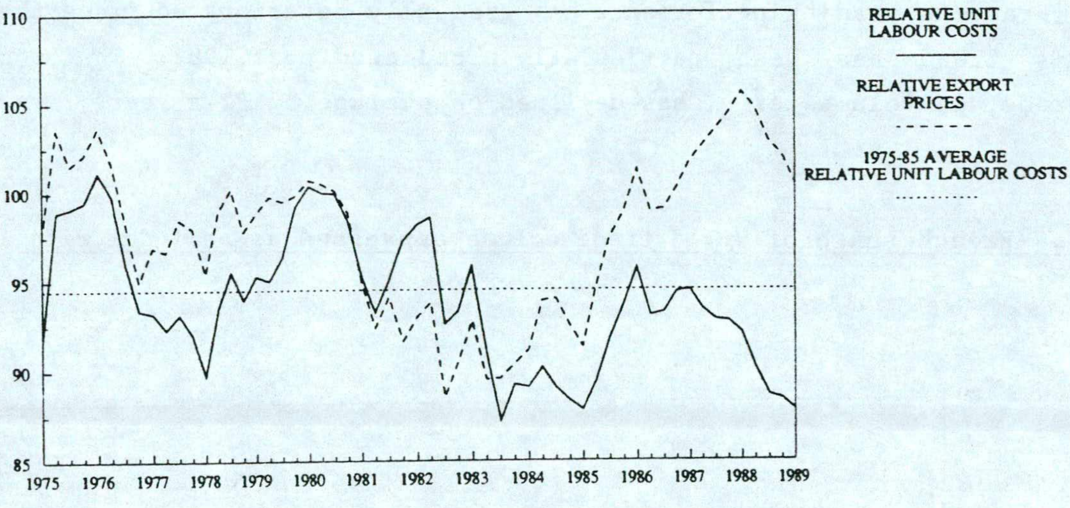
Table 36: Growth of French exports and imports of goods

	Annual Percentage changes	
	1970-1982	1982-1988
Exports	5.9	3.9
World Trade	4.8	6.0
Imports	5.5	4.6
Domestic Demand	2.9	2.1

Source: OECD

81. It is difficult to explain France's recent poor external performance in terms of a lack of cost and price competitiveness. Unit labour costs have been kept well under control and have actually declined over the last few quarters. Relative export prices have edged up probably reflecting restoration of exporters margins. The commitment to the stability of the Franc within the ERM has not led to severe exchange rate misalignment.

Chart 8: French competitiveness



82. The geographical composition of French exports was, however, unfavourable at the start of the 1980s. A relatively small proportion of French exports went to the fast growing North America market and a relatively large proportion went to the stagnant African market. As a consequent French export market growth was noticeably slower than that of its two major European competitors.

Table 37: Geographical composition of exports (1980)

	As % of total exports			
	France	**Germany**	**United Kingdom**	**Italy**
Europe	63	72	58	65
N. America	5	7	11	6
Africa	11	4	8	6
Mid East	6	6	8	12
Other	15	11	15	11
Average annual Export market growth 1980-1987	2.8	3.4	3.6	2.8

83. It is probable, though, that non-price competitiveness is the main area where French trade problems lie. The French themselves are very concerned by the product and sectoral specialisation of their industry. INSEE concluded in a recent report, (Horizon 1993: La France dans la perspective du Grand Marche European), that French industry is not sufficiently specialised compared to Germany, Japan and Italy. As a result export performance is poor due to a failure to gain comparative advantage. Rather than reflecting the nebulous concept of poor industrial structure, however, weak trade performance was probably linked to the general malaise that afflicted French industry of: low profits, low investment, high non wage labour costs, rigid wages, restrictive labour laws and government interference.

84. The French have run a trade deficit since 1970. In accounting terms energy has been the major source of the deficit, but recently manufacturers have compounded the situation. Agriculture has, however, been in surplus throughout the 1980s. Traditionally the French have had a surplus of invisibles, which has more than offset the trade deficit on 9 occasions since 1970.

85. Despite a current account deficit that was only ½ per cent of GDP in 1988, there is widespread concern in France about their external position. There are two reasons for this. First, the worry that the continuing poor performance on the industrial account means that the recent industrial recovery is superficial. Second, and more importantly, concern that any expansion of the payments deficit will put downward pressure on the franc. This could present the government with the dilemma of devaluing the franc, thereby jeopardising its counter inflationary policy, or raising interest rates to a level which could harm the current expansion. At the same time the government is not prepared to risk a current account deficit that enables foreign savings to contribute to the rebuilding of the capital stock.

Table 38: Net overseas assets

US $ billions

	1982	1983	1984	1985	1986	1987
France	-12	-21	-22	-11	1	-10
United Kingdom	56	69	85	105	162	160
Germany	27	27	34	59	106	160
Italy	-21	-18	-18	-32	-34	-40

ANNEX

1. This annex offers a brief chronology of the events that led up to the abrupt change in French economic policy in 1983.

2. The socialist government elected in 1981 inherited on economy with double digit inflation, rising unemployment, an overvalued currency and an emerging current account deficit. Under the Giscard Presidency there had been supply side mismanagement unit labour costs rose rapidly, the replacement ratio increased, labour taxes were pushed up, there was creeping nationalisation and increasing regulation of the labour market. Such policies exacerabated the impact of the oil price stocks of the 1970s. Macro policy was sounder, the central government budget was kept in balance, but the parity of the franc was unchanged from its initial ERM level, set in 1979, despite a significant inflation differential with Germany.

3. Against this background the socialist government embarked on an expansionary and interventionist economic programme. In fiscal terms this meant a sharp rise in government expenditure, which rose by over 4 points as a percentage of GDP 1980-82. The increased spending went primarily on transfers to households, aid to industry and on employing 200,000 new civil servants. Monetary policy became accommodating with credit ceilings being raised. The minimum wage was increased by 38.9% in nominal terms over 1981-82. Mandatory paid leave was extended by one week a year and one hour was cut off the legal work week. Finally companies representing 3% of GDP and 2.6% of the work force were nationalised.

4. The French economy failed to respond to the policies being pursued. The government forecast growth of 3.1% and 2% in 1982 and 1983 respectively against outturns of 1.8% and 0.7%. The rise of unemployment was slowed but not stopped. Inflation continued to run at high levels. The current account deficit in 1982 was treble that of 1981. A significant central government budget deficit emerged.

5. The crucial factor, however, in forcing the government to change policy was the exchange rate. In the face of speculative attacks on the franc the government deployed interest rates, foreign exchange reserves and capital controls, but to limited effect. The franc was devalued in October 1981 and June 1982. After the latter devaluation a six month price and wage freeze was introduced, taxes were raised, some public expenditure postponed and a target was set for the budget deficit.

6. The persistent exchange rate crisis left the government with a choice. Either they stuck to their expansionary policies and left the ERM or pursued policies consistent with exchange rate stability. After a further forced devaluation in March 1983 the government opted for the latter course. Fiscal and monetary retrenchment were, introduced with curbs on public spending, reduced credit ceilings and tighter monetary targets. Industrial policy was shifted away from intervention towards a more liberal stance.

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From: Huw Evans
Date: 4 August 1989

CHANCELLOR

Mr Raikes.
Item F will, as you might [illegible], be particularly well received by many countries @ Antibes. Where do other member countries stand on it? N.

cc

Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mrs M Brown
Mr S Davis
Mr Meyrick
Mr O'Donnell
Ms O'Mara
Mr McKintosh
Mr Tyrie

DELORS STAGE 1

This minute is to keep you in touch with the work in progress, under the direction of Mr Wicks' EMU Group, on Stage 1 of Delors. This will be the major subject for the informal ECOFIN at Antibes on September 8 - 10. A paper on alternative models of EMU for Stages 2 and 3 is being prepared by Mr Odling Smee.

Main elements in Stage 1

The main elements in Stage 1, together with work in hand, are as follows:

A. **Completion of the Internal Market.** This includes a single financial area, and is to be accompanied by a strengthening of Community competition policy. We are

V. important, but a misleading appellation, so far as the UK audience [illegible] concerned drawing up a checklist of all remaining items in the Commission's Single Market Programme, and any other measures we consider necessary for full completion of the internal market, especially those relating to the financial area. Our aim is to identify the more important items together with some estimates of the timescales.

B. **Reform and Doubling of Structural Funds.** No further HMT work in hand. Delors' Stage 1 - unlike Stages 2 and 3 - does not envisage going beyond existing plans for doubling the structural funds.

C. **Strengthening Economic and Fiscal Policy Co-ordination.** There will be a revision to the 1974 Council decision on economic convergence. We expect the Commission to circulate a fairly full paper (but not draft legal text) later this month: we shall provide a detailed commentary. The main features of the Commission text are likely to include: formalising the surveillance discussions of recent ECOFINs; no quantitative guidelines; country reviews when countries are misbehaving; discussions of relations with non Community countries, especially in the face of external disturbances; an evolutionary approach ("learning by doing") as experience grows of surveillance and convergence. We shall want to emphasise: the role of markets in reducing the need for coordinated budgetary policies, and in promoting the completion of the single market; the role of structural reforms (rather than fiscal or monetary policies) in achieving real objectives; and the need for the Council, rather than the Commission, to retain control.

D. **All Community currencies to join the ERM, with the same rules.** Realignments, it is implied, would be used more sparingly. No further HMT work planned at this stage.

E. **All impediments to the private use of the ECU would be removed.** A note is in course of preparation.

F. **The 1964 Council decision defining the mandate of the Central Bank Governors would be replaced.** Central bank Governors have been discussing a draft text (orginating from the Bundesbank) which they are sending to the Commission about now with the expectation that a paper or revised draft will issue from the Commission around end-August. Key points are likely to include; ensuring that the text does not endorse the principle of central banks' independence; the extent to which the Committee of Central Bank Governors would be consulted in advance of national decisions on monetary policy (we need to maintain flexibility); avoiding all reference to Delors' Stages 2 and 3; excluding some objectives, such as full employment, from the Committee's mandate; and accountability to ECOFIN of the Committee's annual report. All this could be quite tricky.

2. I do not think that there are any major additional items for which the UK should be pressing in Stage 1. Our work in hand in related areas includes:

i. **A note on accountability,** distinguishing between accountability to Community institutions on the one hand and to national political institutions on the other. UK statements about the need for political accountability must not be misinterpreted as a call for Community institutions (the European Parliament in particular) to be strengthened.

ii. **The legal basis of revised texts.** The lawyers are investigating which decisions require unanimous and which qualified majority voting. We must attempt to ensure that unanimity applies for all big Stage 1 decisions. In practice we need and expect to get a consensus on texts which will apply to Stage 1.

iii. **Possible high level group.** This idea has been floated by Dumas at the Foreign Affairs Council, but with no agreement. We and the FCO are emphasising UK opposition in our contacts with the French, Commission and others, and the FCO is instructing posts to make it clear that no agreement has been reached on this.

The length of Stage 1

3. Stage 1, it was agreed at Madrid, begins on July 1st 1990. It will continue, at a minimum, until all the directives necessary to complete the Internal Market, and other measures, have been implemented. We shall want to argue that this means implementation, not just by the Council, but by all Member States. In many cases there will be a long lag between full implementation of the regulations necessary to create the internal market and the full economic effects being felt: witness the UK's liberalisation of the financial system (including the abolition of exchange controls) almost a decade ago and the long and still continuing adjustment.

4. In some areas there are already indications of lengthy timescales: for instance, the 1988 Future Financing Agreement provided for the structural funds to be doubled by the end of 1993. And the 1988 Capital Liberalisation Directive

provided for full liberalisation by the end of 1992 for Spain, Portugal, Greece and Ireland - with legal provision for Portugal and Greece to extend to end 1995 which, on current form, the Greeks will need. While we want Stage 1 to begin next year, as agreed, there is an enormous amount of work to be done in the course of Stage 1. Hence this stage will not be fully completed until some years after the completion of the legislative programme. Putting the legislation in place is not sufficient: it needs to be implemented in full, and we need to see it in action for a period, and its effects assessed, before making decisions about further Stages.

The Economic Consequences of Stage 1

5. What will be the effects of completing Stage 1 on the UK and European economies? The 1988 Cecchini report suggested gains of 4 to 6½ per cent in GDP. Our own assessment this year put the gains to the UK at a more modest 2 per cent, with no reason to think a Community figure would be much different. I would want to emphasise that these gains are likely to take some considerable time to come through in full: Cecchini implied 5 to 6 years; a decade would be more realistic.

6. The other elements in Delors Stage 1, beyond the completion of the Internal Market, and which could have substantial economic consequences, are:

i. Especially for the UK, joining the ERM with narrow bands, and making only sparing use of realignments. Countries like Greece will find this adaption difficult.

ii. More serious efforts at coordination of economic policies, as the pressures increase for economic performance to converge within the Community.

7. As the Delors report says, in paragraph 10, the completion of a single market will significantly increase the degree of economic integration within the Community, reduce the room for independent policy manoeuvre and amplify the cross border effects of development originating in each member country. For the UK, the greater degree of interdependence could be amplified if trade flows increase, as a result of joining the ERM, and we would be less able to pursue independent monetary and fiscal policies - in short there will have been a further major evolution. We thought about trying to quantify this and concluded that there is little to be gained at this stage by trying to go beyond the Cecchini report and our own internal work.

8. The single market will involve heavier adjustments for some countries, particularly those which are more heavily protected and those which now control capital movements. Those countries will need to look at how their economies react to the major changes involved in Stage 1 before committing themselves to any further steps along the road to economic and monetary union.

Conclusion

9. Completing the Internal Market, together with other elements in Delors Stage 1, represents a major programme whose effects will be continuing to come through for the rest of this century. We shall want to bring home the scale of these changes and the long time lags between proposals and full effects, in order to try and convince others that concentrating on Delors Stage 1 and seeing how that Stage works is itself a full agenda. Our work on the checklist

for Stage 1 is designed to bring out the timescale of the more important measures.

HPE

H P EVANS

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AND TO PRIORITY OTHER EC POSTS

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FRAME ECONOMIC

EMU: DELORS REPORT: NEXT STEPS
BACKGROUND

1. POST-MADRID WORK ON ECONOMIC AND MONETARY ISSUES WAS DISCUSSED AT ECOFIN ON 10 JULY (UKREP TELNO 2272), AND AT THE FOREIGN AFFAIRS COUNCIL ON 17 JULY (UKREP TELNO 2369), AND WILL BE THE MAIN SUBJECT FOR DISCUSSION AT THE INFORMAL ECOFIN ON 9/10 SEPTEMBER IN ANTIBES. BUT DUMAS HAS TWICE - AT THE FAC AND AT STRASBOURG (UKREP TELNO 2056) - SUGGESTED THE ESTABLISHMENT OF A HIGH LEVEL GROUP OF PERSONAL REPRESENTATIVES OF MINISTERS TO WORK ON QUOTE THE NECESSARY TEXTS FOR THE ELABORATION OF A NEW TREATY UNQUOTE.

LINE TO TAKE

2. YOU MAY DRAW ON THE FOLLOWING IN DISCUSSION WITH NORMAL CONTACTS. POINT (C) NEEDS TO BE GOT ACROSS VERY CLEARLY:

(A) FOLLOWING THE ECOFIN AND FAC DISCUSSIONS, WE HOPE THAT ALL DECISIONS NECESSARY TO ENSURE THAT STAGE 1 CAN START ON 1 JULY 1990 WILL BE TAKEN QUICKLY: THERE IS MUCH DETAILED WORK FOR ECOFIN, BUT WE ANTICIPATE NO MAJOR DIFFICULTY:

(B) THE UK WILL BE PLAYING A CONSTRUCTIVE PART IN THE ECOFIN DISCUSSIONS AT ANTIBES ON WHAT MIGHT FOLLOW STAGE 1:

(C) BUT SINCE THERE WAS NO MADRID AGREEMENT ON POST-STAGE 1 DEVELOPMENTS, IT WOULD CLEARLY BE PREMATURE TO SET UP AN AD HOC GROUP TO DISCUSS TREATY TEXTS. THE FORM OF ANY TREATY TEXTS MUST OBVIOUSLY DEPEND ON THE OUTCOME OF THE ECOFIN DEBATE. THE DONDELINGER GROUP DURING THE SINGLE EUROPEAN ACT IGC IS NOT A PRECEDENT, FOR IT WAS ONLY CONVENED DURING THE IGC. THE DUMAS SUGGESTION NOW IS THEREFORE PREMATURE, AND THE ESTABLISHMENT OF A GROUP ALONG THE LINES HE HAS IN MIND WOULD RISK CROSSING WIRES AND DELAYING THE REAL WORK IN ECOFIN.

MAJOR

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ADDITIONAL 1

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FROM: SIR PETER MIDDLETON

DATE: 4 August 1989

CHANCELLOR

Ch,
X, overleaf, means it would be v. helpful to have any views - however preliminary - asap. (We can of course send a car to pick up a box anytime over the next fortnight, if that would be convenient)
?/8

cc Sir T Burns
Mr Wicks
Mr H Evans
Mr Scholar
Mr Odling-Smee
Miss O'Mara
Mrs M Brown
Mrs Chaplin

ECONOMIC AND MONETARY UNION

I attach the first shot at our study of alternative models of Economic and Monetary Union; it has been prepared by Mr Odling-Smee's team and considered by my Steering Group. The work is nowhere near in a finished state. As paragraph 12 says, much more would need to be done before the alternatives are fully specified. However, I hope that there is sufficient to enable a selection to be made of those alternatives which should be worked up further - either because we may wish to float them as alternatives or because there are aspects of the models which could be thrown into the discussion on Delors.

2. The paper does not consider presentation except where this raises a point of substance. When we know which models we should like to offer as alternatives, we can decide as a matter of tactics on the best presentation. There is a lot of scope here which is not at present fully reflected in the papers.

3. I thought it would be useful to have a go at bringing the arguments together in a set of conclusions which matches the models against the criteria set out in paragraph 7. This section is in an exceedingly provisional state; there has hardly been time to process it in the short period available to do the work.

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4. There are also three annexes which I think you will find particularly interesting. The first is a critique of Delors; but the other two - on Hayek and the Sterling Area - are also essential reading in my view.

5. Finally, we had been working to a timetable (see the final annex) which suggested that the first ~~keen~~ key date would be the Informal ECOFIN at Antibes on 9 September. I now learn that President Mitterrand is to see the Prime Minister on 1 September. So we may find the Cabinet Office or No 10 asking for this work earlier than we had in mind.

pp

P E MIDDLETON

Copies of the report have also been sent to:

Sir George Blunden	)	Bank
Mr A Crockett	)	of
Mr J Flemming	)	England
Mr J Kerr	)	FCO
Sir Alan Walters	)	No 10

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MODELS OF ECONOMIC AND MONETARY UNION

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Annex 1 - Delors proposals for economic and monetary union

Annex 2 - The Hayek competing currencies model

Annex 3 - The sterling and other currency areas

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MODELS OF ECONOMIC AND MONETARY UNION

INTRODUCTION

1. This paper is mainly concerned with models of monetary union which could be put forward as alternatives to that in Delors Stage 3. Fiscal and regional policy issues are largely independent of the particular form of monetary union adopted and are discussed separately and only briefly.

2. The main monetary models considered are:

- Delors Stage 3;

- extending the exchange rate mechanism by:

    - having narrower bands;
    - a common dollar/yen policy;
    - greater co-ordination of monetary policies;
    - incorporating non-EC members;

- competing currencies, either official currencies alone or both official and private currencies;

- the gold standard, or more generally a commodity standard (a weighted average of commodities might in practice be more suitable, although for convenience the discussion is mainly in terms of the gold standard);

- the sterling area, or at least an area in which one currency and one monetary authority is dominant - in practice these will probably be the deutschemark and the German authorities.

3. The Single European Act of 1986 - of which the UK is a signatory - referred in its preamble to the 1972 declaration in which "the Heads of State or of Government approved the objective of the progressive realisation of Economic and Monetary Union". Chapter 1 of the Single Act is headed "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". Both the Hanover European Council in June 1988 and the Madrid European Council in June 1989 reaffirmed the objective of progressive realisation of Economic and Monetary Union. The Single Act and subsequent declarations do not commit the UK to any specific definition of EMU. The Madrid Council agreed that the Delors Report "provided a good basis for further work."

4. By contrast with Delors Stage 3, most of the alternative models do not necessarily require either a single European monetary authority or a single currency. They would therefore not be recognised as forms of monetary union by many observers. (The mere existence of Delors' proposals - and the earlier Werner report - has, of course, conditioned ideas about what monetary union is.) Nevertheless, it should be possible to present each of them as a form of monetary union. It is important to be able to do this, since mere monetary cooperation would not be seen by our EC partners as fulfilling the commitment to progressive realisation of economic and monetary union.

5. The implicit basis of comparison for the alternative models is the situation when Delors Stage 1 is completed. In other words, it is assumed that all currencies are in the ERM with margins of 2¼ per cent, there are free capital flows, and the single market programme has been completed. It is important to recognise that this is likely to lead in time - when the private sector has adjusted - to a much greater integration of economies than at present. With free movement of goods, labour and capital, it could certainly be described as economic union. While a reasonable case could be made for also describing it as monetary union, the Community has clearly decided that the monetary union we are committed to represents something beyond Stage 1.

6. The paper is concerned with the final monetary union, and not with the next steps after Stage 1. However, possible transitional steps are briefly mentioned since they are relevant to a comparison of the models of monetary union.

7. The paper is largely a description of the alternative models, how they might work and their consequences. The concluding section compares them from various points of view:

- economic implications;
- sovereignty;
- how they can be presented as monetary union;
- transitional arrangements;
- acceptability to our EC partners.

These criteria need to be borne in mind in considering the alternative models.

8. The main part of the paper is devoted to the alternative monetary models. There are then brief sections on fiscal and regional policies and a concluding section. Further details on three of the models are in the annexes.

MONETARY MODELS

Delors' Stage 3

9. The Delors report defines achievement of monetary union as the irrevocable locking of exchange rates and the completion of the transition to a single monetary policy. The change-over to a single currency comes <u>after</u> completion of a monetary union: it is seen as the icing on the cake rather than an essential ingredient. There must be some question, however, whether locking of exchange rates can be absolutely irrevocable while separate currencies continue to exist.

10. The European System of Central Banks (ESCB) as recommended by the Committee would be responsible for the formulation of monetary policy and, with the help of the national central banks, for the implementation of this policy. It would also be responsible for exchange rate and reserve management. An ESCB Council, composed of the Chairman, an unspecified number of Board members plus the national Central Bank Governors, would take the policy decisions. The ESCB would be independent of instructions from national governments and Community authorities.

11. The proposed independence is clearly designed to satisfy the Germans. For the great majority of countries, including of course France and the UK, this could be a radical departure. The Federal Reserve in the US and the Bundesbank owe their independence partly to special historical factors. It is highly doubtful whether, in modern circumstances, many EC countries would be willing to offer the same. Handing over to an independent body the management of the exchange rate and the reserves would be especially sensitive (which no doubt explains why the US Treasury have held on to this), and would run counter to the fact that exchange rate agreements are made government to government. The recommended independence would only make any real sense if one took the view (as did the Germans and Americans earlier in their history) that the political authorities could not be trusted to run a sensible monetary policy.

12. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions. For example, what monetary aggregates would be targeted? In the period before transition to a single currency, would as near as possible identical aggregates be targeted in each country or would existing national traditions be respected? How would allowance be made for differences in velocity trends and potential growth rates in allocating national monetary targets? Would the ESCB target bank reserves, would it go further and operate a monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

also, of course
there is no European
political authority

13. A more detailed discussion of Delors is at Annex 1.

Extending the ERM

14. The completion of Delors Stage 1 will represent a considerable strengthening of the discipline on national monetary policies exerted by the EMS. The abolition of capital controls and the advent of the single market in banking will increase market pressures on monetary authorities and cause monetary policies and inflation objectives to converge to a much higher degree than at present. The move to 2¼ per cent exchange rate bands for currencies now with 6% bands and the participation of all Community currencies in the ERM will impose additional convergent pressures on the countries concerned.

15. At that stage any remaining scope for independent monetary policies will stem largely from the possibility of currency realignments. The various ways discussed in this section of extending the ERM do not therefore include any significant curtailment of the freedom to realign. Partly for this reason, they do not greatly increase the convergent pressures that will exist at the end of Stage 1.

16. The first three options - narrower bands, a common dollar/yen policy and greater co-ordination of monetary policies - all involve somewhat increased convergent pressures whether exerted by the market or by Community agreements. The fourth, the incorporation of non-EC members, does not.

(i) <u>Narrower bands</u>

unrealistic?

17. By the end of Delors Stage 1 all EC currencies will be operating within 2¼ per cent bands. This option for extending the ERM envisages a subsequent move to narrower bands of, say, 1 per cent. The move would best be made in one step: smaller and more frequent changes would add complication, without offering significantly greater flexibility.

18. The Delors Report envisaged such a move as a transitional step towards monetary union rather than the final position. It proposed that during Stage 2 not only should realignments become less frequent but "as circumstances permitted and in the light of progress made in the process of economic convergence, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero". Partly as a result of Delors' position, it will not be easy to argue that narrower bands on their own represent monetary union.

19. Monetary policy and targets would continue to be set, as now, at the domestic level. There would be no need for a Community monetary policy or Community monetary targets. Nor would institutional changes be necessary (although legal documents referring to 2¼ per cent bands would require amendment). But as the scope for exchange range fluctuation was reduced, the need for prior consultation about interest rate changes would correspondingly increase.

20. Narrower bands impose a tighter discipline on monetary authorities, forcing them to adjust policies earlier than they would have done with wider bands. They also reduce the monetary authorities' freedom of tactical action to some degree: they would be less able to "punish" speculators by allowing within-the-band variation of the exchange rate. There would therefore be greater pressure on governments to pursue convergent inflation objectives and monetary policies, and the frequency of realignments would fall to the extent that they responded appropriately.

21. The convergence of inflation rates would be crucial to the success of this model. As long as differences in inflation relativities between economies remained, it would be expected and desirable that nominal and real interest rates would differ as the process of adjustment worked through. If instability and disruption were to be avoided, the move to narrower bands would have to await the achievement of sustainably small inflation and interest rate differentials.

(ii) Common dollar/yen policy

22. This could take various forms. At the minimum, it might reflect an agreement on intervention arrangements, designed to ensure that when individual member states intervened vis-a-vis the dollar or yen, they did so consistently and that the market impact of one country's action was not immediately offset by the action of another ERM member. Mutually inconsistent intervention by major countries has occurred in the past but it has not usually involved two ERM members, since they have a common interest in ensuring a consistent outcome. This suggests that informal understandings already exist within the mechanism on how intervention should be undertaken against third currencies. These could perhaps be formalised but there is probably little scope for much further development in this area.

23. The Community could, however, go beyond this to form an agreed view on the implications of changes in dollar and yen rates against ERM currencies and on the appropriate response of individual member states in these circumstances. This view could be formulated with greater or lesser precision and the agreed response of individual ERM countries could be regarded as more or less binding.

24. A more formal variant would be for the Community to adopt specific exchange rate ranges in relation to the dollar and yen. As in the case of the Plaza and Louvre agreements, the ranges would probably be expressed only in terms of the deutschemark. No doubt there would have to be some burden-sharing agreement about intervention too and its implications for individual member states would have to be discussed in a Community forum.

25. An agreed common policy towards the dollar and yen would imply greater discussion of member states' monetary policies at Community level but monetary targets could continue to be set nationally, with no need for targets for the Community as a whole. There would, however, be pressure for more prior discussion before they were adopted. Advance consultation on interest rate changes

would also be desirable because of their implications for the mechanism's relationship with third currencies. This would mean that many monetary policy decisions would be taken on a collective basis rather than mainly by Germany (or whichever country or countries was dominant by the end of Stage 1).

26. No adaptation of the existing institutional arrangements would be strictly necessary. Strategic discussions about individual member states' monetary policies and the action to be taken in response to movements in the dollar and yen could be conducted within the Monetary Committee, as to some degree it already is. Day-to-day tactics would have to be co-ordinated by central banks but if particularly thorny issues arose in specific situations, Monetary Committee members could consult by telephone.

27. Although no institutional changes would be strictly required, the intensification of informal cooperation and coordination might well push the Community towards more formal arrangements. These could be limited to practical matters such as a common pool of reserves for intervention although difficulties could arise if policy decisions, for example on intervention, were taken elsewhere.. Or they could embrace policy-making machinery with an enhanced role for new or existing central institutions.

28. Any common dollar/yen policy which involved a formal role for the dollar and yen rates would require consultations with the US and Japan. For the purpose of this discussion it is assumed that these will not be different in substance from the types of consultation of recent years. However there would be a question of who would represent the Community in such consultations. The Germans would be extremely reluctant to lose their chair at G3 meetings but the Community as a whole would no doubt press to be represented collectively. If the central bank Governors developed an enhanced role there would be pressure for them also to be represented collectively. The Community would no doubt also wish to be represented at a political level. In theory, the Finance Minister of the country holding the Presidency could be invited but it is hard to imagine this would be acceptable to the

no such mtgs (G3?) (it is done bilaterally)

Americans and Japanese if one of the smaller member states were in the Community chair. Moreover, if Germany continued to attend as well, the US and Japan might feel that Europe was being accorded too great a voice in their discussions.

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29. To sum up, the common dollar/yen policy might in practice amount to little more than an elaborate arrangement for sharing decision-making about the external value of EMS currencies rather than allowing Germany to make the decisions alone. The consequences would tend to be slightly inflationary because most governments outside Germany would prefer looser monetary policies than Germany would. There need not be any institutional changes although there would be closer co-ordination and there could be pressure for centralisation of the management of reserves intervention operations, or even decision making.. There would be no need for a transitional phase: the only step beyond Delors Stage 1 would be an agreement about taking the dollar and yen into account in a particular way.

(iii) <u>Greater co-ordination of monetary policies</u>

30. The common dollar/yen policy would involve closer co-ordination of monetary policies in order to make it work. An alternative approach is to <u>define</u> monetary union in terms of some particular form of institutional arrangement for closer co-ordination. There are a number of possibilities, ranging from an enhanced role for existing co-ordinating machinery (eg the Monetary Committee) to the creation of a new body. There are also different degrees to which responsibility for decision-making as opposed to co-ordination and monitoring could be transferred from national to Community level.

31. At one extreme, formal decisions on monetary policy would remain at national level although there would be greater co-ordination of monetary policy than in Stage 1. There would be full consultation even before monetary decisions were taken, and the aggregate implications of individual countries' policies would be monitored, but nothing beyond that. This model can be thought of as a perpetual Stage 2 of Delors.

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32. No institutional changes would be strictly required. (The ESCB is set up in Delors' Stage 2 but partly to get into training for its central role in Stage 3.) If a new body were to be set up to assist in the co-ordination and monitoring of policies, it would be for consideration how independent it should be of existing institutions, and the balance of membership between central banks and Finance Ministers. The creation of a new institution would at least give the impression of a significant step forward, even if its work could equally be done by beefed up versions of existing Community institutions.

33. However, a new institution which was responsible only for co-ordination and monitoring might not be a stable situation. It might lobby for more power and complain that its expertise was not being fully exploited. Although the example of the OECD suggests otherwise, there is a risk that setting up a new institution would intensify pressures to transfer decision-making to it, ie to transform "perpetual Stage 2" into something like Stage 3.

34. Some of this pressure could possibly be headed off by endowing the new institution with carefully limited powers of its own from the start. One obvious example would be to authorise it to manage foreign exchange reserves and intervene in foreign exchange markets in pursuit of collectively agreed policies. This would make it similar to the European Reserve Fund as advocated by the French and discussed in the Delors Report. Member states would pool a limited proportion (say 10 per cent) of their official reserves on a permanent basis. This would provide resources for the Fund which might also be empowered to engage in swap operations with commercial banks for limited amounts. It would manage its own reserves and intervene with them against third currencies, as well as those within the mechanism, at the request of member states. It could also carry out the necessary co-ordination and monitoring of national monetary policies, although these functions would not have to be located in the Fund.

35. While a European Reserve Fund could in principle be restricted to a limited range of operations, this could lead to tensions between it and the governments and central banks taking the decisions. As the Plaza and Louvre experience demonstrated, the difficulty of arriving at agreed policy decisions can cause the operational body to be given insufficiently precise instructions, leaving it room to pursue its own view of what is best. On other occasions the Fund might disagree with the monetary policy decisions taken by governments and central banks. Over time the Fund might seek to expand its role, encouraged no doubt by some governments and/or central banks. Moreover, the fact that it was originally proposed by de Larosiere as only a first stage around which more ambitious functions could gradually accumulate makes it harder to present as a model of monetary union.

36. To conclude this section, a number of alternative models of enhanced co-ordination of monetary policy are in principle feasible. They can be distinguished in a number of ways

- by the extent to which responsibility for monetary policy decisions (as opposed to consultation and monitoring) and operations (eg intervention) is transferred from national to Community level;

- by whether new institutions (eg a European Reserve Fund) are created or not;

- by the nature of the control exercised over Community decision-making or operations (eg the role of Finance Ministers, central bank Governors, independent members etc).

37. In many cases the overall economic effect might be little different from that of Delors Stage 1. This would be so if the new decision makers pursued monetary policies that were just as tight as the Bundesbank would have followed. However there would

be a risk in some cases, especially those where national governments had more of a say, that the outcome would be more inflationary.

38. Given the impact of Delors Stage 3 on the debate, it will be difficult to argue convincingly that these models of enhanced coordination represent monetary union. The more "institutionalised" they are, the easier this may be. This points towards a model in which a new institution is created with some limited powers of its own but firmly under the control of national monetary authorities. The latter would continue to make all important policy decisions after full consultation at Community level in either the new institution (ie its board or a special committee), ECOFIN, the central bank Governors' committee, or the Monetary Committee. The transition to such an arrangement would require only two steps which could be taken in either order: the setting up of the new institution and the enhancement of monetary policy co-ordination.

(iv) <u>Incorporation of non-EC members in ERM</u>

39. Article 5.2 of the Council Resolution of 5 December 1978 establishing the EMS states:

> "European countries with particularly close economic and financial ties with the European Communities may participate in the exchange rate and intervention mechanism."

In practice, none has applied to do so, although Norway, for one, has shown signs of interest from time to time; and an annual consultation procedure has been set up between the Chairman of the EC Monetary Committee and the Norwegian and Austrian authorities.

40. There would be no need to change the existing monetary arrangements - monetary targets and policies would continue to be set at the national level - and there are no significant institutional implications.

41. The perceived advantages and disadvantages of increased membership will differ according to the viewpoint:

(a) a greater area of currency stability would have, in principle, some economic benefits. But in practice the size of the candidate economies is relatively small;

(b) procedurally, having more members of the ERM would make future changes more difficult to agree. That could slow down movement towards monetary union. Alternatively, it could increase the tension sufficiently to generate multi-speed movements by different groupings within the enlarged ERM.

The inclusion of non-EC members would be seen by some to make it harder, rather than easier, to achieve full economic and monetary union on a Community basis (if defined to include, inter alia, the setting of monetary policy for the Community as a whole and perhaps centralised budgetary decisions). Those most enthusiastic for this form of EMU would therefore tend to regard this option as a wrecking amendment - even though it has a perfectly respectable Community basis in the 1978 Council Resolution.

<u>Competing currencies: official</u>

42. In this model there would be a system of competing official currencies each controlled by its own national monetary authority. People and companies throughout the Community would be free to use whichever of the available currencies they wanted. National monetary authorities would then compete to make their currency the most attractive and thus the most widely used.

43. An ecu issued by the authorities (national or European) could also compete with national currencies, but only if it was an independent currency and not a weighted average of the others (as the Delors report recognised). But for this there would have to be an independent monetary authority which would take it outside

the scope of models considered in this paper. (Nor does the paper discuss the issue of an ecu which was a weighted average of currencies, except briefly in Annex 1.)

44. The competing currency proposal was in fact made quite specifically in a European context by Hayek* in 1976 as a replacement for the monetary systems in place at the time. But underlying this proposal was one closer to his heart - that any agent who wished should be allowed to issue his own currency, again competing freely so as to make his product widely and profitably acceptable. The present section discusses the narrower competing national currencies model: the next section considers the more general version in which private currencies are free to compete with national ones.

45. The main requirement is that the legal and institutional framework allows willing parties to transactions - individuals, governments or companies - to use whatever national currency they prefer to make those transactions. Since competition is the driving force of this system, there should be as few barriers to free competition between currencies as possible.

46. On this criterion, it is possible to assess how far conditions in the European Community approximate to what would be necessary for a viable competing currency system and what further steps would need to be taken. In fact, to a very considerable extent, much of what would be required has already largely been achieved or will be implemented within the foreseeable future:

(a) with a few exceptions - not important in this context - the Capital Liberalisation Directive will ensure freedom of capital movements within the Community from 1 July 1990 for all member states other than Spain, Ireland, Greece and Portugal who have a more extended timetable for meeting its requirements;

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* Friedrich Hayek: "The Denationalisation of Money". IEA Hobart Paper No 70. 1976

(b) the Second Banking Coordination Directive, scheduled to take effect from the beginning of 1993, will provide any bank with authorisation in its own country with a passport to open branches in any other part of the Community or to provide services across borders.

47. While these measures will go a long way towards providing the necessary conditions for a competitive currency regime, some obstacles to the free use of Community currencies would remain in practice. In the UK, for example:

(i) Legal tender: At present where no contractual provision exists for repayment, debts have to be settled in legal tender, ie. sterling - if there is a dispute. If we were to remove all obstacles, we would therefore have to extend the definition of legal tender to cover all Community currencies. The best way to do this would be to require creditors to accept at least one Community currency in settlement of a debt but not any one. The disadvantage of permitting any Community currency that the debtor chose would be that transactions costs would be raised significantly (because creditors would insist on explicit agreements about the currency of settlement) and competition between currencies would be impeded.

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An alternative way of removing the obstacle would be to abolish legal tender entirely. But that would mean that any contract - even ones usually left as implicit - would have to state explicitly what form of payment both parties would then be prepared to accept for the purposes of the transaction, and transactions costs could be very high.

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(ii) Company accounts: This is important not only in itself but also because the choice of accounting currency will often make a difference to the total tax liability. The position in UK law is unclear and has never been tested. However, in practice, wherever a company can reasonably argue that it would be appropriate to draw up its accounts in any currency other than sterling, it has been allowed to do so (eg. the oil companies are allowed to draw up their accounts in dollars). Presumably, if a company decided it wanted to denominate its accounts in another Community currency, it would be extending its use of that currency more generally, and so could meet this requirement. A draft Directive, currently scheduled to come into force on 1 January 1990 but unlikely to be agreed for a couple of years or so, provides for companies in the Community to draw up their accounts in ecu (but not other Community currencies) as well as domestic currency.

(iii) <u>Truck Act effects</u>: The Truck Acts themselves were superseded by the 1986 Wages Act which came into force at the beginning of 1987. But that does not override any pre-existing contractual agreement for payment to be made in cash. Section 1 of the 1831 Truck Act provides for employees to be paid in "current coin of the realm" ie. sterling. There is no legal bar to employees being paid in a currency other than sterling, provided both parties agree. But employees can insist on being paid in sterling even if employers would not choose sterling as one of its currencies. It would be necessary to restrict the rights of employees so that they could not insist on being paid in a particular EC currency.

48. The obstacles to perfectly free competition in currencies listed above in the case of the UK, would doubtless be matched by similar or other obstacles in each of the other countries. A comprehensive study would need to go through each country, identify what the relevant obstacles are and consider the prospects for breaking them down.

49. The extent of competition between currencies will also depend on the behaviour of governments. They can be expected to encourage the use of their own currencies to maximise the seigniorage. On the other hand, they may be reluctant to have too much currency held by other EC residents because of a perception that such holdings would be relatively volatile and so monetary policy more difficult to operate. But there is little doubt, for example, that in its own transactions the UK Government displays a marked preference for sterling:

(i) so far as tax payments are concerned, although there is no requirement in tax law to pay tax due in sterling, the legal basis for requiring payment in sterling comes from the general law about debts having to be settled in legal tender. Customs apparently already accept payment in foreign currency in limited circumstances (eg. when it is the only sensible way of collecting the tax from an incoming passenger). But they are currently considering revising this practice because of the Exchequer risk and administrative costs (checking the foreign currency paid to match the sterling bill; keeping separate records for all the currencies until they are converted into sterling etc.) involved;

(ii) we have fought very hard so far to ensure that payments to and from the Community budget are made in sterling, retain control of the flows within the Treasury and deposit any excess sterling overnight with the PGO. No doubt, other Community countries display similar preferences for their own currencies.

50. Even in principle, it is not clear that it would be necessary or desirable to prevent governments from exercising bias in favour of their own currencies. Since the rationale of the system is one of competition, it is hard to see that national governments should be denied all opportunities to give a fillip to their own currencies. On the other hand, if the larger governments in particular became excessively protectionist,

insisting, for example, that all payments to them were made in their own currencies, that would stifle competition rather than intensify it. To prevent this, there might have to be some rules on governmental currency acceptance analogous to the EC public purchasing regulations.

51. Minimal <u>institutional</u> or <u>structural</u> changes would be required under competing currencies. The essence of the system would be that national monetary authorities would continue to administer their monetary policies and currencies just as at present, save for the additional competitive discipline of making sure that their currencies continued to be widely used and accepted. So there would be no need for extra administrative machinery or institutions.

52. Indeed, the approach would be more successful if there were some dismantling of the existing cooperative framework - not least the Exchange Rate Mechanism. If competition between currencies is the driving force:

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(a) cooperation between governments could be positively harmful. It <u>would</u> be harmful if it took the form of collusion between the monetary authorities to over-issue currency as a group and settle for a common positive level of inflation;

? v. far fetched

(b) the ERM - fixing exchange rates between realignments - would also help blunt the required competition. For an extended period of time after a realignment had taken place, potential users of currencies would regard them as more or less equal in value. Normally, the competitive currency model is supposed to ensure that good currencies drive out bad ones. But during this temporary fixity there would be a tendency for the opposite to happen - Gresham's Law, bad money driving out the good. Fluctuations in exchange rates would be an important part of the mechanism through which competitive pressures were exerted.

53. Although this is necessarily an exercise in prediction, experience to date gives some guide as to what the eventual pattern of currency usage under a competitive currency system might be. Several observations seem relevant here:

(a) for transactors to work with a number of currencies means that they need more information than if they stick to a single currency. Some agents - large international firms, for example, - will be better placed to acquire this information than, say, individuals. Provided that their "domestic" currency is reasonably well-behaved, the latter are likely to stick with it even if some other currency is, in principle, a better one; related to this,

(b) currencies with a big initial presence have a substantial in-built advantage. Since there are large numbers of other potential transactors who know and understand them, these currencies will be attractive unless their monetary authorities render them very inconvenient;

(c) in practice, despite the fact that some European currencies have been clearly more inflationary than others and in those situations where it has been permitted, there has been no great observed tendency towards cross-holdings of currencies. For example, although it has been freely permitted since the abolition of exchange controls in 1979, UK residents' holdings of foreign currency are still less than one-tenth of their sterling deposits;

(d) "cocktail" currencies, such as the ecu, have so far not flourished as transactions currencies, though the ecu has done better as an investment currency. There has been little or no pressure for private cocktails based on privately agreed weightings of existing currencies, even though there would be no constraint on transactions in such form if people wanted to make them.

54. Another source of information in this area is the extent to which currencies (and, for that matter, gold) have been well-behaved in the past. "Well-behaved" in this content probably means the extent to which individual currencies have neither depreciated sharply or erratically in value - to the detriment of creditors - nor appreciated sharply or erratically at cost to debtors. Currencies stable in value are the ones most likely to be preferred.

55. So far as pure currency is concerned - notes and coin - the extent of depreciation is easily measured by the rate of inflation, since by definition this money is non-interest bearing. As the following shows, there have been appreciable differences between the rate of depreciation of the major currencies over the last decade or so.

Domestic Value of Currencies, End 1988 **1979Q4=100**

Mark	74.3
Franc	50.2
Lira	35.0
Pound	53.5

Thus, because of inflation, the mark will now buy around three-quarters of what it would at the end of 1979 - an average annual depreciation of about 3¼ per cent. But the lira is now worth only about a third of its end 1979 value, equivalent to annual depreciation of nearly 11 per cent. On this criterion, therefore, the mark would be generally preferred as a transaction medium on account of its greater stability. The lira would be disadvantaged in this respect, while sterling and the French franc would be somewhere in between.

56. But most transactions balances are nowadays interest bearing; about nine-tenths in the case of the UK. So it may be that the effect on the value of the lira from greater Italian inflation is partly or wholly offset by the fact that Italian interest rates have normally been higher than in other major European countries. In fact, during the 1980s as a whole, the real rate of return to the lira has been greater than that of the other currencies:

Real rate of return **Per cent**

	Mark	**Franc**	**Lira**	**Sterling**
1980Q2 - 1988Q4	3.3	3.5	4.2	4.0
1980Q2 - 1984Q4	4.6	2.8	3.1	3.4
1985Q1 - 1988Q4	1.8	4.4	6.0	4.6

But in itself that would not necessarily mean that transactors would remain faithful to the lira. It might be attractive to creditors, but not to debtors. Even creditors would be discouraged by the uncertainty, which may explain the greater return.

57. In the context of measuring the relative attractiveness of each currency for transactions purposes, a better criterion might be the stability and predictability of the purchasing power of each currency taking account of both inflation and the compensation provided by the interest rate. Currencies whose real compensated value was stable would make good transactions vehicles; those which were volatile would not.

58. Volatility can be measured by the standard deviation of the quarterly percentage changes in the compensated real value of each currency. Perfect stability would be reflected in a standard deviation of zero; increased volatility would result in higher recorded standard deviations. The volatility measures turn out to be as follows:

Standard Deviations of Interest Compensated Real Values

Per cent

	Mark	**Franc**	**Lira**	**Sterling**
1980Q2 - 1988Q4	0.501	0.746	0.888	0.762
1980Q2 - 1984Q4	0.455	0.924	0.962	0.818
1985Q1 - 1988Q4	0.280	0.345	0.524	0.683

59. These statistics suggest that there have been significant differences in the stability of the currencies. All currencies have become more stable in compensated value over time, probably consequent on the decline in inflation. But the mark has been relatively the most stable of the four throughout. Over the whole period, there would be little to choose between sterling and the French franc though over the last few years the franc's compensated value has been much the stabler of the two.

60. Assessing the above evidence as a whole suggests the following tentative conclusions:

(a) the inertia in the system suggests that, unless monetary authorities behave much more irresponsibly than they have in the past, national currencies would continue to be used in their own geographical domains (though there might be a question mark over some of the smaller ones);

(b) for larger transactions and especially for international transactions within the Community, one or two of the larger currencies and especially those perceived to be well-behaved might come to be increasingly dominant. The size of the economy for which the mark is already the local currency and its perceived stability would give it a clear advantage;

(c) it is just not clear how fast the tendency towards a small number of dominant currencies would manifest itself or whether the small number would be one or, say, two or three. Much would obviously depend upon the future behaviour of the competing national monetary authorities.

61. Even if the competitive pressures did result in a dominant single currency, this would not necessarily be a permanent state of affairs. Other currencies might re-emerge as their relative quality changed over time. In fact, there is some tension between:

(a) competing currencies acting as a competitive discipline on national monetary authorities to ensure they behave responsibly; and

(b) competing currencies as a precursor to a single currency, Community-wide, when by definition competition would have ceased.

optimal

Presumably the tension would be resolved by the competitive process being suspended when a winner had emerged. In that case, the winning monetary authority might be converted to a Community institution.

62. Competing currencies would permit monetary union in the sense of a single currency but would not necessarily bring it about. If a single currency did emerge, in the first instance it would be a Community currency controlled by a national central bank which, to the extent it was democratically accountable, would be accountable to a national government and parliament. That prospect would be viewed differently by different parties, much depending upon the identity of the winning currency and central bank. It would, as noted in the last paragraph, be possible to convert that central bank to a Community one responsible to the Community as a whole. But that might not be wholly straightforward to implement.

Indeed!

Competing currencies: private

63. The previous section considered a model in which national monetary authorities competed to make their own currencies the most attractive and thus the most widely used. Since stability would be one of the characteristics of the currency people would want to hold, that would be likely to be a feature of the eventual dominant currencies. But there would be no need to restrict entry into this competition to national monetary authorities. Indeed, introducing private sector competition would discourage national monetary authorities from colluding together and settling for a common positive rate of inflation. This was the underlying proposition in Hayek's original pamphlet.

64. There would be no great difference between the mode of operation of competing national currencies and a system where private institutions were also allowed to issue currency. (See Annex 2 for a fuller discussion.) A private currency would effectively be created when a bank or group of banks started to issue notes or to take deposits denominated in that new currency. The new currency would be freely exchangeable against existing currencies at floating rates of exchange. It could be called the private ecu (as in Riboud's scheme) but it would not, of course, have a fixed rate against the official ecu or any individual national currencies.

65. To make its currency attractive, the issuing institution would presumably undertake to render the value of its currency stable against a convenient and representative basket of goods and services. That would mean restricting the nominal value of its issue accordingly. It could then either:

(a) hold at least a fractional reserve of the basket of goods and services in its vaults and undertake to exchange the basket freely at the declared rate for its notes; or, more practically

(b) rely on its reputation such that its currency was perceived to retain a stable value against the basket of goods and services. The bank would then issue only as much currency as was consistent with this happening, given the demand that existed for its particular currency. Calculating the appropriate currency to issue would certainly be feasible in principle though it would involve some difficult technical judgements.

66. There would be a number of uncertainties and difficulties in such a system, discussed in Annex 2. This is inevitable since there is virtually no experience of such a system operating. In principle, these difficulties should be surmountable but whether they could be overcome in practice would remain to be seen.

67. <u>Producing the conditions to allow the emergence of private currencies</u> would probably not be very difficult, if there were private bodies which wanted to take advantage of the opportunity. Presumably the same steps would have to be taken as would be required to allow full competition between national currencies. In addition, it would be necessary to ensure - by Community Directive - that there was no discrimination in law between private currencies and existing national ones. The essence would be that economic agents should be allowed to express their preferences for private or national currencies freely.

68. There would also be no need for official <u>institutional developments</u> to allow the system to operate. However, just as with the national competing currency model, existing cooperative arrangements including the ERM would have to be dismantled if the competitive forces were to be given a favourable environment.

Don't stress this!

69. Since there is little or no experience of privately issued currencies to go on, it is largely speculation as to how well they might do - what their <u>circulation</u> might be - if they were allowed. But it seems clear that they would have a substantial initial disadvantage insofar as their circulation would have to build up from nothing. Just as Esperanto, despite its logical virtue, has not displaced the major existing languages, new private currencies

might have a hard time catching on - unless the proprietary monetary authorities of the national currencies began to behave in wholly irresponsible ways. In any other circumstances, it would take a long time - decades - for private currencies to acquire a large circulation, if it happened at all.

70. This option would probably be <u>less acceptable</u> than the competing national currencies model to other European countries. It would be open - but more acutely - to the same criticism that it would not necessarily bring about a single currency; and at best only with a very long time horizon. Other countries might also take the view that since national governments have invariably not been prepared to experiment with private currencies, it would be wrong to do so at a European level where the effects might be even less predictable.

The gold standard and related models

71. The presentation in this section is mainly in terms of gold, although in practice a broader commodity standard might well be better.

72. An EMS gold standard would presumably share the following key features with the pre-first world war gold standard:

- the monetary unit of all participating currencies would have prescribed limits to its price in terms of gold, with the central bank in each country (or other authority responsible for intervention) buying or selling gold to keep the currency within the prescribed limits

- freedom of imports and exports of gold, and unrestricted rights of citizens of each participant country to sell gold to or buy gold from its central bank.

The established academic view is that unfettered trade in gold was not a universal characteristic of the pre-first world war international gold standard. While the UK certainly put no restraints on imports and exports of gold until the beginning of the first world war, some participants did have means of restraining gold exports when it suited them. But we can take it that, following complete abolition of capital controls in 1990, an EMS gold standard would provide for unfettered trade in gold both between EMS participants and with the rest of the world.

73. An EMS gold standard would require the determination of gold parities (plus bands) for each EMS currency at the outset. The credibility of the system would rest on the availability of some stocks of gold within Europe to cope with fluctuations in the private sectors' demand for gold; but providing EMS members were willing to vary interest rates as quickly and by as much as necessary to attract gold in when they needed it the system might be sustainable with a relatively small level of gold reserves.

74. Unless specifically prohibited from doing so, central banks would certainly choose to diversify their portfolios, ie to hold (interest-bearing) currency reserves as well. Faced with a would-be purchaser of gold, a central bank would in this case have the choice of either selling gold directly from its reserves or using currency reserves to buy more gold on the open market and satisfy its customer that way. If currency reserves were held on a large scale the system would be closer to what is normally described as a "gold exchange standard" - such as existed for a few years between the two world wars and, to some extent, in the Bretton Woods era - rather than the pure gold standard. (Even before the first world war, some currency reserves were held by participants in the international gold standard.)

75. As the Bretton Woods era demonstrated, a gold exchange standard without an effective constraint on currency reserve creation does not necessarily tie down the price level (US prices rose by more than half between the late 1940s and the end of the 1960s while the dollar gold parity remained fixed at $35 an ounce). Helped by the initial dollar shortage which concealed the

underlying situation and influenced by ideas that gold no longer mattered, the US was able to pursue inflationary policies for a very long time. By the early 1970s the monetary tightening that would have been required to maintain the original gold parity was more severe than could be realistically contemplated. The constraint of an EMS gold standard would bite at an earlier stage because there is no "deutschemark" shortage comparable to the dollar shortage, and it would therefore be more effective.

Who should do so?

76. One possible way of economising on the need for gold reserves to run the system would be for European holdings of gold to be pooled and for individual countries to draw on the common gold reserves as needed up to a prescribed limit. This type of arrangement has the advantage of reducing the impact of transient disturbances - a temporary increase in private sector demand for gold in the particular country need have no effect on that country's interest rate - at the cost of delaying adjustments to more fundamental disequilibria.

77. A well known feature of the gold standard as it operated in the United Kingdom in the nineteenth century was that the Bank of England maintained gold backing, pound for pound, for all outstanding Bank of England notes beyond a defined "fiduciary issue"; the latter was set at £14 million in 1844 but increased occasionally in the second half of the century, reaching about £16½ million by the early 1890s. A rule of this sort, requiring central banks' holdings of gold to be in some predetermined proportion of their note issue, would act as a form of automatic monetary stabiliser. If a country experienced a sharp increase in real demand or inflationary pressure there would be an increased transactions demand for notes at given interest rates. The constraint on the note issue would mean that the authorities would not be able to satisfy this demand without an inflow of gold. With less than perfect capital mobility, this would require an increase in interest rates and tend to check the demand or inflationary pressure.

Key

78. However a gold backing rule of this sort is not an essential feature of a gold standard, and there would be practical difficulties in instituting such a rule now. Some countries (including the UK) currently hold a relatively small part of their reserves in the form of gold, and there would have to be an increase or at least a substantial reallocation of gold reserves within Europe if a common EMS-wide backing ratio were to be adopted. The essential ingredient would be a clear commitment that exchange rate parities against gold would ultimately be defended, if tested, by variations in interest rates. Provided the EMS gold parities were fixed irrevocably, the external discipline on domestic monetary policy would mean that the private sector would not have to worry about government reneging on its commitment to reduce inflation. There would be no impediment to optimal policies from "time inconsistency".

79. The international gold standard operated successfully for about 35 years before the first world war without any central institution for the system as a whole, and an EMS gold standard would have no need for a European central bank or for any new institution to coordinate the activities of the national monetary authorities. It is possible that some institutional details would be determined centrally (eg the extent to which national central banks were required to back their note issue with gold), and the initial parities would have to be agreed at Community level, as would any subsequent parity changes either for individual currencies or for the EMS group as a whole. But there is no reason why these sorts of issues should not be settled by ad hoc meetings of Finance Ministers and central bank Governors. There would be no need for regular coordination or centralised decisions on the conduct of national monetary policy. Nor would the aggregate monetary conditions of the EMS bloc as a whole be something that would require centralised or coordinated policies. Monetary conditions within individual EMS countries and for the bloc as a whole would be determined by events outside the bloc (such as the rate of production of gold), rather than by discretionary policy.

80. It is assumed that what is for discussion is a European reform, not a world wide monetary reform; so that what is at issue here is not a gold standard covering all the major industrial countries in the world, including the United States and Japan, but a purely domestic EC arrangement. The yen and dollar would continue to float freely against gold; so all the EMS currencies would float with gold against the dollar and the yen. This means that if the gold price were to rise in dollar terms, the EMS currencies would appreciate against the dollar: shocks to the gold price would be transmitted to the competitiveness of EMS currencies. Civil war in South Africa, for example, would cause an appreciation of European currencies against the dollar and a consequent loss of European competitiveness.

81. It might be difficult to decide at what level to set the EMS gold parities initially: the world gold price would not be invariant to the institution of an EMS gold standard. If the parities were set too high (ie gold was priced too cheaply in terms of EMS currencies), there could be an extended period of uncompetitiveness against the dollar until European price levels adjusted downwards to increase the real price of gold in Europe. If parities were set too low initially (the price of gold in Europe too high) there would be a period of inflation.

82. The EMS members would presumably not attempt to fix their currencies to gold before achieving close convergence of inflation within Europe (at or near a zero rate). There would be a period, corresponding to Delors' Stage 1, in which all EMS participants would have joined the ERM, with parity changes still permissible but increasingly infrequent. There might be some build up of European gold stocks during this period if an increase in stocks was thought to be required for operation of the EMS gold standard: this would give some indication of the effect of the introduction of the gold standard on the world gold price, and reduce the risk of EMS gold parities being set initially at an incorrect level.

83. The risk of volatility in competitiveness would also arise in the case of a multi-commodity standard but might be less serious. Under such a standard the value of unit of a currency

would be defined as equal to so many ounces of commodity X plus so many ounces of commodity Y plus so many ounces of commodity Z, and so on; rather than equal to just a certain number of ounces of one commodity (gold).

84. The selection of commodities for inclusion in the basket and the choice of weights for these commodities could be based on the objective of getting as close as possible to zero inflation, or on minimising the expected impact of commodity price disturbances on the domestic European price level. The former objective would require a basket whose real price was not expected to change in the long term. One way of approaching the latter objective would be to simulate a model of the world economy, including a model of the determination of prices of individual primary commodities, subject it to various shocks, and see which commodity basket best stabilised prices in the face of these shocks. Further work would be required to investigate whether there were commodity baskets that produced a reasonable approximation to both objectives.

85. The optimal basket would not necessarily be the same as would be chosen as a forward indicator of inflation (as in the Chancellor's proposals to the 1987 IMF meetings): the basket would need to include those commodities which were important in determining domestic inflation rather than successful at predicting it. The basket would inevitably include oil, of which the UK has particularly large reserves by European standards.

86. The volatility of the total dollar value of the unit should be reduced as compared with the pure gold standard case. There should particularly be a reduction in volatility arising from supply conditions because fluctuations in the supply of different commodities are not closely correlated. Fluctuations in the dollar value of the unit would therefore reflect mainly world demand conditions. The EMS currencies would tend to appreciate against the dollar when world demand was high and depreciate when world demand was low: this would help to stabilise activity and prices in the European economies but destabilise the United States.

87. A further possible advantage of a multi-commodity standard as compared with a gold standard is that there is less danger of destabilising private sector speculation. The relatively high cost of storage would probably reduce the scale of private sector hoarding of commodities in periods of currency crises: with a gold standard fluctuations in private sector hoarding might be rather large in periods of crisis.

88. While either a gold or a multi-commodity standard should tie down the European price level it is impossible to say whether it would deliver exactly zero inflation over a run of years, or whether on average there would be a small positive or negative inflation rate. The fact that real gold prices have doubled since the late 1940s perhaps indicates that a pure gold standard would have been deflationary on balance over the post war period - more so than a wider commodity standard given the relative weakness of many primary commodity prices.

89. To summarise, the advantages of a gold (or multi-commodity) standard are:

- it provides a nominal anchor for the system;

- because the nominal anchor is external (unlike, say, a monetary target) to the extent that the gold parity is fixed irrevocably, the private sector does not have to worry about governments reneging on previous commitments;

- monetary conditions would move in a stabilising way in Europe in response to world demand shocks.

The disadvantages are:

- there would be no guarantee that it would produce zero inflation over the long term although in practice it might be just as good as the best of the other models;

- it would cause fluctuations in prices and activity;

- the response of EMS currencies to world demand shocks would destabilise other countries and might cause international friction.

90. An alternative variant on the gold standard - and a particular form of gold exchange standard - is the Bretton Woods model: one currency tied to gold while the other currencies have a fixed central parity (with bands) against the first currency. In the present context this would presumably mean the deutschemark on a gold standard and the rest of the EMS on a deutschemark standard. This would have both the advantages and disadvantages of the simple gold standard model, and the problem of fluctuations of the EMS currencies against the dollar would remain. The point of the Bretton Woods arrangements was that they helped to insulate the world economy from the conditions of gold supply. A European "Bretton Woods" would not achieve this. However, the question of a deutschemark area is considered more fully in the next section.

91. The transition to a gold or commodity standard would have to be made largely in a single step on a particular day when the commitment to fixed parities against gold took effect. There would, of course, have been much preparation for this in agreeing the parities and deciding how the system would work, educating markets and public opinion and reallocating gold (or commodity) stocks.

The sterling area

92. According to the Treasury's 1958 evidence to the Radcliffe Committee, the Sterling Area originated in the early nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which prevailed in most of the colonies. Each local currency was statutorily regulated as a local version of the pound, printed or stamped with local symbols, but all representing the sovereign (or a fraction of it) and all backed with some obligatory holding of sovereigns or gold. Thus the sterling area at that time was essentially a special case within the gold standard. What

distinguished these countries was the closeness of their trading ties, their common use of the London capital markets, and in particular the use of sterling as the currency for their external transactions. The gravitation of foreign exchange income of the whole area to London was a natural consequence of normal business and banking practices. Effectively London acted as a clearing centre for the external transactions of the whole area, enabling economies to be achieved in lesser resort to physical gold shipments and eventually in the total holdings of external reserves for the countries of the area.

93. There were no special arrangements to ensure that local monetary and other policies were consistent with the maintenance of exchange parities. In this sense the sterling area was no different from the wider group of countries on the gold standard. However the closeness of trading ties and the common use of London's money and capital markets meant that policy changes in the UK were transmitted through the rest of the area relatively quickly. Because of unambitious economic policies of the overseas civil servants running the colonies, any thought of varying parties rarely occurred and in any case a change would have required legislation. In other words, the idea that the colonies would do other than accept the consequences of UK economic developments and policy (such as it was) did not really arise.

94. After World War II the advantage to the overseas sterling area countries of membership of the sterling area diminished and signs of resentment at having to follow UK monetary policies grew. Although they valued access to the London capital market, they would have liked to have spread their reserves more widely than they did and the tightening of monetary policy which was imposed on them when the UK tightened was unwelcome. Sterling's devaluation in 1967 represented a major turning point when a number of countries did not devalue in line. It was followed by a diversification of reserves out of sterling. Meanwhile some developing country members of the sterling area had been imposing exchange controls on money flows to London. The sterling area eventually broke down when the UK imposed its own exchange controls against the overseas sterling area in 1972.

95. Further details of the operation of the sterling area together with other monetary unions and currency systems are provided in Annex 3.

96. If the sterling area is taken as a model for a European monetary area, the arrangement would have to be based on a strong national currency and the willingness of the rest of the Community to accept the monetary policy of the monetary authorities in that country. It is unrealistic to expect that sterling would be that currency within at least the next five or ten years. The deutschemark is the obvious candidate. The Treasury cited four fundamental features of the sterling area in 1958; expressed in terms of the deutschemark they are:

(a) members use deutschemarks as the normal means of external settlement;

(b) they hold the major part of their reserves in deutschemarks;

(c) they look to the Federal Republic as a major source of external capital;

(d) they co-operate to maintain the strength of the deutschemark.

97. This would be one possible form of evolution from the present situation in which the policies of the Bundesbank already play a leading role in setting ERM interest rates. To some extent (d) applies already, and (c) would not be relevant with today's highly developed world capital markets. The transition to a deutschemark area would be relatively straightforward: a gradual increase in holdings and use of deutschemarks following agreement on the broad framework.

98. A move to a deutschemark area would formalise and hence strengthen the de facto situation of German dominance over monetary policy. Some countries (and academics) see considerable

advantages in the present situation which allows others to borrow the Bundesbank's reputation for monetary rectitude.

99. However, it would not be a popular approach inside or outside Germany. If (a) and (b) have not yet occurred so far within the ERM, that has been in part due to Bundesbank resistance. The difficulties the UK experienced with the sterling balances - and also the transition from dollar shortage to dollar glut in the final years of Bretton Woods - are reminders of the extra constraints that a reserve currency can face. Moreover, rather than completely surrendering sovereignty to West Germany, other member states would want to have some influence on policies that determine the supply of deutschemarks if a deutschemark area became more generally established. In spite of this, however, a deutschemark area might have some attractions for Germany as an alternative to ceding the determination of German inflation to a European Central Bank. Thus this model could possibly emerge as a compromise between those Germans who wanted to retain maximum Bundesbank control, and others (both Germans and other Europeans) who wanted a European Central Bank. But this seems unlikely.

OTHER POLICIES

Fiscal policy

100. Delors' proposals for co-ordination of fiscal policy are discussed in Annex 1, which notes various difficulties about imposing mandatory budgetary guidelines in practice, even if one accepts the case that co-ordination may in principle yield a superior outcome compared with uncoordinated policies.

101. If mandatory central controls on national budgetary policies are not a necessary feature of the Delors Stage 3 model of monetary union, there is still less of a case for them in the alternative decentralised models considered in this paper. All the models will involve some form of constraint being put on national budgetary policies by the exchange rate regime itself.

Providing a dominant group of countries follows responsible budgetary policies, exchange markets will exert pressure on the other countries to adopt responsible policies as well.

Regional policy

102. The Delors report takes as read a need to increase regional and structural assistance in order to make EMU a success. It seems to have in mind both a permanent increase in such spending after the planned doubling by 1992, and also temporary official assistance "to reduce adjustment burdens temporarily" (paragraph 29). A related argument that is sometimes made (eg in the MacDougall Report of 1976) is that the size of the central budget should be substantially increased to introduce the sort of automatic stabilisers between countries that tax and benefit systems currently give rise to between regions of each country.

103. There are two distinct strands to the argument:

- that regional imbalances must be reduced or at least not made worse if EMU is to be viable, and that larger official flows will help to achieve this;

- that official flows are needed to compensate for the fact that countries would no longer have the exchange rate as an instrument of adjustment.

Similar arguments could be made in respect of all but one of the alternative monetary models considered in this paper, as they all reduce or remove the use of the exchange rate as an instrument of adjustment. The exception is competing currencies which requires exchange rate flexibility.

104. These arguments are not convincing, for the reasons set out in Annex 1. The only obvious reason (which of course the report does not mention) for expanding regional flows would be if the richer countries were determined to press ahead with EMU; the poorer countries needed to be bribed into participating; and the richer countries thought it worth the cost. By arguing the case

for extra regional flows so strongly and on largely spurious grounds, the report will increase the pressure on this from the poorer countries.

CONCLUSIONS

105. Having described the alternative monetary models separately, it may be helpful to attempt to compare them directly under a number of different heads. They can be considered from the point of view of: economic implications; sovereignty; whether they can be said to approximate to monetary union; transitional arrangements; and acceptability to our EC partners. The implicit baseline against which the alternative models are being compared is the system at the end of Delors Stage 1.

Economic implications

NB the Delors yardstick

106. The key economic question is how successful each model is likely to be in controlling inflation and providing a stable monetary framework. Recent history suggests that those models in which the German monetary authorities would have a central role would be relatively successful for the foreseeable future, although not necessarily for ever. This applies especially to narrower bands and the sterling area. It also applies to some extent to competing currencies. Here the aggregate EC inflationary outcome would depend on the degree of competition in practice and the strength of people's preferences for a sound currency. If the competitive forces were relatively weak, perhaps because of national preferences for national currencies or high transactions costs, the process whereby sound currencies (eg the deutschemark) would drive out unsound ones might take a very long time during which inflation could be significant.

107. By contrast, those models in which the influence of Germany over monetary policy was watered down by compromises with other EC countries might be more inflationary. This would probably be the case with the common dollar/yen policy and some of the versions of greater monetary coordination. As with Delors Stage 3 the outcome

on inflation would depend to a significant extent on how independent the monetary policy decision process was of political influences.

108. The gold standard may be relatively non-inflationary, although it could be exposed to inflationary bursts in periods when the supply of the commodities on which it was based increased rapidly.

109. The models also differ according to the fixity of exchange rates. Delors Stage 3 is totally fixed. The competing currencies model is likely to involve the most fluctuating exchange rates. Realignments could be expected in all other cases: extended ERM, gold standard and sterling area. The size and frequency of the realignments would in practice depend more on the degree of commitment to exchange rate stability and the rules of the game than on the objective characteristics of the particular system.

110. There are differences in economic efficiency between the models. Other things being equal, totally fixed exchange rates leading to a single currency are beneficial because of the reduction in uncertainty and risk. But other things are not equal: if monetary policy was conducted unwisely under, say, Delors Stage 3, the competing currencies model could be more economically efficient despite fluctuating exchange rates.

111. Each model also has a number of specific economic implications of which the following are the more important:

- an ERM with narrower bands would be sustainable only if inflation and interest rates had converged to at least as great an extent as the bands were narrowed;

- an agreed commitment to stable rates for EMS currencies against the dollar and the yen would leave the Community more exposed to monetary shocks (for example changes in interest rates) elsewhere and would lead to greater exchange rate stability vis-a-vis the dollar and the yen;

- instability would be introduced into a gold standard world by fluctuations in commodity prices, and the response of the Community could lead to friction with the US and other countries.

Sovereignty

112. The institutional changes that are necessary range from creating new European institutions in the case of Delors Stage 3 and some of the variants of greater monetary co-ordination; through agreeing new rules in the case of competing currencies, the gold standard and the sterling area; to relatively little institutional change in the case of most of the options for extending the ERM. Any new institutions under greater monetary co-ordination could be watered down versions of the Stage 3 ESCB (eg an ESCB subject to control by national monetary authorities, an ERF with limited functions), or beefed up versions of existing arrangements, such as the Monetary Committee and the Committee of Central Bank Governors, or something similar.

113. Sovereignty is linked to institutional change, although the relationship is not one for one. Delors Stage 3 involves a considerable loss of sovereignty in the sense of control over monetary policy decisions by national monetary authorities. Some versions of greater monetary co-ordination are similarly affected (though to a lesser extent). While control over decisions remains at national level in all other cases, it is always heavily constrained. The constraints might be perceived to involve a greater loss of sovereignty in cases where other EC authorities - either collectively or the Germans in particular - have a say (ie common dollar/yen policy, greater monetary co-ordination, sterling area) than in cases where the constraint comes through the market (ie narrower bands, competing currencies and the gold standard).

114. The loss of sovereignty may also be perceived to be greatest in cases where the changes are least reversible. Those models which involve major institutional changes, such as Delors Stage 3,

fall into this category because reversing institutional change is a difficult process which would be resisted by most countries. On the other hand, those models (ie narrower bands, common dollar/yen policy, the gold standard, competing currencies and the sterling area) which rely on a commitment to a set of rules may be easier to reverse. Certainly history suggests that pressures can easily arise to cause systems like the gold standard and the sterling area to fall apart.

Definitions of monetary union

115. Given the commitment to monetary union, and the general agreement that it represents something beyond Delors Stage 1, it is important to be able to present alternative models as forms of monetary union. This will be easier for some than for others.

116. The various forms of extended ERM represent little more monetary union than in Delors Stage 1. If greater monetary co-ordination involved creating a new institution (eg a European Reserve Fund), it would be easier to present it as monetary union. The introduction of non-EC members into the ERM could even lead to less monetary co-operation, although there is the alternative possibility that it causes a sub-group of the 12 to press ahead towards a Delors-type union.

117. The other three models may or may not look like monetary union at the end of the day depending on how they develop.

118. While it is possible to assert that competing currencies will eventually lead to a single official currency, the paper argues that this is unlikely. It will be difficult to present this model as monetary union with much conviction.

119. The gold standard does not represent monetary union in the form of a common currency or central monetary policy. However, there is an element of unity in the common acceptance of the rules of the game. Moreover, as time progresses and all countries'

monetary authorities react in identical ways to shocks, it might be a trivial step to lodge authority for monetary policy in a central EC institution which then issues a single currency.

120. The sterling area model, assuming that the deutschemark was the key currency, would be somewhat closer to monetary union than Delors Stage 1. But, as with the gold standard, there would need to be a formal transfer of authority to a single body (in this case a German one) before union was explicit.

Transitional arrangements

121. The paper has not discussed transitional arrangements in detail. The models fall into two broad groups: those in which the arrangements can evolve gradually, and those in which a sharp change has to take place at a particular stage.

122. The evolutionary models are the common dollar/yen policy, greater monetary co-ordination, incorporating non-EC members (although from the point of view of each new member the change is sharp) and the sterling area. It would not be necessary to make precise decisions at the beginning about exactly when and how to advance towards monetary union in these models.

123. With the others - narrower bands, competing currencies and the gold standard - sharp changes in the rules of the game are required at some stage. This may make them more difficult to negotiate.

Acceptability to EC partners

124. Other governments are most likely to be looking for models which show some advance on Delors Stage 1, in the general direction of Stage 3. Greater exchange rate stability and a Community-wide monetary policy are features of interest to them.

125. This tends to favour the more radical of the options for extending the ERM; narrower bands and a common dollar/yen policy probably do not go far enough for most countries. Competing

currencies, the gold standard and the sterling area are so different from Stage 3, especially in not having any central institutional machinery, that they will not be very attractive. However, the fact that previous French governments have flirted with the idea of the gold standard may mean it is an outside runner.

126. Models which strengthen the leading role of Germany will be unpopular among many countries. This applies to narrower bands, the sterling area and, in the long run, competing currencies. It does not apply to Delors Stage 3, the common dollar/yen policy, greater monetary co-ordination or the gold standard. While in some respects Germany (and perhaps one or two others such as the Netherlands) will take the opposite view,they may not act as an effective counter-weight because:

(a) in the case of competing currencies, they may not wish to see the leading role of the deutschemark challenged even if the expectation is that it will win out in the end;

(b) in the case of the deutschemark area, they may be reluctant to create a system which encourages other EC countries to hold deutschemarks in their reserves;

(c) for foreign policy reasons they have supported Delors even though it may not be in their best economic interests.

127. Taking all these points into account, the easiest to sell to our partners as an alternative to Delors Stage 3 is greater monetary co-ordination, especially if it has some new institutional framework. The gold standard is a remote possibility.

Overall assessment of monetary models

128. In terms of the UK's broad objectives of minimising loss of sovereignty (ie retaining independent monetary policies and minimising institutional change) and controlling inflation, the most acceptable alternative models are narrower bands, a common dollar/yen policy, competing currencies and the gold standard. With the exception of the gold standard, none of these look much like monetary union and they are unlikely to be acceptable to our partners. If the gold standard is also ruled out, it may be necessary to fall back on greater monetary co-ordination with some institutional change as a compromise between Delors Stage 3 and the kind of full independence of monetary policy which we would prefer.

Fall back

Fiscal and regional policies

129. Neither the mandatory central controls over national budgetary policies nor the extra official flows to poorer countries that are proposed by Delors are, in economic terms, a necessary part of Delors Stage 3. There may, of course, be other reasons for wishing to see a larger transfer of funds to the poorer countries - for example, a need to bribe them to accept the full package.

130. If this is true of Delors, it is still more true of the alternatives to Delors. All the monetary models discussed here could operate perfectly well without much central co-ordination of fiscal policies or enhanced regional flows.

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ANNEX 1: DELORS PROPOSALS FOR ECONOMIC AND MONETARY UNION

This annex offers a critique of the form of Economic and Monetary Union proposed by Delors (the destination reached in Delors' "third stage").

2. The main features of completion of **monetary union** would involve irrevocably locked exchange rates between EMU participants, and eventually a single currency. Responsibility for monetary policy (including exchange rate policy and management of reserves) would be transferred to the proposed "European System of Central Banks". Key monetary policy decisions would be taken by the Council of the ESCB, which would be independent of both national governments and Community authorities, and would be composed of Governors of the Central banks plus board members appointed by the European Council on contracts whose terms ensure their independence from national political pressures.

3. **Economic union** would involve not just the completion of the internal market programme, increased convergence of the European economies, improved factor mobility etc, but also enhanced structural and regional policies and new powers for the Council of Ministers to impose constraints on national budgets.

(i) Economic union

4. The Delors report does not set out very clearly the reasoning behind its proposals in the fields of budgetary and regional policy. Indeed there is some ambiguity over the degree of central intervention in national budgetary policy that is envisaged. Paragraph 33 of the report - which covers institutional arrangements in the economic field - says:

> "it would seem necessary to develop both binding rules and procedures for <u>budgetary policy</u>, involving respectively effective upper limits on budget deficits of individual

> member countries [and]... the definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance."

Later on in the report, in discussing the steps to be taken in stage three, fiscal arrangements are described as follows:

> "the Council of Ministers... would have the authority to take directly enforceable decisions, ie to impose constraints on national budgets to the extent to which this was necessary to prevent imbalances that might threaten monetary stability".

5. The tone of these two quotations is quite different, even if what they say is formally consistent. The first quotation gives very much the idea of an appropriate overall fiscal position being decided centrally and then budget objectives being allocated to member countries to achieve this overall position. The second quotation might involve no more than intervention in extreme cases where national policies had clearly got out of hand (eg Greece at present).

6. There is no doubt that a theoretical case can be made that uncoordinated fiscal policies may be inferior to a coordinated outcome. But we would need a lot of convincing that the externalities of national fiscal policies were such as to warrant Delors' proposals. Previous fixed exchange rate regimes survived without fiscal coordination, while the experience of many countries in recent years suggests, at least at first sight, that fiscal policy measures have a very limited impact.

7. There would also be practical difficulties with any attempts to coordinate fiscal policy. There would, for example, be accounting problems: countries may have scope for switching items on or off budget so that a given measure of the deficit would be consistent with a range of fiscal impacts. More fundamentally, various aspects of fiscal impact are not reflected in conventionally measured deficits at all (eg changes in unfunded pension liabilities). Again, policies on assets sales or other

compositional issues will affect the economic impact of a given deficit. Would restrictions be set in terms of a more sophisticated measure of fiscal impact than the crude fiscal deficit (eg the Blanchard index used in the recent Monetary Committee paper on the UK)?

8. There would also be control problems. Forecasts of many components of public deficits are subject to considerable margins of error; with the best will in the world, no country is going to meet budget guidelines exactly. There will be some scope for countries that want to exceed guidelines for the deficit to make over optimistic projections of revenue ex ante; it would not always be easy to distinguish genuine forecast error from deliberate flouting of Community directions.

9. A further aspect of budgetary policy that the Delors report does not go into is the extent to which it should take account of the differences in private sector saving and investment behaviour in member states*. If a total Community budgetary balance is to be parcelled out among the member states it is hard to see how the allocation could avoid making allowance for differences in private sector behaviour; but at the same time agreeing on the appropriate allowance is going to be a disputatious procedure, to say the least.

10. As well as the limits on budget deficits, the Delors report calls for the exclusion of access to monetary financing and limits on borrowing in non-Community currencies. The prohibition on monetary financing is a necessary consequence of the particular model of monetary union adopted by Delors in which the monetary growth for the EMU region as a whole is determined centrally. Other models, in which monetary policy in each country was determined independently subject to the constraint of maintaining a fixed exchange rate would not require a rule on monetary financing.

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*There is what may be a cryptic reference to this question is paragraph 30 of the report: "although in setting these limits [on budget deficits] the situation of each member country might have to be taken into consideration".

11. The need for limits on borrowing in non-Community currencies is questionable even within the context of the Delors model. No restriction on private sector borrowing in foreign currency seems to be proposed, and it is not clear why a distinction should be made between the private and public sectors. Nor is it clear why national governments should be prevented from borrowing in what they believe to be the lowest cost way or arranging their portfolio of liabilities in the way they believe to be optimal.

12. The report is littered with references to the possible or probable need to increase regional and structural assistance in order to make EMU a success. It seems to have in mind both a permanent increase in such spending after the planned doubling by 1992, and also temporary official assistance "to reduce adjustment burdens temporarily" (paragraph 29).

13. There are two distinct strands to the argument:

- that regional imbalances must be reduced or at least not made worse if EMU is to be viable, and that larger official flows will help to achieve this;

- that official flows are needed to compensate for the fact that countries would no longer have the exchange rate as an instrument of adjustment.

14. The key question in relation to the first point is whether countries on the periphery would be worse off with EMU. The report says that "historical experience suggests that, in the absence of countervailing policies, the overall impact on peripheral regions could be negative" (paragraph 29). Within Europe in recent years growing integration has actually been associated with _faster_ growth in the periphery than in the geographic core of the EC. During the 1980s, the UK, Spain, Portugal and Italy have grown on average ½ per cent per annum faster than the average for Germany, France and Benelux. And within individual countries, there have been some striking recoveries in their regions. It is also of interest in this

The effect of deregulation. [illegible] undermine this context that the United States has seen an enormous reduction in regional inequalities during the course of this century, and particularly since the second world war.

15. In short, it is much less evident than the report implies that the peripheral countries would suffer. At the very least, it should have kept an open mind on this. Even if the periphery were to be worse off as a result of EMU, it does not follow that there should be greater regional flows. Experience with regional policy suggests that it may not have much effect in reducing regional imbalances: it may even aggravate them by postponing necessary changes in competitiveness and movements of labour and capital.

16. Nor over the medium term are official flows necessary to finance current account deficits. It could be that, as happened under the Gold Standard, the faster growing countries or regions at a lower level of development will run current account deficits over a number of years. But these can and should be financed by voluntary capital flows. If they cannot be financed voluntarily, that would suggest that resources would be better used elsewhere in the Community.

17. The key question in relation to the loss of the exchange rate as an instrument of adjustment is whether European countries are at present able to achieve significant and reasonably durable competitiveness changes through exchange rate changes. It seems most unlikely to us that there is now the degree of "money illusion" in European economies that is required for this to be so.

18. On the whole, then, the case for extra official flows in conjunction with EMU is a lot weaker than the report suggests. The only obvious reason (which of course the report does not mention) for expanding regional flows would be if the richer countries were determined to press ahead with EMU; the poorer countries needed to be bribed into participating; and the richer countries thought it worth the cost. By arguing the case for extra regional flows so strongly and on largely spurious grounds, the report will increase the pressure from the poorer countries.

19. There are no other substantial proposals in the non-monetary sections of the report. Although the report argues that "strong divergences in wage levels and developments, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion", there is no support for price and wage controls to encourage convergence. Nothing more than talk is proposed in this area: "efforts would have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity".

(ii) Monetary union

20. The Delors report defines achievement of monetary union as the irrevocable locking of exchange rates and the completion of transition to a single monetary policy. The change-over to a single currency comes <u>after</u> completion of a monetary union: it is seen as the icing on the cake rather than an essential ingredient. There must be some question, however, whether locking of exchange rates can be absolutely irrevocable while separate currencies continue to exist.

21. The European System of Central Banks (ESCB) as recommended by the Committee would be responsible for the formulation of monetary policy and, with the help of the national central banks, for the implementation of this policy. It would also be responsible for exchange rate and reserve management. An ESCB Council, composed of the Chairman, an unspecified number of Board members plus the national Central Bank Governors, would take the policy decisions. The ESCB would be independent of instructions from national governments and Community authorities.

22. Numerous questions arise which are barely addressed in the report - in particular:

- Would it be sensible or politically feasible for the ESCB's policy-making to be independent of governments, the EC authorities and Parliaments?

- What sort of monetary policy would the ESCB pursue and what instruments would it use?

but it also unavoidable, since there is no Euro-govt.

23. The proposed independence is clearly designed to satisfy the Germans. For the great majority of countries, including of course France and the UK, this would be a radical departure. The Federal Reserve in the US and the Bundesbank owe their independence partly to special historical factors. It is highly doubtful whether, in modern circumstances, many EC countries would be willing to offer the same. Handing over to an independent body the management of the exchange rate and the reserves would be especially sensitive (which no doubt explains why the US Treasury have held onto this), and would run counter to the fact that exchange rate agreements are made government to government. The recommended independence would only make any real sense if one took the view (as did the Germans and Americans earlier in their history) that the political authorities could not be trusted to run a sensible monetary policy.

24. As for the type of policy, it is worth remembering that one of the motives that some current ERM members have in wanting to move to EMU is the hope that this would lead to a better monetary policy in Europe than exists at present - ie predominantly, a German monetary policy. Representation on the ESCB would give them some influence to bring this about.

25. So much of course would depend upon the monetary views of EC countries when and if we ever get to EMU. From the UK's standpoint, there are two ways of looking at it. On the one hand, when we join the ERM, we might not be altogether happy to have our monetary policy dictated to by the Germans; in that sense, movement to an ESCB run policy would have advantages. On the other hand, the influence in the ESCB of countries wanting to run a looser policy than us might be a danger.

26. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions. For example, what monetary aggregates would be targeted? Would the ESCB target bank reserves? Would it go further and operate a

monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

27. The Committee reject a parallel currency strategy. The creation of ECUs by national and central banks would be quite different from the use of official ECUs in intervention (which we favour), since official ECUs are derived from countries' foreign exchange reserves. It would all too likely be in effect a licence for central banks to print the currencies in other countries, especially the DM and other more important components of the ECU. It is not surprising that the Germans vigorously oppose this.

28. It is just about conceivable that national monetary authorities could collectively agree on issues of ECU through each of their central banks in proportion to their currencies' weighting and in place of their own currency issue. But this would be difficult to agree and the effort would greatly complicate whatever steps were taken to strengthen the ERM. Instead, the ECU should continue to develop mainly through the spontaneous "bundling" of currencies by the private sector.

Alternatives to a European Central Bank

29. The Delors report argues that EMU requires centralisation of responsibility for monetary policies: coordination of national monetary would not be sufficient. Hence the proposal for an ESCB and for Community monetary policy being set at the centre by the ESCB Council.

30. It is certainly not enough to ensure that all national monetary policies are consistent with each other: some device is needed to ensure that they are also consistent with an acceptable outcome for inflation, ie the system as a whole needs an appropriate nominal anchor. But there are ways of achieving this that do not involve the centralisation proposed by Delors.

31. One type of solution is to select a nominal anchor that is external to the EMU system - eg gold or the dollar - and for all

currencies within EMU to peg to that nominal anchor. Another type of solution would be for one participant to peg to some nominal anchor - which could again be the dollar or gold, but could also be a domestic monetary aggregate or nominal income - and for other participants to conduct monetary policy so as to fix their exchange rates to the leading currency, as in the sterling area. In this way the nominal anchor for the leading currency would function as a nominal anchor for the whole system. A third solution would involve a system of co-ordination of independent monetary policies that took account of the aggregate impact on inflation (or nominal income) as well as the eventual consistency of the separate policies to the extent that the ERM did not enforce this. None of these solutions would require a European Central Bank, though the second and third would need some forum in which members of the Community could discuss policies and, in the second case, perhaps exercise pressure on the leading country's monetary policy.

ANNEX 2: THE HAYEK COMPETING CURRENCIES MODEL

The starting point for Hayek's thesis is the observation that there is no necessary linkage between monetary issue and public finance. Governments began their monetary careers by restricting themselves to stamping lumps of gold and other precious material to certify their quality and weight. That was a harmless activity and even, provided that the stamps were regarded as authoritative, a socially useful one. But governments soon learnt that they could go farther than this, to their own advantage. By issuing these stamps, quite detached from the original certification purpose, as notes or coin, they were able conveniently to finance an excess of expenditure over revenue.

2. In order to carry off this trick, governments needed to ensure the continuing demand for their use of notes and coin - that people were prepared to provide goods and services to government in return for these notes and coin. To this end, governments generally stipulated that their issue of notes and coin were legal tender, that they had to be accepted as payment for goods and services. In order further to enhance the demand for their notes and coin, and thus facilitate a larger budget deficit, governments also took steps to ensure that they were the monopoly supplier of money. Only governments were therefore allowed to issue currency: others who did so would be branded as counterfeiters and subject to criminal punishment.

3. It was not the fact that someone was providing money which worried Hayek. On the contrary, the provision of money is a major underpinning of civilisation itself, allowing the elevation of economy from one based on barter to one based on transactions. But it was the monopoly position of the supplier which was disturbing, bringing with it the same disadvantages as attend monopoly generally. Now there is a superficial paradox here. Usually, a monopolist restricts the supply of his product to a point less than the quantity which would be supplied if there were free competition. In return, he obtains a more than

proportionately higher price and thus maximises his profits. But a government's temptation is to use its monopoly to supply more money than people want to hold. However, the paradox is only superficial and is easily resolved. The government's action has the further effect of raising prices and, in fact, because the money supplied now has the disadvantage of depreciating in purchasing power over time, less of it in real terms will be demanded. Thus, the situation is exactly the same as in a normal monopoly: a lower real quantity supplied at a higher price since the currency is depreciating.

4. Hayek's worry about government's monopoly supply of money was not a new one. It is, for example, a constant theme in the writings of Milton Friedman* from the early 1950s onwards. Friedman's view, however, was that this was a natural monopoly that governments held and that the answer was for them to be bound by rule to supply the optimal amount of money that people wanted. Friedman's solution was that the supply should be restricted such that it appreciated over time, bearing in mind that it was non-interest bearing, so the total return to holding it was the same as the interest rate in the economy. That would not rule out that the nominal quantity supplied would increase since the real demand for money would be increasing as the economy grew.

5. Hayek's proposal is the alternative one, not of regulating the monopolist but of breaking up the monopoly and allowing as many people as want to provide the service of supplying money. He supposes, reasonably enough, that it would be a subgroup of banks, "issue banks", who would want to compete for the business of supplying currency. It would be an important part of the scheme that each issuing bank would not supply pounds or dollars or some common currency, but its own proprietary currency. Barclays might issue Quintons; Midland would issue McMahons; Lloyds, Morses; and so on. Each would be defined by reference to its unit purchasing power in terms of a defined basket of goods and services.

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* Hayek was, of course, Friedman's colleague at the University of Chicago between 1950 and 1962.

6. Each issuing bank would have an incentive to maximise the demand for its own note issue because it could use the process for profitable investment. But that would not mean that they would issue notes without limit. In principle, Hayek notes, people might freely choose to have either appreciating or depreciating currency but, in practice, the majority preference is likely to be for currency stable in value against the basket of goods people generally buy. So the issuing bank, in its own interests, will restrict its issue to the quantity which will preserve the value of each of its notes against the basket. If Barclays, for example, were to exceed this, then it would know that the Quintons would depreciate against the Morses and McMahons and be acceptable for only a part of the basket it was supposed to purchase. Assuming people wanted a stable currency, preferences would turn against the Quintons in favour of stable Morses and McMahons and Barclays would be punished for its profligacy by finding it could keep fewer of its notes in circulation.

7. It is a vital part of this scheme that issuing banks are not allowed to issue a common currency so as to reverse the normal thrust of Gresham's Law. If a profligate bank were allowed to issue notes fixed by law as equal in value to any other banks' notes, then the profligate bank's money - bad money - would drive out the other banks' good money. Since everyone would know that the profligate bank's money was in reality worth less than the other money - despite what the law claimed - everyone would hang on to the good money but pay for goods and services received with the bad money. In this way, only the bad money would finish up in circulation - Gresham's Law, the bad money having driven out the good. By contrast, under the Hayek proposal, the reverse would happen. It would be the good money which stayed in circulation by virtue of the mechanism described above.

Some Difficulties

8. As it stands, Hayek's proposal is not without its difficulties. Some of the main ones are discussed below.

9. First, it needs to be clear what kind of worry it is that is under discussion. On the one hand, Hayek is clear that the distinguishing feature of money is that it is used as the medium of exchange. (Other attributes - store of value, unit of account, means of deferred payment - he regards either as derivative or as non-essential.) On the other hand, it is equally clear that he is thinking of a commodity supplied by the government, and only by the government, and in the form of a non-interest bearing liquidity. That means he must have in mind notes and coin. Yet in a modern economy the main medium of exchange is not notes and coin, but sight deposits at banks (or building societies). In the UK, for example, notes and coin total only £17 billion whilst sight deposits, for transaction purposes, at banks alone come to seven or eight times as much.

10. This is important because historically the greatest part of the inflation tax has not accrued to the government but to the banking system in the form of the "endowment profit" on their current accounts. More recently, however, the endowment profit has been eaten away. Competition, both between banks and with other financial institutions, has meant that an increasing - and probably by now the greater part - or transactions balances are interest bearing. But once money is allowed to bear interest, the nature of the competitive equilibrium may be quite different. In terms of the example used previously, people may still be prepared to demand depreciating Quintons provided that Barclays were prepared to pay a good rate of interest upon them (or, at least, upon current account Quinton deposits). The outcome may therefore not necessarily be that the currency in circulation has a stable value against goods and services.

11. A second difficulty is that the banks and the public would have to work out how to value each of the note issues that were made. One problem would be to define the standard basket of goods and services against which the currencies were to be defined. But assuming that such a basket would be universally agreed upon, there would still be difficulties. Even if the management of bank X had decided that it wanted to keep its issue of notes at a stable value, it would be faced with a difficult technical

calculation each day in deciding how many notes to print and to issue. The complication would arise from the fact that the demand for its issue would be in the first instance unobservable. If the issuing bank under-estimated this demand, then its issue would appreciate in terms of the basket: if the demand had been over-estimated,its issue would depreciate. The banks might try to error correct, modifying its issue in the light of observed appreciation/depreciation over time. But it could be a period of weeks or months before such information became available. So there would be a possibility of prolonged periods of fluctuating values for a currency whose issuer wanted to avoid that.

12. Hayek supposes that this would not happen because the financial press would perform and publish each day the required purchasing power calculation for each currency in issue. But it is hard to see why the press would be any more able to carry out the calculation than the individual banks could. An alternative source of information could come from the currency exchanges where Quintons would trade against Morses and McMahons. Generally, over time, the exchange rate of the issues of profligate banks would depreciate against other issues. But experience of the foreign exchanges suggests that the observed exchange rate could, in the short term, prove to be information worse than useless.

13. What would be needed to reach Hayek's objectives is that the currency exchanges established exchange rates consistent with the relative purchasing power parity for each pair. Yet in the foreign exchanges this happens only, if at all, in the longest term. Over shorter periods, the rates would be affected by factors such as the believed state of banks' loan books, and predicted changes in management structures causing issuing banks in future to be more or less prudent than was currently the case. Morses might appreciate this week because traders had perceived they had risen in previous weeks and were therefore bidding them up, and so on.

14. A third set of questions relates to the numbers of issuing banks which would be likely to result, or for that matter be desirable, under such a system. From the points of view of making

the system manageable, one might be looking for a smallish number. Hayek supposes, for example, that all shopkeepers would need to price their goods in at least the main available currencies. Because of the changing exchange rates, prices would have to be re-posted at least once a day and consumers would need at least a broad idea of what the pattern of exchange rates was so as to be able to check that they were not being faced with unfair relative prices. Households would need to budget and account separately for at least those of the available currencies that each chose to hold. Company treasurers would have to extend their foreign currency exposure control techniques to purely domestic transactions as well.

15. All this sounds rather complicated and it seems unlikely that more than a few issue currencies would survive. In fact, in Hayek's own illustration there are just seven currencies which circulate. But from the point of view of making the systems fully competitive, this looks like too small a number. Such a small group of issuing banks would quickly come to understand that their group profits could be appreciably higher if they were to stop competing fiercely and exercise a degree of collusion instead. That would mean reconstructing at least an approximation to the monopoly position that the competitive system of issue was supposed to avoid. No doubt the group of issuing banks would justify the collusion, both to themselves and to the public, as an exercise in standardisation designed to increase their customers' well-being. But the result would be just the over-issue in nominal terms, and consequent under-provision in real terms, of money that the scheme was supposed to avoid.

16. The final difficulties would stem from the fact that all of the currency under the Hayek plan would be liability of private companies. Notes and coin issued by the government are at least secured on the taxing power. Hayek does not discuss what would happen if one of his issuing banks were to fail as a result, for

example, of its using the proceeds of the issue for unwise investments or, for that matter, because of fraud on the part of the management. People choosing which currency issues to hold would evidently need to take a view about the soundness of each bank's assets as well as their relative intentions about the size of their note issues.

17. Not all of the difficulties discussed above are necessarily insuperable. But the issues would need to be worked in a great deal more detail before there would be the semblance of a viable system at national level. As the Chancellor has publicly noted, no government has so far been prepared to experiment along Hayekian lines.*

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* "This is not a form of privatisation that Britain, and for that matter, any other country, has so far espoused, and this Government has therefore accepted its responsibilities for the value as well as for the creation of the currency. We have accepted that the state has a clear responsibility to maintain the internal value of the currency - that is to say, to avoid domestic inflation - and, within that context, to maintain the external value of the currency - the exchange rate" Nigel Lawson, "The State of the Market", Institute of Economic Affairs Occasional Paper 80, 1988.

ANNEX 3: STERLING AND OTHER CURRENCY AREAS

The Sterling Area

According to the Treasury's 1958 evidence to the Radcliffe committee, the Sterling Area was far from being a term with a precise meaning. The system originated in the early nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which prevailed in most of the colonies. Each local currency was statutorily regulated as a local version of the pound, printed or stamped with local symbols, but all representing the sovereign (or a fraction of it) and all backed with some obligatory holding of sovereigns or gold. Thus the sterling area at that time was essentially a special case within the gold standard. What distinguished these countries was the closeness of their trading ties, their common use of the London capital markets, and in particular the use of sterling as the currency for their external transactions. The gravitation of foreign exchange income of the whole area to London was a natural consequence of normal business and banking practices. Effectively London acted as a clearing centre for the external transactions of the whole area, enabling economies to be achieved in lesser resort to physical gold shipments and eventually in the total holdings of external reserves for the countries of the area.

2. There were no special arrangements to ensure that local monetary and other polices were consistent with the maintenance of exchange parities. In this sense the sterling area was no different from the wider group of countries on the gold standard. However, the closeness of trading ties and the common use of London's money and capital markets meant that policy changes in the UK were transmitted through the rest of the area relatively quickly. Because of unambitious economic policies of the overseas civil servants running the colonies, any thought of varying parities rarely occurred, and in any case a change would have required legislation. In other words, the idea that the colonies

would do other than accept the consequences of UK economic developments and policy (such as it was) did not really arise.

3. Although some of the largest colonies had been granted independence before sterling left the gold standard in 1931, all Commonwealth countries apart from Canada decided to remain pegged to sterling. In the period to 1939, there were no new formal monetary arrangements, but the sterling area did provide a sort of "zone of (internal) monetary stability" in a world of growing protectionism and "beggar my neighbour" devaluations. After 1939 the arrangements were formalised with trade restrictions, payments and capital controls imposed vis-a-vis the rest of the world, and the agreement of the overseas sterling area (OSA) that any increases in their external reserves would normally be held in sterling.

4. After the War these arrangements remained acceptable to the OSA as they enjoyed the benefits of Commonwealth trade preferences and access to London capital markets in exchange for being willing to pool their reserves and maintain their parity with sterling. All except Pakistan devalued with sterling in 1949, and they followed later. But as world trade and payments arrangements were steadily liberalised under the GATT and IMF, and stock markets developed for commodity exports, the advantage to the OSA countries of membership of the sterling area diminished and signs of resentment at having to follow UK policies grew.

5. Memoranda submitted by several OSA central banks to the Radcliffe Committee stressed that the sterling area was a voluntary association which was not subject to formal rules and obligations but based on considerations of mutual interest. The Commonwealth Bank of Australia said that, in general, the arrangements to hold reserves in sterling <u>had</u> been convenient, but went on to spell out the advantages of spreading their reserves over different forms of holdings. They noted that members of the sterling area had had from time to time to take measures to protect the gold and dollar reserves of the area as a whole and indicated that their willingness to remain within the area rested on their need to have access to the London capital market. The

Reserve Bank of New Zealand grumbled more specifically about the rise in UK Bank Rate to 7% in 1957, spelling out the adverse effects it had had on the New Zealand economy. "These changes came at a time when we could ill afford them." The South African Reserve Bank complained that the credit squeeze in the UK had had "unfavourable repercussions" on South Africa's balance of payments, and dwelt at length on how they had been forced to follow a succession of "drastic measures" which had been of "material assistance from the UK's point of view" but had imposed "an excessive strain upon South Africa and other countries of the area".

6. Other central banks called more explicitly for greater symmetry in policy-setting. After deprecating unilateral actions by the UK, the Central Bank of Ceylon said "a stronger sense of the need for internal discipline among all members must prevail if unevenness in the sharing of benefits and burdens is to be avoided". The Reserve Bank of India saw "undoubted advantage in organising more frequent discussions on the working of monetary policies, exchange controls and related questions of trade and economic policy among the countries of the sterling system". However, the central banks were cautious about instituting more formal arrangements for policy co-ordination; it seems that they were reluctant to be thought to be ceding any sovereignty back to the UK by subscribing to new regulations, and preferred to maintain the status quo whereby the UK in practice, but not by treaty, determined the monetary policy of the sterling area. That said, the Bank of Rhodesia and Nyasaland stressed the Federation's freedom to act independently by pointing out that "the Governor-General is fully empowered to determine the value of the Rhodesian pound" and "any change in the external value of sterling would immediately raise a difficult question of policy for the Federation".

7. Despite this awareness that the sterling area arrangement gave OSA countries little choice but to follow the UK's lead in monetary policy, sterling's devaluation in 1967 represented a major turning point, when a number of member countries either decided against moving their currencies with sterling (Australia,

Hong Kong, S. Africa and Bahamas), or did change and then set about diversifying their reserves against a possible future decision to go in their own direction. There then followed a period of instability, with the sterling reserves under pressure from diversification but the speed of deterioration was moderated by various "sterling agreements" negotiated with members to maintain "minimum sterling proportions". It was only when the UK imposed exchange controls vis-a-vis the OSA in 1972 that the area finally broke up.

8. In 1958 the Treasury had seen the arrangements to be beneficial because UK citizens "could use their own currency over a large part of the world" and were "saved the inconveniences of operating in foreign currencies", and because of the profitable business the sterling system created for the City of London. But the Treasury also believed that the "cohesion and viability of the sterling area depend above all on the strengths of sterling", to which "a current account surplus in the UK balance of payments is of fundamental importance". In the end these conditions were not met and the sterling area came to an end. The reserve role of sterling was ended as a condition of the UK's entry into the EEC.

9. However, the UK-originated problems for sterling were not the only reason for the breakdown. The movement towards political independence (and not only by colonies, as other countries also had political dependence on the UK) had parallel economic consequences. Countries such as India and Ghana set out to achieve ambitious national goals, often spending along the way large sterling balances accumulated during the war. They imposed their own exchange controls on money flows to London as their balance of payments deteriorated, often because of indifferent economic management resulting from a deep lack of understanding of the economic consequences of political and social policies.

10. The sterling area was successful as long as sterling was a strong currency and the rest of the sterling area was willing to accept the monetary policy of the monetary authorities in that

country. The Treasury cited four fundamental features of the sterling area in 1958:

(a) the members use sterling as the normal means of external settlement;
(b) they hold the major part of their reserves in sterling;
(c) they look to London as a major source of external capital;
(d) they co-operate to maintain the strength of sterling.

Other monetary unions and currency systems

11. Unlike the sterling area, there are a number of other arrangements - notably ~~in~~ the French franc zone - still in existence.

12. The franc zone is a centralised concept in origin, depending on a fixed exchange rate relationship between the French franc and the subsidiary currencies. Within the system there are various individual and regional arrangements ranging from near-currency boards, where local currency is issued against French franc assets and managed by the Institut d'Emission d'Outre-Mer in Paris, to the large regional central bank zones in West and Central Africa with autonomous local management. The essential feature of the French African central banks is the continuing role played by France. In effect, it provides the equivalent of a gold standard, and individual countries' policies have to follow from that. This is an external constraint, not one established and maintained by the member countries themselves as a result of a process of discussion leading to a consensus on monetary policies. France still has directors on the boards of the African central banks and France is the dominant country economically as well as politically with a GNP 20 times that of all the African member states taken together.

13. The members of the franc zone each agree to hold at least 65% of their reserves with the French Treasury. Often they place more there, as the terms offered (SDR exchange guarantee and

Bank of France's intervention rate for interest) are attractive. The regional central banks each have an operations account with the French Treasury (as do other countries and zones participating in the franc zone arrangements). All transactions with France pass through this account, which may be in surplus or deficit, but in the latter case subject to an increasing disincentive in the shape of interest rate bands. The same principle applies within the regional central banking zones - individual governments may have a surplus or deficit with the bank, as do commercial banks. However the statutes of the central banks restrict their advances to the African Treasuries to 20% of the previous year's budgetary receipts when the operations account with the French Treasury is in deficit.

14. One of the features of the French overseas system, as of the metropolitan system, is the rediscount and even the medium-term rediscount, which link monetary policy into financing of agriculture, industry and commerce. However, rediscount policies are liberal and liquidity tends to be uncontained for some time after external receipts fall - good for confidence and stability, but not for adjustment.

15. Throughout the system, provided an individual, company, bank or government has local currency it has access to foreign exchange at the fixed rate under what the French proudly refer to as "le garanti francais". The rate against the French franc has been set at FF1 (100 old francs) to CFAF50 since 1948.

16. The two African regions are currently in bad shape and last year produced for the first time an overall deficit by both zones in their operations accounts. Usually, the different economies have tended to balance each other but the oil price fall has brought down the oil producers of Central Africa while soft tropical commodities have remained weak. In West Africa, the big change has been in the Cote d'Ivoire which has been hit particularly hard by lower oil prices and falls in coffee and cocoa prices and has not adapted domestic policies accordingly. Another feature has been, until last year, the fall of the dollar against European currencies including the franc at the same time

as commodity prices weakened in dollar terms. There is a clear case for a devaluation of the CFA franc but the difficulty in reaching agreement and perceptions of cost increases have prevented these proposals coming to the surface. Also, France has vested interests in maintaining confidence and French investment in these zones and in keeping exports from France cheap. However, France is effectively giving a foreign exchange subsidy to the system at present. Meanwhile, countries like the Cote d'Ivoire are having difficulty in moving exports and maintaining producer prices and have acute budgetary difficulties. Interest rate policy is not within their control and, unable to devalue, their only weapon is budgetary. A massive deflation is about to take place as producer prices are cut and salaries are held in inflationary conditions.

17. There have from time to time been regional currency and monetary arrangements within the sterling area. The Eastern Caribbean Central Bank (previously East Caribbean Monetary Authority) with a varying membership of small islands, and before that the British Caribbean Currency Board, which included the larger Caribbean territories, provide examples. They cannot be said ever to have worked well, the problem being the absence of agreement between governments generally and especially at times of crisis. The lack of consensus has, however, had the advantage of restraining the central authorities from moving exchange rates except when forced by external circumstances (eg, the collapse of the sterling arrangements) to do so. Some kind of price stability has therefore been maintained but slow economic growth, poverty and social unrest have been the norm.

18. Other regional arrangements which emerged from the sterling area system were the Common Monetary Area (previously the Rand Monetary Area) centred on South Africa, the East African Currency Board (Kenya, Tanzania and Uganda) and various forms of Central African federal arrangements including that under the Bank of Rhodesia and Nyasaland.

19. Of these systems, the most successful in terms of unified policy has been the South African rand area, no doubt because of

positive, centrally controlled policy and stable political conditions. However, despite the relatively generous facilities offered by South Africa to its constituent members, independence has inevitably tended to lead towards disintegration, with Botswana withdrawing totally and Swaziland loosening the links.

20. The old East African federal arrangements, which survived independence, were very comprehensive, covering railways, harbours, posts, airline and marketing arrangements as well as currency. Significantly, as political differences emerged, it was the currency and financial arrangements which took the strain first. Almost the first split was from a single currency board to three separate central banks, each with its own currency. A common exchange rate was even then maintained for a number of years but collapsed in the face of divergent economic and political policies.

21. In the Central African Federation, which perhaps was more unified as Southern Rhodesia was far more developed than the other members, the split followed a similar pattern although there seems to have been no attempt to unify the exchange rate arrangements after separation.

22. It is probably inappropriate to draw too close parallels between somewhat primitive currency and exchange arrangements in colonial and newly independent countries with those in developed, industrialised ones. However, if there is a lesson to be drawn it is that attempts at monetary unity where it does not exist on the political and administrative planes tend to disintegrate. Where regional currency systems have worked successfully for any length of time, there seems to have been a consistent pattern of control or domination by a single country. On the other hand, federal economic arrangements have tended to break up where the dominant member was unable or unwilling to devise adequate compensation arrangements to offset the disadvantages felt by those at the fringes. There also seem to be strong links between national pride, sovereignty, common aspirations and the currency. Experience with currency boards suggests that emotional local

identification with the currency is often one of the most difficult matters to deal with. Once that has been settled, the technical side can fall into place relatively easily.

PROVISIONAL TIMETABLE FOR FURTHER WORK ON EMU

1989

end-July	Central bank governors submit to Commission draft revise of 1964 Decision on cooperation between central bank governors.
Late August/early September	Commission produce: (i) Paper on Stage 1 legislative changes. This will not include actual draft texts; (ii) List of questions/annotated agenda on preparation for subsequent stages. Likely to be based on Delors' 6 questions;
6 September	Monetary Committee
9-10 September	Informal ECOFIN, Antibes EMU to be sole agenda item (Stage 1 and preparation for subsequent stages)
Mid-Sep-end Oct	Commission (and others) prepare in light of ECOFIN discussion: - legal texts - analytical paper on preparation for subsequent stages.
2-3 October	Foreign Affairs Council (first since July)
9 October	ECOFIN [Tax to be main agenda item. Not clear whether there will be any discussion of EMU.]
13 November	ECOFIN. 'Main decisions' to be taken on Stage 1.
8-9 December	Strasbourg European Council. To 'take stock' of preparations for Stages 2-3.
18 December	ECOFIN. 'Final decisions' (sic) on Stage 1.

1990

January - June	Further work on IGC and Stages 2 - 3.
1 July	Stage 1 begins

[Sometime thereafter - if agreed by simple majority: IGC.]