PO/CH/NL/727
Part F

PO/CH/NL/727
Part. F

ECONOMIC AND MONETARY UNION (EMU)

STARTS: 12/09/89
ENDS : 3/10/89

FROM: JOHN GIEVE
DATE: 12 SEPTEMBER 1989

SIR P MIDDLETON

cc PS/Financial Secretary
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Scholar
Mr Peretz
Mr R I G Allen
Mrs Brown
Mr O'Donnell
Mrs Chaplin

PLP

EMU

... The Chancellor has read the attached paper by Credit Suisse First Boston. He thinks it contains a useful presentation of the case we have already made on fiscal policy and we should feel free to borrow from it, for example in our promised paper on EMU which will focus on monetary questions but will need to have a brief section on economic union.

2. He would also like to consider whether we should not include in our paper proposals to make the ERM technically symmetrical along the lines put forward by Balladur (and our own suggestion that there should be wider cross-holdings of community currencies). This would appeal to the French and give our proposal less of a DM flavour. It would also be fully consistent with freely competing national currencies.

JG

JOHN GIEVE

I The Dangers of Centrally-Controlled Fiscal Policy

The Dangers of Centrally-Controlled Fiscal Policy

Views on the development of EMU range between two extremes. The "dirigiste" approach involves the early pooling of reserves under an embryonic European Central Bank and an eventual move to central EC control over the size and financing of national budget deficits. The "free market" approach envisages competition among rival currencies circulating throughout the EC, with fiscal discipline left to the markets.

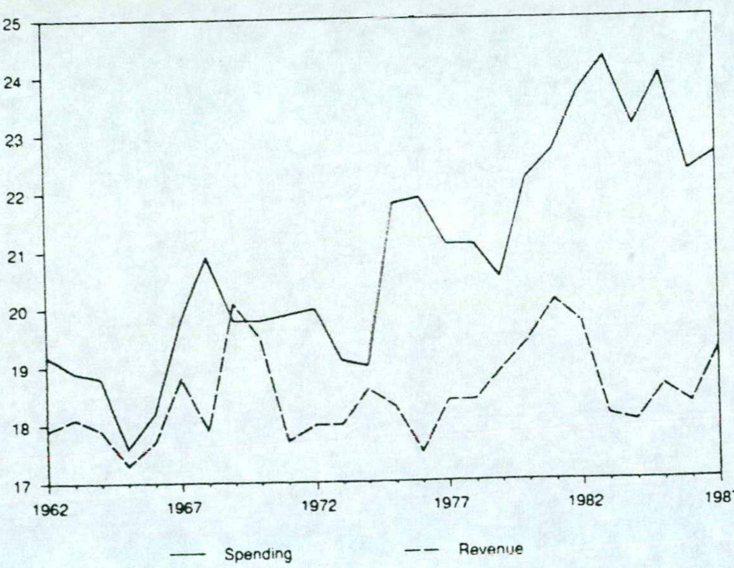
Supporters of the first view stress market imperfections. A key passage of the Delors Report argues that

" ... *experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.*" (Delors Report, section II.3, para 30).

Yet, this is not the core of the conflict. Given the loans to New York in the 1970s and to Latin America in the 1980s, and the rise in the dollar until 1985, the imperfection of markets is undeniable. The crucial issue is: would EC central control help to make up for the shortcomings of markets, or would it merely introduce further imperfections?

The Delors Report and its background papers are concerned with three types of market imperfection: (i) markets would not impose proper fiscal discipline on countries with large government deficits, because of expectations of a bailout; (ii) markets may mistakenly finance unsustainable imbalances, possibly leading ultimately to market closure; (iii) the potential gains from monetary/fiscal policy coordination cannot be realised by the market alone.

Federal Spending and Revenue as % of GNP



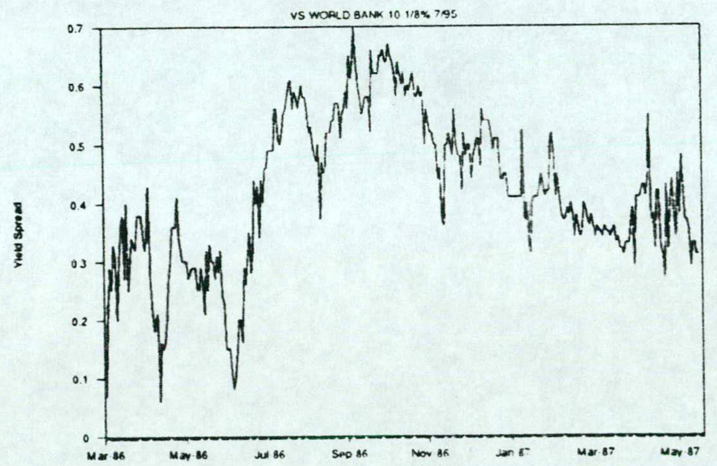
Bailouts more likely under Central Control

On (i), centralised EC political control of fiscal policy would not eliminate the possibility of a bailout, and would probably increase it. A deficit country could play the game of political brinkmanship to the limit without having to watch the market's reaction. The history of pork barrel politics in the US Congress illustrates the temptation to finance large handouts to local areas from small rises in federal taxation. The chart above shows that the result is an upward spiral of US Federal spending and taxes, although the second Reagan Presidency and the Bush Presidency have attempted to break the pattern.

Markets Need to be Guided by Official Bodies, not Supplanted by Them

On (ii), governments, as well as markets, have a poor record of making mistaken, unredeemable loans. Recent debt write-offs and cash injections at privatisation give some idea of the scale: £6 billion for the English and Welsh water industries, Pta 20 billion for the two Spanish railway equipment companies just sold to the French group Alsthom; and a write-off is likely for the bulk of the Lit9000 billion debt outstanding at the Italian public sector steel group Finsider. Large government loans of doubtful value have been made in many other European countries.

AUSTRALIA 11% 5/95



If the markets were left to impose fiscal discipline on individual EC governments, a central EC body could comment on the appropriateness of national deficits. Internationally, this role is played by the IMF and the credit rating agencies such as Moody's. Market anticipations in early 1986, that the latter would downgrade Australia, led to a 0.5 percentage point rise in the relative yield on that country's US-dollar denominated debt. Expectations of the further downgrading this August caused similar, though smaller, movements this year. These moves have sent a clear message to Australia's government but have not cut off her access to overseas borrowing, which has risen from A$45 billion at the time of the 1986 downgrade to A$69 billion in March 1989. For the US, had the Administration or the Fed played the role of a credit agency by breaking silence and indicating displeasure at the strength of the dollar prior to 1985, it seems unlikely that the currency would have risen to unsustainable levels.

I The Dangers of Centrally-Controlled Fiscal Policy

Central Control of Fiscal Policy is no Guarantee that it is Available as a Macroeconomic Policy Instrument

On (iii), international co-ordination of national fiscal policies can offer considerable benefits, especially as the various European economies become more closely integrated[1]. However, coordination need not mean central control, provided policymakers in each country take account of the others' objectives. The Louvre Accord, which led to increased fiscal expansion in Japan and Germany, was an example of voluntary policy co-ordination.

The experience of the US, where neither President nor Congress has full control over the budget, indicates that **determination of fiscal policy at Federal level does not guarantee its availability as a macro-economic policy instrument**[2]. Those who wish to alter US fiscal policy must attempt to move it indirectly, via a range of instruments of which the GRH legislation is one. This contrasts with the situation in countries with a very powerful executive branch of government, such as France or the UK, where fiscal policy is available to policymakers as a discretionary tool for macroeconomic management, should they wish to use it.

The Delors Report envisages federally-imposed limits on the size of national budget balances, with a small central EC budget, so there would be less direct central control over taxes and spending than in the US. Even so, the system would be one of struggle among different powerful groups, closer to the US model than that of France or the UK. It would be vulnerable to a country that threatens to leave the system or that uses political pressure on another issue to bargain for release from its earlier fiscal commitments.

Abolition of Exchange Controls as a Key Step towards a Market-led EMU

In each of the three areas, there is ample scope for measures to offset market imperfections without introducing the new problems caused by EC central control. This provides strong support for the free market approach to EMU. For that approach, abolition of exchange controls is the only major EC-wide legal change needed to allow substantial progress on EMU. This would end government access to captive domestic funds, allowing markets to impose fiscal discipline. Governments that tried to evade market discipline by continued reliance on central bank finance would put upward pressure on their domestic interest rates, or downward pressure on their currency, encouraging them to outlaw such finance via national legislation. On the monetary side, abolition of exchange controls, plus in some countries amendments to company and contract law, would open the way to competition among EC currencies throughout the Community (though no-one would be obliged to accept a currency other than their own). The free-market approach thus offers the potential for substantial progress on EMU, though not full union, without the need for a new Treaty.

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1 See for example Cohen and Wyplosz "The European Monetary Union: An Agnostic Evaluation", Centre for Economic Policy Research, London, Discussion Paper No. 306, April 1989.

2 For a full description of the history of and prospects for the US Federal deficit, and the role of GRH in the Budget process, see: "The US Budget Process and Prospects for the 1990s", CSFB Economics/First Boston Corporation, February 1989.

ANTIBES 1989

As you say, some interesting stuff here.

The 1st paper contains a useful presentation of a case we have already made, & we shd feel free to borrow from it. (Our promised paper on EMU, tho', majoring on EMU, will need to have a self section on ECU).

The 2nd paper reminds me that we shd reconsider whether we shd not include in our worked-out proposed changes to the ERM (à la Balladur, & our own oft-stated suggestion that there shd be freedom for cross-holdings of Community currencies) to make it technically symmetrical. It wd appeal to the French & echo our proposed loss of a DM domination flavour, & be fully consistent with freely competing national currencies.

I shd be interested by a note on the 3rd paper — concentrating on the technical annex on wh. the argument fundamentally depends. NL.

ECOFIN INFORMEL

pso.jt/Middleton/1.13.9

CONFIDENTIAL

FROM: SIR PETER MIDDLETON
DATE: 13 September 1989

CHANCELLOR

cc Sir T Burns
Mr Wicks
Mr Odling-Smee
Mrs Chaplin

EMU

I held a meeting of my group this morning.

The Paper

2. I suggest the following outline for the paper - which follows your speaking note of Antibes.

Section 1 - Philosophy

Three principles: subsidiarity
competition and market forces
stable prices

Points to retention of national monetary policies which are subjected to competitive pressures so that non-inflationary policies prevail.

Section 2 - Delors Stage 1

Description of main elements. Compatibility with our principles.

Commentary on how much more integrated EC economies will be, where possible with examples and quantification (drawn from Cecchini and other large single markets, especially US).

Stress time to see how this works out and allow forces it unleashes to indicate future directions.

Integration (especially abolition of exchange controls) will intensify pressures on national monetary authorities to conduct anti-inflationary policies in line with best. Will make it easier to ~~achieve~~ maintain stable exchange rates [and further developments in ERM].

Section 3 - Beyond Stage 1: Delors

Summary of key features of Delors Stages 2 and 3.

Critique of proposals.

Not best way to satisfy principles in monetary area:

- subsidiarity and stable prices: no reason to believe that primary objective of monetary policy (ie stable prices) more likely to be achieved at EC level than at national level; on the contrary;

- competition and market forces: central monetary institution removes scope for competition between currencies/monetary policies.

Difficulties with proposed ESCB. Institutional/constitutional

Fiscal policy: "binding rules" neither necessary nor desirable.

Regional issues: enhanced official flows not necessary.

Section 4 - Beyond Stage 1: Market approach

Monetary policy: should enhance still further competitive pressures by:

- further liberalising use of currencies;

- further liberalisation of financial sector.

Commentary on likely consequences for inflation, use of currencies and dominance of successful monetary policies.

Fiscal policy: combination of market pressures and Stage 1 surveillance sufficient to ensure ~~consistent~~ sound fiscal policies.

Regional issues: market pressures, ie private capital flows to regions offering best returns on investment, best way to ensure catching up by poorer regions.

Some issues

3. I think we shall have a much better market based solution if our paper proposes both the removal of remaining barriers to the use of EC currencies (which may not be all that great) and additional elements of financial liberalisation which go beyond (or could be made to appear to go beyond) the single market programme. This is both consistent with our approach to monetary union and will look like a more substantial move beyond Stage 1.

4. We must avoid our proposals being trivialised in the way they have recently in the press - use of drachma in our shops etc. ?? There was a general feeling that we should steer clear of suggesting changes to legal tender rules etc, and concentrate more on the freedom to make contracts - enforceable contracts that is - in any European currency.

5. We might make something of the role of the private ECU. It could become, in effect, a thirteenth competing currency without its own central bank. Fixed currency weights would mean that the stronger currencies would represent an increasing proportion of the ECU's value over time.

Further work

6. We need to do further work on the detailed changes that are implied by our proposals for beyond Stage 1. We have already done a considerable amount of work on financial sector liberalisation we will now classify further measures into those which can be regarded as part of Stage 1 and those which we could present as the next stage, if we so desired.

7. We shall prepare a paper on currency liberalisation, in the UK and other countries, consulting posts in the EC where necessary. This will help us decide how much emphasis we want to place on this aspect.

8. We also need to consider whether there are ways of making our version of monetary union attractive to the small man. Since transactions costs in using different currencies is a major barrier for him, we are looking at whether anything can be done about these, though I am not hopeful that much will come out of this.

Cred? cards

Timetable

9. The timetable is very tight. It is Party Conference, Mansion House, Autumn Statement, Commonwealth Prime Ministers time. I doubt whether in practice we shall manage much more than the timetable below. But a week before ECOFIN is very late - and both the FCO and UKREP would be unhappy with that. We can try to squeeze the early stages, but we have to allow posts overseas a bit of time to collect the information we need on currency restrictions in other countries and generally to get the drafting right which will not be easy.

10. The timetable below assumes that the Prime Minister will want it considered by a Ministerial group, as she suggested at her meeting with you on 6 September.

Thursday 21 Sept	:	1st draft to Chancellor
[22-28 Sept	:	Chancellor in Washington]
Friday 6 Oct	:	Revised draft to Chancellor
[Monday 9 Oct	:	ECOFIN]
[10-13 Oct	:	Party Conference]
*Friday 13 Oct	:	Draft to PM +
[18-24 Oct	:	Commonwealth Heads of Government meeting]
Wednesday 18 Oct	:	Draft circulated to Ministerial Group
Friday 27 Oct	:	Ministerial group Final draft to PM and Chancellor
(Week beginning) Mon 6 Nov	:	Circulate paper/press briefing
Monday 13 Nov	:	ECOFIN

* Availability of PM/other Ministers on these dates to be checked.

P E MIDDLETON

FROM: JOHN GIEVE
DATE: 15 SEPTEMBER 1989

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr Odling-Smee
Mrs Chaplin

EMU

The Chancellor was grateful for your note of 13 September. He is generally content with the outline you propose but has the following comments.

<u>Section 2</u> - he thinks it is a matter of maintaining rather than achieving stable exchange rates, and he would wish to include (at least in the first draft) the possibility of development in the ERM on the lines of my minute of 12 September.

<u>Section 3</u> - this will be very important since it will be the first written critique of the Delors proposals since they were presented. He takes it that the section on difficulties with the ESCB will include constitutional and institutional issues.

<u>Section 4</u> - on fiscal policy the emphasis should be on 'sound' rather than 'consistent' fiscal policies; this section should also propose an agreement that deficits would not be financed by printing money.

<u>Side Issues</u> - it will not be possible to steer clear of legal tender rules; that will be the first question he will be asked; however it should not be given too much space in the draft. It is necessary to consider carefully the tax implications of our proposal.

CHANCELLOR OF THE EXCHEQUER

<u>Further Work</u> - he agrees with your paragraph 8; one way of bringing benefit to the small man might be to agree for the use of credit cards throughout the Community.

<u>Timetable</u> - this is very tight; it may be possible to send the draft paper to the Ministerial group (which he thinks should include only the Foreign Secretary, Secretary of State for Industry, and Lord President) at the same time as it goes to the Prime Minister.

JG

JOHN GIEVE

Conservative and Unionist Party, GB
Alianza Popular, ESP
Det konservative folkeparti, DK

EP
PE

EUROPEAN PARLIAMENT
EUROPEAN DEMOCRATIC GROUP

Chairman

LONDON
2 Queen Anne's Gate
London, SW1H 9AA
Tel. (01) 222 1720
(01) 222 1722
Telex 917650 EDGLDN
Fax. (01) 222 2501

20th September, 1989

Peter Lilley, Esq., MP
Financial Secretary,
HM Treasury,
Parliament Street,
London SW1P 3AG

FST
Rather short notice.
Ian

I will be Daniel in the Lion's den - but they need educating.
PL 21/9

Dear Peter,

As I am sure you know, the European Parliament will be debating the question of economic and monetary union during its budget session in October. It would be extremely helpful for the British Members of the European Democratic Group if you were able to come and talk to us during the course of our October National Section meeting earlier in the month.

The meeting will take place during the afternoon of Monday 2nd October at the Engineering Employers Federation, Broadway House, Tothill Street, London SW1. If you think this is a possibility, perhaps our offices could be in touch to finalise the details.

Yours ever,
Christopher

CHRISTOPHER PROUT

PS/Chancellor

The FST thinks he should take this on but would like Chancellor's comments (if possible).

Ian Dunbar
22/9.

cc. Mr Tyrie

FROM: A E W WHITE (EC1)
DATE: 20 September 1989
EXT: 4441

1. MR R I G ALLEN
2. CHANCELLOR

RGA. 20/9

OK as amended

Ch, OK? 20/9

cc: Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Walsh
Mrs Brown
Mr O'Donnell
Miss O'Mara
Mr N P Williams
Mr McIntosh
Mr Polin

BRIEFING ON EMU AND DELORS POST ANTIBES

Following the meeting of ECOFIN at Antibes, we are receiving numerous requests for briefing about the Government's attitude towards EMU and the alternatives to Delors. If you are content, we would propose to circulate the attached Q and A briefing for use in answering inquiries from the Press and in letters from members of the public. The briefing seeks to explain the Government's position without anticipating your forthcoming paper. We would be grateful for any comments you may have.

Wilf White

A E W WHITE

Q AND A BRIEFING ON EUROPEAN MONETARY UNION (EMU)

Q: What are the Delors' proposals?

A: Jacques Delors, President of the European Commission, chaired a Committee of central bank governors whose remit was "to study and propose concrete stages leading towards economic and monetary union". The Committee reported in June 1989. It suggested a three stage process leading to EMU. Stage One would be based on full implementation of the single market, including a single financial area; strengthened competition policy including action against economic aids; closer coordination of economic and monetary policies by member states; inclusion of all Community currencies in the Exchange Rate Mechanism under the same rules; and reform and doubling of the structural funds. Stages Two and Three would require a new Treaty and new institutions. In Stage Two member states would begin to work within EC-wide macroeconomic policy guidelines adopted by majority decision. A "European System of Central Banks" would be set up, though it would not yet have independent powers. Margins of fluctuation in the ERM would be narrowed. Stage Three would involve a move to irrevocably locked exchange rates and the replacement eventually of national currencies by a single Community currency. National budgetary policies and Community structural policies would become subject to binding central rules. The ESCB, acting independently, would determine monetary policy, exchange rate policy with non-EC countries and the management of official reserves.

Q: What has the UK agreed?

A: At the European Council in Madrid in June 1989 the UK agreed with other member states that Stage One of the Delors report should begin on 1 July 1990 but no end date was specified. It was agreed that the Delors report was a basis for further work and that there should be preparatory work for the organisation of ~~an~~ a possible intergovernmental conference "to lay down the subsequent stages". No date for a conference was set, but it was agreed that this should not be ~~after~~ before the first stage had begun, and that it should be preceded by full and adequate preparation.

Q: What are the Chancellor's proposals for the later stages of EMU?

A: The Chancellor has said that the UK cannot accept the ~~degree of centralisation and~~ surrender of both national sovereignty and ~~thereby~~ political accountability which the Delors approach would involve. The UK believes that market pressures are the best way of influencing national governments to adopt low inflation policies and to keep prices and exchange rates stable. That is why the Government is fully committed to Stage One of EMU, including full abolition of all remaining exchange controls in the Community and the achievement of a ~~free~~ single financial area. Stage One itself will bring massive economic change which will take many years fully to work through. The Chancellor has said that ~~further changes may be~~ needed to ensure that all Community currencies are ~~fully exposed to the pressures of competition.~~ freely usable throughout the Community. He has described this as a system in which, within the framework of the EMS, there are freely competing national currencies. He will be circulating his ideas in more detail to his fellow Finance Ministers before they next discuss EMU in November.

He will be

Q: Would this mean that I could buy a Mars bar in London with Portuguese escudos?

A: This would be a matter for ~~for the discretion of~~ the individual shopkeeper. But there has been too much emphasis in the press on the so-called legal tender~~, etc~~ aspects. Competition between currencies would be more likely to operate in practice in major transactions, and in the choice of currency for savings and investment, legal impediments to ~~restrictions on~~ which should be removed.

Q: Is the Chancellor's proposal any more than Stage One?

It is a logical extension of Stage One, which ~~itself~~

A: ~~Stage One~~ itself represents a more fundamental change~~s~~ than many people perhaps appreciate. ~~But there are still likely to be barriers to a single European free financial area which may need to be tackled after Stage One.~~

There is no need now to decide whether, and if so what, further changes should follow Stage 1; but that there is clearly a case for taking any further steps

Q: But surely the Chancellor's approach cannot really be described as monetary union?

(and fully interchangeable)

in the sense that all equally

A: Yes, ~~it can. All~~ currencies would be ~~freely~~ available. And - unlike the Delors approach - the Chancellor's proposal would encourage the convergence of EC inflation rates on the best. Moreover, this highly beneficial outcome would be achieved without the loss of sovereignty in and other problems encountered with the ~~centralised, bureaucratic~~ Delors model.

Since it is a logical extension of Stage One, which all support. As for Stages Two & Three,

Q: Does anyone else support the Chancellor's proposals?

It is hard to see on what grounds others could oppose it,

A: ~~It is too early to say but~~ a number of member states have expressed reservations about aspects of the Delors prescription, ~~[including the loss of national control over monetary and fiscal matters]~~, and have been urging a more cautious, step by step approach.

Q: Won't this proposal simply mean the survival of the one fittest currency?

A: No. Free markets rarely produce monopolies. Market pressures should encourage member states to conduct better monetary policies so that the inflation performance of <u>all</u> EC currencies should follow the performance of the best.

Q: When will the Chancellor submit his paper to ECOFIN?

A: In time for the meeting of ECOFIN on 13 November.

Q: Delaying tactics by UK?

A: No. This is a genuine contribution to discussions on EMU, as promised by the Prime Minister at Madrid. The UK believes that a market-based approach is the right way forward, and avoids the fundamental disadvantages of the Delors' ~~centralised~~ prescription.

Q: [More detailed questions]

A: Wait for the Chancellor's paper.

FROM: J M G TAYLOR
DATE: 21 SEPTEMBER 1989

MR A E W WHITE (EC1)

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr R I G Allen
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Walsh
Mrs Brown
Mr O'Donnell
Miss O'Mara
Mr N P Williams
Mr McIntosh
Mr Polin

BRIEFING ON EMU AND DELORS POST ANTIBES

The Chancellor was grateful for your note of 20 September.

2. He was content with the enclosed Q and A briefing, subject to a number of drafting amendments which I have passed on to you. You are going to circulate a revised text in due course.

J M G TAYLOR

I think these changes are worth proposing even at the cost of some aggravation in the DTI. Mr Redwood has a taste for unqualified statements which could prove embarrassing later.
H.W.
21/9

FROM: S B JOHNSON (FIM2)
DATE: 21 September 1989
Ext: 5559

1. MR WALSH
2. FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr Scholar
Mr H P Evans
Mr R I G Allen
Mrs M Brown
Mr Gilhooly
Mr Ilett - or
Miss Noble
Mr Kroll
Mr Stephens (IAE3)
Mr Nelson (MG1)
Mrs Chaplin
Mr Tyrie

Mr Farrant - B/E

Mr Palmer - BSC

Mr Thomson - UKREP

[PS/FST has already written as proposed]

TRADE AND INDUSTRY SELECT COMMITTEE REPORT: EUROPEAN MARKET AND FINANCIAL SERVICES

attached

Mr Redwood's Private Secretary wrote on 15 September attaching the DTI's draft memorandum responding to the Trade and Industry Select Committee's Report on their enquiry into the Single European Market and Financial Services.

2. The DTI is required to submit the Government's response to the Committee's recommendations by 24 September. A Treasury response is therefore needed today.

3. The draft memorandum reflects to some extent comments already made to the DTI at official level. The memorandum could, however, be further improved by a number of additional drafting changes to some of the individual responses to the recommendations made by the Select Committee. We also suggest one minor amendment to the introduction.

Introduction

4. In the fourth paragraph of the introduction we suggest that it would be better to refer explicitly to the ERM rather than the somewhat less clear phrase "monetary harmonisation". We therefore suggest that this paragraph should be amended to read:

> "The Government are glad to note that the Committee recognise that neither UK Membership of the ERM nor use of a common currency is a prerequisite of free trade in financial services, and that there is no obvious advantage in restricting the freedom of Member States in fiscal policies."

Individual responses

5. The final sentence of the response to **recommendation 2** could be a hostage to fortune. We suggest that it should be deleted and that the response should be redrafted as follows:

> "The UK will join the ERM. But the decision when to join will have to be judged against progress in a number of areas, particularly when the level of UK inflation is significantly lower, when there is capital liberalisation in the Community and real progress has been made towards completion of the Single Market, freedom of financial services and strengthened competition policy.":

6. The Building Societies Commission would, on **recommendation 5**, prefer to hold more closely to wording already suggested at official level. The response would be amended to read (changes underlined):

> "The Government accept this recommendation <u>in principle</u> .... necessary legislative <u>and prudential</u> implications are being considered."

7. The response to **recommendation 7** could be strengthened. We suggest that it should be redrafted as follows:

"It is not the Government's view that the Community approach to competition policy should in general distinguish between financial and other institutions. However, the Government do attach importance to eliminating the existing inequality in the barriers to takeover generally in Community countries. We believe this is best achieved by pressing for the removal of barriers rather than erecting new ones of our own. The results of the Commission's study on barriers to takeover (see Recommendation 6 above) may be expected to provide further evidence of the relative immunity from takeover of companies in some EC countries. In the light of this study, the Government will press the Commission for priority to be given to action to reduce barriers to takeover across the Community on an equal basis."

8. The DTI suggest in their response to **recommendation 17** that the Government should take the initiative of inviting the Commission to review the financial services directives two years after implementation. It is not clear what such a review would achieve. We believe that a higher priority is for the Commission to ensure that the directives are properly implemented in Member States. We therefore suggest that the first sentence of the response should be amended to read:

"The Department agrees that it would be desirable for the Commission to monitor the implementation and working of the financial services directives."

9. On **recommendation 18** we need to bear in mind the special position of the Banking Advisory Committee in respect of banking directives. This could be achieved by simply amending the first sentence of the response to read:

"The Department accepts the recommendation <u>in principle</u>."

10. As presently drafted, the first sentence of the response to **recommendation 21** accepts the Committee's recommendation that the Government should insist that the Investment Services Directive must

be implemented simultaneously with the Second Banking Directive. This could be a hostage to fortune. We suggest that the sentence should read:

"The Government accept the recommendation as an objective."

11. The response to **recommendation 23** could be made clearer if the third sentence is slightly redrafted. We suggest it should read:

"Wherever Member States' regulations were found to prevent the proper operation of the Single Market, the Government would not hesitate to take any action it considered appropriate."

12. The present draft response to **recommendation 28** - that the Government should press for the European Commission's recommendation on a deposit guarantee scheme to be turned into a legally-binding directive - suggests that in the longer term the home country approach to supervision is favoured. We suggest that it is inadvisable to express a view on the advantage of home - or host - country control of deposit guarantee schemes, or to offer a pre-emptive view on any Commission proposal for a recommendation in this area. We therefore suggest that the final two sentences of the draft response should be deleted.

13. Sir David Hannay commented in his telegram of 19 September (copy attached) that it would not be wise to use the present draft response to **recommendation 33** on reciprocity. The Commission's revised proposal last March and the subsequent progress of negotiation in Council fundamentally shifted the emphasis of provision from the potentially protectionist to the objective of opening up third countries' banking markets. As you are aware, the UK voted for the proposal on reciprocity at the ECOFIN Council on 19 June.

14. We agree with Sir David Hannay's recommendation that the first part of the draft response should be replaced with the following:

"The reciprocity provisions agreed by the Council in the Second Banking Co-ordination Directive are acceptable to the UK in that their thrust is to open up third country markets and to avoid building protectionist barriers in the Community - both important UK objectives."

15. We suggest that the remainder of the response should appear as presently drafted.

16. If you agree with these comments, I attach a draft letter for your Private Secretary to send to Mr Redwood's Office.

S B Johnson

S B JOHNSON

ENC

DRAFT LETTER FROM PS/FINANCIAL SECRETARY TO STEWART GILL ESQ, PS TO THE PARLIAMENTARY UNDER SECRETARY OF STATE FOR CORPORATE AFFAIRS, DTI, 1-19 VICTORIA STREET, SW1

TRADE AND INDUSTRY SELECT COMMITTEE REPORT: EUROPEAN MARKET AND FINANCIAL SERVICES

You wrote to Sheila James on 15 September enclosing a copy of the draft memorandum setting out your Department's response to the Trade and Industry Select Committee's Report on their enquiry into the Single European Market and Financial Services. The Financial Secretary has a number of drafting suggestions which he very much hopes can be incorporated.

Introduction

In the fourth paragraph of the introduction the Financial Secretary suggests that it would be better to refer explicitly to the ERM rather than the somewhat less clear phrase "monetary harmonisation". He therefore suggests that this paragraph should be amended to read:

> "The Government are glad to note that the Committee recognise that neither UK Membership of the ERM nor use of a common currency is a prerequisite of free trade in financial services, and that there is no obvious advantage in restricting the freedom of Member States in fiscal policies."

Individual responses

The Financial Secretary believes that the final sentence of the response to recommendation 2 could perhaps be a hostage to fortune. He suggests the deletion of the sentence and a slight re-draft of the response to read:

> "The UK will join the ERM. But the decision when to join will have to be judged against progress in a number of areas, particularly when the level of UK inflation is significantly lower, when there is capital liberalisation in the Community and real progress has been made towards completion of the Single Market, freedom of financial services and strengthened competition policy."

On recommendation 5, the Financial Secretary would prefer the response be amended to read (changes underlined):

> "The Government accept this recommendation <u>in principle</u> .... necessary legislative <u>and prudential</u> implications are being considered."

The Financial Secretary believes that the response to recommendation 7 could be strengthened. He suggests that it should be redrafted as follows:

"It is not the Government's view that the Community approach to competition policy should in general distinguish between financial and other institutions. However, the Government do attach importance to eliminating the existing inequality in the barriers to takeover generally in Community countries. We believe this is best achieved by pressing for the removal of barriers rather than erecting new ones of our own. The results of the Commission's study on barriers to takeover (see Recommendation 6 above) may be expected to provide further evidence of the relative immunity from takeover of companies in some EC countries. In the light of this study, the Government will press the Commission for priority to be given to action to reduce barriers to takeover across the Community on an equal basis."

The draft response to recommendation 17 suggests that the Government should take the initiative of inviting the Commission to review the financial services directives two years after implementation. The Financial Secretary is not clear what such a review would achieve. He believes that a higher priority is for the Commission to ensure that the directives are properly implemented in Member States. The Financial Secretary therefore suggests that the first sentence of the response should be amended to read:

> "The Department agrees that it would be desirable for the Commission to monitor the implementation and working of the financial services directives."

On recommendation 18, the Financial Secretary believes that the special position of the Banking Advisory Committee in respect of banking directives needs to be acknowledged. This could be achieved by simply amending the first sentence of the response to read:

> "The Department accepts the recommendation in principle."

The Financial Secretary also believes that, as presently drafted, the first sentence of the response to recommendation 21 goes rather too far. He suggests that the sentence should read:

> "The Government accept the recommendation as an objective."

The Financial Secretary believes that the response to recommendation 23 could be made clearer if the third sentence is slightly redrafted. He suggests it should read:

> "Wherever Member States' regulations were found to prevent the proper operation of the Single Market, the Government would not hesitate to take any action it considered appropriate."

On recommendation 28 the Financial Secretary would prefer not to express a view at this stage on the advantage of home - or host - country control of deposit guarantee schemes, or to offer a pre-emptive view on any Commission proposal for a recommendation in this area. He therefore believes that the final two sentences of the draft response should be deleted.

The Financial Secretary has seen and agrees with the comments and revised wording suggested in Sir David Hannay's telegram of 19 September on the draft response to recommendation 33 on reciprocity.

I am copying this letter to Sir David Hannay.

STEVEN FLANAGAN
Private Secretary

150533
MDADAN 6004

ADVANCE COPY cc Mr Shapiro ✓

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OF 191340Z SEPTEMBER 89

FRAME ECONOMIC

TRADE AND INDUSTRY SELECT COMMITTEE'S REPORT ON FINANCIAL SERVICES IN THE SINGLE MARKET: HMG'S RESPONSE

1. I DO NOT THINK IT WOULD BE WISE TO USE THE PRESENT DRAFT RESPONSE TO THE SELECT COMMITTEE'S RECOMMENDATION (33) ON RECIPROCITY.

2. THE COMMISSION'S REVISED PROPOSAL LAST MARCH AND THE SUBSEQUENT PROCESS OF NEGOTIATION IN THE COUNCIL FUNDAMENTALLY SHIFTED THE EMPHASIS OF THE PROVISION FROM THE POTENTIALLY PROTECTIONIST TO THE OBJECTIVE OF OPENING UP THIRD COUNTRIES' BANKING MARKETS. THE FINAL TEXT AGREED AT THE ECOFIN COUNCIL ON 19 JUNE WAS REGARDED BY US AS ACCEPTABLE AND WE VOTED FOR IT.

3. I RECOMMEND THEREFORE THAT IN PLACE OF THE PRESENT TEXT (''WE ONLY RELUCTANTLY ACCEPTED A RECIPROCITY CLAUSE IN THE SECOND BANKING COORDINATION DIRECTIVE.....''), WE PUT FORWARD SOMETHING ALONG THE FOLLOWING LINES FOR THE FIRST PART OF THE RESPONSE:

''THE RECIPROCITY PROVISIONS AGREED BY THE COUNCIL IN THE SECOND BANKING COORDINATION DIRECTIVE ARE ACCEPTABLE TO THE UK IN THAT THEIR THRUST IS TO OPEN UP THIRD COUNTRY MARKETS AND TO AVOID BUILDING PROTECTIONIST BARRIERS IN THE COMMUNITY - BOTH IMPORTANT UK OBJECTIVES....''.

4. I HAVE NO PROBLEM WITH THE REMAINDER OF THE PROPOSED RESPONSE: ''WHERE A RECIPROCITY CLAUSE IS TO BE INCLUDED IN A DRAFT DIRECTIVE (EG. THE INVESTMENT SERVICES DIRECTIVE) THE DEPARTMENT WILL NEGOTIATE FOR THE CLAUSE TO FOLLOW THAT IN THE SECOND BANKING COORDINATION DIRECTIVE. TO THAT EXTENT WE CAN ACCEPT THE RECOMMENDATION.'' THIS RIGHTLY AVOIDS CREATING ANY HOSTAGES TO FORTUNE.

HANNAY

MARKED-UP DRAFT OF MEMORANDUM

dti

the department for Enterprise

John Redwood MP
Parliamentary Under Secretary of State for
Corporate Affairs

Department of Trade and Industry

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ECONOMIC SECRETARY	
REC'D	18 SEP 1989
ACTION	Mr Sharples
COPIES TO	PS/CHX, PS/CST, PS/FST, PS/PMG. PS/Sir P. Middleton Mr Wicks, Mr Scholar Mr H Evans, Mr H Walsh Mr R.I.G. Allen, Mr Hebb, Mrs M. Brown Mrs Chaplin Mr Tyrie

41/G

Direct line 215 4417
Our ref
Your ref
Date 15 September 1989

Dear Sheila

As you may know, the Trade and Industry Select Committee have reported on their inquiry into the Single European Market and Financial Services.

This Department is to submit the Government's response to the Committee's recommendations by 24 September. I attach a copy of the Department's memorandum setting out the response, which has been agreed by Mr Redwood. I should be grateful if you would seek Mr Ryder's agreement to the memorandum, prior to our passing it to the Select Committee. I am sending a copy of this letter, and of the memorandum to Mark Lyell Grant at the Foreign and Commonwealth Office, to seek Mr Maude's agreement to the response.

Yours

Stuart Gill

STUART GILL
Private Secretary

ROW.001

FIFTH REPORT OF THE TRADE AND INDUSTRY SELECT COMMITTEE IN SESSION 1988-1989

THE SINGLE EUROPEAN MARKET AND FINANCIAL SERVICES

MEMORANDUM BY THE DEPARTMENT OF TRADE AND INDUSTRY

[ ] September 1989

The Government welcome the Report of the Trade and Industry Select Committee on "Financial Services and the Single European Market". The Government congratulate the Committee on the depth of their Report, which tellingly presents the importance to the UK of Single Market developments in the sector.

The conclusions highlight both the opportunities and the challenges that come with the Single European Market. The Government agree fully with the majority of the Committee's conclusions. Even where the Government are not in full agreement with the conclusions reached, there remains a large element of common ground. The conclusions should be valuable to Government, as well as to practitioners, customers and the authorities in their planning and decision making. Some of them are taken up the Committee's recommendations, to which this memorandum replies in detail.

More generally, the Committee is right to recognise that the emerging Single Market will present the UK's innovative and competitive financial sector with major opportunities, but that foresight and hard work will be needed to make the most of them. The major barriers should be down by the end of 1992, although the Government are seeking far greater progress in the liberalisation of the insurance sector. The Government will do its utmost to maintain a climate in which firms can take opportunities to move into new markets as they change character.

The Government are glad to note that the Committee recognise that neither UK membership of the ERM nor use of a common currency ~~monetary harmonisation~~ is ~~not~~ a prerequisite of free trade in financial services, and that there is no obvious advantage in restricting the freedom of member states in fiscal policies.

As for regulatory and compliance costs, the Government recognise the need to balance these against the consumer and prudential protection attained. The Financial Services Act is being amended by the Companies Bill explicitly to require the self regulatory bodies to take the cost of compliance into account when framing their rules.

The Government's comments on the Committee's individual recommendations are as follows.

TRADE AND INDUSTRY SELECT COMMITTEE INQUIRY INTO THE SINGLE EUROPEAN MARKET AND FINANCIAL SERVICES

1. We recommend that the UK regulatory authorities should ensure that advertisements for retail financial products denominated in other currencies, in ECU or in baskets of other currencies should draw attention to the risk of loss from exchange rate fluctuations that customers may incur.

Regulations under the Consumer Credit Act 1974 were laid before Parliament on 6 July 1989 requiring advertisements and quotations for foreign currency mortgages and other loans secured on an individual's home to carry a "health warning" from 1 February 1990. This will read: "The Sterling equivalent of your liability under a foreign currency mortgage may be increased by exchange rate movements". This regulation does not apply to unsecured loans and loans secured other than on property, because the risk to consumers in these instances is considered to be significantly lower.

Rule 7.22(6) of the Securities and Investments Board provides that UK advertisements for investments other than in Sterling shall: "draw attention to the fact that changes in rates of exchange between currencies may cause the value of the investment to diminish or to increase". All of the self-regulatory organisations and professional bodies recognised by SIB, with one exception, have made a similar provision in their rulebooks. The remaining organisation believes that its general requirements would already require exposure to exchange rate fluctuations to be made clear, and is considering whether to address the point specifically.

2. We recommend as a step towards early completion of the Single Market in financial services, the UK should join the Exchange Rate Mechanism of the EMS as soon as possible at a competitive exchange rate for UK interests.

~~The Government's position is that the UK is not committed to~~ The UK will join the ERM. ~~on any particular date,~~ But the decision when to join will have to be judged against progress in a number of areas, particularly when the level of UK inflation is significantly lower, when there is capital liberalisation in the Community and real progress has been made towards completion of the Single Market, freedom of financial services and strengthened competition policy. [~~The UK will want to see how the ERM works once the major countries have removed their remaining exchange controls, which is itself vital to a single market in financial services.~~]

3. We recommend that the Government urgently reviews the UK fiscal regime as it applies to financial services to ensure that no tax barriers to UK success in the Single Market persist after 1992.

The Chancellor of the Exchequer takes internal market considerations fully into account in determining tax policy; for example, the 1989 Budget contained provisions to remove what could otherwise have become a fiscal incentive for some

UK unit trusts to migrate to Luxembourg on the implementation of the UCITS Directive. As a general rule the UK favours low marginal tax rates which encourage savings and enterprise.

4. *We recommend that the Government and the European Commission should review the implications for the single market in financial services of small countries or dependencies which are partly but not fully integrated into the Community.*

The Government are already aware of the position of such territories with regard to the Single Market in financial services. The Channel Islands and the Isle of Man are not members of the Community and are not obliged to implement Single Market measures. Their relationship to the Community is limited to the application of the provisions of Protocol 3 to the Treaty of Accession. The Islands are included in the customs union; they apply to third countries the levies and other import measures laid down in Community rules in respect of agricultural products; they do not benefit from the provisions relating to free movement of persons and services; and they apply equal treatment to all natural and legal persons of the Community. Gibraltar is a member of the Community and is obliged to implement Single Market measures.

In our work on the negotiation and implementation of the directives we shall continue to take account of the position of such territories and the implications for them of the Single Market measures.

5. *We recommend that the Government should, as a matter of urgency, take steps to enable building societies to take advantage of the single passport by permitting cross-border branching and any other cross-border business consistent with their status.*

The Government accept this recommendation. The Building Societies Commission has acknowledged the competitive case for building societies to be able to conduct business in other Member States subject to a continuing legal obligation to conduct certain types of business through a subsidiary. The necessary legislative implications are being considered.

and prudential

6. *We recommend that the DTI press for early publication of the Commission's study on barriers to takeovers in the Community.*

The Department accepts the recommendation.

The UK dominates takeover activity in the Community. About 80 per cent of all takeovers in the Community occur in the UK. Even though we have a relatively more open capital market than most other Member States, UK companies make about three times as many acquisitions in other Member States than are made in the UK by companies from other Member States. Nevertheless, because of the widely different standards of openness to takeover activity across the Community, the UK took an initiative on the subject in the Council of Ministers which led to the Commission study. The Department is pressing the Commission to make rapid progress and understands that the Commission expect to present the results of this work later in the year.

7. We recommend that the Government should address itself to the vulnerability of UK financial institutions to hostile takeover by a company from elsewhere in the Community, which itself is not vulnerable to takeover, and that it should report this matter to the House. (See revised response)

~~The Government believe that we should press for the removal of barriers rather than erect new ones of our own. The results of the Commission's work on barriers to takeovers (see Recommendation 6 above) may be expected to provide further background on the relative immunity of companies in EC countries from takeover, and make it easier to identify which categories of barriers should be tackled as a priority.~~

~~It is not the Government view that the Community approach to competition policy should in general distinguish between financial and other institutions.~~

8. We recommend that the Commission's merger policy take into account the effect of a concentration in competition within Member States as well as the Community market.

The current draft of the EC Merger Control Regulation addresses such considerations, and we agree that the proposed Regulation should examine competition in the Community or in a substantial part of it, which may include a single Member State. The UK believes that in the assessment of mergers under the Regulation, competition should be the key consideration.

9. We recommend that the DTI report to the House by 1 October 1990 on the operation of the UCITS directive.

We accept the recommendation.

10, 11 and 12. We recommend that HMG should insist on the right of brokers to advertise life insurance overseas under the life insurance services directive. We recommend that HMG should insist on the inclusion of composite companies in the life insurance services directive. We recommend that HMG should insist on the removal of any obstacles to companies doing business both on an established and on a services basis (cumul).

We accept these recommendations. Our negotiations continue to endeavour to achieve the objectives set out by the Committee. It remains to be seen whether satisfactory progress can be achieved in all these areas.

13. We recommend that HMG should press for the early adoption of directives on mass risks both for life and non life and on group pensions etc.

Reference ....

REVISED RESPONSE TO RECOMMENDATION 7

"It is not the Government's view that the Community approach to competition policy should in general distinguish between financial and other institutions. However, the Government do attach importance to eliminating the existing inequality in the barriers to takeover generally in Community countries. We believe this is best achieved by pressing for the removal of barriers rather than erecting new ones of our own. The results of the Commission's study on barriers to takeover (see Recommendation 6 above) may be expected to provide further evidence of the relative immunity from takeover of companies in some EC countries. In the light of this study, the Government will press the Commission for priority to be given to action to reduce barriers to takeover across the Community on an equal basis."

We accept the recommendation. We have made clear our position on this to the Commission and Member States on a number of occasions.

14. We recommend that HMG should press for the standardisation throughout the Community of the statutory duty of insurance brokers to give "best advice".

We accept the recommendation in part. We agree that if the UK duty to provide "best advice" applying to brokers and other intermediaries carrying on insurance business which is also investment business were also to apply throughout the Community, this would be of considerable benefit to European consumers. But the present role of intermediaries and brokers in the Community varies widely between Member States, and such a duty could only be imposed by a directive. In our view the Commission should give priority to the creation of a Single Market in insurance and until this goal is in sight of achievement we should defer consideration of how far there should be harmonisation of control of marketing rules.

15. We recommend that the directives in financial services should, like statute law, be consolidated in due course for the purposes of clarity and consistency.

The Department recognises that a number of benefits would accrue from consolidating directives affecting financial services but believes that it would not be prudent to attempt such consolidation in the foreseable future. A directive consolidating others affecting financial services would be subject to the same procedure as ordinary directives and would thus require a major negotiating input and would risk re-opening discussions on issues of substance already agreed.

The Department recognises in its negotiations the need to ensure consistency across directives.

16. We recommend that HMG should publish a compendium of Community legislation and the UK implementing measures for the Single Market in financial services.

The Department is to publish a booklet at the end of September which will cover directives within the financial services sector. The booklet will outline the main points of each directive giving the references of the latest or final texts of directives and, as far as possible, their method of implementation into UK law. The booklet will be widely distributed.

17. We recommend that the Commission should review the working of the financial services directives two years after their implementation.

~~Although the scope and power of such a review procedure would not be a simple matter, the Department agrees that it would be desirable and will invite the Commission to act accordingly.~~
The Department will wish to see market-opening measures developed and the effects of those measures reviewed on a

The Department agrees that it would be desirable for the Commission to monitor the implementation and working of the financial services directives.

continuing basis.

18. We recommend that a common procedure be adopted for amending the financial services directives.

The Department accepts the recommendation in principle. We recognise the need to avoid a proliferation of incompatible procedures and will bear the recommendation in mind when examining relevant directives.

19. We recommend that the DTI should, as a matter of course, consult formally with consumer groups on all developments concerning the single market.

The Department already aims to consult consumer groups on all Single Market developments affecting them and undertakes to ensure that this happens in all cases in the future. We therefore accept the recommendation.

20. We recommend that, in the period leading up to 1992, UK officials monitoring financial services in posts in other parts of the Community should meet regularly to compare developments in other countries, and pass their accumulated experience through the DTI to UK financial institutions.

The Government accept the recommendation. The Department has begun consultations with the FCO on how best to take the recommendation forward.

21. We recommend that the Government should insist in the European Council that the Investment Services Directive must be implemented simultaneously with the Second Banking Directive.

The Government accept the recommendation as an objective. The Second Banking Coordination Directive has reached Common Position; Council Working Group discussions on the Investment Services Directive are to begin in October. The Government will seek speedy negotiations on the Investment Services Directive. We have already stressed the desirability of simultaneous implementation to the Commission and to other Member States. The European Council (Madrid) reaffirmed the priority task of completing the Single Market, with emphasis on financial services, among other areas.

22. We recommend that the Government press firmly for faster progress on the creation of basic minimum standards for conduct of business rules.

The Government accept the recommendation. The Securities and Investment Board have provided the Commission with their consultation paper on the regulation of conduct of business, which may stimulate Commission thinking in this area. The Government recognise, however, that Member States' differing customs and practices affecting the conduct of financial services business may inevitably make the goal of agreed standards for conduct of business very difficult to achieve in the near future. It is for this reason that the UK supports the Commission's view that there would be an unacceptable risk of delaying negotiation of the Investment Services Directive if its scope were to be widened to further cover conduct of business rules.

23. We recommend that the Government monitor closely any use of the argument of "public good" to justify local market regulation to determine whether it is in reality to protect inefficient home producers.

The Government accept the recommendation. The "public good" test must be satisfied on the basis of the principles laid down by the European Court. Wherever Member States' regulations were found to prevent the proper operation of the Single Market, the Government would not hesitate to take any ~~appropriate~~ action, if considered appropriate.

24. We recommend that specific attention should be given by the DTI to the opportunities and regulatory difficulties involved in cross-border advertising of financial services by satellite.

The Government accept the recommendation. The Government recognise that in the case of broadcast advertising practical difficulties may arise, a number of which have been pointed out by the Committee.

Where broadcast advertising is deliberately directed from one state to another state, it is clear that the advertiser wishes to provide the services he is advertising in that other state. In such a case, directives covering the cross-border provision of financial services will apply.

Those Directives covering the cross-border provision of financial services make specific provision for close cooperation between the home and host authorities. Home authorities are required to take the necessary measures to ensure that a firm they have authorised complies with a host state's conduct of business rules, whether or not the business in question has arisen as a result of cross-border advertising. It should also be noted that the draft Investment Services Directive provides that an investment firm wishing to provide investment services in another Member State's territory must notify the authorities in both the home and host states of the activities which it intends to undertake. The firm may carry on such investment business and any ancillary activities (which would include advertising) one month after notification. Where such notification had not been given, investment business flowing from responses to the advertisements would be in contravention of the Directive, and both home and host authorities would be empowered to take appropriate action to prevent the firm from acting upon responses to those advertisements. Similar notification requirements are contained in the Non-Life Services Directive, and in the Life Services Directive, as currently drafted.

Where the broadcast advertising is accidentally received in a second state, however, the effect of the directives is did not follow instructions, the defendant could be sued in the UK if the contract were to be performed here; or, in the case a tort eg negligence or fraud, the defendant could be sued in the UK if the tort was committed here.

More particularly there are special rules in Articles 13-15 governing consumer contracts, that is contracts concluded by a person for a purpose which can be regarded as being outside his trade or profession, and these rules are deliberately framed in favour of the consumer. Under Article 14, for example, a consumer may bring proceedings against the other party to a contract either in the courts of the Contracting State in which that party is domiciled or in the courts of the Contracting State in which he is himself domiciled. The Government consider that the Convention provides major benefits which should not be disregarded, and that it affords dissatisfied individuals adequate and proper safeguards.

28. We recommend that the Government press for the European Commission's recommendation on a deposit guarantee scheme to be turned into a legally-binding directive.

The Government share the Committee's view of the importance of having suitable deposit guarantee arrangements throughout the Single Market. Such arrangements are in place in the UK and the large majority of other Member States and there are plans to introduce them in the rest. The Commission is expected to review progress in implementing their Recommendation and may decide to make proposals for a Directive in the light of its conclusions. There are, however, differences of view on whether schemes should operate on a host country basis, which may be more convenient for depositors, or a home country basis, which fits more logically with the principle of home country responsibility for authorisation and prudential supervision. ~~In the longer term the home country approach is favoured. But this would mean major changes for Member States and at the present stage of development of deposit protection schemes in other Member States the Government believe it would be premature to seek to impose that solution by a Directive.~~

29. We recommend that the Government should propose to the Commission that all those actively selling services into the UK should be required to participate in the relevant UK compensation scheme.

The Department shares the Committee's view of the importance of adequate compensation being available for UK users of financial services. The Department believes, however, that there are strong grounds for aiming, at least in the longer term, to ensure adequate responsibility for compensation schemes in the state responsible for authorisation, whether the business is done on a branch or services basis. Compensation is closely linked with authorisation and prudential supervision and should thus be the responsibility of the Member State authorising the investment firm in question ie the home state (or, in the case of insurance, the state where the branch or agency writing the business is established). The Department recognises, however, that such an approach would be acceptable only if minimum standards of compensation are agreed, and will take the Committee's concerns into account when negotiating relevant directives.

30. <u>We recommend that the Government should press the Community to introduce minimum standards on redress and compensation for consumers and a means of identifying financial services firms which satisfy those standards.</u>

The Department agrees the importance of redress and compensation for users of financial services. We share the Committee's view of the desirability of making known to UK consumers which scheme (ie the UK scheme or that of another Member State) applies in which circumstances. The Department is currently considering how such information may be conveyed to UK consumers, and will need to ensure that the information is provided in conformity with Community law. The Department also agrees that there is a case for regulatory authorities in the consumer's country to act as a channel of communication with the authorities responsible for the compensation scheme in the country of the supplier. In the negotiation of the Investment Services Directive, we shall look into the practicality of setting up such channels.

The Department believes that all firms in the financial sector should meet minimum standards imposed upon them and that the supervisory and control mechanisms of the relevant authorities should be capable of identifying (and acting upon) those firms which do not satisfy those standards.

31. <u>We recommend that the Government do more to consult interests outside London in considering the financial services industry.</u>

The Government recognise the economic importance of the financial services sector in all UK centres, not just London. The Department has in the past sought to consult as wide a representative view of interests as considered reasonable; and in the light of the Committee's findings, we will review the consultation process.

32. <u>We recommend that the Government review the transport and telecommunications infrastructure for financial centres outside London</u>.

The Government recognise the importance of an efficient transport infrastructure both for the City and for the other UK financial centres. Improvements are already underway.

Programmes for road improvements will ensure that those in the North and Scotland have access to the major markets in the South and in Europe.

The provision of rail links is the responsibility of British Rail (BR) rather than Government. BR is, however, required by the Channel Tunnel Act to produce a plan by the end of 1989 for the provision of international services to centres outside London and in preparation for this has consulted business and other interests.

The reciprocity provisions agreed by the Council in the Second Banking Coordination Directive are acceptable to the UK in that their thrust is to open up third country markets and to avoid building protectionist barriers in the Community - both important UK objectives

The Government recognise the importance to the regions of international air links and provide support for airport infrastructure. Airlines will clearly be prepared to provide direct links between the regions and Europe if it makes commercial sense to do so. The completion of the Single European Market is likely to increase business requirements and make direct flights more viable.

Notwithstanding these developments, the Government will of course keep this important issue under review.

The Government doubt the need to review the telecommunications infrastructure for financial services outside London. British Telecom is under a licence obligation to meet all reasonable demands for service and also have licence obligations which prevent undue preference and discrimination, as have Mercury. The Director General of Telecommunications should be sent specific evidence of any network operations that failed to provide financial centres with an adequate service.

33. <u>We recommend that a reciprocity clause based on "national treatment" be included in the remaining major draft directives on financial services</u>.

~~We have only reluctantly accepted a reciprocity clause in the Second Banking Coordination Directive. Our objective has been to ensure that such a clause achieves liberalisation of third country markets and does not build protectionist barriers.~~ Where a reciprocity clause is to be included in a draft directive (eg the Investment Services Directive) the Department will negotiate that the clause should follow that in the current text of the Second Banking Coordination Directive. To that extent we can accept the recommendation.

34. <u>We recommend that the Government give urgent attention to the implications of the Single Market for export credit insurance and the role of ECGD.</u>

The Government accept this recommendation. The implications of the Single Market both for the role of ECGD and for export credit insurance have been under detailed examination for some time and, indeed, were among the main reasons for the study by Mr R T Kemp of ECGD's status commissioned by Lord Young last Summer. Officials are reviewing Mr Kemp's Report and will be reporting to Ministers in the next few weeks. The Report identifies the future evolution of Community policy on export credit as one of the most significant factors in determining the future shape of ECGD. The Department notes that the Select Committee is about to conduct an enquiry into the future of ECGD.

35. <u>We recommend that the DTI press the European Commission to collect, after 1992, statistics on the openness of individual domestic financial services markets and the comparative cost of financial services in each of them as a means of verifying the real extent of competition in the</u>

A Commission study of the financial sector is underway at present. The Department is content with this initiative but is keeping a careful watch to see that it does not impose a form-filling burden on firms. More generally, the only effective way of ensuring competition is by the prompt adoption and implementation of relevant directives and equally prompt intervention by the Commission, other Member States or the European Court of Justice, if Member States do not fulfill their Community obligations.

36. <u>We recommend that HMG make it a high priority in their negotiations with the Community that speedier progress be made on producing the necessary further directives to create a single market in insurance</u>.

The Government accept this recommendation. The achievement of a single market in insurance continues to be a high priority, and we are making every effort to achieve it.

37. <u>We recommend that keeping up progress towards the achievement of a Single Market in financial services should remain a high priority for HMG.</u>

The Government accept this recommendation. A sound Community regime for the financial sector is a UK priority.

unclear. If the advertiser does nothing in response to any queries he receives following the reception of an advertisement transmitted accidentally in another state, he would not have supplied any service into that state and the directives would not therefore apply. The position would be different, however, if the advertiser did respond to queries since he would then be supplying services.

The Government recognise that, with the increase in cross-border broadcasting, the opportunities and regulatory difficulties arising from cross-border advertising of financial services will also increase. The Government undertake to take the implications of satellite advertising into account when negotiating relevant directives.

25. We recommend that the Government should press for the creation of a single official forum of the Community through which regulatory authorities responsible for all financial services should exchange information and discuss issues of importance.

The Government share the Committee's view of the importance of cooperation between Member States' regulatory authorities. The Government consider, however, that it would be difficult to create a single forum for the existing Banking Advisory Committee, the High Level Securities Regulators Group and EC Insurance Supervisory Conferences, although some joint meetings might be useful. As the Committee have indicated, there is a risk that such a forum might become a Euro-regulator and might undermine the principle of mutual recognition and the network of sectoral and bilateral arrangements provided for by the directives in this sector.

26. We recommend that the Government ensure that SROs in the UK are properly recognised as competent authorities for the purpose of the single market directives.

We accept the recommendation. We are negotiating to ensure that the SROs can be recognised as competent authorities under relevant directives.

27. We recommend that actions for damages should be justiciable in a citizen's own country when he or she has suffered from the activities of a non-established as well as an established non-UK "home" enterprise.

The Civil Jurisdiction and Judgments Convention, given effect in the UK by the Civil Jurisdiction and Judgments Act 1982, sets out the premises for jurisdiction by civil actions against individuals and companies established within the Community. The main rule as to jurisdiction, under Article 2 of the Convention, is that an action can be brought in the country where the individual or company is established. There are, however, alternative grounds of jursidiction. For example, if the transaction was made through an office or agency in the UK, the UK courts would have jurisdiction; or, in the case of a contractual claim eg if an investment firm ec1.bk/meb/idt21.9

UNCLASSIFIED

FROM: MRS M E BROWN (EC1)
DATE: 21 September 1989
Ext: 4709

MR O'DONNELL (IDT)

cc: PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mr White
Mr N Williams

Mr Bonney, UKREP
Mr Blythe, T/Sol

It is a bad + mistaken translation of "Cttee of Central Bank Governors". (!)

EMU: PUBLICATION OF COMMISSION PROPOSALS FOR STAGE 1

I attach a press release issued by the Commission yesterday, announcing its proposals for revised legal texts to improve the coordination of economic and monetary policies as part of EMU Stage 1. Today's report on this in the FT is attached. The proposals are relatively uncontentious, though the UK cannot accept them completely as they stand.

Line to take

UK fully committed to launching Stage 1 of EMU on 1 July 1990, as agreed at Madrid. Part of Stage 1 is to improve the arrangements for coordinating member states' economic and monetary policies, and that is the purpose of the two draft texts just presented by the Commission. The next step, as usual, is for the drafts to be discussed by the member states.

UNCLASSIFIED

[For use if necessary]

Q. Does the UK accept these proposals?

A. When we have studied the texts, we will probably want to propose some amendments, and other states will no doubt want to also. But we expect to be able to reach agreement in good time before Stage 1 starts.

Q. Much more power to central banks? First step to independent central bank and single currency?

A. Given the importance of monetary policy, effective coordination between member states' central banks is very important. There is no question of the revised arrangements heralding a European Central Bank: no decisions have been taken on possible developments beyond Stage 1.

Q. Remit of Central Bankers' Committee being expanded to cover international monetary developments? (as suggested in FT report)

A. Nothing new. The Committee has always taken international monetary developments into account in its discussions.

Q. UK will be subject to binding commitments on economic policy? Budget decisions cleared in Brussels?

A. No question of introducing binding central controls on member states' budgetary policies, nor of the Chancellor having to clear his budget proposals in advance. The proposed surveillance process will be based on mutual discussions and exchanges of information among the individual member states.

You will want to concert with the Bank Press Office on these responses.

We are putting advice separately to the Chancellor on the need for a House of Commons debate on the Delors report, which was recommended by the Scrutiny Committee before the summer. The Commission's proposals will also have to go to the Commons Scrutiny Committee before they are finalised, though there is some doubt about the status of the proposals just issued.

not yet received

JS 21/9

Mary Brown

MRS M E BROWN

THE TIMES

EC takes first steps towards economic and monetary union

From Michael Binyon, Brussels

24

The first administrative steps towards economic and monetary union in the European Community were announced by the European Commission yesterday, in proposals for closer co-operation between central banks and greater economic convergence between member states.

The proposals were revisions of two directives, in 1964 and 1974, which have been superseded by the plans to go ahead with the first phase of the Delors report on European Monetary Union (EMU). They are based on the report itself, the conclusions of the Madrid summit and the debate at the informal meeting of finance ministers in Antibes this month.

The overall principles behind the changes are: parallelism between the economic and monetary aspects of EMU; subsidiarity, meaning the responsibility of national governments for all decisions that are best taken at a lower level, with Brussels entrusted only with decisions that must be taken at Community level; and the diversity of specific situations.

The 1964 directive, which called for co-operation between central banks, has been broadened, setting up a co-ordinating committee to arrange regular consultations between the banks on broad policy, especially over credit, money and exchange markets and the stability of financial institutions.

The committee will exchange information regularly about anything that falls within the banks' competence, and will be consulted before national decisions on the course of annual domestic monetary and credit targets. It will also co-ordinate monetary policies to ensure monetary stability and the smooth functioning of the European Monetary System.

In addition, it will give central bankers opinions on the overall orientation of monetary policy and exchange rate policy, as well as on the measures introduced by member states to ensure that all Community members pursue policies directed towards price stability.

The committee will be the forerunner of a full-time secretariat of EC central bankers, a kind of prototype of the European System of Central Bankers envisaged by the Delors report. It will express opinions to governments and the Council of Ministers on policies that might affect the internal and external monetary situation in the EC.

The other measure announced yesterday was a modification of a 1974 directive which called for convergence in economic decision-making but which had led to a ritual of paperwork and had never worked properly.

The new measure will effectively continue an experiment begun in the summer of regular free-ranging and confidential discussions between finance ministers on economic policy, with specific reviews of the situation in individual countries.

FINANCIAL TIMES

21/9.

Initial plans for EC economic union drawn up

By David Buchan in Brussels

... 28

THE EUROPEAN Commission yesterday finalised proposals for closer policy co-ordination by finance ministers and central bank governors.

These would form the basis for a first step towards economic and monetary union by next summer.

The proposals are not overtly contentious because even Britain subscribes to the need for closer policy co-ordination, though only within the Community's existing institutions.

France, backed by the Commission, hopes the plans will be adopted before the end of its EC presidency in December.

Adoption of the proposals could, however, give a much higher profile to EC policy co-ordination, with individual countries perhaps being put on the spot in front of their EC partners for alleged failure to make their policies conform to Community objectives.

Mr Henning Christophersen, EC commissioner for macro-economic affairs, proposed yesterday that finance ministers should hold regular talks "on the compatibility of policies within member states," instead of just their current occasional desultory discussions about the European economy.

Such regular talks would "put the spotlight on one or two member states" at a time. The president of the Council might choose to make public any resulting policy recommendations.

The basis on which the Committee of European Community Central Bank Governors was set up in 1964 is to be revised. Mr Christophersen said this was being done so that "the committee shall normally be consulted in advance of national decisions on the course of annual domestic and credit targets."

In what would be a departure for central bankers, the governors' committee would be encouraged to express opinions to their governments and possibly to the public.

The revised ground rules for the governors' committee have been in fact largely drafted by the central bankers themselves. Mr Christophersen said it was clear that they intended "to have a higher profile, to formalise their working practices and to establish a secretariat."

The Delors committee, dominated numerically by bank governors of the member states, proposed three sections for such a secretariat, dealing with foreign exchange, monetary and banking supervision policy. It seems unlikely, however, that EC bank governors would tear themselves from their traditional Basle meeting place to base their discussions on Community soil.

For the first time, the governors' committee would get its remit expanded to cover international monetary developments, though mainly their impact on the European Monetary System and the EC economy.

At the informal meeting of finance ministers at Antibes earlier this month, Mr Theo Waigel of West Germany raised one of the few warning notes so far about yesterday's proposals. He said that for the bigger EC states, such as Germany, the mainline forum for international money discussions would remain the Group of Seven.

The irony of the Commission's proposal about co-ordination among finance ministers is that it would replace a 1974 decision that, in mechanical terms, was more constraining.

At the same time, the further stages of the Delors report – still the only blueprint of economic and monetary union for a majority of EC governments – would eventually set binding centralised limits on states' budget deficits and their financing.

Mr Christophersen explained away the seeming paradox in Commission strategy by admitting that policy co-ordination since 1974 had never really taken place. "The Commission had decided to base itself on reality – and the reality is that there is very limited co-ordination," he said.

"Political will" was needed for countries to concert their policies – this could not be imposed on them, he said.

9/

Fax to Lyn Parker, Cabinet Office 270 0074

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...Mr Arthur......DEPT/BUILDING (X)...FCO...ECD(I)

...Mr Lewis......DEPT/BUILDING (X)...Bank of England, Threadneedle St.

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Mrs M Brown (HMT) cc Mr Arthur (FCO)
Mr Lewis (B/E)

We are trying to find out whether ~~these~~ this refers to the Commission's formal proposals or only its draft formal proposals.

[signature] 20/9

14/9

TALSMANDSTJENESTEN - DIENST DES SPRECHERS - SPOKESMAN'S SERVICE - SERVICE DU PORTE-PAROLE
ΥΠΗΡΕΣΙΑ ΕΚΠΡΟΣΩΠΟΥ ΤΥΠΟΥ - SERVIZIO DEL PORTAVOCE - DIENST VAN DE WOORDVOERDER

P(89)

PRESSE-MEDDELELSE • MITTEILUNG AN DIE PRESSE • PRESS-RELEASE • INFORMATION
ΑΝΑΚΟΙΝΩΣΗ ΓΙΑ ΤΟΝ ΤΥΠΟ • INFORMAZIONE ALLA STAMPA • MEDEDELING AAN DE PERS

Brussels, 20 September 1989

COMMISSION PRESENTS PROPOSALS FOR STAGE ONE OF EMU

Today the Commission approved its proposals for Council decisior a closer co-operation between Central Banks and a higher degree economic convergence between Member States of the Community. Tl two proposals are significant elements in the implementation of first phase of the EMU which will enter into force on 1st July

The proposals of the Commission are based upon the ideas of the Delors-report on the EMU, the conclusions of the Madrid Summit the debate on the informal ECO-FIN meeting in Antibes, 9-10 September 1989.

The overall principles behind the two proposals are:

- Parallelism between the economic and monetary aspects of the EMU
- Subsidiarity
- The diversity of specific situations.

X A. Through the modification of the 1964 decision, a Committee c Central Bank is set up to promote the co-operation between t Central Banks of the Member States.

The task of the Committee will be:

1) to hold consultations concerning the general principles and broard lines of policy of the Central Banks, in particular a regards credit, money and foreign exchange markets, stabilit of financial institutions and markets;

2) to exchange information regularly about the measures that fa within the competence of the Central Banks, and to examine those measures. The Committee shall normally be consulted i advance of national decisions on the course of annual domest monetary and credit targets;

3) co-ordination of the monetary policies of a view to the prop functioning of the European Monetary System and the realisat of its objectives of monetary stability;

4) to formulate opinions on the overall orientation of monetary and exchange rate policy as well as on the respective measur introduced in individual Member States with the aim of ensu convergent monetary policies in the Community directed to price stability;

5) to express opinions to governments and the Council of Ministers on policies which might affect the internal and external monetary situation in the Community and keep under review the monetary situation both inside and outside.

B. The proposition on the revision of the 1974 convergence decision is to be seen in the perspective of the completion of the Internal Market and in the context of economic and social cohesion.

In order to achieve sustained non-inflationary growth in the Community together with a high level of employment and the degree of economic convergence necessary for the success of stage one of the EMU, the Council is to undertake multilateral surveillance in restricted sessions.

In these meetings, the Council will on a regular basis examine:

- the economic conditions, prospects and policies in the Community and its Member States;
- the compatibility of policies within Member States and in the Community at large;
- the external economic environment and its interaction with the economy of the Community.

Multilateral surveillance shall cover all aspects of economic policy both the short-term and medium-term perspectives.

This learning-by-doing process, based upon reports and analysis from the Commission shall increasingly result in compatible policies by way of mutual commitments by Member States. In this context, the Council may issue policy recommendations on proposals from the Commission.

Multilateral surveillance shall focus on macroeconomic, microeconomic and structural policies.

It shall also include a review of budget policies, if possible ahead of national budgetary planning, focussing particularly on the size and financing of budget deficits.

It is further suggested that the Chairman of the Council and the Commission regularly shall report on the results of the multilateral surveillance to the European Council and to the European Parliament. The proposal of the Commission also states that governments bring the results of the multilateral surveillance to the attention of their national parliaments in order for these results to be taken into account in national policy making.

"In presenting these two important proposals," says Vice-President CHRISTOPHERSEN, "we have now taken the necessary first steps towards a more effective co-ordination of the economic policies of the Community."

"This strengthening of co-operation in the first stage of the EMU will also provide a sound and successful basis for a further development and a mutual commitment between Member States of the Community," stated Mr CHRISTOPHERSEN.

After having heard the opinion of the European Parliament, the ECO-FIN Council is expected to approved the two decisions on the 13 November well before the European Council in Strasbourg in December.

For further information:

Søren SØNDERGAARD, 236 06 33
Johan REYNIERS, 235 67 28

ec1.bk/meb/emu21.9

CONFIDENTIAL

FROM: MRS M E BROWN (EC1)
DATE: 21 September 1989
Ext: 4709

1. MR R I G ALLEN
2. CHANCELLOR

Dr Scene that the approach suggested in para 13(i) is the best available option

I agree

cc: PS/Financial Secretary
PS/Paymaster General
Mr Wicks
Mr H P Evans
Mr Peretz
Mr Mercer
Mr Dyer
Mr N Williams
Mr White
Mr McIntosh
Miss Wright

Ch/ 'Spillover' seems the least worst option. Content to write to Ld. Pres. in this sense? RGA. 21/9

21/9

EMU: PARLIAMENTARY SCRUTINY

Summary

This minute seeks your view on whether a debate should now be arranged to cover the Delors Report, ECU reweighting and the Stage 1 legal texts.

Delors Report

2. The Commons Scrutiny Committee recommended on 10 May 1989 that the Report should be debated on the floor of the House, and its Chairman, Nigel Spearing, wrote to the Lord President on 12 May to request a debate.

3. You decided that a debate before the Madrid Council would not be desirable; and the Economic Secretary wrote to the Lord President to this effect on 9 June.

4. There were subsequently a number of questions in the House requesting debates on EMU, the European Monetary System and monetary relations, and alternative monetary structures. You will have seen that the Scrutiny Committee's thirty-third report has called for an early debate (cutting attached).

ECU reweighting

5. Mr Spearing wrote to the Economic Secretary on 12 July recommending further consideration of the Regulation on ECU reweighting, to which ECOFIN agreed on 19 June. It is difficult to imagine that ECU reweighting on its own will provide much of a basis for a debate: it may be that the House's European Legislation Committee is concerned to ensure that no precedent is set of decisions being agreed without an opportunity for Parliamentary consideration. Discussion could either be tacked into a debate on EMU or taken in Standing Committee.

Stage 1 Legal Texts

6. The Commission has just published its proposed drafts. We do not yet have the actual texts, but UKREP understand (contrary to expectations) that these are formal proposals. If so, they will be deposited straight away with the Parliamentary Scrutiny Committees, and we will be required to submit Explanatory Memoranda by mid-October. The first meeting of the Commons Scrutiny Committee is on 18 October. The Committee is almost certain to recommend a debate, probably on the floor of the House.

7. The Presidency is aiming for common position on the Stage 1 texts at the November ECOFIN, with formal adoption at the December ECOFIN. These are very tight deadlines which may prove unrealistic. However, if the UK scrutiny procedures had not been completed in time, the UK would have to place a scrutiny reserve on its position at the relevant ECOFINs.

Timetable

8. The timetable is complicated. Key dates are:

5 October:	Monetary Committee discussion of Stage 1 legal texts;
After 5 October:	Commission circulate revised legal texts. Not known whether these will issue before or after deadline for submission of

	Explanatory Memorandum to Commons Scrutiny Committee;
13 October:	Deadline for submission of Explanatory Memorandum on Stage 1 legal texts;
17 October:	Commons return;
18 October:	Commons Scrutiny Committee (first meeting of new Session);
?30 October:	Chancellor's paper on EMU circulated to Finance Ministers;
?10 or 17 November:	Commons prorogued;
13 November:	ECOFIN;
?15 or 21 November:	State Opening;
8-9 December:	European Council;
18 December:	ECOFIN.

9. I understand from the Lord President's Office that it may be possible to find time for a debate during the spill-over Session (17 October - 10-17 November). Otherwise, they think it unlikely that time could be found until after the European Council on 8-9 December.

10. The advantages of going for a debate in the spill-over Session would be that it would meet pressures for an early debate; get a debate out of the way before the European Council; possibly provide useful ammunition for Ministers to use at ECOFIN and Strasbourg (for instance on the importance of Parliamentary sovereignty); and it would probably enable the UK to be in a position to agree the Stage 1 legal texts without imposing a scrutiny reserve. The main disadvantage of an early debate is that it might muddy the ground around the time you were releasing your ECOFIN paper. There is also a danger that the Stage 1 legal texts might subsequently be revised, so that the Scrutiny Committee would have the pretext to recommend another debate on EMU before Christmas.

[Only if the changes in the texts were substantive.] R.A.

11. On the other hand, leaving a debate until the new Session would attract strong criticism in Parliament, and would mean that the UK had to place a scrutiny reserve on any decisions about the Stage 1 legal texts reached at the November and probably also the December ECOFINs.

12. The arguments seem to point to a debate in the spill-over Session, after publication of your ECOFIN paper but before the 13 November ECOFIN. If you wished to go for this, you would need to write to the Lord President and L Committee to seek a slot. One slight presentational difficulty is that you would probably want to lay your ECOFIN paper in the libraries of both Houses before a debate were held; but this would have to be before the paper had been discussed at ECOFIN. UKREP's initial view is that this is acceptable even though it may ruffle some feathers in Brussels.

[Note that there should be no need for scrutiny procedures to be applied to your paper.] R.A.

Conclusions

13. Do you wish to write to the Lord President seeking a debate on EMU:

(i) either in the spill-over Session, preferably the first week of November;

(ii) or as soon as possible after the new Session has started.

Mary Brown

MRS M E BROWN

THE TIMES

European economic union

MPs' onslaught on ministers

4"

By John Lewis, Political Staff

The Government was rebuked roughly yesterday for failing to allow MPs to debate important and sensitive policies to bring about economic and monetary union in the European Community.

In an exceptionally sharply worded report, the Commons select committee on EC legislation complains bitterly that in May it called for a report on the Delors proposals for economic and monetary union, but that Mrs Margaret Thatcher took crucial decisions at the European Summit in June without a Commons debate [M Jacques Delors is President of the EC Commission].

Ministers are accused of breaking the spirit of an agreement made with the Commons in 1980.

The select committee says that important steps to implement stage one of the Delors report will flow from the summit meeting.

"The committee considers that the House could reasonably have expected to have had an opportunity to express its view on the principles involved before a decision of such importance was taken by the European Council.

"It considers that the Government's failure to meet this expectation was contrary to the spirit of the 30 October 1980 resolution. As a result, the House will, in practice, simply be left with exercising the subsidiary role of influencing the details of the relevant implementing proposals for stage one of economic and monetary union.

"In the light of the exchange of correspondence between the chairman of the committee and the Leader of the House on the timing of debates in circumstances such as arise in this case, the committee looks to the Government to ensure both that there is no repetition of this failure in similar circumstances in the future and that, in any event, the House is given an opportunity to consider any proposals for further steps in relation to economic and monetary union well before any decisions as regards their nature.

When it meets again in the autumn, the select committee is expected to ask for a meeting with the new Leader of the House, Sir Geoffrey Howe. MPs will be demanding that their criticisms, with their report on progress on economic and monetary union, should be debated by the Commons.

Ministers are also criticized in another part of the select committee's report for blocking action to stop fraud in the European Community.

The committee draws attention to the firm action now to be taken on frauds, but recalls that Lord Cockfield [a former EC commissioner] told it that he was blocked by United Kingdom and other EC countries when he tried to deal with the matter in 1986.

The Guardian

MPs say Thatcher broke pledge on EC debate

8

David Hencke
Westminster Correspondent

THE Prime Minister was accused yesterday of breaking the spirit of an undertaking to consult MPs before last June's European Community Madrid summit discussed the controversial issue of monetary union.

A report by the all-party select committee on European legislation — which is responsible for scrutinising all European Commission directives — said the Government blocked Parliament from debating the subject before Mrs Thatcher went to Madrid and negotiated a further compromise.

The question of when Britain joined the European Monetary System exchange mechanism divided Mrs Thatcher and Mr Nigel Lawson, the Chancellor, after he unsuccessfully tried to peg the pound to the Deutschmark.

The MPs pointed out that their committee and the Treasury and Civil Service select committee demanded a debate over a month before the summit took place.

"The committee considers that the House could reasonably have expected to have the opportunity to express its view on the principles involved before such a decision of such importance was taken by the European Council[of Ministers].

"It considers that the Government's failure to meet this expectation was contrary to the spirit of the October 30 resolution".

This resolution said no minister should reach agreement on legislation at summit meetings before MPs debated the principle of the issue.

The only exceptions were where the committee had agreed in advance or if there were special reasons. Then the minister had to give a statement to MPs at the first opportunity.

The Government failed to respond to the call for a debate and no special reason for not granting it was given by Mrs Thatcher when she addressed Parliament on the result of the summit.

MPs on the committee are particularly unhappy about the lack of consultation because Mr John Wakeham, the former Leader of the House, agreed to more speedy debates following negotiations with the committee in the summer. MPs are now seeking a further debate on the issue when Parliament returns for the new session.

Thirty third report of the Select Committee on European Legislation; The Madrid European Council; HMSO £2.20

10/1

PwP

FROM: A E W WHITE (EC1)
DATE: 21 September 1989
EXT: 4441

PS/CHANCELLOR

cc: Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr R I G Allen
Mr Peretz
Mr Riley
Mr Walsh
Mrs Brown
Mr O'Donnell
Miss O'Mara
Miss James
Mr N P Williams
Mr McIntosh
Mr Polin

BRIEFING ON EMU AND DELORS POST ANTIBES

Following the Chancellor's comments, I attach a revised Q and A briefing for use in answering inquiries from the Press and in letters from members of the public.

Wilf White

A E W WHITE

Copies also for: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary.

Q AND A BRIEFING ON EUROPEAN MONETARY UNION (EMU)

Q: What are the Delors' proposals?

A: Jacques Delors, President of the European Commission, chaired a Committee of central bank governors whose remit was "to study and propose concrete stages leading towards economic and monetary union". The Committee reported in June 1989. It suggested a three stage process leading to EMU. Stage One would be based on full implementation of the single market, including a single financial area; strengthened competition policy including action against economic aids; closer coordination of economic and monetary policies by member states; inclusion of all Community currencies in the Exchange Rate Mechanism under the same rules; and reform and doubling of the structural funds. Stages Two and Three would require a new Treaty and new institutions. In Stage Two member states would begin to work within EC-wide macroeconomic policy guidelines adopted by majority decision. A "European System of Central Banks" would be set up, though it would not yet have independent powers. Margins of fluctuation in the ERM would be narrowed. Stage Three would involve a move to irrevocably locked exchange rates and the replacement eventually of national currencies by a single Community currency. National budgetary policies and Community structural policies would become subject to binding central rules. The ESCB, acting independently, would determine monetary policy, exchange rate policy with non-EC countries and the management of official reserves.

Q: What has the UK agreed?

A: At the European Council in Madrid in June 1989 the UK agreed with other member states that Stage One of the Delors report should begin on 1 July 1990 but no end date was specified. It was agreed that the Delors report was a basis for further work and that there should be preparatory work for the organisation of a possible intergovernmental conference "to lay down the subsequent stages". No date for a conference was set, but it was agreed that this should not be before the first stage had begun, and that it should be preceded by full and adequate preparation.

Q: What are the Chancellor's proposals for the later stages of EMU?

A: The Chancellor has said that the UK cannot accept the surrender of both national sovereignty and political accountability which the Delors approach would involve. The UK believes that market pressures are the best way of influencing national governments to adopt low inflation policies and to keep prices and exchange rates stable. That is why the Government is fully committed to Stage One of EMU, including full abolition of all remaining exchange controls in the Community and the achievement of a single financial area. Stage One itself will bring massive economic change which will take many years fully to work through. The Chancellor has said that there is no need now to decide whether, and if so what, further changes should follow Stage One; but that there is clearly a case for taking any further steps needed to ensure that all Community currencies are freely usable throughout the Community. He has described this as a system in which, within the framework of the EMS, there are freely competing national currencies. He will be circulating his ideas in more detail to his fellow Finance Ministers before they next discuss EMU in November.

Q: Would this mean that I could buy a Mars bar in London with Portuguese escudos?

A: This would be a matter for the individual shopkeeper. But there has been too much emphasis in the press on the so called legal tender aspects. Competition between currencies would be more likely to operate in practice in major transactions, and in the choice of currency for savings and investment, legal impediments to which should be removed.

Q: Is the Chancellor's proposal any more than Stage One?

A: It is a logical extension of Stage One, which itself represents a more fundamental change than many people perhaps appreciate.

Q: But surely the Chancellor's approach cannot really be described as monetary union?

A: Yes, in the sense that all currencies would be equally available and freely interchangeable. And - unlike the Delors approach - the Chancellor's proposal would encourage the convergence of EC inflation rates on the best. Moreover, this highly beneficial outcome would be achieved without the loss of sovereignty in, and other problems encountered with, the Delors model.

Q: Does anyone else support the Chancellor's proposal?

A: It is hard to see on what grounds others could oppose it, since it is a logical extension of Stage One, which all support. As for Stages Two and Three, a number of member states have expressed reservations about aspects of the Delors prescription, and have been urging a more cautious, step by step approach.

Q: Won't this proposal simply mean the survival of the one fittest currency?

A: No. Free markets rarely produce monopolies. Market pressures should encourage member states to conduct better monetary policies so that the inflation performance of all EC currencies should follow the performance of the best.

Q: When will the Chancellor submit his paper to ECOFIN?

A: In time for the meeting of ECOFIN on 13 November.

Q: Delaying tactics by UK?

A: No. This is a genuine contribution to discussions on EMU, as promised by the Prime Minister at Madrid. The UK believes that a market-based approach is the right way forward, and avoids the fundamental disadvantages of the Delors prescription.

Q: [More detailed questions]

A: Wait for the Chancellor's paper.

cst.rj/docs/22.9.89.3

RESTRICTED

FROM: A G TYRIE

DATE: 22 September 1989

CHANCELLOR

cc: Financial Secretary
Mr Peretz
Mr Odling-Smee
Mrs Chaplin
Mr Lightfoot

EUROPEAN DEMOCRATIC GROUP CONFERENCE ON EMU

The EDG are holding a conference on this in Brussels on 16/17 November.

2. Among the speakers are Giscard d'Estaing, Jacques Delors and Leon Brittan. Apparently, the EDG are about to invite Alan Walters. Since the transcript of any meeting involving the EDG may as well be sent directly to the press I can see some problems with Walters attending. As soon I know that he has definitely been invited I will let you know and you ~~my~~ may want to suggest that he doesn't go.

3. Unless you have objections I might go along, and will, of course, report back.

pp RJ.
A G TYRIE

PWT

Pfpl

FROM: J M G TAYLOR
DATE: 22 SEPTEMBER 1989

MRS M E BROWN - EC1

cc PS/Financial Secretary
PS/Paymaster General
Mr Wicks
Mr H P Evans
Mr R I G Allen
Mr Peretz
Mr Mercer
Mr Dyer
Mr N Williams
Mr White
Mr McIntosh
Miss Wright

EMU: PARLIAMENTARY SCRUTINY

The Chancellor was grateful for your note of 21 September.

2. He would like to aim for a debate on EMU in the spill-over Session, preferably in the first week of November. I should be most grateful for a draft letter to the Lord President in due course.

JT

[Note. Spoke Philip Mawer (Cab Off) today + told him this was our preference - clarified that 1st wk in Nov. meant 6 + Nov].

(Told RIGA this)

JT
29/9

J M G TAYLOR

chex.dc/jmt2/23 **CONFIDENTIAL**

[redacted] Chancellor

cc Mr Evans
Mr Allen
Mr White

I have asked Lord President's office to start investigating possible times. We will provide ⊗ for Chancellor's return next week.

Mary Brown
22/9.

bf. 24/9

28/9

29/9

bf. 4/10

FROM: J M G TAYLOR
DATE: 22 SEPTEMBER 1989

MRS M E BROWN - EC1

cc PS/Financial Secretary
PS/Paymaster General
Mr Wicks
Mr H P Evans
Mr R I G Allen
Mr Peretz
Mr Mercer
Mr Dyer
Mr N Williams
Mr White
Mr McIntosh
Miss Wright

EMU: PARLIAMENTARY SCRUTINY

The Chancellor was grateful for your note of 21 September.

2. He would like to aim for a debate on EMU in the spill-over Session, preferably in the first week of November. I should be most grateful for a draft letter to the Lord President in due course.

J M G TAYLOR

CONFIDENTIAL

18/9

IPPR
INSTITUTE FOR PUBLIC POLICY RESEARCH
18 BUCKINGHAM GATE LONDON SW1E 6LB TELEPHONE 01-834 4423 FAX 01-834 4437

JAMES CORNFORD DIRECTOR

The Right Honourable Nigel Lawson MP
Chancellor of the Exchequor
11 Downing Street
London SW1

PS ah pse

27th September, 1989

Dear Nigel,

I enclose a report on Britain and the European Monetary Question by Gavyn Davies, which I hope may be of interest. Nothing you won't have heard a thousand times before, but perhaps from a novel direction?

Yours sincerely

James Cornford

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

Mr. Nigel LAWSON
Minister of Finance
H.M. Treasury
Parliament Street
SWIP 3AG LONDON
UNITED KINGDOM

27th September, 1989

Dear Sir,

We are pleased to present you with :

- A previously **unpublished survey** which we have recently carried out among **1,428 company leaders** of thc European Community, on the theme of monetary union of Europe.

- The communiqué issued by our Association after its September 20th Board Meeting.

We trust that you will find these documents of interest.

Yours faithfully,

Bertrand de MAIGRET
Secretary General

Encl. : 2

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

PRESS COMMUNIQUE OF SEPTEMBER 20TH

1. European business strongly favours monetary union...

Movement towards European monetary union is gaining momentum, as is proven by the meeting of Heads of States in Madrid and of Finance Ministers in Antibes. But European business is preoccupied by the fact that progress is still too slow.

The recent opinion poll* taken by Gallup for the AMUE** has confirmed the strong interest of European business leaders in the creation of monetary union in Europe. A large majority of them wishes the introduction of a common European currency, as an alternative to the present national currencies. They also find that the Heads of State at their Madrid Meeting in June 1989 ought to have gone further in their decisions.

2... but it remains difficult to develop the commercial use of ecu.

There is a large discrepancy between those who seek the development of a common currency (four out of five) and those who use the ecu (one out of five in 1988).

This gap is the natural consequence of the difference between the general expectation of what a common currency should be, and the current environment of the ecu. Many obstacles still hinder the progress.

3. Goverments, banks and businesses should aim to make the ecu viable and thereby would reduce the costs of "non-Europe".

Many of the technical and practical problems which companies face in using the ecu result from the "infant industry" character of ecu and will disappear once a "critical mass" of transactions has been reached, so that average transaction costs will progressively be reduced. To obtain this critical mass, AMUE appeals to governments, entreprises and banks alike to take appropriate measures in order to ensure "that there should be no discrimination against the private use of the ecu and that existing administrative obstacles should be removed" (Delors Report § 49). This in line with the commitments taken by the Heads of State at their Madrid June Meeting, where it was agreed to implement stage 1 of the Delors Report.

3.1. **Governments** have already taken positive steps in several countries by facilitating borrowings in ecus rather than any other foreign currency (France, Italy), allowing to operate personnal accounts in ecus (France, Germany) or even for a few companies to keep their legal accounts in ecus and to pay accordingly income tax (Netherlands).

However, the most important step in removing administrative obstacles would be to attribute the *status of legal tender to ecu* in all European countries, while maintaining its basket nature. This must go in pair with a process of general convergence in economic and monetary policies. Thus, ecu will *not* become a *parallel currency* which might jeopardize economic stability. It will rather be the true *common currency*, an alternative option to the national currency in each country.

3.2. **Businesses** have to set up their efforts to change old habits and increase the flow of information about practical applications of ecu. This is why AMUE, having already published 400 000 copies of its guide "The ecu for the Europe of 1992", is presently developing a series of seminars which will take place in all major towns and cities of Europe for senior business managment.

3.3. **Banks** are considering together with industrial companies how the transaction costs in using ecu can be reduced.

In order to encourage an informal debate AMUE has decided to undertake a comprehensive study in all European memberstates, analysing all existing obstacles and making suggestions for their removal.

* enclosed document
** Association for the Monetary Union of Europe

Faits et Opinions

25, rue Cambon - 75001 Paris
Téléphone : (331) 42.96.41.65

EUROPEAN COMPANIES

AND

MONETARY UNION

Results of a survey carried out by the Gallup network institutes among 1,428 company leaders in the European Community, at the initiative of

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Authorized publication : 20th September 1989

Télex : GAULLOP 214 789 F **Télécopie : (331) 42.60.40.53**
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1 Figures taken from the July 1988 poll

This document was developed on the basis of the results of an inquiry carried out in July 1989 among 1,428 company leaders (senior managers) (around 200 per country), whose firms have an annual volume of imports and/or exports amounting to at least 300,000 ecus.

The interviews were carried out by professional pollsters in the seven most important countries in the European Community in terms of gross domestic product: Belgium, West Germany, Spain, France, Italy, the Netherlands and Great Britain.

Certain aspects are related to the results of a study carried out in July 1988, with the same target: 1,036 company leaders with the same minimum export and/or import volume were queried in the same countries, by the same institutes, concerning ecu use (1).

1. A common currency : massive support by senior managers

Common currency:

The two polls, carried out a year apart, confirm European managers' very favorable attitude toward a common currency: the percentage of those saying they favour a common currency was estimated at 83% in 1989.

Attitude toward a common currency

	B	FRG	S	F	I	N	GB	Average
Favourable	90	69	92	90	94	82	65	83
Unfavourable	3	19	2	3	5	13	24	10
Don't know	7	12	6	7	1	5	11	7
Total	100	100	100	100	100	100	100	100

An analysis of the results and of the trend in them **by country** shows great stability, except in Great Britain, where some reluctance is seen, and in Germany, where opinion seems more favourable.

(1) The complete results of the two polls and a description of the methodologies used are available from the Association for the Monetary Union of Europe, 26, rue de la Pépinière, 75008 Paris, France.

Some 76% among the managers favourable to a common currency desire the gradual disappearance of the national currencies.

% among managers favorable to a common currency

Should the joint currency lead to the gradual disappearance of the national currencies?

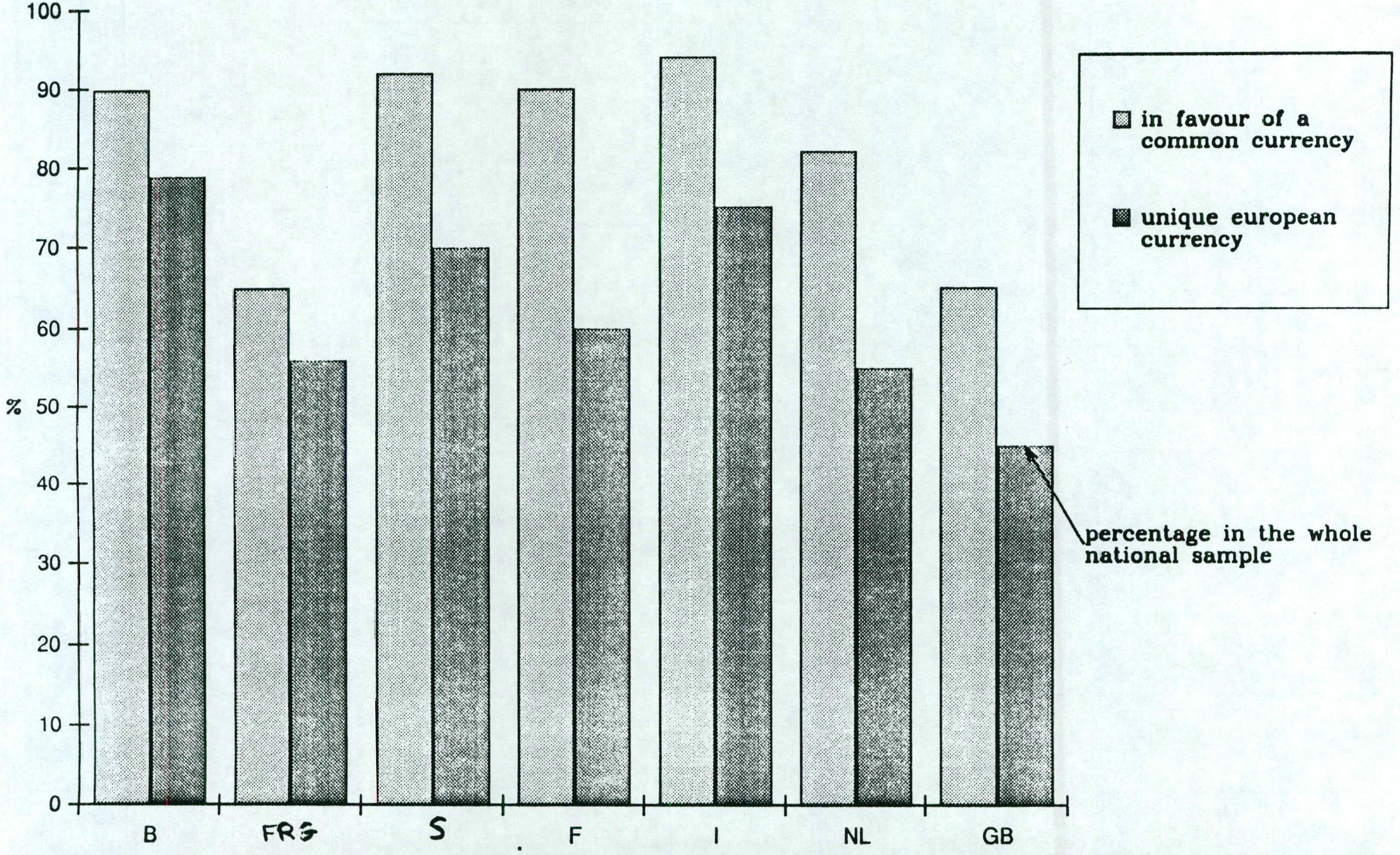
	B	**FRG**	**S**	**F**	**I**	**N**	**GB**	**Average**
Yes	88	81	76	66	80	67	70	76
No	6	13	12	26	18	29	26	18
Don't know	6	6	12	8	2	4	4	6
Total	100	100	100	100	100	100	100	100

Thus the idea of a **common currency** appears very widely associated with the notion of a **single currency**, destined to drive out the national currencies in the long run.

This association between the two concepts of common currency and single currency is less developed in France and The Netherlands than in the other countries covered by the study. On the other hand, it is very strong in Belgium, Italy, and even in Germany, where 81% of the business leaders saying they favour a common currency want the national currencies to disappear gradually.

If one does not remain in the sub-group of managers favouring a common currency, and instead considers all of the managers queried, one can estimate that in 1989, some **63% of the managers in the seven European countries covered by the study want a single common currency in the long run.**

THE DESIRE FOR A COMMON CURRENCY



Central Bank:

Nearly three-fourths of the company leaders queried (73%) want a European Central Bank. But this figure actually masks a split between two groups of countries:

- On one hand are the British managers, who quite divided on the interest of having a European Central Bank (48% are favourable and 40% unfavourable).

- On the other hand, the other countries, which express massive agreement (ranging from 65% of favourable managers in Germany and in The Netherlands to 89% in Italy).

Attitude toward a European Central Bank

	B	FRG	S	F	I	N	GB	Over-all
Favourable	77	65	83	87	89	65	48	73
Unfavourable	11	20	9	5	7	25	40	17
Don't know	12	15	8	8	3	9	12	10
Total	100	100	100	100	100	100	100	100

As a whole, the desire for a European Central Bank remains clear in a majority, but is less widespread than the desire for a common currency. It would seem to be the way of bringing about monetary union that still gives rise to certain questions on the part of company leaders but they have very largely accepted the principle and acknowledged the interest.

The EEC summit meeting in Madrid:

The judgement made by the European managers with respect to the European Council meeting in Madrid on June 26-27, 1989, strengthens this hypothesis.

Those managers were asked whether they considered that the Heads of State or Government meeting in Madrid had gone too far, far enough, or not far enough in their work looking toward European monetary unification.

The results vary perceptibly between countries (cf. the table below).

At European level, a majority (51%) of the managers queried consider that the summit participants should have gone further. But there are very few who think the summit went too far (3%).

As a whole, the majority attitude is to express support for the process of monetary integration, dominated by a desire for a speed-up.

The heads of state and government meeting in Madrid...

	B	FRG	S	F	I	N	GB	Over-all
Should have gone further	58	29	54	37	66	87	24	51
Went far enough	17	46	27	39	29	6	66	32
Went too far	1	9	-	-	1	3	3	3
Don't know	24	16	19	24	4	4	7	14
Total	100	100	100	100	100	100	100	100

And do you think that your government...

	B	FRG	S	F	I	N	GB	Over-all
Should have gone further	52	19	44	27	55	82	47	47
Went far enough	21	54	34	42	38	8	45	35
Went too far	1	7	1	1	2	4	3	2
Don't know	26	20	21	30	5	6	5	16
Total	100	100	100	100	100	100	100	100

Questions asked in July 1989

2. Ecu use : a slow start

It remains true that use of the ecu by business is not developing at a rate that the very favourable attitude on the part of European company leaders toward monetary integration would allow one to hope for.

In 1988, barely a fifth of the managers questioned had already used the ecu. The proportion was 47% in Italy, but less than 10% in Great Britain and The Netherlands.

In 1989, only 11% of the European managers queried said their company had made specific efforts, over the last 12 months, **to increase** ecu use. The proportion reaches 30% in Italy, and generally speaking seems higher in the countries in which ecu use was already more developed.

However, viewing these results in conjunction with those of the inquiry carried out in 1988 shows that the European managers expect immediate and precise advantages from use of a common currency.

The following table sums up the advantages associated with a common currency, as they appeared in the 1988 inquiry.

Advantages expected from a common currency

In your opinion, what would be the main advantages of a common currency?

	B	FRG	S	F	I	N	GB	Over-all
. Reduction of foreign exchange commissions	52	18	38	31	32	43	33	**33**
. Lower costs of administering exchange risks	49	40	48	43	68	40	60	**51**
. Offsetting and reduction of cash flow balances in foreign currency terms	24	12	29	22	13	23	9	**18**
. Stabilization of trade currents	32	29	31	49	42	28	44	**38**
. Safety of investments	13	12	29	20	17	15	17	**18**
. Lowering monetary fluctuations	66	57	63	71	49	76	73	**64**
. Contribution to European construction	34	36	31	46	34	33	28	**35**
. Others	-	1	2	1	2	1	1	**1**
. None of all this applies	-	12	-	-	-	-	3	**3**
. No answer	-	1	1	1	1	3	2	**1**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total greater than 100 because of multiple answers.

Questions asked in July 1988

Similarly, a majority was seen in the 1988 inquiry in all countries, except Germany and Great Britain, considering use of the ecu as "quite interesting" or "rather interesting" for a company , confirming that the ecu's potentialities largely exceed the present use level.

The following table shows the criticisms expressed in 1988 with respect to the ecu in its daily surroundings. Obviously, the conditions involved in using the ecu have not yet come up to the standards defining the "common currency".

Drawbacks connected with ecu use

What drawbacks do you see in the ecu?

	B	FRG	S	F	I	N	GB	Over-all
. I have little knowledge of it	40	31	33	35	31	40	41	**35**
. Does not match needs	18	24	13	13	6	13	14	**14**
. Other habits	35	24	34	21	28	31	24	**27**
. Coins and banknotes are lacking	18	7	19	12	22	23	17	**16**
. Lacks central bank support	20	13	33	27	31	18	27	**25**
. Revision planned of the "basket"	4	5	9	6	6	5	16	**8**
. Difficult to accept	35	20	26	40	39	41	27	**32**
. Too complicated	6	14	7	5	5	5	10	**8**
. Raw materials prices outside ecu system	24	14	25	19	36	19	26	**24**
. Restrictions on use	15	16	10	7	4	9	16	**11**
. Some regions not concerned	13	15	30	16	15	18	25	**19**
. No answer	11	11	3	6	6	9	11	**8**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total greater than 100 because of multiple answers.

Question asked in July 1988

Generalized use of the ecu runs up agains several substantial obstacles, with a major one being very widespread lack of knowledge of the ecu. The force of habit, or the difficulty of getting the ecu accepted, also constitute non-negligible obstacles. Of secondary importance is the abscence of Central Bank support, which is also considered an important disadvantage.

So one can see that the obstacles to development of the ecu are not all of the same nature. Some of them can be cleared away by persuading company leaders, while others are connected with political choices.

Since lack of knowledge and the force of habit can be corrected by suitable instruction, interest in training seminars on the ecu was tested in the 1989 inquiry. Some 80% of the business leaders queried indicated that their company would send at least one person to such seminars.

	B	FRG	S	F	I	N	GB	Over-all
% of companies that would send at least one person	79	79	77	78	88	67	92	80

The main departments interested in participation in training seminars dealing with the ecu are the financial and commercial departments. The following table sums up, for each country, the proportions of companies that would send participants working in the various specialities.

Main departments interested...

	B	FRG	S	F	I	N	GB	Over-all
Financial	31	55	49	38	46	38	60	**45**
Commercial	27	25	18	16	41	21	34	**26**
General Management	19	13	7	13	6	14	29	**15**
Accounting	17	7	13	17	5	22	21	**15**
Taxation	4	9	5	4	46	7	1	**11**
Legal	17	8	4	2	1	2	2	**5**
Other	1	4	8	4	1	3	8	**4**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total may be greater than 100 because of multiple answers.
Percentages calculated on the basis of all companies

The themes considered as the most interesting ones include the general aspects of the ecu (advantages and drawbacks of a common currency, ecu competitiveness by comparison with other major currencies), as well as some very concrete aspects, such as invoicing in ecu terms, or the ecu and exchange risk management.

The following table sums up the judgements made on the interest of the various themes, for all of the managers questioned.

Seminars on ecu use:
percentage of managers interested in the various themes

	Greatly interested	Somewhat inter.	Not so much inter.	Not at all inter.	Don't Know	Over-all percentage of inter.
. The advantages and disadvantages of a common European currency for businesses	54	33	7	4	2	**87**
. The ecu as a factor in price stability	52	30	10	6	2	**82**
.The ecu and exchange risk management	54	28	9	6	3	**82**
. Prospects for ecu development	45	36	10	6	3	**81**
. Ecu competitiveness by comparison with other major currencies	52	30	10	7	3	**80**
. The role of the ecu and of a Central Bank in European construction	46	33	13	6	2	**79**
. Billing in ecu terms	51	27	12	8	2	**78**
. Practical use of the ecu in accounting	44	32	14	8	2	**76**
. Financing in ecu terms	47	27	13	11	2	**74**
. Taxation as connected with ecu use	41	33	14	9	3	**74**

Percentage of managers interested in the various themes (continued)

	Grea-tly in terested	Some-what inter.	Not so much inter.	Not at all inter.	Don't Know	Over-all percent-age of inter.
. The ecu and management of foreign-exchange operations in the company	38	34	15	10	4	**72**
. Ecu use by sales, administrative or financial executives	33	37	16	10	4	**70**
. Ecu definition and its quotation	35	34	18	10	3	**69**
. Legal aspects connected with ecu use	32	35	18	11	4	**67**
. The ecu as a factor in reducing the cost of foreign-exchange cash flow	35	30	18	12	5	**65**
. Company leaders' intentions vis-a-vis the ecu	27	38	19	11	5	**65**
. Investments in ecu	32	27	23	16	2	**59**
. Ecu history	5	18	45	30	2	**23**

As to the people who seem in the best position for providing such training, the financial experts and bankers are clearly the sources most anticipated by the managers queried.

The following table sums up the judgements made with respect to the various possible speakers.

Assessment of possible speakers

	Very interesting	Rather interesting	Not so very inter.	Don't Know	Total
Financial experts	65	26	6	3	100
Bankers	63	26	8	3	100
Central bank representatives or high civil servants in finance field	52	30	14	4	100
Leaders of big businesses	48	33	16	3	100
Certified public accountants and auditors	42	34	21	3	100
Leaders of small and medium-sized firms	34	30	33	3	100
Legal experts	30	38	29	3	100
Professors from universities or "grandes écoles"	23	37	36	4	100
Journalists from the economic press	18	35	44	3	100
Trade association officials	18	33	45	4	100
Politicians, e.g., members of the European Parliament	14	24	58	4	100

ec.jn/McIntosh/28.9.2

FROM: A D McINTOSH
DATE: 28 SEPTEMBER 1989

x4442

2/10

1. ~~MRS~~ BROWN

2. PS/CHANCELLOR

Ch.
We have already told Sir GH's office, + the Cabinet Office, about our prep. You may also have mentioned this at Cabinet. Not sure, ∴, whether we need write now. But if you would prefer to do so, content with the draft?
JS. 2/10

cc: PS/Financial Secretary
PS/Paymaster General
Mr Wicks
Mr H P Evans
Mr R I G Allen
Mr Peretz
Mr Mercer
Mr N Williams
Mr A E W White
Miss R R Wright

EMU: PARLIAMENTARY SCRUTINY

Mrs Brown's minute to the Chancellor of 21 September sought the Chancellor's view on whether a debate should be arranged to cover the Delors Report, ECU reweighting and the Stage 1 Legal texts.

2. The Chancellor thought that a debate should be arranged in the spill-over session, preferably in the first week of November; and your minute of 22 September requested a draft letter to the Lord President. This is attached.

3. We will submit advice on the wording of the motion to be tabled and a further draft letter to the Lord President in due course.

AD McIntosh

A D McINTOSH

ec.jn/McIntosh/29.9.3

DRAFT LETTER:

The Rt Hon Sir Geoffrey Howe QC MP
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1A 2AT

SCRUTINY DEBATE ON ECONOMIC AND MONETARY UNION

The House of Commons Select Committee on European legislation recommended on 10 May that there should be a debate on the Delors Report on European economic and monetary union (EMU). The Chairman of the Committee wrote to you on 19 May requesting such a debate.

At that time I felt that a debate would be premature. Indeed there is no question at present of proposals for legislation on EMU, except for revisions of certain legal texts relating to strengthening of the arrangements for economic and monetary coordination which we have agreed to in "Stage One". As you know, the UK has made clear its fundamental objections to ~~the~~ Delors' prescription for developments beyond that.

I fully recognise, however, the amount of interest generated by this subject, and it will be helpful to have the opinions of the House before the subject next comes up for discussion with my EC counterparts in ECOFIN on 13 November. An early debate will also enable us to go through the scrutiny procedures on legal texts for Stage 1 before these come up for decision at the November ECOFIN. I hope, therefore, that it will be possible to arrange a debate in the spill-over session, preferably in the first week of November. I will write again closer to the time with the proposed wording of the motion.

I would propose to take at the same time the question of ecu reweighting, as recommended by the European legislation committee.

Copies of this letter go to [the Prime Minister], members of 'L' Committee, OD(E), and Sir Robin Butler.

NIGEL LAWSON

FROM: JOHN GIEVE
DATE: 28 SEPTEMBER 1989

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr Peretz
Mr R I G Allen
Mrs Brown
Mr O'Donnell
Mrs Chaplin
Mr Tyrie

ECONOMIC AND MONETARY UNION

The Chancellor was very grateful for the first draft of the paper for ECOFIN on our approach to EMU. He thinks it contains a lot of good material and is a very encouraging first shot. However, he thinks it needs to present the case more directly to its target audiences: the Finance Ministers of the other countries and the press here. He thinks it might be recast on the following lines:

- Stage 1 - a major endeavour.

- No need to decide now on what should follow it; step by step approach best.

- Problems with Delors - political and economic.

- Fiscal conclusions neither acceptable nor necessary.

- Regional approach also misguided (although this section should be drafted with some sensitivity so as not to raise hackles in the outlying countries).

- On monetary policy - which is now the heart of economic policy - it raises major problems both in terms of politics and economic stability.

- There is no need for any institutional change to move forward to irrevocably fixed currencies; the ESCB is only required for a single currency.

- But it is sensible to take a decision now on how to move a little beyond Stage 1 ie take to its logical conclusion.

- This would be a market route to interchangeable currencies which could become irrevocably fixed if countries so desired - a decentralised but genuine form of economic and monetary union.

- The model would also create pressure for price stability.

- The Delors plan is objectionable on democratic grounds. While a strong case can be made for removing political controls over central banks, there must be political accountability.

- The Delors plan would create an imbalance between a single Governor and 12 Finance Ministers which is quite unmatched elsewhere in the world. As many of its proponents recognise, it would only make sense with a further centralisation of political power in the community. But there is no agreement on the desirability of making that move.

- Also no guarantee that a single central bank would pursue anti impressionable policies.

?

2. Within this structure, he thinks it is important that we do not disparage the argument for an independent central bank. We need also to spell out in what sense our proposal would produce EMU. We are talking about interchangeability and perhaps fixing of currencies; there is no need to define EMU in terms of a single currency. He would also like to pose the question of what the economic gains would be from moving to a single currency compared to the enormous political quests.

3. Turning to points made in the existing draft, he has the following comments:

- Paragraph 5 - there is now a worldwide consensus in favour of relying wherever possible on market forces and that is the philosophy behind the Single European Act.

- Paragraph 9 - he hopes the significance can be underestimated!

- Paragraph 10 - we want to move as fast as possible on stage 1.

- Paragraph 13 - 'the abolition of exchange controls <u>within the context of the ERM</u> will intensify the discipline'.

- Paragraph 21 - we should not dismiss the German and Dutch faith in ~~the~~ independent central banks

- paragraph 34 i. - use examples of Netherlands and UK.

JG

JOHN GIEVE

Permanent Secretary
H M TREASURY

Chancellor

EMU

Here is the latest draft. More work - which is being done - is needed before we can be confident about the elements in our approach to the developments beyond stage 1.

John has copies for Nigel Wicks and Terry Burns so you can discuss it with them. There is also a copy which you can give to the Governor if you wish. We shall send copies to the Bank members of the working group tomorrow.

PM.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

EMU

I have scribbled some suggestions.

My feeling overall is that it needs

(a) to spell out more fully the case political & economic against Delors

(b) drop all the regional stuff which will alienate all the peripheral countries and which is not essential to the argument.

(c) draft as a document which will appear in the papers etc ie in a clear, jargon-free way.

Finally we need to sell it to other waverers - Greece, Denmark, Portugal etc.

JC PTO

I agree also with Nigel that we need an alternative definition of monetary union; ie to offer a way out for the waverers (having fostered their doubts about Delors).

ECONOMIST EXTRACT

Entertainment takeovers

Captain Kirk zaps Crocodile Dundee

MELBOURNE

The $1.5 billion battle between two Australian media barons, Mr Christopher Skase and Mr Rupert Murdoch, for the Hollywood studio MGM/UA may mark the apogee of the industry's current takeover boom

EVEN the bid-crazy entertainment industry had to gasp. On September 15th, MGM/UA Communications was bought for $1.5 billion by Qintex, an Australian media and leisure group controlled by Mr Christopher Skase. Two days earlier Mr Kirk Kerkorian, the 72-year-old financier who owns 82% of MGM/UA, had received a $1.4 billion bid from another Australian media empire, Mr Rupert Murdoch's News Corporation. Mr Murdoch looks wise to have stayed his hand; Mr Kerkorian, wiser still to sell. Guess where that leaves Mr Skase?

Mr Kerkorian formed MGM/UA by combining two of Hollywood's greatest studios: Metro-Goldwyn-Mayer and United Artists. Alongside MGM/UA's film and television studios, Qintex is buying a film library of 1,000 United Artists films, including the James Bond and Rocky movies, and 34 recent MGM films including "A Fish called Wanda" and "Rain Man". Mr Skase also gets the home-video and foreign pay-TV rights to roughly 3,000 older MGM films, plus the "roaring lion" trademark.

A former financial journalist, Mr Skase already owns Channel 7, Australia's second most popular television station, which he snapped up for A$600m ($420m) in 1987. In America, Qintex co-produced "Lonesome Dove", one of the few American TV mini-series that could plausibly claim to be art rather than pap.

Despite his past triumphs, Mr Skase's winning of MGM/UA has been met not with applause but guffaws. According to one (rival) American media mogul, $1.5 billion is an "outlandish" price: his company looked at MGM/UA and thought that even $1 billion was too much. Earlier this year Qintex's share price stood at A$1.70. On September 20th, it closed at A$0.75. Industry analysts are worried that Qintex's group debt could reach A$2.4 billion.

Even by the standards of Hollywood, MGM/UA's recent history has been weird.

- In 1985, Mr Kerkorian sold MGM/UA to Mr Ted Turner for $1.5 billion; he then repurchased for around half that sum the whole of United Artists, including its film library, and most of MGM. Mr Turner kept the American rights to MGM's quite separate 3,000-strong film library.
- In March 1989, Mr Kerkorian agreed to sell MGM/UA to Qintex for A$1 billion. At the same time he also agreed to buy back for $250m the lion logo, the 34 MGM films produced since the Turner sale and MGM's television group.
- On September 13th, following rumours that Mr Skase was having difficulty raising the necessary cash, News Corporation bid $1.4 billion for MGM/UA.
- On September 15th, Mr Kerkorian signed an apparently binding deal to sell MGM/UA to Qintex for $1.5 billion and the assumption of around $400m worth of MGM/UA's debt. Mr Kerkorian will buy back one office building for $43m. MGM/UA will probably become part of a renamed Qintex America.

Mr Skase has until the end of the year to find the money to pay Mr Kerkorian. Qintex hopes to raise around $500m from its bankers. Barclays, BankAmerica and Citibank together organised a $400m facilty for Qintex's first offer. A further $1 billion should come from ten mystery investors, mostly European and Japanese: in return they will get a 50-60% share in Qintex America. According to Qintex, these investors were willing to put $500m into the first offer and are keen to back the new deal.

Top billing costs a lot

Qintex is giving Mr Kerkorian a $50m downpayment. In the short term MGM/UA has around $150m in cash or readily collectable debts (mostly box-office receipts). But what about the longer term? MGM/UA lost $61m in the nine months to the end of May—principally because its costs got out of control. Mr Jeffrey Logsdon, an analyst at Crowell, Weedon, a Los Angeles stockbroking firm, reckons that the studio's predictable cashflow (ie, allowing for no smash hits or flops at the box office) is, at best, $150m a year. Post acquisition, the studio's interest bill is likely to be at least $100m a year.

That narrow margin leaves hardly any room to finance new films or TV programmes. To do that, Mr Logsdon guesses that the company may have to borrow another $500m over the next two years. Given the risks of the entertainment industry, making more films, however efficiently, is not a surefire way to make more money. Qintex's plan to exploit the "brand equity" of the roaring lion logo also looks strange. People do not pay to watch films simply because they are made by a particular company, however famous its logo.

Mr Skase's best bet for increasing revenue is selling old MGM and UA films in Europe. In America prices paid for the right to show new movies and programmes are static, if not falling (and Mr Turner owns the domestic rights for most of the MGM films anyway). But last year European television stations bought $630m worth of American shows from the big Hollywood studios—six times the figure for 1980. Over the past two years the prices for some new films and old TV programmes have quintupled because of competitive bidding between two new British satellite television stations, Mr Murdoch's Sky and British Satellite Broadcasting (BSB). As deregulation spreads across Europe, increasing the total number of programme hours from the present 260,000 a year to perhaps 400,000 in 2000, libraries like MGM/UA's will be worth a fortune.

That at least is the theory. There are a number of possible hitches. First, other European countries may match the prices that BSB and Sky have bid, but even Hollywood's most fervent optimists doubt that they will increase them. Second, the EC is still making worryingly protectionist noises about limiting the number of foreign programmes on European television sets.

BUSINESS continues on page 115 ➤

Currency cause and effect

Countries with high inflation need to keep devaluing their currencies to maintain competitiveness. Countries that try to maintain their competitiveness by devaluing their currencies only end up with even higher inflation. Discuss

ECONOMICS FOCUS

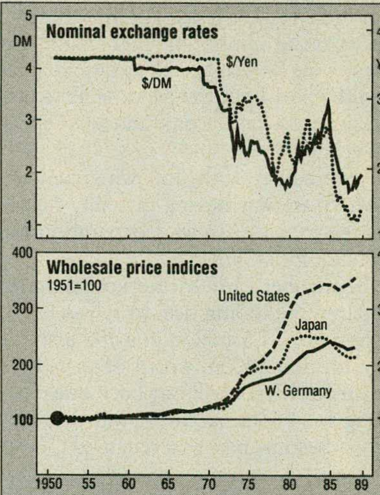
IN MANY ways, the era of floating exchange rates which followed the collapse of the Bretton Woods system of fixed parities proved a profound disappointment. The very term "floating" conveys the hope of the early 1970s—that unpegged exchange rates would move sedately to and fro, keeping the world's economies aligned in competitiveness, thus soothing the trade-balance strains that had arisen in the previous years. But instead of exchange rates that floated, the world got exchange rates that jerked, a new source of economic disruption in their own right. It got something else, too: higher inflation and lower growth.

The Bretton Woods regime collapsed with such a fearful crunch that most people still think of it as a failure. Which it was: it collapsed with a fearful crunch But apart from that, Mrs Lincoln would say it did rather well. In the 1950s and 1960s, America grew at 3½% a year, West Germany at 6½% a year and Japan at 11% a year—and all three did it with an inflation rate (measured in terms of wholesale prices) of less than 1% a year. Yes, these were decades of post-war reconstruction. Yes, it is unfair to compare them with the 1970s and 1980s, which were blighted by the oil-price shocks and their aftermath. But those years of glittering performance must still raise a doubt or two about the supposed advantages of floating.

A new and as yet unpublished paper by Messrs Ronald McKinnon and David Robinson of Stanford University voices many such doubts. Under Bretton Woods, currencies were pegged and inflation was low; after it collapsed, the study points out, the dollar depreciated against the yen and the D-mark, and inflation moved higher in America than in Japan and West Germany. America's wholesale prices went up by 5.6% a year between 1973 and 1988, whereas West Germany's went up by 3.6% a year and Japan's by 2.3% a year. This prompts the question: did America's inflation cause the dollar's depreciation (as advocates of floating rates would say), or vice versa?

The pro-floating orthodoxy might argue roughly as follows. Inflation is driven by demand in the economy, and the main engine of demand is monetary policy. Loose money boosts demand directly, which causes inflation and a current-account deficit, which both cause the dollar to depreciate. At the same time, loose money means lower interest rates, which reduce the overseas demand for dollar assets, which again causes the dollar to depreciate. So it is the misuse of monetary policy (presumably in failed attempts to raise output and employment) that causes the depreciation.

Suppose instead that the American government pursued dollar devaluation as a policy in its own right. The breakdown of Bretton Woods was precipitated by President Nixon's insistence that a devaluation was needed to deal with America's emerging trade deficit. By the early 1970s most economists agreed on that.



Source: Mr R. McKinnon

The Carter administration turned devaluationist in 1977. Mr Carter's Treasury Secretary, Mr Michael Blumenthal, provoked a two-year run on the dollar by announcing that it was overvalued. At the time it was roughly in line with purchasing-power parity (the exchange rate that equalises prices in different countries).

President Reagan's Treasury Secretary, Mr James Baker, began talking the dollar down at the famous meeting in the Plaza Hotel in September 1985. By the time of the Louvre accord of February 1987, the currency was again undervalued against its PPP. As trade worries mounted that year, Mr Baker blew hot and cold about the need to prop it up. In the months before Black Monday, private flows of capital to the United States dried up. Before long the dollar fell again.

So it is entirely plausible to put the desire for dollar devaluation at the start of the process, not at the end. To make this desire a reality, however, financial markets still need to be convinced that monetary policy will eventually ease so as to accommodate the fall in the currency. The devaluation then causes prices to rise (a) directly, by raising the price of imports and the goods that compete with them in American markets, and (b) indirectly, by forcing the Federal Reserve to expand the money supply in order to sustain the devaluation. This second channel, argue Messrs McKinnon and Robinson, has been at work this year. In the spring the Fed responded to inflationary pressure by tightening its monetary policy; but when this caused the dollar to rise, the administration told Mr Greenspan to ease up.

If devaluation causes inflation, and not the other way round, something else follows: devaluation cannot be much use as a means of restoring competitiveness. A lower exchange rate improves competitiveness precisely to the extent that it does not cause higher inflation. If the devaluation causes domestic wages and prices to rise, any gain in competitiveness is immediately eroded. It is an accounting tautology that America's current-account deficit will fall further if and only if the gap between its domestic savings and investment continues to narrow. Currency changes are neither a substitute for this process nor, say Messrs McKinnon and Robinson, a promoter of it.

The post-Bretton Woods transformation of the dollar from a strong currency (the anchor of the system, in fact) to a weak one has cost America dear. Up until the late 1960s, when the system's credibility began to fray, America's interest rates were lower than Japan's: its prime rate was 4-5%, compared with Japan's 6-8%. Since then, through most of the 1970s and all of the 1980s, America's interest rates have been much higher than Japan's. Because these higher nominal interest rates have been combined with higher inflation, the penalty in terms of real interest rates is smaller. That is small consolation. High nominal interest rates, relatively high inflation and exchange-rate volatility are jointly and severally bad.

If Messrs McKinnon and Robinson are right about the links between devaluation and inflation, the policy implication is clear. Even if a new version of Bretton Woods cannot be built, governments need to change their whole approach to exchange rates. In a nutshell, they must disavow devaluation as a cure for current-account deficits.

Madrid European Council "restated [the Council's] determination progressively to achieve economic and monetary union" but did not agree on how to do this.

4. Before considering possible prescriptions, it is necessary to establish the principles on which economic and monetary arrangements should be based. Three principles have emerged clearly from the experience of recent years.

5. First, wherever possible ~~maximum~~ reliance should ~~must~~ be placed on **market forces** to improve economic performance. Competitive pressures lead directly to ~~maximum~~ efficiency and welfare and the will also ensure, over time, the convergence of economic performance and policies in the Community.

6. Secondly, as the Delors report emphasised, all Community arrangements must respect the principle of **subsidiarity**. The Report (paragraph 20) explained that this principle meant that:

> "the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. ... All policy functions which could be carried out at national (and regional and local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union would remain within the competence of the member countries".

7. The first two principles apply to all economic and monetary policies. The third principle applies primarily to monetary policy: the overriding economic objective of the Community must be to secure **stable prices**. Price stability enables economies to function efficiently with high employment and sustainable growth. This means that economic and monetary arrangements must be designed to ensure convergence on the best inflation performance in the Community, not on the average of EC inflation rates.

Stage 1 of EMU

8. The UK is fully committed, with all our partners in the EC, to Stage 1. The full implementation of Stage 1, which begins on 1 July 1990, should rest squarely on the three principles. It consists of the following major steps:

- through the single market programme, to dismantle long-standing barriers to the movement of people, goods and services;

- to strengthen competition policy.

- to liberalise capital movements;

- to strengthen coordination of economic and monetary policies;

- to include all currencies in the ERM on equal terms.

9. The significance of this programme cannot be !over ~~under~~estimated. It will constitute a massive change in the economy of the Community. It will progressively increase freedom of trade in both goods and services, and freedom of movement of capital and labour. [The Cecchini Report painted a picture of a Community in which regulations and technical] barriers would ~~will~~ be drastically reduced; frontier delays will be cut; industries will be restructured to reflect comparative advantage and reap economies of scale; businesses in all sectors will become more efficient as they are exposed to Community-wide competition; and consumers will benefit from lower prices and increased choice.

10. However, as the Cecchini Report recognised, the measures in Stage 1 are certain to take many years to work through the economies of the Community. Half of the 279 single market measures have yet to be agreed by the Community institutions. Hardly any have yet been implemented in the legislation of all twelve member states. Some key measures, including those which will start to bring down barriers to the provision of financial services on a Community-wide basis, will not start to come into effect until 1 January 1993. And it will take much longer for the full economic effects of such measures to be felt. The UK's

We have to make [illegible] possible

experience of liberalising its financial system and of implementing a far-reaching programme of supply-side measures has shown that the process of adjustment is a long and continuing one.

11. The integration of member states' economies during Stage 1 will have important implications for payments arrangements and for the conduct of monetary policies. Greater mobility of people, goods and capital will lead to increased demand for efficient Community-wide payments mechanisms, and the creation of a single market in banking will provide the competitive spur to ensure that improved mechanisms emerge. These may involve some or all of:

- electronic funds transfer facilities (eg credit cards, debit cards, charge cards);

- improved and lower cost international cheque clearing systems;

- simpler and lower cost currency exchange arrangements.

The result will be a significant diminution in the transactions costs and inconvenience of the multi-currency system.

12. Turning to monetary policy, greater economic and monetary integration, and especially the abolition of exchange controls, will intensify pressures on national monetary authorities to conduct anti-inflationary policies in line with the best. There are a number of routes through which these pressures will operate.

13. First, the creation of a single financial area and the abolition of exchange controls will intensify the discipline on monetary authorities to maintain stable currencies. Interest rates will react more sharply than at present to perceptions that the authorities in any one country may be pursuing more inflationary policies than those elsewhere. This and the wish of member states to ensure that their own currencies retain their value and attractiveness to users will increase the incentive to aim for price stability in line with the best performing country.

within the control of the ERM

? Stage 2/3

14. Secondly, the more intensive economic and monetary co-operation envisaged during Stage 1 will strengthen the political commitment, which underlies membership of the ERM, to convergence on price stability.

15. Thirdly, increased integration will bring with it greater mobility of labour and capital. As companies' and workers' location decisions will be influenced by the relative stability of prices in different Community economies, governments will have an incentive to minimise

inflation in order to attract economic activity and discourage emigration.

16. As rates of inflation are reduced and converge, so pressures for exchange rate changes should gradually diminish. This is turn will reduce uncertainty and encourage further integration of the European economy through trade and long-term capital flows. At the same time, improvements in payments mechanisms will simplify and reduce the cost of transactions.

17. The resulting progress towards economic and monetary union will therefore be achieved through the operation of the market - competition among national currencies - not through centralised direction. National authorities will retain their policy-making functions, enhanced by increased co-ordination. Thus the three principles of market forces, subsidiarity and stable prices will have been satisfied.

but will have - as always - to operate within market constraints ./.

Beyond Stage 1: the Delors Report

18. The Delors Report envisages that after Stage 1 changes will be brought about by administrative means. There will be a progressive transfer of responsibility for monetary and fiscal policies away from member states towards Community institutions. Monetary union would entail first irrevocably fixed exchange rates, and then a single European currency. The alleged benefits of this are not explained, but are presumably thought to be a reduction in transactions

historically changes were [illegible] necessary. "irrevocably fixed XR"

costs and exchange rate uncertainty. Responsibility for monetary and exchange rate policy would be transferred to a European System of Central Banks, which would be independent of both national governments and Community authorities.

19. Economic union would, according to the Delors Report, require enhanced structural and regional policies at Community level, and new powers for the Council of Ministers to impose constraints on national budgets. The former would entail increased flows of official finance to meet structural objectives and limit regional imbalances. In the budgetary field, the report envisages binding rules and procedures, including the imposition of constraints on national budgets.

20. The proposals in the Delors Report must be assessed against the three principles set out in section 1. In the **monetary** field the key issue is whether the primary objective of monetary policies in the Community - the achievement of stable prices - can best be achieved by implementing these policies at the Community level or at the level of member states.

21. The UK Government believes that, in general, a centralised European monetary policy, operated by an independent ESCB, will [would] be [likely to be] less successful in achieving stable prices than a system in which the responsibility for national monetary policies remains with member states. Independence of central banks is, on its own, no guarantee

No! (at least in the future)

of satisfactory inflation performance. And centralisation of monetary policy at the level of the Community removes an important source of disinflationary pressure: the competition between national currencies and monetary policies which occurs in a decentralised system. Given the objective of stable prices, the principles of subsidiarity and competition both point clearly to the desirability of individual member states retaining responsibility for their own monetary policies.

22. Any benefits from reduced transactions costs and exchange rate uncertainty of moving to a single currency are likely to be relatively small. As explained above, competition in the financial sector will anyway reduce transactions costs, and increasing exchange rate stability during Stage 1 will reduce uncertainty. Any remaining benefit from a single currency will be unimportant beside the major disadvantages of this form of monetary union.

23. There are constitutional and institutional as well as economic objections to the monetary arrangements proposed in the Delors Report. Handing over the responsibility for national monetary policies to an independent ESCB would entail an unacceptable transfer of power to the Community level. As envisaged in the Report, the ESCB would not be accountable to national parliaments, either directly or through national governments. Any accountability to the European Parliament that might be proposed would not be an adequate substitute for national Parliaments. The Community

Spell out 'the most important element of economic policy'

Spell out – ECSB would be less accountable than any existing central bank in practice – and this is welcomed by many of its proponents – it would only make sense if there were a parallel enhancement of the Community's political institutions so that – for example, the Community would be represented on the IMF etc.

not only of the ECSB but of a single Finance Minister has not yet reached the stage where the sort of political integration which is implied by a single monetary policy and possibly a single currency can be assumed to be inevitable.

24. The arguments against the centralised approach of the Delors Report are equally compelling for **budgetary and regions** policies.

25. Binding rules on the size of national budgets are neither necessary nor desirable. They are not necessary because:

- market forces will provide an incentive to keep deficits under control and converge on best practice. Governments with large deficits will have to borrow at higher interest rates and, in due course, raise more taxation to service the larger debt;

and this will happen very quickly if markets believe the policy to be unsustainable

- the multilateral surveillance arrangements to be developed under Stage 1 will provide early warning of unsustainable fiscal developments before the full market consequences are felt by member states, and identify cases where budgetary policies in particular member states have undesirable spill-over effects in the Community, adversely affecting other member states or undermining exchange rate stability.

So what will happen then? I would leave this out

- fixed exchange rate regimes have in the past operated successfully without such rules;

- the overwhelming majority of federal states do not see the need for rules.

26. Binding rules are not desirable because:

- they would entail an unacceptable loss of sovereignty by member states; budgetary policy is a central issue in national democratic processes;

overstated

- there is no agreed view about the role or effects of fiscal policy, so centrally devised devising rules would inevitably be controversial, difficult to monitor, and quite likely to have undesirable effects;

- they would encourage the development of misleading accounting devices aimed at avoiding the impact of the rules;

- majority voting would ensure that, once in place, they would be difficult to alter in the light of changing circumstances.

27. While binding rules for the size of budget deficits cannot be supported, the Community does have a common interest in discouraging the monetary financing of Budget deficits. An agreement which forbade such practices would increase the exposure of countries' budgetary policies to market pressures as well as making it easier to achieve and maintain price stability.

28. Turning to **structural and regional** policies, it is not the case that economic and monetary integration will have a negative impact on the poorer regions, as suggested in the Delors Report. A centralised approach anyway runs counter to the competitive approach underlying the development of the European single market. Interventionist policies by governments are notorious for creating structural problems rather than relieving them, as the experience of the 1960s and 1970s demonstrates only too clearly. Official transfers to poorer countries and to poorer regions within countries have not had much success in narrowing economic disparities and aiding balanced development. The risk of wasteful expenditure is much increased if market disciplines are largely absent. Official transfers tend to inhibit the process of adjustment and weaken the operation of market forces, exacerbating the problems they are designed to alleviate.

Beyond Stage 1: the Market Approach

29. The approach of the Delors Report to economic and monetary union is not consistent with the three principles set out at the beginning. This section discusses a market approach which is designed to meet these principles.

30. The starting point is Stage 1 in which competitive pressures will be bringing about a gradual convergence of performance and policies. The next step should be to further the process of convergence by strengthening the competitive pressures which will be driving it forward.

31. In the **monetary** sphere this can be done by removing unnecessary restrictions on the use of different Community currencies for transactions and in portfolios, and restrictions on financial services. Taking transactions first, it will be most important to tackle restrictions that bear on large transactions, and on the use of currencies by companies involved in intra-Community trade. Here the costs of operating in more than one currency are likely to be least, and the incentive to change the currency of operation greatest. But it would also be right to do as much as possible to remove restrictions affecting individuals. In some member countries, for example, there is at present a much wider range of choice of means of payment and financial instruments available to consumers than in others. [Add something on credit cards if useful material obtained from current work.]

32. Even after Stage 1 there will remain restrictions on the use of currencies as a medium of exchange or unit of account. In many Community countries there are laws that give a privileged position to the domestic currency as a medium for payment, or in which contracts can be made, or for drawing up accounts. [Expand when/if useful examples collected from posts.] These laws should be examined urgently to see whether the currencies of member states can be given equal status in each Community country. Parties to transactions should not be obliged to accept any Community currency. Governments will, for example, probably wish to continue to collect taxes in domestic currency. But the choice should be a matter for decision by the parties to the transaction, not laid down in law. ?

? Inland Revenue happy with this. I'm sure they need a right to insist on £ if necessary

33. More importantly, many national restrictions will remain after the end of Stage 1 on the use of different currencies in financial portfolios and transactions in financial services. These should be removed. What is involved here is a further step in financial liberalisation, going beyond what will have been achieved by the end of Stage 1.

34. Examples of the main restrictions of this type are:

(i) **restrictions on investments** held by long term savings institutions such as life assurance companies and pension funds. These are

But cf Netherlands & UK

frequently applied to both the currency and geographical location of assets. Some degree of regulation may be required to limit currency risks for prudential purposes (indeed for insurance companies this is required under European law) and Article 4 of the capital movements directive allows for such prudential supervision. But this Article also makes clear that it must not impede capital flows.

And UK's own [illegible]?

(ii) **tax incentives** for domestic investments which distort the free flow of capital. Member states should of course be free to tax financial services as they choose. But tax arrangements should not discriminate between domestic and overseas savings media.

(iii) important steps towards a **single financial area** have already been taken. But a great deal of further work is needed to realise the Delors Report's objective of banking, securities and insurance services being 'offered uniformly throughout the area', in particular: full implementation of directives so far agreed on capital liberalisation, banking, non-life assurance and unit trusts [This perhaps should be classified under Stage 1. We shall need to consider whether to retain or delete it when we have the full list of measures classified according to whether they could be defined within Stage 1 or not.]; rapid progress towards agreements for investment services and insurance [ditto]; consideration of new measures to promote harmonisation of conduct of business rules, compensation schemes, and to ensure open access to distribution channels for financial products from other member states.

35. Use of the ecu should be placed on the same footing as the twelve Community currencies which go to make up the basket of which it is constituted. The ecu could become increasingly used, as a thirteenth currency, competing alongside the other twelve. As each of these improves in quality, so too will the ecu. Meanwhile, the ecu itself could be made increasingly competitive by fixing the currency weights for all time, so that the stronger currencies would represent an increasing proportion of its value, as the others devalued.

36. Any restrictions imposed by Community central banks on the official use of their currencies should be removed. This should lead to the increasing use of different EMS currencies for exchange market intervention, and increased cross-holdings of EMS currencies in national reserves, including increased holdings of ecus. Over time this would make the operation of the ERM more symmetrical, and less centred than at present on a single key currency.

37. All these measures will help to enhance the market forces which will be imposing increasing pressure on member states to adopt sound monetary policies. No one currency will come to dominate the Community, although only a few are likely to be much used outside their home territories. As inflation rates move closer together, exchange rate stability will increase. Transactions costs will fall as competition leads to improvements in payments mechanisms. The system will therefore evolve into a form of monetary (currency) union with price stability and a number of readily interchangeable currencies . Because the evolution will be market-induced, there will be no risk that Europe will end up with the wrong system, as could happen with administratively imposed changes if future developments were not correctly foreseen.

38. Turning to **budgetary** policies, the market approach means that member states should remain free to set their own budget deficits, with market pressures ensuring that the results do not undermine monetary stability. The Community should support market forces in three ways. First, the multilateral surveillance arrangements established in Stage 1 will provide an additional mechanism for identifying unsustainable budgetary policies. Secondly, a Community-wide agreement not to engage in monetary financing of deficits will, through obliging governments to finance deficits from the integrated European capital market, strengthen market disciplines while promoting price stability. Thirdly, there should be no question of

alleviating excessive debt burdens by action at Community level, which would only serve to inhibit the operation of market forces and enlightened self interest.

39. **Regional and structural** disparities in the Community should be alleviated primarily through the operation of market forces. The strengthening of market mechanisms which is central to the achievement of economic union will enable poorer countries to exploit market advantages, such as their low costs, and hence to maximise rates of return and profitable investment opportunities and attract the flows of private capital required to finance them. This is the way to ensure catching up and the achievement of genuine and sustainable growth. It is the pattern observed historically in the great catching up processes - for example when the US caught up with and subsequently overtook Europe in the nineteenth century.

Conclusions

40. The market approach to economic and monetary union is based on the principles of price stability as the key objective, maximum reliance on market forces and subsidiarity. The developments envisaged under Stage 1 of the Delors Report are consistent with these principles. As a result there will be a market-induced convergence of economic performance and policies and a significant reduction in the transactions costs of the multicurrency system.

41. The Delors Report's proposals for later stages, however, depart from the principles by raising policy-making to the Community level when subsidiarity points to retaining national governments' competence, by threatening the price stability objective, and by limiting some of the scope for market forces to operate. By contrast, the market approach extends the role of market forces beyond that of Stage 1, promotes price stability, and ensures that policy is made at the level that is best both economically and politically.

(not case for ending national central banks)

(Imagine power of Gov of ESCB!)

Need to say in whole scheme that EMU — whether or not — would be a common currency; but single ... is ... (market wants to move towards single currency)

Are there (future) gains from single currency over and above single market to offset political costs? GTE etc?

Stage 3 major problem.
No need to decide now what follows
Step by step approach.
Probs with Delors. Political & economic
Fiscal dimension neither acceptable nor necessary
Regional also misguided
Monetary — heart of economic policy making — raises major political, political & economic (stability)
No institutional change (i.e. ESCB) required for progressively fixed currencies — only for single currency.
But if take decision now to extend stage 1 — take to logical conclusion. This will produce a EMU with many advantages: genuine interchangeability @ minimum cost
Pressure for price stability
Delors plan politically & democratically objectionable.
While strong case for no political control of CB, must be political accountability
And 'influence' of the Governors (1) & Finance Ministers (12) — crucial less pressure → stability

37/2 sjf.jf.7.11.10.89 CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: S J FLANAGAN
DATE: 11 October 1989
EXTN: 4340

PS/CHANCELLOR

cc PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mrs M E Brown
Mr O'Donnell
Miss O'Mara
Mrs Chaplin
Mr Tyrie

ECONOMIC AND MONETARY UNION: PAPER FOR ECOFIN

The Financial Secretary has seen the draft paper attached to Mr Wicks' minute of 3 October and the Chancellor's comments (your minute of 6 October). He suggests that 3 additional arguments could be injected:

(i) building on para 20. It has been suggested that less developed members will need to be compensated by resource transfers for giving up the possibility of currency adjustments to sustain domestic competitiveness. This is illogical. If exchange rate changes could bring economic growth it would be folly to move to a single currency. But if (as we are inclined to believe) nominal exchange rate adjustments cannot produce resource transfers to developing countries, they need no compensation for abandoning them;

(in 10D speech)

(ii) an ESCB board drawn from all member states would not have the same anti-inflationary stance as the Bundesbank has developed. So it would impose higher inflation on the states which currently have the lowest inflation (even though probably reducing inflation in high-inflation states);

(iii) the issue of "who get the seigneurage under a common currency" should be raised.

S J FLANAGAN
Private Secretary

006515
MDHIAN 7834

RESTRICTED
FRAME ECONOMIC
FM DUBLIN
TO IMMEDIATE FCO
TELNO 422
OF 291630Z SEPTEMBER 89
INFO IMMEDIATE UKREP BRUSSELS
INFO PRIORITY PARIS
INFO SAVING OTHER EC POSTS

YOUR TELNO 791 TO PARIS: EMU: STAGE 1 LEGAL TEXTS

SUMMARY

1. PRELIMINARY IRISH VIEWS GENERALLY AT ODDS WITH THOSE OF UK. MAIN IRISH CONCERN LACK OF EMPHASIS FOR SAFETY NET BUDGETARY MECHANISM TO ENSURE THAT UNION HOLD TOGETHER. NOT SEEKING A HANDOUT.

DETAIL

2. DEPARTMENT OF FINANCE CONTACT (COUNSELLOR EQUIVALENT) RESPONDED BY EMPHASISING THAT THE VIEWS EXPRESSED WERE PRELIMINARY ONES. HE BEGAN BY FIRST GIVING A GENERAL REACTION.

3. HE SAID THAT THE TEXT DID NOT LAY SUFFICIENT EMPHASIS ON THE COHESION DIMENSION, THE REDUCTION OF DISPARITIES AMONG THE REGIONS OF THE EC. THE IRISH RECOGNISE THAT THERE IS A COMMITMENT TO A DOUBLING OF THE STRUCTURAL FUNDS AND POSITIVE ELEMENTS IN COMPETITION POLICY IN STAGE 1 UP TO 1992 BUT BEYOND THAT NOTHING IS KNOWN. THEY WISH TO SEE A SAFETY NET BUDGETARY MECHANISM WHICH COULD IF NECESSARY BE USED TO PROVIDE ASSURANCE THAT THE BOND OF UNION WILL HOLD. HE EMPHASISED THAT IRELAND WA NOT JUST LOOKING FOR A HANDOUT. HE SAID ALL THEIR HISTORICAL EXPERIENCE OF ECONOMIC AND MONETARY UNION WITH THE UK SHOWED THAT ACTIVITIES AND RESOURCES GRAVITATED TOWARDS THE CENTRE.

4. ON NEGATIVE ASPECTS OF COHESION HE SAID THAT WHATEVER THE RULES THAT ARE DEVISED THE IRISH FEAR A MECHANISTIC APPROACH. THEY BELIEVE THAT ACCOUNT SHOULD BE TAKEN OF WHAT LIES BEHIND A COUNTRY'S ECONOMIC FIGURES.

5. ON POSITIVE ASPECTS OF COHESION THEY BELIEVE THERE SHOULD BE SOME REGULAR BASIS FOR MONITORING HOW OTHER POLICIES SUCH AS THE STRUCTURAL FUNDS AND CAP ARE CONTRIBUTING TO COHESION.

006515
MDHIAN 7834

ON SPECIFIC POINTS HE GAVE IRISH VIEWS AS FOLOWS:

YOUR PARA 4(I)

IN HIS PERSONAL VIEW THE IRISH ARE INCLINED TO GO FOR MUTUALITY IN DECISION MAKING AND HE BELIEVED THAT A BINDING COMMITMENT WAS BETTER ESPECIALLY WHERE POLITICIANS WERE CONCERNED.

PARA 4(2)

IRISH WOULD PREFER TO SEE CENTRAL BANK AUTONOMY VUT WOULD NOT DENY ECOFIN A ROLE IN MONETARY POLICY. THERE SHOULD BE SOME DEMOCRATIC CONTROL ON THE BANK AND SOME ROLE FOR THE COUNCIL BUT IT SHOULD NOT BE IMPOSED.

PARA 4(3)

IRISH THINK THERE HAS TO BE SOME PROVISION TO DEAL WITH EXTRAORDINARY EXTERNAL EVENTS BUT THE VIEW IS NOT STRONGLY HELD AND THEY WOULD TEND TO GO ALONG WITH THE MAJORITY ON THIS, PERHAPS ADDING ''IF NECESSARY'' TO THE TEXT TO ACCOMMODATE THE UK VIEW.

PARA 4(4)

THEY SEE SOME CONFLICT BETWEEN THE TERMS OF ARTICLE 8 AND ARTICLE 2(A) OF THE DRAFT COUNCIL DECISION AMENDING COUNCIL DECISION OF 8 MAY 1964 WHICH WOULD NEED TO BE RECONCILED. THE IRISH VIEW IS THAT THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS SHOULD BE REQUIRED TO ATTEND COUNCIL MEETINGS. A SOLUTION MIGHT BE TO HAVE THE SURVEILLANCE MEETING INFORMAL.

7. ON THE ROLE OF EPC THEY DO NOT FIND THE PROPOSAL ACCEPTABLE. THEY THINK THAT EPC SHOULD HAVE A STRONGER ROLE. IT SHOULD PERHAPS HAVE A DIVIDED ROLE WITH THE MONETARY COMMITTEE ON SURVEILLANCE OF NOMINAL CONVERGENCE. THEY ACCEPT THAT THERE COULD BE A PROBLEM ON HOW THIS WOULD WORK IN PRACTICE BUT EPC SHOULD HAVE SOME ROLE. EPC HOWEVER SHOULD HAVE A SIGNIFICANT ROLE ON SURVEILLANCE OF REAL CONVERGENCE.

8. AS FOR ARTICLE 3 THEY ARE NOT INCLINED TO AGREE.

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FROM: A G TYRIE

DATE: 29 September 1989

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Peretz
Mr Odling-Smee
Mrs Chaplin
Mr Lightfoot

CHANCELLOR

Thanks. Re para 6, 1st qn. yes 2nd qn. no.

SIR FRED CATHERWOOD'S PAPER ON EMU

The EDG are publishing the attached paper by Sir Fred Catherwood on EMU. I understand it is timed to come out next Thursday just before the Party Conference. Of course, it is pretty embarrassing for us in parts, supporting not only immediate membership of the ERM but also monetary union.

2. I have flipped through it and found some annoying lines which include:

> "We in Britain are running a balance of payments current account deficit of about £18 billion a year. An element of this deficit may arise from some over-optimism in last year's budget, but the biggest single cause is the sharp fall in our manufacturing performance relative to that of our main international competitors" (page 9).

> "The urgent need to lower interest rates and break the wage price spiral" (page 10).

> "The balance of trade is the particular constraint which has most often throttled Britain's expansion and, without membership of European Monetary Union, is likely to throttle it again" (page 13).

> "If the Community is not to be unduly dependent on monetary policy, then it needs some fiscal lever ..." (page 16).

"Now we are faced with the job of recovering that lost industrial output and covering a trade deficit which will exhaust the reserves built up from the oil revenue in little over two years" (page 17).

3. I am told that this has gone to the printers and it is too late to offer amendments. In any case, the bureaucratic and diplomatic hassle of getting the EDG to see sense would probably make that not worth while.

4. It is quite possible that this document will, in any case, sink without trace. I think there are two precautionary measures open to us:

- We could ask Christopher Prout (Leader of the EDG) to get Sir Fred Catherwood to delay publication of this until after the Party Conference.

- We could ask him, the EDG generally, and Sir Fred Catherwood in particular, to make it absolutely clear that this is a document representing the views of Sir Fred Catherwood and not the EDG or the Party.

5. I favour the latter course. Any attempt to muzzle this document will probably end up in the press anyway and might be a bigger story than anything a journalist got from reading it.

6. Are you happy for me to convey the message to Prout that this document has to be billed as a solo effort from Catherwood? Do you want No 10 alerted?

RJ.

pp A G TYRIE

Conservatives in the
European Parliament

EUROPE'S NEED, BRITAIN'S OPPORTUNIY:

Economic and Monetary Union

by Sir Fred Catherwood MEP

OFC + 1

BLANK

Contents

for Cambridgeshire and Bedfordshire North

The Author

Sir Fred Catherwood, elected as MEP in 1979, is Vice-President of the European Parliament, having served as Chairman of the Parliament's Committee on External Economic Relations for 5 years and as Deputy Leader of the Conservative Group for 4 years. Last year he was the Parliament's Rapporteur on the institutional consequences of 1992.

Before being elected as an MEP he was Chairman of the British Overseas Trade Board , 1975-79, and has also been Director General of the National Economic Development Council for 5 years.

As an industrialist he spent 12 years as Chief Executive of major British companies. ~~and [illegible] Management~~

This pamphlet expresses the personal views of the author, and commits neither the Conservative party nor the Conservatives in the European Parliament.

Further copies of this pamphlet may be obtained from the offices of the European Democratic Group at 2 Queen Anne's Gate, London SW1H 9AA.

INTRODUCTION

Soldiers, unlike politicians, always begin by asking 'what is the object of the exercise?' This pamphlet tries to answer the question 'what is the object of European Monetary Union?' First it gives the five major common objectives of the twelve member states and then five *additional* reasons for british membership. If these additional British reasons are valid – and readers must judge for themselves – then there are strong Conservative Party reasons for an early commitment by the Government. The British Government *is* committed, with all the others, to 'Monetary Union'. What is at issue is the *form* of that Union and the *pace*.

The key document is the Delors Report which was considered by the Europeam Council (Heads of Government) in Madrid at the end of June. That report was signed by the Governors/Chairmen of the twelve national bansk. It is therefore a banker's report, not a political report, and reflects the firm desire of central bankers for the strongest and most stable currency system as soon as possible – indeed they prepared a timetable. But since Conservatives also want a strong and stable currency the report is none the worse for that. That first natural and pragmatic reaction of the British Government was to see how Stage One went before we were too committed to Stage Two, let alone Stage Three. But this pamphlet argues that time is not on our side.

THE EUROPEAN COMMUNITY ARGUMENTS FOR A STRONGER MONETARY SYSTEM

1. Building on success

The European Monetary System has served our partners well and they want to build on its success. Seven of them, West Germany, France, the three Benelux countries, Denmark and Ireland, have now had ten years experience of full membership of the EMS. To beging with there were some quite heavy adjustments in the exchange rates, especially between the DMark and the French Franc, but as time has gone on, the adjustments have been smaller and less frequent. By contrast the dollar soared to giddy heights and then plunged to the depths and recently has shown marked fluctuations. Throughout this see-saw of the world's most powerful currency, the EMS currencies have remained stable in their relation to each other, so that the majority of the export trade of each country has been carried on a secure basis.

The EMS has also exercised a very salutary external discipline on countries which were previously inflation prone and have trades union movements which are quite as tough and awkward as our own. In each of the seven countries, the rate of inflation is now less than the British rate and the interest rates are lower.

In the early eighties, when the new Socialist government of France had to decide between socialist expenditure and the disciplines of the EMS, it chose the EMS. Under the long Conservative-led coalition of Poul Schluter, Denmark has at last brought its expenditure under control. More remarkable, the Irish government, whose recent high spending included the building of an international airport in the bogs of Connemara, has also brought its expenditure under control and restrained the demands of the unions. So all our partners believe that they are building on a system which has evidently worked and helped them to achieve increased currency stability and economic discipline, despite the currency choas elsewhere.

2. 1992 needs a much stronger currency system

Our Partners believe that with the free movement of currency coming by 1991 and completely free movement of goods and services due by the end of 1992, it is absolutely necessary to strengthen the present EMS. We all accept that the free movement of goods in a market of 320 million will, in the long run, bring greater economic benefits and increased employment. But, in the short run, with the uneven spread of up to date industrial capacity, some coountries will have trade deficits. And, as we in Britain know all too well, trade deficits can lead to large and sudden movements of currencies at the touch of an electronic button and these currency crises are traditionally met by severely restrictive national measures.

Our partners do not believe that it is possible to have twelve national governments defending twelve different currencies with the help of twelve separate national reserves against the movement of billions of their currency. Without a much stronger European system to protect them, the national defensive measures needed would unravel the whole structure of the single European market. They do not think that they can sit back and see whether free movement of currency is possible without disaster. They are absolutely committed to making a success of the single European market and therefore to agreing in good time on a currency system which will be strong enough to contain all the pressures.

These pressures will be considerable. Not only must the new system be able to include Spain, Greece and Portugal as well as Britain, but the Italian lira – currently operating on a loose rein, with a 6% margin – will have to tighten towards the margin limit of 2.25% in the core seven countries. Above all, if sterling is to come in, its link to the dollar and its widespread holding will require a much stronger system.

So our partners believe that we need a Community-wide central banking system which, at the very least, is empowered to come to the aid of any currency under pressure as promptly as a country's own reserve bank. They also believe that we need a greater proportion of national reserves available to the central system to protect its currencies and that the support should be available to the country needing it for a longer period. ~~The strongest~~ A very strong argument against ~~sterling's~~ sterling's full membership of the existing EMS is that it could not give adequate backup when the sterling rate came under strain. The stronger system would meet this valid argument.

?

3. The need to replace the discipline of the DMark with a European-based discipline

The present EMS is dominated by the DMark and therefore by the policy of the Bundesbank. It is too close to a DMark zone for the total comfort of the other members. Of course a DMark zone has its benefits. The discipline of the Bundesbank is at the very heart of the system. The DMark represents ~~35%~~ of the ecu and the German trade surplus keeps the
30%
European Community in trading balance with the rest of the world.

The Germans are also a disciplined nation whose past experience gives strong support to sound currency policy. But, above all, the German federal constitution gives the Bundesbank the same independence from the German Federal Government as the other federal institutions. Its board is appointed by the Landesbanks and is responsible to them rather than to the federal government. So the Chairman of the Bundesbank is in a much more independent position than the Governors of the Banks of England, France or Italy. That independence has greatly helped to keep inflation under strict control in the German Federal Republic.

But, as the others point out, the prime responsibility of the Bundesbank is the DMark and not the European Community. And, they say, the DMark, being a widely-held international currency is subject to all the international pressures of the dollar, but unlike the dollar it does not have the continental breadth of market which makes it much easier for the dollar to absorb currency shocks than the DMark. So, to avoid external shocks, the Bundesbank has to run a much more conservative domestic policy than would be needed in a continental currency system.

But, since the independence of the Bundesbank is seen to be critical to the discipline of the linked European currencies, no one wants to lose that independence in a European Monetary Union. That is why the twelve central bank governors who signed the Delors Report insisted that a central banking system for the Community had to have the same independence. That independence is vital not only for German agreement, but for that of all other Governors of Central Banks. There is no doubt that they see the new system giving them a power of discipline which they do not have at present.

So they want a Community-wide currency system with a discipline which is just as effective in safeguarding the value of the currency, but economically more appropriate and politically more defensible. And though the Bundesbank may be content with a DMark zone, the German government sees the need for change.

4. The power to put European currencies on level terms with the yen and the dollar

To those who deal in them, currencies are tools of greater or lesser use. the lower the margin between buying and selling, the greater the usefulness.

Whatever the fluctuations of the dollar, it has the great advantage of being the world's most widely traded currency and therefore the cheapest currency in which to deal. No single European currency is in the same league. So international trade in oil and farm products is in dollars and a good many countries tie their currencies to the dollar and inside this dollar-dominated trade, its instability does not matter.

The dominance of the dollar would not matter if the United States operated its key currency, as it did until the early seventies, as a stabiliser for the international system. But, since President Nixon floated the dollar, the world monetary system has been unstable and internal American politics have dominated the US policy on the dollar at considerable cost to the rest of the world in general and to the Community in particular.

It is this sense of impotence in that face of the power of an American currency policy geared to domestic politics which drives our leading partners to put in place a combined currency system. This would make it much cheaper to deal in European currency. That in turn would encourage European savings to remain in Europe and would attract savings from elsewhere and materially improve the ability of European banks to attract deposits.

Given a European monetary union which eliminated exchange rate risks within the Community, Europe would, above all, begin to have the same power interests in international monetary negotiations which we already have in international trade negotiations. To those entrusted with those vital interests, that seems a very big prize.

not a good analogy eg. EC abuse of 'dumping' rules.

5. The ending of the high and needless cost of money-changing

Last but not least, there is the mundane but very substantial prize of removing the cost of currency transactions between the Member States, which is especially important for smaller transactions and for smaller companies.

(This does not, incidentally, need a single European currency. Until ten years ago there were three different currencies in the British Isles, all freely interchangeable at no cost, the Irish Pound, the Scottish Pound and the English Pound. Even now there are still two which are freely and fully interchangeable, the Englush and Scottish Pounds).

It is said that a traveller who started from Heathrow with a thousand pounds and flew round Europe changing money in every Community country, would come back wih only six hundred pounds. It is also estimated that the currency cost of exports to small companies is ten times the cost to the multi-nationals, who offset sales against purchases and can command the finest rates for the money they do have to change. But perhaps the biggest cost is uncertainty facing any company making an investment for exports. The calculation depends on an estimate of export revenue, which, in turn depends on a forecast of exchange rates. ~~the~~ The greater the uncertainty,

4

the greater the cost of the investment.

Our community partners believe that it is unrealistic to remove tariff and other barriers to trade while keeping the cost of currency transactions and the expensive risk of changes in rates. Both industry and politicians believe that one market needs, as nearly as possible, one currency.

WHY BRITAIN, ABOVE ALL, NEEDS MONETARY UNION

All the arguments which hold for the rest of the Community also hold for Britain. But *in addition* we in Britain have special needs which can only be met by monetary union.

1. The urgent need to remove the current instability which curbs investment and growth.

payments current account

We in Britain are ~~currently~~ running a balance of ~~trade~~ deficit of about £18bn a year. An element of this deficit may arise from some over-optimism in last year's budget, but the biggest single cause is the sharp fall in our manufacturing performance relative to that of our main international competitors. Before oil forced the pound up so sharply in the early eighties, our share of world trade in manufactures had recovered to 9.7 per cent. It had risen steadily ~~through the late seventies~~ as British industry began investing in new product to take advantage of our membership of the European Community. But by 1984 it had plunged to 7.6 per cent, a drop in British industrial performance of 22 per cent. The skilful alignment of the pound with the fall in the dollar in the mid-eighties restored a competitive currency without any rise in imported inflation and last year British share of trade in manufactures was back to 8.2 per cent – but still 15 per cent below the 9.7 per cent benchmark. So, to get back to ~~where we were ten years ago~~, we still need an increase in British volume of competitive industrial output of over 18 per cent above the normal annual growth.

This kind of increase is not impossible. We have a much smaller share of the Community intertrade in manufactures than our major Community partners. 18 per cent would only bring us half way to the present French share – and parity with the French is not an unrealistic aim. There is a huge market to go for; but we need more capacity – and more incentive to invest in it – to make the new products needed for the markets of the nineties. A wise old Dutch merchant one observed, 'You British are the most inventive people in the world, but you do not invest in your own inventions.' The Government has done a great deal in reducing direct taxes, but two strong disincentives remain: exchange rate risks and high interest rates.

There is already a groundswell of industrial investment. The figures are good – but the trade deficit shows that there is still a huge shortfall and it will not be made up without a much more stable exchange rate between Britain and the rest of the European Community, our biggest and most secure market.

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Every investment decision rests on exchange rate assumptions. The less secure these assumptions, the greater the exchange rate risk. The gyrating exchange rates of the '80s have given no security, an added reason why we have had a totally inadequate investment in new products. The pound went up from 3.85 DMarks in '78 and '79 to 5.07 DMarks in February '81, came back to a fairly stable 3.80 in '83 and '84, then dropped to 2.74 in February '87, rising again to 3.25 in January '89 before falling back recently to just over 3 DMarks. That represents a swing between high and low points of over 70 per cent. How can any industrialist estimate export revenue with fluctuations like that? Every time it makes an investment decision, British industry has to bear currency risks never even dreamt of by its European competitors.

2. The urgent need to lower interest rates and break the wage-price spiral. Inflationary expectations now seem to be built into both interest rates and wage awards.

Even before last year's steep rise in interest rates, one small businessman said, 'How can I hold my market against my Dutch competitors when, with half the cost of interest, they can afford to put down twice as much new investment as I can?' The difference in interest rates is mainly accounted for by the view which lenders take of the likely inflation rate in each country.

After ten years of strenuous effort, we face once more the problem of high inflation. The EMS has clearly dumped the inflationary expectations of the currencies of those EMS members who are firmly linked to the DMark, but these expectations are still built into British interest rates and wage awards.

In view of all the Government's efforts we may think this unfair, but Sterling has lost over nine-tenths of its internal purchasing power since 1957 and indeed half of its purchasing power ~~in the last two years.~~

No British government had done more than the present one to use the powers available to counter inflation. When, by 1986, with great skill and determination, the government had managed to bring inflation down below 4 per cent and, without side-effects, given industry a really competitive rate for the pound, some of us hoped to see a sharp drop in the inflation rate built into wage awards. But increases in annual earnings remained around 8 per cent. When we protested to the negotiators and to the big companies who had led the way that they had neglected a one-off opportunity to break the wage-price spiral, it was clear that, in wage negotiations as with interest rates, sterling was still seen as an inherently inflationary currency and that government was expected to adjust its policies to the 'realities' of the labour market.

That seemed a pessimistic view at the time, but three years later there is a real danger that 9 per cent to 10 per cent will become the norm for increases in earnings and that, after ten years of supreme effort, we will once more be firmly back on the old wage-price spiral, each year's rise being passed on in prices to become the base for next year's awards.

Traditionally governments have adapted to inflation by devaluation, often aided by a credit squeeze, and let the financial markets find a new balance between wages, currency and trade. But that tradition assumes a discipline on wage negotiations which does not now exist.

For a time in the early eighties, inflation, though still excessive, was reduced by the hard pound, which lowered the cost of imports. In the mid-eighties it was reduced by exceptionally rapid growth which, at peak, offset much of the rising cost of industrial earnings (though not those in the public services). But the recent trade deficit has slowed growth. So we are left with inflation (including interest rates) at per cent, wage settlements at 7 9 per cent and rising and base interest rates at 14 per cent. As we pass the anniversary of the big rise in interest rates, they longer affect the no annual rise in the RPI and there is a hope that, this falls, wage settlements as will also fall. But since they did not fall when the inflation rate was 3.8 per will cent, it is hard to be optimistic.

The Government have made lower inflation a condition of fixing the pound in the EMS. But Community experience is that it is *only* the fixing of the national currency to the EMS which can reduce inflationary expectations. which can

Since the French, the Danes, the Irish and the Dutch have fixed their currencies to the EMS, their inflation rates have come down. Their interest rates and inflation rates are now all *lower* than ours. That is hardly surprising, since they are paying wages and interest rates in currencies fixed by international agreement to the DMark. If, even in the present EMS, workers and investors regard their currencies as equivalent to DMarks, how much more in a full European Monetary Union.

In order to remove inflationary expectations, the British Government needs to change the popular expectations to a degree which only its acceptance of this international commitment can inspire. It is argued that to join the EMS next year as stage one of the European Monetary Union is too high a risk unless our inflation rate has come down by then. But if EMS membership reduced inflation for so many of our partners, surely membership should give us similar help.

We have, of course, had ten years longer to develop inflationary expectations, but we have two bonuses which the others did not have. First, they did not know it would work and we now have the benefit of their experience. Second, it worked for them with the much weaker EMS, and we should have the benefit of a very much stronger system.

Their system is tried and works. Why wait until national measures work when they have not done so in the past? If inflationary expectations were not changed by the national measures leading up to 1986, how will they be changed in much more difficult conditions now? Surely the lesser risk is to follow the tried path taken by our Community partners, knowing that the commitment to a stronger system will give us any added help we may need.

3. The need for a continued and credible external currency discipline

A one-off decision to link the pound is not, of course, enough. The merit of a European Monetary Union with an independent banking system is that it is a continued external discipline. It is no longer open to governments to take the easy option of currency devaluatin, fear of which has destabilised trade and development since the Americans floated the dollar in the early seventies. In the fifties and sixties, the Bretton Woods system, supported by the dollar as a key currency provided the discipline for the great economic expansion for nearly three decades after the war. The great era of growth up to the First World War was based on the discipline of the fixed gold system. The experience of the last two decades has surely shown us that we need *external* discipline. If a government which has made the fight against inflation its first priority is still faced with [illegible]% inflation after ten years in office, then clearly the internal national discipline adopted by the Government is not enough and one is entitled to ask what politically acceptable internal discipline *would* be enough. 7

We may still ask whether the external discipline would be credible to wage negotiators and lenders. It is not easy before a currency reform to believe that the pressures which companies face now would suddenly disappear. But, as most wage negotiators know, the strongest pressure comes not from greed – though there is no doubt some of that too – but from fear of being left behind. The higher the rate of inflation, the greater the panic. The Danish, Dutch and French trades unions are just as tough as ours and bargain just as fiercely, but being paid in wages linked to the DMark has reduced the pressure and they now settle for a lot less in money terms than they did and inflation is less as a result.

4. The urgent need to break the stranglehold of the external trade deficit on our industrial expansion

European Monetary Union lessens the absolute balance of payments constraint on the growth of each Member State. If productive capacity is rising in Britain, as it is, then aggregate demand can be allowed to rise with it. This is regardless of whether or not we have a temporary deficit in our trade, caused by a temporarily high proportion of external supply for our aggregate demand. Indeed it is greatly in the interests of the whole Community that countries which can expand should do so, since that helps the growth of all the Member States. ?

Without monetary union, it is left to each Member State to finance a trade deficit by raising interest rates to attract enough hard currency to cover it.

12.

The increased interest rates discourage consumption and curb imports until the trade deficit is corrected, but this may take a long time and meantime the investment which is needed to expand the economy again is also discouraged and output is depressed. This produced the chronic 'stop-go' cycle from which Britain suffered for so long and from which we are beginning to suffer again now that the oil revenue can no longer finance the deficit in our other trade.

If our balance of payments constraint is not removed, it is hard to see how we can easily buiold up the extra industrial capacity we need to give Britain the share of Community and international trade proportionate to our size. Left to ourselves, it could only be done by a tighter and more prolonged squeeze on consumption, both public and private, than is likely from any government which has to face re-election.

But, looked at in Community terms, the large German trade surplus enables other countries to use imported capital to expand their industrial capacity. It makes sense for the Community to build up its collective industrial capacity as strongly as it can in order to compete in world markets with America, Japan and the 'Newly Industrialised Countries'. There is still a constraint, but it is much less at the wider Community level. Under that umbrella we can develop more strongly than if we were each boxed in by our national balance of trade. And the country to benefit most – because we have the biggest deficit – is Britain.

There are, of course, other limi~~ted~~s to growth. We all know of the ecological limits and the supply of skilled workers is another important limit. Economies do overheat – though, the capacity to meet demand from any part of the Community limits the overheating in any particular area. But, since the last war, the balance of trade is the particular constraint which has most often throttled Britain's expansion and, without membership of European Monetary Union, is likely to throttle it again. N

5. To protect the City of London and its vital contribution to the British economy

If European Monetary Union includes the pound sterling, then the incomparable range of services of the City of London will play a key part in European financial markets. It can hardly be otherwise, since London has played a leading role in the development of sophisticated capital markets and especially of international markets. Sterling was, during most of the development period, the key currency. Even when the dollar took over as the key currency, London played a lead role in the development of the Euro-dollar market and, since then, it has been the natural home of international banking, insurance and other financial services. Skills like this are not easily built and trust in financial institutions takes time; so London has all the built-in advantages.

If, however, European Monetary Union goes ahead, but sterling is left out ~~lef tout~~, then the City of London has very different financial prospects. There would be doubts about the rates between sterling and each of the three financial super-currencies, the Dollar, the Ecu and the Yen. Each would be a continental currency with a broad base and these three would be the main means of international transactions, covering most of world trade between them and would be the main deposits for free world savings. New York would still be the natural trading centre for the Dollar, Tokyo for the Yen and Frankfurt would absorb that role for the EMU currencies. It could hardly be otherwise.

?

Sterling would then be marginalised and those banks and dealers whose main deposits and loans were sterling-based would be at arms length from those which were Ecu, Yen and Dollar-based. Of course banks can go into foreign markets and trade in a currency other than that of their own equity and deposit base, but if there are exchange rate fluctuations between the two currencies and especially if their base is in a weak currency, they are at a severe disadvantage.

Quite apart from the City's foreign currency earnings, that would be a blow to the British economy. The early eighties showed how easy it was for a prime currency like the dollar to trawl the world for deposits, how hard it was for Europeans to compete. European Monetary Union aims to trade on even terms, to attract deposits as easily as the dollar. So we would not only be in competition with a very attractive currency across the Atlantic, we would have a new and even more attractive currency right on our doorstep. If we suffered from stop-go when we had a genuine international currency, what would it be like if we had a marginal currency? Bankers and banks can ease the pain by moving to Frankfurt, but the British economy cannot move with them.

POLITICAL URGENCY OF THESE ARGUMENTS

Conservative tradition is naturally and rightly sceptical of major and irreversible change. We know that change produces all kinds of new problems which the brightest brains had never thought of. We are also rightly defensive of British interests and sovereignty and for all these reasons we have preferred to be followers rather than leaders in the movement towards a European monetary system.

On the other hand, we have given anti-inflation policies our highest priority and we do not want to go to the country in two years time with inflation not under control. If national measures alone are not enough, then the link to the EMS, which has always been part of Government's strategy, is necessary well before the election.

Before then, Government has to show that it has a credible strategy which not only deals with inflation, but can bring down interest rates, maintain confidence in sterling and encourage industrial investment. That strategy at present includes a commitment to stage one of the process towards

European Monetary Union. But if we do not take up that commitment – and look as if we mean it – we will cast doubt on our whole economic strategy and it will be hard to maintain the business and financial confidence we need. If our partners then go on without us, it will be almost impossible.

We have more at stake than the election itself. If the economy seemed to be failing at the same time, then all that has been achieved in the last ten years would be at risk and political recovery far more difficult.

How much better, if we believe that a strong European currency system is a key to our future and Europe's, that we should go forward with enthusiasm. The case is powerful and we should put it powerfully. You do not get re-elected if the electorate think that you do not really believe in a key part of your platform.

And if we do take it up with enthusiasm, we will have much more influence in the key debates on the kind of monetary system Europe needs. Those debates have already started; we need to be a lead player.

ISSUES IN THE EUROPEAN DEBATE

The need for a stronger system gives a very powerful incentive to solve the considerable problems which remain. Of those which have emerged from the debate in the Delors Committee, there are two crucial political decisions to be made. The third issue, more muted but very real for each country, is sovereignty.

1. Political accountability of an independent banking system

The Delors Report insists that the European banking system be independent. Not only does the Bundesbank insist, but all the central bankers who signed the report want to ensure that the system has the same independence as the Bundesbank. They see the subservience of central banks to national governments as one of the main causes of inflation.

On the other hand, democrats do not like anyone to hold power without being accountable. Those who appoint them have to be accountable for the appointment and though their decisions have to be independent, they should account for those decisions to an elected body.

So the argument between the tighter and the looser system will turn on the method of aappointment and accountability of those who run it.

2. The balance between fiscal and monetary policy

The second major argument will centre on the kind of collective fiscal policy needed to balance the collective monetary policy of the central banking system. The Delors Report calls for an Economic Council which would aim at convergence of economic policy. There are strong reasons for this *process* – the argument is about the exact instrument. It is estimated that convergence of economic policy can give increases in economic growth as great as anything else in the 1992 package and it is also necessary to the success of the package. The questions are first, whether the process needs to be institutionalised, adding another council with some powers and second, to what extent it need affect fiscal powers at national level.

If the Community is not to be unduly dependent on monetary policy, then it needs some fiscal lever, but it should be quite clear that any powers should be strictly limited to what is needed to make the best use of Community resources. All that is needed at European level is a power of marginal adjustment to make sure that those economies which have a margin for expansion use it, allowing those who have to retrench to do so without slowiøng the growth of the whole Community.

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But if the Community needs fiscal powers for helpful marginal adjustment, it has to remember that fiscal policy, the power to shift resources within the national economy, is a vital political instrument which no government could or would give up.

3. The issue of sovereignty

It is a central policy of the Community that all political decisions should be made as close to the voter as possible. Therefore nothing should be done at Community level where it could as well be done at national or local level. European Monetary Union should aim to pool national sovereignty just so far as is needed to give the Community the collective power which not even the strongest state could exercise alone.

The question which each Member State will be asking is whether the form of European Monetary Union proposed goes along with these guidelines. It has been proposed that an inter-governmental conference be called to look at the best way of balancing our separate and collective needs.

The stakes are high, and especially high for Britain. European Monetary Union could recover for us real and necessary powers which no British government has been able to exercise in the national interest for half a century.

Ever since the war, when we lost financial resources which we have never since regained, some foreign body has had powers over Britain's currency. Attlee was absolutely dependent on President Truman to rescue us from financial disaster in 1947. In 1956 the Americans used the financial powers to force us to withdraw from Suez and the latest biography of Harold Macmillan shows just how dependent he was on the Americans, as was Alec Douglas Home. The dependence of the first and second Wilson governments on President Johnson is well-known and George Brown used to rail at the 'Gnomes of Zurich.' In the mid-seventies Denis Healey had to turn his car round at London Airport and come back to call in the IMF to save us from financial disaster.

All our notional sovereignty could not save us from the market pressures forces which forced the pound up in the early eighties. Despite the great damage this did to our industry (damage with which we are still living) and the resultant huge increase of unemployment, we were impotent to act to save ourselves.

Now we are faced with the job of recovering that lost industrial output and covering a trade deficit which will exhaust the reserves built up from the oil revenue in little over two years.

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Sovereignty is a legal power to be used in the way which serves British interests best. The best use of British monetary sovereignty is to join it with the sovereignty of our European partners so that together we can look after the collective interests which we are impotent to safeguard separately. That will be their aim too.

APPENDIX

~~*Note on the Collection of Papers attached to the Delors Report.*~~

~~The Delors Report, like any collective document, was a compromise, so it is interesting to look through the collection of papers attached to see what points the members had in common and on what they differed. The papers also show the state of the debate to date among the Community's central bankers and the agenda for the continuing and much wider debate.~~

~~For the central bankers, the overwhelming issue is the preservation of the value of their currencies. The central question is whether a new system is needed and, if so, how the new system can best guarantee to maintain the value of the Community's money, how, in particular, it can exercise monetary discipline on national governments.~~

~~They all consider that the present EMS has done a surprisingly good job during its ten-year life, especially after the teething troubles of the first four years. They admire the way in which the need to kep exchange rates in line among the seven full members has . . .~~

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

2 October 1989

James Cornford Esq
Director
Institute for Public Policy
Research
18 Buckingham Gate
LONDON
SW1E 6LB

mp

Dear Mr Cornford.

The Chancellor has asked me to thank you for your letter of 27 September enclosing a report on Britain and the EMS by Gavyn Davies. He read this with interest.

Yours sincerely.
Duncan Sparkes

DUNCAN SPARKES
Assistant Private Secretary

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(FRAME ECONOMIC)
YOUR TELNO 791 TO PARIS: EMU : STAGE ONE LEGAL TEXTS

SUMMARY

1. WITH SARCINELLI IN THE CHAIR OF THE MONETARY COMMITTEE, THE ITALIANS WILL BE LOOKING FOR CONSENSUS RATHER THAN SETTING SPECIFIC OBJECTIVES OF THEIR OWN. IN GENERAL, THEY WOULD:

(I) WELCOME BINDING COMMITMENTS, PROVIDED THESE ARE MUTUALLY AGREED, NOT IMPOSED,

(II) FAVOUR THE PARTICIPATION OF CENTRAL BANK GOVERNORS IN ECFIN MEETINGS, BUT THEY SEE THIS AS PRIMARILY A GERMAN PROBLEM,

(III) FAVOUR RESPECTING NATIONAL INSTITUTIONAL ARRANGEMENTS AS REGARDS PARTICIPATION OF CENTRAL BANKS IN DECISION-TAKING.

DETAIL

2. THE MOST FRUITFUL LEVEL OF APPROACH IN ROME WAS SARCINELLI, AS CHAIRMAN AND ITALIAN REPRESENTATIVE ON THE MONETARY COMMITTEE. I THEREFORE ARRANGED AN APPOINTMENT WITH HIM FOR THIS MORNING. IN THE EVENT, THIS WAS PREEMPTED BY CARLI, WHO SUMMONED ME AT SHORT NOTICE FOR AN INTRODUCTORY AND FAREWELL CALL. WHEN I ARRIVED IN HIS OFFICE, HE CALLED IN SARCINELLI AND ENTERED WITH CHARACTERISTIC VIGOUR INTO THE DISCUSSION OF STAGE ONE. WHAT FOLLOWS THEREFORE REFLECTS CARLI'S VIEWS AS WELL AS SARCINELLI'S.

3. THE ITALIANS WOULD HAVE NO OBJECTION TO THE REFERENCE TO 'MUTUAL COMMITMENTS ON DECISION-MAKING' IN THE FINAL CITATION (PARA 4 (I) OF TUR) PROVIDED THIS MEANS MUTUALLY AGREED COMMITMENTS, NOT IMPOSED ONES. THEY HAVE NO PROBLEM WITH THE CONCEPT OF 'BINDING COMMITMENTS' (IF THIS IS WHAT IS IMPLIED HERE) FOR THE TRADITIONAL ITALIAN REASON THAT CONSTRAINTS THAT ARE INTRINSICALLY NECESSARY CAN BE MORE EASILY ACCEPTED WITH A EUROPEAN LABEL FROM OUTSIDE THE ITALIAN POLITICAL SYSTEM THAN GENERATED FROM WITHIN IT.

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4. ON THE PROVISION CONTAINED IN ARTICLE 5 FOR REVIEWING BUDGET POLICIES AS PART OF THE NEW SURVEILLANCE PROCESS (PARA 4 (II) OF TUR), CARLI COMMENTED THAT THIS WAS NOT, IN HIS VIEW, UNDUE EMPHASIS ON FISCAL POLICY BUT ON THE CONTRARY, DUE EMPHASIS. IN THE LIGHT OF THIS COMMENT, SARCINELLI IS UNLIKELY TO SEEK TO STEER DISCUSSION IN THE DIRECTION OF DELETION OF THESE PROVISIONS. BUT BOTH HE AND CARLI WERE CLEAR THAT SURVEILLANCE SHOULD COVER MONETARY AS WELL AS ECONOMIC POLICIES.

5. CARLI WAS STRONGLY AGAINST THE IDEA OF SPECIAL SURVEILLANCE MEETINGS IN FACE OF 'EXTERNAL DISTURBANCES' AS PROVIDED FOR IN ARTICLE 7 (PARA 4 (III) OF TUR). SARCINELLI ARGUED AGAINST SPECIFIC EXCLUSION OF THE POSSIBILITY OF A SPECIAL AD HOC MEETING, SHOULD CIRCUMSTANCES REQUIRE THIS. IT SEEMED TO BE A QUESTION OF GETTING THE DRAFTING RIGHT AND ON THIS SARCINELLI SEEMED LIKELY TO BE MORE ON OUR SIDE THAN AGAINST US.

6. AS REGARDS ATTENDANCE BY CENTRAL BANK GOVERNORS AT ECOFIN SURVEILLANCE MEETINGS (PARA 4 (IV) OF TUR), NEITHER CARLI NOR SARCINELLI SAW ANY DIFFICULTY. THEY SAW THIS AS PRIMARILY A POHL PROBLEM, BUT AGREED WITH MY SUGGESTION THAT IF ALL OTHER CENTRAL BANK GOVERNORS WERE LIKELY TO BE PRESENT, POHL WOULD HARDLY STAY AWAY. SARCINELLI SUGGESTED THAT THERE MIGHT BE A SOLUTION TO THIS PROBLEM IN THE FRENCH COMPROMISE WHICH DEFINED SUCH MEETINGS AS 'INFORMAL'.

7. CARLI FOUND SOME DIFFICULTY IN UNDERSTANDING OUR POINT ABOUT GIVING MORE EMPHASIS TO THE ROLE OF MARKET FORCES IN SECURING CONVERGENCE OF ECONOMIC POLICY AND PERFORMANCE DURING STAGE ONE, (PARA 5 OF TUR) HE DID NOT SEE HOW MARKET FORCES COULD ACHIEVE THIS RESULT WITHOUT SOME KIND OF INSTITUTIONAL FRAMEWORK.

8. CARLI AND SARCINELLI BOTH AGREED WITH US ABOUT NOT STRENGTHENING THE ROLE OF EPC (PARA 6 OF TUR). SARCINELLI THOUGHT IT WOULD BE DIFFICULT TO ABOLISH EPC AT PRESENT, BUT WOULD WISH TO SEE IT GIVEN A CLEAR SUBSIDIARY ROLE, LEADING EVENTUALLY TO ABOLITION. HE SEEMED ATTRACTED TO THE IDEA OF ALLOCATING E.G. MICRO-ECONOMIC OR MEDIUM-TERM ISSUES TO THE EPC AS A KIND OF INTERIM PALLIATIVE, BUT HE WAS QUITE CLEAR THAT THE MONETARY COMMITTEE SHOULD REMAIN IN THE DOMINANT ROLE.

9. ON THE REVISED DECISION ON CENTRAL BANK COOPERATION, (PARA 7 OF TUR) THE ITALIANS HAD NO PROBLEMS WITH THE REQUIREMENT IN ARTICLE 3 THAT THE COMMITTEE SHOULD NORMALLY BE CONSULTED IN ADVANCE OF

NATIONAL DECISIONS ON THE COURSE OF MONETARY POLICY. THEY WERE IN FAVOUR OF RETAINING AN APPROPRIATE DEGREE OF AUTONOMY FOR CENTRAL BANKS. CARLI COMMENTED THAT THE CONCLUSION ON THIS POINT WOULD NEED TO REFLECT THE PRINCIPLE THAT DIFFERENT INSTITUTIONAL ARRANGEMENTS IN EACH COUNTRY WOULD NEED TO BE RESPECTED.

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10. THE ITALIANS WOULD NOT PRESS FOR DELETION FROM ARTICLE 3 (I) THE REFERENCE TO CENTRAL BANK CONSULTATIONS ABOUT 'THE STABILITY OF FINANCIAL INSTITUTIONS IN MARKETS', (PARA 8 OF TUR). SARCINELLI POINTED OUT THAT THIS WAS ONE OF THE FEW ADDITIONS TO THE 1964 TEXTS. HE ARGUED THAT ALTHOUGH IT WAS NOT FOR CENTRAL BANKS TO REACH DECISIONS ABOUT POLICY, THEY COUL MAKE A USEFUL CONTRIBUTION TO ANALYSIS.

THOMAS

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YOUR TELNO 791: EMU: STAGE 1 LEGAL TEXTS

SUMMARY
1. FRENCH VIEWS CLOSE TO OUR OWN ON MANY POINTS. BUT FRENCH TEND TO BE MORE CRITICAL OF COMMISSION DRAFT, AND THEY FAVOUR SPECIAL SURVEILLANCE MEETINGS.

DETAIL
2. ACTION TAKEN WITH DE FORGES (HEAD, EUROPEAN ORGANISATIONS DEPARTMENT, TRESOR), WHO WAS GRATEFUL FOR THE OPPORTUNITY OF GOING OVER THE GROUND BEFORE 5 OCTOBER.

REVISED CONVERGENCE DECISION
3. (I) FINAL CITATION. DEFORGES TOOK NOTE OF OUR SUGGESTION, OBSERVING THAT IN GENERAL TERMS THE CITATIONS WERE CONFUSED, REPETITIVE AND NEEDED TIDYING UP.
(II) ARTICLE 5. DE FORGES READ OUT HIS OWN COMMENTARY ON THIS ARTICLE, WHICH MADE EXACTLY THE SAME POINT AS US.
(III) ARTICLE 7. DE FORGES SAID THAT BEREGOVOY WAS ATTACHED TO THE IDEA OF SPECIAL MEETINGS WHERE THERE WERE EXTERNAL DISTURBANCES. THE FRENCH DOUBTED THE IMPACT ON INTERNATIONAL CONFIDENCE: SUCH MEETINGS WOULD BE EXCEPTIONAL AND (UNLIKE G 7 MEETINGS) NEED NOT BE HIGHLY VISIBLE.
(IV) ARTICLE 8. THE FRENCH SHARE OUR VIEW. (DE FORGES ADDED THAT THE LAST SENTENCE NEEDED TO BE TIGHTENED UP TO ENSURE THAT PARTICIPATION WAS ONLY AT THE SURVEILLANCE MEETINGS).

4. IN GENERAL TERMS, DE FORGES SAID THE FRENCH THOUGHT THE DRAFT DECISION BADLY DRAFTED AND FULL OF AMBIGUITIES AND REPETITIONS. SPECIFICALLY, THEY THOUGHT THAT THE REPORTING REQUIREMENTS AT ARTICLE 3 WERE TOO HEAVY, TOO CUMBERSOME, TOO CENTRALISED AND TOO MUCH LIKE THE OLD CONVERGENCE DECISION (WHICH HAD NOT WORKED). INSTEAD, THE FRENCH WERE AFTER A LIGHT, RAPID AND EFFECTIVE MECHANISM. ON ARTICLE 7, SECOND SENTENCE, THE FRENCH THOUGHT THE CENTRAL BANK COMMITTEE SHOULD BE QUOTE ASSOCIATED WITH UNQUOTE RATHER THAN JUST QUOTE CONSULTED UNQUOTE.

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5. THE FRENCH AGREE WITH US ON THE RESPECTIVE ROLES OF THE MONETARY AND ECONOMIC POLICY COMMITTEES.

REVISED DECISION ON CENTRAL BANK COOPERATION
6. ARTICLE 3. NO OBJECTION TO OUR SUGGESTION.

7. OTHER UK POINTS: SAME VIEWS AS US.

8. DE FORGES SAID THAT FRENCH HAD TWO PRINCIPAL CONCERNS. THE FIRST (MINOR) WAS TO AMEND ARTICLE 2 SO THAT THE CHAIRMAN OF THE MONETARY COMMITTEE BE GIVEN TREATMENT NO LESS FAVOURABLE THAN THAT OF THE COMMISION IN ATTENDING MEETINGS. THE SECOND (MAJOR) WAS TO INCORPORATE BACK INTO ARTICLE 3 LANGUAGE LOST FROM THE EARLIER TEXT WHICH LINKED MONETARY AND ECONOMIC POLICY MORE EXPLICITLY. SPECIFICALLY, DE FORGES PROPOSED ADDING A NEW PARAGRAPH: QUOTE TO SUPPORT, WITHIN THE SCOPE OF ITS PRIMARY TASK OF PROMOTING ECONOMIC CONVERGENCE IN THE CONTEXT OF PRICE STABILITY. THE OVERALL ECONOMIC OBJECTIVES OF THE GOVERNMENTS AND THE COMMUNITY, PARTICULARLY NON INFLATIONARY GROWTH, FULL EMPLOYMENT AND EXTERNAL BALANCES UNQUOTE.

9. THE FRENCH HAVE NO FIXED VIEWS ABOUT REFERRING TO THE STABILITY OF FINANCIAL INSTITUTIONS AND MARKETS AT ARTICLE 3.1, BUT INCLINE TO DROPPING THE REFERENCE AS UNNECESSARY.

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FCO TELNO 791 : EMU : STAGE ONE : LEGAL TEXTS

SUMMARY
1. THE GERMANS WANT THE NEW CONVERGENCE DECISION TO EMPHASISE PRICE STABILITY AND SOUND FISCAL POLICIES. FOR INTERNAL REASONS THEY ARE AGAINST INVOLVING THE FULL COMMITTEE OF CENTRAL BANK GOVERNORS IN THE WORK OF THE COUNCIL AND THEY SEEK A BIGGER ROLE FOR THE ECONOMIC POLICY COMMITTEE.

DETAIL
2. COUNSELLOR (ECONOMIC) TOOK WINKELMANN, FINANCE MINISTRY, THROUGH THE POINTS IN TUR AND WAS GIVEN THE FOLLOWING DETAILS OF THE MINISTRY'S POSITION.

(I) IN THE FINAL RECITAL, WINKELMANN THOUGHT TIETMEYER MIGHT AGREE TO DROP 'AND MUTUAL COMMITMENTS IN DECISION MAKING' WHICH HE FELT COULD COMMIT THE COMMUNITY TO AN AVERAGING-DOWN OF STANDARDS.

(II) THE GERMANS WOULD LIKE TO ADD A NEW RECITAL: 'WHEREAS PRICE STABILITY IS OF FUNDAMENTAL IMPORTANCE FOR ACHIEVING ECONOMIC GROWTH'.

(III) IN ARTICLE 1, THE GERMANS WOULD LIKE TO INSERT AFTER THE FIRST SENTENCE 'MEMBERS WILL BE GUIDED BY THE FOLLOWING PRINCIPLES: PRICE STABILITY, SOUND BUDGETARY POLICIES, IN PARTICULAR REDUCING EXCESSIVELY HIGH PUBLIC DEFICITS AND INEFFICIENCY, AND INTERNALLY AND EXTERNALLY OPEN MARKETS.' WINKELMANN THOUGHT OUR REFERENCE TO THE ROLE OF MARKET FORCES COULD FIND A PLACE HERE.

(IV) IN THE FIRST TIRET OF ARTICLE 3 THEY WOULD PREFER NOT TO DEFINE THE ECONOMIC INDICATORS BUT TO BE GUIDED BY ''THE G7 LIST''.

(V) ALSO IN ARTICLE 3 (LAST SENTENCE) THEY WOULD LIKE TO INCLUDE THE ECONOMIC POLICY COMMITTEE AS WELL AS THE MONETARY COMMITTEE. THEY ARE AWARE THAT THIS COULD BE DIFFICULT FOR OTHERS BUT NEED IT FOR INTERNAL REASONS, BECAUSE OF THE ROLE OF THE ECONOMICS MINISTRY

IN THE FORMULATION OF GERMAN ECONOMIC POLICY.

(VI) ARTICLE 5. WINKELMANN SAID THAT THEY LIKED THE EXISTING EMPHASIS ON FISCAL POLICY AND INDEED WANTED TO BEEF IT UP TO THE EFFECT THAT 'THE COUNCIL MAY FORMULATE RECOMMENDATIONS ON THE REDUCTION OF EXCESSIVELY HIGH BUDGET DEFICITS AND THE AVOIDANCE OF MONETARY FINANCING'.

(VII) THEY SEE A NEED TO INSERT LANGUAGE ON THE SURVEILLANCE OF MEDIUM TERM ECONOMIC POLICY, EITHER IN ARTICLE 5 OR IN A SEPARATE ARTICLE.

(VIII) ARTICLE 7. THE ARGUMENT THAT SPECIAL MEETINGS COULD DISTURB INTERNATIONAL CONFIDENCE WAS NEW TO WINKELMANN BUT HE THOUGH THAT TIETMEYER MIGHT BE SYMPATHETIC.

(IX) WINKELMANN SAID THAT THEY WANTED TO DELETE THE LAST SENTENCE OF ARTICLE 7 BECAUSE ITS SUBSTANCE WAS SUBSUMED IN THE RESPONSIBILITIES OF THE MONETARY COMMITTEE.

(X) ARTICLE 8. WINKELMANN SAID THAT THEY HAD BEEN TOYING WITH AN AMENDMENT TO THIS ARTICLE TO MAKE IT ABSOLUTELY CLEAR THAT ONLY THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS WOULD BE INVOLVED IN THE MULTILATERAL SURVEILLANCE EXERCISE. THE PROBLEM, AS PREVIOUSLY REPORTED, IS THAT THE BUNDESBANK COMMITTEE OF GOVERNORS IS JEALOUS OF ITS PREROGATIVES AND IS NOT PREPARED TO ALLOW THE GOVERNOR TO OPERATE ON HIS OWN IN AN INTERNATIONAL FORUM IN A WAY WHICH MIGHT BIND THE BUNDESBANK IN RELATION TO MONETARY POLICY. POEHL HAS COMMENTED THAT IF HE WAS INVITED TO SUCH MEETINGS HE WOULD NOT (NOT) GO.

(XI) DECISION ON CENTRAL BANK COOPERATION

(I) THE GERMAN POSITION ON THE NEW ARTICLE 2(A) IS AS ABOVE.

(II) WINKELMANN SAID THAT THEY WOULD NEED TO DELETE THE REFERENCE TO THE 'STABILITY OF FINANCIAL INSTITUTIONS' IN ARTICLE 3(I) SINCE THE SUPERVISION OF BANKS WAS A GOVERNMENT RATHER THAN A CENTRAL BANK RESPONSIBILITY IN THE FRG.

(III) ON ARTICLE 3(II) WINKELMANN THOUGHT THAT IT SHOULD PROVE POSSIBLE TO DEVISE WORDING WHICH WOULD TAKE

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ACCOUNT OF THE UK OBJECTION TO 'PRIOR CONSULTATION' THOUGH THIS WAS NOT A PROBLEM FOR THE GERMANS.

(IV) IN ARTICLE 3(III) THE GERMANS WISH TO INSERT LANGUAGE STRESSING PRICE STABILITY AS A NECESSARY CONDITION FOR THE FUNCTIONING OF THE EMS.

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FCO TELNO 791 TO PARIS: EMU STAGE 1. LEGAL TEXTS.

1. ECONOMIC COUNSELLOR TOOK ACTION WITH MAVROGIANNIS, THE GREEK MONETARY COMMITTEE REPRESENTATIVE FROM THE MINISTRY OF NATIONAL ECONOMY, AND ARETAIOS (BANK OF GREECE), DEPUTY REPRESENTATIVE ON THE AD HOC GROUP.

2. THEY WERE STILL UNSIGHTED ON THE DETAILED DRAFTING BUT TOOK CAREFUL NOTE. THEY WOULD HAVE SOME POINTS. THE MAIN ONE WAS TO INSERT A REFERENCE TO THE NEED FOR MEASURES TO AID THE CONVERGENCE OF ECONOMIES (AS WELL AS OF ECONOMIC POLICY). THE GREEK POSITION ON THE ROLE OF CENTRAL BANKS WAS VERY LIKE OURS.

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FROM: N L WICKS
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CHANCELLOR OF THE EXCHEQUER

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PLP

EMU: DISCUSSION IN MONETARY COMMITTEE

Besides discussing the revisions to the 1964 and 1974 Decisions, Monetary Committee will have on Thursday its first real discussion of the later stages of EMU. The outcome of this discussion, and one later in the month, will be the preparation of a report, presumably the first of many, for November's ECOFIN.

2. I attach the draft of my speaking note for the meeting. Obviously, I will want to alter this in the light of the discussion, but I should be glad to know that you are content with the line it takes.

3. Deliberately, the speaking note avoids trespassing on the ground in your paper, other than to indicate the three broad principles on which we think future developments should be based and which you mentioned at Antibes. The speaking note also suggests that work should be put in hand to elucidate the implications of some features of the Delors report. The purpose here is to try to draw out some of the difficulties and uncertainties involved with the object of feeding the doubts and hesitations already prevalent in some Finance Ministries.

N.L.W.

N L WICKS

EMU: IMPORTANT ISSUES RAISED BY STAGES 2 AND 3

__Draft Speaking Note__

General statement of UK reserve on an IGC and on need for Treaty. Our position well known. Nothing I say should be taken as deviating from that position.

2. When we prepare our paper for Ministers, it is important to remember that the Madrid European Council recognised the Delors Report as __a__ basis, but not the only basis for further work on Stages 2 and 3. Important also to recognise that the two Commission papers which have been tabled for our consideration - the Delors and Christophersen documents - start from the Delors prescription for Stages 2 and 3.

3. We should not feel bound by the constraints imposed by the framework proposed in the Delors Report. We need to think widely and fundamentally at this crucial stage of the development of economic and monetary integration in Europe. The Chancellor set out an alternative approach to President Delors' at Antibes. He will be elaborating on these ideas in a paper which he will put to ECOFIN in November. This will set out an alternative, market-based approach to the long-term development of economic and monetary policy arrangements in the Community.

4. Our approach is based on three guiding principles:

- first, maximum reliance must be placed on market forces to improve economic performance.

- second, all Community arrangements must respect the principle of subsidiarity;

- third, the overriding objective of monetary policies in the Community must be to secure stable prices.

I suggest that our first task should be to identify principles such as these - and there may be others - which should guide developments in the years ahead. They should be clearly set out in our report.

5. Our second task should be to examine the base on which developments <u>after</u> Stage 1 will rest. That is, what will be the state of economic and monetary integration in Europe at the end of Stage 1? Obviously there can be no certainties here. But we need some assessment. For this will provide the starting point.

6. So, we need to analyse the nature, extent and timing of changes in the European economy likely to take place during Stage 1. The Cecchini Report gives some helpful clues as to the magnitude of these effects but, of course, made <u>no</u> assumptions about progress towards EMU.

Nor did Cecchini cover the implications of capital liberalisation and universal ERM membership.

7. As part of this work we should establish what further measures the Commission will need to bring forward, beyond those which are already on the table under the existing single market programme if we are to create a genuinely free European financial area - in the sense the UK has been advocating and which is implied by paragraph 52 of the Delors Report.

8. Turning to President Delors' Report, this raises both economic and political questions. This Committee should consider both sorts of questions. First the political questions. I know that in some Foreign Offices, not mine I hasten to add, there is the view that the function of the Monetary Committee is to deal with technical issues, like the definition of the PSBR, while the diplomats deal with the matters of high policy. That is certainly not our view. We need to consider in this Committee both technical - I prefer to call them substantive - issues, and the political - constitutional ones. We should therefore identify in our report the political implications of the proposals in the Delors Report, and particularly the accountability of the proposed European System of Central Banks if, as is the suggestion in the Delors Report, there is to be a single European currency. This would require a single monetary policy formulated and

implemented by a central institution, the proposed independent ESCB. Now whatever their degree of independence, national central banks everywhere are in some way accountable to national governments. Even where the central bank is very independent, the national Finance Ministry provides a counterbalance in the national constitutional structure. Where is the counterbalance in the Delors scheme? That is a question which needs to be addressed as part of the general issue of political accountability.

9. The second general issue arising out of the Delors Report concerns the single currency. The report assumes that a single currency is the culmination of progress towards EMU. But nowhere does it attempt to specify the economic gains from moving to a single currency. We need to be clear about the nature of these gains and how they will arise.

10. Finally, the Delors Report leaves several important questions unanswered, which we need to explore for ECOFIN as an important input for their consideration of that Report's recommendations. Some may suggest that these issues are technical and need not be dealt with in any Treaty but can be left over to be settled later on. But that would be to dodge responsibility. Unless we are clear about these matters, we will run the risk of an inflationary solution, of establishing arrangements

which have a bias towards inflation. The sort of issues include:

- How would an ESCB acquire and finance foreign exchange reserves? Would it raise money itself in the market (borrowing either in domestic currency or foreign currency as necessary), or would it borrow from the governments of member states? And who would receive the profits from its operations, and bear the losses?

- Who would be responsible for exchange rate policy? This would be a key issue in the operation of monetary policy in the Community, but in no country is it a matter left entirely to an independent central bank.

- Why should there be any need for binding rules - as envisaged by Delors - governing the operation of member states' budgetary policies? Would it be necessary for the Community to agree not to bail out member states with excessive deficits?

- The report calls for binding rules to prevent monetary financing. What do we mean by monetary financing? The Monetary Committee Alternates have done some work on this, but we are a long way from an agreed position. If the ESCB were concerned to limit the growth of anything other than the narrowest definition of money, then it could mean all member states agreeing not to borrow from the banking sector, and perhaps not to issue short-term paper.

- In any case, what kind of monetary policy would be followed by an ESCB? What kind of monetary target should be adopted? At present some member states target narrow measures of money, others broader measures. And there are huge institutional differences between different member states.

- Would the progressive realisation of a single market increase or reduce income differentials between the richer and poorer regions of the Community? And what are the implications of this analysis for Community policies (eg structural funds) for transferring budgetary resources to the peripheral areas?

11. These are not technical issues. They are fundamental policy questions which should be considered <u>before</u> institutional questions such as "what kind of ESCB should we set up" are considered. In short, we should not prejudge the question of institutional change before we have decided whether it is desirable to go down that particular route.

12. On procedure, it seems essential that Finance Ministers should remain in the lead in pursuing the programme of work on EMU, and that the Monetary Committee should be responsible for preparing the documentation and advice for ECOFIN. We may of course, wish to call for more specialised advice both from our Alternates and from the Economic Policy Committee.

13. Let me summarise, Mr Chairman, what I would like to see included in your report to Ministers next month. Firstly, recognition of the major changes that Stage 1 itself will bring and the many steps that are still required before Stage 1 is complete. Secondly, that the Delors Stages 2 and 3 are only one approach to what might happen beyond Stage 1: we need further analysis both of the Delors proposals and of the alternatives to Delors. Thirdly, I believe it is important to recognise that there are a substantial number of areas in which more work is required, so that we can see more clearly the implications both of Stage 1 and of proposals of going beyond that. Such work is essential if well informed political decisions are to be taken on the setting up of an intergovernmental conference.

14. Second, we need to consider the principles which should guide our approach to the future, and alternative concepts of EMU which might satisfy these principles - including the definition I have just given, - and how they might be progressively attained. In particular, which way forward is most likely to achieve price stability, which is the principal objective of monetary policy?

FROM: J M G TAYLOR
DATE: 3 OCTOBER 1989

MR TYRIE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Peretz
Mr Odling-Smee
Mrs Chaplin
Mr Lightfoot

SIR FRED CATHERWOOD'S PAPER ON EMU

The Chancellor was grateful for your note of 29 September.

2. He is content for you to convey the message to Mr Prout that this document should be billed as a solo effort from Sir Fred Catherwood. He does not want No.10 alerted.

J M G TAYLOR

NB

He may mention this paper supporting Delors.

JC

chex.ps/jmt2/6

1. ~~Duke~~ to note

2. PMP

~~[illegible]~~

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

Okey dokey.

~~Jonathan~~ I assume the Chancellor will be speaking? If so, pl. keep me in touch.

3 October 1989

Rt Hon Sir Geoffrey Howe QC MP
Lord President of the Council
and Leader of the House of Commons
Privy Council Office
68 Whitehall
LONDON
SW1A 2AT

~~Moir~~.

cc PS/Financial Secretary
PS/Paymaster General
Mr Wicks
Mr H P Evans
Mr R I G Allen
Mr Peretz
Mrs Brown
Mr Mercer
Mr McIntosh
Mr N Williams
Mr A E W White
Miss R R Wright

Dear Geoffrey

SCRUTINY DEBATE ON ECONOMIC AND MONETARY UNION

The Select Committee on European legislation has recommended that there should be a debate on the Delors Report.

I am sure that we should have such a debate. It would be sensible to have this before the ECOFIN Council on 13 November. I very much hope that it will be possible, therefore, to arrange a debate in the spill-over session, and preferably in the week beginning 6 November.

We could usefully take at the same time the question of ecu reweighting, which has also been recommended for debate by the Committee.

Yours
Nigel

NIGEL LAWSON

ec1.bk/meb/3.10 CONFIDENTIAL

FROM: MRS M E BROWN (EC1)
DATE: 3 OCTOBER 1989
4 4709

CHANCELLOR

cc Paymaster General
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Miss O'Mara
Mrs Chaplin
Mr Tyrie

Brown 1964+1974 Decisions

EMU: REVISION OF 1964 AND 1974 DECISIONS

1. I attach draft briefs on the Stage I legal texts, which will be discussed at Monetary Committee on Thursday, 5 October. Mr Wicks and Mr Peretz will attend.

2. The Commission plan to issue revised texts after the meeting as formal proposals. They will be sent at that stage to the European Parliament. The Presidency's aim (which may be over-ambitious) is to reach common position at the November ECOFIN and adoption at the December ECOFIN.

3. The revised decision on cooperation between central banks is virtually the same as the draft circulated before Antibes. An unwelcome reference to "economic and social cohesion" has crept into recital 2. On the other hand, the previous reference to central bank "powers" in recital 6 has now been amended to "role".

4. The main points for the UK are still:

- to resist any strengthening of the references to central bank autonomy in the preamble - but to accept the present wording as just tolerable;

- to insist that all central bank governors should attend ECOFIN (though only for surveillance meetings: the present draft Article 2 implies that the Chairman will attend all meetings). We should welcome your view on whether this is an absolute sticking point for the UK, since the central bank governors are themselves, at best, unenthusiastic. Only the French are likely to support us and they may fall away on the day. The same point arises on the revised Convergence Decision;

- to delete or tone down the reference to advance consultation before national decisions on monetary policy, including monetary targets (Article 3(1)).

5. The revised Convergence Decision is now in the form of a draft text: only a commentary and skeleton draft were discussed at Antibes. It is not very well drafted (the French are reported to be critical of it on this score) but in substance it has not come out too badly. A number of the amendments proposed in our commentary are presentational and could be dropped if necessary.

6. The main points for the UK are:

- any subsequent action taken under this Decision must be agreed by consensus;

- the role of market forces in promoting economic convergence must be properly acknowledged (in recital 3 if nowhere else);

- the reference in the fourth recital to beyond Stage I must be deleted;

- references to "mutual commitments in decision-making" (fifth recital and Article 2) should be deleted;

- there should not be a special category of surveillance meetings to respond to external disturbances (Article 7);

- All central bankers should attend ECOFIN (Article 8).

7. The Bank have seen our commentaries. On the Decision on central bank cooperation, they have said that they would not want to propose further amendments to the present draft (which is, of course, substantively the one which emerged from the Committee of Central Bank Governors). They have offered no comments on the Convergence Decision, though they have noted that the Treasury and Bank take different views on whether all central bank governors should attend ECOFIN.

Mary Brown.

MRS M E BROWN

REVISED CONVERGENCE DECISION

NEGOTIATING BRIEF ON COMMISSION TEXT OF 26 SEPTEMBER 1989

Note: (1) the highest priority recommendations are asterisked.
(2) Where amended passages are proposed, changes to the Commission text are underlined.

First visa

This provides for Articles 103 and 145 to be the legal base for the Decision.

The legal base is acceptable, because it:

- requires unanimity in adopting Decision;
- was legal base for 1974 Decision.

However, under Article 103(3) implementing directives under the Decision could be agreed by qualified majority. But Finance Ministers recognised at Antibes that the Community should proceed by consensus on all matters relating to Economic and Monetary Union.

> **Recommendation: Seek agreement that there will be a minutes statement, to which both Council and Commission subscribe, that any action arising from this Decision, including further legislation, will be by consensus.*

Other visas

These provide for the European Parliament and the Economic and Social Committee to give opinions before the Decision can be formally adopted. They replicate citations in the 1974 Decision.

Recommendation: *accept*

First recital

This accurately - though selectively - quotes the Madrid Council conclusions on the progressive attainment of EMU.

Arguable that only the reference to the first stage of EMU (lines 4-5) relevant. But probably counter-productive to seek deletion of the rest.

Recommendation: *accept.*

Second recital

This states the need for a high degree of convergence of economic performance to facilitate progress to EMU, and says that policy coordination is needed to achieve this convergence.

The recital is not consistent with the UK's approach: we see the convergence of economic policy and performance resulting primarily from market forces, not policy coordination. Moreover, the first two lines look beyond Stage I.

Recommendation:

(i) Ideally, this recital should be deleted. The fourth recital covers much of the same ground.

(ii) Fallback:

In lines 1-2 delete "in order to facilitate progress towards Economic and Monetary Union".

In lines 3-4 delete "is necessary through greater compatibility and...". Substitute

> *"will flow from the competitive forces stimulated by completion of the single market and from .... ".*

Note: an alternative redraft of lines 1-3 would be:

"Whereas progress towards Economic and Monetary Union will be facilitated by a high degree of convergence of economic performances between Member States which will flow from ..." [continue with proposed amendment to lines 3-4].

Third recital

States that policy coordination should be based on an open market approach.

This should be strengthened to make clear that the open market approach will release competitive forces.

**Recommendation:*

Add at end "which will provide the basis for the operation of competitive forces in the single market".

Note: insist on this amendment, especially if proposed references to competitive forces in recitals two and four are not accepted.

Fourth recital

This states that completion of the single market will "require" more effective policy coordination. It refers to experience in cooperation in the EMS. It states that the first stage of EMU should provide a sound basis for further development.

The lack of acknowledgement of market forces, and the reference to beyond Stage I, are not acceptable.

Recommendation:

- *insert at end of line 3 .. "through the operation of competitive forces".*

*- *delete sub-paragraph (iii).*

Fifth recital

This refers to the principles on which coordination should be based. Some are acceptable, but "mutual commitments in decision-making" is not. The phrase is not defined, and implies binding commitments in the economic field. Germany may support deletion of this phrase, on the grounds that it could commit the Community to averaging-down of standards.

**Recommendation*:

In sub-section (ii), delete "mutual commitments in decision-making as well as for".

German proposal for new recital

The Bonn Embassy reports that Germany would like to add a new recital:

"Whereas price stability is of fundamental importance for achieving economic growth."

Recommendation: accept.

Article 1

This provides for the Council to undertake multilateral surveillance and specifies the coverage of this work.

The first seven lines are a jumble and should be amended if possible because:

- not enough emphasis on price stability;

- role of market forces not acknowledged;

- reference to "the economic and social cohesion" implies more structural spending (this phrase was added to the draft at a late stage).

Recommendation: *propose the following re-draft [this is from the German draft given to Mr Wicks at Antibes. Concertation with Germany desirable before Monetary Committee]:*

"In order to foster coherence of economic policies within and between Member States with an aim of achieving sustained non-inflationary growth and a high level of employment in the Community, Member States will regard

- *price stability*

- *sound budgetary policies directed, under a medium-term orientation, in particular at reducing excessively high public deficits*

- *efficient, internally and externally open markets*

as guiding principles in the conduct of their economic policies.

In this context, the Council will undertake multilateral surveillance by examining .... [continue with rest of Article 1 from Commission draft]."

**Fallback*: *in first line of Commission draft insert "help" after "In order to".*

Support any alternative German amendment which highlights the principles set out above.

Article 2

This provides for multilateral surveillance in restricted sessions, though with the possibility of published communiques. The second paragraph provides for mutual commitments by member states and policy recommendations by the Council.

The second paragraph is objectionable because:

- it does not acknowledge the role of market forces;

- it refers to "mutual commitments" without defining them and leaves open the possibility that these might be binding;

- the Council could only issue "policy recommendations" on a proposal from the Commission.

<u>Recommendation</u>

Amend second paragraph as follows:

> *"Through learning-by-doing, **<u>the aim of</u>** multilateral surveillance should <u>be to encourage member states to adopt compatible policies</u>. In this context, the Council may issue policy recommendations."*

Article 3

This provides for multilateral surveillance to be conducted on the basis of papers by the Commission, covering a wide range of indicators of economic performance, country reports, and an annual economic report. It states that the Council's surveillance work would be prepared by Monetary Committee.

The main points on this Article are

(i) regular country reports (second tiret) would be time-consuming and unnecessary. There is adequate provision for considering individual countries in Article 6 on country-specific reviews;

(ii) committee structure. The present draft is in line with the UK's view that Monetary Committee should prepare surveillance discussions. But the text could helpfully be amended to clarify the Committee's role in relation to

- the Commission (making clear that all surveillance documents will reach the Council via Monetary Committee);

- EPC (specifying that Monetary Committee may consult EPC as necessary - ie. placing EPC in a subordinate role to Monetary Committee. Note: Germany is likely to oppose this and argue for EPC to have a joint role in preparing surveillance meetings).

Recommendation

(i) Delete second tiret on regular country reports. [Note: deletion is desirable but not essential to UK interests]

(ii) Delete final paragraph, and expand first paragraph as follows:

"The Council's work on multilateral surveillance shall be prepared by the Monetary Committee, consulting the Economic Policy Committee as necessary, on the basis of reports and analysis submitted by the Commission. The Chairman of Monetary Committee will participate in the Council meetings. Documents submitted to the Council as a basis for the surveillance exercise shall include: ....".

(iii) Fallback: if (ii) not accepted, amend final paragraph as follows:

> *"The Council's work on multilateral surveillance shall be prepared by the Monetary Committee, consulting the Economic Policy Committee as necessary. The Chairman of Monetary Committee will participate in the Council meetings."*

Article 4

This provides for the European Parliament and the Economic and Social Committee to give "opinions" on the Commission's annual economic report. The 1974 Convergence Decision provided simply for them to be consulted.

Recommendation: question the change from "consultation" to "opinion". But if necessary, accept Article as drafted.

Article 5

This states that multilateral surveillance will focus on macroeconomic, microeconomic and structural policies. It goes on to specify the way in which budget policies should be reviewed - "to the extent possible ahead of national budgetary planning". It provides for EPC to be consulted.

The main points here are

(i) It is not explicit in the first sentence that ECOFIN will discuss monetary and exchange rate policies (though this may be felt to be implicit in "macroeconomic" policies).

(ii) the second and third sentences give undue importance to budget policies, and include the still-dangerous reference to reviewing these ahead of national budgetary planning where possible. (The French are reported to share our concern on this, but Germany wants to strengthen the emphasis on fiscal policy. It may be possible to agree language which emphasises the need to avoid excessive budget deficits and the avoidance of monetary financing, as a quid pro quo for dropping the reference to reviews ahead of national budget planning).

(iii) the final sentence is (probably deliberately) ambiguous as to whether EPC shall be consulted on all aspects of the surveillance exercise, or only on budgetary aspects. It apparently limits EPC's role to consultation, with no direct role in preparing even the microeconomic aspects of surveillance discussions. It is likely that, unless the draft text is clarified on this point, there will be tension between Monetary Committee and EPC once the surveillance arrangements are put into practice. However, the UK might lose rather than gain from trying to alter the present wording.

<u>Recommendation</u>:

(i) - Delete second and third sentences.

- Insert "including monetary" after "macroeconomic" in line 1 of first sentence. [<u>Note</u>: this amendment not essential if ECOFIN role in coordinating monetary policy clearly recognised in discussion].

- Delete "in this context" (last line).

**(ii) <u>Fallback</u>:*

- Delete second sentence and amend third sentence to read:
"The resulting coordination procedure shall involve analysis of medium-term budgetary policy trends, <u>including the size and financing of budget deficits</u>, and their implications for overall economic policy. "

Article 6

This refers to country-specific surveillance.

The phrase "threaten the Community economy" (line 2) implies an overly-centralised approach - though, taken literally, it would seem fairly restrictive and could therefore suit us.

Recommendation:

- *amend "threaten the Community economy "(line 2) to "threaten the attainment of Community objectives";*
- *delete "upon proposals by the Commission and" (lines 2-3): member states should be able to initiate this process too;*
- *amend "promoting" in penultimate line to "encouraging".*

The reference to "country-specific recommendations" (lines 5-6) seems acceptable, since under the Treaty recommendations are non-binding.

Article 7

This provides for meetings to respond to events outside the Community.

Special meetings to respond to external disturbances are not necessary, given monthly ECOFIN meetings and opportunities for informal contact in the interim. Would not be helpful to international confidence. [Not for use: could also be read as conferring express external competence on the Community. Germany may share UK view, but Beregevoy said to be attached to idea of special meetings and to want Central Bankers' Committee to be more directly involved than present draft provides for.]

Recommendation:

(i) delete this Article;

**(ii) Fallback: amend the Article as follows:*

"When events outside the Community threaten to have serious consequences for the Community economy, multilateral surveillance shall include consideration of possible measures. [Discussions shall be prepared by Monetary Committee.] Where monetary or exchange rate policy is concerned, the Committee of Governors ... shall be consulted".

Article 8

This raises the issue of central bankers' attendance at ECOFIN. We consider it important that all governors should attend, on the G7 model, since ECOFIN will regularly discuss monetary and exchange rate policies.

**Recommendation: propose following redraft:*

"In order to ensure better consistency between monetary and other economic policies, The Governors of the Central Banks of the Member States of the European Community shall participate [when appropriate] in surveillance discussions by the Council."

Note: Only France may support the UK on this. If the French fall away, continue to press for the amendment, leaving it open for discussion at the November ECOFIN if necessary.

Article 9

The first sub-paragraph provides for the Chairman of the Council and the Commission to report regularly on the results of multilateral surveillance to the European Council and the Parliament. The skeleton draft circulated for Antibes envisaged a periodic report to the Parliament only.

The second sub-paragraph, providing for Governments to bring the results of multilateral surveillance to the attention of their national Parliaments, replicates a clause in the 1974 Decision. It seems unobjectionable.

> *Recommendation: propose deletion of "to the European Council and" from lines 2-3 of the first sub-paragraph.*

Article 10

This provides for the Commission to report periodically on the effects of surveillance to both the Council and the European Parliament. The Antibes skeleton did not mention the Parliament, and it would be preferable to omit it.

The reference to "progress made" in multilateral surveillance (line 2) may imply that decision-making during Stage I is expected to become increasingly centralised. This would be unacceptable to the UK.

> *Recommendation:*
>
> - *delete "the progress made in multilateral surveillance" in lines 2-3, and substitute "the way in which multilateral surveillance has operated";*
>
> - *delete final sentence.*

[Note: these are not major points. The Article could be accepted if necessary].

Article 11

This repeals the 1974 Convergence Decision and its twin Directive on stability, growth and full employment.

Recommendation: accept this Article.

HM Treasury
September 1989

Mr M Brown (HMT) cc Mr M Cenas S/E Mr M Arthur FCO

EMU Stage I texts as adopted by the Commission

DRAFT COUNCIL DECISION

AB 26/9

on the attainment of progressive convergence of economic performance during stage one of Economic and Monetary Union

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Articles 103 and 145 thereof,

Having regard to the proposal from the Commission,

Having regard to the Opinion of the European Parliament,

Having regard to the Opinion of the Economic and Social Committee,

1 Whereas the European Council, at its meeting in Madrid in June 1989, restated "its determination progressively to achieve Economic and Monetary Union as provided for in the Single Act"; decided that "the first stage of the realization of Economic and Monetary Union would begin on 1st July 1990"; and stated that "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", and 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",

2 (i) Whereas in order to facilitate progress towards Economic and Monetary Union, a high degree of convergence of economic performances between Member States is necessary through greater compatibility and closer coordination of economic policy; (ii) whereas such strengthening of economic policy coordination also contributes to the achievement of Community objectives, in particular to convergence at a high level of economic performance in the framework of monetary stability,

.../...

3 Whereas coordination of economic policies should be based on an open market approach both internally and externally,

4 (i) Whereas the achievement of the goals of the Single European Act, especially the completion of the Internal Market, which will increase the degree of economic and financial integration and reinforce competition and structural change and thus amplify the cross-border effects of economic policies, will require more effective policy coordination; (ii) whereas according to Article 102a Member States shall take account of the experience acquired in cooperation within the framework of the European Monetary System; (iii) whereas the first stage of Economic and Monetary Union should provide a sound basis for its successful further development and sustainability,

5 (i) Whereas the strengthening of coordination should rely on the political will to develop further the consensus on the broad economic policy approach; (ii) whereas progress in this coordination process calls for flexibility, subsidiarity and mutual commitments in decision-making as well as for learning-by-doing,

HAS ADOPTED THIS DECISION :

Article 1

In order to achieve sustained non-inflationary growth in the Community, together with a high level of employment and the degree of economic convergence necessary for the success of Stage One of Economic and Monetary Union, in the perspective of the completion of the Internal Market and in the context of the economic and social cohesion, the Council shall undertake multilateral surveillance. In this context, it will examine on a regular basis :

- the economic conditions, prospects and policies in the Community and its Member States;
- the compatibility of policies within Member States and in the Community at large,
- the external economic environment and its interaction with the economy of the Community.

Multilateral surveillance shall cover all aspects of economic policy in both the short-term and medium-term perspectives.

.../...

Article 2

The Council shall undertake multilateral surveillance in restricted sessions. It may authorise its Chairman to make public the results of its deliberations.

Through learning-by-doing, multilateral surveillance should increasingly result in compatible policies by way of mutual commitments on the part of Member States. In this context, the Council may, acting on proposal from the Commission, issue policy recommendations.

Article 3

The Council shall proceed with multilateral surveillance on the basis of reports and analysis submitted by the Commission. These shall include :

- indicators of economic performance including monetary and budgetary policies, supply and demand trends, price and cost developments, employment, financial markets, external and internal imbalances,

- regular country reports on national economic conditions, prospects and policies,

- an annual report on the economic outlook of the Community which shall review the economic outlook and the underlying economic policy orientation.

The Council's work on multilateral surveillance shall be prepared by the Monetary Committee, whose chairman will participate in the Council meetings.

Article 4

On a proposal from the Commission the annual economic report shall be adopted by the Council, having regard to the opinions by the European Parliament and the Economic and Social Committee.

.../...

Article 5

Multilateral surveillance shall focus on macroeconomic, microeconomic and structural policies. It shall include a review of budget policies, to the extent possible ahead of national budgetary planning, focussing particularly on the size and financing of budget deficits. The resulting coordination procedure shall involve analysis of medium-term budgetary policy trends and their implications for overall economic policy. The Economic Policy Committee shall be consulted for the surveillance exercise in this context.

Article 6

When potential or actual economic developments in one or more Member States threaten the Community economy, the Council, upon proposal by the Commission and after consultation of the Monetary Committee, shall proceed to an examination of the economic situation. Such examination may result in the formulation of country-specific recommendations with a view to promoting the necessary policy corrections.

Article 7

When events outside the Community threaten to have serious consequences for the Community economy, the Council, upon proposal by the Commission and after consultation of the Monetary Committee, shall meet to consider possible measures. Where monetary or exchange rate policy is concerned, the Committee of Governors of the Central Banks of the Member States of the European Community shall be consulted.

Article 8

In order to ensure better consistency between monetary and other economic policies, the Committee of Governors of the Central Banks of the Member States of the European Community shall support the multilateral surveillance exercise. Its Chairman shall be invited to participate in the Council meetings.

.../...

Article 9

The Chairman of the Council and the Commission shall report regularly on the results of multilateral surveillance to the European Council and to the European Parliament.

Governments shall bring the results of the multilateral surveillance to the attention of their national parliaments so that it can be taken into account in national policy making.

Article 10

On the basis of a report submitted by the Commission, the Council shall periodically examine the progress made in multilateral surveillance through the application of this decision. This report shall also be transmitted to the European Parliament.

Article 11

The following acts are hereby repealed :

(i) the Council Decision of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Community;

(ii) the Council Directive of 18 February 1974 on stability, growth and full employment in the Community.

Done at ...., ...

CONFIDENTIAL

DRAFT COUNCIL DECISION AMENDING 1964 DECISION ON COOPERATION BETWEEN CENTRAL BANKS

Preamble

This recalls the Madrid decision that the first stage of the implementation of EMU should begin on 1 July 1990; suggests that both this and the new article 102(a) of the Treaty call for increased convergence which should aim at domestic price stability as a necessary condition for exchange rate stability; states that the Council should "give consideration to" extending the scope of the autonomy of the central banks and that the arrangements for formulating monetary policy under EMU should provide both for "adequate" autonomy for the institutions and for commitment to price stability; and finally notes the tasks and role of the Committee of Central Bank Governors should be extended and reinforced.

Comment

The major point of difficulty for the UK lies in the references to central bank autonomy. Recital 4 appears to endorse changes in the present constitutional structures and balances in member states during Stage 1 and recital 5 to prejudge developments thereafter. Nevertheless, we can probably live with the present compromise text, unless others try to strengthen it.

[NB. Paragraph 52 of the Delors Report has already noted that during Stage 1 "... consideration should be given to extending the scope of central banks' autonomy".]

Recital 2 also glosses article 102(a) of the Treaty. While we have no objection to references to convergence towards "non-inflationary growth", the reference to "economic and social cohesion" is not acceptable.

Recital 6 is, however, an improvement on earlier versions, in that the reference to central banks' "powers" has been amended to "role".

Recommendation

In recital 1, we would prefer "progressive realisation of" to "implementation" in line 2, given the wording of the Madrid communique.

In recital 2, delete "and of economic and social cohesion between the Member States". While convergence towards non-inflationary growth is implied in Article 105, "economic and social cohesion" are certainly not.

If others seek to strengthen the reference to central bank autonomy in recital 4, seek deletion of whole recital, on the grounds that its extension is not an issue for Stage 1. Otherwise accept.

Amend recital 6 to "Whereas, in view of the objective of progressive realisation of Economic and Monetary Union ..."in line with the Madrid communique.

Article 1

This sets up the Committee of Central Bank Governors. It is unchanged from the 1964 Decision and gives us no difficulty.

Article 2

This makes small changes to the text of the 1964 Decision to reflect current practice. It creates no problems for us.

Article 2a

This provides that the Chairman of the Central Bank Governors shall be invited to participate in ECOFIN meetings.

Comment

It has never been envisaged that the Chairman should attend all ECOFIN meetings and, indeed, an earlier version of the text noted he should simply attend "whenever it deals with issues involving the tasks of the Committee of Governors". We ourselves would normally see attendance confined to the surveillance discussions, when we would argue that all Central Bank Governors should be present, although the Governors themselves may well have little enthusiasm for this.

Recommendation

Delete, on the grounds that this provision is more appropriate to the revised convergence decision than to the central bank decision and that in any case, all Governors should attend surveillance discussions.

If pressed, amend to "The Governors of the Central Banks of the Member States of the European Community shall participate [when appropriate] in surveillance discussions by the Council". This follows the UK's proposed wording for the revised convergence decision.

If others argue there will be other occasions on which the Chairman might usefully attend ECOFIN, add "The Chairman of the Committee shall be invited to participate in other meetings of the Council of Ministers when it deals with issues involving the tasks of the Committee of Governors."

Article 3

This defines the Committee's tasks and provides for preparation of an annual report on its activities and on Community monetary and financial conditions for transmission to ECOFIN, the European Parliament and the European Council. The Committee "may" authorise the Chairman to make the outcome of its deliberations public.

Comment

The major problem for the UK in this article is the reference to consultation "in advance of national decisions on the course of monetary policy" (sub-paragraph (2)) eg the setting of monetary targets. In the UK, this is the responsibility of Government rather than the central bank and we should certainly oppose any commitment to advance discussion of specific decisions such as interest rate changes - as, indeed, would the Central Bank Governors themselves. For similar reasons, we have difficulty with the reference in sub-paragraph (1) to consultation on "the broad lines of policy of the Central Banks".

We also have problems with the suggestion that Governors should "promote" coordination (sub-paragraph 3), "ensuring" convergent monetary policies (sub-paragraph 4). These words suggest a rather more executive role for the Committee. That could strengthen earlier claims for an extension of its powers and lead to tension with ECOFIN which should continue to have overall responsibility for economic, including monetary, policy.

The reference to "credit" in sub-paragraph 3(1) now looks rather dated and a revised formulation of this sentence could usefully sweep it away. The Germans have in the past opposed the reference to the stability of financial institutions and markets, since this is not a matter for the Bundesbank, but should be able to accept the present wording, with its reference to "within their competences".

If possible, we would prefer the annual report to be submitted simply to ECOFIN but this may be difficult to negotiate.

We can accept that the Committee's deliberations should be made public but only if the discussions as such remain completely confidential, that there is no prior "consultation" on the course of monetary policy and the decision to go public is taken by consensus.

Recommendation

Amend sub-paragraph 1 to read "to discuss the general principles and broad lines of monetary policy, including the foreign exchange markets and within their competences .....".

Ideally, omit final sentence of sub-paragraph 2. If this is not negotiable, amend to read "There shall normally be discussion in the Committee in advance of national decisions on the broad course of monetary policy such as the setting of monetary targets for the following year". The text needs to allow for the fact that some countries do not set monetary targets; and that in other countries, such targets are set by governments, not by central banks. It would also help to secure a minutes statement clarifying that there could be no commitment to discuss decisions on interest rate changes in advance, as Central Bank Governors have already accepted among themselves.

Amend sub-paragraph 3 to read "to facilitate the coordination of the monetary policies ....".

Amend sub-paragraph 4 to read " ... with the aim of encouraging monetary policies .....".

Delete "the European Parliament and the European Council" from paragraph 3. If this cannot be negotiated, we can accept the present draft, provided it continues to cover ECOFIN, as it does now.

Article 3(a)

This provides for Committee members to act "according to their own responsibilities and having due regard to Community objectives". It is designed to limit German attempts to give the members of the Committee a wholly independent status and as such we support the compromise, although we shall have to watch attempts by others (eg the Danes) to insert unacceptable definitions of objectives: those are probably better left unspecified.

Article 4

This covers meetings of the Committee. It remains as in the 1964 decision and causes us no problems.

Article 5

This covers procedure and staffing. It enables the Committee for the first time to create sub-committees and provide its own research services. The resource implications and the fact that some others will regard the new structure as the first step towards an ESCB might suggest that the Committee's proposals in this area should be submitted to ECOFIN but we would not want to volunteer this ourselves, although we could back the suggestion, if others chose to put it forward.

6

DRAFT COUNCIL DECISION

amending the Council Decision of 8th May 1964
on co-operation between the Central Banks of the Member States
of the European Economic Community

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular to Article 105(1) and to the first indent of Article 145 thereof,

Having regard to the Recommendation of the Commission dated 1989,

Having regard to the Opinion of the European Parliament,

Having regard to the Opinion of the Economic and Social Committee,

Whereas the European Council, at its meeting in Madrid on 26th and 27th June 1989, decided that the first stage of the implementation of Economic and Monetary Union shall begin on 1st July 1990;

Whereas Article 102(A) of the Treaty as well as the implementation of the first stage of the Economic and Monetary Union calls for an increased degree of convergence in economic performance towards non-inflationary growth and of economic and social cohesion between the Member States;

Whereas greater convergence should be promoted with a view to achieving domestic price stability, which is at the same time a necessary condition for stable exchange rates, in accordance with the requirements of the European Monetary System;

6

DRAFT COUNCIL DECISION

amending the Council Decision of 8th May 1964
on co-operation between the Central Banks of the Member States
of the European Economic Community

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Whereas arrangements for the formulation of monetary policy in an Economic and Monetary Union should provide for adequate autonomy for the institutions and for commitment to price stability, which is essential to the success of that Union;

Whereas, in view of the objective of Economic and Monetary Union, the tasks and role of the Committee of Governors of the Central Banks of the Members States of the European Community should be extended and reinforced;

HAS DECIDED AS FOLLOWS:

Article 1

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(a) Article 2 shall be amended to read as follows:

"The Committee shall be composed of the Governors of the Central Banks of the Member States and the Director General of the Luxembourg Monetary Institute. If they are unable to attend, they may nominate another representative of their institution.

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(b) After Article 2, the following new Article 2a shall be inserted:

"The Chairman of the Committee shall be invited to participate in the meetings of the Council of Ministers."

(c) Article 3 shall be amended to read as follows:

"The tasks of the Committee shall be:

(1) to hold consultations concerning the general principles and the broad lines of policy of the Central Banks, in particular as regards credit, money and foreign exchange markets and including, within their competences, issues affecting the stability of financial institutions and markets;

(2) to exchange information regularly about the most important measures that fall within the competence of the Central Banks, and to examine those measures. The Committee shall normally be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;

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In carrying out its tasks, the Committee shall keep under review the trend of the monetary situation both inside and outside the Community.

The Committee shall prepare an annual report on its activities and on the monetary and financial conditions in the Community, which will be transmitted to the Council of Ministers, the European Parliament, and the European Council.

The Committee may authorise its Chairman to make the outcome of its deliberations public."

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(e) Article 5 shall be amended to read as follows:

"The Committee shall adopt its own rules of procedure. It may create sub-committees and provide its own Secretariat and research services."

Done at .....

For the Council

The President

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(For information only)

DRAFT CONSOLIDATED COUNCIL DECISION

of 8 May 1964

on co-operation between the Central Banks of the Member States of the European Economic Community

(64/300/EEC)

(as amended by Council Decision .... of ....)

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The Committee shall meet at regular intervals and whenever circumstances so require. The Commission may, if it considers the situation necessitates such a step, request an emergency meeting of the Committee.

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Done at Brussels, 8 May 1964

For the Council

The President

H. FAYAT

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The President
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CONFIDENTIAL

FROM: J ODLING-SMEE
DATE: 3 OCTOBER 1989
Ext: 4409

CHANCELLOR

cc: Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Wicks
Mr H Evans
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Riley
Mr Walsh
Mrs Brown
Mr S Davies
Miss Noble
Miss O'Mara
Mr Kroll
Mr Sharples
Mrs Chaplin
Mr Tyrie

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

You did not discuss this at yesterday's meeting. The question is set out in para 4 & 5 below. Which approach do you prefer?

JL

On balance, I favour option A. At a later stage, if we publish, we could include (List 3 in Stage 1, too; [illegible] but we would have to do so. It would be question of information [illegible]

EMU: MEASURES REQUIRED TO COMPLETE THE SINGLE FINANCIAL AREA

... I attach a note listing the measures required to complete the Single Financial Area so that we can decide which we will present as being part of Stage 1 and which additional to Stage 1. The attached four lists prepared by FIM divide possible measures up two different ways:

- into current measures (ie already agreed or under preparation), set out in Lists 1 and 2, and new measures, in Lists 3 and 4;

- into measures essential for a narrow definition of the Single Financial Area, in Lists 1 and 3, and those that go beyond this, in Lists 2 and 4.

We need to consider which lists we want to define as being within Stage 1 and which beyond.

2. As the note points out, the Delors Report takes a very wide definition of Stage 1 which includes almost all the measures on the four lists. The Bank believe that it is a mistake to try to define Stage 1 any more narrowly than this. They do not think that we could persuade other countries to accept our position, and we would find it harder to resist pressures to embark on Stage 2 sooner rather than later. But even if Stage 1 is limited along the lines suggested below, we should not have difficulty arguing that it is still enormous. In addition we have so far been drafting your paper on the assumption that we would want to claim that there were further measures to be taken beyond Stage 1, so it is worth investigating how we would back this up.

3. The Prime Minister's conditions for joining the ERM (when "real progress has been made towards .... freedom of financial services ...." HC, 12 July) would be achieved as long as at least List 1 measures were included in Stage 1.

4. The more we put into Stage 1, the more substantial Stage 1 becomes and the longer it will last, but the less we shall have left over to characterise later stages of our EMU. Some sort of balance is required, and two options suggest themselves:

	<u>Stage 1</u>	<u>Beyond Stage 1</u>
Option A	Lists 1 and 2	Lists 3 and 4
Option B	Lists 1 and 3	Lists 2 and 4

Under Option A, Stage 1 would be said to consist of all the measures which are already agreed or under preparation, with new measures falling outside it. Under Option B, Stage 1 would be said to consist of all measures which are essential to create the core conditions for the Single Financial Area (defined to be free capital movements, freedom of establishment, and freedom to sell across borders), with less essential measures falling outside it.

5. The advantage of Option A is that it incorporates a time dimension by separating measures according to when they are likely to be implemented, and it leaves some substantial items for beyond Stage 1. The advantage of Option B is that Stage 1 will take a very long time to complete, because the List 3 measures still have to be put on the agenda. The choice between Options A and B depends on how we wish to play it: A would be chosen if the emphasis was on what remained to be done beyond Stage 1, and B if the emphasis was on the scale of Stage 1. Mr Wicks has pointed out that we may be able to have it both ways with Option A. If others say that Stage 1 contains many more measures than Option A does, we could reply that, to the extent that was true, it would make Stage 1 a very long process indeed which would underline the futility of planning beyond Stage 1. He and I favour Option A, but I understand that Sir P Middleton favours B.

6. As well as deciding on the definition of Stage 1 it is necessary to consider whether it is in the UK's interests to propose all the additional measures in Lists 3 and 4. A particular problem is posed by the removal of tax incentives to residents to invest in domestic savings media (eg PEPs, BES). Although we expect the Commission to attack us over PEPs and BES at some stage, our policy is to sit tight until they do. It would be a little odd to invite them to investigate such tax incentives throughout the Community, especially given our general resistance to Community involvement in tax affairs, although we could be constructive should they take the initiative.. Despite the logic of including the removal of tax incentives, it might be best to expunge it from the list.

X✓

7. Your views are invited on:

(a) the definition of Stage 1;

(b) whether to include all the measures on Lists 3 and 4.

JO-8

J ODLING-SMEE

CONFIDENTIAL

MEASURES REQUIRED TO COMPLETE THE SINGLE FINANCIAL AREA

This note seeks to classify measures required to complete the single financial area into those which are clearly part of Stage 1, those which could also be presented as part of Stage 1 if required, and those which could be presented as beyond Stage 1.

2. There are no clear boundaries to Stage 1. The Delors report (paragraph 52) takes a wide definition, saying that in Stage 1:

> "... 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."

On this interpretation, Stage 1 will not be complete until all measures required for a single financial area are put in place, including complete liberalisation of capital movements and removal of all barriers to cross border provision of financial services within the Community. This will clearly take a long time.

3. To avoid all possible measures being defined to be within Stage 1, one could adopt a more limited definition which would strike an appropriate balance between what was desirable and what was realistic on a reasonable timescale. This would be based on distinctions between:

- measures already agreed or under preparation and other measures, ie a distinction according to the likely timescale for implementation;

- measures which created the core conditions for a single financial area and other measures, where the core conditions would be defined as:

(i) the removal of constraints on free movement of capital between member states;

(ii) the right for financial firms established in one member state to branch into other member states without further authorisation requirements;

(iii) the right for financial firms established in one member state to sell financial services across borders into other states subject to non-discriminatory regulation by the host state over the way the service is sold.

4. Distinguishing the measures in these two ways defines four lists:

<u>List 1</u> includes those single market measures in the financial field already agreed or under preparation which are essential to fulfil the core conditions set out above.

<u>List 2</u> includes further measures agreed or under preparation which are not essential.

<u>List 3</u> includes new measures to achieve greater uniformity in the provision of financial services which are essential for the core conditions.

<u>List 4</u> includes new measures which are not essential for the core conditions.

5. The measures in List 1 will remove the basic constraints on capital movements; and represent a move most of the way towards freeing the banking, securities and insurance sectors. But this leaves a good deal to be done to achieve uniform access to markets and many covert barriers untouched. List 1 falls well short of the full achievement of Stage 1 in the sense of Delors.

6. The measures in List 2 represent substantial further progress towards harmonisation of standards and the creation of a level playing field for competition in financial services. They will still permit certain regulatory obstacles and tax distortions.

7. The measures in List 3 are necessary to create the core conditions of a single financial area as defined above. They are not yet under preparation and so in practice it would be a long time before they were implemented.

8. The measures in List 4 remove the main outstanding obstacles to the single financial area. But it will still take some time before market operators become sufficiently accustomed to the new rules to create a fully operational single financial area, and numerous cultural differences will continue to fragment the market.

CONFIDENTIAL

ANNEX A

CHECKLIST OF MEASURES REQUIRED FOR COMPLETION OF SINGLE FINANCIAL AREA

LIST 1 - CURRENT MEASURES ESSENTIAL FOR CORE CONDITIONS

Capital Movements

1. Capital Liberalisation Directive. Adopted June 1988. Implementation due by 1 July 1990 for 8 majors, and 1 January 1993 for Greece, Ireland, Spain and Portugal with option for further extension for Greece and Portugal. Requires removal of all direct and indirect controls on capital movements within EC, and therefore in effect erga omnes. Exceptions allowed for measures to prevent tax evasion, to allow for prudential supervision and for declarations for administration or statistical information. (Article 4).

Banking

2. Second Banking Directive. Common position reached in June 1989. Full implementation required by 1 January 1993. Allows EC authorised banks (and building societies) to branch freely into other states and sell a defined range of services across borders.

3. Own Funds Directive (adopted) and Solvency Ratios Directive. (common position reached June 1989). Support the main directive by laying down minimum standards of capital adequacy for banks.

Securities

4. Undertakings for Collective Investment in Transferable Securities Directive (UCITS). Adopted 1985. Due for implementation by most member states by October 1989 and in Greece

and Portugal 1 April 1992. Provides European passport for unit trust type vehicles which invest in a defined range of traded securities.

5. Investment Services Directive. Discussion of draft in Council working group due to begin shortly. Target is for adoption in time for implementation by 1 January 1993 in line with the banking directive. Aims to give a passport to non-bank financial institutions to undertake investment business across the Community on the basis of home state authorisation. (Must provide for fair competition between bank and non-bank securities businesses).

6. Position Risk Directive. Discussion of draft in Commission working group has just begun. Lays down minimum capital adequacy standards for securities business. Hence a necessary condition for agreement to the investment services directive.

Insurance

7. Non-life Services Directive. Adopted 1988. Due for implementation by 1 July 1990. Allows non-life assurers to insure risks (other than motor liability) across frontiers but only large commercial risks will be free of host state control of premium rates and policy terms and conditions.

8. Life Services Directive. Draft under discussion in Council working group. Target is common position by end of year. This is a limited measure which provides freedom for life assurers to sell policies across borders only when they are approached by customers on their 'own initiative'. UK aiming to see it extended to allow advertising, to allow brokers to arrange policies with foreign insurers and ideally to replace the 'own initiative' restriction with simple requirement that the customer agrees to place himself under the protection offered by the home state of the insurer.

9. Motor Insurance Directive. Draft under discussion in Council working group. Extends the non-life services directive to cover motor liability (and therefore only brings large commercial motor risks within the liberal regime).

10. Second Life Services Directive. Not yet drafted; due by end of year. Designed to extend limited liberal regime of first life services directive to group life and pensions business.

11. Third Life Services Directive. Not yet drafted; due by end 1990. Designed to extend liberal regime to individual 'mass risk' business.

12. Second Non-Life Services Directive. Not yet drafted; due by end 1990. Required to extend liberal non-life regime beyond large risks to individual 'mass risk' business.

LIST 2 - CURRENT MEASURES NOT ESSENTIAL FOR CORE CONDITIONS

Capital Movements

1. Measures to counter tax evasion. Draft directives on withholding tax and mutual assistance between tax authorities were published in February. Tax proposal dead but not buried. Further measures to counter tax evasion now under discussion in ad hoc high level group. UK see such measures as unnecessary but is prepared to respond constructively.

Banking

2. Measures to extend mutual recognition of financial techniques. Proposals under discussion include a mortgage directive (text proposed by Commission to be reconsidered this month but unlikely to lead to early action) and a mortgage bonds directive (Commission proposals effectively shelved).

3. Measures to harmonise consumer protection. Recently adopted Consumer Credit Directive provides standard formula for calculating the cost of credit (APR). Commission is likely to propose a draft recommendation on transparency of bank charges.

4. Measures to harmonise further the minimum standards of prudential supervision of banks. An example is the draft Directive on Consolidated Supervision now under discussion in Commission working group.

5. Measures to encourage European markets by laying down common standards. Examples are the Commission statement on Electronic Funds Transfer at Point of Sale (January 1987) which considers common technological standards in this field but makes no formal proposals; the Winding Up Directive which would harmonise national laws in the event of liquidation; and the Commission recommendation on payment systems (November 1988) which seeks to encourage standardisation.

Securities

6. Insider Dealing Directive. Common position reached June 1989. Lays down minimum standards for outlawing insider dealing.

7. Prospectus Directive. Adopted April 1989 and due for implementation April 1991. Lays down minimum standards for information to be published in prospectus when securities offered for sale to the public.

8. Directive on disclosure of major share holdings. Adopted December 1988 for implementation 1 January 1991. Requires disclosure of acquisition or disposal of shareholdings above certain thresholds.

9. Directive on mutual recognition of listing particulars. Adopted 1987. Amendment now under discussion with a view to implementation by April 1991.

Insurance

10. Insurance contracts directive. Draft under discussion for many years.

11. Annual accounts of insurance undertakings directive. Draft under discussion for many years. Generally welcomed by UK. Will standardise information to be disclosed in accounts.

12. Winding up of insurance undertakings directive. Draft published 1986.

LIST 3 - NEW MEASURES ESSENTIAL FOR CORE CONDITIONS

Capital movements

1. Measures to eliminate regulatory obstacles to free flow of capital. Financial institutions such as life assurance companies and pension funds are, in most EC states, subject to strict regulation of investments. In many cases this extends to both the currency and the location of investments. A degree of regulation is necessary for prudential reasons, and in the case of life assurance companies is required under European law. However it is arguable that the restrictions applied by certain countries infringe the requirements of the Capital Liberalisation Directive. The Commission could be asked to investigate. (We understand some work on this is already planned.)

Insurance

2. A European passport for insurance companies on the banking model could be pursued. The directives currently under consideration will not allow insurance companies to branch in to other member states on the basis of home country authorisation. (Strictly this should be a 'core' measure. It is included here because progress on this point is still distant).

LIST 4- NEW MEASURES NOT ESSENTIAL FOR CORE CONDITIONS

Capital movements

1. Measures to remove tax distortions on the free flow of capital. Many member states offer tax incentives to residents investing or depositing in domestic savings media. Such incentives distort the free flow of capital and arguably contravene the Capital Liberalisation Directive. The Commission could be asked to investigate.

2. Measures to eliminate regulatory obstacles to capital movements. Certain countries which claim to have no exchange controls impose restrictions on capital markets which impede the free movement of capital. For example, West Germany restricts foreign currency debt issues by German residents where the first purchasers are also German residents, and restricts purchases of certain classes of government debt by overseas residents. Another example arises where governments require financial institutions to invest in government debt to a prescribed extent, sometimes at preferential rates. The Commission could be asked to investigate.

Banking

3. Measures to limit 'public good' restrictions on activities of banks allowed under the banking directive. Member states may use the provision in the directive which allows limits on mutual recognition of financial techniques where justified on 'public good' grounds to restrict activities of banks.

4. Measures to establish a European mortgage market. Restrictions on financial techniques in the mortgage market are common. Further steps may be needed to open other markets to UK style mortgages.

5. <u>Further measures to harmonise consumer protection</u>. Banks will have to comply with local consumer protection rules. For example EC banks operating in UK must comply with the Consumer Credit Act and any code of practice resulting from the Jack Report. This fragments the market and makes it more difficult to conduct European wide operations. A fully open market would require standardised regulations on advertising, quotations, mailing of credit circulars to minors etc. A logical conclusion would be a European code of banking practice.

6. <u>Measures to harmonise consumer credit markets</u>. Credit cards are far more common in the UK than in countries such as Germany where until recently a formal cartel blocked the major credit card organisations from negotiating with individual German banks. This may be a matter for European competition policy.

7. <u>Standardisation of deposit protection schemes</u>. Could be pursued by a directive taking forward the 1986 recommendation.

8. <u>Prudential standards</u>. The Commission may propose a directive taking forward the 1986 recommendation on large exposures.

<u>Securities</u>

9. <u>The UCITS Directive could be amended</u> to accommodate the full range of authorised unit trusts soon to be allowed in the UK (including funds investing in the money markets, futures and options and commodities).

10. <u>Harmonisation of conduct of business rules</u>. Could be pursued by a directive supplementing the Investment Services Directive to facilitate cross border selling. Essentially this would require establishing the basic principles of the SIB rule book in European law.

11. <u>Measures to open distribution channels for financial services</u>. For example the UK requirement on investment advisers to offer 'best advice' could be pursued at a European level.

Insurance

12. Conduct of business rules for the sale of life assurance (disclosure of commission, requirement of intermediaries to give best advice etc) could be applied at a European level.

FROM: N L WICKS
DATE: 3 OCTOBER 1989
Ext : 4369

WICKS PAPER FOR ECOFIN

CHANCELLOR OF THE EXCHEQUER

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

I have marked a few comments. The main question is on style – should it be personal to you? – & on how far you hint at eventual fixed rates.

J

ECONOMIC AND MONETARY UNION: PAPER FOR ECOFIN

I attach a further draft of the paper for ECOFIN on our approach to EMU, revised in the light of your comments, recorded in your Private Secretary's minute of 30 September.

2. Some points on the draft:

(i) We need to decide whether to distinguish between developments in Stage 1 and later stages; or whether to elide the whole process into a "super" Stage 1 and to argue that nothing is necessary thereafter. A good case can be made for the latter approach; indeed it reflects the most desirable outcome from our point of view. But on reflection I think it better to opt for the former approach. The Madrid communique and most opinion in the Community appears to accept that there should be something after Stage 1, though what that something should be is unclear as is its timing. For us to argue that Stage 1 is the end of the process would court the risk of having that our paper dismissed from the outset, even by those who are sympathetic to our viewpoint. Much better therefore for the argument to be about the content of what comes after Stage 1 and about timing. The paper has been drafted in that sense.

(ii) To the extent possible the paper has been drafted so as to expose underlying issues and principles.

(iii) The order of the argument in the paper is: introduction, Stage 1, beyond Stage 1, knocking copy on Delors and conclusions. That order - beyond Stage 1 before the knocking copy on Delors - seems preferable because it makes the paper look more positive: it brings our proposals up front and allows some of the knocking Delors material - on no need for budgetary rules or enhanced regional policies - to be put positively in the section on our approach to beyond Stage 1. But if you wish, the order can easily be reversed.

(iv) The paper is written in impersonal style. But we can put it in the first personal plural if you wish.

(v) You will want to reflect on the sentence in square brackets in paragraph 13. It will go down well in the Community, but less well elsewhere.

2. We will need to give some thought before too long to the presentation and publicity for the paper so as to maximise its impact here and in Europe.

N.L.W.

N L WICKS

THE MARKET APPROACH TO ECONOMIC AND MONETARY UNION (EMU)

Introduction

The European Council confirmed at its meeting in Madrid in June the objective of the progressive realisation of EMU but did not specify how that objective was to be realised, beyond agreement to launch the first Stage on 1 July 1990. By common consent the next steps in economic and monetary integration of the twelve Member States will be crucial to the future economic development of the European Community. That development must be based on firm and durable foundations which reflect both the diversity and the unity of the economic and monetary situation in Europe. This paper describes an approach which would lay these sound foundations and which at the same time avoids the disadvantages of other approaches which are under consideration.

Stage 1

2. The starting point for any consideration of the future economic and monetary construction in Europe has to be Stage 1 of EMU. This will bring about massive changes in the European economy. Unnecessary barriers to the movement of people, goods and services will go. Competition will be more fierce. Capital will, for the first time in three-quarters of a century, be free to move where it likes, when it likes. And all member countries will be in the ERM on equal terms.

3. The path on which Europe will be thrust as a result of these changes is impossible to map with any precision. The forces released will reshape all our economies in a new European mould. By any standards it is a major endeavour. It would be rash to move to a theoretical blue print of European economic and monetary arrangements, worked out before market realities have had a chance to point the way forward. It will take many years for this to happen, as we have seen in respect of smaller liberalisations in individual countries.

4. Stage 1 will project Europe forward on the basis of the fundamental principles for a successful policy for economic and monetary integration in Europe. First, Stage 1 will increase the influence of markets and competition. It will thus reflect the worldwide consensus in favour of relying wherever possible on market forces. This is the philosophy behind the Single European Act. Second, it will do this while respecting the principle of subsidiarity: policy functions are most effectively performed by national governments while being clearly directed towards wider European progress. Third, it will increase the pressures on governments to compete in monetary policies, so bringing inflation down everywhere.

better definition

5. In particular, the removal of exchange controls on 1 July 1990 within the context of the ERM will intensify the competitive pressures on governments to conduct anti-inflation policies. As the market will only be satisfied with stable prices, it will increasingly drive national governments to compete with the best performers. Countries will in practice be competing with each other to ensure that their currencies retain their value. Otherwise their attractiveness will diminish rapidly. So we can have some confidence that the measures begun in Stage 1 will move us in the direction of a low inflation Europe with increasing exchange rate stability.

6. Community-wide payments mechanisms will become more efficient during Stage 1 as increased competition in banking stimulates improvements. The transactions costs and inconvenience of the multi-currency system will be reduced.

Spell out example of credit cards

e.g. It is already possible at very minimal cost to pay .... by credit card. Such

Beyond Stage 1

7. The competitive forces set free in Stage 1 will lead to increased integration of Member States' economies for many years thereafter. But more steps should be taken in due course to enhance further the process of integration.

8. To try to decide now - even before that Stage has begun - how the progressive realisation of EMU should be carried forward after

that Stage is both hazardous and unnecessary. Indeed, to devote our energies now to planning further stages beyond Stage 1 would put Stage 1 itself at risk. There is only a limited amount of time available from both governments and officials. Yet half of the 279 single market measures have still to be agreed by Community institutions; and hardly any have been implemented in the legislation of all twelve Member States. Key measures, such as those to bring down barriers in the provision of financial services will not even start to come into effect until January 1993.

9. Despite the uncertainties, it seems clear that if the objectives of Stage 1 are realised, inflationary pressures will be reduced and with them the pressure for exchange rate changes between the currencies of Member States. The ERM will have become more stable as a result of a natural process - and the benefits of further integration in Europe will follow through increased trade and long-term capital flows. The competition among currencies will become greater and the pressures on governments to keep down inflation will also be greater.

10. In the monetary sphere these pressures towards a low inflation Europe can be enhanced by the complete removal of remaining restrictions on the use of Community currencies for transactions and savings. In the case of transactions, restrictions on companies and individuals which give a privileged position to domestic currency as a means of payment or for use in contracts have no place in a system of competing currencies. Parties should be free to decide what currency to use uninhibited by the law. The costs to individuals of changing between Community currencies can be reduced further by tackling remaining barriers to the use of relatively cheap means of payment (eg credit cards). Greater use of the private ECU will also reduce transactions costs.

11. In the case of savings and financial services more generally, there will remain many restrictions on their availability in all currencies throughout the Community even after Stage 1. For example, restrictions on the currency and geographical location of

the assets of long-term savings institutions exist in many countries, often beyond the limits of what is essential for prudential purposes. Tax incentives for domestic investments distort the free flow of capital. And financial services will not be offered uniformly throughout the single financial area because of differences in, for example, conduct of business rules, compensation schemes, the regulatory requirements for establishing insurance companies, and the financial techniques and distribution channels which are permitted.

?

12. All these should be examined with a presumption that they should be removed, in order to strengthen the process of monetary integration and complete the development started in Stage 1.

13. In addition, Community Central Banks should remove all restrictions on the official use of their currencies. This should lead to the increasing use of different EMS currencies for intervention and increased cross-holdings of EMS currencies in national reserves. [With increasing stability of exchange rates leading to smaller fluctuations, the market discipline on monetary policies could be strengthened by narrowing the ERM bands.] and eventually exchange rates would become effectively fixed. [It is even conceivable that the number of currencies would eventually diminish]

No

14. All these measures will strengthen the process of convergence on price and exchange rate stability and lower transactions costs. and credit [There will be] a number of readily interchangeable currencies in this version of monetary union.

15. Sound monetary policies will impose constraints on national budgetary policies. Within these, Member States would remain free to set their own budget deficits, with pressures from the integrated European capital market and multilateral surveillance ensuring that the results do not undermine monetary stability. The only universal requirement which might be ~~necessary~~ advisable is not to finance deficits by printing money, or through other forms of monetary financing. There would also be no question of alleviating excessive debt burdens by action at Community level, which would only inhibit market forces.

16. Regional and structural disparities in the Community would be alleviated primarily through the operation of market forces. The strengthening of market mechanisms which is central to the achievement of economic union would enable the countries with the lower per capital GNP to exploit market advantages, such as their low costs, and hence to maximise rates of return and profitable investment opportunities and attract the flows of private capital required to finance them. This is the way to ensure catching up and the achievement of genuine and sustainable growth.

The Delors Report

17. The approach described above envisages that economic and monetary union would be achieved as a result of the operations of market forces. By contrast, the Delors report envisages moving by administrative means and institutional change first to irrevocably fixed exchange rates, then to a single currency. Responsibility for monetary policy would be transferred to a European System of Central Banks (ESCB), independent of both governments and Community authorities. There would be binding rules on the size of national budget deficits. And there would be enhanced regional and structural policies and financial flows.

18. There are a number of major defects with this approach quite apart from the fact that it was framed in the absence of any appreciation of the effects of Stage 1.

19. First, binding rules on the size of budget deficits are neither necessary nor desirable. They are unnecessary because deficits of different size and composition in different countries will be perfectly compatible with the sound monetary policies which the ERM and competition will encourage governments to pursue. Market pressures and multilateral surveillance will prevent deficits becoming unsustainable or unneighbourly. Binding rules are undesirable because they would entail an enormous loss of sovereignty by Member States for what - given the uncertain knowledge about the effects of budgetary policy - would be wholly unpredictable results.

20. Second, the Report's structural and regional proposals are defective. There must of course be opportunity for the prosperity of the poorer regions to gradually raise towards that of the more prosperous. But there is no reason to think that moves to European economic and monetary union, properly handled, would have a negative impact on the poorer areas requiring compensatory action. And we know, from the attempts which countries have been making to improve the structure of their economies that, interventionist policies by governments have created more problems than they have solved when they have moved against the grain of the market.

I don't think this is true of Bundesbank

21. Third, it is acknowledged throughout the world that monetary policy is at the heart of macro-economic policy. Countries vary in the degree of independence of their central bank with respect to political controls. But there are arrangements everywhere for accountability to & close cooperation with national governments. Parliaments The proposals in the Delors Report explicitly make no provision for accountability to national governments. So elected governments would have no means at their disposal to influence the key area of macro-economic policy in Europe. Nor would they be able to bring the central banking system to account for major failings - there can be no guarantee that a single central bank or an ESCB would pursue anti-inflationary policies and there can be no guarantee that it would successfully fulfil that mission whatever Treaties might say. Yet the electorate would still hold governments responsible for their economic well being. The Delors Report's proposals would thus create an imbalance of power, quite unmatched elsewhere in the world, between the ESCB and the twelve Finance Ministers of the Member States. That imbalance could only be rectified by centralising the power of the Finance Ministers requiring a European Finance Ministry and with it a European Government. There is certainly no agreement among the Member States on the desirability of making that move.

22. In short, there are enormous political and economic risks in moving to a single currency. The Delors Report nowhere sets out the economic gains from such a move. They are unlikely to outweigh the risks. In any event, it would be the height of imprudence to

embark on the course proposed in the Delors Report when there is an alternative one available which would provide an evolutionary and market based approach to economic and monetary integration union in Europe.

Conclusions

23. The market approach to EMU will not, of course, meet those definitions of monetary union that include a single currency. But such a definition precludes debate and removes any role for the market in favour of a central plan. Moreover, by eliminating competition and accountability from members' monetary policies, it runs the risk of producing a higher inflation rate in Europe - one in which performance approximates more to the average than to the best. The administratively imposed changes that are required would inevitably fail to foresee future developments. And they involve constitutional and institutional changes which are wholly unnecessary.

24. By contrast, the form of monetary union advocated in this paper would develop naturally towards the commonly agreed objective of stable prices achieved by the alignment, though competitive mechanisms, of the twelve Member States' monetary policies. It is a multi-currency solution with increasingly interchangeable currencies in Europe. It involves no major constitutional change. As experience is gained with these changes and the effects of Stage 1 absorbed, it might be desirable to formalise the fixity of exchange rates. But that cannot be decided yet when there is so much change to take place as a result of what is already happening.

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(FRAME ECONOMIC)

YOUR TELNO 791 TO PARIS : EMU : STAGE I LEGAL TEXTS

SUMMARY

1. THE DUTCH ARE IN GENERAL AGREEMENT WITH OUR VIEWS BUT SEE NO NEED FOR THE PARTICIPATION OF ALL CENTRAL BANK GOVERNORS IN ECOFIN MEETINGS. THEY PROPOSE TO PRESS FOR SOME AMENDMENTS OF THEIR OWN.

DETAIL

2. IN THE ABSENCE OF MORE SENIOR MINISTRY OF FINANCE OFFICIALS IN WASHINGTON, ARCHER HAS SEEN VERWOERD, HEAD OF INTERNATIONAL MONETARY AFFAIRS, MINISTRY OF FINANCE WHO WAS JOINED BY TWO OTHER MEMBERS OF HIS DIRECTORATE FOR DETAILED DISCUSSION OF THE TEXTS.

3. VERWOERD SAID THAT THE DUTCH AND UK POSITIONS IN DISCUSSIONS ON 5 OCTOBER WOULD BE SIMILAR. THEIR LONGTERM COMMITMENT TO EMU WAS NOT IN DOUBT. THEY AGREED WITH THE UK THAT THERE HAD TO BE VERY THOROUGH DISCUSSION OF ALL THE OPTIONS BEFORE PROCEEDING BEYOND STAGE I AND COULD SEE NO REASON FOR HASTE IN SETTING UP AN IGC. BUT ONE ISSUE ON WHICH THERE WOULD BE DIFFERENCES BETWEEN THE NETHERLANDS AND THE UK WAS OVER THE ROLE OF CENTRAL BANK GOVERNORS. THE NETHERLANDS BELIEVED THAT THERE WOULD PROBABLY BE A STRONG CASE FOR ULTIMATELY GIVING THE GOVERNORS AN INDEPENDENT ROLE.

REVISED CONVERGENCE

4. THE DUTCH AGREED THAT IT WAS INAPPROPRIATE TO REFER TO MUTUAL COMMITMENTS ON DECISION MAKING IN THE FINAL CITATION. NO DECISION HAD BEEN REACHED ABOUT THE NEED FOR BINDING COMMITMENTS EVEN FOR A STAGE II.

5. THE DUTCH AGREED THAT ARTICLE 5 MIGHT BE AMENDED. THEY THEMSELVES SAW AN UNNECESSARY OVERLAP WITH ARTICLE 4 AND WOULD BE CONTENT WITH A SHORTENED ARTICLE 5 GIVING A MANDATE TO THE EPC ON MEDIUM AND LONG TERM POLICY SURVEILLANCE. ARCHER ASKED ABOUT THE DUTCH VIEW ON THE ROLE OF EPC. VERWOERD SAID THAT LIKE US THE DUTCH WERE HAPPY WITH THE ROLE GIVEN TO THE MONETARY COMMITTEE. BUT THEY THOUGHT THAT THE EPC SHOULD BE CONTINUED AND THAT A CLEAR MANDATE LINKED TO MEDIUM AND LONG TERM POLICY SURVEILLANCE WOULD BE APPROPRIATE AND WOULD NOT CONFLICT WITH THE PRIMACY OF THE MONETARY COMMITTEE.

6. VERWOERD ARGUED THAT THERE WAS NO PROBLEM IN THE REFERENCE IN

ARTICLE 7 TO MEETINGS TO CONSIDER EXTERNAL EVENTS. ECOFIN ALREADY MET 10 TIMES A YEAR. IN PRACTICE THIS WOULD PROVE SUFFICIENT AND SURVEILLANCE REMITS COULD BE DEALT WITH IN THE COURSE OF THE EXISTING PATTERN OF MEETINGS.

7. ON ARTICLE 8, THE DUTCH VIEW IS THAT IT IS ADEQUATE FOR CENTRAL BANK GOVERNORS TO BE REPRESENTED BY THEIR CHAIRMAN AT ECOFIN SURVEILLANCE MEETINGS. THE DUTCH DO NOT WISH TO ESTABLISH A PRECEDENT THAT MIGHT BE DIFFICULT IN SUBSEQUENTLY MOVING TO AN INDEPENDENT ROLE FOR THE GOVERNORS. BUT THEY HAD ALSO TAKEN INTO ACCOUNT THAT THE GOVERNORS THEMSELVES DID NOT WISH THAT THEY SHOULD ALL ATTEND.

8. THE DUTCH ALSO WISH TO MAKE A NUMBER OF OTHER DETAILED SUGGESTIONS:

A. ARTICLE 1 ADD ''THE SIZE AND FINANCING OF BUDGET DEFICITS''. THE DUTCH THINK IT MORE APPROPRIATE TO MENTION THIS HERE THAN IN ARTICLE 5.

B. ARTICLE 2 ADD AFTER COMMISSION ''OR THE MONETARY COMMITTEE''. THE DUTCH ARE CONCERNED THAT THERE SHOULD BE NO SUGGESTION THAT THE COUNCIL SHOULD NOT MAKE RECOMMENDATIONS ITSELF.

C. ARTICLE 4 ADD ''MONETARY COMMITTEE''.

D. ARTICLE 7 OMIT ''MONETARY''. GIVEN THE REMIT OF THE COMMITTEE GOVERNORS TO CONSIDER MONETARY POLICY, THE DUTCH SEE IT AS UNNECESSARY TO PROVIDE FOR CONSULTATION ON THIS UNDER ARTICLE 7.

E. ARTICLE 8. OMIT ''BETTER' AS A DRAFTING POINT.

F. ARTICLE 9. OMIT THE SECOND CLAUSE. THE DUTCH THINK THIS SHOULD BE LEFT TO NATIONAL GOVERNMENT'S DISCRETION. THERE COULD ALSO BE A CONTRADICTION BETWEEN SUCH PROVISION AND RESTRICTED SESSIONS.

REVISED DECISION ON CENTRAL BANK COOPERATION

9. THE DUTCH UNDERSTAND THE UK PROBLEM OVER COMPETENCE RAISED BY ARTICLE 3 AND CAN PROBABLY AGREE TO OUR PROPOSED AMENDMENT. VERWOERD COMMENTED THAT OTHERS HAD SIMILAR PROBLEMS.

10. ON THE REFERENCE TO ''THE STABILITY OF FINANCIAL INSTITUTIONS AND MARKETS'', FINANCIAL INSTITUTIONS WA MISLEADING AND TOO BROAD. THE DUTCH WOULD PREFER TO RETURN TO THE TEXT OF THE DELORS REPORT REFERRING TO ''BANKING'' INSTITUTIONS AND MARKETS.

JENKINS

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(FRAME ECONOMIC)

YOUR TELNO 791 TO PARIS : EMU : STAGE 1 LEGAL TEXTS

1. THE LUXEMBOURGERS DO NOT HAVE ANY SIGNIFICANT PROBLEMS WITH EITHER OF THE DRAFT TEXTS AND ARE NOT PLANNING TO RAISE ANY POINTS. YVES MERSCH (DIRECTEUR DU TRESOR, WHO WILL ATTEND THE MONETARY COMMITTEE ON 5 OCTOBER) COMMENTED AS FOLLOWS ON THE POINTS WE PLAN TO RAISE.

REVISED CONVERGENCE DECISION

2. (I) MERSCH DOES NOT DRAW THE SAME INFERENCE FROM THE OFFENDING PHRASE BUT HE CONFIRMED THAT THERE SHOULD BE NO BINDING COMMITMENT AND WOULD SUPPORT OUR ATTEMPTS TO MAKE THIS CLEAR.

(II) IN HIS VIEW ARTICLE 5 REFLECTS THE DECISIONS REACHED AND DOES NOT NEED AMENDING. BUT HE WOULD NOT OBJECT TO AMENDMENTS TO MEET THE CONCERNS OF OTHERS, INCLUDING BY IMPLICATION OURS.

(III) HE TAKES OUR POINT BUT DOES NOT FEEL SUCH MEETINGS SHOULD BE ENTIRELY RULED OUT IN VERY EXCEPTIONAL CIRCUMSTANCES: THEY SHOULD CERTAINLY NOT BECOME INSTITUTIONALISED. HE COULD LIVE WITH THE DRAFT PROVIDED THIS WAS CLEARLY UNDERSTOOD.

(IV) HE HAD NO STRONG VIEWS ON THIS.

(V) YOUR PARA 6. AS A GENERAL PRINCIPLE THE LUXEMBOURGERS BELIEVE THE FEWER COMMITTEES THE BETTER. EPC HAS NOT BEEN A NOTABLE SUCCESS AND SHOULD PERHAPS BE REQUIRED IN FUTURE TO FOCUS ON MEDIUM TERM POLICIES AND PERSPECTIVES. HE SAID THE COORDINATION COMMITTEE SHOULD BE ABOLISHED.

REVISED DECISION ON CENTRAL BANK COOPERATION

3. (I) YOUR PARA 7. MERSCH WILL NOT INTERVENE AS LUXEMBOURG HAS NO CENTRAL BANK.

(II) YOUR PARA 8. MERSCH CAN ACCEPT THE REFERENCE TO CENTRAL BANK CONSULTATIONS.

CAMPBELL

FCO PASS SAVING TO ATHENS, BONN, BRUSSELS, COPENHAGEN, DUBLIN, LISBON, MADRID, PARIS, ROME AND THE HAGUE

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YOUR TELNO 791 TO PARIS : EMU : STAGE I LEGAL TEXTS

SUMMARY

1. THE DANES ARE CONTENT WITH THE COMMISSION'S DRAFT LEGAL TEXTS AND HAVE NO SERIOUS POINTS TO RAISE IN THE MONETARY COMMITTEE ON 5 OCTOBER. THEY ARE GENERALLY UNSYMPATHETIC TO OUR PROPOSED AMENDMENTS.

DETAIL

2. ACTION TAKEN WITH PAGTER KRISTENSEN (ECONOMIC AFFAIRS MINISTRY) AND ORTMANN (MFA) LEAVING A PAPER BASED ON PARAS. 4-8 OF TUR WITH THEM. ORTMANN SAID THAT THE MINISTRY OF ECONOMIC AFFAIRS WERE IN THE LEAD ON EMU AND THAT THE MFA COULD NOT ADD ANYTHING TO THEIR COMMENTS.

3. PAGTER KRISTENSEN SAID THAT HIS MINISTRY HAD NO DIFFICULTIES WITH THE COMMISSION'S PROPOSALS, APART FOM AN INSTITUTIONAL POINT RELATING TO THE HEAVY WORKLOAD ON THE ECOFIN COUNCIL (SEE PARA 3(VI) BELOW). HIS RESPONSES TO THE POINTS RAISED IN TUR WERE :

A. REVISED CONVERGENCE DECISION
(I) FINAL RECITAL. THE DANES CONSIDER RECITALS HAVE NO LEGAL STANDING AND CAN NOT THEREFORE BE LEGALLY BINDING. THEY REGARD THIS PARTICULAR RECITAL AS NO MORE THAN WISHFUL THINKING SIMILAR TO THAT EXPRESSED IN ARTICLE 2 (''MULTILATERAL SURVEILLANCE SHOULD INCREASE BY RESULT...'').
(II) ARTICLE 5. THE DANES DO NOT ACCEPT OUR OBJECTIONS TO THIS ARTICLE. PAGTER KRISTENSEN REFERRED TO ARTICLE 3 (COUNCIL SURVEILLANCE OF MONETARY AND BUDGETARY POLICIES) AND ARTICLE 8 (CENTRAL BANK GOVERNORS SUPPORTING MULTILATERAL SURVEILLANCE TO ENSURE BETTER CONSISTENCY BETWEEN MONETRARY AND OTHER ECONOMIC POLICIES) TO DEMONSTRATE THAT OUR CONCERN WAS ALREADY COVERED.
(III) PAGTER KRISTENSEN SAID THAT ARTICLE 7 SIMPLY REITERATES THE PROVISIONS IN THE CAPITAL LIBERALISATION DIRECTIVEBOUT THE THREAT TO INTERNATIONAL CONFIDENCE BUT THOUGHT THAT A RESPONSIBLE PRESIDENCY COULD TIME THE DISCUSSION SENSIBLY TO AVOID PUBLICITY.
(IV) ARTICLE 8. THE DANES DISAGREE WITH US. THEY HAVE DIFFICULTY IN

APPRECIATING HOW THE ATTENDANCE OF CENTRAL BANK GOVERNORS COULD CONTRIBUTE TO ECOFIN SURVEILLANCE MEETINGS. THEY ALSO FEEL THAT IF CENTRAL BANK GOVERNORS WERE INVITED, FEW WOULD WANT TO ATTEND.
(V) THE DANES AGREE ON THE IMPORTANCE OF THE ROLE OF MARKET FORCES. PAGTER KRISTENSEN THOUGHT THAT THE POINT WAS MET IN THE THIRD ''WHEREAS'' (COORDINATION OF ECONOMIC POLICIES...BASED ON OPEN MARKET APPROACH....).
(VI) THE DANES PREFER TO GIVE THE ECONOMIC POLICY COMMITTEE A STRONGER ROLE AND ARE OPPOSED TO WEAKENING ITS CURRENT ROLE. THEY CONSIDER THE MONETARY COMMITTEE COULD BECOME OVERLOADED AND WOULD PREFER ARTICLE 3, LAST SENTENCE TO READ, ''THE COUNCIL'S WORK...SHALL BE PREPARED BY THE MONETARY COMMITTEE AND IF NECESSARY ALSO BY THE ECONOMIC POLICY COMMITTEE...''.

B. REVISED DECISION ON CENTRAL BANK COOPERATION.
(I) PAGTER KRISTENSEN SAID THAT IF THE UK HAD INSTITUTIONAL PROBLEMS WITH ARTICLE 3 DENMARK WOULD RESPECT THAT. HE WAS CONFIDENT THAT A TEXT COULD BE FOUND WHICH MET THE UK'S PROBLEMS AND WHICH WAS ACCEPTABLE TO THE DANES.

C. OTHER POINTS.
(I) DANISH POSITION ON ATTENDENCE OF CENTRAL BANK GOVERNORS AT ECOFIN (SEE PARA. 3(IV) ABOVE).
(II) THE DANISH CENTRAL BANK HAS AS MUCH AUTONOMY AS THE GERMAN BUNDESBANK. THE DANES HAVE NO DIFFICULTY WITH THE TEXT AS IT STANDS.
(III) DENMARK HAS NO DIFFICULTY WITH THE REFERENCE IN ARTICLE 3(I) TO CENTRAL BANK CONSULTATION BECAUSE OF THE INCLUSION OF THE PHASE,''WITHIN THEIR COMPETENCES''. PAGTER KRISTENSEN EXPLAINED THAT CONTROL IN DENMARK LAY WITH THE FINANSTILSYNET (BANKING AND INSURANCE INSPECTORATE) WHICH IS ANSWERABLE TO THE MINISTER OF INDUSTRY, RATHER THAN THE CENTRAL BANK.

WILLIAMS

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YOUR TELNO 791 TO PARIS: EMU TEXTS

1. COUNSELLOR CALLED ON 3 OCTOBER ON DR WALTER MARQUES OF BANK OF PORTUGAL, WHO IS ONE OF THE PORTUGESE REPRESENTATIVES ON MONETARY COMMITTEE. FOLLOWING POINTS WERE MADE BY LATTER WHO SAID HE HAD ALREADY BEEN IN CONTACT WITH CROCKETT:

(A) THE PORTUGESE WERE ALSO WORRIED ABOUT BINDING COMMITMENTS (YOUR PARA 4 (1))

(B) WHILE THEY ACCEPTED THERE COULD BE NO ECONOMIC CONVERGENCE WITHOUT FISCAL/BUDGETARY CONVERGENCE, THEY WERE WORRIED ABOUT DETAILED RULES BECAUSE OF PORTUGAL'S SPECIAL BUDGETARY PROBLEMS. UNLIKE ANY OTHER EC COUNTRY , PORTUGAL WAS HAVING TO EXPAND ITS ECONOMY VERY FAST IN ORDER TO CONVERGE WITH THE REST OF EUROPE WHILE COPING WITH THE DEBTS OF THEIR DECOLONISATION AND REVOLUTION. IT WOULD BE POLITICALLY IMPOSSIBLE TO ACCEPT A FIXED RATIO FOR THE PUBLIC DEFICIT EG OF FIGURE 5 OR 6 PERCENT WHICH MIGHT BE ACCEPTABLE TO FRANCE OR GERMANY. THERE SHOULD BE ALLOWANCES FOR DIFFERENT BUDGERTARY SITUATIONS IN DIFFERENT COUNTRIES.

(C) THEY AGREED STRONGLY WITH OUR VIEW ON PARA 4 (3) AND THOUGHT SPANISH WOULD ALSO SUPPORT.

(D) THEY DID NOT HAVE STRONG VIEWS ABOUT THE RELATIVE ROLES OF THE MONETARY AND ECONOMIC POLICY COMMITTEES, BUT BROADLY AGREED WITH OUR VIEWS. (THEY NORMALLY SEND LOWER LEVEL FUNCTIONARIES FROM THE BANK AND THE MINISTRY OF FINANCE TO THE EPC.)

(E) ON CONSULTATION, THEY SAW OUR POINT. (THERE WAS A ROW BETWEEN THE BANK AND THE MINISTRY OF FINANCE ON CREDIT LIMITS EARLIER THIS YEAR WHICH PROBABLY COLOURED MARQUES' VIEWS.)

(F) AS REGARDS STABILITY OF MARKETS, THEY WERE WORRIED ABOUT GIVING AWAY COMMERCIAL BANKING SECRETS, ESPECIALLY IN VIEW OF LOW SOLVENCY OF PORTUGESE BANKS: THERE SHOULD BE SOME APPROXIMATION OF PRUDENTIAL RULES, BUT NOT TOO MUCH.

(G) ON PRESENCE OF CENTRAL BANK GOVERNORS AT ECOFIN, THEY THOUGHT PRESIDENT OF CENTRALS BANKS ALONE OUGHT TO ATTEND AUTOMATICALLY WITHOUT HAVING TO BE INVITED, BUT NO-ONE ELSE.

2. MARQUES DOUBTED WHETHER AGREEMENT COULD BE REACHED ON TEXTS BY DECEMBER, BUT HE POINTED OUT THAT SEVERAL DELEGATIONS, NOTABLY GERMANS,HAD TENDED TO CHANGE POSITIONS IN UNEXPECTED WAYS DURING THE LENGTHY NEGOTIATIONS.

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REC. 6 OCT 1989 6/10
ACTION Mrs Brown
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ASSOCIATION FOR THE MONETARY UNION OF EUROPE

BF 13/10

Mr. JMG TAYLOR
Private Secretary
TREASURY CHAMBER (British Government)
Parliament Street
SW1P 3AG LONDON
UNITED KINGDOM

3rd October, 1989

Dear Sir,

We are pleased to present you with :

- A previously **unpublished survey** which we have recently carried out among **1,428 company leaders** of the European Community, on the theme of monetary union of Europe.
- The communiqué issued by our Association after its September 20th Board Meeting.

We trust that you will find these documents of interest.

Yours faithfully,

Bertrand de MAIGRET
Secretary General

Encl. : 2

ASSOCIATION POUR L'UNION MONETAIRE DE L'EUROPE
26 Rue de la Pépinière - 75008 Paris
Tél. : 33 (1) 45 22 33 84 - Télex : 282438 - Fax : 33 (1) 45 22 33 77

PRESS COMMUNIQUE OF SEPTEMBER 20TH

1. European business strongly favours monetary union...

Movement towards European monetary union is gaining momentum, as is proven by the meeting of Heads of States in Madrid and of Finance Ministers in Antibes. But European business is preoccupied by the fact that progress is still too slow.

The recent opinion poll* taken by Gallup for the AMUE** has confirmed the strong interest of European business leaders in the creation of monetary union in Europe. A large majority of them wishes the introduction of a common European currency, as an alternative to the present national currencies. They also find that the Heads of State at their Madrid Meeting in June 1989 ought to have gone further in their decisions.

2... but it remains difficult to develop the commercial use of ecu.

There is a large discrepancy between those who seek the development of a common currency (four out of five) and those who use the ecu (one out of five in 1988).

This gap is the natural consequence of the difference between the general expectation of what a common currency should be, and the current environment of the ecu. Many obstacles still hinder the progress.

3. Goverments, banks and businesses should aim to make the ecu viable and thereby would reduce the costs of "non-Europe".

Many of the technical and practical problems which companies face in using the ecu result from the "infant industry" character of ecu and will disappear once a "critical mass" of transactions has been reached, so that average transaction costs will progressively be reduced. To obtain this critical mass, AMUE appeals to governments, entreprises and banks alike to take appropriate measures in order to ensure "that there should be no discrimination against the private use of the ecu and that existing administrative obstacles should be removed" (Delors Report § 49). This in line with the commitments taken by the Heads of State at their Madrid June Meeting, where it was agreed to implement stage 1 of the Delors Report.

3.1. **Governments** have already taken positive steps in several countries by facilitating borrowings in ecus rather than any other foreign currency (France, Italy), allowing to operate personnal accounts in ecus (France, Germany) or even for a few companies to keep their legal accounts in ecus and to pay accordingly income tax (Netherlands).

However, the most important step in removing administrative obstacles would be to attribute the *status of legal tender to ecu* in all European countries, while maintaining its basket nature. This must go in pair with a process of general convergence in economic and monetary policies. Thus, ecu will *not* become a *parallel currency* which might jeopardize economic stability. It will rather be the true *common currency*, an alternative option to the national currency in each country.

3.2. **Businesses** have to set up their efforts to change old habits and increase the flow of information about practical applications of ecu. This is why AMUE, having already published 400 000 copies of its guide "The ecu for the Europe of 1992", is presently developing a series of seminars which will take place in all major towns and cities of Europe for senior business managment.

3.3. **Banks** are considering together with industrial companies how the transaction costs in using ecu can be reduced.

In order to encourage an informal debate AMUE has decided to undertake a comprehensive study in all European memberstates, analysing all existing obstacles and making suggestions for their removal.

* enclosed document

** Association for the Monetary Union of Europe

Faits et Opinions

25, rue Cambon - 75001 Paris
Téléphone : (331) 42.96.41.65

EUROPEAN COMPANIES

AND

MONETARY UNION

Results of a survey carried out by the Gallup network institutes among
1,428 company leaders in the European Community,
at the initiative of

ASSOCIATION FOR THE MONETARY UNION OF EUROPE
26, rue de la Pépinière
75008 - PARIS
Tel : 33 (1) 45 22 33 84

Authorized publication : 20th September 1989

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1 Figures taken from the July 1988 poll

This document was developed on the basis of the results of an inquiry carried out in July 1989 among 1,428 company leaders (senior managers) (around 200 per country), whose firms have an annual volume of imports and/or exports amounting to at least 300,000 ecus.

The interviews were carried out by professional pollsters in the seven most important countries in the European Community in terms of gross domestic product: Belgium, West Germany, Spain, France, Italy, the Netherlands and Great Britain.

Certain aspects are related to the results of a study carried out in July 1988, with the same target: 1,036 company leaders with the same minimum export and/or import volume were queried in the same countries, by the same institutes, concerning ecu use (1).

1. A common currency : massive support by senior managers

Common currency:

The two polls, carried out a year apart, confirm European managers' very favorable attitude toward a common currency: the percentage of those saying they favour a common currency was estimated at 83% in 1989.

Attitude toward a common currency

	B	FRG	S	F	I	N	GB	Average
Favourable	90	69	92	90	94	82	65	83
Unfavourable	3	19	2	3	5	13	24	10
Don't know	7	12	6	7	1	5	11	7
Total	100	100	100	100	100	100	100	100

An analysis of the results and of the trend in them **by country** shows great stability, except in Great Britain, where some reluctance is seen, and in Germany, where opinion seems more favourable.

(1) The complete results of the two polls and a description of the methodologies used are available from the Association for the Monetary Union of Europe, 26, rue de la Pépinière, 75008 Paris, France.

Some 76% among the managers favourable to a common currency desire the gradual disappearance of the national currencies.

% among managers favorable to a common currency

Should the joint currency lead to the gradual disappearance of the national currencies?

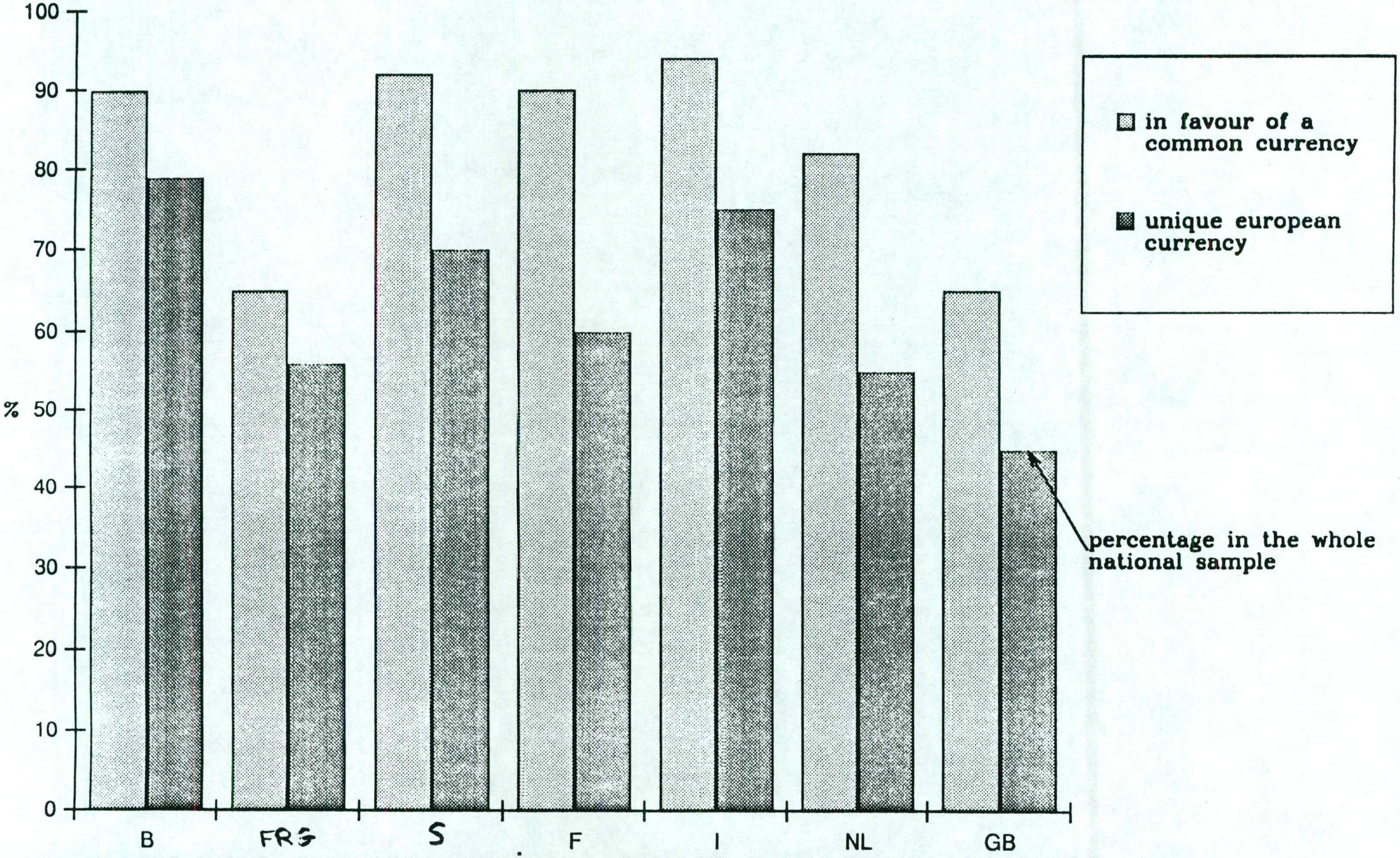
	B	**FRG**	**S**	**F**	**I**	**N**	**GB**	**Average**
Yes	88	81	76	66	80	67	70	76
No	6	13	12	26	18	29	26	18
Don't know	6	6	12	8	2	4	4	6
Total	100	100	100	100	100	100	100	100

Thus the idea of a **common currency** appears very widely associated with the notion of a **single currency**, destined to drive out the national currencies in the long run.

This association between the two concepts of common currency and single currency is less developed in France and The Netherlands than in the other countries covered by the study. On the other hand, it is very strong in Belgium, Italy, and even in Germany, where 81% of the business leaders saying they favour a common currency want the national currencies to disappear gradually.

If one does not remain in the sub-group of managers favouring a common currency, and instead considers all of the managers queried, one can estimate that in 1989, some **63% of the managers in the seven European countries covered by the study want a single common currency in the long run.**

THE DESIRE FOR A COMMON CURRENCY



Central Bank:

Nearly three-fourths of the company leaders queried (73%) want a European Central Bank. But this figure actually masks a split between two groups of countries:

- On one hand are the British managers, who quite divided on the interest of having a European Central Bank (48% are favourable and 40% unfavourable).

- On the other hand, the other countries, which express massive agreement (ranging from 65% of favourable managers in Germany and in The Netherlands to 89% in Italy).

Attitude toward a European Central Bank

	B	FRG	S	F	I	N	GB	Over-all
Favourable	77	65	83	87	89	65	48	73
Unfavourable	11	20	9	5	7	25	40	17
Don't know	12	15	8	8	3	9	12	10
Total	100	100	100	100	100	100	100	100

As a whole, the desire for a European Central Bank remains clear in a majority, but is less widespread than the desire for a common currency. It would seem to be the way of bringing about monetary union that still gives rise to certain questions on the part of company leaders but they have very largely accepted the principle and acknowledged the interest.

The EEC summit meeting in Madrid:

The judgement made by the European managers with respect to the European Council meeting in Madrid on June 26-27, 1989, strengthens this hypothesis.

Those managers were asked whether they considered that the Heads of State or Government meeting in Madrid had gone too far, far enough, or not far enough in their work looking toward European monetary unification.

The results vary perceptibly between countries (cf. the table below).

At European level, a majority (51%) of the managers queried consider that the summit participants should have gone further. But there are very few who think the summit went too far (3%).

As a whole, the majority attitude is to express support for the process of monetary integration, dominated by a desire for a speed-up.

The heads of state and government meeting in Madrid...

	B	**FRG**	**S**	**F**	**I**	**N**	**GB**	**Over-all**
Should have gone further	58	29	54	37	66	87	24	51
Went far enough	17	46	27	39	29	6	66	32
Went too far	1	9	-	-	1	3	3	3
Don't know	24	16	19	24	4	4	7	14
Total	100	100	100	100	100	100	100	100

And do you think that your government...

	B	**FRG**	**S**	**F**	**I**	**N**	**GB**	**Over-all**
Should have gone further	52	19	44	27	55	82	47	47
Went far enough	21	54	34	42	38	8	45	35
Went too far	1	7	1	1	2	4	3	2
Don't know	26	20	21	30	5	6	5	16
Total	100	100	100	100	100	100	100	100

Questions asked in July 1989

2. Ecu use : a slow start

It remains true that use of the ecu by business is not developing at a rate that the very favourable attitude on the part of European company leaders toward monetary integration would allow one to hope for.

In 1988, barely a fifth of the managers questioned had already used the ecu. The proportion was 47% in Italy, but less than 10% in Great Britain and The Netherlands.

In 1989, only 11% of the European managers queried said their company had made specific efforts, over the last 12 months, **to increase** ecu use. The proportion reaches 30% in Italy, and generally speaking seems higher in the countries in which ecu use was already more developed.

However, viewing these results in conjunction with those of the inquiry carried out in 1988 shows that the European managers expect immediate and precise advantages from use of a common currency.

The following table sums up the advantages associated with a common currency, as they appeared in the 1988 inquiry.

Advantages expected from a common currency

In your opinion, what would be the main advantages of a common currency?

	B	FRG	S	F	I	N	GB	Over-all
. Reduction of foreign exchange commissions	52	18	38	31	32	43	33	**33**
. Lower costs of administering exchange risks	49	40	48	43	68	40	60	**51**
. Offsetting and reduction of cash flow balances in foreign currency terms	24	12	29	22	13	23	9	**18**
. Stabilization of trade currents	32	29	31	49	42	28	44	**38**
. Safety of investments	13	12	29	20	17	15	17	**18**
. Lowering monetary fluctuations	66	57	63	71	49	76	73	**64**
. Contribution to European construction	34	36	31	46	34	33	28	**35**
. Others	-	1	2	1	2	1	1	**1**
. None of all this applies	-	12	-	-	-	-	3	**3**
. No answer	-	1	1	1	1	3	2	**1**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total greater than 100 because of multiple answers.

Questions asked in July 1988

Similarly, a majority was seen in the 1988 inquiry in all countries, except Germany and Great Britain, considering use of the ecu as "quite interesting" or "rather interesting" for a company , confirming that the ecu's potentialities largely exceed the present use level.

The following table shows the criticisms expressed in 1988 with respect to the ecu in its daily surroundings. Obviously, the conditions involved in using the ecu have not yet come up to the standards defining the "common currency".

Drawbacks connected with ecu use

What drawbacks do you see in the ecu?

	B	FRG	S	F	I	N	GB	Over-all
. I have little knowledge of it	40	31	33	35	31	40	41	**35**
. Does not match needs	18	24	13	13	6	13	14	**14**
. Other habits	35	24	34	21	28	31	24	**27**
. Coins and banknotes are lacking	18	7	19	12	22	23	17	**16**
. Lacks central bank support	20	13	33	27	31	18	27	**25**
. Revision planned of the "basket"	4	5	9	6	6	5	16	**8**
. Difficult to accept	35	20	26	40	39	41	27	**32**
. Too complicated	6	14	7	5	5	5	10	**8**
. Raw materials prices outside ecu system	24	14	25	19	36	19	26	**24**
. Restrictions on use	15	16	10	7	4	9	16	**11**
. Some regions not concerned	13	15	30	16	15	18	25	**19**
. No answer	11	11	3	6	6	9	11	**8**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total greater than 100 because of multiple answers.

Question asked in July 1988

Generalized use of the ecu runs up agains several substantial obstacles, with a major one being very widespread lack of knowledge of the ecu. The force of habit, or the difficulty of getting the ecu accepted, also constitute non-negligible obstacles. Of secondary importance is the abscence of Central Bank support, which is also considered an important disadvantage.

So one can see that the obstacles to development of the ecu are not all of the same nature. Some of them can be cleared away by persuading company leaders, while others are connected with political choices.

Since lack of knowledge and the force of habit can be corrected by suitable instruction, interest in training seminars on the ecu was tested in the 1989 inquiry. Some 80% of the business leaders queried indicated that their company would send at least one person to such seminars.

	B	FRG	S	F	I	N	GB	Over-all
% of companies that would send at least one person	79	79	77	78	88	67	92	80

The main departments interested in participation in training seminars dealing with the ecu are the financial and commercial departments. The following table sums up, for each country, the proportions of companies that would send participants working in the various specialities.

Main departments interested...

	B	FRG	S	F	I	N	GB	Over-all
Financial	31	55	49	38	46	38	60	**45**
Commercial	27	25	18	16	41	21	34	**26**
General Management	19	13	7	13	6	14	29	**15**
Accounting	17	7	13	17	5	22	21	**15**
Taxation	4	9	5	4	46	7	1	**11**
Legal	17	8	4	2	1	2	2	**5**
Other	1	4	8	4	1	3	8	**4**
Total	(1)	(1)	(1)	(1)	(1)	(1)	(1)	**(1)**

(1) Total may be greater than 100 because of multiple answers.
Percentages calculated on the basis of all companies

The themes considered as the most interesting ones include the general aspects of the ecu (advantages and drawbacks of a common currency, ecu competitiveness by comparison with other major currencies), as well as some very concrete aspects, such as invoicing in ecu terms, or the ecu and exchange risk management.

The following table sums up the judgements made on the interest of the various themes, for all of the managers questioned.

Seminars on ecu use:
percentage of managers interested in the various themes

	Greatly interested	Somewhat inter.	Not so much inter.	Not at all inter.	Don't Know	Over-all percentage of inter.
. The advantages and disadvantages of a common European currency for businesses	54	33	7	4	2	**87**
. The ecu as a factor in price stability	52	30	10	6	2	**82**
.The ecu and exchange risk management	54	28	9	6	3	**82**
. Prospects for ecu development	45	36	10	6	3	**81**
. Ecu competitiveness by comparison with other major currencies	52	30	10	7	3	**80**
. The role of the ecu and of a Central Bank in European construction	46	33	13	6	2	**79**
. Billing in ecu terms	51	27	12	8	2	**78**
. Practical use of the ecu in accounting	44	32	14	8	2	**76**
. Financing in ecu terms	47	27	13	11	2	**74**
. Taxation as connected with ecu use	41	33	14	9	3	**74**

Percentage of managers interested in the various themes (continued)

	Greatly interested	Somewhat inter.	Not so much inter.	Not at all inter.	Don't Know	Over-all percentage of inter.
. The ecu and management of foreign-exchange operations in the company	38	34	15	10	4	**72**
. Ecu use by sales, administrative or financial executives	33	37	16	10	4	**70**
. Ecu definition and its quotation	35	34	18	10	3	**69**
. Legal aspects connected with ecu use	32	35	18	11	4	**67**
. The ecu as a factor in reducing the cost of foreign-exchange cash flow	35	30	18	12	5	**65**
. Company leaders' intentions vis-a-vis the ecu	27	38	19	11	5	**65**
. Investments in ecu	32	27	23	16	2	**59**
. Ecu history	5	18	45	30	2	**23**

As to the people who seem in the best position for providing such training, the financial experts and bankers are clearly the sources most anticipated by the managers queried.

The following table sums up the judgements made with respect to the various possible speakers.

Assessment of possible speakers

	Very interes-ting	Rather interes-ting	Not so very inter.	Don't Know	Total
Financial experts	65	26	6	3	100
Bankers	63	26	8	3	100
Central bank representatives or high civil servants in finance field	52	30	14	4	100
Leaders of big businesses	48	33	16	3	100
Certified public accountants and auditors	42	34	21	3	100
Leaders of small and medium-sized firms	34	30	33	3	100
Legal experts	30	38	29	3	100
Professors from universities or "grandes écoles"	23	37	36	4	100
Journalists from the economic press	18	35	44	3	100
Trade association officials	18	33	45	4	100
Politicians, e.g., members of the European Parliament	14	24	58	4	100

CH/EXCHEQUER

REC.	6 OCT 1989
ACTION	Mrs Brown
COPIES TO	FST, Sir P. Middleton, Sir T. Burns, Mr Wicks, Mr H.P. Evans, Mr Odling-Smee, Mr Scholar, Mr R.I.G. Allen, Mr Peretz, Mr Riley, Mrs Brown, Mr W. White, Mrs Chaplin, Mr Turie

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

to Mr RIG Allen (This page)

Mr White
Please deal
MB 6/10.

Mr. JMG TAYLOR
Private Secretary
TREASURY CHAMBER (British Government)
Parliament Street
SW1P 3AG LONDON
UNITED KINGDOM

3rd October, 1989

Ch/
Content with a PS ack?
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yes
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Dear Sir,

We are pleased to present you with :

- A previously **unpublished survey** which we have recently carried out among **1,428 company leaders** of the European Community, on the theme of monetary union of Europe.
- The communiqué issued by our Association after its September 20th Board Meeting.

We trust that you will find these documents of interest.

Yours faithfully,

cc. Mr. RIG Allen
Mrs. Brown

Bertrand de MAIGRET
Secretary General

PS/Chancellor

This report offers no surprises. An acknowledgment will do. We should not comment. As their name suggests the Association are EMU lobbyists.

Wilf White

Encl. : 2

ASSOCIATION POUR L'UNION MONETAIRE DE L'EUROPE
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MARKET APPROACH TO EMU

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THE MARKET APPROACH TO ECONOMIC AND MONETARY UNION

Introduction

At the informal meeting of European Finance Ministers in Antibes on 8-10 September 1989, the UK offered to circulate a paper about its approach to Economic and Monetary Union (EMU).

2. This paper describes the fundamental principles underlying that approach. In the light of these principles, it assesses the significance of Stage 1 of EMU, which will begin on 1 July 1990, and the proposals for subsequent changes contained in the Delors report. It puts forward an alternative, market-based, approach to the long-term development of economic and monetary policy arrangements in the Community.

Fundamental principles

3. Article 102(a) of the Treaty of Rome recognises that "the convergence of economic and monetary policies" is necessary for the development of the Community. But the Treaty does not specify how this objective should be achieved. Nor does it prejudge the question of whether institutional changes may be needed. The Conclusions of the