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PART A

MEETING OF THE EUROPEAN COMMUNITY (EC) ECONOMIC AND FINANCE COUNCIL (ECOFIN), 11 JUNE 1985, LUXEMBOURG

, Luxembourg

PO -CH /NL/~~0111~~ 0855

PART A

Begins: 7/6/85

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FROM: JANET BARBER

DATE: 7 JUNE 1985

1. MR ~~UNWIN~~ JU 7/6/85

2. CHIEF SECRETARY

ECOFIN 11 JUNE

You are due to attend ECOFIN on 11 June. Mr Unwin and Mr Louth (DTI, on 2(f)) will be in support. Mr Byatt will attend as Chairman of the Economic Policy Committee, for item 2(b). The Council begins at 11.00 am in the Kirchberg European Centre in Luxembourg, following on from the EIB Board of Governors meeting which you are also attending.

2. There are 6 substantive items on the agenda

(a) development of the European Monetary system

(b) measures to encourage investment and employment

(c) 1986 Community Budget reference framework

(d) 20th VAT directive

(e) travellers allowances

(f) UCITS (Unit Trust) Directive.

Detailed briefs on all these items are attached.

<u>DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM - BRIEF A</u>

3. EC Finance Ministers last discussed the development of the EMS at their informal meeting at Palermo in April. They endorsed the Central Bank Governors' package to improve the usability of the official ecu, and also had a more general discussion on further

strengthening of the EMS. Finance Ministers considered it important that ECOFIN and its advisory bodies should keep a firm hold on EMS issues. Accordingly the Committee of Central Bank Governors and the Monetary Committee are now examining the longer term perspectives for the development of the EMS, including the development of the ecu (private and official) and the liberalisation of capital movements.

4. At this ECOFIN, we are expecting oral statements on the longer term EMS issues from the chairman of the Monetary Committee (Mr Tietmeyer) and the chairman of the Committee of Central Bank Governors (Mr Duisenberg). A draft of Mr Tietmeyer's statement is attached to Brief A. On the whole, the report presents no problems; and on paragraph 5(b) which refers to the "completion of the exchange rate system" (and which would include the participation of sterling) we are trying to get the qualification "where further progress is desirable" added. A copy of Mr Duisenberg's report is also attached to Brief A.

5. It is desirable that ECOFIN should send a brief report on the EMS to the Milan European Council to forestall, and if possible, prevent, any substantive discussion there. Ideally this report would simply inform the European Council that work on the EMS by the expert bodies is underway, and that the results will be reported to ECOFIN in due course. We are suggesting to Mr Tietmeyer that he might propose this in his statement. We also think that the Presidency (Mr Goria) might suggest this. The speaking note in Brief A can be drawn on either to support Mr Tietmeyer and/or Mr Goria, or to make the proposal yourself if necessary.

6. You should also know that the Dutch Finance Minister, Mr Ruding, recently made a speech saying that sterling should join the exchange rate mechanism. Brief A includes defensive material on this.

MEASURES TO ENCOURAGE INVESTMENT AND EMPLOYMENT - BRIEF B

7. ECOFIN has a remit to report to the June European Council in Milan on measures to combat unemployment through sustained

more employment-intensive growth.

8. This issue was discussed by the co-ordinating group for economic and financial policies on 3 June. Sir Peter Middleton and Mr Byatt attended this meeting. There were two papers on the table:

(i) a long, technical Commission paper on investment and employment (Annex C to Brief B)

(ii) a report to ECOFIN from the Economic Policy Committee on profitability and rates of return in the Community (Annex D to Brief B)

While (ii) was acceptable to the UK, we had some problems with (i), particularly the idea that in the short term wage moderation has a deflationary effect and is therefore counterproductive in increasing employment, making "demand support" necessary, in this case support for investment, implying, inter alia, additional public sector investment.

9. The outcome of the co-ordinating group's discussion was a draft set of conclusions for ECOFIN to send to the European Council (Annex B to Brief B); and the chairman of the group Dr Sarcinelli, may report to ECOFIN on the basis of this document. The document on the whole is a great improvement over the Commission paper on investment and employment, although there is still a reference to accelerating public sector infrastructure projects at both the national and Community level on which we would want to be fairly cautious.

10. However we think that the Presidency is unlikely to want to report to Milan on the basis of the co-ordinating group's draft conclusions. Instead, Mr Goria is likely to :

(i) invite the Commission to carry on their work

(ii) suggest that a substantive report to Milan would be premature, given the difficult issues involved

(iii) suggest a verbal report to Milan saying that work is continuing

(iv) suggest that a report should be made to ECOFIN later in the year, perhaps with the annual economic report in December.

We would have no great difficulties with this procedurally, but you might like to indicate our views on the best policies for employment and to register our worries about the public sector infrastructure point. You should also ask for the report to Milan to be circulated in advance of the European Council. A speaking note is at Brief B.

1986 REFERENCE FRAMEWORK - BRIEF C

11. The budget discipline text adopted by the Council at the end of 1985, provides a mechanism for limiting the growth in Community expenditure. The first full year to which budget discipline applies is 1986. The budget discipline procedure requires the setting by the Council of a "reference framework" for the budget at the start of the budgetary process.

12. Therefore ECOFIN must set the reference framework for the 1986 Budget before the publication of the Preliminary Draft Budget early next month. Before it is fixed the European Parliament must be consulted. But the Presidency has refused to invite a delegation from the European Parliament to ECOFIN. Also the Commission have failed to meet their undertaking to provide the necessary figures. This will frustrate substantive discussion at this ECOFIN. They must be compelled to produce them quickly.

13. Therefore at this ECOFIN you should insist on the following:

(i) that the Council issue an invitation for the Parliament to consult on the reference framework before the end of June. Given the Chancellor's and the Economic Secretary's commitments, this would best be in the week beginning 24 June

(ii) that the Council decide now to fix the reference framework immediately after meeting the Parliament

(iii) that the Commission produce the detailed figures which were promised to the May Budget Council as soon as possible, as a basis for discussion with the Parliament.

(iv) that at this meeting ECOFIN have a run over the principles and elements of the reference framework

Brief C includes a draft speaking note, a one page aide memoire, and a rather longer background note.

14. You might like to note the following timetable of dates which might be relevant for the reference framework:

June ECOFIN	11 June
Economic Secretary's appearance before TCSC	17 June
Foreign Affairs Council	18/19 June
Possible special ECOFIN	week beginning 24 June
Milan European Council	28/29 June
Publication of preliminary draft budget for 1986	early July
July ECOFIN	8 July

20TH VAT DIRECTIVE - BRIEF D

15. The 20th VAT directive concerns payments of special aid to farmers in Germany via the VAT system to compensate them for a reduction in monetary compensation amounts via a green mark valuation. A package was agreed last June as part of the Fontainebleau deal, but the directive has not yet been adopted. The main problem has been German refusal to account separately for VAT and aid in invoices etc, whereas the Commission and other member states have been concerned about the proper measurement of own resources.

16. This accounting problem will be the main topic of discussion at ECOFIN. We and other member states are now satisfied that the Germans can be trusted to safeguard own resources, and you

can support a Presidency compromise proposal, embodying an annual reporting procedure, along these lines. The Commission, however, are less relaxed, and may propose more stringent requirements for the Germans, which you should oppose.

17. If agreement is reached on the Presidency package, the issue of conciliation with the European Parliament may arise. The Presidency are likely to suggest that the Directive should not be formally at this meeting, but that the Council should write on the basis of the agreed text to the Parliament to say that its concerns have been met, as a conciliatory gesture. The Directive would then be formally adopted as an "A" point at a subsequent Council. You should not object to this.

18. If the question of the formal conciliation procedure is raised you should say that, although the UK supports its use where appropriate, the 20th VAT Directive does not meet the criterion of "significant financial effect". Formal conciliation is therefore not appropriate in this case.

19. The latest relevant document on this subject is a Presidency statement to ECOFIN (6783/85, available in French only) which sets out the three options described in Brief D. This is attached to Mr Unwin's brief should you need it.

TRAVELLERS ALLOWANCES - BRIEF E

20. This item concerns tax allowances for travellers (eg wine allowance) and small consignments. There is a compromise package of more generous allowances on the table at ECOFIN. A change in this direction is desirable in the interests of "A People's Europe".

21. We can accept the compromise package, which is described in document 5757/2/85 REV2 attached to Brief E. (There is a more recent text, document number 7036/85, in French only, which we have not yet received, but which UKREP should have. This is similar to 5757/2/85 REV2, but includes the three amendments listed in paragraph 9 of the background note to Brief E). However other

Member States are likely to have problems with various aspects of it eg :

(i) as the compromise stands there are no time limits on derogations granted to Denmark, Ireland and Greece. Other Member States are likely to object to this (and indeed we can support them, but we would not want to press the matter in isolation).

(ii) the French may backtrack on the compromise on fuel in bus tanks.

(iii) there is disagreement on whether revalorisation of allowances should be settled by qualified majority voting.

22. At the moment it is difficult to say whether or not agreement on the compromise will be reached. You should be cautious, h owever, about agreeing to a package other than the compromise - UKREP, who are familiar with this matter, would be able to advise you on this if the issue arose.

UCITS (UNIT TRUST) DIRECTIVE - BRIEF F

23. The UK is in favour of the proposed UCITS ("undertakings for collective investment in transferable securities") Directive which should go some way to open up European markets to the UK Unit Trust industry. At ECOFIN, permanent representatives are expected to present a global compromise on six key issues in the Directive. We can accept this compromise. However, the Germans and the Dutch have problems on two of the issues :

(i) Article 26 on investment in government securities (German reservations);

(ii) Article 29 on limits on acquisitions of voting shares (Dutch reservations)

and discussion at ECOFIN is likely to focus on these two points.

24. DTI are in the lead on this issue, and Mr Louth will be in Luxembourg to advise you. The situation is very fluid; DTI are currently in negotiation with the Dutch, and the Financial Secretary is to raise Article 26 with the Germans at his meeting in Bonn on 10 June. (A copy of the Financial Secretary's speaking note for Bonn is attached to Brief F).

25. The most recent document on the UCITS Directive is an interim report to the Council (document 7170/85). This document is available in French only, and is attached to Mr Unwin's brief should you need it. Mr Unwin also has the latest version of the draft UCITS Directive, document 7119/84.

Other Matters

26. Some "A" items (ie items not requiring discussion) will be taken at the beginning of the meeting - so far we have not received a list of these.

27. Personality notes are attached - top copy only.

28. Copies of this briefing to to those on the attached list.

Janet Barber

JANET BARBER
EC1

ECOFIN, 11 JUNE BRIEF A

THE EUROPEAN MONETARY SYSTEM

SPEAKING NOTE

(i) agree in general with State Secretary Tietmeyer's report. Agree in particular with the priorities he has identified for further work on the future development of the EMS over the next six months. Strongly endorse his view that the responsibility on these matters must rest with ECOFIN, with the Central Bank Governors' Committee and the Monetary Committee and that we must continue to deflect the pressures from the "institutionalists" in the Dooge Committee and elsewhere and deflate exaggerated expectations about what can be done in the short-term. Suggest/agree that it would be helpful in this context for ECOFIN to inform the Milan European Council of the work we have put in hand.

(ii) UK supports further developments of the ecu, both private and official. But progress needs to be soundly based, not artificially generated.

(iii) Important areas for strengthening the EMS are further relaxation of exchange controls and increased convergence of economic policy and performance.

(iv) Herr Tietmeyer's report refers to the question of UK participation in the exchange rate mechanism. We accept that is a desirable objective and keep it under review. On balance our judgement remains that, for the present, UK membership would not be of advantage to the UK in meeting our own economic goals nor necessarily beneficial to the system as a whole. With that caveat would agree that a more detailed examination of this question would be appropriate.

THE EUROPEAN MONETARY SYSTEM

UK objectives

We expect that Ministers will simply be invited to take note of the oral interim reports being made by the Chairman of the Monetary Committee (Tietmeyer) and the Chairman of the Central Bank Governors (Duisenberg) and request that the work be continued. Some general discussion might follow on the potential development of the EMS. A defensive speaking note on sterling's participation in the exchange rate mechanism is provided below, in case it is required. The Italians are planning to include the further development of the EMS as part of the agenda for the Milan European Council. It has been mentioned in a memorandum by S. Andreotti as one of the subjects to be discussed at an inter-governmental conference to draft a new Treaty of Union for the Community. It is therefore desirable for ECOFIN - and we understand that Tietmeyer has proposed this to the Italian presidency - to send a brief progress report to the European Council to forestall any substantive discussion in Milan.

Points to make

(i) agree in general with State Secretary Tietmeyer's report. Agree in particular with the priorities he has identified for further work on the future development of the EMS over the next six months. Strongly endorse his view that the responsibility on these matters must rest with ECOFIN, with the Central Bank Governors' Committee and the Monetary Committee and that we must continue to deflect the pressures from the "institutionalists" in the Dooge Committee and elsewhere and deflate exaggerated expectations about what can be done in the short-term. Suggest/agree that it would be helpful in this context for ECOFIN to inform the Milan European Council of the work we have put in hand.

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Defensive speaking note: Sterling participation in the exchange rate mechanism (for use only if required)

Exchange markets continue to be characterised by uncertainty about the dollar. A readjustment of the dollar would involve substantial capital flows out of the US currency into other reserve currencies, including sterling and the deutschemark. Recent events have shown that such flows are not necessarily evenly distributed and have led to significant changes in the £/DM exchange rate. Such movements could put undue pressure on the mechanism if sterling were a member.

Oil market developments also continue to have an impact on sterling. For instance, earlier in June, sterling fell by around 1½ per cent against the deutschemark, on fears about oil prices.

We also have to pay regard to the implications of reduced exchange rate flexibility for the operation of monetary policy. Our view is that seeking to maintain sterling within a given band would tend to increase interest rate volatility.

Background

ECOFIN last discussed the development of the EMS at Palermo in April. The Central Bank Governor's package to improve the useability of the official ecu was endorsed and there was a more general discussion concerning the further strengthening of the EMS. Finance Ministers considered it important to retain the initiative on these matters with itself and its advisory bodies. The Committee of Central Bank Governors and the Monetary Committee were requested by ECOFIN to begin work on the future development of the EMS, and in particular the role of the ecu, both private and official.

2. Both Tietmeyer and Duisenberg will be making oral reports to ECOFIN on Tuesday. These reports will be of an interim nature and will simply list a range of issues which both Committees intend to consider in the second half of the year. These issues include

- the private and official use of the ecu
- convergence of economic policy and performance
- liberalisation of capital movements
- prospects for (and meaning of) the institutional phase of the EMS.

We have seen a draft of Tietmeyer's report which is generally acceptable. Although he proposes to say that the 1971/2 goals of EMU "remain valid in the longer term" there is general agreement that they are not on the Community's agenda now or in the foreseeable future. He also refers to sterling's membership of the exchange rate mechanism as an area where further progress is desirable. Duisenberg's report will indicate some differences of view regarding the development of the ecu. The Governors intend to take a closer look at the implications of the private development of the ecu and the use of the ecu as a reserve asset. Duisenberg characterises the Governors' work as dealing with "complex questions of both a political and technical nature".

3. The Dutch Finance Minister, Ruding, recently made a speech expressing his hope that the UK would soon become a full member of the EMS. He believed that sterling's role as an international currency had diminished and that its petro-currency features and the potential conflict with domestic monetary objectives should not be considered as undue constraints on membership. Ruding's analysis indicated, however, some misconceptions:-

- Ruding suggested that the EMS was very flexible as regards allowing the exchange rate parities to change in response to economic developments. But this tends to reduce the disciplines that the ERM is intended to provide and could encourage speculation if realignments became more frequent.

- Ruding did not seem to appreciate the difficulties that might be created by having two widely traded currencies in the system. If, for instance, the dollar substantially depreciated then the funds flowing out of the US currency might not be equally distributed between the alternatives, such as sterling and the deutschemark. This could have quite significant effects on the £/DM exchange rate and, if sterling were a full member, could put pressure on the mechanism.

- the influence of oil price expectations on sterling's exchange rate should not be underestimated. Recent experience has shown that the £/DM rate can change significantly, and quickly, in response to oil market developments.

- Ruding suggests that we would only join if others relaxed their exchange controls. We have never used this argument. Our line has been that liberalisation of capital movements is a Treaty of Rome obligation and so not directly related to the question of ERM participation (which is not a Treaty obligation).

- As the Chancellor has recently said, membership of the ERM would tend to increase interest rate volatility, not reduce it. Conflicts with domestic policy objectives cannot, therefore, be ruled out.

4. Though the question of ERM participation is likely to be raised we expect it will be in a low-key way and the matter is unlikely to be pressed. Other countries have indicated that they are only looking for modest progress in the EMS in the medium-term. Nor is the UK isolated. The Italians have been under some pressure to reduce their wider (6 per cent) margins in the mechanism. A number of other countries still retain exchange controls (we abolished ours in 1979). The German authorities do not recognise the private ecu as a foreign currency and German residents are restricted in their use of it (there are no restrictions on UK residents and London is a major centre for ecu capital and money market activity). Also the Germans, as well as the Dutch, have made it clear that they believe that, at present, the limits of progress have been reached on the official ecu and nothing much more can be done for the private ecu. The Germans, in particular, have strong reservations about the use of the ecu for intra-marginal intervention. In contrast, the Belgians, French, Italians and Greeks all see possibilities for further progress.

MR TIETMEYER'S DRAFT REPORT TO ECOFIN

PLEASE FIND BELOW THE TEXT OF THE ORAL REPORT BY MR. TIETMEYER, CHAIRMAN OF THE MONETARY COMMITTEE, WHICH HE WILL PRESENT TO THE ECO/FIN COUNCIL OF 11 JUNE 1985. YOU ARE REMINDED THAT THIS REPORT IS TO BE PRESENTED UNDER MR. TIETMEYER'S RESPONSIBILITY, AS AGREED AT THE LAST MEETING OF THE MONETARY COMMITTEE. HOWEVER, IF THIS REPORT SHOULD GIVE RISE TO OBJECTIONS ON YOUR PART, PLEASE TRANSMIT THEM TO THE SECRETARIAT BY 19HOO ON THURSDAY 6 JUNE.

A. KEES
COMEUR B

THE LONG TERM GOALS OF THE EMS AND THE FIELDS OF ACTION IN A MEDIUM TERM PERSPECTIVE

ORAL REPORT BY THE CHAIRMAN

THE FINANCE MINISTERS, AT THEIR IHFORMAL MEETING IN PALERMO, ASKED THE MONETARY COMMITTEE TO PRESENT A SHORT REPORT FOR THE MEETING OF THE ECO/FIN COUNCIL OF 11 JUNE 1985 ON THE LONG TERM GOALS OF THE EMS, AS WELL AS ON THE FIELDS OF ACTION IN A MEDIUM TERM PERSPECTIVE. GIVEN THE SHORT DELAY INVOLVED, THE REPORT AT THIS POINT IN TIME CAN BASICALLY ONLY OFFER AN OUTLINE OF THE ISSUES WITH GENERAL INDICATIONS AND QUESTIONS, RATHER THAN DEFINITIVE ANSWERS.

1. THE MONETARY COMMITTEE HAS TREATED THE GOALS OF THE EMS AGAINST THE BACKGROUND OF THE MORE FAR-REACHING GOALS OF ECONOMIC AND MONETARY UNION, AS SET OUT IN THE COUNCIL RESOLUTIONS OF 1971 AND 1972. IN THE COMMITTEE'S VIEW THE GOALS OUTLINED AT THAT TIME FOR THE CREATION OF AN ECONOMIC AND MONETARY UNION REMAIN VALID IN THE LONGER TERM. INDEED THE REQUIREMENTS FOR ITS REALIZATION DO NOT EXIST AT PRESENT, THIS IS ESPECIALLY THE CASE FOR THE GOAL OF A COMMON CURRENCY. IN FACT A BROADLY-BASED POLITICAL AND INSTITUTIONAL PROCESS OF INTEGRATION WOULD BE REQUIRED FOR THE REALIZATION OF ECONOMIC AND MONETARY UNION.

2. AGAINST THIS BACKGROUND THE EMS HAS MORE LIMITED OBJECTIVES. IT IS A SCHEME FOR ''CLOSER MONETARY COOPERATION'' WHICH SHOULD LEAD ''TO A ZONE OF MONETARY STABILITY''. THE EMS
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AIMS ABOVE ALL AT ''POLICIES CONDUCIVE TO GREATER STABILITY AT HOME AND ABROAD''. THIS GOAL HAS AT THE SAME TIME A LONGER TERM DIMENSION. IN PARTICULAR THIS MEANS AS STABLE AS POSSIBLE PRICE LEVELS AND AS STABLE AS POSSIBLE EXCHANGE RATES BETWEEN THE EMS CURRENCIES.

THE EMS SUFFERED FROM CERTAIN DIFFICULTIES AT THE START: SUBSTANTIAL SHORTCOMINGS WITH RESPECT TO THE CONVERGENCE OF ECONOMIC POLICIES AND AS A RESULT RELATIVELY FREQUENT CENTRAL RATE CHANGES. IN THE LAST TWO TO THREE YEARS, HOWEVER, IT HAS BEEN POSSIBLE TO MAKE DISTINCT PROGRESS IN CONVERGENCE. THE EXCHANGE RATE STABILITY WITHIN THE EMS STANDS OUT POSITIVELY COMPARED TO THE MOVEMENTS OF THE USD AND OTHER CURRENCIES

3. INDEPENDENTLY FROM THE GOALS OF ECONOMIC AND MONETARY UNION, THE EMS HAS ITS OWN WORTH. IN ACCORDANCE WITH THE INTENTIONS OF THE EUROPEAN COUNCIL DECISION OF 1978 IT HAS BECOME A ''DURABLE AND EFFECTIVE SCHEME''. THE WILLINGNESS OF ALL THE EMS PARTNERS TO FOLLOW THE GOAL OF A ZONE OF MONETARY STABILITY IN PRACTICAL ECONOMIC POLICY HAS GROWN PERCEPTIBLY. AT THE SAME TIME A VERY CLOSE COOPERATION BETWEEN THE MONETARY AUTHORITIES, PARTICULARLY THE CENTRAL BANKS, HAS DEVELOPPED. THE EXISTING OBJECTIVES AND RULES PROVIDE A SUFFICIENT LEVEL OF REALISM AND FLEXIBILITY FOR FURTHER DEVELOPMENT.

- 3 -

4. THE TRANSFORMATION OF THE EMS INTO A SO-CALLED ''FINAL SYSTEM'', AS FORESEEN IN THE INTRODUCTION OF THE EUROPEAN COUNCIL RESOLUTION OF THE YEAR 1978, HAS SINCE NOT TAKEN PLACE. THIS IS BECAUSE - AT LEAST IN THE OPINION OF SEVERAL MEMBERS - FOR THIS TO HAPPEN AN INSTITUTIONAL THRESHOLD WOULD HAVE TO BE SURMOUNTED, FOR WHICH THE PROCESS OF POLITICAL INTEGRATION HAS NOT PROVIDED THE PRECONDITIONS. THIS SUBJECT WAS REGARDED BY THE COMMITTEE AS NOT TOPICAL IN THE PRESENT AND FORESEEABLE CIRCUMSTANCES AS WELL.

5. FROM THESE DISCUSSIONS BY THE MONETARY COMMITTEE WHICH HAVE TO BE FURTHER INTENSIFIED, THERE ARE ALREADY SEVERAL OBSERVATIONS WHICH CAN BE MADE:

A) ALL THE MEMBERS ARE OF THE VIEW THAT STEPS TO STRENGTHEN THE EMS IN A PRAGMATIC WAY AND TAKING INTO ACCOUNT THE LONG TERM GOALS, ARE BOTH POSSIBLE AND DESIRABLE.

B) THERE IS ALREADY A BROAD MEASURE OF AGREEMENT ON THE ASSESSMENT OF THE THREE AREAS WHERE ACTION IS POSSIBLE AND NECESSARY: THE SECURING OF FURTHER CONVERGENCE, PROGRESS IN THE LIBERALIZATION OF CAPITAL MOVEMENTS AND STEPS TOWARDS THE COMPLETION OF THE EXCHANGE RATE SYSTEM. AGAINST THIS, DIFFERENCES OF VIEW STILL EXIST IN THE AREA OF THE ECU FOR WHICH MORE DETAILED TECHNICAL EXAMINATIONS, IN CLOSE COOPERATION WITH THE COMMITTEE OF CENTRAL BANK GOVERNORS, HAVE BEEN STARTED.

- 4 -

6. THE COMMITTEE CONSIDERS - AS ALREADY STATED EARLIER - FURTHER PROGRESS IN AND THE CONSOLIDATION OF CONVERGENCE AS THE CENTRAL TASK FOR STRENGTHENING THE EMS. THE TASKS WHICH ARISE FROM THIS ARE LESS OF A PROCEDURAL NATURE BUT RATHER ARE MORE A FUNCTION OF PRACTICAL ECONOMIC POLICY DECISIONS, WHICH THE COMMITTEE WILL INFLUENCE WITHIN THE POSSIBILITIES GIVEN TO IT. IT WILL MAKE SPECIAL EFFORTS TO GIVE THE EXISTING COORDINATION AND SURVEILLANCE PROCEDURES MORE WEIGHT.

7. ONE FIELD OF ACTION WHICH HAS LAGGED BEHIND IN THE PAST IS THE LIBERALIZATION OF CAPITAL MOVEMENTS, AS WAS PRESCRIBED IN THE TREATY OF ROME. A FREE CAPITAL MARKET WOULD NOT ONLY STRENGTHEN THE ECONOMY OF THE COMMUNITY BUT ALSO THE CONVERGENCE CONSTRAINT IN THE EMS. THE COMMITTEE IS AWARE THAT ADVANCES IN THIS AREA MUST BE MADE WITH APPROPRIATE CAUTION AND THAT THE STEPS INTRODUCED FOR GRADUAL LIBERALIZATION SHOULD, HOWEVER, BE REINFORCED. THE COMMITTEE ITSELF HAS SET UP A PROCEDURE ENTAILING A MORE RIGOUROUS EXAMINATION OF THE EXISTING RESTRICTIONS. IT WELCOMES THE FACT THAT THE COMMISSION, AT THE LAST EXAMINATION OF THE APPLICATION OF THE SAFEGUARD CLAUSES, SET STRICTER CRITERIA. MOREOVER, IT ENCOURAGES THE COMMISSION TO PUT FORWARD PROPOSALS TO THE COUNCIL AS SOON AS POSSIBLE FOR THE TRANSFER OF TRANSACTIONS FROM LISTS C AND D OF THE LIBERALIZATION DIRECTIVE TO LISTS A AND B. THE COMMITTEE WILL DEAL ACTIVELY WITH QUESTIONS OF THE LIBERALIZATION OF CAPITAL MOVEMENTS AND IN THIS CONNECTION WILL ALSO DEVOTE ITS ATTENTION TO THE

QUESTION OF THE DUAL EXCHANGE MARKET IN BELGIUM AND LUXEMBOURG.

8. A DEBATE ON THE LONG TERM GOALS AND PERSPECTIVES OF THE EMS ALSO BRINGS UP QUESTIONS OF THE COMPLETION OF THE EMS: THE PARTICIPATION OF THE UNITED KINGDOM IN THE EXCHANGE RATE MECHANISM, THE GRADUAL ABOLITION OF SPECIAL RULES FOR ITALY'S BROAD BAND, CRITERIA FOR FUTURE PARTICIPATION BY GREECE, SPAIN AND PORTUGAL IN THE EMS. IN THE COMMITTEE'S OPINION THESE SUBJECTS REQUIRE MORE DETAILED EXAMINATION.

9. THE COMMITTEE SPENT A SUBSTANTIAL AMOUNT OF ITS TIME DISCUSSING ECU QUESTIONS, WHERE A DISTINCTION HAS TO BE MADE BETWEEN THE OFFICIAL AND THE PRIVATE ECU. AS HAS ALREADY BEEN POINTED OUT, THIS IS THE FIELD OF ACTION WHICH STILL NEEDS THE MOST DETAILED TECHNICAL EXAMINATIONS. A NUMBER OF MEMBERS HAVE INDICATED THAT HERE ANY FURTHER STEPS REQUIRE FIRSTLY THE CLARIFICATION OF THE LONG TERM GOALS AND PERSPECTIVES FOR THE ECU.

THE OFFICIAL ECU WAS DESCRIBED IN THE DECISION OF 1978 AS BEING ''AT THE CENTRE'' OF THE EMS. THERE IT WAS GIVEN IN PARTICULAR FOUR FUNCTIONS (DENOMINATOR FOR THE EXCHANGE RATE MECHANISM, BASIS FOR ITS DIVERGENCE INDICATOR, DENOMINATOR FOR THE CREDIT MECHANISMS AND MEANS OF SETTLEMENT). ITS FUNCTION AS A MEANS OF SETTLEMENT HAS REMAINED LIMITED. ACCORDING TO

- 6 -

THE CONCLUSIONS OF THE EUROPEAN COUNCIL OF BREMEN THE FINAL SYSTEM SHOULD, HOWEVER, BRING WITH IT 'THE FULL UTILISATION OF THE ECU AS A RESERVE ASSET AND A MEANS OF SETTLEMENT'. AS YET THE REQUIREMENTS FOR THE ENTRY INTO THE 'FINAL SYSTEM' HAVE NOT BEEN FULFILLED. IT IS - AS INDICATED - ALSO NOT WITHIN SIGHT AT PRESENT.

THE PRIVATE ECU IS IN CONTRAST NOT A CONSTITUENT INSTRUMENT OF THE EMS. IT HAS DEVELOPED SPONTANEOUSLY AS A KIND OF ''BY-PRODUCT''.

SO FAR THE COMMITTEE'S DISCUSSIONS HAVE SHOWN THAT THERE ARE DIVERGENT VIEWS OF THE FURTHER ROOM FOR MANOEUVRE IN THE AREA OF THE ECU : SOME SEE ROOM FOR MANOEUVRE FOR FURTHER MEASURES WITHIN THE EXISTING INSTITUTIONAL THRESHOLD. OTHERS FEEL IT IS NECESSARY TO CLARIFY CERTAIN QUESTIONS, SOME OF WHICH ARE FUNDAMENTAL (POSSIBLE REPERCUSSIONS OF THE ECU ON NATIONAL MONETARY POLICY AND ON THE FUTURE ROLE OF THE CENTRAL BANKS). IT WOULD, HOWEVER, BE PREMATURE AND WOULD CONTRADICT THE STILL OPEN CHARACTER OF THE DISCUSSION IN THE COMMITTEE, TO ALREADY REPORT ON CONCLUSIONS AT THIS STAGE, OR EVEN TO GIVE INDICATIONS CONCERNING CONCRETE STEPS.

- 7 -

10 I WOULD THEREFORE LIKE TO OUTLINE FOR YOU IN THE FOLLOWING SECTION SOME OF THE QUESTIONS WHICH THE COMMITTEE MUST STILL DEAL WITH IN MORE DETAIL. THESE INCLUDE THE QUESTION OF WHETHER THE ECU, OFFICIAL OR PRIVATE, CAN FULFIL FUNCTIONS SIMILAR TO THAT OF A RESERVE CURRENCY WITHOUT NECESSITATING A TRANSFER OF OPERATIONAL RESPONSIBILITIES TO THE EUROPEAN LEVEL. WHAT ADVANTAGES WOULD SUCH A DEVELOPMENT HAVE FOR THE COMMUNITY AND FOR THE INTERNATIONAL MONETARY SYSTEM AND WHAT DISADVANTAGES WOULD BE CONNECTED WITH THIS? ANOTHER CENTRAL QUESTION IS THAT OF HOW THIS DEVELOPMENT WOULD TAKE PLACE. CAN AND SHOULD SUCH A DEVELOPMENT BE ACTIVELY ENCOURAGED? HOW WOULD OTHER CHANGES IN THE AREA OF THE ECU'S OFFICIAL USE AFFECT THE EMS, ITS DISCIPLINARY ACTION AND CONVERGENCE? THE COMMITTEE HAS ALREADY TAKEN UP THESE QUESTIONS. IT FEELS, HOWEVER, THAT MORE DETAILED INVESTIGATION IS REQUIRED BEFORE ITS CONCLUSIONS CAN BE PUT BEFORE YOU.

FINALLY THESE DISCUSSIONS HAVE SHOWN THAT, AT LEAST IN THE VIEW OF SOME MEMBERS, THE RESERVE FUNCTION OF THE ECU SHOULD PROBABLY BE DEVELOPED PRIMARILY VIA THE PRIVATE ECU RATHER THAN VIA THE OFFICIAL ECU.

AS FAR AS THE USE OF THE PRIVATE ECU IS CONCERNED, THE QUESTION ASKED ABOVE ALL WAS WHAT IS THE SPECIFIC CONTRIBUTION OF THE PRIVATE ECU FOR THE EMS. HERE, AS WELL, THE QUESTION AROSE OF WHETHER THE MONETARY POLICY OF THE MEMBER STATES IS IMPAIRED BY THE USE OF THE PRIVATE ECU. THE COMMITTEE WILL ALSO COMMENT ON WHETHER CONTROL OR SUPERVISION IS NECESSARY FOR THE USE OF THE PRIVATE ECU AND, IF SO, HOW IT SHOULD BE CARRIED OUT. LASTLY SOME MEMBERS REQUESTED THAT THE USE OF THE ECU AS A TRADE DENOMINATOR SHOULD BE EXAMINED.

AS A PRELIMINARY CONCLUSION FROM AN EXAMINATION OF THE LONG TERM GOALS AND PERSPECTIVES OF THE EMS WHICH IS STILL UNDER WAY, I WOULD LIKE, AS CHAIRMAN OF THE MONETARY COMMITTEE, TO MAKE THE FOLLOWING REMARKS: THE EMS REPRESENTS IMPORTANT PROGRESS IN THE PROCESS OF INTEGRATION. IT SHOULD CONTINUE TO BE REINFORCED FROM WITHIN ITSELF AND TO BE FURTHER DEVELOPED TO THE EXTENT THAT THIS CAN BE JUSTIFIED. HOWEVER, IT SHOULD NOT BE BURDENED WITH EXAGGERATED PRESSURES FOR ACTION FROM THE EXTERIOR. THE MONETARY COMMITTEE WILL CONTINUE INTENSIVELY TO EXPLORE THE POSSIBILITIES FOR STRENGTHENING THE EMS. TECHNICAL WORK IS PRESENTLY UNDER WAY. THE CLARIFICATION OF THE LONGER TERM EFFECTS OF CERTAIN STEPS MAY POSSIBLY WIDEN THE ROOM FOR ACTION. FOR THESE REASONS THE COMMITTEE REQUESTS THAT THE PROMOTION OF THE EMS SHOULD CONTINUE TO REMAIN A MATTER FOR THE RESPONSIBLE BODIES.

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- A L'ATTENTION DE M. DELORS
  (COPIE POUR MM. RUSSO, KEES, MINGASSON,
  SECRETARIAT DU COMITE MONETAIRE)

MR DUISENBERG'S

REPORT TO ECOFIN

INSTITUT MONETIRE LUXEMBOURGEOIS, LUXEMBOURG
- A L'ATTENTION DE M. JAANS

PRESIDENT DUISENBERG HAS ASKED ME TO CIRCULATE THE FOLLOWING COVERING NOTE AND DOCUMENT ON HIS BEHALF.

KIND REGARDS,
G. MORELLI

IN CONFORMITY WITH THE GOVERNORS' REQUEST AT OUR MEETING ON 14TH MAY THAT I INFORM THE MINISTERS OF OUR FUTURE WORK ON THE LONG-TERM PERSPECTIVE OF THE EMS, I ENCLOSE THE TEXT I INTEND TO USE FOR MY ORAL REPORT AT THE COMING E C O F I N MEETING.

COMMITTEE OF GOVERNORS OF THE
CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY

4TH JUNE 1985

ORAL REPORT
PRESENTED BY THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS
ON 11TH JUNE 1985 TO THE MEETING OF EC FINANCE MINISTERS
ON THE FUTURE WORK OF THE COMMITTEE OF GOVERNORS
ON THE LONG-TERM PERSPECTIVE OF THE EMS

AT THE INFORMAL MEETING IN PALERMO ON 13TH APRIL 1985, I INFORMED MINISTERS OF THE AGREEMENT IN PRINCIPLE GOVERNORS OF EEC CENTRAL BANKS HAD REACHED TO INCREASE THE USABILITY OF THE ECU. I CAN NOW INFORM YOU THAT THE INSTRUMENTS CHANGING THE AGREEMENT OF CENTRAL BANKS OF 13TH MARCH 1979 WERE SIGNED YESTERDAY IN BASLE. THE CHANGE WILL TAKE EFFECT ON 1ST JULY 1985, WITH THE EXCEPTION OF THE EXTENSION TO THIRD HOLDERS OF THE RIGHT TO ACQUIRE OFFICIAL ECUS, WHICH DEPENDS ON A DECISION TO BE TAKEN BY THE COUNCIL.

IN ADDITION I CAN INFORM MINISTERS THAT THE BANK OF GREECE HAS TAKEN THE OCCASION TO SIGN THE AMENDED AGREEMENT BETWEEN CENTRAL BANKS, INTENDING TO CONTRIBUTE GOLD AND DOLLARS AGAINST ECUS BUT NOT, INITIALLY, TO PARTICIPATE IN THE EXCHANGE RATE MECHANISM.

IN PALERMO I REMINDED MINISTERS THAT PROGRESS CONCERNING THE ECU WAS ONLY ONE ELEMENT OF THE RAMBOUILLET DISCUSSIONS AND EXPRESSED THE CENTRAL BANKS' INTEREST IN THE PROGRESS MINISTERS IN THEIR TURN WOULD FEEL ABLE TO MAKE, NOTABLY IN THE

FIELD OF RESPECTING EXISTING COMMITMENTS.

I ALSO EXPRESSED THE OPINION THAT IT WOULD BE VERY DIFFICULT TO AGREE ON HOW TO INCREASE FURTHER THE ROLE OF THE ECU IF WE CANNOT AGREE ON WHY TO DO SO. TO THIS END I ANNOUNCED THE CENTRAL BANKS' INTENTION TO DISCUSS THE LONG-TERM PERSPECTIVE OF THE EMS AND THE ECU. MINISTERS THEREUPON ASKED ME TO INFORM THEM IN JUNE ON HOW WE ENVISAGE TO PROCEED. GOVERNORS HAVE HAD A FIRST DISCUSSION ON THIS COMPLEX ISSUE, AND ANYTHING I CAN SAY AT THIS STAGE IS OF A PRELIMINARY NATURE.

THE GOVERNORS AGREED THAT THE LONG-TERM OBJECTIVE OF MONETARY INTEGRATION REMAINS THE ATTAINMENT OF AN ECONOMIC AND MONETARY UNION. THIS WAS AGREED IN 1969 IN GENERAL TERMS AND FURTHER SPECIFIED IN THE COUNCIL RESOLUTION OF 22ND MARCH 1971. THE EMS, THOUGH MORE LIMITED IN ITS GOALS, SHOULD THEREFORE CONSTITUTE A STEP IN THIS DIRECTION.

THERE ARE, HOWEVER, DIFFERENT VIEWS ON THE PATH TO BE TAKEN TO THE ULTIMATE OBJECTIVE. SOME CONSIDER THAT THE RESOLUTION OF THE EUROPEAN COUNCIL ON THE ESTABLISHMENT OF THE EMS OF 1978 LAYS DOWN THE ROLE OF THE ECU AND THE EUROPEAN MONETARY FUND WITH SUFFICIENT PRECISION TO WARRANT A SUCCESSION OF SMALL STEPS WITHIN THE PRESENT INSTITUTIONAL FRAMEWORK. THESE SHOULD FURTHER INCREASE THE ECU'S USABILITY AND BRING CLOSER THE SITUATION IN WHICH THE ECU, BEING FULLY UTILISED AS A RESERVE ASSET AND A MEANS OF SETTLEMENT, WILL PERFORM ITS INTENDED CENTRAL ROLE AND THE EXPANDED EUROPEAN MONETARY FUND WILL REPLACE THE PRESENT EUROPEAN MONETARY CO-OPERATION FUND. THESE GOVERNORS STRESS THE POLITICAL AND PSYCHOLOGICAL SIGNIFICANCE THEY ATTACH TO THE PROGRESSIVE INCREASE OF THE ECU'S ROLE.

OTHERS ARGUE THAT THE REASON WHY THE ECU'S ROLE SHOULD BE EXPANDED WILL HAVE TO BE CLARIFIED BEFORE AGREEMENT ON HOW TO DO SO CAN BE REACHED. IN THEIR VIEW SUCH STEPS - WHICH WOULD IMPLY ADDITIONAL OBLIGATIONS - WOULD LIMIT THE CENTRAL BANKS' ABILITY TO FULFIL THEIR TASK OF PURSUING MONETARY STABILITY. THEY WOULD THUS INTERFERE WITH THE CHECKS AND BALANCES SAFEGUARDING THE PRESENT POSITION OF CENTRAL BANKS AT A NATIONAL LEVEL. THIS WOULD ONLY BE IN ACCORDANCE WITH THE OBJECTIVE OF DEVELOPING THE EMS INTO A ZONE OF MONETARY STABILITY IF THE NECESSARY SAFEGUARDS WERE THEN ESTABLISHED AT A COMMUNITY LEVEL BY DEFINING THE EUROPEAN FUND'S TASKS AND AUTONOMY IN A REVISED TREATY LINKING THE ECU AND THE FUND WITH THE ULTIMATE OBJECTIVE OF ECONOMIC AND MONETARY UNION.

GIVEN THESE DIFFERENCES, IT WILL BE NECESSARY TO EXPLORE WHAT THE SCOPE IS FOR FURTHER CHANGES WITHOUT FIRST AGREEING ON THE ADEQUATE LEGISLATION AT THE COMMUNITY AND NATIONAL LEVELS WHICH, ACCORDING TO THE EMS RESOLUTION OF 1978, SHOULD PROVIDE THE BASIS FOR THE FULL UTILISATION OF THE ECU.

GOVERNORS INTEND TO TAKE A CLOSER LOOK AT THE IMPLICATIONS OF THE EXPANSION OF THE PRIVATE ECU MARKET, EXPLORING AMONG OTHER THINGS HOW IT MAY AFFECT CENTRAL BANK POLICIES AND IN WHAT WAY IT MAY PROMOTE PROGRESS TOWARDS THE GOAL OF MONETARY INTEGRATION.

THEY ALSO INTEND TO EXAMINE WHAT THE IMPLICATIONS WOULD BE OF A POLICY TO ENCOURAGE THE ECU'S DEVELOPMENT INTO AN INTERNATIONAL RESERVE ASSET: THE MOTIVE TO DO SO, THE POSSIBILITIES AND THE CONSEQUENCES, BOTH FOR EUROPE AND FOR THE INTERNATIONAL MONETARY SYSTEM. A MAIN QUESTION IN THIS RESPECT IS WHETHER AND

HOW THE ECU COULD LESSEN OUR DEPENDENCE ON THE DOLLAR.

FROM THIS BRIEF REVIEW IT IS CLEAR THAT WE ARE DEALING WITH COMPLEX QUESTIONS OF BOTH A POLITICAL AND A TECHNICAL NATURE.

THE CHOICES TO BE MADE ARE POLITICAL. BUT THEY CAN ONLY BE MADE IF THE POLICY IMPLICATIONS OF THE VARIOUS TECHNIQUES ARE CLEARLY SPELT OUT. THIS CAN ONLY BE EXPECTED FROM THE COMMITTEES WHOSE MEMBERS' COMPETENCE ENABLES THEM TO DO SO. AS FAR AS THE COMMITTEE OF GOVERNORS IS CONCERNED, WE INTEND TO PURSUE OUR DISCUSSIONS AND KEEP MINISTERS INFORMED OF ANY PROGRESS.

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<u>ECOFIN, 11 JUNE : BRIEF B</u>

INVESTMENT AND EMPLOYMENT IN THE COMMUNITY

<u>SPEAKING NOTE</u>

(i) much valuable work being done on how Community might best promote investment and employment. Agree studies should continue;

(ii) UK believes best way forward is to ensure a medium-term financial framework which produces steady, non-inflationary growth, coupled with greater efforts to free markets. Provides essential stable background for investment decisions. Higher profitability and hence further moderation in the evolution of real wages are also key ingredients. Also important is increased labour market flexibility;

(iii) must be cautious, however, about increasing public sector infrastructure. We should recognise that such projects must pass a rate of return test; and that expenditure on public sector infrastructure must be compatible with reducing or consolidating public sector deficits;

(iv) content for ECOFIN to report to Milan European Council on interim basis that work is in hand. Would be helpful if text of report/statement could be circulated to Finance Ministers in advance of European Council.

INVESTMENT AND EMPLOYMENT IN THE COMMUNITY

Points to make

(i) Economic outlook for Community broadly favourable with modest but continuing growth and lower inflation, although disappointing progress in reducing unemployment. Some risks to prospects from US, but recent budgetary and exchange rate developments there seem consistent with sort of gradual adjustment needed. Some recovery in investment already taking place. [For UK at least business investment reached record highs last year].

(ii) Draft Ecofin conclusions broadly acceptable stressing need for more efficient investment, higher profitability and further real wage moderation within a framework of adequate nominal GNP growth. But doubt value of major programmes to increase public infrastructure spending or to raise investment incentives. Both would be counter-productive if they increased budgetary deficits. [Also doubt their efficacy on microeconomic grounds - see (vii) to (ix) below].

(iii) Agree that better investment performance needed. But should consider carefully how to achieve it. Quality as well as quantity important consideration.

(iv) Best way to improve investment and employment prospects is to ensure a medium-term financial framework which produces steady non-inflationary growth, coupled with greater efforts to free markets. Provides essential stable background for investment decisions. Higher profitability and hence further moderation in the evolution of real wages are also key ingredients. Useful analysis in EPC's profitability report illustrates this well.

(v) Also important is increased labour market flexibility - as Commission's draft conclusions rightly note. But disappointing that more emphasis is not placed on reducing administrative burdens on firms - as agreed at last European Council.

(vi) Should point up fallacy in some of Commission's argument that wage moderation necessarily deflationary. Within fixed nominal framework slower growth of real wages provides more not less room for output growth.

(vii) Fully accept that better investment record necessary for more jobs but investment which is capital intensive may provide few extra jobs. As EPC's profitability paper notes, this argues against more specific investment incentives.

(viii) UK's 1984 budget addressed just this issue. Aim was to reduce tax-induced distortions of investment, including between labour and capital, and to promote more efficient investment.

(ix) Commission suggest major increase in public infrastructure spending. We should all recognise that such projects must pass a rate of return test if there are to be real gains. Indiscriminate public spending benefits no-one. We must also take full account of adverse impacts on budgetary objectives.

Background

Ecofin has to report to the European Council in Milan on 28-29 June on measures to combat unemployment with sustained and more employment intensive growth. The Commission is likely to table three papers:

- draft conclusions on investment and employment for Ecofin to submit to the European Council

- EPC's report on profitability

- a Commission paper on investment and employment in the Community.

Ecofin draft conclusion for Milan (Annex B to this brief)

2. Discussion is likely to focus on this item. The conclusions are broadly acceptable. The paper recommends more investment and rightly emphasises the need for improved profitability together with greater real wage moderation if employment prospects are to improve. The Commission avoids any explicit recommendation for specific investment incentives though its general call for tax reductions to enhance productive potential would include them. It also calls for greater public sector infrastructure spending particularly on transport and communications.

3. Investment incentives turn relative factor prices against more jobs and seem a poor way of promoting more employment intensive growth though we can clearly support more general tax reductions to improve supply performance. On public spending the UK has argued it does not have a substantial backlog of infrastructure projects offering good economic returns and this remains our view. The reference to transport could cover the Channel fixed link project but on this the UK has decided that there should be no Community involvement or other public funding whether by grants or guarantees.

EPC Report on Profitability (Annex D to this brief)

4. Mr Byatt as EPC Chairman will introduce this item. It provides some useful analysis and a set of policy conclusions which are acceptable to the UK. In particular it acknowledges the role of real wage moderation in raising profitability and that investment incentives may have encouraged excessive capital intensity in the past and thereby harmed employment opportunities. The points to make suggest you endorse the report in general and pick out these issues

Commission's Paper On Investment and Employment (Annex C to this brief)

5. The Co-ordinating Group this week discussed a lengthy fairly detailed version of a paper though the Commission may well produce a shorter more policy oriented piece for Ecofin. As it then stood the paper covered investment performance in the Community, the determinants of investment, the relationship with growth and employment and included a policy section. Most of the paper's policy prescriptions have already been covered above. In brief it argues that in the short-term wage moderation is deflationary and therefore counter-productive in increasing employment; thus there is a need for demand support. We would challenge this analysis. But in any case, it is not clear what it meant by "demand support". It could mean fixed nominal GDP or a fixed nominal monetary and fiscal policy framework, in which case this would be broadly consistent with UK views. But if it means some relaxation of monetary and fiscal policies, it would be unacceptable, because it ignores the risks of higher inflation.

6. The paper seems to suggest supporting demand in the short-term through, inter alia, investment incentives. This conflicts with the UK's objective that distortions to markets caused through the tax system should be reduced, as reflected in the measures taken in the 1984 Budget. Investment

incentives also run counter to the aim of improving factor price relationships, an aim which the paper appears to share. There is evidence that investment in the EC has been excessively capital intensive and so unhelpful to employment.

7. The Commission also reiterate the need to support demand in the short-term through public sector investment, both at the national and Community level. We need to be cautious about this, both on grounds of rates of return and of implications for national and Community budgets. We need to be cautious also about any suggestion of national or Community guarantees for risky investments, which might otherwise not be carried out. (We understand from UKREP that the Commission are considering this idea). Such guarantees would of course be a potential call on public expenditure.

8. Annex A provides a detailed commentary on the earlier sections of the paper.

ANNEX A TO BRIEF B

INVESTMENT AND EMPLOYMENT IN THE COMMUNITY

The Commission paper is in four sections:

I Investment performance in the Community.

II The main determinants of investment.

III The relationship between investment, economic growth and employment in the Community.

IV Possible policies to promote investment.

The following brief considers the first three sections. Section IV has been covered earlier in the brief.

SECTION I: INVESTMENT PERFORMANCE IN THE COMMUNITY

1. This section is mainly factual. It highlights:

   (a) the relatively poor investment performance in the Community since 1970 compared to Japan and the US;

   (b) the fall in the average investment ratio (gross fixed capital formation as a percentage of GDP at market prices) of the Community from 22.6 per cent in 1970 to a low of 18.5 per cent in 1983 - with only modest recovery since. Trends within the Community are analysed by asset type and sector.

2. The sustained weakness of investment combined with high levels of capital retirement (attributed to accelerated obsolescence in the wake of energy price and labour cost increases) is claimed to have reduced capital stock growth rates to the extent that current capital stock levels impose a serious constraint on potential rates of economic growth. This claim is backed by evidence that, despite only recent slow growth in output, current rates of capacity utilisation are rapidly approaching normal levels.

Comment

3. Commission figures indicate that although the UK's investment ratio appears to have been significantly lower than the Community average since 1970 there has been a relative improvement in more recent years. Furthermore, our own national accounts figures indicate that the investment ratio troughed in 1981 (rather than 1983, as for the Community as a whole), and that by 1984 it had risen to the levels of the late 1970s - with a further increase expected for 1985. On capacity utilisation, the Commission appear to quote CBI figures for the UK, and their interpretation is consistent with our own assesment that normal levels are currently being reached. However they do not note the recent increase in the percentage of firms citing expansion of capacity as one of the main reasons for investment. The April 1985 figure (29 per cent) was higher than any recorded since the question was first asked in late 1979, and suggests that, while the efficiency motive is still paramount, rationalisation is giving way

somewhat to capacity expansion. Thus while the Commission identify the UK as one of the countries where the investment recovery is most evident, there are also perhaps emerging signs that the UK recovery is starting to produce the sort of investment that the Commission regard as necessary for higher medium-term growth.

SECTION II: THE MAIN DETERMINANTS OF INVESTMENT

1. Here the paper seeks to identify the main reasons for the poor investment performance. The decline in the rate of return on capital is noted, and this is mainly attributed to:

(a) energy price increases and associated recession;
(b) excessive real wage cost growth relative to the growth of labour productivity ie. a positive real wage gap, throughout the period 1960-1981.

Particularly between 1974 and 1981 energy prices had a large impact, and the real wage gap widened, although since 1982 the wage gap has moved favourably. Sustained substitution of capital for labour in response to the wage gap is claimed to be the prime reason for increased capital intensity, and hence a lower rate of return. This substitution is also seen as the cause of the Community's unsatisfactory employment trend.

2. Up to the later 1970's low rates of return were partly offset by low real interest rates in their effect on the incentive to invest. However rising real interest rates since 1979 (attributed to restrictive monetary policies to curb inflation without sufficient reduction in budget deficits) increased the cost of capital and led to reduced investment, particularly expansion investment. The resulting position is seen to be one in which the current capital stock is insufficient to enable demand increases to sustain growth in output.

Comment

3. The arguments of this section are (somewhat inevitably) circular, but also at first sight a little confusing. The substitution of capital for labour is said to have led to the capital stock growing faster than GDP ie. higher capital output ratios - see page 21. However with investment as a proportion of GDP falling, and accelerated scrapping as a result of energy price (and labour cost) increases we might have expected the capital stock to grow more slowly than GDP. The key to the Commission's argument is that successive increments to the capital stock were less and less productive so that despite

(net) investment as a proportion of GDP falling, output itself grew at an even slower rate than the capital stock. For this to occur the growth rate of the capital stock would have to be falling faster than the net investment ratio (with the growth rate of output falling even faster) and the situation would be unsustainable. This is not a particularly easy argument to follow and the Commission paper does not properly articulate it. It is by no means clear why such unproductive new investment should take place. Furthermore it is difficult to test this argument against the data, given the known problems in adequately measuring the capital stock. Certainly for the UK we have good reason to believe that the official capital stock estimates overestimate the true stock, and it is not clear to what extent capital has been substituted for labour over the past fifteen years.

SECTION III: THE RELATIONSHIP BETWEEN INVESTMENT, ECONOMIC GROWTH AND EMPLOYMENT IN THE COMMUNITY

1. This section illustrates that a very substantial increase in the investment ratio would be required to raise the Community's potential sustainable growth rate by one percentage point from the current growth rate of 2 per cent. In addition, although such an increase would assist unemployment, it would not produce any rapid reduction given current high levels of capital intensity. This leads the Commission to conclude that the pursuit of job creating economic growth must involve policies aimed at wage cost moderation to induce the substitution of labour for capital. On the other hand they claim that wage moderation is likely to have a depressing effect on demand in the short term, and so some measure of demand support is also required.

Comment

2. The problem of achieving any significant reduction in unemployment via increases in demand with no changes in relative factor prices (the capital widening route) is well taken. A similar point was recently made by the London Business School in one of their recent forecast releases. They showed that with existing capital-labour ratios unrealistic increases in investment would be required to make significant employment gains. Regarding the capital deepening route (substitution of labour for capital via lowering the relative price of labour to capital) the Commission are perhaps rather pessimistic about the effect of wage moderation on aggregate demand. They cite the depressing effect on private consumption, but fail to mention the effects on company expenditure as a result of higher profits, and competitiveness effects on net exports. In contrast to the Commission simulations, Treasury work reported in the recent publication on 'The Relationship Between Employment and Wages' suggested that for the UK the output effects of lower nominal wages would be positive even in the short-run, given unchanged money supply and PSBR/GDP ratio. If this policy framework is what the Commission menas by 'demand support' then there is no need to disagree, since it fits well with the financial framework of the MTFS. If on the other hand the Commission intends 'demand support' to mean some relaxation of monetary

policy (it acknowledges the need for budgetary restraint) then it is not clear that such a policy is necessary for significant employment gains to satisfactory materialise through capital deepening.

BRIEF C

ECOFIN: 11 JUNE

REFERENCE FRAMEWORK

SPEAKING NOTE

OPENING REMARKS

1. Reference Framework an important matter - for which thanks are due to M. Bergovoy 's predecessor. Glad that we are now getting down to tackling it. But very much regret that Commission have not provided the necessary figures. We should have had a substantive discussion on them. Must ask that they produce them next week - even if some have to be on a provisional basis. 1984 Budget known - as are main outlines of 1985. Those provide most of basic data we need.

2. Recognise the particular problems this year with the delays over the 1985 Budget. But no excuse for further delay. All the necessary data is available. Essential that we take our decision on the Reference Framework before the PDB is published early next month. Would have liked to have done so today. However, must respect commitment to consult European Parliament. Therefore ask that we agree now to invite Parliament to a special session with a view to taking a decision then. UK would be ready to participate in a meeting in week beginning 24 June. [If no agreement on a June meeting: must fix Reference Framework no later than 8 July Council].

3. Meanwhile believe we should go over the principles and elements now so that having met the Parliament we can straightaway tackle the figures. Three components of the Reference Framework:

(a) guideline;

(b) DNO;

(c) non-FEOGA Guarantee DO.

4. **Guideline** in principle very simple; complication however with enlargement. Accept cannot get all FEOGA Guarantee for EC twelve into guideline calculated purely for EC ten. Recognise that some addition to the guideline figure for 1986 will be necessary because of enlargement. But this must be a matter of judgement, not automatic. The extra costs should be accommodated within the guideline so far as possible. Objective, however, must be to apply to twelve, mutatis mutandis, the discipline designed for ten.

5. **Non-obligatory expenditure**; in the budgetary discipline text the Council undertook to stand on the maximum rate as calculated in the Treaty. Recognise that there are particular problems; overhang of commitments has been a source of concern to us for some time; Commission should start now to liquidate it. Welcome that; but liquidation must be within maximum rate - 7.1 per cent.

6. **Other obligatory expenditure**. Digressive repayments to Spain and Portugal must clearly be entered here at the expected level. Also the 10 per cent repayment of Customs duties etc. We need to make a realistic estimate of the FEOGA Guidance sums - bearing in mind the recently agreed ceiling for those. Suggest that other elements be at the 1985 rate, uplifted by the maximum rate.

7. **Summary**. Commission should produce their figures straight away - next week at latest whatever has happened on price fixing. We must sort out our thinking on the Reference Framework now; invite the Parliament to meet us this month; and resolve that we shall immediately thereafter fix the figure for 1986.

DEFENSIVE

8. [It if is argued that Reference Framework should not be set until Commission has produced PDB.] Throughout the discussions on the budgetary discipline text last autumn it was always envisaged that the Reference Framework would be fixed before the PDB was produced. The argument was solely whether it could be done as

early as March. The Commission at that time had argued only that the data would not be available until April. There was <u>never</u> any suggestion of waiting until after publication of the PDB. The necessary data are now available and there is therefore no hindrance. On the contrary desirable that the Commission should be aware of the Council's views on the reference framework before putting forward the PDB.

9. [If it is argued that Reference Framework should await outcome of price fixing.] The argument that ECOFIN should wait because the Agriculture Council cannot finish the price fixing is absurd. The Commission undertook to produce the financial guideline along with the price fixing proposals and did so.

1986 LEGAL BASE

10. [For use if **Legal Basis** of 1986 Budget is raised.]

This is a very important issue. Cannot pursue today in detail. Must all be clear, however, that until ORD finally ratified VAT ceiling is 1 per cent, not 1.4 per cent. We must all hope, and work, for early ratification. No objection to the draft 1986 Budget being drawn up on the assumption that increased Own Resources will be available. But both sides of the budgetary authority need to be clear and to make explicit throughout the budgetary procedure that there can be no legitimate Budget in excess of the 1 per cent ceiling nor could such a Budget be implemented until the ORD has been ratified by all Member States. Trust that the Commission will make this point clear when they bring forward the PDB. Further discussion of the precise legal status of the Budget in these circumstances may be needed. But it is clear that the 1986 Budget must remain a draft or provisional one until the ORD has completely come into force.

BUDGETARY DISCIPLINE: REFERENCE FRAMEWORK: AIDE MEMOIRE

1. Budgetary discipline text requires a reference framework (a cash limit) to be set at the start of the budgetary procedure. This must be tight enough to be a real constraint - but not unrealistic so that it has to be revised.

2. The preliminary draft Budget will be published by the Commission early in July, therefore reference framework must be set end June at latest.

3. Must be discussion with Parliament before reference framework is set; Parliament has not been invited to June ECOFIN; therefore, invitations should issue forthwith for a meeting before the end of June - (July ECOFIN - on 8th is really too late) - after which ECOFIN must promptly fix the Reference Framework.

4. Commission undertook to provide necessary figures. So far have failed to do so. ECOFIN cannot therefore discuss quanta. Commission must be made to meet their undertakings - by next week at the latest.

5. Subject to resolution of treatment of agricultural expenditure after enlargement, total size of the reference framework for 1986 should be just under 31 becu covering three elements:

   (a) agricultural expenditure in accordance with the guideline 20.45 becu;

   (b) non-obligatory expenditure (DNO) calculated in accordance with the Treaty 6.3 becu;

   (c) provision for other compulsory expenditure (DO) 4.1 becu.

6. Guideline. Applies to FEOGA Guarantee - 70 per cent of the Budget. Most important part of budget discipline for UK. Guideline figure 20.45 becu. Issue is what addition, if any, to make for Spain and Portugal.

7. DNO. Objective is to get all this within maximum rate (7.1 per cent). No special provision should be made for IMPs or for the costs of enlargement, nor for overhang from the past. 6.3 becu provision must provide resources for IMPs etc.

8. Other DO. Must include specific provision for relief for Spain and Portugal and for 10 per cent refunds of Customs etc. duties. Also for FEOGA guideline which has its own multi-annual ceiling. Otherwise modest uplift on 1985 is all that is required.

9. Voting on the Reference Framework is by Qualified Majority (QM). Two large States, or one large and two small are sufficient to block a QM.

REFERENCE FRAMEWORK: BACKGROUND

At the end of 1985 the Council adopted the budgetary discipline provisions. The UK has consistently attached great importance to these for both Community, and UK domestic purposes. Vital that they be properly applied. 1986 is the first full budgetary year to which budget discipline applies.

2. Because of delays with the 1985 Budget the 1986 Preliminary Draft Budget will be published only in July. The reference framework should be established before that; that will require a meeting with the European Parliament - if at all possible in June.

REFERENCE FRAMEWORK

3. The reference framework is analogous to a cash limit. In principle it is the limit of expenditure for the Community in the year in question - however, it can be varied. Voting on it is by Qualified Majority.

4. There are three elements to the reference framework; provision for agricultural guarantee expenditure - governed by the guideline; for non-obligatory expenditure - governed by the maximum rate; for other compulsory expenditure for which no specific provision is made.

5. The reference framework was largely the brainchild of M.Delors (who now shows little interest in his progeny). The UK prime interest has always been in restraining agricultural expenditure; nevertheless if this part of the budgetary discipline is brought into question or set aside that would have repercussions on others.

6. European Parliament must be consulted before the reference framework is set; it will almost certainly wish to argue for a much higher figure than will be acceptable to us. Moreover, a number of Council Members will be less than enthusiastic for the reference framework and, if the Parliament are reluctant to come, argue for deferment of settling the reference framework.

Given the need to set it at the start of the budgetary process you should insist either on an early meeting with the Parliament, or else, if they decline to come, nevertheless proceeding to fix the reference framework. All should be completed by July ECOFIN (8 July) at latest.

7. Leaving aside FEOGA Guarantee expenditure in Spain and Portugal the Reference Framework should be just under 31 becu as below.

Guideline	20.45
Other DO	4.1
DNO	6.3
	30.85

The Commission are likely to seek 35 becu, including 540 mecu for Guarantee expenditure in the new Members. At the outside therefore the objective must be to hold the total to 31.4 becu. There are, in fact, arguments for going below that.

THE GUIDELINE: FEOGA GUARANTEE

8. This expenditure - some 70 per cent of the Budget - is subject to the financial guideline. The formula for calculating this is laid down in the budget discipline conclusions and the Commission's calculations of the guideline for 1986 - 20.45 becu - and there is unlikely to be any serious argument about this.

9. The main point of contention is the Commission's proposal that the costs of enlargement in 1986, some 540 mecu, should be <u>additional</u> to the guideline. Article 2 of the budget discipline conclusions states that "account shall be taken of exceptional circumstances, in particular in connection with enlargement." (The Irish have stated in the Council minutes that they consider that the cost of disposing of the present high level of agricultural stocks is also an exceptional circumstance, but this point is not very likely to surface at this ECOFIN Council.) The UK delegation has never accepted that the costs of enlargement should be added on to the guideline automatically or in full.

10. On the other hand it would clearly be difficult to absorb these costs entirely within a guideline devised for a Community of ten. MAFF estimate the costs arising from Spanish and Portuguese accession at:

				mecu
1986	**1987**	**1988**	**1989**	**1990**
530	620	765	920	1145

11. We are not yet able to advise on how best to resolve this problem. It will not therefore be possible to propose a solution at this ECOFIN Council, though we must be ready to do so by the time of the subsequent Council discussion of the Reference Framework.

12. There are a number of options, ranging from an annual negotiation in the Council about how much, if anything, to add on to the guideline for enlargement (an ad hoc approach) to recasting the basis for calculating the guideline so as to build in some allowance for enlargement (a formula approach). We have suggested to other Member States sympathetic to budget discipline (Netherlands, Germany, France) that we should discuss privately how best to resolve this problem.

13. It will be necessary to make clear on 11 June that the UK does not accept the proposition that the costs of enlargement should be added, automatically and in full, to the guideline. This expenditure will have to be examined rigorously with a view to absorbing as much as possible within the guideline.

NON-OBLIGATORY EXPENDITURE

14. The increase allowed by the Treaty for non-obligatory expenditure is 7.1 per cent; this applies to both payment and commitment appropriations. Only the former are relevant for present purposes. The total of permissible payments for 1986 is 7.5 becu. There will be strong pressure to allow a larger sum for this but it must be resisted.

15. The major factors likely to be argued are the overhang of commitments from earlier years (perhaps 9 becu of which the Commission may seek to liquidate about half). IMPs - where there is a commitment to 1.6 becu of new money; and adopting the Structural Funds for enlargement. It will be difficult to get others to stand firm on all of these - but we must strive for that. Our figure of 6.3 becu excludes them all. Our objective is to stand strictly on the maximum rate of 7.1 per cent.

Commitments overhang

16. The Commission may well seek an increase in non-obligatory payment appropriations for 1986 of 40.5 per cent. This is claimed to be justified because of the need to liquidate outstanding commitments from previous years, ie contracts which have been entered into but for which payment has been delayed. These relate largely to Regional and Social Fund expenditure and at the end of 1983 amounted to almost 9 becu. The Commission propose to liquidate half of this, 4.4 becu, in 1986. They argue that this "cost of the past" cannot be included in the maximum rate, which would cover new expenditure.

17. The UK position is that expenditure on payments resulting from past commitments is no different in kind from other non-obligatory expenditure, and cannot be artificially ring-fenced. Indeed, past commitments should take priority over new expenditure plans, as they would in any private sector enterprise. The expenditure involved in liquidating outstanding commitments is a real addition to the total. At a time when Member States are restraining their domestic public expenditure, in line with Commission recommendations, it is unrealistic and inconsistent of the Commission to press for a 40 per cent increase in non-obligatory expenditure.

Integraged Mediterranean Programmes (IMPs)

18. The Southern Member States will argue that expenditure on IMPs (1600 mecu of additional money over 7 years as well as 2500 mecu from the Structural Funds) of which Greece should get 2000 mecu should fall outside the maximum rate provisions. The

UK oppose this. There can be no justification for treating IMPs expenditure differently from other non-obligatory expenditure. The only exception clause in the budget discipline agreement relates to agricultural expenditure and enlargement. IMPs do not apply to Spain and Portugal, and are not related to price support expenditure. They must therefore be financed from within the maximum rate.

Enlargement: ERDF and ESF

19. The Commission are likely to press for major increases in the Structural Funds to allow Spain and Portugal to take up their full shares. It is doubtful, in fact, whether they could absorb large sums immediately. Even if they could, that is no argument for spreading outside the proper limits. It may be suggested that it is to the UK's benefit for the ERDF to be increased so that we maintain our present level of receipts. However, we are likely to become net contributors and it would obviously be better for us to be such to a smaller rather than a larger fund.

OTHER COMPULSORY EXPENDITURE

20. There are no specific provisions for calculating the element for other (non-agricultural guarantee) compulsory expenditure. We have suggested a figure of 4.1 becu. This allows for the transitional relief for Spain and Portugal, the 10 per cent Customs refunds, and the new ceiling on FEOGA Guarantee, with a modest uplift from 1985 for the remaining elements.

Relief for Spain and Portugal

21. It has been agreed that on a transitional measure Spain and Portugal should have a proportion of their contributions returned in the early years. How much is paid to them depends upon their contributions - and hence on the size of the Budget. A sum of about 1.55 becu, however, would be of the right order.

FEOGA Guidance

22. Provision must also be made within the Reference Framework for obligatory expenditure which is not covered by the agricultural

guideline. An important element is expenditure on farm structures' FEOGA Guidance. (About 25 per cent of this expenditure is non-obligatory and so covered by the maximum rate.) Here the UK objective is to achieve the lowest rate of increase capable of mustering a qualified majority of votes in Council. Ideally, this would be no higher than the maxium rate for non-obligatory expenditure of 7.1 per cent. If Germany, and perhaps France and the Netherlands, support this position we should continue to press for it.

23. However in April 1985 a new 5 year multi-annual programme for FEOGA Guidance was agreed. This involved provision for a total of 5250 mecu in commitments, and cannot be accommodated within the likely maximum rate over the period. Some Member States will argue that extra provision above the ceiling will be necessary for Spain and Portugal. Our objective should be to agree a clear figure which covers all Guidance spending, including, if possible, <u>the effects of enlargement</u>.

TIMING

24. The Commission will publish the 1986 PDB early in July. They are likely to announce its contents before then. The announcement may, then, precede the fixing of the reference framework. The next regular ECOFIN is 8 July; that is the very latest date for fixing it. Given the need to consult the Parliament, and to consider the figures when the Commission has produced them there are good grounds for a special ECOFIN late in June. Otherwise <u>everything</u> will have to be done on 8 July.

<u>Next year</u>

25. Finally it would be desirable to secure agreement on procedure for next year. That implies resolving now to fix the 1987 framemwork by the end of May next year.

ANNEX A

CONCLUSIONS OF THE COUNCIL ON THE MEASURES NECESSARY TO GUARANTEE THE EFFECTIVE IMPLEMENTATION OF THE CONCLUSIONS OF THE EUROPEAN COUNCIL ON BUDGETARY DISCIPLINE

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaties establishing the European Communities,

Whereas at its meetings on 19 and 20 March and 25 and 26 June 1984 the European Council reached agreement on a series of decisions and guidelines to ensure the relaunch of the Community and establish a solid basis for further development during the present decade;

Whereas principles on budgetary and financial discipline are specifically laid down;

Whereas the European Council considered it essential that the rigorous rules which at present govern budgetary policy in each member state shall also apply to the budget of the Communities, and stated that the level of expenditure will be fixed on the basis of available revenue, and that budgetary discipline will apply to all budgetary expenditure;

Whereas the European Council invited the Council of Ministers to adopt the measures necessary to guarantee the effective application of the principles as set out in its conclusions,

HAS ADOPTED THE FOLLOWING CONCLUSIONS:

Article 1

1. At the beginning of the budgetary procedure each year, the Council shall fix a reference framework, i.e. the maximum level of expenditure which it considers it must adopt to finance Community policies during the following financial year in accordance with Articles 2 to 5 inclusive and Article 9.

2. In order to fix the reference framework, the Council shall act by qualified majority in accordance with Article 148(2), second indent of the EEC Treaty.

3. The relevant provisions of the financial guidelines concerning the Common Agricultural Policy, set out in the Annex to the Commission communication of 6 March 1984, shall be implemented; these provisions are annexed to these Conclusions.

Article 2

The Council shall ensure that the net expenditure relating to agricultural markets calculated in accordance with Article 4, will increase by less than the rate of growth of the own resources base. This development shall be assessed on comparable bases from one year to the next.

Account shall be taken of exceptional circumstances, in particular in connection with enlargement.

Article 3

The amounts to be taken into account for the application of Article 2 shall be—

(*a*) as regards expenditure—

that chargeable to Section III, Part B, Titles 1 and 2 (EAGGF Guarantee) of the Budget. The calculation of agricultural expenditure for the purposes of the guideline referred to in Article 2 shall be this expenditure, reduced by the sum of amounts corresponding to the marketing of ACP sugar, refunds in connection with food aid and the payments by producers in respect of the sugar and isoglucose levies as well as the revenue from any future internal agricultural charges;

(*b*) as regards the own-resources base—

the potential revenue on the basis of which Titles 1 and 2 of the Revenue side of the Budget are determined. The calculation of the Community's own resources base for the purposes of the guideline referred to in Article 2 shall be the total VAT base upon which the VAT rate of the year in question is calculated, the amount of financial contributions (if any) included in the Budget of the year, together with the own resources, other than those derived from VAT, set out in Revenue Title 1, less the sugar and isoglucose levies as well as the revenue from any future internal agricultural charges.

When the potential revenue from VAT is changed following an alteration in the VAT ceiling, the guideline provided for in Article 2 shall thereafter be calculated as if the new maximum VAT rate had been applied in all the years relevant to the calculation of the guideline.

Article 4

The level of net expenditure relating to agricultural markets for a given financial year shall be calculated as follows—

(*a*) the level of expenditure, as defined in Article 3(*a*), shall be the average of the actual outturn expenditure for 1984, and the best estimate of the outturn for 1985;

(*b*) the own resources factor shall be established by dividing the forecast level of the own resources base for the financial year in question, as defined in Article 3(*b*), by the average own resources base for 1984 and 1985;

(*c*) the level of expenditure for the financial year in question shall be determined by multiplying the amounts obtained by the application of paragraphs (*a*) and (*b*), unless the Council acting by the majority defined in Article 1(2) decides otherwise;

(*d*) the method of calculation shall be re-examined in accordance with the Fontainebleau conclusions under the heading "budgetary imbalances" on the basis of the report to be presented by the Commission one year before the 1·4 per cent VAT ceiling is reached.

Article 5

In the event of failure to respect the qualitative guideline referred to in Article 2, the Council shall, during the following two financial years, ensure that, barring aberrant developments, agricultural expenditure is brought back within the limits imposed by this guideline. In so doing, the Council shall concentrate its activity primarily on the production sectors responsible for the failure to adhere to the guideline.

Article 6

1. The Council shall, when exercising its powers as legislative authority or branch of the budgetary authority, ensure that the reference framework is respected.

2. At the request of a member of the Council or the Commission, the Council, acting by the majority referred to in Article 1(2), may amend the reference framework.

Article 7

1. Except in the case of decisions mentioned in paragraph 4, when the Council is on the point of adopting an act which appears likely to increase expenditure for a financial year beyond the reference framework applicable to that year, the adoption of that act shall, at the request of a member of the Council or the Commission, be suspended.

2. Within a period not exceeding one month, the Council, acting by the majority referred to in Article 1(2), shall determine whether the proposed act would, if adopted, lead to the reference framework being exceeded.

3. If the Council concludes that the proposed act would, if adopted, lead to the reference framework being exceeded, it shall reconsider the proposed act with a view to taking appropriate measures.

4. In the case of decisions affecting net expenditure relating to agricultural markets, the procedures laid down in paragraphs 5(*c*) and 6(*b*) of the Annex to the Commission's communication of 6 March 1984 shall apply.

Article 8

When the Council is on the point of adopting an act which has considerable financial implications for several years, the Council shall, before taking the final decision, formulate an opinion on whether the financial implications of the proposed act are compatible with the principles and guidelines governing the Community's budgetary policy.

Article 9

1. The Council shall comply with the maximum rate provided for in Article 203(9) of the EEC Treaty throughout the budgetary procedure.

2. In order to achieve this:

—when establishing the Draft Budget, the Council shall keep the increase in expenditure other than that necessarily resulting from the Treaties or from acts adopted in accordance therewith to a level no higher than half the maximum rate provided for in Article 203(9);

—at the second reading, the Council shall adopt a position such that the maximum rate is not exceeded.

3. Paragraphs 1 and 2 of this Article are without prejudice to the provisions of Article 203 of the EEC Treaty, particularly those of the last sub-paragraph of paragraph 9.

Article 10

On the assumption that the 1986 budget will be prepared on the basis of own resources being increased in that year, these conclusions shall first apply to the exercise of the Council's powers in 1985 concerning expenditure in the financial year 1986.

ANNEX A I

EXTRACT FROM THE COMMISSION COMMUNICATION OF 6 MARCH 1984 REFERRED TO IN ARTICLE 1 PARAGRAPH 3

"5. As regards the decisions which have a determinant effect on the volume of agricultural expenditure, that is the decision on agricultural prices which the Council of Agriculture Ministers must take each year on a proposal from the Commission, the Commission proposes the following rules—

(*a*) When submitting its agricultural proposals the Commission will supply a quantified estimate of their budget impact in relation to the movement in the growth of the Community's own resource base calculated according to a common and constant formula, namely the sliding average of the growth rates for the current year, the year immediately preceding and the year ahead. These figures will allow a judgement to be made of the compatibility of the proposals with the guideline referred to in paragraph 2.

(*b*) The Commission will draw up its proposals on prices (and related measures) in the light of the guideline referred to in paragraph 2. To this end the Commission confirms that it intends in the coming years to pursue a restrictive price policy for sectors in surplus and for those where a rapid growth in expenditure is coupled with limited outlets for disposal.

(*c*) On this basis the Commission suggests that the European Council request the Council to adopt the following rule: if in the Commission's opinion the Council of Agriculture Ministers seems likely to take decisions whose cost would exceed that of the original proposals of the Commission, the final decision must be referred to a special Council session attended by both Finance and Agriculture Ministers and can be taken only by that special session.

6. As regards the preparation and implementation of the budget the Commission proposes the following rules—

(*a*) In submitting its budget proposals in the context of its preliminary draft budget the Commission will take account of all foreseeable expenditure in the budget year concerned, including that stemming from its price proposals.

The aim of the Commission and the Council will thus be to keep EAGGF Guarantee expenditure within the appropriations for the year.

(*b*) The Commission will institute an early-warning procedure enabling it to detect promptly any risk during the year of budgetary over-runs and report to the Council and Parliament forthwith.*

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* Apart from a Council decision on prices in excess of the Commission's proposals (when the special decision-making procedure in paragraph 5(*c*) would apply), such " over-runs " could only occur as a result of compelling economic developments which could not have been foreseen when the budget was adopted.

It will in any event report to the Council and Parliament each month on the trend of agricultural expenditure.

After making use of all the opportunities afforded by the routine management of the CAP it will if need be propose to the Council and Parliament measures designed, without detriment to the principles of the CAP, to restrict increases in agricultural expenditure. It will be incumbent on those institutions to take the necessary decisions as speedily as possible so that these measures can achieve their purpose. Where appropriate the Council's decisions could be taken at a special session of the kind referred to in paragraph 5(*c*).

The Commission will not introduce a supplementary budget until it has exhausted all the opportunities for savings afforded by the routine management of the CAP and by any additional Council decisions.

(*c*) In the event of failure to respect the qualitative guideline referred to in paragraph 2 (by reason either of a special Council decision (paragraph 5(*c*)) or of a supplementary budget), adherence thereto will mean both the Council and the Commission must during the following two financial years ensure that, barring aberrant developments, agricultural expenditure is brought back within the limits imposed by the qualitative guideline. In so doing they must concentrate primarily on the production sectors responsible for the failure to adhere to the guideline."

ANNEX A II

Council conclusions on co-operation with the Commission and the European Parliament on budgetary discipline

The Council on 28 November and 4 December had a thorough discussion in the light of the meeting on 21 November on how to ensure the necessary co-operation between the European Parliament, the Commission and the Council in the matter of budgetary discipline.

The Council adopted the following conclusions—

—firstly to invite the Commission and the European Parliament to examine with it ways in which the co-operation necessary for a budgetary discipline common to all three Institutions may be brought about;

—secondly to invite a delegation of the Parliament to meet it shortly before the meetings at which the Council is due to fix the reference framework for the year.

The Council authorised its President to transmit to the European Parliament the outcome of its deliberations on budgetary discipline, namely its conclusions on—

—the measures necessary to guarantee the effective implementation of the conclusions of the European Council on budgetary discipline.

—co-operation with the Commission and the European Parliament on budgetary discipline.

BRIEF D

ECOFIN 11 JUNE

Subject: DRAFT 20TH VAT DIRECTIVE

UK objectives:

1. To give effect to the Fontainebleau package, of which this directive is a part. On the directive itself, this requires the resolution of three outstanding problems:

   a. the terms under which the continued German refusal to agree to separate statements of VAT and the special aid in traders' accounts, tax invoices and tax returns may be accommodated without prejudicing Own Resources

   b. the scope of the directive

   c. the inclusion in the directive of a Minutes Statement to the effect that in future the VAT mechanism will not be employed as a means of granting national aid

It is anticipated that there will be a general discussion on these issues; and that the Chief Secretary will not be required to intervene.

Line to take:

2. You should accept that FRG will no longer be expected to separate VAT and the special aid on traders' invoices, traders' accounts and VAT returns.

3. You should support the Presidency's solution to the problem of accommodating the Germans, involving additional Articles requiring the Germans to ensure that Own Resources are safeguarded and embodying an annual reporting monitoring procedure, together with a statement that the VAT mechanism will not be used again to effect grants of national aid.

4. You should not support the alternative Commission solution, for an addition to Article X which would allow the Commission to decide on the basis of its first annual report that reversion to separation of VAT and national aid was required. You could make the point that Article X already requires FRG to safeguard Own Resources, and that default could be pursued by normal means.

5. Even more vigorously you should oppose the second alternative solution which though akin to the Commission solution would permit the Council, on the basis of a qualified majority, to take action on an adverse annual report. You may say that the UK is not in favour of a precedent to be set whereby the Council intervenes in Community administration matters on the basis of a qualified majority.

6. On the question of scope of the directive, you should support the majority Member States' view that the text of the directive should include a statement that the compensation granted by the Germans should not exceed the effects arising out of the dismantling of monetary compensatory amounts.

7. You should continue to support the inclusion of a Minutes Statement precluding the employment of the VAT mechanism as a means of granting national aid in future.

8. However, if the Presidency deflects other Member States from supporting this line, you can agree to the majority view.

Background

1. The agricultural prices settlement in March 1984 included a 5 percentage point cut in German monetary compensation amounts (MCAs) to take place through a green mark revaluation in January 1985. The Agriculture Council agreed that the resulting loss of income to German farmers could be partially offset by means of a subsidy to output prices paid through the VAT system. The cost of the aid was to be divided between the Community and Germany itself.

2. At Fontainebleau in June 1984, the Germans sought, and got agreement to, a somewhat more generous package of aid, ie 5 per cent from 1 July 1984 to 31 December 1988. It is this package which is the subject of the 20th VAT directive. However, the directive has not yet been formally adopted, one of the reasons being that Germany will not agree to separate accounting of the aid and VAT.

3. The FRG's national legislature has anticipated Community law. Other Member States have already made considerable concessions to accommodate German legislation in consideration of this Directive; principally that special aid need not be restricted to products previously eligible for MCA's but can be a global payment for all products; also flexibility as to the starting and finishing dates for the payment of aid, in line with German legislation.

4. The European Parliament's opinion on the directive was delivered in April 1985, and questions many aspects of the Council's handling of the matter; and also includes the EC Parliament's view that separation of VAT and special aid on traders' invoices, accounts and VAT returns is necessary to safeguard Own Resources. The Conciliation Procedure, provided for by Joint Declaration in 1975 may be invoked by either the Council or Parliament. In this event we are in favour of better conciliation generally, provided that the terms of the Joint Declaration are met.

5. The UK, like other Member States, now accepts that the Germans will not separate VAT and the special aid in all traders' invoices, accounts and VAT returns. This acceptance is based on German assurances that Own Resources

will not suffer. The Presidency is now fairly relaxed on this issue, though the Commission is still pressing for "belt and Braces" monitoring of the progress towards completion of the special aid exercise.

6. Our general view is that, because the special aid emanated from Fontainebleau, the sooner the exercise is completed the better, always provided that Own Resources are adequately safeguarded.

ECOFIN, 11 JUNE : BRIEF E

TRAVELLERS' ALLOWANCES

Relevant document: 5757/85 Rev 2 with amendment.

UK OBJECTIVE

1. Adoption of the package, although we would prefer inclusion of a commitment to review the derogations involved after 2 years - we can support this point if raised by others but will not wish to instigate it.

POINTS TO MAKE

2. These proposals have been under discussion for far too long, and must be adopted urgently. Heads of Government have endorsed the importance of these increases in the context of "a People's Europe" - we must now demonstrate that we mean what we say.

3. [If subject is raised] The derogations to be granted to Denmark, Greece and Ireland should be reviewed after two years - we cannot afford to have an indefinite two-tier system of allowances, and the member states concerned should be prepared to demonstrate their commitment to the ideas of "a People's Europe".

BACKGROUND

4. The main proposals are:-

a. increase in the value element of the travellers' allowance (intra-Community tax-paid goods) from 280 ECU (£163) to 350 ECU (about £200) - with derogations for Denmark, Ireland and Greece.

b. Increase in the still wine allowance (intra-Community tax-paid) from 4 to 5 litres - with derogation for Denmark.

c. Increase in the tax exemption for small consignments sent between private citizens in the Community - value limit goes from 70 ECU (£40) to 100 ECU (about £60) - with derogation for Ireland.

d. Two-yearly adjustment of the value of allowances to maintain their real value.

e. Duty free admission of fuel in bus tanks up to a maximum of 600 litres.

f. Increases in the optional value limit for travellers aged under 15 and in the tea and coffee allowances, none of which is applied in the UK.

5. This is the 5th Council (including Internal Market and Foreign Affairs Councils) at which a similar package has been considered. Adjustments have been made along the way, but it is still uncertain whether agreement will be secured this time. The proposals in the package were originally culled from several draft directives stalled in the Council working group, and have been given political importance by the People's Europe Report to the European Council which included similar proposals.

6. The UK has already indicated that we are prepared to drop our one original objection - to an increase in the wine allowance - in order to secure agreement to the package. Our other main concern has been over fuel in vehicle tanks - we would like to see duty free admission of all fuel in the standard tanks of both buses and lorries. The current proposal is likely to be the best that can be achieved at the moment. It provides for duty free admission of up to 600 litres of bus tanks (amendment originated by Germany and in line with the People's Europe report) and further work on the problem of lorries.

7. The UK's other point of concern is the derogations to be allowed to Ireland, Greece and Denmark on travellers' allowances and to Ireland on small consignments. We feel strongly that there should be a time limit of one to two years on such derogations, but it may not be in our best interests in other fields to make this point too forcefully. It is likely to be made by the Commission and others and we can then support.

8. Other points of difficulty may be the proposal for two-yearly reviews of the allowances to be settled by qualified majority voting - acceptable to us but not to Germany, Denmark and Greece; and German and French objections to derogations.

9. As far as we are aware the text is likely to be 5757/85 Rev 2 with the following amendments:

a. revised minutes statement on double taxation (French text attached),

b. re-inserted minutes statement inviting the Commission to conduct a study of the possibility of making a distinction between genuine travel and artificial shopping trips,

c. insertion of a 600 litres limit for fuel in bus tanks.

EUROPEAN COMMUNITIES
THE COUNCIL

Brussels, 23 May 1985 (28.05)
(OR.f)

5757/2/85		
REV 2		
		RESTREINT

FISC 33
TRANS 37

NOTE

from: PRESIDENCY

to : PERMANENT REPRESENTATIVES COMMITTEE

No. prev. doc. 5757/1/85 FISC 33 TRANS 37

Subject: Tax exemptions for travellers, small consignments and fuel
- Amended compromise proposal

Delegations will find annexed hereto a new version of the Presidency's compromise proposal on tax exemptions, amended further to the Permanent Representatives Committee meeting on 30 April 1985.

.../...

Presidency's compromise solution

I. Tax exemptions for travellers coming from another Member State (6th Directive)

1. Exemption in value for travellers aged 15 and over

350 ECU from 1 July 1985 but

- GR : exemption per item : 280 ECU
- DK : exemption per item : 280 ECU
- IRL: exemption per item : 77 ECU
- clause similar to that of Article 2(2) of Directive 84/231/EEC to allow remission of tax in the countries of export.

2. Exemption in value for travellers under the age of 15

90 ECU from 1 July 1985 but

- IRL: exemption per item : 77 ECU

3. Quantitative exemptions (as from 1 July 1985)

(a) - Still wine	:	5 litres, but
= DK	:	4 litres
- Tea		200 gr
tea extracts and essences	:	80 gr
- Coffee		1 000 gr
coffee extracts and essences	:	400 gr

.../...

(b) Extension until 31 December 1987 of the authorization given to Denmark to limit the exemptions for certain tobacco products, distilled beverages and spirits imported by travellers resident in Denmark when the journey abroad lasts for less than 48 hours.

4. Procedure proposed for fixing the exemptions expressed in national currencies

(a) Periodic review of the amounts of exemptions: insert the following Article in Directive 69/169/EEC:

> "Every two years, and for the first time not later than 31 October 1987, the Council, acting by a qualified majority on a proposal from the Commission, shall adjust the amounts of the exemptions referred to in Article 2 and Article * [1] in order to maintain their real value."

(b) A derogation for Member States whose national exemptions would have to be reduced at the time of the annual adjustment: simply add the words "or in a reduction of that exemption" to Article 7(4).

II. Tax exemptions for small consignments within the Community (4th Directive)

1. Increase in the exemption

to 100 ECU from 1 July 1985 but

- IRL: exemption per item: 77 ECU

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[1] Article relating to the derogations for Denmark, Greece and Ireland referred to in points 1 and 2 above.

.../...

2. Periodic review of the amounts of exemptions

Insert the following Article in Directive 74/651/EEC:

> "Every two years, and for the first time not later than 31 October 1987, the Council, acting by a qualified majority on a proposal from the Commission, shall adjust the amounts of the exemptions referred to in Article 1 and in Article * ([1]) in order to maintain their real value."

3. Newspapers, periodicals, brochures and books sent by a person who is liable for tax shall not be included in the "small consignments" arrangements.

III. Tax exemptions for fuel in the fuel tanks of commercial motor vehicles

1. Increase in the excise and VAT exemption from 1 July 1985 for buses: normal fuel tank.

2. The Council will decide before 1 July 1986, on the basis of a proposal from the Commission, on the increase in the excise and VAT exemption for fuel contained in the fuel tanks of lorries.

([1]) Article relating to the derogation for Ireland referred to in point 1 above.

Annex to the ANNEX

Statements for entry in the Council minutes
when the Directive is adopted

- "Tax exemptions for travellers coming from another Member State"

1. The Council agrees that the Member States have the right to maintain the exemption which they granted on 1 January 1983 to merchant seamen engaged in international travel within the limit of the amount laid down in Article 2(1) of Directive 69/169/EEC as applied at 1 January 1983.

The Council undertakes to adopt at the earliest opportunity, on a proposal from the Commission, amendments to Directive 181/83 and Regulation No 918/83 incorporating the abovementioned right.

2. The Council calls upon the Commission to submit to it as soon as possible a proposal for the amendment of Directive 69/169/EEC in order to eliminate double taxation in the Community where the value of an article or articles imported by a traveller is greater than the exemption, expressed in national currency, applied by the Member State of importation and less than the exemption, expressed in national currency, applied by the Member State of exportation.

- "Tax exemptions for small consignments within the Community"

The Council and the Commission note that the proposal includes the grant of exemptions for periodicals and books sent by persons liable to tax and the Council undertakes to discuss this matter before the end of the year.

LE CONSEIL

Réf. : 5757/2/85
REV 2

RESTREINT
FISC 33
TRANS 37

23 mai 1985

Objet : Franchises fiscales pour voyageurs, petits envois et carburant

Remplacer, dans l'Annexe à l'ANNEXE, la déclaration 2. par le texte suivant :

"2. Le Conseil invite la Commission à lui présenter, dans les meilleurs délais, une proposition de modification de la directive 69/169/CEE visant à éliminer les doubles impositions qui sont susceptibles de se produire, sur la base des dispositions actuelles, en trafic intracommunautaire."

ECOFIN: 11 JUNE 1985 : BRIEF F

Agenda item (F) Draft UCITS (unit trust) directive

Relevant document: Latest progress report - 7170/85

UK objectives

To obtain agreement on the package deal of key outstanding issues; and to ensure that work continues, urgently, on the remaining outstanding points, with the aim of adopting the directive within the next six months. The Chief Secretary will wish to intervene inview of the importance of this measure.

Line to take:

1. UK supports this proposal. Adoption will be significant step forward in liberalising services in the Community.

2. Directive should strike right balance between investor protection and greatest possible freedoms for unit trusts. Concern that directive might become over-restrictive and over-detailed. Must be flexible to accommodate changing needs in interests of financial services sector and Europe's investors.

3. Proposed package contains some restrictive elements we would prefer to do without. However can accept in spirit of compromise. This is without prejudice to UK proposal - on unit trust portfolio management funds - still to be discussed.

4. Important that directive adopted soon. Suggest report back to ECOFIN in October 1985.

Defensive briefing

Article 1 (scope)

1. Q. Is scope of directive too wide/narrow/imprecise?

A. Exclusions in Article 1 remove UCITS for which detailed requirements of directive are inappropriate.

Article 19 (depositaries)

2. Q. Why should directive allow certain UCITS to operate without safeguard of a depositary?

A. We would prefer depositary requirement to apply to all UCITS; but, as a compromise, can accept the derogations [especially as Dutch see them as important].

3. Q. Are investors of depositary-less UCITS at risk?

A No - directive requires there to be adequate alternative safeguards.

Article 26 (investment in Government securities)

4. Q. Why should UCITS be allowed to invest 100% in a single Government's securities?

A. Why not? UK gilts funds are common and offer opportunity to invest in a variety of HMG stocks. This is desirable.

5. Q. But such a fund involves no risk-spreading (and falls outside directive's scope).

A. Accept no spreading of solvency risk; but there is spreading of (small) investment risk. [There are variations in market movements of prices of government stocks.]

6. Q. Why should relaxation of basic rule apply also to non-Member States?

A. See no reason to restrict UCITS investment in (eg) US government stocks.

7. Q. What about investment in poor risk countries (eg Mexico, Brazil)?

A. Impossible in directive to distinguish between future good and bad risk countries. Must leave this to individual Member States. (In any case there are safeguards when UCITS invests more than 35% in a single Government's stock - prior approval by authorities; disclosure in prospectus; securities to be quoted on approved market.

Article 27 (investment in other UCITS)

8. Q. Why allow a UCITS to invest in another UCITS?

A. Enables UCITS to invest small sums economically in specialist funds [a general fund investing in a Japan fund]

9. Q. Is 5% limit too much/little?

A. Prefer 10% limit but can accept proposal in spirit of compromise.

10. Q. Should provision be made for linked investment companies (as Luxembourg propose)?

A. Acceptable, if others agree. Alternatively this could be left to individual Member States control.

Article 29 (limit on acquisition of voting shares)

11. Q. Should not directive specify agreed limits for acquisition of voting shares by (a) a single UCITS and (b) a group of unit trusts?

A. Preferably yes, but it is clear that agreement is impossible. Co-ordination of national limits is an acceptable compromise, pending further harmonisation.

12. Q. What is the present UK limit?

A. A unit trust can acquire no more than 10% of voting shares. In addition we could accept a limit of 25% or 30% applied to a group of unit trusts under the same manager.

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13. Q. <u>Could you accept the lower limit - 5% - which (eg) Germany proposes for investment in German companies?</u>

A. Yes, with reluctance. In imposing stricter limits we hope Member States concerned [Germany, Italy and? Greece] will apply limits as liberal as possible; and not too out of line with limits fixed in other Member States.

<u>Article 41 - (borrowing)</u>

14. Q. <u>Is the proposed limit or borrowing too little/much?</u>

A. We can accept the proposal in the spirit of compromise. Presently we do not allow unit trusts to borrow at all (other than back-to-back loans for foreign currency purposes).

Background

1. ECOFIN will be asked to approve a package deal of six key outstanding issues. Discussion will centre on Articles 26 and 29 where Germany and the Netherlands respectively have reservations. A (minor) proposal by Luxemburg on Article 27 may also be raised. An agreement by ECOFIN will be subject to three general positions:

(a) a general reservation on the directive by Greece (which is to be further discussed by officials in Brussels on 12 June 1985);

(b) Agreement of outstanding points on 20 other articles of the directive;

(c) the simultaneous adoption of a directive liberalising capital movements in respect of units in directive-complying UCITS (this is being negotiated).

2. The package deal is the outcome of a year's sustained negotiation. Its acceptance would clear the way for discussions on the remaining - mainly technical - points. Many of the outstanding issues will fall or be easily resolved with the prospect of adoption of the directive by the end of the year.

The directive

3. The directive will harmonise the laws applying to undertakings for Colective Investment in Transferrable Securities (UCITS) - ie unit trusts in the UK and Eire and their continental equivalents. Authorisation in one Member State will allow the UCITS to market its units throughout the community, without any further authorisation, and subject only to compliance with local (national) marketing rules.

4. This goes further than directives in similar fields (eg banking) fields, as it would give UCITS freedom of establishment as well as freedom to provide services. National controls will be reduced with greater reliance on the effectiveness of other Member States' controls over their own UCITS. This is a welcome step towards a common internal market in financial services but has made for difficulties in agreeing the directive's minimum standards. However different fiscal regimes and the maintenance of exchange controls by some Member States will lessen the impact of the directive.

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5. The UK, with a strong, innovative and diverse unit trust industry, stands to gain from the dismantling of these barriers to trade. Accordingly we are keen supporters. The directive would further our wider interest in seeing greater harmonisation of the Community markets in services, especially financial services.

6. We have argued for a directive which is as liberal as possible, consistent with the need to give adequate protection to investors, and which catches only those UCITS for which the directive's provisions are appropriate (ie the UK's authorised unit trusts investing mainly in quoted securities). We have the support of the Netherlands as well as Luxemburg and Denmark (although the Dutch tend to take a very liberal line, reflecting the limited - and some might say inadequate - degree of financial regulation in Holland). Germany and Italy are prominent in arguing for more detailed regulation whilst most other States (including France) lie somewhere in between.

7. UK unit trusts are authorised by the Department of Trade and Industry, under the Prevention of Fraud (Investments) Act 1958. The January 1985 White Paper "Financial Services in the United Kingdom" proposes fresh legislation, planned for 1985/86 which will, inter alia, reform the present controls over unit trusts taking into account the directive's requirements. To fit in with our legislative timetable the directive would need to be adopted by the end of the year.

The package

Article 1

8. The coverage of the directive is now satisfactory and is agreed subject to the general reservations of Greece (and the Netherlands).

Article 19

9. The Dutch have been successful in obtaining a limited waiver of the requirement that every UCITS should have a depositary (trustee) who is the person responsible for safeguarding the assets and protecting unitholders interests. The derogation from this requirement benefits a UCITS taking the form of an open-ended company and listed on a stock exchange where all, or nearly all, transactions in the units take place via the stock exchange. We are content with this but would have preferred not to have it.

Article 26

10. Germany has been alone in arguing against the provision which allows a UCITS to invest 100% in securities issued by a single Government (eg a UK gilts fund). They consider there is no risk spreading and have also previously argued against allowing unrestricted investment in the securities issued by non-Member States. We contend that the safeguards in the directive, including special safeguards introduced to reflect Germany's concern, are adequate to protect investors interests.

11. Germany takes this stance because it has no equivalent of gilts funds; but UK experience is that they work well and meet investor's needs. We see no reason why they should not be sold on a Community-wide, rather than national, basis.

Article 27

12. This is now agreed subject to a minor and late proposal by Luxemburg which would have the effect of banning double charging when a corporate UCITS invests part of its funds in another corporate UCITS with which it is linked. We have no objection, although others might because the term "link" is left undefined. To avoid a complicated discussion Luxemburg might be prepared to withdraw; but if others agree we could support them.

Article 29

13. The Dutch have picked, as an example of unnecessary restrictions, this article which limits the acquisition of voting shares to prevent a UCITS acquiring "significant influence". Such an acquisition would not be in accord with the investment purpose of the UCITS. (The limit also prevents the acquisition of large, difficult to realise, holdings).

14. The difference between the UK and Dutch view of "significant influence" (25-30%) and the German and Italian view (5%) is unbridgeable. The solution is to allow (eg) Germany to insist that its limit applies to all UCITS but only in relation to purchases of shares in German companies. We can accept this because (1) it gives rise to no immediate practical difficulties; (2) we suspect Germany and Italy will find it increasingly difficult to maintain a stricter limit; and (3) there is no other solution. We think the Dutch will accept with reluctance.

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Article 41

15. This is agreed.

Financial Services Division
Department of Trade and Industry

6 June 1985

UCITS (unit trust) directive

Speaking note for Financial Secretary's meeting with State Secretary Tietmeyer

- Pleased to see the progress being made on this directive since Mr Fletcher's meeting in February 1985;

- stress the importance UK attaches to early adoption of directive [which Dr Tietmayer also sees as important as a tangible sign of progress in opening up the internal market in services];

- express concern that directive should not be over-detailed or over-restrictive [must allow for flexibility to meet changing needs otherwise Community services industry - and Europe's investors - will lose out];

- in particular worried about the German position on Article 26 in respect of limits on investment in Government securities;

[Germany seems to take view that a unit trust investing 100% in stock of a single Government involves no risk spreading and is thus either:

(a) too risky and should not be allowed to be promoted to investors; or

(b) should not be regulated by the directive because of the absence of risk spreading and;

(c) such a UCITS marketed in another Member State would amount to the offering of securities of the first Member State in the second Member State contrary to Article 68(3) of the Treaty (capital movements).]

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- clearly (a) is wrong - UK gilts funds are attractive to investors and enable them to buy into a variety of HMG stocks:

- on (b) such funds do spread a (small) investment risk and see no reason to exclude them from directive.

- Commission says (c) is incorrect and, in any case, it is odd for Germany to argue that line in view of its interest in seeing greater liberalisation of capital movements;

- Furthermore the capital movements directive already allows purchase of UK gilts by Germany; what is difference when the gilts are bought via regulated and supervised UCITS.