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PART 3

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CONFIDENTIAL FILING

European Monetary System (EMS)

EUROPEAN POLICY

PT 1: June 1979

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PRIME MINISTER

DELORS COMMITTEE

The Governor has prepared the attached draft paper to circulate at the Delors Committee next Friday. You ought to have a look at it before then.

It takes little account of what we said

It is frankly not very good. It does, at the beginning, make the point about the massive transfer of powers away from national governments which would be involved in full EMU and returns to the subject briefly at the end. It is also cast in the conditional tense. But otherwise it simply draws up a detailed plan of action for implementing full EMU in three stages. It does also contain some pretty odd statements for a Governor of the Bank of England, eg. "before the end of stage one, all member states to participate in the ERM".

In short, it is hardly an adequate reflection of the views expressed at your meeting on 15 February. You are seeing the Chancellor tomorrow and may like to discuss with him what should be said to the Governor.

CD?

C. D. POWELL

28 February 1989

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**PERSONAL**
**AND CONFIDENTIAL**

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

**28 February 1989**

**Charles Powell Esq**
**10 Downing Street**
**LONDON**
**SW1**

Dear Charles

**DELORS COMMITTEE**

... The Bank have prepared the attached draft paper for the Governor to circulate to the Delors Committee, following the Prime Minister's meeting on 15 February. The Governor wishes to circulate this to the Committee by Friday. In view of this tight deadline, I am sending you a copy at the same time as it is shown to the Chancellor and Treasury officials for comments.

Yours
Alex

**A C S ALLAN**
Principal Private Secretary

## III Concrete steps towards economic and monetary union

### 1 Principles governing a step by step approach

As is apparent from the previous two chapters of the Committee's report, there is a very considerable gap between what has so far been achieved, in terms of the substantial progress made in monetary policy co-ordination and promoting exchange rate stability, and what needs to be done if the ultimate objective of EMU is to be attained. In particular, as discussed in Chapter II, EMU will only be possible when a number of important and difficult prerequisites have been met: the underlying economic conditions need to be conducive to the sustainability of the union, there has to be the political will to see the necessary transfer of power from member states to the Community, and mechanisms need to be in place to enable appropriate economic policies to be formulated and implemented both efficiently and effectively.

As far as ensuring that the underlying economic conditions are right, the key requirement is that markets for goods, services capital and labour throughout the Community are sufficiently integrated and flexible to make it feasible to abandon the exchange rate as an adjustment mechanism. Completion of the internal market legislative programme is a priority here, but even after 1992 time would be needed to allow markets to adjust to the new legal framework and to enable the potential of that programme to be realised. Consideration would also need to be given to the question of whether EMU would be politically acceptable to certain member states whilst significant differences in national income levels remained and, if it would not be acceptable, how those differences might best be reduced.

On the political front, EMU would involve a major shift in economic decision-making power from member states to the Community as a whole. Key areas of macroeconomic policy would have to be determined collectively or at least be subject to constraints that

? Central Bank Governors

were determined collectively. This would necessitate a willingness to engage in binding ex-ante co-ordination and, eventually, the transfer of appropriate powers to relevant Community institutions. This would involve its own difficult problems such as, for example, determining the appropriate balance of power between central banks and governments at the Community level.

Finally, the policies that the Community would need to set would include not only monetary policy but also exchange rate policy towards non-Community currencies and significant constraints on member states' fiscal policies (in particular, limits on budget imbalances and on how budget deficits are financed). Such policies are aimed at key economic variables, such as price stability, growth, income distribution and unemployment, which are inevitably politically sensitive. This is true at the moment within member states, and the task of reconciling conflicting views amongst the Community as a whole would inevitably be even more challenging.

The Committee therefore believes that economic and monetary union would be too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Rather, the process would be a long one and a step by step approach would be necessary. Moreover, the failure of earlier attempts to achieve EMU suggests that it would be important always to build on success and to retain flexibility so that there was the possibility of correcting the course of action in the light of experience gained or in order to allow for the impact of developments external to the Community.

The Committee is of the view that, in addition to the general principle of subsidiarity explained earlier in this Report, a number of considerations have to be taken into account in designing a flexible step-by-step approach to EMU.

(a) Discrete but evolutionary stages

For the purposes of exposition the approach outlined below is based on three apparently discrete stages. To some extent these stages are inherently discrete: this is so, for example, inasmuch

as institutional change is involved or major policy decisions (such as the move to fixed exchange rates) are required. But overall the approach should be an evolutionary one, with changes taking place within each stage is well as between them. Moreover, flexibility is needed in determining the content of each stage. Because achieving EMU will be a long process, conditions will change inside and outside the Community, as will beliefs in the appropriateness of particular policies. There must be room for modification in the light of experience rather than pursuing a prescribed and detailed course of action.

(b) Parallelism

Parallelism - in the sense of moving at an equal pace towards EMU in the many areas where action is needed - is important in order to avoid imbalances which could cause economic strains and the loss of political support for the process. Perfect parallelism at all times is impossible. But bearing in mind the need to achieve a substantial degree of economic union if monetary union is to be successful, and given the degree of monetary co-ordination already achieved, it is clear that material progress on the economic front is a necessary condition for further progress on the monetary front. Otherwise too great a strain would be put on monetary policy.

(c) Calendar

In the same way that flexibility is needed in determining the content of each stage, the Committee considers that the timing of the moves from stage to stage cannot be set in advance but will have to be judged in the light of circumstances. This is an essential part of the evolutionary and flexible approach. However, it would be appropriate to give a clear indication of the timing of the start of the first stage, and the Committee suggests that this could be July 1990 when the directive for the full liberalisation of capital movements comes into force.

(d) Indivisibility and gradualism

The Committee believes that any new institutions would have to be carefully designed. On the one hand it can be argued that institutional change is necessary from the outset as a bold

step to demonstrate political commitment to early and real progress. On the other hand it can be argued that much needs to be done before new institutions could perform useful tasks and that the credibility of new institutions could be destroyed if they were established before member states were willing to transfer power to them. The Committee considered that to avoid the risk of policy conflict and market uncertainty it would in any event be important to ensure that responsibility for particular areas of policy was at all times well defined. It would need to be clear, for example, whether ultimate responsibility lay at the Community or at the national level and, in each case, with which institutions.

(e) Participation

The Committee considered the possibility that some member states might take institutional steps before others were prepared to do so. It formed the unanimous opinion that any such discriminatory approach, which would in any event have to be outside the framework of the Treaty of Rome, would be divisive and would put at risk the existing fabric of the European Communities.

(f) Role of the ECU in the evolutionary approach

In considering how EMU would best be achieved, the Committee looked at the possible attractions of developing a parallel currency, the ECU, in such a way that it would gradually displace existing national currencies and eventually take over as a single currency for the Community. However, although this was a superficially attractive approach, the Committee decided that the arguments in its favour were not convincing. Besides being too difficult to achieve without unacceptable costs, the Committee felt that it would not contribute to solving in an orderly manner the problem of co-ordinating national monetary policies; on the contrary it would add a thirteenth currency to an already difficult co-ordination exercise and there was a risk that it might undermine monetary policies oriented towards price stability. The development of a parallel currency would also not avoid the need for institutional change or the difficult questions that such change would pose.

Nevertheless, the Committee recognised that at the start of the final stage of EMU some form of parallel currency arrangement would be needed to make the transition from irrevocably fixed exchange rates to a single currency feasible. Moreover, in view of their belief, expressed in Chapter II of this Report, that the ECU should in due course become the Community's single currency, the Committee felt that in the meantime it would be sensible to continue to promote the use of the ECU whilst recognising that for several years to come any increase in its use was likely to be gradual and should, in any case, be dictated largely by market demand.

## 2 A three stage process

The Committee, having examined a number of possible approaches, considered that, as a broad indication, the likely concrete steps in any move towards EMU might be along the following lines.

### Stage 1 [making a success of the single market]

- completion of the internal market, including full liberalisation of capital movements;

- closer policy coordination, including increasing willingness to consult ex-ante;

- further enhancement, as necessary, of the effective working of the ERM; all Member States to bring their currencies within the narrow margins of the ERM;

- development of existing institutions to promote the greater degree of monetary and economic policy co-ordination.

### Stage 2 [soft union]

- joint formulation of monetary policy and more formal centralisation of coordination of fiscal policy; outcome of coordination process increasingly binding;

- greater exchange rate stability within the ERM (and, possibly, narrower ERM margins) but central rates still adjustable if necessary; joint fomulation and co-ordinated execution of exchange rate policy in relation to third countries;

- new institution(s) established in embryo and given limited functions;

Stage 3 [hard union]

- fixed exchange rates, moving as soon as practicable to a single currency;

- single monetary policy; single exchange rate policy (in relation to third countries' currencies);

- acceptance of agreed constraints to fiscal policy as being binding;

- new institutions fully in place.

The Committee believes that a three stage process would be sensible for the following reasons. The first priority would be to complete the internal market and demonstrate that, using the considerable powers that already exist, closer policy co-ordination and economic convergence and integration would be feasible. This would be the key task of Stage 1 which would be the most important stage - getting the fundamental economic conditions right and establishing in practice that the necessary political will existed. Once this had been achieved, attention could be focussed on limiting exchange rate movements and institutionalising the joint-decision making process (stage 2). A move to full EMU (stage 3) would only take place when experience with this softer form of union had been found to be satisfactory.

However, the Committee wishes to emphasise that the division into three stages, according to particular institutional requirements, is primarily expositional. As indicated above, the process will largely be evolutionary and the detailed form that each stage

should take could only be determined in the light of experience with the preceding stage. Because of this, the more detailed outline below of the three stages focusses on stage 1, and the discussion of stages 2 and 3 concentrates on the issues that would need to be decided when it was felt that the transition to these stages was feasible.

3 Stage 1

During this stage the emphasis would be on achieving the necessary political and economic conditions and on greater ex-ante coordination of policy.

In the economic field:

(a) complete removal of internal barriers and the liberalisation of movement of goods, services, labour and capital within the Community, according to the internal market programme; strengthening of Community competition policy;

(b) the full and effective implementation of the "Brussels package" for reforming and doubling the structural funds by 1993, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;

(c) the replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of economic and fiscal policy co-ordination. An important aim of the new procedure would be to encourage the reduction of fiscal imbalances and to improve the assessment of the economic policies of the member states. The assessment would form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. In particular, the new procedure would provide for the regular discussion in ECOFIN, on the basis of preparatory work by the Monetary Committee and Committee of Governors, and with the attendance when appropriate of Central Bank Governors, of:

- the co-ordination of fiscal and monetary policies;

- policy co-ordination on fiscal imbalances, with quantitative medium-term guidelines; and a programme for the reduction, where necessary, of budget deficits to specified levels;

- guidelines for the financing of national budget deficits, to reduce and eventually eliminate monetary financing;

- multilateral surveillance of economic performance and policies, based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger recommendations regarding the future course of national policies.

2 In the monetary field:

(a) the liberalisation of all capital movements in the Community, as provided for in the June 1988 directive;

(b) policy co-ordination: the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new decision giving the Committee greater authority and visibility and a permanent Secretariat with a research facility. The thrust of the revision to the 1964 Council Decision would be to encourage a strengthening of the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee would:

- formulate recommendations on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would consider national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;

- make policy recommendations to individual governments and to the Council of Ministers on non-monetary policies that could affect the internal and external monetary situation of the Community, especially the functioning of the EMS;

- submit an annual report on its activities and the monetary situation of the Community to the European Parliament;

- set up a sub-committee to start regular consultations concerning matters of common interest in the field of banking supervision.

The responsibilities and procedures of the Monetary Committee would be enhanced in parallel with the Committee of Central Bank Governors.

(c) EMS arrangements. The Committees would consider what further specific steps might be appropriate to strengthen exchange rate management within the Community. These might include:

- a general move, undertaken at appropriate moments, towards increased holdings of EC currencies in member states' reserves, and their use, where appropriate, in intervention.

- Countries that do not participate in the ERM might be permitted to participate, if they wished, in the very Short-Term Financing facility (VSTF). They would agree to lend under the facility in return for the ability to draw on it.

- Market rate on government short-term ecu paper to be used as the rate of remuneration on official claims arising in the ERM.

- Before the end of stage 1, all member states to participate in the ERM.

(d) ECU arrangements: removal of regulatory impediments that may prevent the use of the ECU in setting prices, keeping accounts, and contracting and settling any kind of financial obligations. Greater use of the private ECU as a currency to be held in national reserves and for use in intervention (including acceptance of the private ECU in settlement of obligations arising from VSTF transactions in the EMS). Increased borrowing by member states in the form of debt obligations denominated and payable in ECU. The ECU would remain a basket currency.

## 4 Stage 2

The need for a flexible approach suggests that the detail of Stage 2 should not be settled until conditions were right for the transition from Stage 1 to Stage 2. However, it is possible to illustrate a range of options.

A key feature of this stage would be that the outcome of the ex-ante co-ordination process described in Stage 1 would become increasingly binding on member states. An important policy objective would be to achieve increased exchange rate stability in the narrow band of the ERM. Some degree of institutional change would probably be desirable in order to assist the co-ordiantion and implementation of policies.

In the economic field the progressively tighter co-ordination of policy formulation and its implementation could be in achieved various ways. Decisions would continue to be taken by finance ministers but it would appropriate to reconsider the form in which they should meet and the supporting facilities they might need. One possible approach might be simply to continue with the arrangements established in Stage 1. However as the need for closer co-ordination grew and the outcome of the process became increasingly binding, this might prove unmanageable. It might therefore be desirable to establish some form of permanent secretariat to provide ECOFIN with analysis and advice; this secretariat could be staffed by officials from national finance ministries. There might also be scope for easing the burden on ECOFIN by establishing a committee of junior ministers able to

prepare the groundwork. In this case it might be appropriate to rationalise the existing roles of Coreper, the Monetary Committee and the Economic Policy Committee with respect to ECOFIN.

A possible extension of this approach would be to institutionalise these arrangements by setting up a new body, perhaps a Centre for Economic Policy Co-ordination (CEPC), which would take over from ECOFIN responsibility for co-ordination of certain key aspects of macroeconomic and budgetary policy making. Finance ministers would still take the decisions in the CEPC but, by formally separating these elements of policy from other Community policy, the greatly increased importance of co-ordination in this sphere would be recognised and it would be easier to design special arrangements to ensure that this decision-making process worked smoothly.

In terms of policies, it is likely that during Stage 2 there would need to be:

- the introduction of progressively more precise rules relating to the size of budget deficits and their financing;

- the adoption of medium-term guidelines for key financial targets and economic programmes in the member states;

- the joint adoption of budgetary objectives when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- the formulation of a common view on the exchange rates of Community currencies vis-a-vis major third currencies.

A decision would also need to be taken on the extent to which co-ordination was necessary in other areas of fiscal policy.

In the monetary field a key objective of Stage 2 in terms of co-ordinated monetary and exchange rate policies would be greater exchange rate stability within the ERM, perhaps leading to a narrowing of the fluctuation margins of the mechanism; however,

central rates would still be adjustable if necessary. There would also be joint formulation and co-ordinated execution of exchange rate policy in relation to third countries.

The Committee felt it would be desirable in Stage 2 to set up, at least in embryo, the institution (the European System of Central Banks) which would be required in Stage 3 to help to determine and implement the common monetary and exchange rate policy.

[As discussed in Chapter II of this Report], there would be broadly two options. Firstly, decisions could be taken by the central monetary board of the ESCB but execution of policy left to national cental banks - the so-called federal approach. Alternatively, the central board as well as determining policy could be responsible for implementing certain elements where this would not result in a loss of efficiency - the so-called centralist approach; one such element might be the implementation of exchange rate policy vis-a-vis non-Community currencies. The first of these options would be more in keeping with the principle of subsidiarity but the decision taken at this stage would need to take into account the final form envisaged for Stage 3.

As well as the degree to which implementation of policy was left to national central banks, a key decision would have to be taken during Stage 2 on the appropriate balance of responsibilities and competencies between the ECSB and the CEPC in respect of monetary and exchange rate policy.

5 Stage 3

Stage 3 would be the end of the process of achieving EMU and therefore its essential elements have already been discussed in Chapter II of this Report. The crucial difference between Stages 2 and 3 would be that exchange rates would be irrevocably fixed from the start of Stage 3. By the beginning of this stage the outcome of the co-ordination processes would also need to be fully binding in the relevant areas. It would have to be decided, in the light of experience with the previous two stages, whether further institutional changes might be needed to reflect

both the transfer of power from national to Community level that would have taken place by Stage 3 and also the irreversibility of the final step.

In the economic field the question would again arise of whether the existing arrangements needed formalising or strengthening in any way. The options would remain essentially as in Stage 2.

In terms of policy, a decision would have to be taken whether to continue the development assistance, if any, provided during earlier stages to make the transition to EMU more manageable and acceptable to some member states. It would also have to be decided whether, exchange rates having been fixed, some sort of transfer mechanism would be needed to provide temporary adjustment assistance to regions adversely affected by exogenous shocks or whether market prices were sufficiently flexible to make such temporary relief unnecessary.

In the monetary field, the ECSB would assume responsibility for any aspects of monetary and exchange rate policy it had not already acquired. As in Stage 2, however, the ECSB could be developed either in federal form (with implementation of policy devolved upon national central banks as appropriate) or in a centralised form (with policy implemented by the decision making body, independently capitalised).

The key development during the course of Stage 3 would be the transition from fixed exchange rates to a single currency as soon as this became practicable. The primary consideration here would be the need to convince the markets that monetary union was irreversible, although another important consideration would be the potential gains in efficiency offered by the existence of a single currency unit rather than twelve.

## 6 Further considerations

The Committee believes that there are three further essential elements which need to be born in mind when considering progress towards EMU. These are outside the competence of members of the present Committee, but, because of their importance, they are outlined briefly below.

(i) National parliamentary approval. The proposed transfer of powers in Stage 2 could not take place in most [all?] member states without domestic legislation or even constitutional amendment.

(ii) Treaty change. Institutional change of the kind required to achieve EMU would at some point necessarily entail amendments to Treaty of Rome. However, this would not be needed until Stage 2, and the principle of flexibility would suggest that the form of the institutions, and hence the sort of Treaty change necessary, should not be determined until the point in Stage 1 when it was felt that the transition to Stage 2 was feasible. At that point there would be two options: either comprehensive treaty revision dealing with the changes necessary for both Stages 2 and 3 and with the procedures for passing from one stage to the next, or revision dealing only with changes necessary for Stage 2 with further revision left until it was required.

(iii) Accountability. Because of the far-reaching transfer of power from member states to the Community as a whole implicit in EMU, very careful consideration would need to be given to the manner in which the institutions to be created were made suitably accountable.

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cc AP

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

17 February 1989

The Prime Minister was grateful for your letter of 13 February and has noted your views about our joining the ERM. She would like to have a talk, not just about that but covering other subjects as well. Her preference would be to hold it a bit later in the spring or early summer, perhaps in May or June. Would you like to ask your office to ring Amanda Ponsonby here to try to fix a time in either month when you are anyway going to be in the United Kingdom.

C. D. POWELL

The Right Honourable Sir Leon Brittan, Q.C.

mem

fle (84) ECL

bc PU.

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

17 February 1989

**DELORS COMMITTEE: ECONOMIC AND MONETARY UNION**

Thank you for your letter of 17 February. I agree that the priority is to circulate a redraft of Part III and the EMU Group should first advise the Governor on that. The sense of the Prime Minister's meeting was that an alternative draft of Part II should be circulated as soon as possible. Whether at or after the 14 March meeting would depend upon the availability of the draft and on the Governor's judgement.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Alex Allan (H.M. Treasury) and Roger Lavelle (Cabinet Office).

(CHARLES POWELL)

John Footman, Esq.,
Bank of England.

cqpl

BANK OF ENGLAND
LONDON EC2R 8AH

17 February 1989

Charles Powell Esq
Private Secretary to
The Prime Minister
10 Downing Street
London
SW1

Dear Charles

**DELORS COMMITTEE: ECONOMIC AND MONETARY UNION**

Thank you for sending me a copy of your letter of Alex Allan of 15 February.

The Governor has asked me to clarify the sequence of drafting described in your penultimate paragraph. As yet, the Governor has not circulated any redraft of Part III to the Committee, although some of the raw material for such a redraft is contained in the second of the two papers submitted for the Prime Minister's meeting on Wednesday. The next meeting of the Committee, on 14 March, will be considering Part III, not Part II, so that the first priority for the EMU Group must be to advise the Governor on a detailed redraft of Part III. Part II will not be taken again until April, so the ideal time for the Governor to put in a redraft of that part would be shortly after the March meeting. As you say, the two redrafts could then form the basis for a minority report if necessary, though the Governor does not intend to prepare them in terms that effectively rule out any chance of their being adopted by the Committee.

I am sending copies of this letter to Alex Allan (HMT), Stephen Wall (FCO) and Roger Lavelle (Cabinet Office).

Yours sincerely

John Footman

J R E Footman
Private Secretary
to the Governor

SUBJECT
cc MASTER

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file

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

15 February 1989

Dear Alex,

**DELORS COMMITTEE: ECONOMIC AND MONETARY UNION**

The Prime Minister held a further meeting with the Chancellor, the Foreign Secretary and the Governor of the Bank of England this afternoon, to discuss progress in the Delors Committee.

The Governor gave an account of the Committee's most recent meeting. He had pressed for the draft report to be amended so that it did no more than describe the practical and technical consequences which would follow if Heads of Government decided to move forward towards Economic and Monetary Union. It would be quite clear that the decisions rested with Heads of Government and that the Committee's Report could not pre-empt them. There appeared to be quite wide support for this approach, although it remained to be seen how far it would be reflected in the further work of the rapporteurs. He had also circulated some suggestions for practical steps towards EMU which stopped short of requiring Treaty amendment. These would be discussed at the Committee's next meeting.

In discussion, it was agreed that the language of the existing drafts of Parts II and III of the Committee's Report was prejudicial. The result was to make it look as though the goals of a common currency and a Central Bank were already agreed and the Committee's task was simply to prescribe the steps necessary to reach them. This went far beyond the remit from the Hanover European Council. The draft also included references to Treaty amendment, which went beyond the Committee's competence. And it made dirigiste solutions, for instance the expansion of the Community's regional and social funds, appear to be the inevitable concomitant of progress towards EMU. We must work for a much more agnostic report, which set out starkly the far-reaching consequences for national sovereignty of the steps necessary to reach EMU.

There were various possible ways to achieve this. One could argue that the draft was so far from what we could accept that the Governor should circulate his own statement at

the next meeting, explaining in clear and positive terms the problems we saw with the Report. This was in essence the solution which the Chancellor had proposed in his minute. Against this, there were still several meetings of the Committee to be held and it would be inept for the Governor to disown the draft report at this stage without further efforts to amend it.

The conclusion reached was that the Governor should circulate an alternative version of Part II of the Committee's Report at the next meeting, drawing on the points in the Chancellor's minute. A text should be prepared, in appropriately stark language, by the EMU Working Group. Taken with the version of Part III of the Report which the Governor had already circulated, this would provide some leverage for securing amendments in the Delors Committee. In the event that the resulting text was still unsatisfactory, the Governor's versions could then be the basis for a dissenting minority commentary on the full Committee's Report.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), John Footman (Bank of England) and Roger Lavelle (Cabinet Office).

yours sincerely,

(C.D. POWELL)

Alex Allan, Esq.,
HM Treasury.

CC(91)1

PRIME MINISTER

DELORS GROUP

You are meeting the Governor, Chancellor and Foreign Secretary tomorrow to take stock of the position in the Delors Group. You saw some papers over the weekend; others are now available.

Issues

You will want to reach a view on two points:

i) how, in the light of today's meeting of the Delors Group, should the Governor handle subsequent meetings?

ii) what should be your tactics when you meet Poehl next weekend?

Possible Approaches

You saw over the weekend the Governor's paper (Flag A) in which he advocated the following approach:

- He would argue at today's meeting of the Delors Group against Part II of the Report (the description of the nature of the Economic and Monetary Union) and would offer to provide a revised draft outline of this part.

- For Part III (not under discussion today) he would submit a re-draft before the next meeting of the Delors Group. This would focus on the so-called Stage 1 of the EMU, and set out proposals for early practical steps on the lines listed in Annex 1 of his minute. As to the so-called Stages 2 and 3 of EMU his re-draft would contain only "a very much abbreviated description"; it would not describe the form, content or timing of any Treaty change.

The Chancellor has now sent in a minute (Flag B) disagreeing with this approach. He argues that Parts II and III of the present draft Report are so bad that it is impossible to

expect that the Group will agree to an acceptable re-draft. He therefore proposes that the Governor should in effect declare UDI from the rest of the Group and submit a free standing statement of his own views and conclusions. This would focus on positive steps that can be taken to enhance economic and monetary co-operation, and argue that a fundamental amendment to the Treaty goes beyond the competence of the Group.

Other papers in the folder (not required reading) are:

Flag C note by the Cabinet Office;

Flag D the draft of Part II under discussion in the Delors Group today;

Flag E the draft Part III which was discussed at the January meeting of the Group;

NB: The Governor is sensitive to the fact that he is on the Delors Group in a personal capacity; he would not want you to reveal to Poehl that you have seen drafts of the report.

Handling

You may like to start by asking the Governor to report on the outcome of today's Delors Group meeting. In the light of that, does he still feel that the strategy set out in his minute at Flag A is the right one?

You could then ask the Chancellor to speak to his minute.

You will want to consider carefully the respective merits of the Governor's and Chancellor's different approaches. Charles and I both feel that, unless the Governor has had unexpected success today, the Chancellor is being the more realistic, and that at some point the Governor will have to submit a statement of his own views - in effect a minority report. Certainly that should be the outcome if the only available alternative is signing up to an unsatisfactory consensus draft.

But the timing of submitting a separate statement needs to be considered carefully. Once this has been done, the Governor's leverage over the rest of the Group, such as it is, will disappear. So there is a case for waiting, until it is clear that there is no hope of forming an alliance with Poehl and others.

This point is reinforced by the fact that you are to see Poehl next week. The final decision on the Governor's tactics should wait until after that meeting.

That means the first priority is to settle the line you will take with Poehl. One possible approach would be:

- to remind Poehl of what he said in his earlier articles on the subject. You agreed almost completely and urge him to stick to those positions which he knows to be right;

- to argue that the Delors Report should be limited to the sort of structure set out on page 2 of the Chancellor's minute (Flag B);

- to explain to Poehl what we can live with in terms of the substance of a report and test his reactions;

- to feel out whether he might be prepared to join the Governor in a minority report.

We might then arrange a further meeting later next week to decide how the Governor should, in the light of the Poehl meeting, proceed. Meantime, you could ask the Governor to put in hand the re-drafts he suggests in his minute.

PAUL GRAY
14 FEBRUARY 1989

CONFIDENTIAL

CCB/89

Qz06294

MR GRAY

DELORS COMMITTEE: PRIME MINISTER'S MEETING ON 15 FEBRUARY

I attach a brief on the paper circulated by the Governor's Office on 10 February and the Chancellor's minute of yesterday.

2. The Governor is attending a meeting of the Delors Committee today and something will turn on his latest impressions of the climate of opinion there. The brief suggests that if counsels of moderation are being heard again, it may be too early to assume that the Governor needs to table a minority report - in effect the Chancellor's proposal. An alternative tactic might be to table a paper, on the lines of the Chancellor's proposal, plus a revised Part III to the Committee's report, as recommended by the Governor.

3., The Prime Minister may conclude that drafts of both papers should be prepared as soon as possible, for clearance if necessary in a resumed meeting.

R G LAVELLE

14 February 1989

DELORS COMMITTEE: MEETING ON 15 FEBRUARY

A. Purpose of Meeting.

To hear the Governor's report on the most recent meeting of the Delors Committee (on 14 February); to consider whether he should circulate a UK paper before the next meeting and if so to decide what it should say.

B. Background

i. Prime Minister's meeting on 14 December.

At the last Ministerial stocktaking the Governor was asked to seek to ensure that the Delors Committee's report was descriptive not prescriptive; that it spelled out the full implications of EMU in terms of loss of national sovereignty; that it made clear that EMU was not necessary for completion of the single market in 1992; and that there should be no recommendation for Treaty amendment. The meeting commissioned production of a possible UK paper setting out practical steps we could support which might be tabled in liaison with Poehl.

ii. Delors Report: general state of play.

The Bank of England paper of 10 February recalls that it has been envisaged since October that the report would have three parts, the first describing historic developments, the second being an account of the nature of economic and monetary union and the third suggesting "concrete stages" to that end. As discussed below the drafts of Parts II and III have subsequently been given a pronounced prescriptive and institutional content. Discussions have now reached a critical phase. There are now only two meetings of the Committee (in March and April) before the report is submitted to ECOFIN in May.

**iii. Part II of the report.**

The Governor will report at tomorrow's meeting on the discussion of the latest version of Part II of the report and the Committee's reception of his alternative draft outline. As his note of 10 February said, the current draft is unsatisfactory in a variety of ways. In particular it is prescriptive rather than descriptive, suggesting the need for Treaty change, new institutional arrangements and the adoption of the ecu as a common currency. It is preoccupied with an unreal elaboration of a post-1992 world. It notes at least some of the implications of EMU for sovereignty. Thus it accepts apparently without qualms, that setting a brisk pace for attainment of EMU will require replacing market forces, eg exchange rate adjustments, by increased central regulation and increased structural funds. But the Report signally fails to draw the conclusion that this prospect is such as to rule out its attainment for the foreseeable future: and it seeks to disguise some of the less palatable messages by references to gradualism or the "principles of subsidiarity". The motor for EMU appears to be the desire for a central monetary institution for which the logical counterpart has to be greater political union having extensive ramifications. The Bundesbank is bought off by a design for a future central bank having a similar autonomy. With no model similarly to hand, the institutional proposals for economic union are an undefined revamping of existing institutions.

**iv. Part III.**

The Governor's paper summarises the current draft of Part III with its three stages towards economic and monetary union. Stage 1 would begin with the completion in July 1990 of capital liberalisation and there is an expectation of its completion by 1992. As drafted stage 1 would encompass some further coordination of economic and monetary policies but little in the way of concrete steps. It is also envisaged that during that period a process of Treaty amendment would be set in hand. Although a variant including early

establishment of a Reserve Fund has apparently been dropped, Stage 1 of the report still includes a number of additional unacceptable elements eg provision for implementation of a tax on savings and language suggesting a fuller Community role in decisions on national tax rates and monetary policies than is acceptable. The process of Treaty amendment envisaged would provide for sufficient powers, introduced by stages, to lead the way to full EMU without further reference to Parliament. The final stages of attainment of EMU are sketched out in a relatively perfunctory fashion, many of the institutional proposals having been covered in Part II.

**C. The Governor's proposals.**

The Governor's proposals of 10 February for bringing the report into a more acceptable form comprise:

- a shorter Part II (following an outline he has apparently offered) simply descriptive of economic and monetary union

- a substantial redraft of Part III, concentrating on the practical steps listed in his 10 February paper but also taking in acceptable points from the existing draft. He envisages that at the end a reference would be made to need to consider towards the end of stage 1 any necessary Treaty changes to implement the institutional changes contemplated in stage 2.

**D. The Chancellor's Proposals.**

In his minute of 13 February the Chancellor says that on reflection he has concluded that Parts II and III of the draft report are so bad that it would not be practicable for the Governor to secure agreement to an acceptable redraft; and that he might to get on a slippery slope if he submitted a redraft of Part III which included any material on the so-called stages 2 and 3. The Chancellor therefore favours circulating a free

standing statement of his views which might be included in the report.

**E. Discussion.**

There seems little doubt that it would be very desirable for the Governor to put in a full statement of the United Kingdom's position given the apparently very damaging drift of discussion in the Delors Group over the last meeting or so. But it may be too early to decide precisely what the objective of the paper should be. The Chancellor's judgement that it may be best to go for a free standing paper, reflects the view that the rot has spread so far that it is necessary in effect to submit a minority report at this stage. It was very much this concern which informed the Chancellor's decision to make his recent speech at Chatham House. On the evidence so far it does indeed seem implausible that a consensus could be reached in the Committee of a kind acceptable to us. The Committee has proved something of a hothouse. Some of those present may have been politically naive, or prepared to contemplate with equanimity a transfer of power to central bankers or both. The report so far is a very long way away from the proposal for concrete stages in the Hanover Council. It suggests an approach which would be wholly unacceptable to the House of Commons.

In substance however there is very little between the Governor and Chancellor's approach. Each wants a cut down Part II and III. The essential judgement is a tactical one: whether it is preferable at this stage to table a minority report (albeit with the possibility of some adherents) or to adopt a presentation which might increase the number of adherents to a moderate approach. While it may be unreal to look for a satisfactory consensus report, it may also be too early to assume the need for a minority report. A split Committee would seem preferable to the latter. At earlier stages in the Committee's work a number of moderate voices were heard reflecting the common sense view that it was too early to contemplate institutional change and distracting to think about such things this side of 1992. What has been largely missing from the Committee's discussion so

far is any animadversion to recognisably concrete steps. Those in the Governor's paper might well be acceptable to many. If enclosed in a minority report they might tend to be discounted, now and later.

Much will depend on the latest impressions of the Committee's approach which the Governor brings to the meeting. However if he can report some signs of movement back to common sense, it may be worth considering whether the optimum tactic will be to seek to carry this process a stage further while preserving the possibility of a minority report.

The prospects for the Madrid European Council are relevant here. The May ECOFIN meeting may well bring a further douche of common sense. The expectation must be that Madrid will receive the Delors Report and ask ECOFIN to work up further proposals in the light of it - with a good deal of shadow boxing over the terms of reference of that further work. Talk of Treaty amendment is unlikely to be at crisis point; if only because the French will still be on the defensive over the tax on savings. Against this background, a split Delors Committee would get matters off to a healthier start.

**F. Content of UK Paper or Papers**

If the meeting concludes that a paper on the lines suggested by the Chancellor should be one possible UK contribution, it would be worth spending some time considering its content in a little more detail, following the outline on page 2 of his minute.

Taking the sections in order the short historical review of economic and monetary cooperation is tactical in intent. A moderately constructive presentation should not be unduly controversial. The Chancellor then suggests that to replace the existing Part II, there should be a stark presentation of the massive shift of sovereignty that would be implied by EMU. Although it is clearly essential that this message should emerge clearly from this Chapter, and indeed there is a good deal of material of this kind in it already, a presentation likely to win

other adherents may need to start with an apparently neutral and technical description of some of the characteristics of EMU. The Governor's outline, which we have not seen, may suggest this. He has already made the point in a letter to Delors that the content and timing of any Treaty change are outside the expertise of the Committee. It would clearly be right to say this again.

Turning to the positive steps which could be taken in the period immediately ahead to enhance cooperation, both the Chancellor and the Governor favour putting forward the steps in the attachment to the Governor's letter of 10 February. These largely speak for themselves and consist of steps to carry forward some closer coordination of economic policies in ECOFIN together with steps to enhance cooperation on exchange rates and promote use of the private ecu. The proposals conclude with steps to strengthen monitoring of monetary policies, provision of enhanced research capacity and increased consultation over banking supervision. Two points may be noted. First, while not all the proposals would be readily accepted by Poehl, they are not so extensive in number for it to seem desirable to make this a reason for exclusion of any. Secondly, while it is tempting to include in this list a proposal for accelerated capital liberalisation, the points included in the commentary against this seem of considerable weight.

The Chancellor concludes that the UK paper should end by explaining why the approach in Part III of the existing report is flawed. A central point here is that it is clearly not possible now both to foresee conditions in the distant future and wholly unrealistic politically to set in motion a single process of Treaty amendment which would carry through to the attainment of EMU. It would be possible to combine this message with the reminder that such steps are irrelevant to the period to 1992. The achievement of the single market programme will itself impose disciplines from the bottom up. It makes sense to envisage some closer coordination of economic and monetary policies, ie top down, to complement that process.

The Chancellor's paper suggests that there should be no reference at all to the final stages of EMU or any reference to the consideration of the possibility of Treaty change eg towards the end of 1992. This is an important point. There is much to be said for leaving any such reference, if it had to be made, for a later political debate, even though the language would, at that stage as well, involve no commitment to amendment.

Paragraph 6 of the Governor's paper records his proposal to submit a substantial redraft of Part III of the report to the Delors Committee after this week's discussion. As envisaged, this paper would appear to enclose the concrete steps in the annex to his present paper in a package drawing on some of the acceptable elements in the existing draft. In tactical terms that might enhance the acceptability of this element of the UK contribution. If a double presentation were thought appropriate a proposal essentially reflecting the Chancellor's suggestion might be tabled along with a revised Part III. The latter should however eschew any account of stages 2 and 3 or reference to Treaty amendment.

G. Handling.

After a brief recapitulation of the outcome of the December Ministerial meeting it may be appropriate to invite the Governor to report on the latest meeting of the Delors Committee and how this may have influenced his views on the paper that he may judge it appropriate to circulate to the next meeting. The Chancellor may base his comments on the approach in his counter paper. The Foreign Secretary will no doubt comment in particular on tactical considerations. It may be convenient to deal with some of the general considerations bearing on circulation of a paper (Section E above) before considering the content of a paper or papers in more detail (Section F above).

## H. Conclusions

You may conclude that the Governor should be invited to prepare a paper on the lines outlined in the Chancellor's note, as amended in discussion. It may also be appropriate for the Governor to finalise a revision of Part III of the report, again on lines considered in discussion. Both papers should be circulated as soon as possible for clearance perhaps by a resumed meeting.

chex.rm/aa1/14 **CONFIDENTIAL**

cc R. Lavelle
B cc CDP

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

**PRIME MINISTER**

**DELORS COMMITTEE**

WITH PG?

I have been thinking further over the weekend about the Governor's note attached to the Bank's letter of 10 February, which he had discussed with me last week.

I fully understand the difficult situation which the Governor faces in the Committee, not least in the light of the terms of reference given to the Committee by the European Council (text attached). But after further reflection I have come to doubt whether the tactics which he suggests in his letter, and which I had discussed with him, are likely to lead to the outcome which he is seeking. My reading of Parts II and III of the draft Report suggests that they are so far from being satisfactory that he would face an impossible task in the Group to secure agreement to an acceptable redraft.

There are also, in my view, risks in submitting a redraft of the whole Part III of the Report (which would set out the steps towards EMU) as the Governor suggests. Unless the redraft were to be dismissive of the so-called stages II and III of the transition to EMU - and this would be unacceptable to some members of the Group - the redraft might give the impression that he favoured the steps which were envisaged for those stages.

I therefore feel that the Governor might well do better to submit to the Group a free-standing statement of his views and conclusions, which might be included in the Report. It is of course possible that one or two other members of the Group might support this statement: if so, so much the better.

I suggest that this statement might include the following elements:

- A short review of the history of economic and monetary co-operation in the Community, leading to the present position. Tactically, it would be right to present the value of co-operation in as positive terms as possible.

- A passage to the effect that it was clear from Group's discussion that "full" EMU, as conceived by the Group, would require massive shifts of economic and political sovereignty from member states, together with some paragraphs to provide the evidence for this in suitably stark terms.

- A comment that such a shift would require fundamental amendment to the Treaty, noting that this issue goes beyond the competence of the members of the Group - who are monetary, not constitutional and political experts, and saying that it is for Heads of State and Government to draw the constitutional consequences, and not something to which Central Bank Governors should make recommendations.

- A passage setting out the positive steps which could be taken in the period immediately ahead to enhance economic and monetary co-operation within the Community.

- A conclusion that this would be a more fruitful approach to progress on carrying forward economic and monetary co-operation than that described in the main Report, which has fundamental flaws, which should be spelt out.

I hope that we can have an opportunity to discuss this approach at our meeting on Wednesday.

I am sending a copy of this minute to the Foreign and Commonwealth Secretary and to the Governor of the Bank of England.

[N.L.]
13 February 1989

invited the Commission to prepare proposals for concrete measures to implement the Community's contribution to the international cooperation referred to in Toronto.

5) MONETARY UNION

The European Council recalls that, in adopting the Single Act, the Member States confirmed the objective of progressive realization of Economic and Monetary Union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this Union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr Jacques DELORS, President of the European Commission.

The Head of State and Government agreed to invite the President or Governor of their Central Banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite :

- Mr Niels THYGESEN, Professor of Economics, Copenhagen,
- Mr LAMFALUSSY, Director-General of the Bank for International Settlements in Basle, Professor of Monetary Economics at the Catholic Univerty of Louvain-la-Neuve
- Mr Miguel BOYER, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.

Prime Minister

I think it would be a mistake to invite Mr. Pöttering to talk about this on its own. He might suggest that he comes in for a wider discussion in May / June. Agree?

Yes CDP 16/2.

THE RIGHT HONOURABLE
LEON BRITTAN, QC
VICE PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

RUE DE LA LOI, 200
1049 BRUSSELS - TEL. 235 25 14
235 26 10

**PERSONAL AND CONFIDENTIAL**

13th February 1989

Dear Prime Minister,

I am enclosing a copy of an extract from the speech that I made to the Conservative Group for Europe last Friday, because it makes a particular point about current monetary developments in the Community, which I thought might be of interest.

The general arguments for joining the Exchange Rate Mechanism of the EMS are not in any sense new.

But the new factor that has struck me increasingly in the last few weeks is that if Britain were to join the ERM, the consequence would, paradoxically, be to check the movement towards Economic and Monetary Union and impede the consideration of radical proposals such as the creation of a common currency or a Central Bank.

Why?

I have tried to show why I have come to this conclusion in the speech extract that I enclose, and that may be sufficient for the point to be taken into consideration.

But I would also of course be very happy to discuss further the reasons why I have come to this view, if you feel that that would be of any assistance.

Yours,

Leon

The Rt.Hon. Margaret Thatcher, MP
Prime Minister and First Lord
of the Treasury.

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Brussels, 10 February 1989

# MONETARY PROGRESS IN THE EUROPEAN COMMUNITY

## Case stronger than ever for UK participation in the Exchange Rate Mechanism

Extract from the speech by Sir Leon Brittan, Vice President of the European Commission, to the Conservative Group for Europe, Coventry, 10 February, 1989

"As the 1992 programme gathers momentum, attention has increasingly focused on the separate question of the need for progress in the monetary sphere.

The UK already does more than half of its trade with other members of the Community. Anyone who has experience of the realities of exporting will know the advantages arising from exchange rate stability. This is particularly true for smaller businesses which do not have easy access to the financial techniques for hedging exchange rate risks that are available to big multinational companies.

In addition, events of the last years have again underlined the need for continual vigilance in the battle against inflation. Among our European Community partners, few would doubt the contribution made by the exchange rate mechanism of the European Monetary System to the control of inflation.

For both of these reasons I believe that Britain would be best served now by fully joining the EMS. That is indeed a view that I have held and expressed publicly since early 1986.

As to developments beyond the EMS, the increasing interdependence between the economies of the different member states is inevitably leading to greater coordination of member states' monetary and exchange rate policies.

That is why the Heads of Government last year set up the Delors Committee to report on how further progress towards monetary union might be achieved. We will all read that report with interest when it appears later this spring.

What is already clear to me, in my short time in Brussels, is the manifest importance attached by our partners to sterling joining the exchange rate mechanism of the EMS. They would warmly welcome such a step, not just as a gesture of unity, important though that would be for many of them, but because they know and appreciate that in economic and financial terms British full membership of the EMS would greatly strengthen the Community, quite apart from any benefits it might confer on Britian.

By the same token, because British membership is regarded as of such value and of such significance, I believe that it would be readily understood that the introduction of such an important and widely-traded currency as the pound into the Exchange Rate Mechanism would change the basis of the monetary discussion. There would be strong arguments, indeed, for a period of stocktaking until the full impact of the new situation - for Britain and for the Community as a whole - became clear, before taking further major steps in the monetary field.

Meanwhile, increased monetary cooperation in Europe is again on the agenda, and it is too important an issue for Britain's voice not to be heard. Only as full members of the EMS can we really hope to influence its future direction. That is why the case for entry now is stronger than ever."

For further information, please contact:
Michael Berendt : 235 8562
Elizabeth Kaiser : 235 2210

PA 8

PRIME MINISTER

THE DELORS COMMITTEE

You are having a further meeting with the Chancellor, Governor and Foreign Secretary on Wednesday to consider the state of play reached in the Delors Committee. This will follow the next meeting of the Committee itself on Tuesday; and precede your meeting with Pohl at the Anglo/German Summit.

The Governor has sent in today a further progress report (enclosed), which you may like to glance at over the weekend. He will give you an oral update on Wednesday on developments at the Tuesday meeting of the Committee.

We will let you have further briefing next week.

PLCG.

PAUL GRAY
10 February 1989

DS2AOU

cc CDP
cc BUP

BANK OF ENGLAND
LONDON EC2R 8AH

Pf

10 February 1989

Paul Gray Esq
Private Secretary to
the Prime Minister
10 Downing Street
London
SW1

Dear Paul

Ahead of the Prime Minister's meeting next Wednesday I attach a short note by the Governor setting out progress to date, together with a paper that has been agreed between Bank and Treasury officials, describing possible UK proposals for early practical steps.

I am sending a copies of this letter and enclosures to Alex Allan (HMT) and Stephen Wall (FCO).

Yours ever

John

J R E Footman
Private Secretary
to the Governor

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CCB1/91.

DELORS COMMITTEE: FURTHER PROGRESS REPORT

Proposed Structure of the Report

1 The Committee decided at its October meeting that its Report should fall into three parts:-

(i) Part I would describe development and progress in the Community to date, (no draft yet circulated, but expected to be uncontroversial).

(ii) Part II should describe as fully and clearly as possible the nature of an economic and monetary union, underlining the degree of economic union that must necessarily accompany monetary union.

(iii) Part III was to suggest the "concrete stages" that would need to be passed through before an economic and monetary union could be put in place.

There was a clear preference that the tone of the report should be descriptive rather than prescriptive. It was also agreed (reluctantly by some) that the report should not lay down any particular timetable for moving through the various stages.

The Draft Report to Date

(i) Part II: The Description of Economic and Monetary Union

2 A first draft was discussed in December, which devoted a great deal more space to monetary than to economic union and was also prescriptive and detailed. The redraft in the light of that discussion is on the agenda for the next meeting of the Committee on Tuesday, February 14.

The redraft is a considerable improvement. It has been quite extensively rewritten but it remains unsatisfactory - it is still long and prescriptive. The vision of the Report remains fundamentally that of a corporatist, interventionist and bureaucratic Community. More positively, however, the redraft admits that the necessary institutional framework is already in place for establishing and maintaining the single market, formulating and implementing supportive common policies and co-ordinating macro-economic policies, whereas the earlier draft implied that institutional change in the monetary field was necessary in order to complete successfully the 1992 programme.

4 At next week's meeting of the Committee I will therefore be arguing strongly for a shorter and simpler Part II that reflects the strong original preference of the Committee for a description of economic and monetary union. I will point out in particular that the Committee has already agreed that it is unrealistic to think in terms of an early and comprehensive amendment to the Treaty that would map out in detail the path towards eventual economic and monetary union. I will therefore offer the Committee a draft outline of this part of the Report on the lines that members had originally agreed.

(ii) Part III: The Description of Economic and Monetary Union

5 A first draft of Part III, discussed by the Committee at its January meeting, suggested three stages towards economic and monetary union:

(i) Stage 1, to start at the same time as the full liberalisation of capital movements (effectively June 1990), would not involve any transfer of decision-making authority from the Member States to the Community, but policy co-ordination in both economic and monetary fields would be strengthened. Budgetary policy co-ordination would be strengthened. The Committee of Central Bank Governors would develop further the co-ordination of monetary and exchange rate policy initiated with the Basle/Nyborg agreements and institute regular meetings on

banking supervisory matters. All Member States would join the ERM and the band of permitted exchange rate fluctuations would be narrowed. At some point in this period the Community would prepare and ratify a single Treaty covering all the steps towards economic and monetary union.

(ii) Under Stage 2, following ratification of the new Treaty, final decisions on the conduct of policy would remain with the Member States, but there would be a gradual transfer of power to the centre. A European System of Central Banks (ECSB) would be set up along federal lines to conduct communal foreign exchange intervention and as a forum for binding ex-ante co-ordination of national monetary policies.

(iii) Stage 3 would be marked by the irrevocable fixing of exchange rates, accompanied by a shift in the ultimate responsibility to ESCB for the formulation of monetary policy and decisions on exchange market intervention.

Bank of England Redraft of Part III

6 I intend to submit a substantial redraft of Part III to the Committee, as soon as possible after next Tuesday's discussion of Part II, and before the Committee's rapporteurs have submitted their own redraft for discussion by the Committee at its March meeting. This redraft will concentrate on proposals for early practical steps in Stage 1 acceptable to the UK, as listed in Annex I attached. As indicated in the Annex, not all these proposals are likely to be acceptable to Poehl.

7 It will also pick up the acceptable points from the rapporteurs' existing draft, ie,

- completion of the 1992 programme;
- strengthening Community competition policy;
- full implementation of Brussels package on structural funds;
- an increasing degree of economic and fiscal policy co-ordination;

- enhancing responsibilities and procedures of Monetary Committee in parallel with Committee of Central Bank Governors.

8 The redraft will also contain a very much abbreviated description of Stages II and III, which involve institutional change, indicating that they are illustrative of the possible direction in which the Community may wish to move.

9 I have already written to Delors to register my view that the Committee should not prescribe the form, the content or the timing of any Treaty change that a move from Stage 1 to Stage 2 may require. A brief reference will be made in the redraft to the need to consider towards the end of Stage 1 any necessary Treaty changes to implement the institutional changes envisaged in Stage 2. It may be impossible to obtain the unanimous agreement of the Committee to so unspecific a reference in the Report to the timing and content of Treaty change. In this case, it will be necessary for the Report to reflect two different views.

R. C-P.

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ANNEX I

**POSSIBLE UK PROPOSALS FOR EARLY PRACTICAL STEPS TOWARDS ECONOMIC AND MONETARY UNION**

Key

A = Poehl likely to support
B = Poehl neutral, or attitude uncertain
C = Poehl likely to oppose

| | Comments |
|---|---|
| Economic Policy | |
| (1) Closer co-ordination of economic policies in ECOFIN, based on regular (six-monthly?) surveillance discussion of economic developments in Community countries. Discussions to cover prospects for the fiscal stance in member countries as well as monetary policy. Central bank governors to participate, where appropriate. Discussions to be based on preparatory work carried out by Monetary Committee, Economic Policy Committee, Central Bank Governors' Committee. | A. Participation of central bank Governors is optional. But if it were recommended, that might help secure support of other Governors. Discussions could then be at informal ECOFINs, which Governors attend. |
| (2) Develop understandings in ECOFIN about level of national budget deficits in a medium-term context, aiming eventually to bring deficits in all countries down to level achieved in best. | A. |

(3) Develop guidelines for the financing of national budget deficits, so as to stop monetary financing.

A. A complex subject because of institutional differences in different countries. EC Monetary Committee is already studying the subject the subject, and is making some progress.

[Capital Liberalisation

(4) Implement capital liberalisation directive in all member states as quickly as possible.

B. But all except Ireland, Spain, Portugal and Greece are committed to implementation before July 1990. It may not be realistic to urge them to move faster.

(5) Member states to [agree to amend/ consider amending] directive to repeal safeguard clause, which permits countries to reintroduce controls as a temporary measure, to make capital liberalisation permanent and irreversible.

B. This would provoke strong opposition from Italy and some other Southern European states, and could cause others to try to link it to an agreement to harmonise the taxation of savings. On the other hand, if others do not agree, we could make something of the argument that if they are not ready to take this minor

step, then it is idle to talk about faster progress to EMU. However, a proposal to repeal could stir up the issue of Treaty amendment too since it carries with it the implication that Articles 73, 108 and 109 (which contain similiar provisions) should also be revised.]

Increased co-operation on exchange rates

(6) A general move towards increased holdings of EC currencies in member states' reserves and their use, where appropriate, in intervention.

C. This would apply to all EC currencies, whether or not in the ERM. It is useful for central banks to have a range of currencies at their disposal so they can intervene in different currencies depending on where the market pressures are. At present holdings of other EC currencies, and their use for intervention, are inhibited by the EMS inter-central bank agreement. The measure would be permissive

| | |
|---|---|
| | only : it would not require such holdings. The Bundesbank oppose : they only hold $s in their reserves, and wish to limit other countries' holdings of DM. |
| (7) Countries that do not participate in the ERM to be permitted to participate, if they wish, in the very short-term financing facility (VSTF). | B. This would enable the Bank of England to arrange short-term drawings from other EC central banks where necessary and agreed : and in return the Bank would agree to lend to other EC central banks on the same terms. |
| (8) Use market rate on Government short-term ecu paper as the rate of remuneration on official ecu liabilities arising in the EMS. | A. This is of no significance to the UK while we are outside the ERM, unless (7) were agreed. This would replace the present cumbersome calculation based on a basket of interest rates. It is made possible by the existence of the UK Treasury bill programme. |

Promoting use of the private ecu

| | |
|---|---|
| (9) Increased holdings of private ecu in national reserves, and their use, where appropriate, in intervention. | A. The private ecu can be a useful intervention currency. In the past the Bundesbank have not favoured this proposal because of the weight of the DM, in the ecu basket (see 6), but Poehl's attitude is now more receptive. |
| (10) Acceptance of private ecu in settlement of VSTF obligations in EMS, rather than official ecu. | B. Like (8) this would only be significant for the UK, as a non-member of the ERM, if (7) were agreed. |
| (11) Removal of national regulatory impediments that prevent market participants using the ecu in setting prices, for corporate accounts, for contracts and as a means of settlement. | A (B on some aspects). |
| (12) Other countries to follow UK lead in issuing government debt denominated and payable in ecu. | B. |

Further enhancement of Monetary Co-operation

(13) Deepen and strengthen monitoring and co-ordination of national monetary policies in Central Bank Governors' Committee and Monetary Committee including :

- consideration of guidelines for national monetary policies, regular discussion of monetary targets, etc.

- discussion of the overall monetary stance of the Community, and exchange rate relationships with third countries ($, Yen).

- discussion of monetary/fiscal policy mix in the Community.

A. (Though Bundesbank likely to object to detailed discussion of monetary/exchange rate issues in the Monetary Committee, or ECOFIN.)

(14) Provide Central Bank Governors' Committee with a permanent secretariat including a research capacity.

A. Bundesbank strongly favour building up Central Bank Governors' Committee.

Banking Supervision

(15) Central Bank Governors' Committee to start regular consultations concerning matters of common interest in banking supervision.

A. It might be feasible in due course for the Central Bank Governors' Committee to take over much of the work of the Commission's Banking Advisory Committee, with the Central Bank Governors' Secretariat taking over the Commission's functions. But this would raise difficult issues, not least for countries like Germany whose banks are not supervised by the central bank.

10 DOWNING STREET

Tessa

Could you pl. arrange a meeting with:

- Ch. / Exch.
- F.C.S.
- Governor / Bank
+ CDP + PG.

Confirm by note

on 15, 16, ~~[illegible]~~ or 17 February to discuss the DELORS GROUP.

Allow 1½ hrs. pl.

[It ~~[illegible]~~ has to be after the 14 Feb. and before the Anglo-German summit].

RRCG 3/2

CC BK/LP
COP.

D

COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

CSEMU/10/89
31st January 1989

## II. How to define the final stage of economic and monetary union

### 1. Introduction

1. The establishment of an economic and monetary union will represent the result of the process of progressive economic integration in Europe. This result will have been attained when the Community forms a single currency area in which all residents can engage freely and without impediment in any kind of economic activity, subject only to commonly applied or mutually recognised rules and regulations and supported by economic policies geared towards price stability, balanced growth and converging standards of living, high employment and external equilibrium.

2. The EC Treaties, as amended by the Single European Act, provide the legal foundation for many of the necessary steps. However, the existing Treaties do not suffice for the creation of an economic and monetary union. The realisation of this objective calls for new arrangements which can only be established on the basis of a new Treaty and consequent changes in national legislations. For this reason the union will have to be embodied in a Treaty which clearly lays down the basic functional and institutional arrangements, as well as provisions governing their step-by-step implementation.

3. Even with a single market, a unified monetary system and an institutional and functional framework for economic management, the Community will continue to consist of independent nations with differing economic characteristics, traditions, social customs and languages. The existence and preservation of this plurality and diversified structure necessitate that a large degree of autonomy in economic decision-making should continue to rest with individual member countries and that a balance

be struck between national and Community competences. For this reason it is not possible simply to model an economic and monetary union for the Community on the example of existing economies; it is necessary to develop an innovative and unique approach.

An essential element of any approach consistent with the historical and economic conditions in member countries is the distribution of economic policy responsibilities within the Community in strict conformity with the constitutional "principle of subsidiarity". According to this principle, the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community must be narrowly confined to those areas in which collective decision-making is necessary, whereas all policy functions which can be carried out at national (or local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union must remain within the competence of the member countries.

With due regard to the principle of subsidiarity and taking into account what is already provided for in the EC Treaties, the need for a new structure to enable policy decisions to be taken at the Community level arises primarily - though in differing degree - in the field of macro-economic management. As a monetary union requires a single monetary policy, the responsibility for the formulation of this policy as well as decisions on day-to-day operations must be vested in one decision-making body. In the field of fiscal policy the need for centralisation is less imperative and a wide range of budgetary decisions should be left to national authorities. At the same time, however, all member countries will have to recognise and accept in their decision-making the existence of the constraints on national fiscal policy that emanate from participation in an economic and monetary union.

4. A step-by-step approach to implementing an economic and monetary union can be set out only if there is a clear understanding of this final objective, of its implications for the working of the economy and economic policy decisions, and of the principal elements that have to be in place for its successful and durable functioning. Economic union and monetary union are closely intertwined, form two integral parts of a single whole and must therefore be implemented in parallel. It is for reasons of

expositional clarity that the following sections look separately at the principal features defining an economic and a monetary union. This description begins with the concept of a monetary union, chiefly because an economic union can be circumscribed more clearly and specifically once the main elements of a monetary union have been identified.

## 2. The principal features of monetary union

5. A monetary union describes a single currency area, which, as already stated in the 1970 Werner Report, is realised when three conditions are fulfilled:

- the assurance of total and irreversible convertibility of currencies;
- the complete liberalisation of capital transactions and full integration of banking and other financial markets; and
- the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.

The first two of these requirements - the convertibility of Community currencies and the creation of a free and fully integrated financial market - have already been met, or will be with the completion of the internal market programme. A monetary union will, however, be accomplished only when the decisive step is taken to lock irrevocably the exchange rates between Community currencies. This will be the single most important step towards creating a situation in which all currencies can be used equally to set prices, make payments and denominate debts or credits.

6. The three above-mentioned conditions are sufficient for the establishment of a single currency area, but would not necessarily mark the end of the process of monetary unification in the Community. At a later stage the adoption of a single currency, while not strictly necessary for the creation of a monetary union, may be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary union. In this connection, the Committee endorses the idea that the ECU should become the future currency of the Community and that an official declaration to this effect should be made at

the time of the decision to draw up a new Treaty. While the Treaty should allow for an appropriate period of transition, this would mean that ultimately the ECU would replace existing national currencies to serve as the only means of payment, unit of account and store of value for all residents of the Community. The introduction of a single currency would, however, be possible only some time after exchange rates had been locked and when market forces had fostered a spreading use of the ECU in commercial and financial transactions.

As a result of the permanent fixing of exchange rates national currencies will become increasingly closer substitutes: their interest rates will tend to converge and differences between prices of goods traded throughout the Community will largely disappear. However, the pace with which these developments take place will depend critically on the extent to which firms, households, labour unions and other economic agents are convinced that the decision to lock exchange rates will not be reversed. Initially, the continuing existence of national currencies may leave doubts about the commitment to unchangeable exchange rate parities and engender market perceptions of differences between individual currencies' quality and standing. Both coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies will be crucial in dispelling such doubts over time.

7. The successful functioning of a monetary union in which national currencies co-exist has far-reaching implications for the formulation and execution of monetary policy in the Community. The adoption of permanently fixed exchange rates in an environment of free and fully integrated capital and money markets generates the need for a single monetary policy carried out through new operational procedures and not simply through the co-ordination of as many national monetary policies as there are currencies participating in the union. This, in turn, requires the attribution of the responsibility for monetary policy to a new institution (the principal features of which are outlined in Section 4), which will not only form the basis for centralised and collective decisions on the expansion of money and credit in the Community, but will also possess the necessary financial attributes (i.e. its own balance sheet) and the regulatory powers to enforce implementation of the chosen policy. One possibility for managing a common monetary policy might be to employ the official ECU as a common

reserve instrument which, firmly controlled by a central monetary institution, would determine the scope for national monetary expansion in line with the Community's monetary policy stance. [Could another possibility be for one of the existing national currencies to be chosen as the anchor of the System and managed collectively in the framework of the European System of Central Banks?]

This shift from national monetary policies to a single monetary policy is an inescapable consequence of entering a monetary union and marks one of the principal institutional changes required by economic and monetary union. In practice, however, the incision will not be so deep but rather will represent the completion of a progressively intensified co-ordination of national monetary policies, which had in many respects already foreshadowed the move to a single monetary policy in the Community. Even prior to the decision to fix exchange rates permanently, the liberalisation of capital movements and financial market integration will have created a situation in which the conduct of a completely autonomous monetary policy at the national level has been rendered much more difficult. Once every banking institution in the Community is free to accept deposits from and grant loans to any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between the national central banks' area of jurisdiction, the area in which their currency is used and the area in which "their" banking system operates will be lost and it will only be possible for monetary policies to be effective if they are merged into a single mould.

8. The decision to lock exchange rate parities between national currencies irrevocably will have profound effects on the functioning and the performance of the economy of the Community.

A monetary union will remove exchange rate uncertainties and lower costs of transactions between residents of different countries in the Community. This will provide a stimulus to intra-Community trade and contribute to a more efficient allocation of resources, and thereby raise the level of economic activity and employment in the Community. At the same time, movements of exchange rates unwarranted by fundamental factors can no longer be a source of macro-economic disturbances and competitive distortions. Moreover, once the locking of exchange rates has gained credibility in the market place, firms and households in all countries are

likely to behave more conformably and will thereby contribute to the evolution of a more homogeneous economic structure in the Community. Finally, the creation of a single currency area in combination with an unrestricted common market will mean that the Community will be much less susceptible to external shocks.

The most serious problem posed by a monetary union is that the exchange rate can no longer serve as an instrument for adjusting economic imbalances among member countries. To the extent that market mechanisms do not perform an adequate equilibrating role, other policies, such as income, fiscal and structural policies, will have to be used more intensively to bring about the corrections in cost and price trends that used to be obtained from time to time by realignments of exchange rate parities. For this reason the implementation of a monetary union must be accompanied by parallel progress in creating or strengthening effective alternative adjustment mechanisms, such as those discussed in the next section. Moreover, while the freezing of exchange rate relationships will not eliminate the possibility of imbalances between the supply of and demand for economic resources in individual Community countries, the statistical measurement and the economic interpretation of such imbalances may become more difficult in a fully integrated market since balance-of-payments disequilibria would essentially assume the meaning of regional imbalances. As a consequence, balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer be able to play a significant role as guidepost for policy-making. Moreover, with parities irrevocably fixed, foreign exchange markets would cease to provide a source of pressure for policy corrections when economic disequilibria developed and persisted. However, the balance between the economic benefits and costs of exchange rate fixity will become more and more favourable as the Community develops into an optimum currency area. In order to tilt the balance in this direction it is essential that the move towards monetary union should be coupled with measures designed to strengthen the mobility of factors of production and a close co-ordination of non-monetary policies.

9. In summary, the realisation of a monetary union means that in a situation of free capital movements and full financial integration the exchange rates between Community currencies are irreversibly fixed. This

will create a monetary union in which, at least initially, all national currencies circulate freely, although they might eventually be replaced by the ECU as the sole Community currency. The transition from a situation of fixed but adjustable exchange rates to a system of permanently locked parities implies a fundamental change in the economic management of the Community. National monetary policies will have to give way to a single monetary policy for the Community as a whole, formulated and executed jointly in the context of a European System of Central Banks. At the same time, a single currency area implies the abandonment of the exchange rate as an instrument of adjustment of imbalances among Community countries and therefore requires, in parallel to the process of monetary integration, measures to co-ordinate effectively policies in non-monetary areas.

## 3. The principal features of economic union

10. The definition of economic union is less straightforward than that of monetary union. It certainly comprises the complete freedom of movement of persons, goods, services and capital, and it also includes a certain amount of public functions carried out through regulation, taxation and expenditure. The scope of these functions, however, as well as their distribution between central and local governments, varies from country to country and has evolved historically. This is why, in defining the essential elements of economic union, the Community should be guided by two basic criteria: consistency with the principles that define the economic order of the Community countries, and a guarantee of appropriate balance between the economic and the monetary components of the union.

As regards the first criterion, beyond the differences that may exist between member countries or - within the same country - in different political periods, the distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods. Within this broad conception, the scope for attributing to the Community economic functions that are at present exercised at national levels is limited by adherence to the principle of subsidiarity and by the fact that certain fundamental functions are at present exercised at the national level.

As for the second criterion, a balance between the economic and the monetary components of the union is essential because of the close interdependence between real and monetary developments and the strong interactions between economic and monetary measures. As a consequence, there is a need for common policies effected at the Community level and for close co-ordination of national policies. Without a coherent set of non-monetary policies at the Community and national levels it would be impossible to maintain permanently fixed exchange rates between Community currencies; conversely, without a monetary policy in support of a single currency area, the Community would not be able to develop into a full economic union.

The creation of a single market in Europe, which constitutes a major component of economic union, will impart strong impulses to economic growth and increase economic welfare through both a further specialisation in line with countries' and regions' comparative advantages and the exploitation of economies of scale in production, research and marketing. These gains will materialise as the residents in the enlarged market without internal frontiers respond to price, wage and interest rate movements, which, transmitted throughout the Community, will provide important incentives for a more efficient use of economic resources. There is no doubt that this process will stimulate economic activity and employment in the Community as a whole, and will generate greater economic freedom and increased trade in goods and services.

11. In a situation of irrevocably locked exchange rates this process will benefit from a monetary environment of greater certainty, but - as previous historical experience shows - it will also encounter certain economic risks. This is because the process of adjustment and restructuring set in motion by the removal of physical, technological and regulatory barriers is unlikely to run smoothly or always produce satisfactory results within reasonable periods of time, while exchange rate realignments will not be available as an instrument in support of adjustment. Moreover, economic imbalances emanating from labour and other cost developments in one member country, external shocks with differing repercussions on individual economies, or divergent non-monetary policies pursued at national levels cannot be corrected by exchange rate changes but, as pointed out in the previous section, will have to be eliminated largely by

other policy measures. Only if such imbalances can be reduced rather quickly or their emergence be avoided altogether will it be possible to reap the benefits of economic union without undue costs in the form of marked pressures on output and employment in certain regions of the Community.

12. It is primarily for these reasons that the creation of an economic union requires action in three interrelated areas: measures to create a larger market without internal frontiers and to strengthen its functioning; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needs to be reinforced or complemented; arrangements which make it possible both to limit the scope for macro-economic divergences between member countries and to design an overall economic policy framework for the Community as a whole.

13. The measures aimed at creating and strengthening the market are to a large extent envisaged in the EC Treaty and the Single Act establishing, by 1992, a single market without internal frontiers. The creation of this market presupposes a "level playing-field" for all residents of the Community, which allows them to make decisions on production, investment and consumption in broadly similar conditions and on the basis of similar levels of information. To this end all barriers which tend to separate markets along national borders have to be eliminated. In particular, all technical and regulatory obstacles have to be removed, norms have to be harmonised or mutually recognised, and certain common minimum standards governing social policy and consumer and environmental protection have to be agreed. Moreover, tax treatment must not discriminate in favour of or against economic activities across Community countries. At the same time, competition policy - conducted at the Community level - has to operate in such a way that access to markets is not impeded and market functioning not distorted by the behaviour of private or public economic agents.

In addition to clearly formulated policies for the dismantling of barriers and the prevention of restrictive practices, efforts may also have to be made to encourage the adoption by all countries of wage-setting

procedures based on productivity developments and to strengthen the regional and occupational mobility of labour.

14. Community policies to complement the single market are necessary because, even in a large economic space without internal frontiers, market forces cannot be expected to lead, on their own, to an optimal allocation of resources and a balanced distribution of wealth throughout the Community. Such policies are needed in a wide range of areas, such as agriculture, transport, research and technological development, environment and, in particular, regional and structural development. Unless the move to economic and monetary union is postponed until a distant date at which all Community countries have reached a broadly similar stage of development, the creation of a single market and the locking of exchange rates will take place in a situation in which owing to ill-adapted structures and differences in productivity, some major regional disparities will exist. The impact of economic and monetary integration on these disparities is difficult to assess: on the one hand, transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially at the periphery of the Community, to the highly developed areas in its centre, and could therefore produce undue economic and political tensions arising from possible dislocations of industries and labour forces. On the other hand, however, economic integration would also provide less developed regions with lower wage levels a unique opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location is much less determined by transport costs and market proximity. In order to encourage and guide the necessary structural adjustment which will help the Community's poorer regions to catch up with the wealthier ones, the Community must develop an effective policy and be endowed with adequate financial resources which will allow it to assist regional development efforts undertaken at national levels.

An important step in this direction was taken in February 1988 with the decision to enlarge considerably the resources of the Community's structural funds and to reorganise structural policies. The principal objective of these policies would not be to subsidise incomes and simply temper inequalities in standards of living but to help to equalise the conditions for production through investment programmes in such areas as

physical infrastructure, communication, transportation and education. The success of these policies hinges not only on the size of the available financial resources, but to a decisive extent also on the effectiveness of the investment programmes. Indeed, the more recent experience of countries inside and outside the Community has shown that structural and regional development programmes are particularly successful when improvements in the resource base of regions encouraged by investment in infrastructure and education are reinforced by decentralised initiatives for local entrepreneurship, modernisation of urban areas and local institutional arrangements favouring development. It is precisely in this respect that the Community's structural policies have been revised. A longer-term approach in this area will offer countries with lower levels of productivity an appropriate period of transition and in this sense constitutes an essential element of the policy mix to ensure continuing economic integration and the attainment of economic and monetary union.

Furthermore, as long as wage flexibility and labour mobility have not increased considerably, changes in competitiveness in different regions of the Community could lead to relatively large declines in output and employment in areas with deteriorating competitiveness. In order to ease adjustment burdens temporarily, it might be necessary in certain circumstances to organise financing flows through official channels. Such financial support would be additional to what may be provided by spontaneous capital flows and should prompt the recipient to intensify rather than delay economic adjustment. It would therefore have to play a role similar to that of conditional balance-of-payments assistance available under present monetary arrangements.

15. Macro-economic developments are the third area in which action is required. While policies to ensure a proper distributional and allocative functioning of the market without frontiers will have to be formulated and, in part, executed at the Community level, many of the developments on which macro-economic conditions depend will continue to be determined by factors and decisions operating at the national level. This applies not only to wage negotiations and other market-determined behaviour, but in particular also to budgetary policies. Apart from the relatively small Community budget, such policies will necessarily remain the preserve of member states even at the final stage of economic and monetary union, unless the decision

was taken that major public goods constituting the bulk of public sector activity (internal and external security, justice, social security, environment) should to a large extent be provided at the Community level, thereby significantly enlarging the Community budget. In any event, adherence to the principle of subsidiarity implies that Community competence be kept to a minimum.

However, with budgetary and other relevant decisions being taken at national levels, an economic and monetary union can only operate on the basis of mutually consistent and prudent behaviour by governments, unions and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies might not only undermine monetary stability, but would also generate imbalances in the real and financial sectors of the Community and render it difficult, if not impossible, to pursue appropriate macro-economic policies for the Community as a whole. This is why all countries will have to accept that sharing a common market and a single currency area imposes narrow constraints on their national budgetary policies and requires strict fiscal discipline. Similarly, strong divergences in wage levels not justified by different trends in productivity would produce economic and monetary tensions.

To some extent market forces will exert a disciplinary influence because financial markets, consumers and investors will respond to differences in macro-economic developments in individual countries and regions, assess the budgetary and financial position of different countries, penalise excessively expansionary fiscal behaviour or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals. In particular, in the financial field, rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces may either be too slow and weak or too sudden and disruptive. For this reason an economic and monetary union requires arrangements which effectively ensure a close and flexible co-ordination of national fiscal policies.

In the macro-economic area, therefore, the aim must be to set up arrangements which will enable the Community to monitor its overall economic situation, to assess its consistency with regard both to

individual countries and to common objectives, and to formulate guidelines for policy. This is particularly important for fiscal and budgetary policies, where arrangements are required which will effectively limit the scope for budget deficits that can be incurred by individual member countries of the Community. Safeguards in this respect will have to include (in accordance with the criteria laid down for a European System of Central Banks) strict limits on the maximum permissible access to monetary financing, as well as on borrowing in non-Community currencies. In addition, agreement must be reached on a system of rules which limits the maximum size of national budget deficits. Finally, co-ordination arrangements in the fiscal field must enable the Community to conduct a coherent mix of fiscal and monetary policies, i.e. to dispose of a system of rules that can be applied with a view to determining the aggregate balance on national budgetary positions, including that of the Community.

16. In summary, the establishment of an economic union implies:

- the creation of an internal market without physical, regulatory or fiscal frontiers, supplemented by a competition policy which effectively removes distortions in competition;
- common policies in transport, research and technological development, and regional and structural development which will help to exploit the full potential of the single market and its role in the allocation of resources, but which will also help regions with lower productivity to catch up with the richer parts of the Community;
- a framework for monitoring and co-ordinating general macro-economic developments in the Community with a view to attaining non-inflationary, balanced economic growth;
- rules setting maximum possible deficits for national budgets and strict limits on both monetary financing and borrowing in third currencies;
- effective procedures for the co-ordination of national budgetary policies to avoid undesirable repercussions on monetary policy.

These requirements not only have to be met in order to derive the greatest possible benefit from an enlarged economic space, they are also indispensable for the cohesion of the monetary union.

4. Institutional arrangements

17. Management of the economic and monetary union therefore calls for an institutional framework which will allow policy to be decided and executed at the Community level in those economic areas that are of direct relevance for the functioning of the union. The institutional framework should guarantee efficient economic management, properly embedded in the democratic process. The creation of a monetary union necessitates the setting-up of a new monetary institution, placed in the constellation of Community institutions (European Council, Council of Ministers, European Parliament, Commission and Court of Justice). The establishment of economic union does not require the creation of a new institution, but the formulation and implementation of common policies in non-monetary fields and the co-ordination of policies under the competence of national authorities, require a revision and, possibly, some restructuring of existing Community institutions.

18. The need for a new monetary institution arises because a single monetary policy cannot be decided and implemented independently by different central banks and because decisions concerning day-to-day monetary policy operations must be centralised if they are to respond quickly to changing market conditions. For these reasons the Community's domestic and international monetary policy must be organised in a European System of Central Banks (ESCB). The System could consist of a central institution, with its own balance sheet, and national central banks. At the final stage the ESCB - acting through its Council - would be responsible for formulating the thrust of monetary policy and managing the Community's exchange rate vis-à-vis third currencies. The day-to-day operations conducted at the Community level, possibly involving changes in interest rates and the use of other policy instruments, would be carried out under the responsibility of the Board of the central institution, supported by its own staff. The national central banks would be entrusted with the

implementation of policies at the regional level in accordance with guidelines established by the Council.

The European System of Central Banks, which would embody the Community's monetary order, should rest on the following basic principles:

Structure and organisation

- a federative structure, since this corresponds best to the political structure of the Community (e.g. a European Central Bank Council representing all the central banks in the union);
- a centralised body (Board with its supporting staff) responsible for the implementation of Council decisions as far as they apply at Community level;
- appointment of members of the Board for relatively long periods on an irrevocable basis;

Mandate and functions

[- the mandate of the System must be to maintain the stability of money as the prime objective of the Community's monetary policy. While fulfilling this task, the System has to support the general economic policy of the Community. Stability of the currency in terms of prices must take precedence over exchange rate stability;
- the System will be responsible for the formulation of monetary policy at the Community level, for the co-ordination of policy implementation at the regional level and for the maintenance of a properly functioning payment system;]

or, alternatively

[- a commitment to regulate the amount of money in circulation and of credit supplied by banks and other financial institutions on the basis of criteria designed to ensure non-inflationary economic growth as well as to maintain a properly functioning payment system;]
- the System will be responsible for the formulation of banking supervisory policy at the Community level and co-ordination of banking supervision policies of the national supervisory authorities;

- national central banks remain responsible for policy implementation at the regional level;

Status

- independence of instructions from national governments and Community authorities;
- a proper democratic legitimisation which might be achieved through regular reporting to [a committee of the European Parliament and the Council of Ministers] and through [the European Parliament and the Council of Ministers] participating in the appointment of the members of the Board;
- supervision of the administration of the System independently of the Community bodies, for example by a supervisory council or a committee of independent auditors;
- submission of an annual report by the ESCB to the Council of Ministers and the European Parliament;

Policy instruments

- the instruments available to the System will be specified in its statute, together with a procedure for amending them; the instruments will comprise both regulatory powers and the authority to conduct central banking operations in money and foreign exchange markets;
- strict limitation of lending to all public authorities;
- monetary policy instruments oriented towards a free market economy;

Seat of the institution

- to be decided.

19. The institutional requirements for effective conduct of economic policies should be assessed in the light of the functions which will be performed at the Community level. As noted in the previous section, there are three broad areas in which the Community has to be involved: firstly, the establishment and maintenance of a single market for persons, goods, services and capital; secondly, the formulation and implementation of

common policies aimed at strengthening and balancing the process of market integration; and thirdly, co-ordination of macro-economic policies, in particular with a view to promoting prudent fiscal behaviour, avoiding inappropriate divergences between national fiscal policies and formulating a macro-fiscal policy stance of the Community.

The necessary institutional framework for performing these three tasks is already in place with different, though partly overlapping, functions conferred on the Council, the European Parliament, the Commission and the Court of Justice. In order to ensure a flexible and effective conduct of policies in those economic areas in which the Community is involved, two basic requirements have to be fulfilled: firstly, to the extent that policies are decided and enacted at the Community level, there must be a clear distribution of responsibilities among the existing Community institutions, with due regard to whether decisions relate to the setting of broad policy directions or to day-to-day operations in the light of current developments. Secondly, in those areas in which the Community's role is restricted to the co-ordination of national policies, its task must be guided by a system of rules which are accepted by, and can be applied to, individual member states. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the day-to-day execution of these policies would be in the hands of the Board, a similar allocation of responsibilities between the Council of Ministers and the Commission could be envisaged in the economic field.

In order to be able to carry out their functions within the existing institutional framework, the Community bodies must possess adequate instruments and means. As far as the implementation of the single market is concerned, the necessary procedures and arrangements have been laid down in the Treaty of Rome and the Single Act, conferring upon the Community the legislative, executive and judicial authority to put the internal market programme into effect.

With regard to common policies aimed at strengthening the functioning of the single market, the foundations for a more effective Community role in regional and structural policies have recently been put in place, involving both a doubling of the resources of structural funds and a reorganisation of policies. At a more advanced stage of the process these mechanisms might be further extended and made more effective.

In order to enable the Community to pursue an appropriate macro-economic policy, new procedures, taking due account of the basic principle of subsidiarity, will have to be developed. This applies particularly to the area of public revenue and expenditure where competences will be mixed, with the bulk of the budgetary decisions being made at national level and Community budgetary decisions being confined to the limited expenditures and revenues required for the purpose of common policies. These procedures must define and maintain a fair balance between co-ordination through rules fixing a set of objectives and constraints and discretionary co-ordination adapted to a particular economic situation. This implies a need for both horizontal co-ordination - between member countries and the Commission and the Council - and vertical co-ordination between a member country and the Commission.

The objective of the co-ordination of macro-economic policies is to determine a strategy for growth and employment in an environment of price stability and economic cohesion. For this purpose co-ordination must aim at: defining medium and short-term policy approaches, bearing in mind all their economic and social implications; setting a multi-year framework for national and Community budgetary policies; managing common policies, particularly with a view to improving economic and social cohesion; and determining, in close consultation with the ESCB Council, the Community's exchange rate policy.

The most difficult and most important task in this context is to develop a credible procedure for joint decision-making on the overall stance of fiscal policy, i.e. the size and the financing of the aggregate budgetary position in the Community. In this context the Community must be given the possibility of directly influencing the budgetary policies of individual member countries through a system of rules and by collective decisions. However, given the fact that the ultimate budgetary decision-making power will rest with national parliaments, the system of rules can serve essentially only as a framework for increasing the transparency of the co-ordination process, which, for example through public announcement of limits on budgetary positions, could help to exert greater peer pressure.

While the involvement of the Community in non-monetary policies will be based on the existing institutional setting, it is of paramount importance that the ensuing policy decisions should result in a coherent

and consistent set of measures which clearly signal the Community's policy stance. Without an unequivocal formulation of non-monetary policies, in particular in the fiscal field, the responsibility for macro-economic policy for the Community as a whole would fall virtually entirely to the European System of Central Banks. This would not only cede too great a responsibility to the monetary authorities, it would also leave the Community with only one macro-economic policy tool and therefore significantly impede an effective policy geared to stability and growth.

20. The new Treaty laying down the programme, procedures and organs of the economic and monetary union will create a situation in which the existing Community institutions (European Council, Council of Ministers, European Parliament, Commission, and Court of Justice) will be supplemented by a new institution of comparable status, the European System of Central Banks. Relationships and interactions between these bodies will have to be defined not only in order to construct a consistent institutional framework, but also to ensure an effective procedure of consultation and co-ordination between fiscal and monetary policies. To this end appropriate and regular relations between the existing institutions and the European System of Central Banks must be established which provide for consistent consultation procedures without, however, impinging on the policy responsibilities entrusted to each institution in its own field of economic and monetary management. Such consultation procedures could include participation by the President of the Council and the President of the Commission in meetings of the ESCB Council, and participation by the Chairman of the ESCB Council in meetings of the Council of Ministers. Moreover, the involvement of the European Parliament and national parliaments in the co-ordination process should be strengthened and the European Parliament should be consulted in advance on the stance of economic policy in the Community. The consultation process should include a yearly joint assessment of the overall economic and monetary situation and prospects, and the formulation of a general policy guideline for the year to come. Moreover, the Council of Ministers and the Commission would submit a report each year to the European Council and the European Parliament on the functioning and the status of the economic and monetary union.

MR TURNBULL

Mr Gray to see

**LOBBY PARTY**

The FT has confirmed to me that today's Front Page story arose from the Lobby Party. Philip Stephens said he checked the rules with old hands and was assured he could report what was said provided he did not quote.

I said that I thought the Prime Minister, while recognising that whatever she said and wherever she said it was liable to be reported, would be rather fed up that she could not even go to a party these days without being on duty, as it were.

Anthony Bevins, the Independent, in his single-minded pursuit of the lobby system, is now reported to be doing a small piece tomorrow identifying the Prime Minister as the source of the FT and Telegraph stories.

I don't think we should worry too much about this. There was little new of real substance in what the Prime Minister said last night, set against what she has said in public before and my briefing.

BERNARD INGHAM
January 25, 1989

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# Business confidence hit by curbs on inflation CBI warns

**By Peter Norman,** Economics Correspondent

THE Government's policy of using high interest rates and a strong pound to curb inflation has hit business confidence among British manufacturers and weakened export hopes.

In its latest quarterly survey of industrial trends, the Confederation of British Industry has cast doubt on whether manufacturers will be able to contribute significantly to any lessening this year in Britain's massive current account payments deficit.

However, industrial investment is continuing at a high level, suggesting that companies still hope government policies will succeed in damping consumer demand before having an adverse effect on output and profits.

The CBI's January survey of 1,300 companies, employing about half Britain's manufacturing labour force and responsible for roughly half the country's exports, found more managers were gloomier about the future than at any time since the summer of 1986.

In particular, they were significantly less hopeful about export prospects than in October at the time of the CBI's last quarterly survey.

In the intervening period, bank base rates were raised to 13 per cent from 12 per cent while the pound's trade weighted exchange rate rose by 2.3 per cent and has risen further since.

The number of manufacturers expecting a fall in exports over the next four months has more than doubled.

Paradoxically, there was a modest increase in the number of industrialists expecting an increase in new export orders

# Thatcher stands firm against joining EMS

**By Philip Stephens,** Political Editor

MRS Margaret Thatcher has virtually ruled out full British membership of the European Monetary System during her third term of office despite growing pressure in the European Community for closer monetary co-operation.

She also remains unconvinced that the planned creation of the single European market in 1992 will persuade her to take sterling into the EMS exchange rate mechanism if she wins a fourth term in the election due by the same date.

For the short term, Mrs Thatcher has made it clear to Mr Nigel Lawson, the Chancellor, that efforts to reduce inflation must take priority over the Treasury's concern to stabilise sterling's value against the D-Mark.

The pound's recent rise against the West German currency has not dented her view that it is impossible for the Government to set targets both for inflation and for the exchange rate.

She is said, however, to be extremely angry over recent press reports that she has been at odds with the Chancellor over his strategy for the March budget.

Last year she vetoed an attempt by Mr Lawson to restrict mortgage interest relief to the basic rate of tax, but she is understood to reject completely suggestions that there has been a row over mortgage relief this year.

Mrs Thatcher's opposition to full membership of the EMS is well known but the approach of 1992 appears, if anything, to have hardened her opposition.

Her view is that the relative stability of the system in recent years will be undermined in the run-up to 1992. The greater freedom of capital movements associated with a single market will significantly limit the ability of central banks to "buck" the market.

She also sees the forced response in other EMS countries to the recent rise in West German interest rates as evidence of the inflexibility of the system.

In that context Mrs Thatcher remains sceptical that the Delors Committee of central bankers will be able to come up with concrete proposals to move the Community towards the creation of a single European currency or a Community central bank. The Committee is due to report on its deliberations to the Madrid summit of Community leaders in June.

More generally, Mrs Thatcher is understood to be fairly confident that the recent rises in interest rates are curbing the growth of consumer spending. She is also said to have been heartened by evidence in yesterday's survey from the Confederation of British Industry that investment is still growing strongly.

She has ruled out as impracticable in the short term any move to take mortgage interest payments from the retail prices index. Mrs Thatcher believes they would have to be replaced by some other measurement of housing costs and that would only be possible when the rate of increase in the RPI was slowing rather than accelerating, as at present.

# Wall St and $ rise as Fed pledges to stabilise prices

**Correspondent**

MEASURES aimed at making the police more efficient were announced yesterday by Mr Hurd, the Home Secretary.

Speaking at a Policy Studies Institute seminar, he turned down calls for a Royal Commission on the police and said he did not want to change the basis on which Britain is locally policed.

The measures were:

- Better analysis of information in monitoring how the police use their money, staff, car fleets and buildings;
- Agreeing ways in which police performance can be measured more systematically;
- Agreeing how to identify and adopt good practices;
- Applying the work of outside bodies such as the Audit Commission;
- Encouraging the public to be interested and involved in police work.

Mr Hurd's remarks come at a time when the independent magazine Police Review has come out in favour of a Royal Commission and when elements in the Police Federation are calling for a "great debate" on the changing nature of policing.

A number of independent bodies, such as the Audit Commission and the Policy Studies Institute, have criticised the efficiency of the police, while others have advocated a national police force.

**Sir Darbyshire**, Crime Correspondent, writes: More police are to be detailed to street duties in London both to combat crime and the public's fear of being attacked, Sir Peter Imbert, the Metropolitan Police Commissioner said yesterday.

Announcing his strategy for 1989, Sir Peter also stressed the need for an improvement in policing style to reflect an element of public service".

Sexual assault, mugging, racial attack, child abuse and domestic violence were identified as the types of crime which caused most widespread public concern.

Sir Peter also said: "Increased efforts, locally, nationally and internationally, must be directed at the illicit trade in drugs, particularly in relation to cocaine for which the United Kingdom is seen as a lucrative and growing market."

**Transport Correspondent**

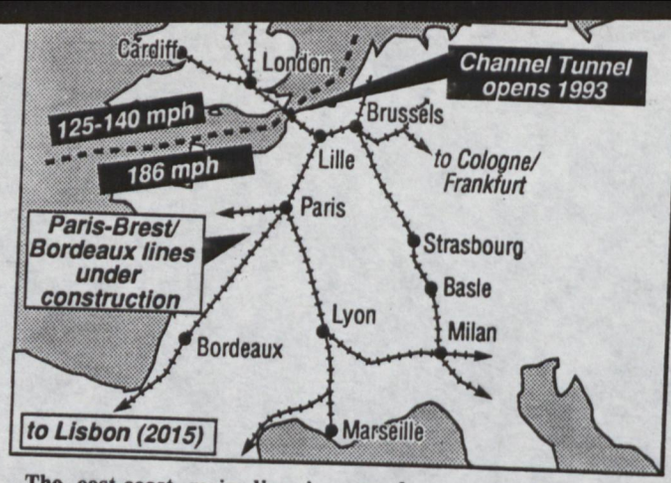
**PLANS for a £60 billion high-speed train network round Europe, with Britain linked via the Channel tunnel, were put to the Common Market Commission in Brussels yesterday by Sir Robert Reid, chairman of British Rail.**

**It would provide services "twice as fast as a car but at half the cost of flying", he claimed.**

**Sir Robert is chairman of the Community of European Railways, which represents the 12 Common Market nations plus Austria and Switzerland.**

**Channel tunnel trains will eventually run on routes such as Manchester-Milan, Edinburgh-Cologne and Glasgow-Marseilles, but their speed in Britain will be restricted by track and signal systems.**

**British Rail is not even sure it will win approval for a 186 mph line across Kent from the Channel tunnel to London, even though the trains will be designed to run at such a speed on the Continent.**




**The east-coast main line is currently being upgraded to operate with 140-mph trains. Electric services are due to start from King's Cross to Leeds next October and should be running to Edinburgh in 1991.**

**Initially they will travel at the same speed as the 125-mph diesels, with the pace being gradually increased.**

**In France, trains are already operating at 168 mph between Paris and Lyons. Even higher speeds are planned on new lines, such as those now being built out of Paris to improve services to Brittany and Bordeaux.**

**France is expanding its high-speed network, with a route from Paris to Lille, Brussels and Cologne.**

**A spur from Lille to the Channel tunnel would enable trains to reach Paris from London in three hours. This could be cut to 2½ hours with a high-speed line in Britain.**

# Thatcher veto on joining EMS

**By George Jones**
**Political Editor**

MRS THATCHER has delivered a new blow to the drive by Mr Lawson, Chancellor, to establish stable exchange rates by ruling out British membership of the European Monetary Fund during the lifetime of this Parliament.

Although the Prime Minister is denying reports that she is at loggerheads with Mr Lawson over increasing tax relief on mortgages in the forthcoming Budget, it became clear last night that deep differences remain between them over the Government's longer-term economic strategy.

Mrs Thatcher has made clear to colleagues that she remains hostile to the EMS, which was the main source of last year's damaging rift between her and Mr Lawson over exchange rate policy.

She is insisting that reducing inflation must take priority over Mr Lawson's desire to stabilise the pound against other European currencies, particularly the German Deutschmark.

Nor does Mrs Thatcher accept that the pressures of the European single market in 1992 will force Britain to join the EMS. She believes that she can hold out against it throughout her third term in power and beyond.

There is no sign either that Mrs Thatcher will back the Chancellor's campaign to remove mortgages from the Retail Price Index, the main indicator of inflation.

He has said it is "daft" for Britain to include mortgages in the RPI, and has blamed them for distorting the inflation rate and making it artificially high.

Mrs Thatcher believes some indicator of housing costs must be included in the RPI. There would also be political problems about taking out mortgage interest at a time when inflation was rising to its highest level for several years.

However, she has moved to quash speculation of a pre-Budget rift with Mr Lawson. According to recent reports, a battle of wills was developing between them, with the Chancellor persuading the Prime Minister to drop a campaign to lift the limit of tax relief on mortgage interest from its current £30,000 ceiling.

In recent weeks, she has overruled the Chancellor and Mr Clarke, Health Secretary, to insist on the inclusion of tax relief on private medical insurance premiums for the elderly in the forthcoming review of the National Health Service.

Tory MPs have been alarmed by reports of a rift between Mrs Thatcher and Mr Lawson, particularly at a time when the economy is under pressure.

The indications are that while the longer-term differences remain, neither Mrs Thatcher nor Mr Lawson wants a row in the run-up to what will be his sixth and possibly final Budget.

● Mrs Thatcher wants to see the Private Member's Bill to introduce new privacy curbs on the press and broadcasters to be given an airing in the Commons.

She has made clear to colleagues that she is sympathetic to the aims of the Privacy Bill introduced by Mr John Browne, Conservative MP for Winchester.

Although Home Office ministers and the Lord Chancellor, Lord Mackay, believe the Bill is unworkable, Mrs Thatcher wants it to get a second reading on Friday so that it can be discussed in detail by MPs.

**By John**
**Trans**
**Corresp**

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COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

22nd December 1988

Note to the members of the Committee

Please find enclosed a copy of the revised Part III of the Skeleton of the final report. It is circulated for discussion at the Committee's next meeting on 10th January 1989.

In agreement with the Chairman the following changes have been made in comparison with the previous draft (CSEMU/5/88 of 9th December 1988):

- removal of the section on "The role of the ECU", in consideration of the fact that the issues relating to a parallel currency and the ECU will be discussed in January on the basis of papers distributed by members of the Committee. The passage of the report dealing with the role of the ECU will be redrafted in the light of this discussion;
- insertion of a section on "The Treaty" (which incorporates the part on "How to proceed" previously contained in Part II.5 of the Skeleton), in accordance with the wish expressed by the Committee to deal with these issues in Part III of the report;
- incorporation of drafting suggestions made by Governor de Larosière concerning his proposal on a European Reserve Fund;
- various editorial amendments;
- preparation of an Annex containing a synopsis of Scenarios A and B.

Gunter D. Baer  Tommaso Padoa-Schioppa

COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

CSEMU/6/88
22nd December 1988
Draft Skeleton of Report

## III. Concrete steps towards economic and monetary union

### 1. Principles governing a step-by-step approach

The request made by the European Council to the Committee to study "concrete steps" reflects the awareness that an economic and monetary union, as outlined in Part II of this Report, is too profound a change in the economic and institutional structure of the Community to be realised at one stroke. Households, corporations, unions and public administrations will need time to adapt their economic behaviour to a new setting. Similarly, it will not be possible to attribute new powers to the Community at once in all fields. Rather, it will be necessary to build on success and to retain the possibility of correcting the course of action in the light of new experiences.

The ambition, but also the complexity, of the final objective of economic and monetary union reinforce the need to define clearly the process which is to lead to European economic and monetary unification. The present diversity in the situations of the different European countries and the variety of areas involved - which go well beyond the economic and monetary sphere - make it necessary to be both clear and precise concerning the path to be mapped out.

The Committee is of the view that, in addition to the general principle of subsidiary explained earlier in this Report, a number of considerations have to be taken into account in designing a step-by-step approach to economic and monetary union.

#### (a) Discrete but evolutionary steps

The process of implementing economic and monetary union will have to be divided into a limited number of clearly defined stages. Each stage will have to represent a significant change with respect to the

preceding one. New arrangements coming into force at the beginning of each stage will gradually develop their effects and bring about a change in economic reality so as to pave the way for the next stage. This evolutionary development within each stage will apply to both functional and institutional arrangements.

(b) Parallelism

Parallel advancement in many interrelated areas is an indispensable prerequisite for the avoidance of imbalances which could cause economic strains and loss of political support for the continuing process of developing the Community into an economic and monetary union. Perfect parallelism, however, at each and every point of time is impossible and could even be counterproductive. Already in the past the advancement of the Community in certain areas has been combined with temporary standstill in others, thus involving a process of only partial parallelism. A certain amount of temporary deviations from parallelism is part of the dynamic evolutionary process of the Community. However, parallelism has to be maintained in the medium term.

(c) Calendar

The Committee considers that the conditions for moving from stage to stage cannot be defined in advance. They depend on too many factors to permit the announcement of explicit deadlines. The timing of, especially, the move to irrevocably fixed exchange rates will have to be judged in the light of circumstances by those responsible, including the Centre for Economic Policy Co-ordination (CEPC) and the European System of Central Banks (ESCB), which will have been created in the second stage. A clear commitment to the final stage, as described in Part II, is however indispensable. There should be a clear indication of the timing of the first step. It should begin when the Directive for the full liberalisation of capital movements comes into force, and there should be a presumption that it will not last beyond the end of 1992.

(d) Indivisibility and gradualism

As has been said above, progress should be both evolutionary and step-by-step. There has to be a balance between the need to make significant steps and the need for gradualism. In achieving this balance it should be recognised that in certain specific areas the ultimate

responsibility for given policy decisions, if not operational duties, has to be clearly defined. Unless it is unmistakable who (i.e. whether national governments or the Community; which organ or institution) has "the last word", there is a risk of market uncertainty and policy conflict.

(e) Participation

There is one Community, but not all the members have participated fully in all its aspects from the beginning. So far this has mainly been the consequence of successive enlargements and, for the EMS, of the decision of some countries not to join the exchange rate agreement. A consensus on the final objectives of the Community, as well as participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date on which some member countries join certain arrangements. The management of each set of arrangements should be the responsibility of those who fully participate in it.

## 2. Two scenarios in three steps

What follows are two scenarios based on the above principles. Each has three distinct steps towards economic and monetary union.

There are many similarities between the two scenarios. In both scenarios:

(i) each stage represents a significant change with respect to the preceding one, and allows for functional and institutional developments within each stage;

(ii) there are parallel developments on the economic and monetary sides;

(iii) no precise calendar is given for moving from step to step, but in both cases stage one would begin with the coming into force of the Directive for the full liberalisation of capital movements;

(iv) step three would include the passing of the definitive "gate" of the "irrevocable locking of parties", which in turn implies the coming into force of a monetary regime in which the responsibility to ensure price stability is exerted jointly through the ESCB. A parallel movement would have to be made on the economic side with an increased role for the CEPC.

The essential differences between the two scenarios primarily concerns step one, in which they take varying views on the questions of (a) indivisibility and gradualism; and (b) participation.

a. Indivisibility and gradualism

Scenario A unambiguously leaves in national hands the full responsibility for monetary decision-making in the first phase. There would be an upgrading of the procedures for policy-co-ordination both in the economic and monetary areas, but the new procedures would not be binding and no change would have to be made in either the Treaty of Rome or in national legislation. Changes in secondary Community legislation would be sufficient.

In scenario B on the other hand, although the responsibility for policy decisions would remain wholly in national hands, the first stage would include from the outset the creation of a European Reserve Fund (ERF). It would have some monetary policy instruments available to it; and would be a training ground for the conduct and formulation of the unique European monetary policy.

b. Participation

While shaped for the specific needs of the exchange rate mechanism of the EMS the first step of scenario A would be consistent with participation of all Member States of the Community. In contrast, in scenario B only those countries which fully participate in the exchange rate mechanism of the EMS would participate in the ERF.

These differences in the first stage of each scenario would entail some slight differences in their second stages. In particular, the second stage of scenario B would include the unwinding of the ERF and its absorption in the ESCB.

Both scenarios see scope for immediate and meaningful measures in both the economic and monetary areas. An important question is whether these should involve immediately some changes in national legislation. It may be thought that the political and institutional debate that would inevitably accompany any act to be taken by national parliaments should be reserved for the "big change" of a new Treaty rather than for an initial step only. On the other hand, it may be considered that this is too constraining and that immediate moves to create an embryo monetary institution should be made, even if these would require changes in national legislation.

Amongst the justifications for a more substantial first step are the following three observations.

- The creation by 1992 of a single European market for capital transactions and financial services is an irreversible process in which European countries have engaged and which requires central banks of countries participating in the EMS to improve monetary policy co-ordination at both internal and external levels.

- The sizable fluctuations within the international monetary system have led central banks to rely more heavily on intervention in the foreign exchange markets on a co-ordinated basis. However, such a policy necessarily has a direct influence on the implementation of domestic monetary policies in these countries. It is therefore necessary and urgent that central banks create means for analysing such issues on a permanent and common basis. It is not only a matter of strengthening the impact of their operations, but also of maintaining the efficiency of their monetary management both at domestic and European levels.

- The tendency of the European central banks to conduct their monetary policies on the basis of differentials vis-à-vis other countries is not necessarily conducive to fostering a monetary policy satisfactory for the Community as a whole. The creation of a common monetary think-tank for analysis and recommendations would make it possible to address this problem better. The deliberations within this monetary think-tank would in effect provide all the central banks with a better basis for setting their own national approaches in a European context while preserving full decision-making autonomy.

## 3. The Treaty

The implementation of economic and monetary union must, as specified in Article 102A of the Treaty, be embodied in a new Treaty. The first step of both scenario A and B could be implemented without a new Treaty. This would however be required for moving from step one to step two.

One procedure would be to conclude a new Treaty each time a political consensus to advance one step has been reached. The advantage of this procedure is that it clearly lays open at each step the political commitment. Its disadvantage is that, as well as being unwieldy and slow, the overall consistency of the process may not be sufficiently safeguarded and sight may be lost of the ultimate objective. It also carries the risk that progress in parallel between the monetary and non-monetary sides would not be respected.

The Committee is therefore in favour of concluding a single comprehensive Treaty which would formulate clearly the essential features and institutional arrangements of economic and monetary union and the steps in which it can be achieved.

The Treaty would facilitate the implementation process through the provision of "organic laws" and enabling clauses and would indicate the procedures by which the decision will be taken to move from stage to stage. Each move would require an appraisal of the situation and [unanimous] political agreement. [Should unanimity be adopted as the rule for all the

stages? Who should participate in the decision? The European Council may have to take the final decision, but what say will the organs of the economic institution and monetary institution respectively have in proposing, or giving advice on, the decision?]

4. Scenario A

A(1) Stage one

(to be enacted in conjunction with the coming into force of the directive on short-term capital movements.)

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted in the Single Act; strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;
- full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for reducing fiscal imbalances, as well as for improving the assessment of the

overall policies of the Member States in the light of both their economic and social consequences and their consistency. The assessment will form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. In particular, the revised 1974 convergence decision will:

- set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines, where appropriate, and medium-term orientations; and a programme for member countries concerned to consolidate their budgetary position [by reducing, where necessary, the central government deficit to no more than X% of GNP over a period of Y years].
- establish a process of multilateral surveillance of economic performance and policies based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger at the Community level recommendations and endorsements to correct national policies;
- provide for the possibility of promoting, where felt appropriate, concerted actions of the member countries;

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage measures will be taken to deal with both the problem of fiscal evasion caused by the full liberalisation of capital movements and discriminatory measures which risk distorting capital flows;
- policy co-ordination: the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be

replaced by a new decision giving the Committee greater authority and visibility and making it the forerunner of the Council of the European system of central banks to be created under the new Treaty. The thrust of the revision of the 1964 Council Decision will be to encourage a strengthening of the co-ordination of monetary policy among all member countries of the Community. To this end, the Committee will be invited to:

- formulate recommendations on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;
- make policy recommendations to individual governments and the Council of Ministers on non-monetary policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public;
- submit an annual report on its activities and the monetary situation of the Community to the European Parliament;
- set up a sub-committee to start regular consultations concerning matters of common interest in the field of banking supervision.

In order to enhance its role in the process of monetary policy co-ordination:

- the Committee's opinions and recommendations would not have to reflect unanimity, but could be established by a qualified majority [determined on the basis of weighted votes?]; the recommendations would not be binding;

- the Committee would be chaired by a Chairman who would be elected for a period of [three] years;
- the Committee would be supported by a permanent Secretariat.

- EMS arrangements: all member countries [in a position to do so] would become participants in the exchange rate mechanism of the EMS with the same fluctuation margins; [the very short-term and the short-term financing mechanisms would be strengthened to make the system better equipped to counter, if needed, destabilising short-term capital movements;] margins of fluctuation would be narrowed from 2.25 to [1]%;
- ECU arrangements: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting and settling any kind of pecuniary obligations. The ECU remains a basket.

A(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy co-ordination (CEPC) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. The Centre would be responsible for the:
  - introduction of progressively more precise rules relating to the size of the budget deficits and their financing;
  - adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
  - joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- enlargement of resources for supporting the structural policies of the Member States and strengthening the Community investment programmes in the fields of research and infrastructures;
- the Centre would also take a view on the exchange rates of the Community vis-à-vis major third currencies.

In the monetary field:

- creation of the European System of Central Banks (ESCB) described in Part II of this Report, with its decision-making organs (Council and Board), staff, balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the present institutional monetary arrangements (EMCF, Committee of Governors and its permanent Secretariat). The ESCB would be initially endowed with a certain proportion of gold and third currencies, previously held as foreign exchange reserves by national central banks, as well as certain contributions of national Community currencies. The initial endowments could be increased over time.

  The tasks of the ESCB would be:

  - to act as a forum for [binding] ex ante co-ordination of national monetary policy targets, with monetary policy still being conducted by national central banks. The co-ordination would take place in the ESCB Council, which in addition, would take over the functions performed in stage one by the Committee of Governors. The ESCB Council would be supported by a permanent staff (which replaces the permanent Secretariat set up in stage one), and the staff would be supervised by the Board;
  - to conduct [limited] exchange market interventions, both in third currencies and within the EMS [in

concertation with central banks whose currencies were used? In accordance with guidelines established by the Council?];

- to represent the Community (together with representatives of national central banks) in international monetary meetings;
- to manage its holdings of third currencies and national Community currencies;
- to administer the short-term and very short-term financing mechanisms;
- to administer the private ECU clearing system;
- [the Chairman of the ESCB Council would attend the ECO/FIN meetings and the ESCB would make an annual report to the European Parliament? the Council?]

[N.B. Owing to the small size of ESCB interventions and to the firm control exercised by its Council (or to the provision to co-ordinate interventions with the national central banks concerned), the impact of these operations on domestic monetary conditions of member countries should be negligible. Its main function would be to provide a signal to the market.]

A(3) Stage three

(The beginning of this final stage would be marked by the definite locking of parities. This should be decided when the economic conditions in the participating countries are judged appropriate. This stage corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.)

In the economic field:

The authority of the Centre for economic policy co-ordination would be extended. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;] The Centre would have the authority:

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to Member States or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange

rate policy; the execution of interventions would be entrusted to [one or ?] national central bank;

- the implementation of the Community's monetary policy would be carried out by the Board of the ESCB in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of the ESCB Council, the Board would be empowered both to impose and vary minimum reserves [in ECU; national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets and to set lending interest rates.

A(4) Last stage

- the ECU replaces national currencies.

5. Scenario B

B(1) Stage one

(to be enacted in conjunction with the coming into force of the directive on short-term capital movements.)

In the institutional field:

- preparation and ratification of the Treaty on the economic and monetary union, with a procedure similar to the one followed for the Single European Act.

In the economic field:

- complete removal of internal barriers and liberalisation of exchanges of goods, services and capital within the Community, according to the single market programme adopted

in the Single Act; strengthening of Community competition policy and of the executive and judiciary authority to identify and sanction infringements of Community law;

- full implementation of the "Brussels package" for reforming and doubling the structural funds, designed to strengthen substantially the ability of Community policies to promote regional development and to correct economic imbalances;
- replacement of the 1974 Council Decision on economic convergence by a new procedure for an increasing degree of budgetary policy co-ordination. The thrust of the revision of the 1974 convergence decision will be to strengthen considerably the possibilities for reducing fiscal imbalances, as well as for improving the assessment of the overall policies of the Member States in the light of both their economic and social consequences and their consistency. The assessment will form the basis for a more effective co-ordination of macro-economic policies, with co-ordination being based on recommendations and carried out with due account of the views of the Committee of Governors. In particular, the revised 1974 convergence decision will:

  - set up a new procedure for budgetary policy co-ordination, with increasingly precise quantitative guidelines, where appropriate, and medium-term orientations; and a programme for member countries concerned to consolidate their budgetary position [by reducing, where necessary, the central government deficit to no more than X% of GNP over a period of Y years];
  - establish a process of multilateral surveillance of economic performance and policies based on macro-economic indicators. Where developments are judged inadequate or detrimental to commonly set objectives, these would trigger at the Community level recommendations and endorsements to correct national policies;

- provide for the possibility of promoting, where felt appropriate, concerted actions of the member countries;
- views about exchange rates of major third currencies should be taken within a Community framework.

In the monetary field:

- capital transactions: the coming into force of the June 1988 directive liberalising monetary movements in July 1990 will establish a regime of complete freedom of capital transactions. During this first stage measures will be taken to deal with both the problem of fiscal evasion caused by the full liberalisation of capital movements and discriminatory measures which risk distorting capital flows;
- EMS and policy co-ordination: following the procedure used in 1978 for the creation of the EMS (a Resolution of the European Council followed by an agreement between central banks), and complemented, as appropriate, by changes in national legislation, a reform of EMS arrangements would be implemented along the following lines:

  - creation of a European Reserve Fund, the ERF, [replacing EMCF when all EMS countries are participants] with the task of intervening in third currencies and eventually in Community currencies intramarginally or at the limit in order to supplement individual action when tensions appear. The ERF's intervention should take place after unanimous agreement has been reached between central bank members. Interventions would serve the two purposes of creating a "training ground" and providing a signal effect through concerted interventions;
  - the resources of the ERF will be provided by a pooling of reserves of the participating central banks that would represent initially 10% of their gold holding and 10% of their foreign currency holdings;
  - the ERF would ensure the management of these reserves;

- the ERF would also set up a Monetary Policy Department which would be in charge of analysing in particular interest rate trends, monetary aggregates and domestic demand. It would thereby facilitate from a Community point of view the concerted management of exchange rates and the co-ordination of monetary policies among the different participating central banks;
- this phase could go along with the creation of a monetary policy co-ordination committee, which would define common surveillance instruments, propose harmonised objectives, and would progressively graduate from an ex post analysis to an ex ante approach to monetary policy adjustment;
- all the EEC's central banks would be eligible to join the ERF. However, membership would be subject to their participation in the exchange rate mechanism and the pooling of a portion of their reserves;
- as a forerunner of the future European Central Bank or the European system of central banks, the management of the ERF would consist of:

    - a Board of Directors which would comprise automatically the Governors of each central bank participating in the ERF; [a member of the Commission would attend the Board meetings];
    - an Executive Committee whose members would be selected by the Committee of Governors on the basis of competence. This Executive Committee would be of a small size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
    - two committees: a Foreign Exchange Policy and a Monetary Policy Committee. They would report regularly to the Committee of Governors and, in the framework of a more active "monitoring", would recommend appropriate action in the field of exchange rates and interest rates;

- two departments: a Foreign Exchange and Reserves Management Department, and a Monetary Policy Department;
- [Accountability? The President of the Executive Committee would attend the ECO/FIN meetings and the ERF would make an annual report to the European Parliament? the Council?]

- ECU developments: removal of regulatory impediments that may prevent market participants using the ECU in setting prices, keeping corporate accounts, and contracting and settling any kind of pecuniary obligations. The ECU remains a basket.
- bank supervision: regular consultations concerning matters of common interest in the field of banking supervision are held within [the European Reserve Fund? the Committee of Governors];

B(2) Stage two

(to be enacted when the new Treaty comes into force.)

In the economic field:

- the Centre for economic policy co-ordination (CEPC) would start operating with a view to promoting convergence and co-ordination of economic policy in the Community. The Centre would be responsible for the:

  - introduction of progressively more precise rules relating to the size of the budget deficits and their financing;
  - adoption of medium-term guidelines for key financial targets and economic programmes in the member states;
  - joint adoption of budgetary objectives, when felt appropriate, as part of a co-ordinated budgetary and economic policy;

- enlargement of resources for supporting the structural policies of the Member States and strengthening the Community investment programmes in the fields of research and infrastructures;
- the Centre would also take a view on the exchange rates of the Community vis-à-vis major hard currencies.

In the monetary field:

- creation of the European System of Central Banks (ESCB) described in Part II of this Report, with its decision-making organs (Council and Board), staff, balance sheet, and legal underpinnings: mandate to preserve price stability, independence, accountability, decision-making procedures. The ESCB would replace the pre-existing institutional monetary arrangements (EMCF, ERF, Committee of Governors). The ESCB would take over the claims and liabilities of the ERF, assume its functions and incorporate its institutional features. Apart from the resources taken over from the ERF, the ESCB would also receive certain contributions of national Community currencies. The initial endowments could be increased over time. In addition to the tasks that had already been entrusted to the ERF in the preceding stage, the ESCB would:

  - act as a forum for [binding] ex ante co-ordination of national monetary policy targets, with the conduct of monetary policy still being left to national central banks. The co-ordination would take place in the ESCB Council (replacing the Board of Directors of the ERF), which would be supported by an [enlarged] permanent staff (incorporating the departments of the ERF), managed by the Board (replacing the Executive Committee of the ERF);
  - conduct [on a larger scale than in the preceding stage] exchange market interventions, both in third currencies and within the EMS, at the discretion of the Board, but

in accordance with guidelines established by the ESCB Council;

- represent the Community (together with representatives of national central banks) in international monetary meetings;
- administer the short-term and very short-term financing mechanisms;
- administer the ECU clearing system;
- [the Chairman of the ESCB Council would attend the ECO/FIN meetings and the ESCB would make an annual report to the European Parliament? the Council?]

[N.B. Owing to the relatively small size of ESCB interventions and to the firm control exercised by the ESCB Council (or the provision to co-ordinate interventions with the national central banks concerned), the impact of ESCB operations on domestic monetary conditions of member countries should be [rather small, negligible]. Its main function would still be to provide a signal to markets.]

B(3) Stage three:

(The beginning of this final stage would be marked by the definite locking of parities. This should be decided when the economic conditions in the participating countries are judged appropriate. This stage corresponds to the final stage described in Part II. It should be observed that the so-called "final stage" is not necessarily a stage beyond which the system would not be susceptible to further evolution. Rather, it is one in which the fundamental requirements of an economic and monetary union would have been fulfilled, albeit in a setting that might be subject to changes and improvements.)

In the economic field:

The authority of the Centre for economic policy co-ordination would be extended. [Following the programme set out in the new Treaty, legislative and executive measures would be taken, at

the Community as well as the national level, leading to the creation of a European Fiscal Framework (EFF). Such a system would cover: essential tax harmonisation; the respective roles of national and Community budgets; "own" resources of the Community budget; the size of budget deficits and their financing;] The Centre would have the authority:

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to Member States or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community structural policies and to Community loans (as a substitute for the present medium-term loans facility).

In the monetary field:

- announcement of irrevocable fixing of parities between the Community currencies;
- concurrently the full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted to [one or ?] national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decisions of

# Synopsis of Scenarios A and B

## SCENARIO A

### Stage One

comes into force at the same time as the full liberalisation of capital movements. Stage one would not involve any transfer of decision-making authority from the Member States to the Community. Policy co-ordination in both the economic and monetary fields would be strengthened. This would be done in existing fora.

### Institutional field

Prepare and ratify a single Treaty on all the steps towards EMU, using a procedure similar to the one followed for the Single European Act.

### Economic field

Complete the 1992 internal market programme and strengthen competition policy:

implement accompanying policies and reform of structural funds to promote regional development and correct economic imbalances.

reinforce budget policy co-ordination through reform of the 1974 Convergence Decision to establish:-

- quantitative guidelines and medium-term orientations;
- a process of multilateral surveillance based on macro-economic indicators;
- the possibility of promoting concerted actions.

### Monetary field

Complete the programme for the full liberalisation of capital movements.

Replace 1964 Decision defining the mandate for the Committee of Central Bank Governors to give them more authority and visibility. The Committee would:-

- formulate recommendations on monetary and exchange rate policy;
- make policy recommendations on non-monetary policy;
- submit an annual report to the Parliament;
- have a regular subcommittee on banking supervision matters;
- make its decisions by qualified majority;
- have a chairman appointed for [3] years and have a permanent secretariat.

Strengthen the EMS, by enlarging participation [by member countries in a position to do so] and narrowing the fluctuation bands.

Remove regulatory impediments to the use of the ECU.

## SCENARIO B

### Stage One

comes into force at the same time as the full liberalisation of capital movements. Stage one would not involve any transfer of decision-making authority from the Member States to the Community. Policy co-ordination in both the economic and monetary fields would be strengthened. A new body, the European Reserve Fund, would be created.

### Institutional field

Prepare and ratify a single Treaty on all the steps towards EMU, using a procedure similar to the one followed for the Single European Act.

### Economic field

Complete the 1992 internal market programme and strengthen competition policy:

implement accompanying policies and reform of structural funds to promote regional development and correct economic imbalances.

reinforce budget policy co-ordination through reform of the 1974 Convergence Decision to establish:-

- quantitative guidelines and medium-term orientations;
- a process of multilateral surveillance based on macro-economic indicators;
- the possibility of promoting concerted actions.

take a view on the exchange rates of major third currencies

### Monetary field

Complete the programme for the full liberalisation of capital movements.

Set up a European Reserve Fund, composed of all Member States fully participating in the ERM.

Tasks:-

- analyse monetary developments, especially interest rate trends, monetary aggregates and domestic demand;
- define common surveillance instruments, propose harmonised objectives and progressively graduate from ex post analysis to an ex ante approach to monetary policy adjustment;
- manage the pooled reserves - 10% of gold and foreign currency holdings;
- intervene on the exchange markets after unanimous agreement between central bank members;
- [make an annual report to the Parliament].

Structure:-

- a Board of Directors comprised of the Governors of all the participating central banks; [a member of the Commission would participate];
- an executive committee of 3-5 members selected by the Board of Governors;
- a foreign exchange policy committee; and a monetary policy committee;
- a small permanent staff.

Remove regulatory impediments to the use of the ECU.

Regular consultations on bank supervision in (the ERF? the Committee of Governors).

## Stage Two

comes into force with the ratification of the Treaty.
In stage two, the final word on the conduct of policy remains with the member states. There is however a transfer of some instruments of policy to the Centre but not of sufficient magnitude to overwhelm national policy decisions.

### Economic field

Center for economic policy co-ordination (CEPC)

Tasks:-

- the progressive introduction of rules relating to the size and financing of budget deficits;
- adoption of medium-term guidelines for key financial targets and economic programmes in the Member States;
- joint adoption of policy measures, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
- economic management of common policies and enlarged structural funds and strengthening Community investment programmes especially in the fields of research and infrastructure;
- to take a view on the exchange rate vis-à-vis major third currencies and other international monetary matters.

Its structure would be based on that of the existing Community institutions.

### Monetary field

European System of Central Banks (ECSB) consisting of the Council, the Board and the staff and the national central banks.

Tasks:-

- act as a forum for [binding] ex ante co-ordination of national monetary policies;
- conduct intervention [in concertation with central banks whose currencies are used? in accordance with guidelines established by the Council?];
- represent the Community in international monetary meetings (together with representatives of National Central Banks);
- administer short and very short financing mechanisms;
- administer the private ECU clearing system.

Structure:-

- Council composed of the Governors of the national central banks and the members of the Board. The Council would meet [every two weeks] and be chaired by [the Chairman of the Board]. A member of the Commission would attend. Decisions would be made by [qualified] majority.
- Board composed of initially 3 members (the number could increase over time) appointed for [8] years by the [European Council]. It would be responsible for day to day management and be supported by its own staff.

## Stage Two

comes into force with the ratification of the Treaty.
In stage two, the final word on the conduct of policy remains with the member states. There is however a transfer of some instruments of policy to the Centre but not of sufficient magnitude to affect national policy decisions.

### Economic field

Center for economic policy co-ordination (CEPC)

Tasks:-

- the progressive introduction of rules relating to the size and financing of budget deficits;
- adoption of medium-term guidelines for key financial targets and economic programmes in the Member States;
- joint adoption of policy measures, when felt appropriate, as part of a co-ordinated budgetary and economic policy;
- economic management of common policies and enlarged structural funds and strengthening Community investment programmes especially in the fields of research and infrastructure;
- to take a view on the exchange rate vis-à-vis major third currencies and other international monetary matters.

Its structure would be based on that of the existing Community institutions.

### Monetary field

European System of Central Banks (ECSB), consisting of the Council, the Board and the staff and the national central banks. The ESCB would absorb the ERF.

Tasks:-

- act as a forum for [binding] ex ante co-ordination of national monetary policies;
- conduct intervention [in concertation with central banks whose currencies are used? in accordance with guidelines established by the Council?];
- represent the Community in international monetary meetings (together with representatives of National Central Banks);
- administer short and very short financing mechanisms;
- administer the private ECU clearing system.

Structure:-

- Council composed of the Governors of the national central banks and the members of the Board. The Council would meet [every two weeks] and be chaired by [the Chairman of the Board]. A member of the Commission would attend. Decisions would be made by [qualified] majority.
- Board composed of initially 3 members (the number could increase over time) appointed for [8] years by the [European Council]. It would be responsible for day to day management and be supported by its own staff.

## Stage Three

The beginning of this stage would be marked by the irrevocable fixing of parities. This will require a shift in the ultimate responsibility for monetary policy decision-making from the periphery to the centre. There will have to be a [corresponding] shift in responsibilities for economic policy-making.

### Economic field

A European Fiscal Framework (EFF) would be created.

In implementing the EFF the tasks of the CEPC would be as follows:-

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility);
- to decide the exchange rate policy vis-à-vis major third currencies.

### Monetary field

The tasks of the ESCB would be expanded to include:-

- full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council; the execution of interventions would be entrusted to (one or?) national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decision of the ESCB Council, the Board would be empowered both to impose and vary minimum reserves [in ECU, national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets.

Its structure would be adapted to increase the number of Board members and enlarge its permanent staff.

## Stage Three

The beginning of this stage would be marked by the irrevocable fixing of parities. This will require a shift in the ultimate responsibility for monetary policy decision-making from the periphery to the centre. There will have to be a [corresponding] shift in responsibilities for economic policy-making.

### Economic field

A European Fiscal Framework (EFF) would be created.

In implementing the EFF the tasks of the CEPC would be as follows:-

- to impose constraints on national budgets to the extent to which this is necessary to prevent imbalances that may threaten monetary stability;
- to make discretionary changes (through a procedure to be defined) in Community resources to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- to propose discretionary changes (through a procedure to be defined) in the level of harmonised taxation rates;
- to apply some form of conditionality to existing Community budgetary transfers and to Community loans (as a substitute for the present medium-term loans facility);
- to decide the exchange rate policy vis-à-vis major third currencies.

### Monetary field

The tasks of the ESCB would be expanded to include:-

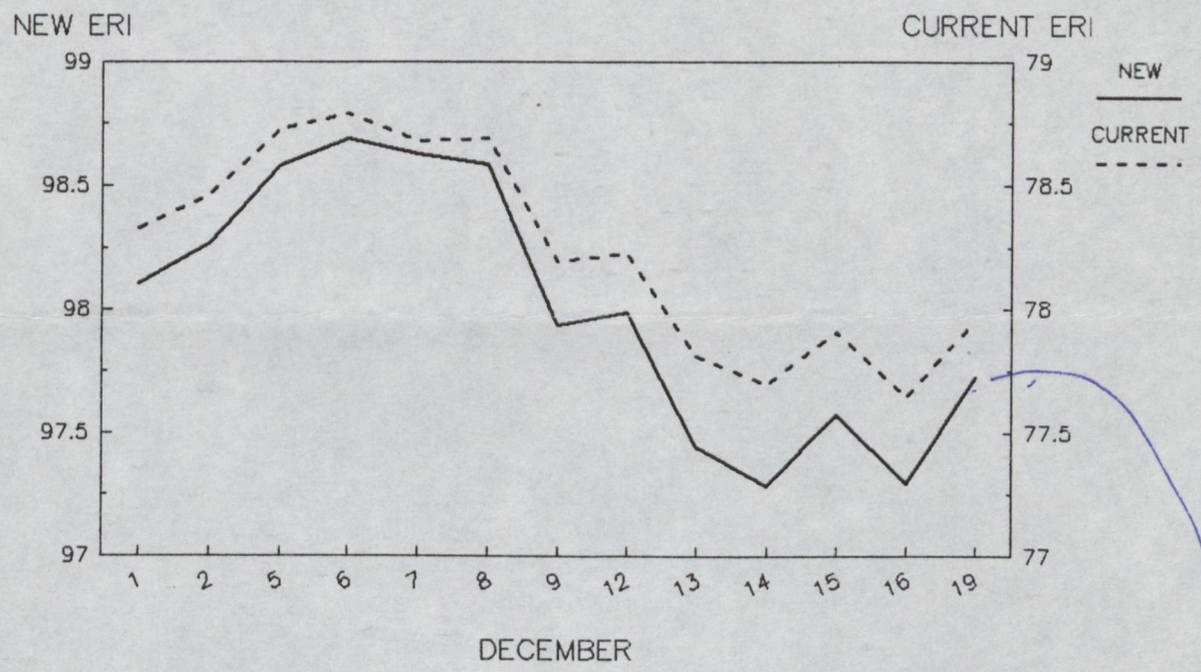
- full responsibility for the formulation of monetary policy in the Community would be attributed to the ESCB Council, replacing the [binding] ex ante co-ordination procedure followed during the preceding stage;
- decisions on exchange market interventions in third currencies would be made entirely under the responsibility of the ESCB Council; the execution of interventions would be entrusted to (one or?) national central bank;
- the implementation of the Community's monetary policy would be carried out by the Board in co-operation with national central banks. In order to be able to influence overall monetary developments in accordance with the decision of the ESCB Council, the Board would be empowered both to impose and vary minimum reserves [in ECU, national currencies, third currencies?] to be held by national central banks and to operate directly in the money markets.

Its structure would be adapted to increase the number of Board members and enlarge its permanent staff.

COVERING **SECRET** Prime Minister 2.

MG EVENING REPORT. 7a

## STERLING ERI: CURRENT AND NEW INDICES




The purpose of this note is to draw attention to the introduction of a new official ERI for sterling which the Bank of England will publish from 3 January 1989.

The change was announced in the November edition of the BEQB and the December edition of the EPR.

Since the change in index has attracted little press attention, IDT have agreed to take appropriate opportunities to remind commentators of the change in the ERI.

Today's closing ERI was 78.0; the new index would have been 77.7. ??

77.7

NPW

N P WILLIAMS

b

**MG EVENING REPORT**

**FOREIGN EXCHANGE MARKETS** — **Monday 19 December 1988**

| Previous close | | Today opening 8.30am | Today close 4.00pm | Xchange $/currency since Plaza | since Paris | since 16 October 1987 |
|---|---|---|---|---|---|---|
| 77.7 | £ERI | 78.0 | 78 | -4.9 | 12.9 | 6.0 |
| 1.8120 | $/£ | 1.8265 | 1.82 | 33.1 | 19.1 | 9.3 |
| 3.1949 | DM/£ | 3.2037 | 3.2105 | -17.8 | 15.0 | 7.1 |
| 1.5385 | ECU/£ | 1.5413 | 1.544 | | | |
| 94.1 | $ERI | - | 93.9 | -32.7 | -9.7 | -6.3 |
| 1.7632 | DM/$ | 1.7540 | 1.764 | 61.9 | 3.5 | 2.1 |
| 124.45 | Yen/$ | 123.95 | 124.1 | 94.1 | 23.7 | 15.1 |

Jan $15.15 Feb $14.82 Mar $14.60 Spot Brent Jan $15.10 Feb $14.77 Mar $14.57

**UK RESERVE TRANSACTIONS ($million)**

(a)

| Today | This month so far | Total since 1 Apr 88 |
|---|---|---|
| 6 | 220 | 5327 |
| 40 | 350 | -1581 |
| **46** | **570** | **3746** |

(a) Spot and forward transactions on a done date basis.

(b)

| | Estimated end-month position * |
|---|---|
| Market intervention | 399 |
| Off-market transactions | 340 |
| **TOTAL** | **739** |
| Net borrowing | 190 |
| Valuation changes | 0 |
| **TOTAL CHANGE IN RESERVES** | **929** |

(b) Spot transactions only on a value date basis, as in published figures.

* On conventional assumption of no further market intervention.

**OTHER COUNTRIES MARKET INTERVENTION ($million equivalent)**

| | | | | | |
|---|---|---|---|---|---|
| Belgium | - | Germany | - | Italy | - |
| Denmark | - | Holland | - | Japan | - |
| France | - | Ireland | - | US | - |

**MARKET COMMENT**

The dollar closed in New York on Friday night slightly lower as markets adjusted their books prior to the weekend and it continued to ease in the Far East on profit taking.Today the dollar has firmed as (mainly US)corporates squared their end-year books.The dollar reached a high of DM1.7657.The markets had a Christmas feel about them and trading was generally thin.
Sterling rose against the Mark today on the back of a firmer dollar and a generally weaker Mark.The Chancellor's comments during the weekend helped to give a firmer tone.

Rates at 6.25PM: $1.8210 DM3.2113 DM/$1.7635 Y/$124.05

Ian Polin

| HONG KONG | Previous | Today | Change |
|---|---|---|---|
| Hong Kong dollar | 7.8085 | 7.8065 | 0.002 |
| Hang Seng Index | 2629.16 | 2611.84 | -17.32 |
| 3 month interbank rate | 9 11/16% | 9 5/8% | DOWN 1/16% |

Terry Smeeton

NAME: I.C.Polin
TEL NO: 270-5556

C

SECRET

**MONEY MARKETS** **Monday 19th December 1988**

**INTEREST RATES**

| | £ Interbank | | Eurodollar | |
|---|---|---|---|---|
| | Today | Change | Today | Change |
| 7 days | 12 3/8 | -1/8 | 8 13/16 | 1/16 |
| 1 mth | 12 13/16 | -1/16 | 9 3/4 | 0 |
| 3 mth | 13 | -3/32 | 9 1/2 | -1/16 |
| 12 mth | 12 3/4 | -1/8 | 9 5/8 | -1/16 |

**BILLS**

| | Today | Change |
|---|---|---|
| 3 Month Treasury Bills | 12 19/32 - 12 17/32 | -1/32 |

**BANK MONEY MARKET OPERATIONS**

| | Purchases £ m | Rates | Discount Rate on Eligible Bank Bills |
|---|---|---|---|
| Band 1 (0-14 days) | | | 12 9/16-7/16 |
| Band 2 (15-31 days) | | | 12 37/64-35/64 |
| Band 3 (32-63 days) | | | 12 43/64-21/32 |
| Band 4 (64-91 days) | | | 12 39/64-37/64 |
| TOTAL BILLS | 0 | | |
| Repurchase | 125 | Due 21 December at 12 3/8-13/16% | |
| Lending | | | |
| TOTAL OPERATIONS | 125 | against surplus | £ 250 m |

**US RATES**

| | 3 month CDs | 10 yr Tsy Bond | 20 yr Tsy Bond |
|---|---|---|---|
| Today/Change | 9.38 0.00 | 9.17 0.00 | 9.13 0.00 |

**STOCK MARKET**

| | FT Ind-Ord | FTSE | Gilt index |
|---|---|---|---|
| Today/Change | 1434.6 -1.4 | 1770.5 -3.2 | 87.20 0.11 |

**MARKET COMMENT**

GILTS/INDEX-LINKED opened firmer with shorts up 1/8, mediums and longs 3/16. Early progress was lost during the day and at the close there was gains of 3/16 through the list including index-linked.

EQUITIES opened firmer, the UK provisional GDP statistics showing growth of 1.2% in Q3 and annual growth of 3.4% produced no reaction. Prices eased and the market closed little changed on the day.

Carl DAVEY

NAME: Carl Davey
TEL NO: 270 4613

SECRET

**GILT-EDGED MARKET** — **Monday 19th December 1988**

Transactions basis, cash values (£m); sales + purchases -

**ISSUE DEPARTMENT: MARKET TRANSACTIONS**

| | Today | December |
|---|---|---|
| Gross sales shorts | 36.9 | 479.1 |
| Gross sales mediums | 9.9 | 218.4 |
| Gross sales longs and undated | 11.1 | 420.7 |
| Gross sales index-linked | 8.0 | 157.8 |
| Part paid calls | | |
| Buying in non-next maturities shorts | -37.7 | -427.7 |
| Buying in non-next maturities mediums | -11.6 | -399.3 |
| Buying in non-next maturities longs | -10.6 | -464.7 |
| Buying in non-next maturities index-linked | -6.6 | -160.5 |
| CRND: Market transactions | | -1.2 |
| TOTAL 'GROSS' SALES | -0.6 | -177.4 |
| Buying in of next maturities | | -20.9 |
| Redemptions | -0.1 | -2.2 |
| TOTAL TRANSACTIONS WITH MARKET | -0.7 | -200.5 |

| | | | | | Future calls |
|---|---|---|---|---|---|
| Sales required to meet | * | target of | £ | m | |

**PRICES/YIELDS OF GILT-EDGED STOCKS**

| | Yesterday's close: Par yield (per cent) | Change from yesterday's close: Price (£/32) | Change from yesterday's close: Yield (%) |
|---|---|---|---|
| Shorts | 10.637 | 5 | -0.04 |
| Mediums | 10.184 | 8 | -0.04 |
| Longs | 9.488 | 10 | -0.03 |

**REPRESENTATIVE STOCKS**

| | Price (£/32): Today | Price (£/32): Change | Yield (per cent): Today | Yield (per cent): Change |
|---|---|---|---|---|
| 8% Treasury 1992 | 92 16 | 4 | 10.74 | -0.04 |
| 8 3/4 Treasury 1997 'C' | 92 1 | 7 | 10.15 | -0.04 |
| 11 3/4% Treasury 2003/07 | 114 2 | -12 | 9.82 | -0.02 |
| 3% Treasury 1992 | 82 8 | 4 | 9.07 | -0.04 |
| 2 1/2% Index-Linked 2016 | 103 6 | 4 | 3.73 | 0.00 |
| 2% Index-Linked 1994 | 95 1 | 1 | 3.77 | 0.00 |

**GILT FUTURES**

| | | Open | Close | Volume |
|---|---|---|---|---|
| Long Contract | March | 95.19 | 95.19 | 8834 |
| Medium Contract | 0 | | | |

NAME: Carl Davey
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EUROPEAN MONETARY UNION

SUMMARY

1. BEREGOVOY SETS FRENCH PRIORITIES FOR EUROPEAN MONETARY UNION IN TERMS OF MANAGING THE ECU AGAINST EXTERNAL CURRENCIES.

DETIAL

2. AT A PRESS CONFERENCE ON 15 DECEMBER BEREGOVOY (MINISTER OF THE ECONOMY) SAID THAT FRANCE'S TOP PRIORITY IN THE DEBATE ON MONETARY UNION WAS TO ARRIVE AT A COMMON MANAGEMENT OF THE ECU AGAINST THE DOLLAR AND THE YEN, ADDING THAT THIS WAS THE POSITION TAKEN BY LAROSIERE ON THE DELORS GROUP BEREGOVOY SAID THAT HE DID NOT THINK PEOPLE WERE YET READY FOR A EUROPEAN CENTRAL BANK WITH ISSUING POWERS. THE MANAGEMENT OF THE ECU WOULD BE THROUGH A FUND - OR A BANK - WHICH WOULD HAVE CONTROL OF PART OF THE EXCHANGE RESERVES OF EACH PARTICIPATING COUNTRY.THE MANAGEMENT OF INTRA-COMMUNITY PARITIES WOULD REMAIN THE RESPONSIBILITY OF NATIONAL CENTRAL BANKS.

LLEWELLYN SMITH

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10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

14 December 1988

Dear Alex,

**DELORS COMMITTEE: ECONOMIC AND MONETARY UNION**

The Prime Minister had a meeting this evening with the Chancellor, the Foreign Secretary and the Governor of the Bank of England to discuss progress in the Delors Committee since it began its work last September and objectives for the next stage.

The Governor reported on the most recent meeting of the Committee on 13 December. This had begun consideration of a draft report to Heads of Government. There was general agreement that the report should be in three parts. The first part would describe the present situation in the EMS. It had not yet been drafted but was not expected to give rise to major problems. The second part would be a definition of the meaning of Economic and Monetary Union (EMU). This had been the main aspect discussed on 13 December. The intention was to describe what EMU would mean in terms of institutional change, were it to be implemented. To a considerable degree, this would simply repeat the conclusions of the Werner Report of 1970, although there would be some differences. This part of the report would not tell Heads of Government what needed to be done, but simply spell out the practical implications of EMU. The third section would examine the case for early institutional change as the basis for progressive steps towards Economic and Monetary Union. The Committee had not yet tackled this aspect seriously.

A number of points were made in discussion:

- the report should make clear that Economic and Monetary Union was not essential for completion of the Single Market. This was probably the view of a majority of the Committee;

- it would be particularly important to ensure that the report spelled out the full implications of EMU in terms of the substantial transfer of power and authority from national institutions. There should be no ambiguity about the scale of the change which would be involved. It would then be much harder for Ministers subsequently to argue in the Council for the adoption of general objectives on EMU, without regard to the very substantial implications for national governments and parliaments;

- it should be our objective to secure the widest possible opposition within the Committee to Treaty amendment. The prospects for this appeared to be quite reasonable. It was particularly useful that Herr Poehl appeared firmly opposed to it. It would be important to bind him to this position;

- even though we might take the above points as read, it was vital that they should be clearly stated and spelled out in the report, so that others could not evade them.

- we should also do everything possible to forge tactical alliances in the Committee. The highest priority must go to holding Poehl to his present views. We could probably look to the Dutch, Belgian and Danish representatives for support. That should be the nucleus of a majority and thus the key to securing the right report;

- at some stage, we might want to put forward proposals of our own on practical steps which could be taken towards closer economic and monetary co-operation, without involving Treaty amendment or major institutional change. But it would be important not to put forward ideas which would alienate Poehl. It was inherently likely that something on these lines would feature in the report: some ideas had already been tabled by the Belgian representative.

Summing up the discussion, the Prime Minister said the Governor should try to ensure that the Committee's report was descriptive and not prescriptive. We wanted to see it spell out clearly the full implications of EMU in terms of loss of national sovereignty. It should also make clear that EMU was not necessary for completion of the Single Market in 1992, and should reject Treaty amendment. Our tactics should be to forge a firm alliance with Poehl, enlarging that to include as many like-minded members of the group as possible. Meanwhile work should be put in hand on a paper setting out a number of practical steps which we could support and which might be put forward in liaison with Poehl. But no decision had yet been taken actually to table such proposals: in any case it was unlikely to be feasible to do so before the February meeting. The Treasury/Bank working group should produce a draft for Ministers to consider.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and John Footman (Office of the Governor of the Bank of England).

Yours sincerely.

(C.D. POWELL)

Alex Allan, Esq.,
HM Treasury.

CC/Blup.

**PRIME MINISTER** 13 December 1988

**DELORS COMMITTEE**

At first sight the four arguments which the Governor plans to put to the Delors Committee seem sensible. (Para 22 (ii)-(iv)).

On reflection, however, I am not so sure. All of my experience with the Bank suggests a considerable hankering for closer European monetary integration (by senior officials).

What is particularly worrying is Para 21 (iv) which mentions the need for the final report to contain "careful recommendations for concrete steps on the basis of firm arguments about fundamental objectives" as well as "the possibility of developing existing co-ordination and co-operations structures". The prospect of being confronted by a report offering concrete steps and careful developments based on existing structures, which I take it are things which would have the Governor's support, is far worse than a report which provides Delorian flights of fancy. If the Report were to be written to the Governor's liking, it could prove a tricky document to handle.

To the extent that you wish to provide a steer to the Governor, the following points might be considered:

(a) Benefits of Monetary Union

The Delors Committee looks like perpetuating a fundamental fallacy of the Werner Report - namely that an EEC monetary union will bring substantial net economic benefits to consumers even after

barriers to trade, capital and labour mobility have been removed.

The Committee needs to spell out the net benefits in great detail. What will almost certainly emerge is that after the benefits of freer trade have been taken into account, those from a further move to monetary union are negligible. The major argument for monetary union, therefore, will be shown to be greater political union.

(b) Implications of an Economic Union

The Delors Report looks like being a highly political document held together by sections of detailed technical analysis of central banking structures and of monetary and exchange rate policy.

One of its weakest areas will almost certainly be the detailed consequences for Brussels which follow from an economic union: in particular the need to co-ordinate regional policy, housing policy (for labour mobility) incomes policy (if only one country decides to have one) taxation of labour employment policies, overall budgetary + funding policy etc. This will show, in a particularly stark form, the extent to which sovereignty is lost through economic union and the likely inefficiencies it will impose on European economies.

The Governor should insist this is spelt out.

(c) Developing Alternatives

In developing alternatives, as much as possible

should be made of the need for:

(i) basic and major revisions to the Treaty of Rome

(ii) the possibilities of a two-tier, three-tier, or greater-tier Europe and how they might relate to each other: this is a particularly fruitful line of country as it isolates the fanatics.

[or pr contra the non-fanatics!]

BRIAN GRIFFITHS

PRIME MINISTER

DELORS COMMITTEE: MEETING WITH THE CHANCELLOR AND THE FOREIGN SECRETARY AND GOVERNOR OF THE BANK OF ENGLAND

I agreed generally with the points in Charles's note. The Bank's paper suggests that we have no plan. We must get one, and quick. I suggest possible elements are as follows:

i) It should be axiomatic that any concrete suggestions made for action within the foreseeable future should not require Treaty amendment.

ii) The Committee's report should be descriptive rather than prescriptive in nature.

Pöhl has, according to paragraph 18 of the Bank's paper, made clear that he is unlikely to sign a report which goes beyond seeking to describe the objective of EMU and the means of moving towards it, without seeking to be prescriptive or mandatory, either in terms of action or time. The Governor should sign up to that approach and continue to make common cause with Pöhl.

If the Committee's report can make clear that the more ambitious forms of EMU require the surrender of political sovereignty and centralisation of decision making, so much the better.

iii) The Governor should actively seek coalitions with like-minded members of the Committee, such as Pöhl. They should concert drafts of passages for the report and be ready to table at the Committee's meetings. This will require lobbying, concertation of positions etc., if we are not to be outflanked by Delors.

iv) We should put forward practical points for carrying forward economic and monetary union within the Community such as:

- further development of the ECU;
- carry forward the approach in the second banking directive and the insurance directives so that there is a real Common Market in all financial services within the Community.

The Bank and the Treasury need to put forward more of these practical points. The question to ask is: what are the practical steps in the financial and economic field which the Community's industry, commerce and ordinary consumer would welcome now?

N.L.W.

N. L. WICKS

13 DECEMBER 1988

MRMABB

SW2APF

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PRIME MINISTER

DELORS COMMITTEE: ECONOMIC AND MONETARY UNION

You have a meeting tomorrow with the Foreign Secretary, the Chancellor, and the Governor to discuss the line which the Governor should take in the Delors Committee. You read the Governor's paper and my brief note over the weekend.

You will find further advice in the folder from Nigel Wicks, Brian Griffiths and Roger Lavelle.

The first point is to ask the Governor to report on today's meeting of the Delors Committee.

The second point is to settle the question whether we should be putting forward specific proposals of our own in the Delors Committee or keeping them for the later phase of discussion between Ministers.

The third point is to commission the Treasury and Bank to work up some proposals. We shall need them eventually, whether now or later.

The fourth point is to devise some advice for the Governor in the next phase of the Committee's work. This will need to cover:

- the nature of the Committee's report. Should it be descriptive or prescriptive?

- the need to bring out the implications of some of the more radical ideas being discussed, in terms of loss of sovereignty and control over national economic policies;

- to secure agreement that whatever is proposed should not require Treaty amendment;

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- to devise some practical steps forward on which we could all agree;

- the need to forge some tactical alliances e.g. with Poehl. This will require some more active lobbying than the Governor has tried so far.

C.D.P

(C. D. POWELL)
13 December 1988

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MR GRAY

DELORS COMMITTEE : PRIME MINISTER'S MEETING ON 14 DECEMBER

The background paper circulated by the Bank of England will be supplemented by the Governor's oral account of the meeting of the Delors Committee on 13 December.

2. The Community will have difficulty enough digesting the policies required to complete the single market. Some members of the Delors Committee recognise this. But for the moment most seem to have forgotten that the task they have been set also had a fairly ignoble origin (Genscher manoeuvres). There also seems so far a pre-occupation with monetary as opposed to economic issues - repeating what paragraph 6 of the background note suggests the Committee identified as a mistake of the past.

3. I am not sure how the Prime Minister will wish to structure the meeting on 14 December. One possibility might be to cover the ground in the attached annotated agenda (paragraph references are to the Bank of England paper).

4. On the question of a possible UK written imput to the Delors Committee, and possibly on some of the other issues identified below, the Prime Minister may conclude that further work should be commissioned.

R G LAVELLE

12 December 1988

DELORS COMMITTEE : ANNOTATED AGENDA

1. Which members are setting the pace? What are they looking for from the study?

Paragraph 7 identifies four possible attitudes. Larosiere looks to be the most serious standard bearer for institutional change, with Pohl leading the pragmatists. Larosiere's kites probably have official approval: Pohl is his own man. Thygesen can probably be discounted, despite the volume of his contributions.

2. What are likely to be the main messages of the report? And the principal hazards?

The final report is expected to contain sections on the final form of EMU and on intermediate steps. Paragraph 17 anticipates overall a descriptive rather than a prescriptive report. This would be in line with a present majority reluctance (paragraph 14) to come out in favour of the Treaty amendment required by any more than modest institutional change. But paragraph 19 notes possible bids for significant commitments; and Larosiere's proposals (paragraph 12) are certain to be fully spelt out.

3. How can we limit the likelihood of a damaging report?

It may be possible to go some way to neutralise the impact of the section on EMU by a comprehensive catalogue of the prior hoops required plus demonstration of the evident lack of agreement on any monetary institution model. Larosiere's apparently phased steps can be demonstrated to require Treaty amendment and to be technically dubious. See also Q.4.

4. **Should we be prepared to advocate our own alternative set of next steps? If so, when? What steps beyond those might be bearable?**

The outcome of the Delors Committee's meeting on 13 December will be relevant here. The Governor's Luxembourg speech set out a possible group of concrete monetary steps following on from the Basle-Nyborg agreement, eg greater use of EMS currencies in Community intervention, along with fuller economic policy coordination through existing institutions. There has been a case for allowing more ambitious debate to lose momentum in the Delors Group while nurturing our own ideas in the Monetary Committee. But to figure in the report these ideas would need to be tabled, (perhaps along with disposal of major heresies, eg the requirement for monetary union before 1992.)

As regards additional measures, Larosiere's proposals include the establishment of a monetary policy department to analyse trends in interest rates, monetary aggregates and demand to underpin coordination of monetary policies. Would creation of some kind of Community research capability be worth consideration? Might other harmless distractions include elaboration of Pohl's monetary principles (Annex, page 2)? As regards closer economic coordination, the ECOFIN Council meeting this week has already agreed that there should in future be informal twice yearly discussions of the economic situation, detailed arrangements to be settled later. In this context, a 1974 Directive already exists on the attainment of a high degree of convergence of economic policies in the Community. Its resurrection and fuller implementation might also be given some ceremonial value.

5. **How will the issue of UK membership of the ERM figure in the debate?**

The question of UK membership of the ERM is touched on in a number of the background papers. It is taken by other participants to be a necessary evolutionary element.

6. **Is subsequent political discussion likely to take place mainly in the French Presidency? If so, can we yet identify the strategic implications?**

Negotiation of the report in the Delors Committee is a self-contained phase. Political discussion will follow, in ECOFIN and at Madrid. It is at Madrid that the danger of a vote for an inter-Governmental conference on a Treaty amendment will first arise. The general expectation is that Madrid will be concerned primarily with procedure, or at least not be the decisive meeting.

Assuming no stomach at Madrid for Treaty amendment, it seems important that a clear UK prescription for first concrete steps should already have been tabled. As regards further activity during the French Presidency, would work on any of the measures already mentioned under Q.4, eg clarification of the terms of reference and work programme of a possible research institute be a tolerable addition? French policy problems elsewhere - withholding tax on savings - will be an additional complication. Conceivably, if blocked, they could make this the excuse for talk of a two-speed Europe.

(1)

PRIME MINISTER

ECONOMIC AND MONETARY UNION

You have a meeting with the Chancellor, the Foreign Secretary and the Governor of the Bank of England next week to review progress in the Delors Committee, and consider where it is likely to lead.

You will wish to see, over the weekend, the attached paper which has been prepared by the Bank of England. It describes the work of the Committee to date. It shows that they are still thrashing around and that no clear majority view has yet emerged. It also shows that Delors himself is way out ahead of most other members of the Committee in his ambitions for the sort of recommendations it should make.

It is not at all clear from the Bank's paper what views the Governor is putting forward on the substance of the issues being discussed. The next phase, in which the Committee will start to draw up its report, will be crucial. Yet the Governor's proposed observations seem to be largely procedural.

There is a difficult choice to be made here. On the one hand, there is a respectable argument for not making specific proposals in the Delors Committee but keeping them for the phase of discussion by Ministers. On the other hand, we may have less of a problem in the long term if we can influence the Committee towards relatively modest recommendations now.

This question needs to be discussed at the meeting. You may also want to commission work on practical proposals which we could put forward either now or later. Such a paper should really be written by the Treasury: but there are some sensitivities since the Governor is serving on the Committee in his personal capacity. You will want to get the Treasury and Bank to work more closely together on the next stage. At the moment, we really don't seem to have a policy.

C D P

C. D. POWELL

9 December 1988

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DELORS COMMITTEE: A PROGRESS REPORT

1 The Delors Committee has now met three times at monthly intervals since its work began in Basle in September. The meetings to date have essentially been devoted to a general consideration of final objectives and what progress towards EMU would entail, but the nature of the paper submitted by Larosiere to the November meeting invited the Committee for the first time to consider a "concrete step". The Committee's work will move definitively into its second phase at its meeting on 13 December, when members will consider two draft sections of their report, covering the final form of EMU and possible intermediate institutional stages. (The first section of the report, still to be written, will describe the present position of EMS and the current state of economic and monetary integration.) Thereafter, Delors envisages four further meetings, of which the last two - in March and April 1989 - would be devoted to finalisation of the report.

2 This paper draws together the various threads running through the discussion to date to provide a thematic, rather than chronological, progress report. It concludes with a brief assessment of the first draft of sections I and II of the Committee's report and notes the line which the Governor proposes to take. The annex contains a summary of the more important proposals for a European Central Bank or Monetary Fund.

The Mandate

3 The Hanover European Council:

(i) recalled that in adopting the Single Act the Member States had confirmed the objective of progressive realisation of EMU;

(ii) decided to examine at the European Council in Madrid in June 1989 the means of achieving EMU;

(iii) decided to entrust to the Delors Committee the task of studying and proposing concrete stages leading towards EMU;

(iv) instructed the Committee to complete its proceedings in good time to enable the ECOFIN Council to examine its results before the European Council meeting.

In her statement following the European Council, to the House of Commons on 30 June, the Prime Minister noted that the Single European Act "... said that we would make progressive steps to the realisation of monetary union ..." but added that "... progress towards it would not necessarily involve a single currency or a European central bank ...".

The definition of economic and monetary union

4 At an informal meeting in Basle in July, Delors indicated that his initial interpretation of the mandate was to focus on the question of a parallel or a common currency; the institution necessary to manage it and the way in which a transition could be made to such a system. The relationship between the system and the institutional structures and political aims of the Community seemed almost an after-thought, not least because the European Council itself had not addressed this question at Hanover. The other members of the Committee made it clear from the outset that the mandate was to consider economic and monetary union, which was a very different matter from a common currency. They argued that simply spelling out mechanical steps towards monetary union would

be no proper response to the mandate, particularly if politicians had not fully grasped what economic union meant. Nor did it make any sense to ask, in effect, "How by setting up a central bank do we create EMU?"

5 In considering the concept of an economic and monetary union, the Committee decided to use as a working definition the structure proposed in the Werner Report of 1970. That Report argued that economic and monetary union implied the following principal consequences:

(i) total and irreversible mutual convertibility of Community currencies, accompanied by the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberalisation of capital movements. This should "preferably" be accompanied by a sole Community currency;

(ii) centralised control of monetary and credit policy throughout the union;

(iii) control of external monetary policy to fall within the jurisdiction of the Community;

(iv) unified capital market policies;

(v) decision-making at Community level on the essential features of budgets, with particular emphasis on variations in their volume and the methods of financing or using the surpluses or deficits;

(vi) shared responsibility for regional and structural policies;

(vii) systematic and continued consultation between the social partners at Community level.

In describing this final objective, the Werner Report argued that economic and monetary union "... will make it possible to realise

an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium ...".

6 Having accepted Werner's outline as a working definition of economic and monetary union, the Committee began its discussions by laying particular emphasis on identifying from the failures of the past the mistakes to be avoided in this present exercise. These were speedily identified as:

(i) an excessive emphasis on monetary union as opposed to economic and monetary union;

(ii) reliance on fine-tuning;

(iii) under-estimation of the effect of external shocks;

(iv) a rigid timetable made unrealistic by the lack of political will.

The Committee concluded from its analysis that gradual and parallel progress in economic and monetary areas was essential.

7 This apparent unanimity tends to obscure the fact that the Committee has still not brought out into the open the extent to which members differ over:

(i) an acceptable timeframe for EMU;

(ii) the extent to which economic union should lead monetary union; and

(iii) the need to resolve at Community level the consequential regional and structural problems.

Some members of the Committee would even argue that the existing degree of economic union in the Community has already caught up with the level of monetary union and that there would be no harm if monetary union were to run ahead of economic union in the next

stage. Others are almost certainly more attracted to the political gains they see in a symbolic monetary union and are inclined to under-estimate the extent to which such a move would be a leap rather than a step. Delors himself has identified four distinctive possible attitudes (a tentative identification of supporters in brackets):

(i) EMU as an essential locomotive for the internal market; (Thygesen)

(ii) an important element to be put in place at a suitable moment; (Lamfalussy, ?Larosiere)

(iii) a crowning element to be adopted as a last step; (Andriessen, Rubio, ?Godeaux); or

(iv) a goal towards which pragmatic progress should/could be made; (Pöhl, Duisenberg, Boyer, Ciampi, Doyle, ?Moreira, Hoffmeyer).

Delors has argued that the European Council recognised EMU as an essentially political decision but one which must be supported by the right technicalities. He has suggested that the European Council Mandate has set an implied timetable and has directed the discussion towards the identification of those elements in economic union that were essential to ensure the smooth working of monetary union.

8 The monetary consequences of a move to economic and monetary union as defined by Werner (the total and irreversible convertibility of currencies, the elimination of exchange rate margins, the irreversible fixing of parity rates and the complete liberalisation of movements of capital) were recognised by the Committee as presenting the European Council with the most difficult political choices at the earliest date. This led the Committee to consider Pöhl's concept of a contrast between "hard" union (broadly the Werner definition) and "soft" union, in which exchange rate changes would continue to be available, effectively permitting a two-speed Europe.

9 The maximalist consequences of hard union compared with the changes implied by a steadily developing soft union produced differences of opinion within the Committee which remain unresolved. Delors' own starting point may have been at the hard end of the spectrum, but it seems unlikely that he will wish to pull too far ahead of the consensus of the Committee. The majority of Governors, and some of the outside members, were very sceptical that an early move to "hard" union was a practical possibility and Delors was obliged to concede that further consideration was needed of Pöhl's concept of a "soft" union, but the Committee have not yet returned to the subject.

Institutional

(i) A Central Bank

10 There has been no disagreement with the intellectual proposition that complete economic and monetary union would clearly require some form of central monetary institution with appropriate independence, accountability and defined functions. There is, however, no clear majority view as to the timing of such an institution nor on the extent to which it could be developed progressively. The Committee has considered various models but has so far not succeeded in defining either the type of institution, or the framework within which it is expected to operate or the nature of its functions. Indeed, Delors himself from the outset appears to have been uncertain whether the European Council had in mind a system of European central banks, a Federal Reserve type system, a single central institution or a "simple" monetary fund.

11 The Committee has set these more or less radical institutional initiatives against the merits of evolution of the present system. This could take the form of such steps as better ex-ante consultation on monetary and exchange rate policies; attempts to pre-coordinate intervention with wider consultation with the smaller countries; diversification of reserves and development of the ECU. The exhaustive discussions leading up to 1987 revisions to the EMS agreement decided at Basle/Nyborg are felt to have provided a clear picture of what can be identified as the

deficiencies of the present system. They have also served as a reminder that almost any further meaningful development will run into legal and institutional difficulties, whether at national or Community level. One area that has not really been addressed is the necessity for convergence of performance rather than for co-ordination of policies in the context of EMU.

(ii) The Larosiere proposal

12 Before the November meeting of the Committee, Larosiere circulated a paper on "first stages towards the creation of a European Reserve Bank". This has been described as a personal paper, but there are clear indications that Beregevoy and his senior officials would not fundamentally disagree with its contents. In this proposal, an amended Treaty would map out the stages leading eventually towards a full Euopean Central Bank. Each stage would need the prior consent of all participating Member States before it could be implemented. The first stage would be the establishment of a European Reserve Fund (ERF) which would concentrate on pragmatic steps: further pooling of reserves, intervention in foreign exchange markets and the co-ordination of monetary policy. ERF intervention would initially, at least, be supplementary to national intervention and could be either in Community currencies or in support of a G7 type policy vis-a-vis third currencies. The reserves of the ERF would be provided by a deposit by Member States of 10% of their gold and foreign currency reserves and an amount of national currency to be derived from a set formula. These deposits would be permanent and not in the form of renewable swaps, in contrast to present EMS arrangements. The ERF would ultimately assume the powers of the existing European Monetary Co-operation Fund once all Member States had joined the ERM and the ERF. A small monetary policy research department would analyse monetary policy developments and trends in the Community, providing support to a Co-ordination Committee which would initially propose harmonised monetary policy objectives for Member States. Co-ordination would eventually become ex-ante rather than ex-post. Monetary policy instruments could also be harmonised in time.

13 Larosiere's proposal for an ERF was seen, and was clearly designed to be seen, as the next step up in the range of possibilities: it would fall a long way short of the more extreme ideas but might provide a base upon which further progress could be built as convergence of economic performance was progressively achieved. It was recognised that Larosiere's proposal was the most concrete to emerge so far (though that may not be saying very much), in that it was designed to build on existing mechanisms, required minimum changes (though not necessarily minor) to existing competences and, being constructed as a Fund rather than as a Bank, avoided a further bout of Community elephantiasis. It was considered by some to be practical, in the sense that it could probably be made to work if such an outcome to the Committee's work was to be desired, but there was considerable scepticism from others (including non-Governor members) over, for example, the extent to which such a Fund would cope in the immediate future with conflicts between domestic monetary and exchange rate policies. There were also felt to be some very difficult technical questions to be considered.

(iii) Treaty Amendment

14 The Committee has rapidly come to the realisation that even the French proposal implies the need to revise the Treaty and it is evident that the majority of the Committee are very reluctant indeed to propose to the European Council that it should contemplate any such step at this stage. This arises out of the view that amendments to the Treaty could not be confined to monetary affairs and that the sort of gradualism which the majority of the Committee claim to favour would become impossible against that background.

15 The Committee has touched on ideas that would develop the role of the Central Bank Governors' Committee within its existing competences but seems to believe that binding ex-ante co-ordination of policies cannot be achieved in that framework. There has been no discussion of a third possibility: that in the event of a fundamental divergence of view, a group of Member States might, despite Article 102a, decide by multilateral agreement outside the Treaty, to set up some form of institutionalised co-ordination of policies, leaving others to join when they could.

A parallel currency or a common currency?

16 This issue has not yet been tackled and will be on the agenda for December.

What sort of report?

17 Although the tone of the Committee's discussions to date has been pragmatic, the underlying range of opinions within the Committee is probably very wide. It nevertheless seems useful to consider what type of report will finally emerge. One clear strand of thinking is that, having been given the mandate, the Committee must produce something that is credible in terms of analysis, does not duck the essential question put to it and offers clear guidance to the European Council on the technical implications of the political choices they may wish to make. There is a clear preference for a descriptive rather than a prescriptive report. Larosiere, for example, envisaged a report which described progressive phrases of monetary convergence, budgetary convergence and finally total economic convergence, but which provided flexibility to take account of the different national levels of performance, savings ratios etc. The report to the European Council could on this view describe the nature of economic and monetary union, the autonomous central bank, the operation of co-ordinated budgetary policies and so on, leaving to Heads of State and Government a decision on how much progress they wish to make. It might also offer them an illustrative menu of the steps that would need to be taken.

18 While discussions to date have revealed wide divergences of opinion, these have not crystallised into disagreement in the absence of a draft report. The Committee has to some extent been able to argue in abstract terms, though majority seems to favour a report that will seek to describe the objective of Economic and Monetary Union and the means of moving towards it without seeking to be prescriptive or mandatory either in terms of action or time. Pöhl, for one, has made it clear that anything that goes beyond this would be almost impossible for him to sign.

19 It seems doubtful that a final report on these lines will satisfy Delors, who is likely to be seeking something that will look and sound at Madrid like a credible step forward, even if its content is almost entirely symbolic. One view is that he will attempt to move the Committee in the direction of a much more ambitious-seeming commitment, which Heads of State and Government could endorse at Madrid next June. This might, for example, seek to put in place by end-June 1990 (when capital liberalisation will essentially be completed) a package consisting of the immediate introduction of a policy co-ordination framework, accompanied by a proposal to amend the Treaty that would bind Member States to move without further Treaty amendments to form monetary union at some future date. This would be defined explicitly in terms of objective economic performance indicators and of progress to be retrieved in economic policy co-ordination. There would probably also be a commitment to provide the legal framework for the introduction of an ERF in due course, somewhat on the lines of Larosiere's proposals.

The first draft report

20 A first draft of the sections of the report dealing with the definition of economic and monetary union and the concrete steps that might be taken towards that goal has been circulated for discussion in Basle on 13 December. In his covering minute, Delors notes that the draft covers several important areas that have not yet been discussed and argues that the draft should be seen as a discussion paper, rather than an initial expression of the Committee's views.

21 This is a wise, if slightly disingenuous, caveat because the report will really not do in this form. It goes considerably beyond the line so far agreed by the members of the Committee in a number of important respects. Most notably, it does not reflect the Committee's reservations on the need/desirability of recommending an amendment to the Treaty and the amount of detail which the report should contain. It frequently adopts a prescriptive tone and embodies a centralising and directive tendency which reads very much like the discredited views of the Werner report. Perhaps its most important deficiency is that it

does not attempt to relate its recommendations to the concept of economic and monetary union by argument but rather relies on assertion. Nor does the draft adequately reflect the feelings expressed by representatives from the newer or economically weaker Member States at the impact on their peripheral economies of a centralised economic and monetary union, irrespective of the resource transfers that might be arranged. The underlying assumption appears to be that a partial economic and monetary union within a Community of twelve Member States is an acceptable prospect. Finally, despite the lip-service paid to the concept of parallelism in economic and monetary union, the paper is heavily biased towards the detail of monetary union. It is probably unfair to say that the draft bears no relation to the discussions held in the Committee so far, but it is hard to resist the view that much of it could have been written before the Committee's discussions began.

22 The earlier part of this paper concluded that the underlying differences of opinion had not yet come to the surface in the Committee's discussion. Reactions to this draft can be expected to show with much greater clarity where the weight of the Committee's opinion lies. For his part, the Governor will make it clear that he is unhappy with both the tone and the content of the draft. He will argue that:

(i) the paper is excessively assertive and needs to be more analytical, stating the problems, analysing the various arguments for and against and, where possible, producing a recommendation that is related to the argument;

(ii) the draft is too prescriptive, giving far too little weight to possible alternatives. The European Council will need to be presented with choices, have the implications of each choice spelt out and be given the arguments for and against. In some cases, the Committee may be able to recommend a particular option, but there will be cases which must be left to the European Council to decide;

(iii) the paper offers far too much detail in areas which have not been justified by the arguments. The detail, if any, will have to flow from an analysis of what is necessary to bring

about economic and monetary union, rather than prescribing the number of monthly board meetings of a putative Federal European Monetary Institution;

(iv) the structure of the report does not follow closely enough to the model earlier set out by the Committee for a paper which built up gradually to careful recommendations for concrete steps on the basis of firm arguments about fundamental objectives. Far too much attention is paid to irrelevant final details, while the possibility of developing existing co-ordination and co-operations structures is almost entirely ignored.

In summary, the Governor will suggest to the Committee that the report should not be grandiose and political, straying into areas that are not within its remit. If the final report is to be credible and useful it must set out all the options and analyse them as carefully and fairly as possible. There will be some areas where the European Council will wish to be left to draw its own conclusions. Where the Committee does feel able to make recommendations, they must be firmly based on the underlying analysis.

BANK OF ENGLAND
8 December 1988

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ANNEX

SUMMARY OF PAPERS ON A EUROPEAN CENTRAL BANK

DELORS' PAPER (CSEMU/4/88)

Delors suggests that the Committee, having considered economic union at its October meeting, should now discuss the "structure and features" of monetary union. Of the problems to be solved in order to establish monetary union, next week's meeting will look at institutional questions and the meeting in December at currency questions. The institutional questions are in turn divided into three groups:

(a) the key features (or principles) of a European Central Bank System (ECBS) [based on Pöhl's paper];

(b) the extent of institutional change necessary to achieve an ECBS and, in particular, the balance of power between an ECBS and national central banks (NCBs) [based on Thygesen's paper]; and

(c) the first steps [based on Larosiere's paper].

This annex summarises these three papers and also the proposals put forward earlier by the Schmidt/Giscard Committee (CMUE). References to page numbers are to the relevant paper.

TWO CONTROVERSIAL ISSUES

Two particularly controversial issues are raised several times in the various papers:

(i) the need for Treaty change at the beginning of the process, setting out the final stage and the steps to it. Pöhl calls this the "package solution" in contrast to the "small coin" of renegotiating the Treaty at each and every step of the process (page 42). Delors also mentions this, of course - as does Thygesen, in approving tones (page 2) and Larosiere (page 8);

(ii) the possibility - albeit as second-best - of a two-tier Europe (Pöhl, pages 39 to 42; Thygesen, page 14).

PÖHL'S PAPER - "FURTHER DEVELOPMENT OF THE EMS"

[This summary concentrates on sections IIa, III and IV of Pöhl's paper. The key points in the earlier sections, which are less relevant to next week's discussion, are:

(i) adjustments to exchange rates will remain necessary for the foreseeable future (page 1);

(ii) monetary integration cannot be reached in a quantum leap or ahead of general economic integration (pages 2 to 3);

(iii) monetary stability must be paramount (page 2);

(iv) in principle national currencies could be retained in a monetary union, but in practice a single currency would be more credible (page 5);

(v) in monetary union, the basic stance of monetary policy must be laid down at Community level. NCBs will only be executive bodies. But harmonisation of NCBs' monetary policy instruments will not be necessary at first. Nor, because of remaining differences in instruments and targets, will it be possible at first to set a Community monetary target (pages 7 to 8);

(vi) because of structural imbalances within the Community it will be necessary to create a "system of fiscal adjustment" - compensation for having renounced devaluations as a means of maintaining competitiveness. The necessary fiscal adjustment would require "an extremely large volume of funds" (page 10);

(vii) monetary union will limit national sovereignty in economic policy. To ensure cohesion of monetary policy there must be a central authority for fiscal/economic policy. Agreement on the appropriate fiscal/monetary policy mix would have to be reached. Overall, "the loss of national sovereignty ... [would be] so serious that it would probably be bearable only in the context of extremely close and irrevocable political union". (pages 7, 12)

Principles of monetary union (pages 12 to 14)

[Also set out in Delors' paper]

(i) mandate of ECBS must be to maintain monetary stability; but has also to support general economic policy;

(ii) the ECBS must be independent of national governments/Community authorities;

(iii) voting power would have to depend on economic importance of member states;

(iv) a federal structure would correspond best to the existing state of national sovereignty;

(v) there would have to be strict limits on the granting of credit to public authorities;

(vi) monetary policy must be managed without recourse to quantitative controls;

(vii) the ECBS should undertake banking supervision.

Models of monetary integration

(i) European Monetary Fund (ie a regional IMF). Would be involved in balance of payments adjustment and financing. But would have no effective say until balance of payments problems arose and thus little influence on the setting of monetary policy until it was too late. Moreover, would mix government and central bank functions. Therefore, not suitable (pages 15 and 16).

(ii) A parallel currency (pages 17-30) [This section is more relevant to the December meeting and therefore only briefly summarised here.] A parallel currency seems an 'elegant' solution - the driving force of monetary integration would be the market, not national governments. But impractical - a parallel currency needs to be able to gradually crowd out domestic currencies, thus gradually transferring monetary power from NCBs to the ESCB. Impossible to achieve symmetrical crowding out (DM more likely to replace ECU than vice versa).

(iii) A European Monetary Authority (pages 31 to 34). This would gradually "harmonise" national currencies. Could be achieved by extending the role of the EC Governors. EC Governors collectively independent - but individual central banks may be dependent on national governments - desirable to gradually reduce this. Need not have operational instruments initially. Gradually move from existing ex-post exchange of information, to ex-ante exchange, to an obligation to consult in advance, to the right of the EMA to issue binding instructions. EMA functions would be to:

(i) co-ordination intervention policy (within the Community and vis-a-vis third currencies);

(ii) at a later stage it could "assume the entire responsibility for influencing exchange rates";

(iii) and, ultimately, responsibility for determining central rates could be transferred from national governments to the EMA/EC Governors.

Transitional problems (pages 35-44)

(i) The extent to which a Treaty change would be necessary depends on the scope of NCBs' existing powers [viz the Hoffmeyer questionnaire].

(ii) Before responsibilities are transferred to an EMA, necessary to ensure adequate allocation of responsibility at Community level [ie need to ensure "principles" mentioned earlier are adhered to - particularly the independence of the EMA].

(iii) Ideally, integration would take place in stages geared towards a clearly formulated final objective - a "package solution" rather than "small coin".

(iv) A timetable for implementation of the stages should not be set (cf Werner and the 1970s).

(v) Existing differences in economic development will probably deter some member states from joining, at least initially. Hence two-tier Europe may be inevitable; only participating countries could have a full say in the decision making.

THYGESEN'S PAPER - "A EUROPEAN CENTRAL BANK - SOME INSTITUTIONAL CONSIDERATIONS"

Thygesen assumes liberalisation of capital movements and fixed but adjustable exchange rates - ie not full monetary union. There are four issues:

1 What decisions need to be taken jointly?

Any international/regional monetary system has to deal with two issues: (i) the method of adjusting to payments imbalances and (ii) the overall thrust of monetary policy in the system. Within the EMS it would be possible to gradually centralise such decisions as a means of moving towards monetary union (pages 2 to 5). More specifically (pages 5 to 8), collective decisions would be needed on:

(i) short-term interest rate differentials (and possibly intervention as well). Co-operation already works well in the EMS (sometimes). But need to avoid public disagreements over policy. By making such decisions collective ones by the ECBS, national/political pressures (and hence public disagreement) may be less.

(ii) intervention policy vis-a-vis third currencies. Third currency distortions often affect Community currencies asymmetrically (eg $ and DM/FFc), causing tensions. Joint intervention would be more efficient. Would require some pooling of reserves.

(iii) changes in reserves held at the ECBS. This would enable the ECBS to exert an influence on the rate of monetary expansion in the Community.

(iv) decisions on realignments (inasmuch as still necessary). Whether it is sensible to 'centralise' such decisions depends on what will convince the markets most. Danger that if decisions are transferred to ECBS from governments, latter might not have to bear opprobrium of initiating realignments and therefore may feel less constrained to follow mutually compatible policies. Transfer of power in this respect should therefore not take place until monetary union is closer to being a reality.

2 Decentralisation of operations

ie how much will implementation, as opposed to formulation, of policy have to be centralised? Three possibilities:

(i) fully decentralised ie ECBS has no operational capacity, relies on NCBs. Too loose - danger of conflicts of interest for individual NCBs between national and Community interests (pages 8 to 9);

(ii) fully centralised. At first, at least, the ECBS would be too inexperienced and have too little influence to be effective (eg FR Board v FR Banks in first years of US system). More suitable at later stages of integration when a common currency is well advanced (p9).

(iii) intermediate ie operational responsibility shared. The recommended solution (p9).

3 Composition of governing bodies (pages 10 to 11)

Could an ECBS, with operational responsibilities and a small staff, be run on the basis of monthly instructions from the EC Governors meeting? Or would a permanent and centralised governing body be needed? A compromise may be best, with the balance of power shifting from EC Governors to the centre as integration improves. Suggests Board (the centre - "nominated at European level")/EC Governors (as it it now)/Open Market Committee (OMC) structure. OMC would have mix of Board and EC Govs members. EC Govs participation on OMC would rotate (5-6 Governors at a time, with major countries having a turn more frequently than minor ones). Rotation is better than "full representation plus weighted voting" [Pöhl's proposal] because latter does not allow Board members to vote without complicating the voting weights.

4 Autonomy and accountability (pages 11 to 14)

Unprecedented to have advanced monetary integration ahead of political/economic integration. Suggests that, at first, the ECBS will inevitably have more autonomy than NCBs do, and only as economic/political integration improves will a close relationship between the ECBS and other Community institutions be possible. In the meantime, various methods for organising "constructive dialogue" between the ECBS and the political authorities are possible:

(i) by regular reporting to ECOFIN;

(ii) by monitoring by the Monetary Committee;

(iii) as in Germany, by allowing non-voting participation in the OMC by representatives of the political authorities (eg finance ministries?)

(iv) by regular reporting to the European Parliament.

The ECBS would be obliged to explain its actions (creating moral pressure) without being subject to control by the political authorities.

In a two-tier system the arrangements would have to be modified - non-participants could not have the same status as participants (p14).

Timetable for change (pages 14 to 15)

(i) management of relations with third countries - possible sooner rather than later;

(ii) relative interest rates - by mid-1990 (ie when most member states will have removed all exchange controls);

(iii) power to decide realignments - by 1992/93 (when the internal market is largely complete). A parallel currency might be actively encouraged at that stage too;

(iv) change from informal co-operation to explicit joint monetary targets - also by 1992/93.

LAROSIERE PAPER: FIRST STAGES TOWARDS THE CREATION OF A EUROPEAN RESERVE BANK

A Treaty amendment could map out the stages leading eventually towards a full European Central Bank (ECB). Each stage would need the prior consent of [all?] member states before it could be implemented. The establishment of a European Reserve Fund (ERF) with progressively greater powers would be a first stage, leading gradually to a European Reserve Bank (an ECB?). An ERF would concentrate on pragmatic steps: pooling of reserves, intervention and monetary policy coordination.

(i) Intervention

An ERF could intervene in the forex markets on behalf of member states both vis-a-vis third currencies (eg G7 type policy) and in Community currencies (marginal and intermarginal ERM intervention). Initially, at least, this would supplement national intervention. The ERF's reserves would be provided by member states/central banks providing an endowment of say 10% of their gold and foreign currency reserves and an amount of national currency to be derived from a set formula. This would be on a permanent basis, not in the form of renewable swaps. The ERF would have additional resources in the form of swap lines with the FRB and the BoJ. These arrangements would be in addition to the existing swaps with the EMCF, but the ERF should ultimately assume the powers of the EMCF once all member states had joined the ERM and the ERF.

(ii) Monetary surveillance

A monetary policy department could analyse monetary policy developments and trends in the Community, providing support to a coordination committee which would initially propose harmonised monetary policy objectives for member states. Eventually, coordination would become ex ante rather than ex post. Monetary policy instruments could also be harmonised in time.

(iii) Structure

The structure of an ERF could be:

(a) Board of Directors (ie central bank Governors with rotating chairmanship)

(b) a permanent Executive Committee (three or four members selected by Governors),

(c) Forex Committee, and

(d) Monetary Policy Committee, to monitor, report and recommend action in their respective areas.

Preconditions for ERF membership would be ERM participation and the partial transfer of reserves.

## SCHMIDT/GISCARD COMMITTEE (COMMITTEE FOR THE MONETARY UNION OF EUROPE)

### Proposed action programme

(i) early Treaty amendment to permit creation of ECBS;
(ii) federal structure for the ECBS;
(iii) development of ECU as a parallel currency;
(iv) greatly strengthened economic co-operation in ECOFIN; and
(v) continued interim development of EMS.

### European Central Bank

(i) Functions:
- to ensure monetary/price stability
- to ensure fixed exchange rates
- to co-ordinate ECU note issue
- to undertake "special responsibilities" on ECU markets
- (possibly, at later stage) banking supervision.

(ii) Structure:
- Supervisory Board (Governors plus Council president etc)
- Board (three governors permanently, plus three rotating)
- Open Market Committee (independent members appointed at European level, plus 6 governors on same principle as the Board; other governors etc in advisory capacity).

### Interim steps

(i) removal of capital controls;
(ii) participation of all currencies in the ERM;
(iii) gradual narrowing of ERM margins;
(iv) market interest rates to be applied to the official ECU;
(v) private ECU developed;
(vi) issue of private ECU securities by public sector;
(vii) collective Community financing of intra-marginal intervention and intervention against the dollar.

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LIBERALISATION OF CAPITAL MOVEMENTS : TAXATION OF SAVINGS

1. WE HEARD LAST NIGHT FROM GEOFFREY FITCHEW (DG XV) THAT ACCORDING TO DIXON (DELORS CABINET) THE MAIN REASON FOR DELORS DECIDING TO POSTPONE PRODUCTION OF A COMMISSION PROPOSAL ON TAXATION OF SAVINGS UNTIL AFTER END-DECEMBER DEADLINE AGREED AT THE TIME OF THE APPROVAL OF THE CAPITAL LIBERALISATION PACKAGE AT LAST JUNE'S ECOFIN, IS NOT SO MUCH BECAUSE THE FRENCH ARE IN SOME DISSARAY AS TO WHAT SORT OF PROPOSAL WOULD BE ACCEPTABLE TO THEM, BUT BECAUSE DELORS HIMSELF - HAVING NOW CAREFULLY READ AND DIGESTED THE DOSSIER - HE HAS COME TO THE CONCLUSION THAT THE WHOLE SUBJECT IS CONSIDERABLY MORE COMPLEX THAN HE HAD EXPECTED.

2. FITCHEW, HOWEVER, THOUGHT THAT FOR DELORS TO DELAY APPROVAL OF THE PROPOSAL BEYOND THE LIFE OF THE PRESENT COMMISSION WOULD BE A MISTAKE. ALL THAT THE COMMISSION WERE COMMITTED TO DO WAS TO PRODUCE A PROPOSAL: ADOPTION OF IT BY THE COUNCIL WAS NOT (REPEAT NOT) A PRECONDITION TO CAPITAL LIBERALISATION, WHATEVER THE FRENCH MIGHT NOW BE SAYING (AND THE FRENCH POSITION WOULD BECOME INCREASINGLY AWKWARD WITH THE PASSING OF TIME). MOREOVER IT MIGHT WELL BE RATHER MORE DIFFICULT FOR DELORS TO WIN APPROVAL OF SUCH A PROPOSAL FROM THE INCOMING COMMISSION.

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BANK OF ENGLAND
LONDON EC2R 8AH

9 December 1988

Paul Gray Esq
Private Secretary to
The Prime Minister
10 Downing Street
London
SW1

Dear Paul

Ahead of the meeting with the Prime Minister on 14 December, I enclose an assessment of the work of the Delors Committee to date. This includes a note on the line to be taken by the Governor at the meeting of the Committee on Tuesday 13 December. The Governor will be able to give a verbal account of that meeting on Wednesday.

I am sending copies of this to Stephen Wall (FCO) and Alex Allan (HMT).

Yours ever

John

J R E Footman
Private Secretary
to the Governor

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DELORS COMMITTEE: A PROGRESS REPORT

1 The Delors Committee has now met three times at monthly intervals since its work began in Basle in September. The meetings to date have essentially been devoted to a general consideration of final objectives and what progress towards EMU would entail, but the nature of the paper submitted by Larosiere to the November meeting invited the Committee for the first time to consider a "concrete step". The Committee's work will move definitively into its second phase at its meeting on 13 December, when members will consider two draft sections of their report, covering the final form of EMU and possible intermediate institutional stages. (The first section of the report, still to be written, will describe the present position of EMS and the current state of economic and monetary integration.) Thereafter, Delors envisages four further meetings, of which the last two - in March and April 1989 - would be devoted to finalisation of the report.

2 This paper draws together the various threads running through the discussion to date to provide a thematic, rather than chronological, progress report. It concludes with a brief assessment of the first draft of sections I and II of the Committee's report and notes the line which the Governor proposes to take. The annex contains a summary of the more important proposals for a European Central Bank or Monetary Fund.

The Mandate

3 The Hanover European Council:

(i) recalled that in adopting the Single Act the Member States had confirmed the objective of progressive realisation of EMU;

(ii) decided to examine at the European Council in Madrid in June 1989 the means of achieving EMU;

(iii) decided to entrust to the Delors Committee the task of studying and proposing concrete stages leading towards EMU;

(iv) instructed the Committee to complete its proceedings in good time to enable the ECOFIN Council to examine its results before the European Council meeting.

In her statement following the European Council, to the House of Commons on 30 June, the Prime Minister noted that the Single European Act "... said that we would make progressive steps to the realisation of monetary union ..." but added that "... progress towards it would not necessarily involve a single currency or a European central bank ...".

The definition of economic and monetary union

4 At an informal meeting in Basle in July, Delors indicated that his initial interpretation of the mandate was to focus on the question of a parallel or a common currency; the institution necessary to manage it and the way in which a transition could be made to such a system. The relationship between the system and the institutional structures and political aims of the Community seemed almost an after-thought, not least because the European Council itself had not addressed this question at Hanover. The other members of the Committee made it clear from the outset that the mandate was to consider economic and monetary union, which was a very different matter from a common currency. They argued that simply spelling out mechanical steps towards monetary union would

be no proper response to the mandate, particularly if politicians had not fully grasped what economic union meant. Nor did it make any sense to ask, in effect, "How by setting up a central bank do we create EMU?"

5 In considering the concept of an economic and monetary union, the Committee decided to use as a working definition the structure proposed in the Werner Report of 1970. That Report argued that economic and monetary union implied the following principal consequences:

(i) total and irreversible mutual convertibility of Community currencies, accompanied by the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberalisation of capital movements. This should "preferably" be accompanied by a sole Community currency;

(ii) centralised control of monetary and credit policy throughout the union;

(iii) control of external monetary policy to fall within the jurisdiction of the Community;

(iv) unified capital market policies;

(v) decision-making at Community level on the essential features of budgets, with particular emphasis on variations in their volume and the methods of financing or using the surpluses or deficits;

(vi) shared responsibility for regional and structural policies;

(vii) systematic and continued consultation between the social partners at Community level.

In describing this final objective, the Werner Report argued that economic and monetary union "... will make it possible to realise

an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium ...".

6 Having accepted Werner's outline as a working definition of economic and monetary union, the Committee began its discussions by laying particular emphasis on identifying from the failures of the past the mistakes to be avoided in this present exercise. These were speedily identified as:

(i) an excessive emphasis on monetary union as opposed to economic and monetary union;

(ii) reliance on fine-tuning;

(iii) under-estimation of the effect of external shocks;

(iv) a rigid timetable made unrealistic by the lack of political will.

The Committee concluded from its analysis that gradual and parallel progress in economic and monetary areas was essential.

7 This apparent unanimity tends to obscure the fact that the Committee has still not brought out into the open the extent to which members differ over:

(i) an acceptable timeframe for EMU;

(ii) the extent to which economic union should lead monetary union; and

(iii) the need to resolve at Community level the consequential regional and structural problems.

Some members of the Committee would even argue that the existing degree of economic union in the Community has already caught up with the level of monetary union and that there would be no harm if monetary union were to run ahead of economic union in the next

stage. Others are almost certainly more attracted to the political gains they see in a symbolic monetary union and are inclined to under-estimate the extent to which such a move would be a leap rather than a step. Delors himself has identified four distinctive possible attitudes (a tentative identification of supporters in brackets):

(i) EMU as an essential locomotive for the internal market; (Thygesen)

(ii) an important element to be put in place at a suitable moment; (Lamfalussy, ?Larosiere)

(iii) a crowning element to be adopted as a last step; (Andriessen, Rubio, ?Godeaux); or

(iv) a goal towards which pragmatic progress should/could be made; (Pöhl, Duisenberg, Boyer, Ciampi, Doyle, ?Moreira, Hoffmeyer).

Delors has argued that the European Council recognised EMU as an essentially political decision but one which must be supported by the right technicalities. He has suggested that the European Council Mandate has set an implied timetable and has directed the discussion towards the identification of those elements in economic union that were essential to ensure the smooth working of monetary union.

8 The monetary consequences of a move to economic and monetary union as defined by Werner (the total and irreversible convertibility of currencies, the elimination of exchange rate margins, the irreversible fixing of parity rates and the complete liberalisation of movements of capital) were recognised by the Committee as presenting the European Council with the most difficult political choices at the earliest date. This led the Committee to consider Pöhl's concept of a contrast between "hard" union (broadly the Werner definition) and "soft" union, in which exchange rate changes would continue to be available, effectively permitting a two-speed Europe.

9 The maximalist consequences of hard union compared with the changes implied by a steadily developing soft union produced differences of opinion within the Committee which remain unresolved. Delors' own starting point may have been at the hard end of the spectrum, but it seems unlikely that he will wish to pull too far ahead of the consensus of the Committee. The majority of Governors, and some of the outside members, were very sceptical that an early move to "hard" union was a practical possibility and Delors was obliged to concede that further consideration was needed of Pöhl's concept of a "soft" union, but the Committee have not yet returned to the subject.

Institutional

(i) A Central Bank

10 There has been no disagreement with the intellectual proposition that complete economic and monetary union would clearly require some form of central monetary institution with appropriate independence, accountability and defined functions. There is, however, no clear majority view as to the timing of such an institution nor on the extent to which it could be developed progressively. The Committee has considered various models but has so far not succeeded in defining either the type of institution, or the framework within which it is expected to operate or the nature of its functions. Indeed, Delors himself from the outset appears to have been uncertain whether the European Council had in mind a system of European central banks, a Federal Reserve type system, a single central institution or a "simple" monetary fund.

11 The Committee has set these more or less radical institutional initiatives against the merits of evolution of the present system. This could take the form of such steps as better ex-ante consultation on monetary and exchange rate policies; attempts to pre-coordinate intervention with wider consultation with the smaller countries; diversification of reserves and development of the ECU. The exhaustive discussions leading up to 1987 revisions to the EMS agreement decided at Basle/Nyborg are felt to have provided a clear picture of what can be identified as the

deficiencies of the present system. They have also served as a reminder that almost any further meaningful development will run into legal and institutional difficulties, whether at national or Community level. One area that has not really been addressed is the necessity for convergence of performance rather than for co-ordination of policies in the context of EMU.

(ii) The Larosiere proposal

12 Before the November meeting of the Committee, Larosiere circulated a paper on "first stages towards the creation of a European Reserve Bank". This has been described as a personal paper, but there are clear indications that Beregevoy and his senior officials would not fundamentally disagree with its contents. In this proposal, an amended Treaty would map out the stages leading eventually towards a full European Central Bank. Each stage would need the prior consent of all participating Member States before it could be implemented. The first stage would be the establishment of a European Reserve Fund (ERF) which would concentrate on pragmatic steps: further pooling of reserves, intervention in foreign exchange markets and the co-ordination of monetary policy. ERF intervention would initially, at least, be supplementary to national intervention and could be either in Community currencies or in support of a G7 type policy vis-a-vis third currencies. The reserves of the ERF would be provided by a deposit by Member States of 10% of their gold and foreign currency reserves and an amount of national currency to be derived from a set formula. These deposits would be permanent and not in the form of renewable swaps, in contrast to present EMS arrangements. The ERF would ultimately assume the powers of the existing European Monetary Co-operation Fund once all Member States had joined the ERM and the ERF. A small monetary policy research department would analyse monetary policy developments and trends in the Community, providing support to a Co-ordination Committee which would initially propose harmonised monetary policy objectives for Member States. Co-ordination would eventually become ex-ante rather than ex-post. Monetary policy instruments could also be harmonised in time.

13 Larosiere's proposal for an ERF was seen, and was clearly designed to be seen, as the next step up in the range of possibilities: it would fall a long way short of the more extreme ideas but might provide a base upon which further progress could be built as convergence of economic performance was progressively achieved. It was recognised that Larosiere's proposal was the most concrete to emerge so far (though that may not be saying very much), in that it was designed to build on existing mechanisms, required minimum changes (though not necessarily minor) to existing competences and, being constructed as a Fund rather than as a Bank, avoided a further bout of Community elephantiasis. It was considered by some to be practical, in the sense that it could probably be made to work if such an outcome to the Committee's work was to be desired, but there was considerable scepticism from others (including non-Governor members) over, for example, the extent to which such a Fund would cope in the immediate future with conflicts between domestic monetary and exchange rate policies. There were also felt to be some very difficult technical questions to be considered.

(iii) Treaty Amendment

14 The Committee has rapidly come to the realisation that even the French proposal implies the need to revise the Treaty and it is evident that the majority of the Committee are very reluctant indeed to propose to the European Council that it should contemplate any such step at this stage. This arises out of the view that amendments to the Treaty could not be confined to monetary affairs and that the sort of gradualism which the majority of the Committee claim to favour would become impossible against that background.

15 The Committee has touched on ideas that would develop the role of the Central Bank Governors' Committee within its existing competences but seems to believe that binding ex-ante co-ordination of policies cannot be achieved in that framework. There has been no discussion of a third possibility: that in the event of a fundamental divergence of view, a group of Member States might, despite Article 102a, decide by multilateral agreement outside the Treaty, to set up some form of institutionalised co-ordination of policies, leaving others to join when they could.

A parallel currency or a common currency?

16 This issue has not yet been tackled and will be on the agenda for December.

What sort of report?

17 Although the tone of the Committee's discussions to date has been pragmatic, the underlying range of opinions within the Committee is probably very wide. It nevertheless seems useful to consider what type of report will finally emerge. One clear strand of thinking is that, having been given the mandate, the Committee must produce something that is credible in terms of analysis, does not duck the essential question put to it and offers clear guidance to the European Council on the technical implications of the political choices they may wish to make. There is a clear preference for a descriptive rather than a prescriptive report. Larosiere, for example, envisaged a report which described progressive phrases of monetary convergence, budgetary convergence and finally total economic convergence, but which provided flexibility to take account of the different national levels of performance, savings ratios etc. The report to the European Council could on this view describe the nature of economic and monetary union, the autonomous central bank, the operation of co-ordinated budgetary policies and so on, leaving to Heads of State and Government a decision on how much progress they wish to make. It might also offer them an illustrative menu of the steps that would need to be taken.

18 While discussions to date have revealed wide divergences of opinion, these have not crystallised into disagreement in the absence of a draft report. The Committee has to some extent been able to argue in abstract terms, though majority seems to favour a report that will seek to describe the objective of Economic and Monetary Union and the means of moving towards it without seeking to be prescriptive or mandatory either in terms of action or time. Pöhl, for one, has made it clear that anything that goes beyond this would be almost impossible for him to sign.

19 It seems doubtful that a final report on these lines will satisfy Delors, who is likely to be seeking something that will look and sound at Madrid like a credible step forward, even if its content is almost entirely symbolic. One view is that he will attempt to move the Committee in the direction of a much more ambitious-seeming commitment, which Heads of State and Government could endorse at Madrid next June. This might, for example, seek to put in place by end-June 1990 (when capital liberalisation will essentially be completed) a package consisting of the immediate introduction of a policy co-ordination framework, accompanied by a proposal to amend the Treaty that would bind Member States to move without further Treaty amendments to form monetary union at some future date. This would be defined explicitly in terms of objective economic performance indicators and of progress to be retrieved in economic policy co-ordination. There would probably also be a commitment to provide the legal framework for the introduction of an ERF in due course, somewhat on the lines of Larosiere's proposals.

The first draft report

20 A first draft of the sections of the report dealing with the definition of economic and monetary union and the concrete steps that might be taken towards that goal has been circulated for discussion in Basle on 13 December. In his covering minute, Delors notes that the draft covers several important areas that have not yet been discussed and argues that the draft should be seen as a discussion paper, rather than an initial expression of the Committee's views.

21 This is a wise, if slightly disingenuous, caveat because the report will really not do in this form. It goes considerably beyond the line so far agreed by the members of the Committee in a number of important respects. Most notably, it does not reflect the Committee's reservations on the need/desirability of recommending an amendment to the Treaty and the amount of detail which the report should contain. It frequently adopts a prescriptive tone and embodies a centralising and directive tendency which reads very much like the discredited views of the Werner report. Perhaps its most important deficiency is that it

does not attempt to relate its recommendations to the concept of economic and monetary union by argument but rather relies on assertion. Nor does the draft adequately reflect the feelings expressed by representatives from the newer or economically weaker Member States at the impact on their peripheral economies of a centralised economic and monetary union, irrespective of the resource transfers that might be arranged. The underlying assumption appears to be that a partial economic and monetary union within a Community of twelve Member States is an acceptable prospect. Finally, despite the lip-service paid to the concept of parallelism in economic and monetary union, the paper is heavily biased towards the detail of monetary union. It is probably unfair to say that the draft bears no relation to the discussions held in the Committee so far, but it is hard to resist the view that much of it could have been written before the Committee's discussions began.

22 The earlier part of this paper concluded that the underlying differences of opinion had not yet come to the surface in the Committee's discussion. Reactions to this draft can be expected to show with much greater clarity where the weight of the Committee's opinion lies. For his part, the Governor will make it clear that he is unhappy with both the tone and the content of the draft. He will argue that:

(i) the paper is excessively assertive and needs to be more analytical, stating the problems, analysing the various arguments for and against and, where possible, producing a recommendation that is related to the argument;

(ii) the draft is too prescriptive, giving far too little weight to possible alternatives. The European Council will need to be presented with choices, have the implications of each choice spelt out and be given the arguments for and against. In some cases, the Committee may be able to recommend a particular option, but there will be cases which must be left to the European Council to decide;

(iii) the paper offers far too much detail in areas which have not been justified by the arguments. The detail, if any, will have to flow from an analysis of what is necessary to bring

about economic and monetary union, rather than prescribing the number of monthly board meetings of a putative Federal European Monetary Institution;

(iv) the structure of the report does not follow closely enough to the model earlier set out by the Committee for a paper which built up gradually to careful recommendations for concrete steps on the basis of firm arguments about fundamental objectives. Far too much attention is paid to irrelevant final details, while the possibility of developing existing co-ordination and co-operations structures is almost entirely ignored.

In summary, the Governor will suggest to the Committee that the report should not be grandiose and political, straying into areas that are not within its remit. If the final report is to be credible and useful it must set out all the options and analyse them as carefully and fairly as possible. There will be some areas where the European Council will wish to be left to draw its own conclusions. Where the Committee does feel able to make recommendations, they must be firmly based on the underlying analysis.

BANK OF ENGLAND
8 December 1988

ANNEX

SUMMARY OF PAPERS ON A EUROPEAN CENTRAL BANK

DELORS' PAPER (CSEMU/4/88)

Delors suggests that the Committee, having considered economic union at its October meeting, should now discuss the "structure and features" of monetary union. Of the problems to be solved in order to establish monetary union, next week's meeting will look at institutional questions and the meeting in December at currency questions. The institutional questions are in turn divided into three groups:

(a) the key features (or principles) of a European Central Bank System (ECBS) [based on Pöhl's paper];

(b) the extent of institutional change necessary to achieve an ECBS and, in particular, the balance of power between an ECBS and national central banks (NCBs) [based on Thygesen's paper]; and

(c) the first steps [based on Larosiere's paper].

This annex summarises these three papers and also the proposals put forward earlier by the Schmidt/Giscard Committee (CMUE). References to page numbers are to the relevant paper.

TWO CONTROVERSIAL ISSUES

Two particularly controversial issues are raised several times in the various papers:

(i) the need for Treaty change at the beginning of the process, setting out the final stage and the steps to it. Pöhl calls this the "package solution" in contrast to the "small coin" of renegotiating the Treaty at each and every step of the process (page 42). Delors also mentions this, of course - as does Thygesen, in approving tones (page 2) and Larosiere (page 8);

(ii) the possibility - albeit as second-best - of a two-tier Europe (Pöhl, pages 39 to 42; Thygesen, page 14).

PÖHL'S PAPER - "FURTHER DEVELOPMENT OF THE EMS"

[This summary concentrates on sections IIa, III and IV of Pöhl's paper. The key points in the earlier sections, which are less relevant to next week's discussion, are:

(i) adjustments to exchange rates will remain necessary for the foreseeable future (page 1);

(ii) monetary integration cannot be reached in a quantum leap or ahead of general economic integration (pages 2 to 3);

(iii) monetary stability must be paramount (page 2);

(iv) in principle national currencies could be retained in a monetary union, but in practice a single currency would be more credible (page 5);

(v) in monetary union, the basic stance of monetary policy must be laid down at Community level. NCBs will only be executive bodies. But harmonisation of NCBs' monetary policy instruments will not be necessary at first. Nor, because of remaining differences in instruments and targets, will it be possible at first to set a Community monetary target (pages 7 to 8);

(vi) because of structural imbalances within the Community it will be necessary to create a "system of fiscal adjustment" - compensation for having renounced devaluations as a means of maintaining competitiveness. The necessary fiscal adjustment would require "an extremely large volume of funds" (page 10);

(vii) monetary union will limit national sovereignty in economic policy. To ensure cohesion of monetary policy there must be a central authority for fiscal/economic policy. Agreement on the appropriate fiscal/monetary policy mix would have to be reached. Overall, "the loss of national sovereignty ... [would be] so serious that it would probably be bearable only in the context of extremely close and irrevocable political union". (pages 7, 12)

Principles of monetary union (pages 12 to 14)

[Also set out in Delors' paper]

(i) mandate of ECBS must be to maintain monetary stability; but has also to support general economic policy;

(ii) the ECBS must be independent of national governments/Community authorities;

(iii) voting power would have to depend on economic importance of member states;

(iv) a federal structure would correspond best to the existing state of national sovereignty;

(v) there would have to be strict limits on the granting of credit to public authorities;

(vi) monetary policy must be managed without recourse to quantitative controls;

(vii) the ECBS should undertake banking supervision.

Models of monetary integration

(i) European Monetary Fund (ie a regional IMF). Would be involved in balance of payments adjustment and financing. But would have no effective say until balance of payments problems arose and thus little influence on the setting of monetary policy until it was too late. Moreover, would mix government and central bank functions. Therefore, not suitable (pages 15 and 16).

(ii) A parallel currency (pages 17-30) [This section is more relevant to the December meeting and therefore only briefly summarised here.] A parallel currency seems an 'elegant' solution - the driving force of monetary integration would be the market, not national governments. But impractical - a parallel currency needs to be able to gradually crowd out domestic currencies, thus gradually transferring monetary power from NCBs to the ESCB. Impossible to achieve symmetrical crowding out (DM more likely to replace ECU than vice versa).

(iii) A European Monetary Authority (pages 31 to 34). This would gradually "harmonise" national currencies. Could be achieved by extending the role of the EC Governors. EC Governors collectively independent - but individual central banks may be dependent on national governments - desirable to gradually reduce this. Need not have operational instruments initially. Gradually move from existing ex-post exchange of information, to ex-ante exchange, to an obligation to consult in advance, to the right of the EMA to issue binding instructions. EMA functions would be to:

(i) co-ordination intervention policy (within the Community and vis-a-vis third currencies);

(ii) at a later stage it could "assume the entire responsibility for influencing exchange rates";

(iii) and, ultimately, responsibility for determining central rates could be transferred from national governments to the EMA/EC Governors.

Transitional problems (pages 35-44)

(i) The extent to which a Treaty change would be necessary depends on the scope of NCBs' existing powers [viz the Hoffmeyer questionnaire].

(ii) Before responsibilities are transferred to an EMA, necessary to ensure adequate allocation of responsibility at Community level [ie need to ensure "principles" mentioned earlier are adhered to - particularly the independence of the EMA].

(iii) Ideally, integration would take place in stages geared towards a clearly formulated final objective - a "package solution" rather than "small coin".

(iv) A timetable for implementation of the stages should not be set (cf Werner and the 1970s).

(v) Existing differences in economic development will probably deter some member states from joining, at least initially. Hence two-tier Europe may be inevitable; only participating countries could have a full say in the decision making.

THYGESEN'S PAPER - "A EUROPEAN CENTRAL BANK - SOME INSTITUTIONAL CONSIDERATIONS"

Thygesen assumes liberalisation of capital movements and fixed but adjustable exchange rates - ie not full monetary union. There are four issues:

1 What decisions need to be taken jointly?

Any international/regional monetary system has to deal with two issues: (i) the method of adjusting to payments imbalances and (ii) the overall thrust of monetary policy in the system. Within the EMS it would be possible to gradually centralise such decisions as a means of moving towards monetary union (pages 2 to 5). More specifically (pages 5 to 8), collective decisions would be needed on:

(i) short-term interest rate differentials (and possibly intervention as well). Co-operation already works well in the EMS (sometimes). But need to avoid public disagreements over policy. By making such decisions collective ones by the ECBS, national/political pressures (and hence public disagreement) may be less.

(ii) intervention policy vis-a-vis third currencies. Third currency distortions often affect Community currencies asymmetrically (eg $ and DM/FFc), causing tensions. Joint intervention would be more efficient. Would require some pooling of reserves.

(iii) changes in reserves held at the ECBS. This would enable the ECBS to exert an influence on the rate of monetary expansion in the Community.

(iv) decisions on realignments (inasmuch as still necessary). Whether it is sensible to 'centralise' such decisions depends on what will convince the markets most. Danger that if decisions are transferred to ECBS from governments, latter might not have to bear opprobrium of initiating realignments and therefore may feel less constrained to follow mutually compatible policies. Transfer of power in this respect should therefore not take place until monetary union is closer to being a reality.

2 Decentralisation of operations

ie how much will implementation, as opposed to formulation, of policy have to be centralised? Three possibilities:

(i) fully decentralised ie ECBS has no operational capacity, relies on NCBs. Too loose - danger of conflicts of interest for individual NCBs between national and Community interests (pages 8 to 9);

(ii) fully centralised. At first, at least, the ECBS would be too inexperienced and have too little influence to be effective (eg FR Board v FR Banks in first years of US system). More suitable at later stages of integration when a common currency is well advanced (p9).

(iii) intermediate ie operational responsibility shared. The recommended solution (p9).

3 Composition of governing bodies (pages 10 to 11)

Could an ECBS, with operational responsibilities and a small staff, be run on the basis of monthly instructions from the EC Governors meeting? Or would a permanent and centralised governing body be needed? A compromise may be best, with the balance of power shifting from EC Governors to the centre as integration improves. Suggests Board (the centre - "nominated at European level")/EC Governors (as it it now)/Open Market Committee (OMC) structure. OMC would have mix of Board and EC Govs members. EC Govs participation on OMC would rotate (5-6 Governors at a time, with major countries having a turn more frequently than minor ones). Rotation is better than "full representation plus weighted voting" [Pöhl's proposal] because latter does not allow Board members to vote without complicating the voting weights.

4 Autonomy and accountability (pages 11 to 14)

Unprecedented to have advanced monetary integration ahead of political/economic integration. Suggests that, at first, the ECBS will inevitably have more autonomy than NCBs do, and only as economic/political integration improves will a close relationship between the ECBS and other Community institutions be possible. In the meantime, various methods for organising "constructive dialogue" between the ECBS and the political authorities are possible:

(i) by regular reporting to ECOFIN;

(ii) by monitoring by the Monetary Committee;

(iii) as in Germany, by allowing non-voting participation in the OMC by representatives of the political authorities (eg finance ministries?)

(iv) by regular reporting to the European Parliament.

The ECBS would be obliged to explain its actions (creating moral pressure) without being subject to control by the political authorities.

In a two-tier system the arrangements would have to be modified - non-participants could not have the same status as participants (p14).

Timetable for change (pages 14 to 15)

(i) management of relations with third countries - possible sooner rather than later;

(ii) relative interest rates - by mid-1990 (ie when most member states will have removed all exchange controls);

(iii) power to decide realignments - by 1992/93 (when the internal market is largely complete). A parallel currency might be actively encouraged at that stage too;

(iv) change from informal co-operation to explicit joint monetary targets - also by 1992/93.

**LAROSIERE PAPER: FIRST STAGES TOWARDS THE CREATION OF A EUROPEAN RESERVE BANK**

A Treaty amendment could map out the stages leading eventually towards a full European Central Bank (ECB). Each stage would need the prior consent of [all?] member states before it could be implemented. The establishment of a European Reserve Fund (ERF) with progressively greater powers would be a first stage, leading gradually to a European Reserve Bank (an ECB?). An ERF would concentrate on pragmatic steps: pooling of reserves, intervention and monetary policy coordination.

(i) Intervention

An ERF could intervene in the forex markets on behalf of member states both vis-a-vis third currencies (eg G7 type policy) and in Community currencies (marginal and intermarginal ERM intervention). Initially, at least, this would supplement national intervention. The ERF's reserves would be provided by member states/central banks providing an endowment of say 10% of their gold and foreign currency reserves and an amount of national currency to be derived from a set formula. This would be on a permanent basis, not in the form of renewable swaps. The ERF would have additional resources in the form of swap lines with the FRB and the BoJ. These arrangements would be in addition to the existing swaps with the EMCF, but the ERF should ultimately assume the powers of the EMCF once all member states had joined the ERM and the ERF.

(ii) Monetary surveillance

A monetary policy department could analyse monetary policy developments and trends in the Community, providing support to a coordination committee which would initially propose harmonised monetary policy objectives for member states. Eventually, coordination would become ex ante rather than ex post. Monetary policy instruments could also be harmonised in time.

(iii) Structure

The structure of an ERF could be:

(a) Board of Directors (ie central bank Governors with rotating chairmanship)

(b) a permanent Executive Committee (three or four members selected by Governors),

(c) Forex Committee, and

(d) Monetary Policy Committee, to monitor, report and recommend action in their respective areas.

Preconditions for ERF membership would be ERM participation and the partial transfer of reserves.

## SCHMIDT/GISCARD COMMITTEE (COMMITTEE FOR THE MONETARY UNION OF EUROPE)

### Proposed action programme

(i) early Treaty amendment to permit creation of ECBS;
(ii) federal structure for the ECBS;
(iii) development of ECU as a parallel currency;
(iv) greatly strengthened economic co-operation in ECOFIN; and
(v) continued interim development of EMS.

### European Central Bank

(i) Functions:
- to ensure monetary/price stability
- to ensure fixed exchange rates
- to co-ordinate ECU note issue
- to undertake "special responsibilities" on ECU markets
- (possibly, at later stage) banking supervision.

(ii) Structure:
- Supervisory Board (Governors plus Council president etc)
- Board (three governors permanently, plus three rotating)
- Open Market Committee (independent members appointed at European level, plus 6 governors on same principle as the Board; other governors etc in advisory capacity).

### Interim steps

(i) removal of capital controls;
(ii) participation of all currencies in the ERM;
(iii) gradual narrowing of ERM margins;
(iv) market interest rates to be applied to the official ECU;
(v) private ECU developed;
(vi) issue of private ECU securities by public sector;
(vii) collective Community financing of intra-marginal intervention and intervention against the dollar.

Prime Minister (4)

You may like to look at this interesting speech by the Governor of the Bank of England.

CDP 25/xi

THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM

... I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train - principally but not exclusively in the Committee formed under President Delors - about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on "concrete stages" is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market - "1992" for short - and the exchange rate mechanism of the EMS.

- one, that 1992 will destroy exchange rate stability by removing one of the major defences of the ERM - namely exchange controls; and
- the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much greater degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate - and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants - Germany and the Netherlands - had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; whilst in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years - a period which has encompassed considerable external

turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be coordinated. A fair degree of coordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case - there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that coordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgment, is "no". The purpose of the internal market programme is to remove barriers and distortions to trade - in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price - that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies - something that is not always the case at the moment in the Community with,

for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency - provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer term decisions - including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur within countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; between member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences - often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even promote currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of

convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union, as a premature obsession with that process that is likely to be an impediment to the internal market.

The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the economic challenges that will have to be faced. It is also worth spelling out what monetary union - a single currency - would involve in political terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy; and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur between countries, in the same way as today they exist within countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes - means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the commitment of governments and electorates to the long term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal - topical though it may be to investigate the details of a European currency or a European central bank - but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

The decision is a difficult one. I would not deny that the existing participants have on the whole been happy with their choice; but it has to be said that many small, open economies started from a position of enjoying little effective policy freedom, or saw benefits in the discipline of alignment with the counter-inflationary deutschemark. This latter factor was perhaps particularly important in the early years of the ERM's life, when inflation was high. Now that inflation is less of a problem, one can see emerging, in the debate about the symmetry or otherwise of adjustment under the mechanism, some of the concerns that have influenced the United Kingdom over the years.

I have to say that it is still not obvious that the conditions are yet right for United Kingdom participation in the ERM. As you well know, our domestic monetary policy is at present responding to the excessive growth of domestic demand during the course of this year, and to the inflationary pressures that accompanied

it. The main objective of policy is to exert steady downward pressure on inflation. Interest rates play an important part in this process and we while we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation.

From the viewpoint of the ERM itself I think it still also true to say that the involvement of sterling in the mechanism at this stage would introduce a new element of complexity into its operation.

What then are the practical steps open to us? I suggest that we should concentrate first on promoting the real economic integration of the Community. The success of the single market programme will be important, of course, but even after 1992 we must expect to see further steps towards integration, and the markets will need time to take full advantage of the opportunities created. In many if not all member states there are instances of structural imperfections and rigidities which make markets work less than perfectly and which can hinder adjustment to changing circumstances; this tends to be true of labour markets in particular. If the Community is to work smoothly as a single market, such structural problems will need to be dealt with.

Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy coordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

There are a number of further practical steps that could be considered. For example, there might be greater use of EMS currencies in intervention within the Community. The ECU might have a useful role to play here, as markets in it develop; the impact of a country's intervention in ECUs upon relative exchange rates in the rest of the EMS will be muted by the wide spread of currencies in the ECU basket. But such issues can be controversial, and it cannot be denied that, even now, there are differences between ERM participants on the appropriate course of monetary and exchange rate policies. These are genuinely held differences which will not easily be resolved. One should perhaps not be too surprised that it is proving difficult to agree the precise terms of a common policy in regard to the ERM; and it

underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an "exogenous shock" for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major pre-occupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and has been continued at summit meetings and meetings of Finance Ministers and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

Tonight is not the occasion to speculate where the Plaza-Louvre process of policy co-ordination and exchange rate management is leading. Some siren voices regard it as wholly misconceived. Others hanker after a return to a Bretton Woods type system, and are encouraged by the successes of the ERM to hope that this is no longer so fanciful an idea as it may have seemed only a few years ago. Still others believe we are heading for a tripolar currency system based on a US dollar zone, a Japanese Yen zone and the EMS.

What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short-term

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.

CONFIDENTIAL

FILE KK

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

23 November 1988

14/12

**EUROPEAN COMMUNITY: DELORS COMMITTEE**

As you know, the Prime Minister is holding a meeting in December to consider progress in the Delors Committee on economic and monetary union in Europe. It might be helpful if the Treasury were to prepare a short paper for the meeting, either as a brief for the Prime Minister or to be available to all the participants in the meeting. I should be grateful if you could put this in hand.

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

CONFIDENTIAL

RG

RA – EMS file

Prime Minister [2]

You will wish to see.
Generally very helpful.

RLG
17/11

Agreed MF

FOR RELEASE ON
DELIVERY AT 5.00 PM GMT

Speech given by

**THE RT HON ROBIN LEIGH-PEMBERTON**
**GOVERNOR OF THE BANK OF ENGLAND**

at the 1988 Forex Conference
of the Forex Club, Luxembourg
on Tuesday 15 November 1988

**THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM**

... I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train - principally but not exclusively in the Committee formed under President Delors - about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on "concrete stages" is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market - "1992" for short - and the exchange rate mechanism of the EMS.

- one, that 1992 will destroy exchange rate stability by removing one of the major defences of the ERM - namely exchange controls; and

- the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much greater degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

1988-11-10 11:00 BANK OF ENGLAND - GFD 01 001 7000 P.07



The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate - and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants - Germany and the Netherlands - had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; whilst in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years - a period which has encompassed considerable external

turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be coordinated. A fair degree of coordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case - there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that coordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgment, is "no". The purpose of the internal market programme is to remove barriers and distortions to trade - in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price - that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies - something that is not always the case at the moment in the Community with,

for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency - provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer term decisions - including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur within countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; between member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences - often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even promote currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of

convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union, as a premature obsession with that process that is likely to be an impediment to the internal market.

The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the economic challenges that will have to be faced. It is also worth spelling out what monetary union - a single currency - would involve in political terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy: and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur between countries, in the same way as today they exist within countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes - means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the commitment of governments and electorates to the long term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal - topical though it may be to investigate the details of a European currency or a European central bank - but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

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Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy coordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

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underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an "exogenous shock" for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major pre-occupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and has been continued at summit meetings and meetings of Finance Ministers and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

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What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short-term

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.

SRWBQF

CONFIDENTIAL AND PERSONAL

PRIME MINISTER

ECONOMIC AND MONETARY UNION

You have had sporadic accounts from the Chancellor about the work of the so-called Delors group discussing economic and monetary union and the European Central Bank. Poehl has put in quite a sensible paper drawing a distinction between "hard" and "soft" economic and monetary union and recommending the latter, which would fall well short of anything like a European Central Bank. Delors himself is pressing much more far-reaching ideas which would involve transferring substantial powers over economic policy from member states to the Community and the establishment of new institutions. Work has started on the first draft of a report to be considered at the meeting in December.

I understand that our input is very limited. Given that the United Kingdom is not a full member of the ERM, which already sets us slightly apart from the majority of others in the Group, our passivity could imply that we are standing aside from the exercise and can therefore be disregarded. The risk is that we shall end up in unproductive isolation with the rest being dragooned by Delors into support for proposals which we do not like. One way to avoid this would be to come forward with further practical proposals of our own. The City should be able to produce ideas; and I understand that the Treasury are now compiling some.

I think it would be useful if you were to have a discussion with the Chancellor, the Governor and perhaps the Foreign Secretary (although beware of it looking like an in EMS discussion) in December. Agree that I should arrange this?

C.D.P

Yes ms

(C. D. POWELL)
28 October 1988

CONFIDENTIAL AND PERSONAL

file ecu

1) PG o/r
2) file

cc HMT.

10 DOWNING STREET
LONDON SW1A 2AA

*From the Private Secretary*

15 August 1988

I am writing, in Paul Gray's absence on leave, to acknowledge your letter and enclosure of 11 August.

I shall ensure that he sees this on his return.

(P.A. BEARPARK)

Sir Alan Walters

August 11, 1988

Mr. Paul Gray
10 Downing Street

Dear Paul,

I think you (and the Treasury!) should be aware of Roland Vaubel's comment on the EMS. It is attached.

Yours sincerely,

Alan Walters

Attachment

1. ack
2. cc Tsy
3 pgs or.

Alan Walters
with kind regards
Roland Vaubel

Roland Vaubel

Symposium "New Institutional Arrangements for The World Economy", Konstanz, July 1987
forthcoming 1988 in: H.-J. Vosgerau (Ed.), Springer.

# Comment on "The European Monetary System: A Regional Bretton Woods or an Institutional Innovation?" by Manfred Wegner

Manfred Wegner's description and appraisal of the European Monetary System (EMS) shows only one side of the coin: its success in reducing exchange rate fluctuations among the member currencies participating in the exchange rate mechanism (ERM). What is the other side of the coin? Let us compare the years before and after the establishment of the EMS.

1. Nominal and real exchange rate variations vis-à-vis (eight) other major OECD currencies have on average increased more for the ERM currencies than for the other OECD currencies or the other European OECD currencies (Ungerer et al., 1986, Tables 22 and 25).
2. Nominal effective exchange rate variations have on average decreased less for the ERM currencies than for the other European OECD currencies (Ungerer et al., 1986, Table 28).[1)]
3. The average annual rate of depreciation vis-à-vis the DMark has on average decreased less for the ERM currencies than for other major European OECD currencies (calculated from Lehment, 1987, Table 2 a).
4. Expected exchange rate changes as proxied by the standard deviation of long or short term interest rates have increased among the ERM currencies; they have grown a little less, but since 1979 have been larger, than among the other major OECD countries (Ungerer et al., 1986, Tables 43 and 44; Harbrecht, Schmid, 1987, Figures 12 and 15).

1) This cannot be explained by the fact noted by Wegner (p. 14) that "a number of European countries such as Austria and Switzerland are quasi-members of the EMS, and others such as the United Kingdom have tacitly accepted exchange rate targeting in recent years".

5. The weighted average of the inflation rates decreased much more slowly, and in 1986 was still a little higher, in the ERM countries than in the rest of the OECD (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1; 1985, Figure 4; Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 3). It also decreased more slowly in the EMS than in the other European OECD countries although it is still lower in the former than in the latter group (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1).
6. If the seven years before and after the establishment of the EMS are compared, the standard deviation of inflation rates shows an increase among the ERM currencies but a decrease among the other major OECD currencies (Collins, 1987, Table 2). Over the whole life of the EMS, the dispersion of inflation rates has also been much larger among the ERM currencies than among the major OECD currencies (Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 5; de Grauwe, 1985, Figure 3). For the more recent past, this is not true any longer (Collins; Harbrecht, Schmid, ibid.) but there remain the fact that inflation convergence took longer in the EMS than in the rest of the OECD.
7. From December 1978 to December 1985, bid-ask spreads vis-à-vis the DMark increased for the average of ERM currencies. and they increased more for the ERM currencies than for an average of other major European OECD currencies (Le' 1987, Tables 4a and 4b).
8. Since the establishment of the EMS, all old member EEC[1]) have experienced larger growth rates in the with non-ERM countries than with other ERM coun Grauwe, 1985, Table 2).

1) As de Grauwe points out, this is not tru Ireland which joined the EC customs uni and may still have been benefitting f trade creation.

9. Real growth of investment and GDP was much slower in the ERM countries than in the other OECD countries; compared with 1973-78, it declined more in the ERM-countries than in the other major OECD countries; in the other European OECD countries, investment has even increased (de Grauwe, 1987, Table 1).[1)]

To sum up: the exchange rate mechanism of the EMS does not seem to have contributed to reducing nominal effective exchange rate variations, inflation and inflation differences of the member currencies, or to increasing intra-ERM trade, investment and growth in the member countries.

The EMS exchange rate arrangement is a cartel of national money producers with a price leader. Cartels are inherently unstable; ceteris paribus, they raise price (here: the price of holding money) and reduce the output (here: real money balances). The EMS money supply cartel is neither a necessary nor an efficient step on the way to a common European currency.

Whether such a single European currency should be "the final objective of the Community", as Wegner (p. 29) suggests, is an open question to which politicians and economists cannot know the answer. It depends on the trade-off between price level stability and transaction costs. As I have argued elsewhere (Vaubel 1987), only individual money users possess the knowledge and incentive required to make that choice. The optimal way of finding out whether currency union is efficient and, if so, of bringing it about is unrestricted currency competition or "choice in currency" (Hayek 1976). The European Currency Unit (ECU) can be instrumental in this process, especially if its weights are permitted to respond to revealed currency preferences (Vaubel 1987).

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1) "The disinflationary stance and the high real interest rates of the 1980s" emphasized by Wegner (p. 26) do not explain this difference, since disinflation was faster in the other OECD countries.

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**Table 22. Variability of Bilateral Nominal Exchange Rates Against Non-ERM Currencies, 1974–1985[1]**

| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | Average 1974–78 | Average 1979–85 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Belgium | 36.6 | 40.8 | 29.4 | 31.1 | 45.7 | 33.8 | 43.9 | 53.1 | 57.1 | 52.3 | 36.1 | 57.0 | *36.7* | *47.6* |
| Denmark | 32.6 | 33.6 | 25.5 | 30.6 | 39.0 | 30.3 | 38.8 | 53.7 | 45.9 | 47.3 | 34.0 | 55.9 | *32.3* | *43.7* |
| France | 34.1 | 34.5 | 47.8 | 27.0 | 45.9 | 35.6 | 44.4 | 60.7 | 57.6 | 65.1 | 39.7 | 61.8 | *37.8* | *52.1* |
| Germany, Fed. Rep. of | 34.3 | 35.1 | 30.0 | 32.6 | 46.4 | 39.3 | 45.9 | 48.1 | 33.1 | 38.6 | 36.3 | 53.5 | *35.7* | *42.1* |
| Ireland | 18.1 | 47.5 | 61.4 | 25.7 | 32.3 | 29.1 | 43.4 | 57.7 | 36.8 | 63.9 | 39.2 | 65.4 | *37.0* | *47.9* |
| Italy | 24.8 | 28.7 | 70.4 | 26.3 | 39.9 | 32.0 | 53.9 | 65.0 | 39.9 | 55.6 | 39.2 | 50.0 | *38.0* | *47.9* |
| Netherlands | 35.4 | 38.9 | 35.4 | 28.8 | 45.7 | 32.5 | 40.6 | 57.6 | 33.1 | 45.8 | 42.2 | 66.5 | *36.8* | *45.5* |
| **Average ERM[2]** | **30.8** | **37.0** | **42.8** | **28.9** | **42.1** | **33.2** | **44.4** | **56.6** | **43.4** | **52.6** | **38.1** | **58.6** | *36.3* | *46.7* |
| Austria | 44.0 | 38.0 | 33.4 | 35.3 | 46.9 | 49.9 | 45.5 | 51.5 | 35.3 | 43.1 | 40.7 | 62.5 | *39.5* | *46.5* |
| Canada | 12.9 | 16.7 | 17.0 | 34.1 | 36.1 | 18.3 | 18.3 | 17.0 | 24.6 | 7.3 | 23.5 | 26.8 | *23.4* | *19.4* |
| Japan | 33.3 | 22.1 | 22.1 | 59.5 | 96.7 | 68.3 | 64.7 | 48.5 | 54.5 | 18.4 | 33.6 | 84.8 | *46.7* | *53.3* |
| Norway | 30.5 | 40.2 | 30.7 | 34.4 | 42.4 | 29.9 | 30.0 | 42.9 | 61.1 | 22.7 | 42.3 | 51.7 | *35.6* | *40.1* |
| Sweden | 33.4 | 37.3 | 25.8 | 64.2 | 38.7 | 30.6 | 28.2 | 65.5 | 79.7 | 24.4 | 30.3 | 48.8 | *39.9* | *43.9* |
| Switzerland | 63.1 | 28.1 | 18.7 | 57.4 | 72.8 | 38.1 | 43.0 | 62.1 | 46.4 | 29.1 | 44.2 | 72.4 | *48.0* | *47.9* |
| United Kingdom | 25.7 | 56.4 | 82.5 | 34.4 | 48.8 | 54.0 | 34.4 | 79.9 | 43.7 | 26.4 | 51.1 | 75.7 | *49.6* | *52.2* |
| United States | 24.3 | 24.7 | 22.2 | 41.3 | 58.2 | 37.2 | 38.2 | 40.5 | 43.5 | 14.8 | 35.2 | 59.5 | *34.2* | *38.4* |
| **Average non-ERM[2]** | **33.4** | **32.9** | **31.5** | **45.1** | **55.1** | **40.8** | **37.8** | **51.0** | **48.6** | **23.3** | **37.6** | **60.3** | *39.6* | *42.8* |
| **Average European non-ERM[2]** | **39.3** | **40.0** | **38.2** | **45.1** | **49.9** | **40.5** | **36.2** | **60.4** | **53.2** | **29.2** | **41.7** | **62.2** | *42.5* | *46.2* |

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Weighted average (MERM weights) of variability of bilateral nominal exchange rates against non-ERM currencies, with variability measured by coefficient of variation (multiplied by 1,000) of average monthly bilateral exchange rates.

[2] Unweighted average.

**Table 25. Variability of Bilateral Real Exchange Rates Against Non-ERM Currencies, 1974–85[1]**

| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | Average 1974–78 | Average 1979–85 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Belgium | 42.8 | 35.7 | 31.0 | 27.9 | 40.8 | 36.6 | 50.6 | 56.4 | 50.5 | 44.6 | 36.0 | 55.9 | *35.6* | *47.2* |
| Denmark | 38.7 | 41.5 | 38.7 | 28.9 | 38.3 | 35.2 | 40.9 | 50.0 | 41.9 | 44.2 | 32.7 | 54.4 | *37.2* | *42.7* |
| France | 34.7 | 31.1 | 38.5 | 27.2 | 44.8 | 41.3 | 41.7 | 52.6 | 51.7 | 51.0 | 36.2 | 64.2 | *35.3* | *48.4* |
| Germany, Fed. Rep. of | 29.1 | 43.4 | 24.3 | 27.8 | 38.7 | 35.8 | 58.9 | 50.1 | 33.8 | 42.2 | 40.5 | 49.9 | *32.7* | *44.5* |
| Ireland | 25.3 | 49.3 | 36.7 | 25.6 | 29.6 | 29.6 | 44.5 | 52.4 | 37.1 | 52.6 | 38.7 | 65.8 | *33.3* | *45.8* |
| Italy | 26.4 | 23.9 | 49.2 | 26.4 | 36.0 | 48.6 | 38.1 | 51.1 | 34.6 | 36.5 | 34.1 | 50.4 | *32.4* | *41.9* |
| Netherlands | 30.6 | 36.6 | 38.4 | 25.4 | 39.8 | 35.1 | 48.9 | 61.4 | 34.6 | 48.3 | 44.9 | 63.1 | *34.2* | *48.0* |
| **Average ERM[2]** | **32.5** | **37.3** | **36.7** | **27.0** | **38.3** | **37.5** | **46.2** | **53.4** | **40.6** | **45.6** | **37.6** | **57.7** | *34.4* | *45.5* |
| Austria | 34.9 | 42.5 | 30.4 | 29.6 | 39.2 | 43.3 | 56.4 | 55.2 | 36.9 | 46.0 | 42.8 | 59.3 | *35.3* | *48.6* |
| Canada | 14.0 | 14.8 | 17.2 | 26.5 | 36.4 | 22.8 | 18.3 | 22.1 | 25.3 | 8.4 | 25.1 | 26.4 | *21.8* | *21.2* |
| Japan | 30.6 | 21.4 | 28.1 | 52.6 | 84.9 | 84.6 | 57.0 | 59.7 | 59.6 | 21.9 | 37.6 | 82.0 | *43.5* | *57.5* |
| Norway | 23.2 | 36.5 | 28.5 | 30.3 | 39.3 | 35.9 | 29.8 | 43.2 | 53.1 | 20.4 | 40.7 | 54.2 | *31.6* | *39.6* |
| Sweden | 28.6 | 32.7 | 28.8 | 48.0 | 32.1 | 33.2 | 29.8 | 66.8 | 73.7 | 18.7 | 29.1 | 49.6 | *34.0* | *43.0* |
| Switzerland | 53.6 | 36.4 | 14.8 | 50.1 | 61.1 | 33.8 | 52.8 | 62.7 | 42.8 | 33.2 | 48.2 | 67.2 | *43.2* | *48.7* |
| United Kingdom | 30.0 | 30.4 | 62.6 | 33.3 | 43.0 | 77.2 | 36.8 | 69.8 | 42.6 | 25.5 | 47.6 | 81.9 | *39.9* | *54.5* |
| United States | 24.9 | 21.1 | 23.6 | 35.9 | 51.8 | 46.5 | 36.7 | 47.1 | 44.7 | 16.6 | 37.6 | 58.6 | *31.4* | *41.1* |
| **Average non-ERM[2]** | **30.0** | **29.5** | **29.2** | **38.3** | **48.5** | **47.2** | **39.7** | **53.3** | **47.3** | **23.9** | **38.6** | **59.9** | *35.1* | *44.3* |
| **Average European non-ERM[2]** | **34.1** | **35.7** | **33.0** | **38.3** | **42.9** | **44.7** | **41.1** | **59.5** | **49.8** | **28.8** | **41.7** | **62.5** | *36.8* | *46.9* |

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Weighted average (MERM weights) of variability of bilateral real exchange rates (nominal exchange rates adjusted for relative consumer price movements—wholesale prices for Ireland) against non-ERM currencies, with variability measured by the coefficient of variation (multiplied by 1,000) of average monthly bilateral exchange rates.

[2] Unweighted average.

Source: Ungerer et al. (1986)

**Table 28. Variability of Nominal Effective Exchange Rates, 1974–85[1]**

| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | Average 1974–78 | Average 1979–85 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Belgium | 18.6 | 23.2 | 27.6 | 9.4 | 15.4 | 9.3 | 14.5 | 14.5 | 35.9 | 20.2 | 8.3 | 18.6 | *18.8* | *17.3* |
| Denmark | 21.0 | 18.5 | 24.8 | 18.0 | 14.4 | 17.3 | 20.1 | 24.4 | 19.5 | 27.6 | 14.0 | 32.1 | *19.3* | *22.1* |
| France | 26.3 | 21.9 | 40.3 | 5.4 | 17.0 | 14.9 | 18.3 | 31.5 | 40.8 | 40.4 | 17.4 | 34.6 | *22.2* | *28.3* |
| Germany, Fed. Rep. of | 25.7 | 23.6 | 36.5 | 20.2 | 20.4 | 23.0 | 23.9 | 22.4 | 15.9 | 15.2 | 18.6 | 30.2 | *25.3* | *21.3* |
| Ireland | 10.8 | 39.6 | 63.1 | 16.3 | 19.9 | 12.4 | 22.9 | 23.3 | 10.7 | 39.4 | 17.0 | 33.4 | *29.9* | *22.7* |
| Italy | 31.6 | 5.4 | 63.4 | 14.7 | 20.2 | 8.6 | 28.9 | 39.5 | 15.7 | 28.9 | 17.7 | 15.7 | *27.1* | *22.1* |
| Netherlands | 15.9 | 19.5 | 33.5 | 8.1 | 16.8 | 11.0 | 13.1 | 26.0 | 14.7 | 14.6 | 16.9 | 33.2 | *18.8* | *18.5* |
| **Average ERM[2]** | **21.4** | **21.7** | **41.3** | **13.1** | **17.7** | **13.8** | **20.2** | **25.9** | **21.9** | **26.6** | **15.7** | **28.3** | *23.1* | *21.8* |
| Austria | 31.4 | 21.4 | 31.8 | 17.2 | 14.2 | 32.9 | 22.4 | 23.9 | 10.0 | 20.5 | 20.6 | 35.6 | *23.2* | *23.7* |
| Canada | 6.8 | 15.1 | 16.2 | 33.2 | 39.5 | 14.3 | 7.2 | 17.3 | 19.8 | 11.1 | 14.6 | 33.3 | *22.2* | *16.8* |
| Japan | 31.5 | 10.0 | 21.7 | 53.6 | 85.5 | 71.0 | 70.3 | 21.4 | 35.1 | 24.2 | 11.4 | 56.4 | *40.4* | *41.4* |
| Norway | 15.3 | 25.6 | 26.6 | 21.5 | 23.1 | 8.8 | 7.4 | 10.3 | 44.1 | 8.6 | 25.8 | 17.6 | *22.4* | *17.5* |
| Sweden | 24.4 | 22.8 | 21.2 | 60.7 | 1.9 | 14.6 | 4.3 | 49.6 | 67.1 | 4.3 | 5.3 | 11.8 | *26.2* | *22.4* |
| Switzerland | 54.7 | 13.0 | 24.8 | 54.0 | 59.4 | 18.4 | 18.5 | 55.9 | 24.1 | 6.9 | 25.8 | 48.3 | *41.2* | *28.3* |
| United Kingdom | 12.2 | 41.8 | 71.6 | 12.7 | 26.2 | 40.2 | 30.1 | 58.3 | 20.0 | 23.5 | 33.2 | 51.0 | *32.9* | *36.6* |
| United States | 18.7 | 29.9 | 7.5 | 14.3 | 35.7 | 10.3 | 23.6 | 48.8 | 44.3 | 30.4 | 43.6 | 61.1 | *21.2* | *37.4* |
| **Average non-ERM[2]** | **24.4** | **22.5** | **27.7** | **33.4** | **35.7** | **26.3** | **23.0** | **35.7** | **33.1** | **16.2** | **22.5** | **39.4** | *28.7* | *28.0* |
| **Average European non-ERM[2]** | **27.6** | **24.9** | **35.2** | **33.2** | **25.0** | **23.0** | **16.5** | **39.6** | **33.1** | **12.7** | **22.1** | **32.9** | *29.2* | *25.7* |

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Based on the IMF's multilateral exchange rate model (MERM) and monthly data. Variability is measured by the coefficient of variation (multiplied by 1,000) of average monthly effective exchange rates.

[2] Unweighted average.

Source: Ungerer et al. (1986)

Tabelle 2a: Durchschnittliche jährliche Änderung des DM-Außenwerts gegenüber anderen europäischen Währungen in v.H.

| | | März 1973 - März 1979 | | | März 1979 - März 1986 | | |
|---|---|---|---|---|---|---|---|
| I. | Belgischer Franc | 2.0 | 2.3[a] | 6.0[a] | 3.7 | 2.8[a] | 3.6[a] |
| | Dänische Krone | 4.1 | | | 4.0 | | |
| | Holländischer Gulden | .8 | | | .7 | | |
| II. | Französischer Franc | 6.1 | 9.7[a] | | 4.2 | 4.5[a] | |
| | Irisches Pfund | 10.0 | | | 3.3 | | |
| | Italienische Lira | 12.9 | | | 5.9 | | |
| III. | Norwegische Krone | 4.6 | 7.0[a] | | 2.3 | 2.9[a] | |
| | Schwedische Krone | 6.5 | | | 4.5 | | |
| | Pfund Sterling | 10.0 | | | 2.0 | | |

[a] ungewichteter Durchschnitt

Quelle: Deutsche Bundesbank, Monatsberichte, verschiedene Ausgaben. (Lehment)

## Table 44. Long-Term Interest Rates, 1974–85[1]

(Monthly averages in percent)

| | 1974 | 1975 | 1976 | 1977 | 1978 | Average 1974–78 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | Average 1979–84 | 1985 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Belgium | 8.7 | 8.5 | 9.1 | 8.8 | 8.4 | *8.7* | 9.5 | 12.0 | 13.7 | 13.6 | 11.9 | 12.0 | *12.1* | 10.6 |
| Denmark | 14.5 | 13.1 | 13.2 | 13.4 | 14.5 | *13.7* | 15.8 | 17.7 | 18.9 | 20.4 | 14.5 | 13.9 | *16.9* | . . . |
| France | 10.5 | 9.5 | 9.2 | 9.6 | 9.0 | *9.6* | 9.5 | 13.0 | 15.7 | 15.6 | 13.6 | 12.4 | *13.3* | . . . |
| Germany, Fed. Rep. of | 10.4 | 8.5 | 7.8 | 6.2 | 5.8 | *7.7* | 7.4 | 8.5 | 10.4 | 9.0 | 7.9 | 7.8 | *8.5* | 6.9 |
| Ireland | 16.9 | 14.6 | 15.5 | 11.3 | 12.8 | *14.2* | 15.1 | 15.3 | 17.3 | 17.1 | 13.9 | 14.6 | *15.6* | 12.6 |
| Italy | 9.9 | 11.5 | 13.1 | 14.6 | 13.7 | *12.6* | 14.0 | 16.1 | 20.6 | 20.9 | 18.0 | 14.9 | *17.4* | . . . |
| Netherlands | 9.8 | 8.8 | 8.9 | 8.1 | 7.7 | *8.7* | 8.8 | 10.2 | 11.6 | 10.1 | 8.6 | 8.3 | *9.6* | 7.3 |
| **Arithmetic average ERM** | **11.5** | **10.6** | **11.0** | **10.3** | **10.3** | *10.7* | **11.4** | **13.3** | **15.5** | **15.2** | **12.6** | **12.0** | *13.3* | . . . |
| Standard deviation | 2.8 | 2.3 | 2.7 | 2.8 | 3.1 | *2.5* | 3.2 | 3.1 | 3.5 | 4.3 | 3.3 | 2.7 | *3.2* | . . . |
| Difference between highest and lowest value | 8.2 | 6.1 | 7.7 | 8.4 | 8.7 | *6.5* | 8.4 | 9.2 | 10.2 | 11.9 | 10.1 | 7.1 | *8.9* | . . . |
| Coefficient of variation | 0.24 | 0.21 | 0.25 | 0.27 | 0.30 | *0.23* | 0.28 | 0.23 | 0.23 | 0.28 | 0.26 | 0.22 | *0.24* | . . . |
| **Weighted average** | **10.3** | **9.5** | **9.4** | **9.1** | **8.6** | . . . | **9.6** | **11.8** | **14.4** | **13.8** | **12.0** | **11.0** | . . . | . . . |
| Australia | 9.1 | 9.8 | 10.2 | 10.3 | 9.1 | *9.7* | 9.8 | 11.6 | 14.0 | 15.3 | 14.3 | 13.8 | *13.1* | 14.1 |
| Austria | 9.7 | 9.6 | 8.8 | 8.7 | 8.2 | *9.0* | 8.0 | 9.2 | 10.6 | 9.9 | 8.2 | 8.0 | *9.0* | 7.8 |
| Canada | 8.9 | 9.0 | 9.2 | 8.7 | 9.3 | *9.0* | 10.2 | 12.5 | 15.2 | 14.3 | 11.8 | 12.8 | *12.8* | 11.0 |
| Japan | 9.3 | 9.2 | 8.7 | 7.3 | 6.1 | *8.1* | 7.7 | 9.2 | 8.7 | 8.1 | 7.4 | 6.8 | *8.0* | 6.3 |
| New Zealand | 6.1 | 6.3 | 8.3 | 9.2 | 10.0 | *8.0* | 12.0 | 13.3 | 12.8 | 12.9 | 12.2 | 12.6 | *12.6* | 17.7 |
| Norway | 7.1 | 7.3 | 7.3 | 7.4 | 8.4 | *7.5* | 8.6 | . . . | 12.3 | 13.2 | 12.9 | 12.2 | *9.9* | . . . |
| Portugal | . . . | . . . | 9.7 | 10.8 | 16.2 | *7.3* | 16.7 | 16.7 | 16.7 | 16.8 | . . . | 21.5 | *14.7* | . . . |
| Sweden | 7.8 | 8.8 | 9.3 | 9.7 | 10.1 | *9.1* | 10.5 | 11.7 | 13.5 | 13.0 | 12.3 | 12.3 | *12.2* | 12.3 |
| Switzerland | 7.1 | 6.4 | 5.0 | 4.1 | 3.3 | *5.2* | 3.4 | 4.8 | 5.6 | 4.8 | 4.5 | 4.7 | *4.6* | 4.7 |
| United Kingdom | 14.8 | 14.4 | 14.4 | 12.7 | 12.5 | *13.8* | 13.0 | 13.8 | 14.7 | 12.9 | 10.8 | 10.7 | *12.7* | 10.6 |
| United States | 8.1 | 8.2 | 7.9 | 7.7 | 8.5 | *8.1* | 9.3 | 11.4 | 13.7 | 12.9 | 11.3 | 12.5 | *11.9* | 11.0 |
| **Arithmetic average non-ERM** | **8.8** | **8.9** | **9.0** | **8.8** | **9.2** | *8.6* | **9.9** | **11.4** | **12.5** | **12.2** | **9.6** | **11.6** | *11.0* | . . . |
| Standard deviation | 2.3 | 2.2 | 2.2 | 2.1 | 3.1 | *2.0* | 3.2 | 3.0 | 3.0 | 3.2 | 4.1 | 4.2 | *2.8* | . . . |
| Coefficient of variation | 0.26 | 0.25 | 0.24 | 0.24 | 0.34 | *0.23* | 0.32 | 0.27 | 0.24 | 0.27 | 0.42 | 0.36 | *0.25* | . . . |

Source: International Monetary Fund, *International Financial Statistics*, various issues.

[1] Long-term government bond yields.

## Table 43. Short-Term Interest Rates, 1974–85[1]

(Monthly averages in percent)

| | 1974 | 1975 | 1976 | 1977 | 1978 | Average 1974–78 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | Average 1979–84 | 1985 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Belgium | 9.3 | 4.6 | 8.3 | 5.5 | 5.2 | *6.6* | 8.0 | 11.2 | 11.5 | 11.4 | 8.2 | 9.5 | *10.0* | 8.3 |
| Denmark | 13.3 | 6.5 | 10.3 | 14.5 | 15.4 | *12.0* | 12.6 | 16.9 | 14.8 | 16.4 | 12.0 | 11.5 | *14.0* | 10.0 |
| France | 12.9 | 7.9 | 8.6 | 9.1 | 8.0 | *9.3* | 9.0 | 11.8 | 15.3 | 14.9 | 12.5 | 11.7 | *12.5* | 9.9 |
| Germany, Fed. Rep. of | 8.9 | 4.4 | 3.9 | 4.1 | 3.4 | *4.9* | 5.9 | 9.1 | 11.3 | 8.7 | 5.4 | 5.5 | *7.7* | 5.2 |
| Ireland | 11.3 | 10.0 | 10.8 | 7.7 | 8.4 | *9.6* | 13.5 | 15.4 | 13.5 | 13.2 | 10.1 | 8.7 | *12.4* | . . . |
| Italy | 14.6 | 10.6 | 15.7 | 14.0 | 11.5 | *13.3* | 11.9 | 17.2 | 19.6 | 20.2 | 18.5 | 17.3 | *17.5* | 15.2 |
| Netherlands | 9.2 | 4.2 | 7.3 | 3.8 | 6.2 | *6.1* | 9.0 | 10.1 | 11.0 | 8.1 | 5.3 | 5.8 | *8.2* | 6.3 |
| **Arithmetic average ERM** | **11.4** | **6.9** | **9.3** | **8.4** | **8.3** | *8.8* | **10.0** | **13.1** | **13.9** | **13.3** | **10.3** | **10.0** | *11.8* | . . . |
| Standard deviation | 2.1 | 2.5 | 3.4 | 4.1 | 3.8 | *2.9* | 2.5 | 3.1 | 2.8 | 4.0 | 4.3 | 3.7 | *3.2* | . . . |
| Difference between highest and lowest value | 5.7 | 6.4 | 11.8 | 10.7 | 12.0 | *8.3* | 7.6 | 8.1 | 8.6 | 12.1 | 13.2 | 11.8 | *9.8* | . . . |
| Coefficient of variation | 0.19 | 0.36 | 0.36 | 0.49 | 0.45 | *0.33* | 0.26 | 0.24 | 0.20 | 0.30 | 0.42 | 0.37 | *0.27* | . . . |
| **Weighted average** | **11.2** | **6.6** | **7.9** | **7.5** | **6.7** | . . . | **8.4** | **11.8** | **14.1** | **13.0** | **10.3** | **10.1** | . . . | . . . |
| Japan | 12.5 | 10.7 | 7.0 | 5.7 | 4.4 | *8.1* | 5.9 | 10.9 | 7.4 | 6.9 | 6.4 | 6.1 | *7.3* | 6.5 |
| Norway | 8.1 | 7.5 | 7.4 | 9.8 | 9.4 | *8.4* | 8.4 | 11.2 | 12.3 | 13.9 | 12.3 | 12.7 | *11.8* | . . . |
| Sweden | 7.5 | 7.8 | 7.9 | 10.0 | 7.2 | *8.1* | 8.2 | 12.2 | 14.4 | 13.3 | 10.9 | 11.8 | *11.8* | 13.8 |
| United Kingdom | 11.4 | 10.2 | 11.1 | 7.7 | 8.5 | *9.8* | 13.0 | 15.1 | 13.0 | 11.5 | 9.6 | 9.3 | *11.9* | 11.6 |
| United States | 10.5 | 5.8 | 5.0 | 5.5 | 7.9 | *6.9* | 11.2 | 13.4 | 16.4 | 12.3 | 9.1 | 10.2 | *12.1* | 8.1 |
| **Arithmetic average non-ERM** | **10.0** | **8.4** | **7.7** | **7.7** | **7.5** | *8.3* | **9.3** | **12.6** | **12.7** | **11.6** | **9.7** | **10.0** | *11.0* | . . . |
| Standard deviation | 1.9 | 1.8 | 2.0 | 1.9 | 1.7 | *0.9* | 2.5 | 1.5 | 3.0 | 2.5 | 2.0 | 2.3 | *1.9* | . . . |
| Coefficient of variation | 0.19 | 0.22 | 0.26 | 0.25 | 0.23 | *0.11* | 0.27 | 0.12 | 0.24 | 0.21 | 0.20 | 0.23 | *0.17* | . . . |

Source: International Monetary Fund, *International Financial Statistics*, various issues.

[1] In general call money rates. 3-month treasury bill rates for the United Kingdom.

Source: Ungerer et al. (1986)

Table 2: CPI Inflation Rates

| | 3/72-3/79 | | 3/79-3/86 | | 3/79-3/82 | | 3/83-3/86 | |
|---|---|---|---|---|---|---|---|---|
| Belgium | 7.6 | | 5.5 | | 7.1 | | 4.8 | |
| Denmark | 8.9 | | 7.1 | | 11.9 | | 4.8 | |
| France | 8.7 | | 8.3 | | 13.4 | | 6.0 | |
| Germany | 4.3 | | 3.3 | | 5.6 | | 1.9 | |
| Italy | 13.0 | | 12.3 | | 18.6 | | 9.4 | |
| Netherlands | 6.5 | | 3.6 | | 6.4 | | 2.3 | |
| U.S. | 6.8 | | 5.7 | | 10.6 | | 3.6 | |
| Japan | 10.8 | | 6.2 | | 5.5 | | 10.5 | |
| U.K. | 12.2 | | 7.7 | | 14.2 | | 5.2 | |
| Switzerland | 4.1 | | 3.5 | | 5.0 | | 2.6 | |
| | avg | std | avg | std | avg | std | avg | std |
| EMS | 8.2 | 2.6 | 6.7 | 3.4 | 10.5 | 4.6 | 4.9 | 2.5 |
| Non-EMS | 7.6 | 3.3 | 5.3 | 1.7 | 8.1 | 4.5 | 4.8 | 3.1 |

Source : Collins (1987)

Table 1 : Macroeconomic performance of EMS and non-EMS industrialized countries.

| | EMS | Non-EMS | European Non-EMS |
|---|---|---|---|
| Growth of GDP (yearly average) | | | |
| 1973-78 : | 2.8 | 2.9 | 1.9 |
| 1979-85 : | 1.7 | 2.7 | 1.8 |
| Growth of Investment (yearly average) | | | |
| 1973-78 : | 1.4 | 2.8 | -0.2 |
| 1979-85 : | 0.3 | 2.5 | 0.4 |
| Inflation rate (yearly average) | | | |
| 1973-78 : | 9.1 | 9.6 | 12.5 |
| 1979-85 : | 8.3 | 6.9 | 8.8 |
| 1985 : | 4.6 | 3.8 | 5.9 |

Source : OECD, Main Economic Indicators

Note : (1) The Non-EMS countries are the following : Austria, Norway, Sweden, Switzerland, Finland, Spain, UK, Canada, US, Japan. The European Non-EMS consists of the same countries excluding the US, Japan and Canada.
(2) The averages of each group of countries are obtained using GDP weights.

Source : de Grauwe (1987)

Tabelle 3 - Inflationsraten in OECD-Ländern(a)

| Jahr | EWS-Länder | OECD insgesamt | OECD-Europa | OECD ohne EWS-Länder | OECD-Europa ohne EWS-Länder |
|---|---|---|---|---|---|
| 1979 | 8,5 | 9,8 | 10,6 | 10,1 | 14,3 |
| 1980 | 11,7 | 12,9 | 14,3 | 13,2 | 18,5 |
| 1981 | 11,5 | 10,5 | 12,2 | 10,3 | 13,2 |
| 1982 | 10,4 | 7,8 | 10,5 | 7,1 | 10,7 |
| 1983 | 8,5 | 5,2 | 8,2 | 4,3 | 7,7 |
| 1984 | 6,6 | 5,2 | 7,4 | 4,7 | 8,6 |
| 1985 | 5,5 | 4,5 | 6,5 | 4,2 | 7,9 |
| 1986 | 2,7 | 2,6 | 4,0 | 2,6 | 5,9 |
| - Veränderung 1986 gegenüber 1979: | | | | | |
| | -5,8 | -7,2 | -6,6 | -7,5 | -8,4 |
| - Veränderung 1985/86 gegenüber 1979/80: | | | | | |
| | -6,0 | -7,8 | -7,2 | -8,3 | -9,5 |

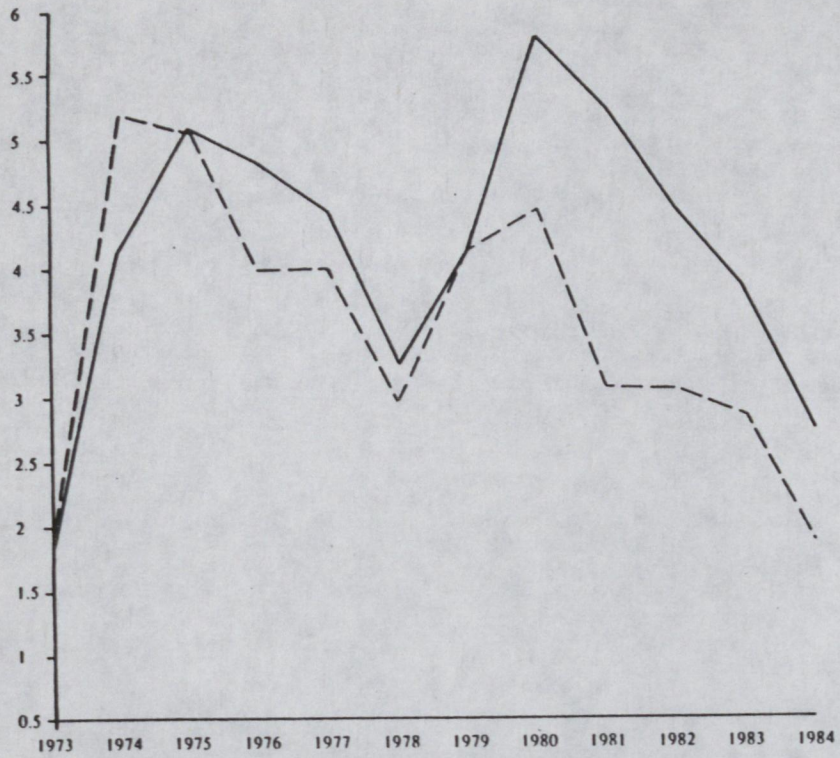
(a) Anstieg der Verbraucherpreise gegenüber dem Vorjahr (Gewichtung nach OECD).

Quelle: OECD [a; b]; eigene Berechnungen.

Aus: Scheide, Sinn (1987)

4a

**Figure 3: Standard Deviation of national inflation rates in the EMS and in Non-EMS Industrial Countries. (in per cent)**

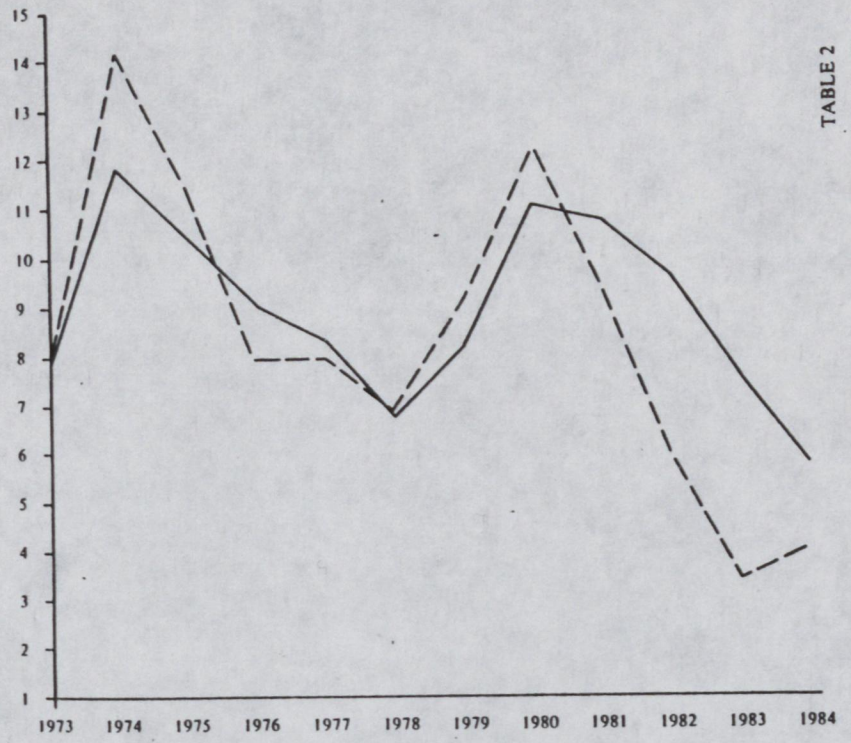



Source: IMF, International Financial Statistics

Note: The non-EMS industrial countries are the US, the UK, Japan, Canada, Austria, Norway, Sweden, Switzerland.
The standard deviation here measures the deviation of national inflation rates from the weighted mean inflation rate in each group of countries.



**Figure 4: Average Inflation Rates in the EMS and in the Non-EMS Industrial Countries.**
(In percent)




Source: IMF, International Financial Statistics.

Note: The inflation rates in each group of countries are weighted averages. The weights are obtained from GDP figures.
See also notes of Figure 3.

Source: de Grauwe (1985)

TABLE 2
Average Yearly Growth of Trade (Export & Import), 1979–84

| | with EMS countries | with non-EMS countries* |
|---|---|---|
| *Old EEC members* | | |
| Belgium | 0.3 | 4.9 |
| France | 1.3 | 5.3 |
| Germany | 1.4 | 4.4 |
| Netherlands | 0.4 | 3.9 |
| Italy | 0.4 | 2.2 |
| *New EEC members* | | |
| Denmark | 2.8 | 2.5 |
| Ireland | 5.9 | 3.8 |
| United Kingdom | 4.1 | 4.9 |

Source: IMF, Direction of Trade.
*The same countries as in Figure 1.

(6)

Tabelle 4 a: Abstand des Geld- und Briefkurses vom Mittelkurs im amtlichen Frankfurter Devisenhandel in v.H.[a]

| | Dezember 1970 | Dezember 1978 | | Dezember 1985 | |
|---|---|---|---|---|---|
| I. Belgischer Franc | .13 | .16 | .15 | .20 | .18 |
| Dänische Krone | .12 | .17 | | .22 | |
| Holländischer Gulden | .11 | .12 | | .12 | |
| II. Französische Franc | .15 | .18 | .20 | .24 | .27 |
| Irisches Pfund | .11 | .19 | | .23 | |
| Italienische Lira | .17 | .22 | | .34 | |
| III. Norwegische Krone | .12 | .16 | .18 | .18 | .20 |
| Schwedische Krone | .11 | .19 | | .24 | |
| Pfund Sterling | .11 | .19 | | .19 | |

[a] Amtliche Devisenkurse gegenüber der D-Mark an der Frankfurter Börse.

Quelle: Deutsche Bundesbank, Monatsberichte, verschiedene Ausgaben.

Tabelle 4 b: Abstand des Geld- und Briefkurses vom Mittelkurs im Düsseldorfer Sortenhandel in v.H.

| | Ende Dezember 1978 | | Ende Dezember 1985 | |
|---|---|---|---|---|
| I. Belgischer Franc | 2.0 | 1.9 | 2.0 | 2.1 |
| Dänische Krone | 2.5 | | 3.2 | |
| Holländischer Gulden | 1.3 | | 1.2 | |
| II. Französische Franc | 2.6 | 3.0 | 2.7 | 3.1 |
| Irisches Pfund | - | | 2.4 | |
| Italienische Lira | 3.4 | | 3.5 | |
| III. Norwegische Krone | 2.8 | 2.5 | 2.7 | 2.5 |
| Schwedische Krone | 2.4 | | 2.7 | |
| Pfund Sterling | 2.4 | | 2.1 | |

Quelle: Handelsblatt, verschiedene Ausgaben. (Lehment)

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FRAME ECONOMIC

MEETING OF EC MONETARY COMMITTEE: 19 JULY

SUMMARY

1. THE COMMITTEE MET WITH LITTLER IN CHAIR. UK WAS REPRESENTED BY LOEHNIS, ARROWSMITH AND O'MARA. STEK (NETHERLANDS) WAS APPOINTED CHAIRMAN OF THE MONETARY COMMITTEE ALTERNATES IN SUCCESSION TO MICOSSI (ITALY). DURING THE TOUR DE TABLE ON EXCHANGE AND INTEREST RATE DEVELOPMENTS, SOME DOUBTS WERE EXPRESSED ABOUT THE SUSTAINABILITY OF THE DOLLAR'S RISE AND STRESS WAS LAID ON AVOIDING ANY PUBLIC COMMENT WHICH MIGHT CALL INTO QUESTION THE COMMITMENT TO INTERNATIONAL COOPERATION ON EXCHANGE RATES. THE COMMITTEE AGREED THE COMMISSION'S PROPOSALS FOR FORMAL RULES FOR THE CONDUCT OF A COMMUNITY MONETARY POLICY COULD NOT YET BE REGARDED AS AN OPERATIONAL ISSUE AND COMMISSIONED FURTHER WORK SEMI-COLON IT WAS AGREED THE COMMITTEE SHOULD CONTINUE ITS STUDIES OF SOME OF THE SUBJECTS WHICH WERE ALSO LIKELY TO BE COVERED BY THE DELORS GROUP, SET UP AFTER THE HANOVER COUNCIL SEMI-COLON THE COMMITTEE EXPRESSED SATISFACTION THAT GREECE HAD BEEN ABLE TO ACCEPT THE COMMISSION'S POLICY RECOMMENDATIONS IN RELATION TO THE COMMUNITY LOAN, WHILE ENTERING SOME RESERVATIONS ON THE GREEK PERFORMANCE TO DATE, AND DATES FOR FUTURE MEETINGS AND A POSSIBLE WORK PROGRAMME WERE PROPOSED.

CHAIRMANSHIP OF MONETARY COMMITTEE ALTERNATES

2. LITTLER REPORTED THAT, AFTER CONSULTATION WITH OTHER MEMBERS OF THE COMMITTEE, HE HAD INVITED STEK OF THE DUTCH FINANCE MINISTRY TO REPLACE MICOSSI AS CHAIRMAN OF THE ALTERNATES, ON THE LATTER'S DEPARTURE TO THE PRIVATE SECTOR.

TOUR D'HORIZON: EXCHANGE AND INTEREST RATE DEVELOPMENTS

3. IN THE USUAL TOUR DE TABLE, GLESKE (FRG) NOTED THAT MOVEMENTS IN THE DOLLAR/YEN RATE HAD NOT BEEN AS PRONOUNCED AS THOSE IN THE DOLLAR/DEUTSCHMARK RATE. THIS EXPLAINED WHY THE BANK OF JAPAN HAD NOT BEEN INTERVENING RECENTLY. GLESKE STRESSED THAT THE ABSENCE OF JAPANESE INTERVENTION SHOULD NOT BE

TAKEN AS AN INDICATION THAT INTERNATIONAL COOPERATION WAS NOW LESS EFFECTIVE. THERE HAD BEEN VERY CLOSE CO-ORDINATION. GERMANY, BY CONTRAST, HAD INTERVENED, BUT TO INHIBIT ANY FURTHER UPWARD MOVEMENT IN THE DOLLAR RATHER THAN TO STIMULATE A FALL. AS THE UPWARD TREND OF THE DOLLAR HAD CONTINUED, THE US HAD INTERVENED TOO AND THE GERMANS WERE NOW ABOUT TO RAISE THEIR REPURCHASE RATE TO 4 PER CENT. OVER THE LONGER TERM, THE GERMANS WERE MORE PESSIMISTIC THAN MANY AMERICANS ABOUT THE DOLLAR OUTLOOK. THE US NEEDED TO MAKE FURTHER ADJUSTMENTS AND MARKET SENTIMENT COULD CHANGE QUICKLY. LAGAYETTE (FRANCE) AND SARCINELLI (ITALY) ALSO QUESTIONED WHETHER THE CURRENT TURNROUND IN THE DOLLAR WAS SUSTAINABLE.

4. TIETMEYER (FRG) AND LITTLER STRESSED THAT INTERNATIONAL COOPERATION WAS ALIVE AND WELL AND EMPHASISED THE NEED TO AVOID ANY PUBLIC STATEMENTS WHICH MIGHT CALL THAT INTO QUESTION.

5. SUMMING UP, LITTLER NOTED THAT DESPITE THE BUOYANCY OF THE DOLLAR, THE US PROBLEM WAS NOT RESOLVED. ACTION WOULD NOT BE TAKEN ON THE BUDGET DEFICIT BEFORE THE US ELECTION AND THE WORLD FISCAL BALANCE WOULD THEREFORE REMAIN UNCOMFORTABLE, THROWING A BIGGER BURDEN OF ADJUSTMENT ON MONETARY POLICY THAN MANY WOULD WISH TO SEE. EXCHANGE RATE STABILITY WAS IN THE INTERESTS OF ALL.

COHERENCE OF MONETARY POLICIES IN THE COMMUNITY

6. IN DISCUSSION OF THE COMMISSION'S PAPER, ATTENTION FOCUSSED ON THE ANNEX SETTING OUT POSSIBLE FORMAL RULES FOR THE CONDUCT AND COORDINATION OF MONETARY POLICIES IN THE EMS. SEVERAL MEMBERS STRESSED THAT THIS COULD NOT YET BE CONSIDERED AS AN OPERATIONAL ISSUE AND QUESTIONED DETAILS OF THE COMMISSION'S APPROACH. MARTINEZ MENDEZ (SPAIN) PROPOSED A COMMISSION STUDY ATTEMPTING TO HARMONISE MONETARY DEFINITIONS AMONG MEMBER STATES. SUMMING UP, LITTLER COMMENTED THAT THE COMMISSION'S PAPER WAS EXPLORATORY RATHER THAN PRESCRIPTIVE. MEMBER STATES WERE NOW MUCH NEARER TO A COMMON MONETARY POSITION BUT IT WAS INEVITABLY COMPLEX. HE NOTED WITH INTEREST THAT NO ONE HAD IDENTIFIED ANY CONFLICT BETWEEN THE REQUIREMENTS OF NATIONAL POLICY AND THE PATH TO CONVERGENCE. HE SUGGESTED THE COMMISSION MIGHT PREPARE A FURTHER PAPER WHICH COULD EXAMINE THE EXTENT TO WHICH MONETARY POLICY WAS DRIVEN BY INTERNAL AND EXTERNAL FACTORS RESPECTIVELY AND WHETHER ANY LINK EXISTED BETWEEN MOVEMENTS IN SHORT TERM INTEREST RATES AND THE GROWTH OF REAL ACTIVITY.

SAVINGS AND INVESTMENT IN THE MAIN INDUSTRIAL COUNTRIES

7. IN THE ABSENCE OF TRICHET (FRANCE), DISCUSSION OF THIS PAPER WAS DEFERRED.

FOLLOW UP TO HANOVER EUROPEAN COUNCIL

8. LITTLER NOTED THAT THE REMIT GIVEN TO THE DELORS GROUP HAD NOT MADE ANY REFERENCE TO THE WORK OF THE MONETARY COMMITTEE BUT HE SUGGESTED WORK SHOULD NEVERTHELESS CONTINUE ON SUBJECTS WHICH NOW SEEMED LIKELY TO BE COVERED BY THAT GROUP TOO. MEMBERS WOULD WANT TO KEEP IN TOUCH WITH COLLEAGUES SERVING ON THE GROUP AND IT MIGHT BE POSSIBLE FOR PERIODIC REPORTS TO BE MADE TO THE COMMITTEE. HE WOULD CHECK AT THE SEPTEMBER MEETING WHICH TOPICS MEMBERS WOULD LIKE TO PURSUE AND WHETHER THEY WERE WILLING TO SUBMIT PAPERS. HE KNEW, FOR INSTANCE, THAT THE UK WOULD LIKE TO PRODUCE A NOTE ON THE DEVELOPMENT OF THE PRIVATE ECU. LITTLER ALSO SUGGESTED THAT THE COMMISSION MIGHT WORK UP A PAPER ON COMMON DEFINITIONS, RULES AND GUIDELINES FOR A COMMUNITY MONETARY POLICY, COMBINING ANALYSIS WITH THE IDENTIFICATION OF PROBLEMS ARISING FROM INTERACTION IN THE USE OF POLICY INSTRUMENTS. FINALLY, HE PROPOSED A COMMISSION STUDY OF THE RELATIONSHIP BETWEEN EXTERNAL IMBALANCES AND THE FREEDOM OF CAPITAL MOVEMENTS.

GREECE: SURVEILLANCE IN CONNECTION WITH COMMUNITY LOAN

9. THE COMMITTEE EXPRESSED SATISFACTION THAT GREECE WAS ABLE TO AGREE WITH THE COMMISSION'S BASIC ANALYSIS AND MAIN POLICY RECOMMENDATIONS AND WELCOMED GREECE'S EMPHASIS ON IMPLEMENTING A MEDIUM TERM PROGRAMME FOR ITS PUBLIC FINANCES. IT WOULD APPRECIATE A PROGRESS REPORT IN DUE COURSE. HOWEVER, THE TERMS OF THE COMMUNITY LOAN HAD SPECIFIED FIVE AREAS OF CONDITIONS TO BE MET AND WHILE THE COMMITTEE ACCEPTED SOME DISTINCTION BETWEEN INTERMEDIATE AND ULTIMATE TARGETS, IT WAS IMPORTANT TO GET THE FUNDAMENTALS ON INFLATION AND THE PUBLIC FINANCES RIGHT. CONCERN WAS ALSO EXPRESSED ABOUT THE POSSIBLE SHORT TERM NATURE OF THE CAPITAL INFLOWS WHICH UNDERLAY THE GOOD PROGRESS MADE ON THE EXTERNAL FRONT. IN CONCLUSION, LITTLER SAID HE WOULD SEEK THE COUNCIL CHAIRMAN'S AGREEMENT TO MAKING A VERY BRIEF ORAL STATEMENT ON THE GREEK LOAN DURING LUNCH AT THE NEXT FORMAL ECOFIN.

FUTURE MEETINGS

10. DATES FOR THREE FUTURE MEETINGS WERE PROPOSED:

6 SEPTEMBER: AT WHICH THE COMMITTEE WOULD FOCUS ON PREPARATIONS FOR THE BERLIN IMF/IBRD MEETINGS, AN EXAMINATION OF THE SPANISH ECONOMY AND THE DEFERRED FRENCH PAPER ON SAVINGS AND INVESTMENT,

25 OCTOBER: WHICH WOULD COVER MONETARY TARGETS FOR 1989 AND FURTHER WORK ON STRENGTHENING THE EMS, AND

29 NOVEMBER: AT WHICH THE COMMITTEE WOULD TAKE A COMMISSION PAPER ON MACROECONOMIC INDICATORS, FOCUSSING ON THE MEDIUM TERM,

AND THE ANNUAL EXAMINATION OF RESTRICTIONS ON CAPITAL MOVEMENTS.
OTHER BUSINESS
11. LITTLER REPORTED THAT HE WOULD BE MAKING THE CHAIRMAN'S ANNUAL VISIT TO OSLO ON 22 JULY WITH KEES (SECRETARIAT) IN ORDER TO KEEP THE NORWEGIANS IN TOUCH WITH THE MONETARY COMMITTEE'S THINKING.

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SPAIN AND THE EUROPEAN MONETARY SYSTEM

SUMMARY

1. SPAIN HAS CONFIRMED FOR THE FIRST TIME THAT THE PESETA WILL ENTER THE ECU BASKET AT THE SEPTEMBER 1989 REVIEW. THERE ARE SIGNS THAT ENTRY INTO THE EMS WILL NOT BE LONG DELAYED THEREAFTER.

DETAIL

2. SOLCHAGA (MINISTER OF ECONOMY AND FINANCE) SPOKE AT A MEETING OF THE COMMITTEE ON EUROPEAN MONETARY UNION IN MADRID ON 5 JULY. HE SAID THAT THE PESETA WILL BE INCLUDED IN THE BASKET OF CURRENCIES USED TO DETERMINE THE VALUE OF THE ECU IN SEPTEMBER 1989. THIS COINCIDES WITH THE 5-YEAR REVIEW OF THE WEIGHTING GIVEN TO THE CURRENCIES WITHIN THE ECU. HE ADDED THAT THIS MOVE IS A NECESSARY PRELIMINARY TO SPANISH INTEGRATION IN THE EXCHANGE RATE MECHANISM OF THE EMS, THE TIMING OF WHICH DEPENDED UPON POLITICAL AND ECONOMIC FACTORS WHICH WOULD BE CLEARER BY THE END OF THE SPANISH PRESIDENCY IN MID-1989.

3. MIGUEL BOYER, THE SPANISH CHAIRMAN OF THE COMMITTEE MEETING, ELABORATED ON SOLCHAGA'S REMARKS AT A SUBSEQUENT PRESS CONFERENCE. HE SAID THAT SOLCHAGA HAD INDICATED THAT SPAIN MIGHT NOT WAIT UNTIL THE END OF THE TRANSITIONAL PERIOD IN 1992 TO IMPLEMENT A FULL LIBERALISATION OF CAPITAL MOVEMENTS. FURTHERMORE THE LIKELIHOOD WAS THAT THE ENTRY OF THE PESETA INTO THE EMS WOULD TAKE PLACE AFTER INTEGRATION IN THE ECU BUT BEFORE LIBERALISATION. BOYER SAID THAT HE INTERPRETED SOLCHAGA TO MEAN THAT EMS ENTRY WOULD NOT BE LONG DELAYED AND PERHAPS WOULD TAKE PLACE BEFORE 1990.

COMMENT

4. THE OPTION OF INCLUDING THE PESETA IN THE ECU WAS FORESEEN IN A JOINT DECLARATION ANNEXED IN THE TREATY OF ACCESSION, WITH THE 5-YEAR REVIEW NOTED AS THE FIRST OPPORTUNITY FOR APPLICATION. THIS IS THE FIRST PUBLIC STATEMENT BY THE SPANISH GOVERNMENT OF THEIR INTENTION TO APPLY FOR THE PESETA'S INCORPORATION AT THE REVIEW

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MIPT: EUROPEAN MONETARY COOPERATION

FOLLOWING IS OUR TRANSLATION OF OFFICIAL TEXT OF CHANCELLOR KOHL'S REMARKS ON THE HANOVER COUNCIL AT HIS PRESS CONFERENCE ON 9 JUNE:
''THE NEXT EUROPEAN COUNCIL MEETING WILL BE HELD IN HANOVER ON 27/28 JUNE. WE ARE MAKING INTENSIVE PREPARATIONS FOR THIS SUMMIT.

ATTENTION WILL FOCUS ON THE FOLLOWING TOPICS IN HANOVER:

-THE INTERNAL MARKET: BASED ON A SURVEY OF ACHIEVEMENTS UNDER THE GERMAN PRESIDENCY WE WANT TO DRAW UP GUIDELINES AND PRIORITIES, A ''WORKING PROGRAMME'', FOR THE TIME AHEAD. WE HAVE MADE CONSIDERABLE PROGRESS IN RECENT MONTHS IN ALL THE AREAS TO WHICH WE INTENDED TO DEVOTE PRIORITY.

- WE WANT TO DISCUSS HOW WE CAN BEST DO JUSTICE TO THE SOCIAL DIMENSION OF THE INTERNAL MARKET. WE MUST GAIN STRONGER SUPPORT FOR THE INTERNAL MARKET FROM EMPLOYEES.

- IN HANOVER WE WANT TO MAKE PREPARATIONS FOR THE FURTHER DEVELOPMENT OF MONETARY POLICY COOPERATION ON THE PATH TO ECONOMIC AND MONETARY UNION. IT IS NOT A QUESTION OF TAKING A DECISION ON THE ESTABLISHMENT OF A EUROPEAN CENTRAL BANK. SUCH A BANK, FIRMLY ROOTED IN A EUROPEAN CENTRAL BANK SYSTEM, CAN ONLY LIE AT THE END OF THIS ROAD.''

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EUROPEAN CENTRAL BANK AND MONETARY COOPERATION

SUMMARY
1. GERMANS STILL FAVOUR CENTRAL BANK GOVERNORS BEING CHARGED BY HANOVER EUROPEAN COUNCIL WITH A STUDY ABOUT THE FUTURE OF EUROPEAN MONETARY COOPERATION BUT DO NOT SEE THIS SQUARING WITH THEIR UNDERSTANDING OF MITTERAND'S POSITION. NO WISH TO EXLUDE THE UK FROM THE STUDY. A DRAFT MANDATE FOR THE STUDY BEING PREPARED.

DETAIL
2. GERMAN THINKING REMAINS FLUID. JELONEK (FOREIGN MINISTRY) CONFIRMED TO ME TODAY THAT THE TIDE IN BONN HAD BEEN MOVING STEADILY TOWARDS REMITTING THE SUBJECT TO CENTRAL BANK GOVERNORS (THUS IMPLICITLY ADMITTING THAT THE GENSCHER CAMP HAD HAD TO CONCEDE ON THE IDEA OF A STUDY BY WISE MEN). BUT IN RECENT DAYS THE AUSWAETIGES AMT HAD BEEN CONSIDERING HYBRID IDEAS INVOLVING CENTRAL BANK GOVERNORS AND INDEPENDANT EXPERTS OF HIGH STANDING. THESE IDEAS INCLUDED A MIXED GROUP OF UP TO TWELVE PEOPLE (IE BANK GOVERNORS OR INDEPENDENT EXPERTS, AS GOVERNMENTS CHOSE): OR A GROUP DOUBLE THAT SIZE (AN EXPERT PER COUNTRY AS WELL AS THE BANK GOVERNOR): OR THE TWELVE GOVERNORS BEING ''ADVISED'' BY A GROUP OF EXPERTS BUT SUBORDINATE TO THEM.

3. THIS UNHELPFUL EMPHASIS ON EXPERTS DERIVES FROM KOHL'S MEETING WITH MITTERAND AT EVIAN. ACCORDING TO TELTSCHIK, WHOM I ALSO SAW TODAY, MITTERAND SAID THAT HE COULD NOT AGREE TO A GROUP COMPOSED SOLELY OF CENTRAL BANK GOVERNORS SINCE THEY WOULD NOT MOVE MATTERS FORWARD. HE WOULD HAVE NO OBJECTION TO INCLUSION OF CENTRAL BANK GOVERNORS IN A GROUP BUT HE WOULD ALSO WANT TO NOMINATE A POLITICAL REPRESENTATIVE THOUGH NOT (NOT) GISCARD. TELTSCHIK COMMENTED THAT A GROUP OF 24 PERSONS WAS THEREFORE THE OBVIOUS SOLUTION YET THAT

WOULD BE UNWIELDY. EUQALLY, IT WOULD BE DIFFICULT TO IDENTIFY CRITERIA FOR SELECTING A SMALLER NUMBER. SO FAR THE GERMANS HAD SEEN NO WAY ROUND THIS. TELTSCHIK EMPHASISED - AS DID JELONEK - THAT THERE WAS NO IDEA OF EXCLUDING FROM THE STUDY THOSE MEMBER STATES WHICH WERE NOT MEMBERS OF THE ERM. I SAID THAT IT WAS NOT ACCEPTED IN LONDON THAT THE CASE FOR A STUDY HAD BEEN CONCLUSIVELY MADE, AND THAT THE INVOLVEMENT OF NON-EXPERTS WOULD MAKE THE IDEA LESS ATTRACTIVE. IT WAS NO GOOD MOVING TOWARDS THE FRENCH POSITION FOR THE SAKE OF GENERAL AGREEMENT IF ONE PARTED COMPANY IN SO DOING FROM OTHER PARTNERS.

4. THE GERMAN DRAFT OF A MANDATE FOR THE EUROPEAN COUNCIL TO GIVE TO THE GROUP DOING THE STUDY ASKS THE GROUP TO CONCENTRATE ON CONCRETE STEPS TO IMPROVE COORDINATION OF FINANCIAL AND MONETARY POLICY AND ON STRENGTHENING THE EMS, BOTH IN THE CONTEXT OF THE SINGLE MARKET. A EUROPEAN CENTRAL BANK IS REFERRED TO AS BEING ''WITHIN THE FRAMEWORK OF A SYSTEM OF (PRESUMABLY NATIONAL) CENTRAL BANKS'' - THE SO-CALLED ''FEDERAL'' SOLUTION. JELONEK COMMENTED TO ME THAT THE MANDATE SHOULD BE BROAD, FOCUSSING ON WHICH STEPS WERE DESIRABLE, IN WHAT ORDER AND FORM AND THE IMPLICATIONS OF EACH. THE RESULTS OF THE STUDY, WHICH MIGHT BE CALLED FOR IN A YEAR, EIGHTEEN MONTHS OR TWO YEARS, WOULD NOT BE BINDING ON GOVERNMENTS BUT WOULD, THE GERMANS HOPED, BE VERY INFLUENTIAL. A REFERENCE IN THE PREAMBLE OF THE MANDATE TO MEMBER STATES' COMMITMENT TO EUROPEAN UNION MIGHT BE AN UNCONTROVERSIAL WAY OF SAYING THAT MONETARY UNION WAS AN AIM WITHOUT EXPLICITLY AFFIRMING THIS.

COMMENT

5. THE GERMANS ARE NOW TRYING TO CATCH THE HARE THEY HAVE RUN. THE REASSERTION OF THE AUTHORITY OF THE FINANCE AND ECONOMIC MINISTERS (WITH THE STRONG URGING OF THE BUNDESBANK) OVER THE AUSWAERTIGES AMT, AS THE RESULT OF WHICH THE PRESIDENCY WOULD ALMOST CERTAINLY HAVE PROPOSED REMITTING THE SUBJECT TO THE SAFE HANDS OF CENTRAL BANKERS, HAS BEEN UPSET BY MITTERRAND. IT IS NOT CLEAR HOW FAR GENSCHER WILL WANT OR BE ABLE TO EXPLOIT THIS, NOR HOW MUCH GROUND THE CHANCELLERY WILL FEEL OBLIGED TO YIELD. MY GUESS IS THAT THEY WILL TRY TO HANG ON TO A CENTRAL ROLE FOR BANK GOVERNORS BUT WILL NOW NEED MORE ACTIVE SUPPORT THAN PREVIOUSLY FOR SUCH A RELATIVELY ANODYNE SOLUTION.

6. SEE MIFT FOR KOHL'S REMARKS ABOUT HANOVER AT HIS PRESS CONFERENCE YESTERDAY.

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INFO ROUTINE WASHINGTON, UKDEL OECD, TOKYO
INFO SAVING CGS IN THE FRG AND BERLIN

FRAME ECONOMIC

MY TELNO 519: EUROPEAN MONETARY COOPERATION.

SUMMARY

1. BUNDESBANK PRESIDENT POEHL TELLS ME THAT HE WELCOMES PUBLIC DEBATE ON EUROPEAN MONETARY UNION AND EUROPEAN CENTRAL BANK, SINCE IT SHOULD BRING OUT THE DIFFICULTIES AND FOSTER REALISM. HE EXPECTS KOHL AT THE HANOVER EUROPEAN COUNCIL TO PROPOSE A STUDY OF FURTHER MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A EUROPEAN CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND ALL THE IMPLICATIONS. STUDY PROBABLY TO BE DONE BY COMMITTEE OF CENTRAL BANK GOVERNORS. POEHL'S VIEWS ON HARMONISATION OF TAXATION NOT FAR FROM OURS. HE AGREES THAT SOME STIMULATION OF DOMESTIC DEMAND IS DESIRABLE IN FRG.

2. POEHL'S DOUBTS ON MONETARY UNION AND EUROPEAN CENTRAL BANK ELABORATED IN A MAJOR NEWSPAPER ARTICLE (SEE MIFT).

DETAIL.

3. POEHL, WHOM I VISITED ON 31 MAY, SAID THAT HE WELCOMED THE PUBLIC DISCUSSION OF MONETARY UNION AND A CENTRAL BANK, SINCE IT WOULD SHOW UP THE MANY DIFFICULTIES AND FOSTER MUCH NEEDED REALISM. WHEN HE HAD EXPLAINED THE SUBJECT AT A RECENT MEETING IN THE FEDERAL CHANCELLERY, KOHL HAD SAID THAT HE HAD NOT PREVIOUSLY REALISED THAT THE MATTER WAS SO COMPLICATED OR THAT THE IMPLICATIONS OF A CENTRAL BANK WERE SO FAR REACHING.

4. POEHL TOLD ME THAT HE DID NOT BELIEVE THAT GOVERNMENTS WERE READY TO ACCEPT THE CONSEQUENCES OF A CENTRAL BANK. FINANCE MINISTERS, STOLTENBERG INCLUDED, WERE NOT EVEN WILLING TO LEAVE DECISIONS ON EXCHANGE RATE CHANGES IN THE ERM TO THE COMMITTEE OF CENTRAL BANK GOVERNORS. MONETARY UNION WOULD GO FAR BEYOND THAT. BUT COORDINATION

OF MONETARY POLICY IN THE EMS, WITH AGREED TARGETS, MIGHT BE POSSIBLE AS A FURTHER STEP. IN ANY DEVELOPMENT OF THE ROLE OF THE CENTRAL BANK GOVERNORS, THE INDEPENDENCE OF THE LATTER MUST BE FULLY UPHELD. THERE COULD BE NO CONVERGENCE IN THEIR ROLES THAT WOULD REDUCE THE INDEPENDENCE OF THE BUNDESBANK.

5. POEHL SPOKE IN FAVOUR OF ''HORIZONTAL DEVELOPMENT'' OF THE EMS, NOT ONLY THROUGH BRITISH PARTICIPATION IN THE ERM BUT ALSO THROUGH ASSOCIATION OF AUSTRIA AND PERHAPS SWITZERLAND.

6. WHEN I DESCRIBED OUR POSITION ON HARMONISATION OF TAXATION, POEHL AGREED THAT FREEDOM OF CAPITAL MOVEMENTS WOULD EXERT PRESSURE TOWARDS SIMILAR LEVELS OF TAXATION IN SOME FIELDS AND THAT DIFFERING LEVELS IN OTHER FIELDS WOULD NOT PREVENT A SINGLE MARKET FROM FUNCTIONING (AS TODAY IN USA AND SWITZERLAND). HE THOUGHT HOWEVER THAT CENTRAL DIRECTIVES MIGHT BE NEEDED IN A FEW TAXATION MATTERS, TO NUDGE THE MARKET TOWARDS REDUCTION OF DIFFERENCES IN TAXATION AND THUS HEAD OFF UNWANTED DISTORTIONS.

7. POEHL EXPECTS THE FEDERAL CHANCELLOR AT THE EUROPEAN COUNCIL IN HANOVER TO PROPOSE THAT A STUDY BE COMMISSIONED OF FURTHER STEPS IN MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND WHAT ALL THE MANY IMPLICATIONS WOULD BE. THE MANDATE MIGHT BE IN GENERAL TERMS OR MORE SPECIFIC. THE FORUM DOING THE STUDY MIGHT BE THE COMMITTEE OF CENTRAL BANK GOVERNORS. ECOFIN WAS UNSUITABLE, SINCE THE COMMUNITY AS SUCH HAD NO COMPETENCE IN MONETARY MATTERS AND THE COMMISSION MUST NOT BE LET IN ON THE SUBJECT.

8. ASKED ABOUT THE MEETING OF THE FRANCO-GERMAN ECONOMIC COUNCIL ON 30 MAY, POEHL SAID THAT BEREGOVOY WAS NOT INTERESTED IN A EUROPEAN CENTRAL BANK. FRANCE WAS INTERESTED IN ''SYMMETRY'', WHICH IN EFFECT MEANT, AMONG OTHER THINGS, REDUCTIONS IN IMBALANCES IN TRADE IN THE EC, WHICH IN TURN MEANT STIMULUS OF GREATER DOMESTIC DEMAND IN THE FRG. IN POEHL'S VIEW DECISIONS CONCERNING FRENCH IDEAS FOR MUTUAL SUPPORT OF CURRENCIES IN THE EMS COULD NOT LEGALLY OR APPROPRIATELY BE TAKEN BY THE EUROPEAN COUNCIL - ONLY BY THE CENTRAL BANK GOVERNORS.

9. I TOOK UP THE QUESTION OF STIMULATING DEMAND IN THE FRG, SUGGESTING THAT TAKING A SAW TO THE FOREST OF REGULATION IN THE ECONOMY WOULD BE A POSSIBLE APPROACH. POEHL SAID THAT HE SAW FORCE IN THE ARGUMENT THAT THE FRG WAS NOT GROWING FAST ENOUGH. THE UK WAS THE MODEL. GERMANY COULD NOT ACHIEVE 3-4 PERCENT GNP GROWTH PER

ANNUM. BUT THE D-MARK WAS LOSING VALUE IN REAL TERMS, FUELLING THE IMBALANCE IN TRADE EG WITH FRANCE. I DREW ATTENTION TO THE FRG'S SURPLUS OF DM 17 BILLION IN TRADE WITH UK IN 1987.

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Article from "Frankfurter Allgemeine Zeitung" of 28 May 1988

# THE VISION OF A EUROPEAN CURRRENCY AREA

## What would have to be done

**by Karl Otto Pohl**

We are currently undergoing a phase of new initiatives in the European Community spearheaded by the intention to create a European internal market by 1992, for which the generally favourable economic and monetary situation offers good preconditions. Monetary stability is not only widely recognised as the primary goal of monetary policy but also achievable in Europe more than ever before; notwithstanding existing differences such as those on financial policy, there is widespread convergence between economic policy and economic developments. By 1992, we will therefore hopefully have made considerable advances along the road towards economic union in Europe. It is worth supporting this goal if only for purely economic reasons. A single internal market is likely to be a source of considerable economic growth in Europe. Beyond this, however, the realisation of a European currency union is doubtless a political goal of great significance.

There are good reasons for the fact that plans for the European internal market go far beyond trading considerations. The establishment of an integrated financial market appears imperative. Free transfer of capital and unrestricted convertibility of all European currencies are essential components of a single internal market and would also provide a foundation for future monetary union. A further decisive criterion for monetary union is the final and irrevocable fixing of exchange rates. The 1970 Werner Report contained the following definition of monetary union, which is still valid today: "Monetary Union requires the complete and irreversible convertibility of currencies, the elimination of exchange rate bands, irrevocably fixed parities and the complete liberalisation of capital movements."

A monetary union based on this definition would have far-reaching consequences for economic development in Europe. It would be the monetary superstructure of an economic union in which the movement of goods, services, labour and capital took place more or less unrestricted. This does not necessarily presuppose the harmonisation of all policies; continuing differences in tax systems, collectively agreed arrangements and other areas would lead to advantages or disadvantages for particular locations. Although the market would enforce a certain degree of harmonisation, basic political consensus, a functioning system of financial compensation and a high degree of cooperation on economic, financial and monetary policies would be necessary to avoid an increasing imbalance in the economic development of the Member States resulting, finally, in the complete breakdown of the system.

It would then only be a small step from monetary union to a single currency. Although national currencies could, in principle, be kept, the introduction of a single currency unit in place of the national currencies would probably imbue the monetary union with a "monetary identity" which would eliminate the residual risk of parity changes between national currencies and thus create a symbol for the perpetuation of a single currency area. Replacing national currencies with a Community currency would put the final touch to the process of monetary integration.

But this final situation is still a long way off. That is why the concept of a parallel currency has been discussed since the 1970s as an alternative to the step-by-step achievement of a European monetary union as defined in the Werner Report. This concept implies the idea of bringing an EC currency into circulation in addition to the national currency, as a vehicle for monetary agreement. Those who support this idea assume that this European currency will gradually displace the franc, guilder, and deutschmark and evolve into the sole and general means of payment and store of value in Europe.

In comparison to the task of transferring national responsibilities to the Community which has proved difficult in past experience, the concept of parallel currencies may indeed appear to be an "elegant" solution at first sight. Upon closer inspection, however, it becomes clear that this concept also requires far-reaching institutional adjustment measures if the "currency race" it sets in motion is to take its course in a manner acceptable to all Member States.

Currencies must prove their worth on the market

Parallel currencies will not abolish the necessity of taking those political decisions necessary for the creation of a monetary union. The idea that official preference shown for a parallel currency will give it the edge over national currencies is not very realistic. The market decides upon the acceptability of a currency according to interest and exchange rate considerations; attempts to disturb the functioning of the market with official measures hold few chances of success as the development of the private and official Ecu has shown which becomes less attractive when capital transfer restrictions, foreign exchange controls and convertibility restrictions are eliminated and exchange rates become more stable.

Using the ecu as a parallel currency - or simply as a currency - will meet with difficulties, not least because of its particular construction. A basket-ecu constructed on the basis of a weighted average of national currencies cannot exercise an insistent and especially not an evenly distributed displacement pressure on national currencies and cannot therefore be regarded as an additional means of integration. The basket-ecu cannot develop an independent quality of its own. If one disregards some slight indifference margins, it is bound to mirror the weighted average of the interest and exchange rates of those currencies contained in the basket.

An independent European currency must be able to maintain the same high standards as the best of the national currencies. If this were not the case, the EC central banks would have to be

obliged to safeguard the parallel currency's exchange rate through unrestricted buying. Such intervention obligations would have considerable monetary consequences amounting, in the last analysis, to a constant creation of the relatively strong currencies to finance purchases of the European currency.

A parallel currency strategy demands a functioning market displacement procedure. The well-balanced substitution of all EC currencies (that means the deutschmark as well) with the parallel currency which necessity demands would only be possible, if the parallel currency

- were accorded the same status on the internal market as every other EC currency;

- were able to compete with the strongest EC currency as an investment currency subject to interest rate and exchange rate developments; and

- were burdened with the lowest possible costs in its role as transaction currency which would virtually only be possible if it were guaranteed by sufficiently firm exchange rates with the other national currencies.

All this, however, more or less defines the final situation to which the parallel currency itself should lead. Why take the costly detour via the parallel currency? Europe would gain little whilst having to put stability at considerable risk if it were to realise the concept of a parallel currency.

The creation of a monetary union does not necessarily demand a European system of central banks. It is also possible to imagine successful cooperation on monetary policy between the national central banks if a high degree of convergence is simultaneously achieved in other policy areas. A minimal institutional framework would, however, afford greater reliability for a monetary union and, above all, for a single currency.

Taking this step towards the institutional phase of cooperation on monetary policy with the aim of creating a European central bank system presupposes that answers - the clearer, the better - have been given to a series of questions, so as to avoid going in the wrong direction from the very beginning.

Such a system requires a clearly defined mandate. It should be in line with the aim of the Deutsche Bundesbank Act, namely, "to secure the currency", ie to see to it that prices remain stable. This might appear self-evident for a central bank, but in practice, there is always a tendency to burden monetary policy with additional tasks such as stabilising exchange rates or assisting with regional structural policies, employment or other tasks, which could conflict with the real aim of a central bank of securing the currency.

Priority for keeping prices stable does not mean that a European central bank would have a deflationary "bias" from the word go. Experience gained in the 1970s - not only in the Federal Republic - has rather more shown that one cannot, as it were, buy a little more inflation for a little less unemployment. On the contrary, countries with a low inflation rate generally had a lower unemployment rate and vice versa. The large majority of those Germans haunted by the memory of two traumatic inflations who know what price stability means for prosperity and social justice would hardly be willing to accept a central bank system which accords this aim less importance than the Deutsche Bundesbank Act does.

The task of looking after price stability would at least be facilitated, if not made possible, if a European Central Bank were independent in its decision-making and opinion-forming processes; independent not only of national governments but also of the EC institutions, ie the Commission and the Council of Ministers. This would demand considerable amendments to the existing constitution of central banks in several Member States - probably also that in the Federal Republic of Germany; in its current, more or less two-tier system with eleven Land central

banks and the directorate in Frankfurt, it is doubtful whether this system could be maintained.

According to our concept, the monetary instruments at the disposal of a European central bank would be set up so as to enable it to manage money supply effectively without having to resort to quantitative controls (or other direct interventions in the finance markets). The machinery must therefore provide interest policy instruments as well as liquidity policy instruments with which it will be possible to exercise general as well as detailed control of the European money market.

A European central bank system can really only be organised as a decentralised, federal system, ie on a subsidiary basis according to which only the necessary minimum is centralised and as much as possible left to national competence. A European central bank system should therefore be more akin to the Bundesbank system or the Federal Reserve system in the United States than the centralist system in most European countries.

Finally, we believe that such a European central bank system must not be entitled to finance national deficits by creating money. This is by no means self-evident in all countries. In the Federal Republic of Germany the Bundesbank is forbidden to do this by the Deutsche Bundesbank Act.

<u>All foreign currency reserves in one large pot?</u>

We must also find an answer to the question of the extent to which a European central bank should be responsible for exchange rate policy vis a vis third currencies, ie in the first place dollar and yen. Monetary stability requires safeguards against external influences, as we saw with the Bretton Woods system. The stabilisation of exchange rates cannot and should not be the main aim of monetary policy, especially in an inflationary environment. Within this framework, however, there is by all means room for cooperation on monetary policy with countries outside the Community. This may also include intervention on the foreign exchange markets. A European central bank would be

responsible for such activities and would therefore have to purchase and administer at least part of what are now still national currency reserves. This was foreseen when the European Monetary System was set up, but foundered due to the unwillingness of practically all the countries concerned (not the Bundesbank, which only insisted on a statutory regulation) to transfer part of their foreign currency reserves irrevocably to the supranational institution.

There are also a number of apparently less fundamental problems, whose relevance one should not, however, underestimate. Where for example should a European central bank be located - in Frankfurt, in Paris, in Brussels or in London?

An infinite number of difficult questions still have to be answered in connection with the creation of a European currency and a European central bank system. One problem arises from the fact that four members of the European Community - Great Britain, Spain, Portugal and Greece - are not even members of the current exchange rate system, the EMS and that there are exceptional rules for Italy in the form of an extended band for the lira. Under these circumstances, one does not have to be a defeatist to have certain doubts as to whether the political environment is really ripe for such far-reaching decisions and for the relinquishment of sovereign rights as the creation of a European central bank and a European currency would demand.

In the meantime, however, developments have not stood still. We have made considerable progress towards monetary integration in the course of the last few years. Monetary cooperation in Europe has become more intensive since the foundation of the European Monetary System. The Bundesbank has made a considerable contribution to this process ie with its approval on two occasions to the extension of the EMS rules, most recently with the Agreements reached in Basle and Nyborg in September 1987. Economic development in the member states has reached a high level of convergency. Exchange rates in the European Monetary System are relatively stable. The coordination of intervention

vis a vis the dollar is already well developed, at least among the countries which are members of the EMS exchange rate system.

The Committee of EC Central Bank Governors plays an important role in this process of monetary cooperation. It has proved itself a useful institution for coordinating monetary and currency policy in the European Monetary System. I believe that it could be given more extensive powers in managing the monetary system, especially as the system is founded on an agreement between the central banks. For example, the EC Central Bank Governors could make the necessary exchange rate corrections professionally, at the proper time and without creating a stir. The Finance Ministers, however, have rejected such proposals.

The European Monetary Cooperation Fund (EMCF), on the other hand, is not suitable as the nucleus of a European central bank system. The EMCF lacks one important feature, namely independence of the institutions of the European Community. It is a creation of the EC Council of Ministers and would therefore, at least in principle, be dependent on the decisions of this body.

The commitment to keep the European Monetary System operational has increased the need for closer cooperation. In the nine years since the EMS was founded, the Bundesbank has made considerable contributions to the smooth and successful operation of this regional monetary system. The deutschmark has thereby - unintentionally - slipped into the role of the most important intervention and key currency. It has become the stability factor within the European Monetary System and thus forms the decisive basis for the successful functioning of the system. The weight of the economy of the Federal Republic within the European Monetary System has also contributed to the success of German economic and monetary policy in securing the stability of the deutschemark and maintaining it as the most stable currency within the European Monetary System. It would be disastrous not only for the Federal Republic but equally for the other European partners if one were to loosen the moorings of the European Monetary System without knowing what should take its place.

Dangers to the European exchange rate mechanism

Some of our partners refer to the loss of economic and monetary freedom which they have to face as a result of the dominating role of the deutschemark within the European Monetary System. They see themselves restricted in pursuing independent growth, employment and stability objectives to the extent to which they have accepted exchange rate links with the deutschmark. They demand a "symmetrical" division of burdens in protecting exchange rates within the European Monetary System. This discussion has been going on since the creation of the European Monetary System. Lengthy negotiations were necessary before the Central Banks were able to reach an agreement on intervention obligations. Both those countries whose currencies reach the lower intervention point as well as those whose currencies reach the upper intervention point are obliged to sell or purchase foreign currency as the case may be. The system is in this respect by all means "symmetrical". There are not contractual obligations as far as so-called intra-marginal interventions are concerned. These are intended to keep exchange rates within the limits. Intra-marginal interventions do, however, require the approval of the central bank whose currency is used for intervention. The Bundesbank has usually approved the use of the deutschmark when this has not clashed with its own monetary objectives.

The Basle/Nyborg Agreements extended the already generous credit facilities partially - and under certain conditions - to include intra-marginal interventions. One must realistically expect that the Bundesbank will have to provide the major part of this financial commitment whenever substantial intra-marginal interventions are necessary. This can mean a considerable burden on monetary policy, particularly as the Bundesbank is also expected to intervene within the framework of cooperation with the United States. It is not because we are unwilling to cooperate that we refuse to accept intervention commitments in excess of our contractual obligations.

There are other more serious reasons. Should the bundesbank begin to include EMS currencies in its reserves, as it has been urged to do, this would not strengthen the European Monetary System but would in fact weaken it, since countries with a weak currency would no longer be obliged to make appropriate adjustments. The Federal Republic is of course committed to contributing towards equilibrium within the monetary system, ie in the present situation to reducing its current account surpluses. However this should not take place by means of weakening monetary discipline but by pursuing a policy aimed at increasing domestic demand, as the recent tax reductions set out to do. Finally, interventions cannot be a permanent substitute for timely adjustments to exchange rates as long as economic developments in the member states continue at different rates. Happily this is not the case at the moment but cannot be ruled out entirely in the future.

The study presented by Gros and Thygesen at the beginning of the year on the functioning of the European Monetary System in the past years emphasises the positive key role of German monetary policy and demonstrates that the claimed "asymmetry" has not hindered the cohesion of the system but has in fact secured it: "The advantages of the Bundesbank's leading role could be lost if the European Monetary System becomes symmetrical and the Bundesbank's ability to control the monetary aggregates in the Federal Republic is reduced without establishing credible rules for joint money creation."

A European monetary union is a desirable political and economic objective. Some considerable progress has already been made in this direction. The directive to liberalise capital transactions within the Community proposed by the European Commission, which I hope will be approved in the near future, possibly at the next meeting of the Council of Ministers of Finance on 13 June, would be a milestone in this development. Participation by all member states in the exchange rate mechanism of the European Monetary System would be a further important step. The question of whether further institutional changes aimed at a monetary union can be

introduced depends on the governments and parliaments concerned. Realism and moderation are more useful than wishful thinking.

NOTE FOR THE RECORD

The Foreign Secretary telephoned the Prime Minister at 0745 this morning to ask whether he and the Chancellor could come together to see the Prime Minister today. The Prime Minister said that she saw no need for this. She would of course be seeing the Chancellor in the course of the day to discuss the situation in the markets. But if they all three met, it would increase speculation about difficulties. The best thing which the Foreign Secretary could do would be to keep quiet. The present difficulties were occurring because people were saying too much.

The Foreign Secretary replied that he had said nothing in his speech at Perth which he had not said before. Other speakers had referred to the EMS and he was bound to reply. He had used a formulation which he had employed before. The Prime Minister said that he should have known that the timing of his remarks and the fact that they were not in his published text was bound to cause trouble. He had succeeded in making life very difficult. She would see the Chancellor. That apart, the best thing was to keep quiet.

The Foreign Secretary said that he still thought a meeting between the three of them to try to settle the semi-public dispute would be useful. The Prime Minister said that she had nothing to do with any disputes. The row was a trumped-up one and had been caused quite unnecessarily. The EMS had not been on the agenda. The Foreign Secretary had been the one to put it there.

The Foreign Secretary started to explain why he thought we would be better off within the EMS. The Prime Minister said that it would simply bring us down to Germany's rate of growth. We were <u>not</u> going in at present. The Foreign Secretary had caused havoc over the weekend by his remarks and created the problem. The key thing now was to keep quiet.

She would be talking to the Chancellor and the Foreign Secretary could do so too if he wished. But there should be no meeting of the three of them.

The Foreign Secretary said that anyway he would be seeing the Prime Minister tomorrow (in fact he is not) and could continue their discussion. The Prime Minister did not dissent.

C.D.P

C. D. POWELL

16 May 1988

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MIPT: EUROPEAN MONETARY COOPERATION

SUMMARY

1. POEHL OUTLINES BUNDESBANK THINKING ON PROGRESS TOWARDS MONETARY UNION. TIETMEYER WELCOMES THE BUNDESBANK'S STATEMENT AND COMMENTS ON THE PROSPECTS FOR FURTHER DISCUSSION AT HANOVER.

DETAIL

2. AT A PRESS CONFERENCE FOLLOWING THE REGULAR MEETING OF THE CENTRAL BANK COUNCIL IN FRANKFURT ON 5 MAY, POHL ISSUED A STATEMENT CONCERNING THE COUNCIL'S VIEWS ON EUROPEAN MONETARY COOPERATION.

3. POHL EMPHASISED THAT THE BUNDESBANK DID NOT INTEND TO DELAY PROGRESS TOWARDS CLOSER MONETARY COOPERATION. HE OBSERVED THAT THE EC WAS ENTERING A NEW PHASE WITH THE SINGLE MARKET CLEARLY IN SIGHT AND WITH THE LIBERALISATION OF CAPITAL MOVEMENTS. THE QUESTION WAS COULD THERE BE ECONOMIC UNION WITHOUT MONETARY UNION. THE CONDITIONS FOR MONETARY UNION IDENTIFIED IN THE WERNER REPORT (IRREVERSIBLE MOVEMENTS TOWARDS FIXED EXCHANGE RATES, THE PARITY AND CONVERTIBILITY OF CURRENCIES AND THE COMPLETE LIBERALISATION OF CAPITAL MOVEMENTS) WERE STILL VALID. DESPITE RECENT PROGRESS (NYBORG, ETC) IN THE BUNDESBANK'S VIEW A COMMON EUROPEAN CURRENCY AND A EUROPEAN CENTRAL BANK REQUIRED SUPRANATIONAL DECISIONS INVOLVING SOVEREIGNTY WHICH EUROPEAN GOVERNMENTS WERE NOT YET READY TO TAKE. HE EMPHASISED THE COOPERATION BETWEEN ALL MEMBERS OF THE EC WOULD BE NECESSARY TO CREATE THE RIGHT CONDITIONS FOR PROGRESS. THE FEDERAL REPUBLIC AND FRANCE ALREADY COOPERATED INTENSIVELY. BUT HE QUESTIONED HOW FURTHER PROGRESS COULD BE MADE WHEN FOUR MEMBERS OF THE EC, THE UK, SPAIN, PORTUGAL AND GREECE, WERE NOT YET MEMBERS OF THE ERM AND ONE, ITALY HAD SPECIAL ARRANGEMENTS. FURTHER PROGRESS DEPENDED ON A GREATER CONVERGENCE OF ECONOMIC, FISCAL, REGIONAL AND SOCIAL POLICIES. AND WHERE SHOULD A FUTURE EUROPEAN FINANCIAL CENTRE BE: FRANKFURT, PARIS OR PERHAPS LONDON. HE MENTIONED THREE

ELEMENTS THAT WOULD BE NECESSARY ON THE WAY TO CLOSER COOPERATION:

A) THE EMS SHOULD BE COMPLETED:
B) CAPITAL MOVEMENTS WITHIN EUROPE HAD TO BE FULLY LIBERALISED - ''THE LITMUS TEST FOR THE SINGLE MARKET'':
C) THE COMMITTEE OF CENTRAL BANK GOVERNORS SHOULD INTENSIFY COOPERATION - IT MIGHT BE RIGHT FOR THEM TO TAKE OVER FROM THE COUNCIL OF MINISTERS RESPONSIBILITY FOR DECISIONS REGARDING CHANGES IN EMS ALIGNMENTS.

FOR THE GOVERNMENT, TIETMEYER WELCOMED THE BUNDESBANK'S STATEMENT. HE SAID THAT THERE WAS A LARGE MEASURE OF AGREEMENT BETWEEN BONN AND FRANKFURT. IN RESPONSE TO A QUESTION ABOUT THE PROSPECTS FOR HANOVER, TIETMEYER SAID THAT HE COULD WELL IMAGINE THAT THERE WOULD BE A DISCUSSION ABOUT THE COORDINATION OF MONETARY POLICY.

4. ASKED ABOUT THE BUNDESBANK'S CONCERNS ABOUT ITS AUTONOMY AND THE REQUESTS FROM THE CENTRAL BANK COUNCIL FOR A PREAMBLE TO THE AGREEMENT ESTABLISHING THE FRANCO-GERMAN ECONOMIC AND FINANCE COUNCIL, TIETMEYER SAID THAT CHANCELLOR KOHL HAD WRITTEN TO THE COUNCIL ON 27 APRIL SAYING THAT SUCH A PROTOCOL WAS NOT NECESSARY AND THAT THE RIGHTS OF THE BUNDESBANK WOULD BE SAFEGUARDED.

5. FULL TRANSLATION OF THE TRANSCRIPT OF THE PRESS CONFERENCE FOLLOWS BY BAG.

6. FCO PLEASE ADVANCE TO BRAITHWAITE (FCO), SIR G LITTLER (TREASURY), LOEHNIS (BANK OF ENGLAND).

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EUROPEAN MONETARY UNION.

SUMMARY

1. BUNDESBANK CENTRAL COUNCIL DISCUSSES EUROPEAN MONETARY UNION ON 5 MAY ON BASIS OF AN INTERNAL STUDY. ACCEPTS NEED FOR PROGRESS TOWARDS STILL DISTANT GOAL OF MONETARY UNION. EXAMINES NECESSARY CONDITIONS FOR REACHING THIS AND FAVOURS MAKING COMMITTEE OF CENTRAL BANK GOVERNORS IN BASLE NUCLEUS OF PRAGMATIC COOPERATION. TIETMEYER (FEDERAL FINANCE MINISTER) PRESENT AND PUBLICLY WELCOMES DISCUSSION. STRESSES THE EXISTENCE OF A LARGE MEASURE OF AGREEMENT BETWEEN BONN AND FRANKFURT, BUT CONFIRMS THAT THERE IS STILL NO AGREED POSITION OF THE FEDERAL GOVERNMENT. GENSCHER CONTINUES TO PROMISE HIS OWN IDEAS (MY TELNO 422): REPORTS OF DIVIDED COUNSELS INSIDE THE CHANCELLERY. TIETMEYER ANNOUNCES THE FEDERAL GOVERNMENT WILL BE CONSULTING OTHER MEMBER STATES AND MENTIONS BOTH THE MAY INFORMAL MEETING OF FINANCE MINISTERS AT TRAVEMUENDE AND THE JUNE ECOFIN AS PLACES WHERE THE ISSUE WILL COME UP. TRAVEMUENDE LIKELY TO BE IMPORTANT.

DETAIL.

2. MINISTER (ECONOMIC) CALLED ON RIEKE (BUNDESBANK) AUTHOR OF THE DISCUSSION PAPER ON MONETARY UNION TAKEN BY THE BUNDESBANK AT A REGULAR THURSDAY MEETING ON 5 MAY AT WHICH TIETMEYER (FINANCE MINISTRY) WAS PRESENT AT HIS REQUEST. RIEKE WAS VERY FRANK (PLEASE PROTECT). HE GAVE THE IMPRESSION THAT THE BUNDESBANK RECOGNISED THE PRESSURES TOWARDS FURTHER MONETARY INTEGRATION (HE DID NOT SAY THEY SAW THE NEED). IT HAD THEREFORE UNDERTAKEN A THOROUGH ANALYSIS OF THE APPROPRIATE CONDITIONS FOR IT AND HAD SOUGHT A PRAGMATIC WAY FORWARD, IE COOPERATION THROUGH THE COMMITTEE OF CENTRAL BANK GOVERNORS IN BASLE.

3. HIS PAPER, WHICH IS ABOUT 50 PAGES LONG, FALLS INTO 3 PARTS: (A) AN ASSESSMENT OF THE NATURE OF MONETARY UNION, DRAWING HEAVILY ON THE WERNER REPORT, BUT TAKING INTO ACCOUNT DEVELOPMENTS SINCE THEN, SUCH AS THE IMMINENCE OF THE SINGLE MARKET. RIEKE SAID THAT

THIS PART UNDERLINED THE INDESPENSABLE INGREDIENTS OF MONETARY UNION AS IDENTIFIED BY WERNER - EXCHANGE RATE STABILITY AND FULL CONVERTABILITY - IMPLYING CLOSE CONVERGENCE OF DOMESTIC ECONOMIC POLICY, AND ENDORSED THEM.
RIEKE COMMENTED THAT NONE OF THIS WAS NEW BUT NEEDED TO BE SAID TO THE POLITICIANS. THIS SECTION HAS BEEN INTERPRETED IN THE GERMAN PRESS AS THE BUNDESBANK SETTING PRECONDITIONS WHICH RIEKE WAS AT PAINS TO DENY (BUT SEE PARA BELOW)
B) AN ANALYSIS OF THE VARIOUS IDEAS IN PLAY ABOUT THE FORM THAT PROGRESS TOWARDS MONETARY UNION MIGHT TAKE.

THE PAPER FOCUSSED PARTICULARLY ON THE CONCEPT OF A PARALLEL CURRENCY WHICH RIELE DESCRIBED AS PROBABLY UNWORKABLE, BUT IF WORKABLE, DANGEROUS, ESPECIALLY TO THE DEUTSCH MARK. IT WAS EVIDENT THAT THE BUNDESBANK SAW THIS IDEA AS AN ESPECIALLY INSIDIOUS SOFT OPTION THAT IT WAS IMPORTANT TO KILL.
C) A SUGGESTED WAY FORWARD, GIVING AN ENHANCED ROLE TO THE COMMITTEE OF CENTRAL BANK GOVERNORS IN BASLE AS THE NUCLEUS OF COOPERATION AT THE EUROPEAN LEVEL. RIEKE SAID THE BANK REJECTED ANY MODEL WHICH INVOLVED THE NUCLEUS TAKING ON RESPONSIBILITY CENTRALLY FOR SUPPORTING MEMBER CURRENCIES OR EXTENDING CREDIT (THE SO CALLED IMF MODEL). THIS WOULD CONTINUE TO REST WITH NATIONAL CENTRAL BANKS. (THE USE OF THE WORD ''FEDERAL'' IN THIS CONNECTION IS INTENDED TO EMPHASISE DECENTRALISATION OF RESPONSIBILITY). THE BANK'S CONCEPTION WAS MUCH LIGHTER AND MORE PRAGMATIC THAN AN IMF. WHILE MEMBER GOVERNMENTS WOULD NOT BE EXPECTED TO REVEAL BUDGETARY SECRETS IN DETAIL BEFORE THEY BECAME PUBLIC NATIONALLY, THE ESSENCE OF THE WAY FORWARD WOULD BE MUCH CLOSER SHARING THAN NOW OF INFORMATION ABOUT THE TRENDS OF DOMESTIC ECONOMIC POLICY MAKING BEFORE DECISIONS WERE TAKEN (RIEKE DESCRIBED THIS AS EX ANTE RATHER THAN EX POST DISCUSSION).

4. THE BUNDESBANK REGARD THEMSELVES AS HAVING MADE A CONSTRUCTIVE CONTRIBUTION TO THE DEBATE IN TWO WAYS. FIRST, THEY SEE THE FORMULA OF THE CENTRAL BANK GOVERNORS, WHICH IT SUITS THEM TOO, AS BEING HELPFUL TO THE UNITED KINGDOM IN PARTICULAR. RIEKE SAID THAT ''UNLIKE SOME OTHERS'' THEY DID NOT WANT TO MOVE FORWARD WITHOUT THE UK. SECONDLY, THEY FEEL THEY HAVE COME FORWARD WITH A REAL (AND GOOD) ALTERNATIVE WITH WHICH TO BEAT GENSCHER AND THOSE IN THE CHANCELLERY (UNSPECIFIED) WHO THOUGHT LIKE HIM. THEY ARE HOWEVER WORRIED THAT ITS VERY LACK OF GLAMOUR WILL MEAN THAT IT FAILS TO ATTRACT SUFFICIENT SUPPORT. THAT THIS DANGER IS REAL IS CLEAR FROM THE ALMOST TOTAL LACK OF NOTICE ACCORDED TO THE PROPOSAL IN GERMAN REPORTS OF POEHL'S PRESS CONFERENCE, WHERE THE BANK'S SUPPOSEDLY NEGATIVE ATTITUDE WAS HIGHLIGHTED.

COMMENT
5. THE BUNDESBANK IS FOLLOWING UP ITS DISCUSSION WITH ANOTHER PAPER. BOTH OF THESE WILL ALMOST CERTAINLY BE IN TIETMEYER'S POSSESSION AT TRAVEMUENDE. AS SEEN FROM HERE, THAT MEETING LOOKS CRUCIAL IN THE PROCESS OF SHAPING THE GERMAN - AND THE PRESIDENCY - POSITION FOR HANOVER. ON THE ONE HAND ARE THE MODEST AND PRAGMATIC IDEAS OF THE BANK WITH WHICH TIETMEYER HAS ASSOCIATED THE FINANCE MINISTRY. ON THE OTHER ARE THE GLAMOROUS BUT DOUBTFUL BEING FLOATED BY GENSCHER. THE PROBLEM IS THAT MERIT AND POLITICAL PULLING POWER ON THIS ISSUE IN BONN DO NOT GO HAND IN HAND. THE PRAGMATIC SCHOOL IS UNLIKELY TO BEAT GENSCHER WITHOUT THE ASSISTANCE OF OTHER PARTNERS.

6. SEE MIFT FOR MAIN POINTS OF POEHL'S PRESS CONFERENCE. HE DREW HEAVILY ON THE BANKS INTERNAL PAPER WITHOUT HOWEVER MENTIONING ITS EXISTENCE WHICH IS NOT PUBLIC KNOWLEDGE.

7. FCO PLEASE ADVANCE TO BRAITHWAITE (FCO) SIR G LITTLER (TREASURY) LOEHNIS (BANK OF ENGLAND)

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EC MONETARY COOPERATION
1. THIS TELEGRAM PROVIDES GUIDANCE ON RECENT PROPOSALS FOR THE FURTHER DEVELOPMENT OF EUROPEAN MONETARY COOPERATION, INCLUDING GENSCHER'S STUDY OF THE FEASIBILITY OF ESTABLISHING A EUROPEAN CENTRAL BANK.
UK OBJECTIVES
2. OUR MAIN IMMEDIATE OBJECTIVE IS TO ENSURE THAT THESE IDEAS ARE DISCUSSED TOGETHER IN THE PROPER FORA: IE BY ECOFIN, THE COMMITTEE OF EC CENTRAL BANK GOVERNORS, AND THE MONETARY COMMITTEE: AND TO INDICATE THAT (WHILE SCEPTICAL ABOUT THE IDEA OF THE EARLY ESTABLISHMENT OF A EUROPEAN CENTRAL BANK) OUR APPROACH TO THE DISCUSSIONS WILL BE POSITIVE.
PROPOSALS
3 (I) THE FRENCH FINANCE MINISTER, M BALLADUR, WROTE TO HIS EC FINANCE MINISTER COLLEAGUES IN JANUARY, WITH A PAPER ON EUROPEAN MONETARY CONSTRUCTION, PROPOSING VARIOUS STEPS INCLUDING: EARLY LIBERALISATION OF CAPITAL MOVEMENTS, LESSENING THE CURRENT (QUOTE) ASYMMETRY (UNQUOTE) WITHIN THE ERM, ADOPTING A COMMON STANCE TOWARDS NON-COMMUNITY CURRENCIES, AND FINALLY THE LONG-TERM DEVELOPMENT OF A SINGLE CURRENCY AREA WITH A COMMON CENTRAL INSTITUTION. HE ACKNOWLEDGED THAT THIS LAST IDEA RAISED A NUMBER OF PROBLEMS AND, AT THE FEBRUARY ECOFIN LUNCH, WAS AT PAINS TO EMPHASISE ITS LONG TIMESCALE COMPARED WITH THE OTHER POINTS OF MORE IMMEDIATE OPERATIONAL INTEREST.
(II) THE ITALIAN FINANCE MINISTER, AMATO, WROTE TO COLLEAGUES, WITH SIMILAR PROPOSALS AT THE END OF FEBRUARY, AGAIN ACKNOWLEDGING THAT THE CREATION OF A EUROPEAN CENTRAL BANK HAD TO BE A GRADUAL PROCESS, THOUGH HE SUGGESTED WORK SHOULD BE SET IN HAND TO IDENTIFY WHAT PRACTICAL STEPS COULD BE TAKEN TOWARDS IT.
(III) THE GERMAN FOREIGN MINISTER, GENSCHER, SET OUT MORE AMBITIOUS PROPOSALS, INITIALLY DEVELOPED IN A PARTY, NOT

GOVERNMENT, CONTEXT, IN A PAPER THAT WAS HANDED AROUND AT THE INFORMAL MEETING OF FOREIGN MINISTERS AT LAKE CONSTANCE ON 5 MARCH. HE SUGGESTED THAT THE EUROPEAN COUNCIL AT HANOVER IN JUNE SHOULD ASK FIVE TO SEVEN WISE MEN TO FORMULATE THE FOUNDATIONS FOR A EUROPEAN CURRENCY AREAS, DRAFT A STATUTE FOR A EUROPEAN CENTRAL BANK, AND WORK OUT TRANSITIONAL ARRANGEMENTS. HIS PROPOSALS ALSO ADVOCATED INCREASED USE OF THE ECU, LEADING TO ITS ADOPTION AS A COMMUNITY CURRENCY.

(IV) THE GERMAN FINANCE MINISTER, STOLTENBERG, CIRCULATED PROPOSALS OF HIS OWN TO FELLOW FINANCE MINISTERS ON 17 MARCH. THESE CONCENTRATE ON THE IMMEDIATE GOAL OF SECURING FREEDOM OF CAPITAL MOVEMENTS THROUGHOUT THE COMMUNITY, AND BUILDING ON THE IMPROVEMENTS IN THE EXCHANGE RATE SYSTEM AGREED LAST YEAR AT BASLE AND NYBORG. THE PAPER STRESSES THE IMPORTANCE OF ALL MEMBER STATES GIVING PRIORITY TO CONVERGENCE AND PRICE STABILITY. HE SEES A EUROPEAN CENTRAL BANK AS BEING NEEDED AFTER FULL ECONOMIC AND MONETARY UNION, A LONG WAY IN THE FUTURE. ANY SUCH INSTITUTION SHOULD BE INDEPENDENT OF INSTRUCTIONS FROM MEMBER GOVERNMENTS OR OTHER COMMUNITY BODIES. HE SUGGESTS CONSIDERATION SHOULD BE GIVEN TO THE QUESTION OF WHETHER INTERMEDIATE STEPS TOWARDS A EUROPEAN CENTRAL BANK ARE POSSIBLE AND USEFUL, AND IF SO WHAT SUCH STEPS SHOULD BE.

LINE TO TAKE

4. IF ASKED ABOUT THE UK ATTITUDE TO THESE PROPOSALS YOU SHOULD DRAW ON THE FOLLOWING:

(I) WE ATTACH GREAT IMPORTANCE TO MAKING RAPID PROGRESS TOWARDS DISMANTLING CAPITAL CONTROLS IN EUROPE. (ALL SUCH UK CONTROLS WERE OF COURSE ABOLISHED IN 1979). THIS IS THE IMMEDIATE TASK, AND WE ARE VERY MUCH HOPING THAT THE COMMISSION'S DRAFT DIRECTIVE ON CAPITAL LIBERALISATION CAN BE ADOPTED BEFORE THE END OF THE GERMAN PRESIDNCY - EVEN THOUGH IT MAY TAKE SOME TIME TO COME INTO EFFECT IN ALL COUNTRIES.

(II) WE SUPPORT THE GROWING USE OF THE PRIVATE ECU, BOTH AS A FINANCIAL ASSET AND A CURRENCY FOR DENOMINATION OF TRANSACTIONS, INCLUDING ITS USE AS AN INTERVENTION CURRENCY. THERE IS A LARGE MARKET IN ECU ASSETS IN LONDON.

(III) WE ALSO THINK IT IMPORTANT TO STRENGTHEN THE DEGREE OF COOPERATION ON INTEREST RATE AND MONETARY POLICY THAT IS NOW BEING BUILT UP BETWEEN EC COUNTRIES AND THEIR CENTRAL BANKS.

(IV) THESE DEVELOPMENTS WILL ALL TEND TO BRING ABOUT GREATER CONVERGENCE IN FINANCIAL POLICIES BETWEEN COMMUNITY COUNTRIES.

(V) NOTE THAT MOST OF THOSE WHO HAVE DISCUSSED THE CONCEPT OF A EUROPEAN CENTRAL BANK HAVE SEEN IT VERY MUCH AS A LONG-TERM GOAL. SHOULD NOT LET DISCUSSION OF THAT DISTRACT ATTENTION FROM

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THE IMMEDIATE TASKS: NOTABLY THE AIM OF ACHIEVING FULL LIBERALISATION OF CAPITAL MOVEMENTS.
(VI) NOTE THAT ALL THESE IDEAS ARE LIKELY TO BE DISCUSSED BY FINANCE MINISTERS AND CENTRAL BANK GOVERNORS AT THE INFORMAL ECOFIN IN MAY. SHOULD CONSIDER AFTER THEN WHAT IF ANYTHING IN THIS AREA SHOULD BE DISCUSSED AT HANOVER.
5. IF ASKED ABOUT THE UK LINE ON ERM ENTRY, YOU SHOULD CONFIRM THAT IT HAS NOT CHANGED.

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# THE EUROPEAN MONETARY SYSTEM: HOW WELL HAS IT WORKED?

by

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## I. INTRODUCTION

The Treaty of Rome makes no reference to monetary union or specific exchange-rate arrangements. In 1968 Raymond Barre, then EC Commissioner, wrote a proposal advocating tighter consultations of member governments concerning macroeconomic policy, and in particular monetary policy. The celebrated Werner Report of 1970 was an outgrowth of Barre's ideas. Although this report set monetary union as the ultimate Community objective, it was careful to emphasize preconditions in the form of coordinated policies and the establishment of narrower margins of fluctuations around exchange rate par values. The so-called snake arrangement, instituted in 1972, was believed to be the Werner Report in action. In fact, from the Werner Report the "snake" system borrows only the idea of reducing currency fluctuations without setting a machinery to coordinate policies. The "snake" failed.

The decision taken in 1978 by Chancellor Schmidt and President Giscard d'Estaing to create a "zone of monetary stability" came as a surprise, not only to the general public, but also to central banks. Samuel Brittan (1979) speculated that the birth of the EMS had less to do with a desire for monetary stability than a Franco-German reaction to the weakness of the dollar and the unreliability of the Carter Administration. Whatever the reasons, the European Monetary System became a reality on March 13, 1979.

Several authors predicted failure, or at leat modest success. Cohen (1981, p. 21) stated that "the potential for an inflationary bias is there and, unlike the hypothethical reverse danger of a deflationary bias, could well become serious in practical terms... Any disciplinary effect of the joint float on a deficit member would probably be more than offset by the 'safety valve' of access to the credit facilities." Fratianni (1980, p. 165) predicted that "the EMS is destined to become an adjustable-peg system. How well this system will fare depends on the disparity of inflation rates and timeliness of parity adjustments. The current disparity of inflation rates and underlying policies among EEC countries suggests frequent realignments. Yet history teaches us that decision makers perceive parity changes as costly political decisions and, therefore, postpone taking action." Vaubel (1980) identified in the EMS the emergence of "egalitarianism, collectivism, and etatism" and worried about the built-in moral hazard incentives and inflation bias.

The EMS has not failed. Many economists and policymakers consider it a success, partly on the strength of the evidence I review in this paper. Yet, the relevant question is not whether the EMS has survived or done well according to some absolute criterion, but whether it has performed better or worse than an alternative exchange-rate regime. Needless to say, this is a demanding task because of

the difficulty of holding ceteris paribus. In Part II of the paper I compare the performance of the EMS countries both with its own pre-EMS history and with non-EMS countries. Methodologically, this exercise can be likened to a comparison of unconditional expectations; hence its limitations. In Part III of the paper I consider the workings and merit of the EMS relative to the free floating alternative. While there is a considerable amount of theoretical work on the relative desirability between an EMS-type arrangement and free floating--with and without credible monetary authorities--the empirical work bearing on this proposition is still in its infancy. I have relegated to Part IV concluding comments and speculations concerning the motives of each EMS country in being part of this arrangement.

## II. THE RECORD

### Exchange rates

There have been eleven parity changes or realignments during the life of the EMS, seven of which occurring during the first four years and four in the subsequent four years (cf. Table 1). In the approximately eight-year period going from March, 1979 to January 12, 1987 --date of the last parity change--the Italian lira experienced the largest parity depreciation, 45 percent, vis-à-vis the Deutsche mark; the Dutch guilder the smallest depreciation, 4 percent (cf. Table 2).[1]

[1] The parity realignment of 2.6 percent between the Irish pound and the French franc was the smallest parity change in absolute.

--insert Tables 1-5 here--

Did these parity changes evolve to take into consideration inflation differentials within the EMS countries? In Tables 3 and 4 I have shown cumulative bilateral inflation rate differences--over the period 1979-1986--measured by percentage changes of the wholesale price index and the consumer price index, respectively. Italy, again, has had the highest inflation differential in relation to Germany (64 and 84 percentage points, respectively); the Netherlands the smallest (1 and 3 percentage points, respectively). A comparison of Table 2 with Tables 3 and 4 reveals that bilateral depreciations were positively associated with a higher domestic inflation rate.[2] This positive association, however, was far from being complete, leaving room for real exchange rate changes (cf. Table 5). In particular, the French franc, the Italian lira and the Irish pound have had sizeable real appreciations vis-a-vis the other EMS currencies. With respect to the DM, the FF has appreciated 8 percentage points, the Lit 38

[2] The co-movement between nominal exchange rate realignments and inflation rate differentials were tested by regressing the cross-section data of Table 2 (Exr) on the cross-section data of Tables 3 and 4 (wpi and cpi, respectively):

$$Exr = -5.59 + .65*wpi \qquad SEE = 10.3$$

$$\text{t values} \quad (2.45)\ (9.86)$$

$$Exr = -6.8 + .50*cpi \qquad SEE = 9.6$$

$$(3.17)\ (10.7)$$

percentage points, the Lit 38 percentage points, and the Irish pound 35 percentage points.[3]

One interpretation of the EMS is that monetary authorities of the participating countries do not understand the EMS to be a fixed-exchange rate arrangement, but rather as one aimed at preventing high variability of exchange rates. High variability implies that exchange rate movements have a large unexpected component. Risk-averse individuals will move resources away from the riskier trade sector to the less risky non-traded sector. Hence high variability of exchange rates--despite the existence of future or forward markets--hampers the growth of trade.

Ungerer et al.(1986) give detailed evidence about exchange-rate variability within the EMS countries, within the non-EMS countries, and between them. Here are the salient results of this study. First, intra-EMS exchange rate variability--both nominal and real--declined after the creation of the EMS. This is particularly so for bilateral exchange rates, evidence that corroborates the earlier study by Rogoff (1985) who had instead concentrated on predictability, showing that the variance of the forecast error of the risk-neutral rational expectations model was lower during the first five years of the EMS than during the preceding five years. In contrast, non-EMS exchange-rate variability went up after the creation of the EMS.

[3] These were the real exchange rate changes based on the consumer price index.

Much more subtle is the evidence concerning the interaction between EMS and non-EMS countries. On the basis of the IMF's multilateral exchange rate model there is little evidence in Ungerer el al. to suggest that the pre-EMS period behaves differently than the post-EMS period.[4] As an alternative, I computed the standard deviation and the coefficient of variations of the annual percentage change of the effective exchange rate as defined by the OECD (see below for a description of the data) for the seven EMS countries, three European non-EMs countries--Austria, the United Kingdom and Switzerland-- and three non-European countries--Canada, Japan and the United States. The results, presented in Table 6, indicate a sizeable increase in variability for two of the EMS countries--Belgium and the Netherlands-in contrast to the rather stable pattern in non-EMS countries. This fact suggests that part of the gain in reduced exchange-rate variability within the EMS countries was eroded through a higher variability of exchange rates between EMS and non-EMS countries.[5]

--insert Table 6 here--

Why has there been a significant decline in the growth rate of intra-EMS trade after 1979, in relation to

[4] Cf. Tables 28 and 29 in Ungerer et al. (1986).

[5] In support of this point Ungerer et al. (1986, table 22) show that the coefficient of variation of bilateral exchange rates, measured with respect to non-EMS countries' currencies, rises from 36.3 in the period 1974-78 to 46.7 in the period 1979-85 for the average EMS countries, and from 39.6 to 42.8 for the average non-EMS countries.

both its own past and to non-EMS trade growth, despite the achieved lower (within the EMS) exchange rate variability?[6] De Grauwe and Verfaille (1987) tackle this issue by testing a cross-sectional model of bilateral export flows, the determinants of which being the growth of demand of the importing country, the growth of output supply of the exporting country, exchange-rate variability, the nature of the trade arrangement between the pairs of countries and an indicator of protectionism, the latter quantified by cumulative percentage overvaluation of the currency of the importing country. Overvaluation is defined in terms of productivity-adjusted real exchange rate. The main findings are that the slowdown in the growth of output in the EMS and the slowdown in the integration process had a larger impact

[6] Vaubel(1987) reports the following trade statistics

| | Average yearly growth of exports and imports, 1979-1984 | |
|---|---|---|
| Old EEC members | with EMS countries | with non-EMS countries |
| Belgium | 0.3 | 4.9 |
| France | 1.3 | 5.3 |
| Germany | 1.4 | 4.4 |
| Netherlands | 0.4 | 3.9 |
| Italy | 0.4 | 2.2 |
| New EEC members | | |
| Denmark | 2.8 | 2.5 |
| Ireland | 5.9 | 3.8 |
| United Kingdom | 4.1 | 4.9 |

Source: IMF, Direction of Trade.

Denmark, Ireland and the United Kingdom, the new members of the EEC, have experienced larger trade growth rates with the EEC countries than the old members. The late entry into customs union may explain in part the difference in performance; there is, however, the possibility, only applicable to the United Kingdom, that the EMS arrangement has in fact retarded trade growth within the EEC.

on intra-EMS trade growth than the beneficial effect of lower exchange-rate variability. What remains to be explained, according to the authors, is "whether the EMS arrangement might have induced both low exchange rate variability and low growth of output."

Inflation rates and money growth

Proponents of the EMS have pointed to the reduction in inflation rates in the EMS countries as a sign of the system's success. Statements of this kind need to be carefully scrutinized in two ways. First, is the inflation rate during the EMS period significantly lower than in the pre-EMS period? Meaningful statistical inferences cannot be made by simply comparing two periods. Naturally, these periods will differ by the number, size and nature of the shocks, as well as by the exchange-rate regime under consideration. Only under the heroic assumption of equivalent shocks can we attribute to the exchange-rate regime the decline in the inflation rate. To relax in part the assumption of homogeneous shocks--and this is the second point--one can compare the performance of the EMS economies with economies which are "similar" to the EMS economies, except for the exchange-rate regime.

In Table 7 I have reported the average inflation rates--measured in terms of the consumption deflator--of the eight EMS countries, the EMS average, and the averages of the

non-EMS countries for the pre-EMS period 1974-1978 and the post-EMS period 1979-1986. The data are annual and come from the diskettes of the OECD, Economic Outlook N. 41 (June 1987). The aggregation over countries was made by multiplying the country's growth rate by the country's weight based on GNP share calculated in 1982 prices and exchange rates.[7] In addition to the two sample averages, Table 7 shows the difference between the two periods and indicates whether this difference is significantly different from zero.[8]

--Insert Table 7 here--

The essential point emerging from the table is that the small two percentage point decline in the inflation rate in the EMS is not statistically significant, whereas the large declines in the other six countries are. These results may not do justice to the drastic disinflation that has taken place in the EMS countries in the last three years, and indeed the outcome would drastically change if we ignored the first four years of the EMS. Belgium had an

[7] These weights are: Belgium = 1.1, Denmark = 0.7, France = 7.0, Geramny = 8.5, Ireland = 0.2, Italy = 4.5, Netherlands = 1.8, Austria = 0.9, United Kingdom = 6.3, Switzerland = 1.2, Canada = 3.9, Japan = 14.0, United States = 40.9.

[8] The following t statistic was employed:

$$t = (x_1 - x_2)/[std(1/n_1 + 1/n_2)^{1/2}]$$

where $std = [(n_1 * var_1 + n_2 * var_2)/(n_1 + n_2 - 2)]^{1/2}$, $x_1$ = sample average of the pre-EMS period, $x_2$ = sample average of the EMS period, $var_1$ = variance of the pre-EMS period, $var_2$ = variance of the EMS period, $n_1$ = number of observations in the pre-EMS period, and $n_2$ = number of observations in the EMS period.

inflation rate of 1.4 per cent in 1986 compared to to an inflation rate of 7.1 per cent in 1982; Denmark 3.6 per cent compared to 9.8 per cent; France 2.2 per cent compared to 10.6 per cent; Germany -0.4 per cent compared to 4.7 per cent; Ireland 3.7 per cent compared to 14.7 per cent; Italy 6.0 per cent compared to 15.7 per cent; and the Netherlands 0 per cent compared to 5.1 per cent.

Different considerations can be made with respect to the growth rate of the money stock which slows down significantly in Belgium, Germany, Italy and the Netherlands, whereas it rises in the other three European non-EMS countries (again Table 7). The incompleteness of money data for Denmark and France, however, prevents us from making statistically relevant comparisons between EMS and non-EMS aggregates. As an alternative to the money stock I considered the growth rate of the monetary base, which has the advantage of closely reflecting the policy actions of the central banks.[9] In Table 8 I report the sample averages of the annualized growth rate of the monetary base of each EMS country and their relative growth rates, defined by the difference of the country's growth rate and the growth rate of the EMS aggregate excluding the country in question.

--insert Table 8 here--

[9] These are quarterly data obtained from the International Financial Statistics (line 14) of the IMF.

Italy and Ireland experienced significant (but at the relatively high 20 per cent confidence level) declines in the growth of the monetary base; France, in contrast, had an increase in the relative growth. The interplay of these forces within the EMS was such to leave the EMS monetary base growth in the 79-86 period virtually unchanged with respect to the pre-EMS period.[10]

--insert Table 9 here--

Interest rates

Integration of the finacial markets implies that, in the absence of expected real exchange rate changes, real rates of interest cannot differ among countries. Rogoff (1985) shows that the difference between German and French and German and Italian short-term real interest rates increased during the EMS period. Furthermore, the conditional variance of these interest rates--based on two alternative ways to proxy the expected rate of inflation--rose as well in the post-EMS period.[11] Giavazzi and Pagano (1985) present evidence that the spread between offshore and onshore interest rates widens and becomes more variable when an expectation of a parity realignment sets in. Tying the

[10] There is a slowdown in the growth rate of the monetary base of the "rest of the world" but it is not statistically significant. It should be noted that the growth rate of the monetary base has large variances in all countries, a fact that explains why apparently large drops in the sample means do not result statistically significant.

[11] Cf. Table 5.

evidence produced by Giavazzi and Pagano with that of Rogoff one arrives at the conclusion that the reduced variability of the exchange rates cannot be credited to coordinated monetary policy, but rather to the existence of capital controls that have effectievly put a wedge between German interest rates, on the one hand, and French and Italian interest rates, on the other hand. Goodhart (1986), on the strenth of this evidence, argues implicitly against the entry of the United Kingom in the EMS, because the crucial role of London as a major financial center requires freedom of capital movement. Put it differently, if the cost of joining the EMS is the application of exchange controls, the EMS is not worth it.

The evidence on interest rates cited above was based on data going up to 1984. What has happened more recently? The most important development is the exchange liberalization process that has taken place both in Italy and France, forcing the real interest rates in these countries to rise relative to those abroad. I have calculated in Table 9 the short-term real rate of interest using two alternative data sets: the annual data of the OECD and the monthly three-month Treasury rates published by the Harris Bank's Weekly Review. In both instances I have assumed that individuals were blessed with perfect foresight as to the next period's rate of inflation. While the two data sets yield different quantitative results, qualitatively they concur in pointing to a narrowing of the differentials.

The narrowing of the interest-rate differential is consistent with the hypothesis that countries like France and Italy have used the exchange rate as an exogenous variable and have adopted a policy of letting their domestic currencies appreciate in real terms vis-à-vis the Deutsche mark.

--insert Table 9 here--

Economic growth and unemployment

How have the EMS countries performed on the real side of the economy? The evidence is very clear concerning unemployment, less so about output growth. Unemployment rates have increased substantially in the post-EMS period: in each of the EMS countries the increase is statistically significant at the five percent level (cf. Table 10). But this is also true for the other three European countries, which are not part of the EMS, in contrast with the experience of the Canada-Japan-US group. The unemployment story does not carry over, however, to the growth of real gnp where the slowdown is statistically significant for France, Ireland and the Netherlands. It should be noted that the growth rates of output in the 74-78 period were low to begin with, making the economic slowdown even more pronounced.

--insert Table 10 here--

The nature and size of the real slowdown in Europe is very controversial and the subject of ongoing research. One critical issue is whether the higher unemployment results from high real wage rates (Classical explanation) or from inadequate spending (Keynesian explanation). It should be noted that unemployment in Europe is largely concentrated among the young and the unskilled, particularly in well-defined geographical areas. In a recent paper Drèze et. al. (1987) argue that European unemployment exhibits both Classical and Keynesian characteristics. These economists propose a series of supply-side measures aimed at reducing the high wedge between the private cost of labor, inclusive of taxes, and the social cost, i.e., net of tax. But they also propose Germany, France and the United Kingdom to generate additional government spending to expand productive capacity--which is currently almost fully used--in the future.[12]

From the perspective of our paper the above discussion highlights that the EMS is a monetary arrangement, not a fiscal one. Indeed there is evidence that fiscal policies among the EMS countries were more divergent after 1979 than before.

[12] The proposal entails higher public debt today and more taxes in the future. The higher public debt today serves to induce an intertemporal substitution of labor away from the future (when the economy will be at full employment) and towards the present (when resources are unemployed).

## III. AN INTERPRETATION OF THE EMS

The EMS was created to achieve "a zone of monetary stability in Europe" that would eventually culminate into the establishment of a European Monetary Fund. Central banks have interpreted "a zone of monetary stability" to mean: (1) lower variability of exchange rates, and (2) lower and converging inflation rates among EMS countries.

The evidence presented in Section II of the paper can be summarized as follows. The EMS has been successful in reducing nominal and real exchange rate variability. Yet, intra-EMS trade growth has fallen. It is conceivable that trade growth would have fallen even more with more exchange rate variability. As to inflation, the facts are more ambiguous. The achieved reduction in the inflation rates turns out to be not as significant as the reduction in inflation rates among non-EMS countries, when the entire post-EMS period is considered. If, instead, one isolates the 1982-86 period the story becomes much more favorable for the EMS. Finally, there is some evidence that France and Italy have used the EMS as a disinflationary mechanism, by letting their currencies appreciate in real terms vis-à-vis the Deutsche mark and their real rates of interest rise relative to the real rates of interest prevailing in Germany.

Two questions immediately come to mind. Why would France and Italy accept the discipline of the EMS in preference to appropriate domestic disinflationary policies? Why would Germany be part of a scheme that makes it a potential importer of inflation? The rest of the paper is devoted to answer these two questions.

Credibility hypothesis

The key issue underlying the first of the two questions is whether or not membership in the EMS facilitates disinflation relative to an independent policy of disinflation. High-inflation countries may find it worthwhile to join an EMS-type arrangement because of the benefit derived by linking their currencies to that of a low-inflation country. These benefits stem from the reputation the low-inflation country's central bank has earned in the market place.

A central bank with little or no reputation faces an inflation rate higher than would prevail if the central bank had committed itself to a credible strategy of disinflation.[13] This central bank can borrow reputation by

[13] There is one branch of the literature on reputation that considers conditions under which policy shifts are credible (e.g., Barro and Gordon 1983), while another branch emphasizes that the central bank is free to follow discretionary policies and determine its level of credibility (e.g., Cukierman and Meltzer 1986). According to the latter view it is not clear that the EMS enjoys a comparative advantage in generating reputation over an independent monetary policy of disinflation.

commiting its country's currency to a policy of real exchange rate appreciation with respect to the currency of a low-inflation, credible, central bank. The EMS can be intepreted as an arrangement of this type, with relatively high-inflation France and Italy borrowing reputation from low-inflation Germany.

Giavazzi and Pagano (1986) explore theoretically the advantage of high-inflation countries of tying their hands, as far as monetary policy is concerned. The critical point for these economists is not whether the EMS is an effective disciplinary force, but whether the high-inflation countries gain from the arrangement. The gain of reputation is only one aspect of joining the EMS; high-inflation countries have also to consider the losses in competitiveness implied by real exchange rate appreciations. The Giavazzi-Pagano model postulates that monetary authorities prefer more output to less output, value a positive rate of inflation because it creates revenues, but dislike inflation variability because of its adverse effects on output. The latter responds positively to real exchange rate depreciation and inflation "surprises". Finally, the real exchange rate of the high-inflation countries appreciates between realignments, but returns to its initial value at the time of a realignment (i.e., changes in parities are set equal to cumulative inflation differentials). Under these conditions, the EMS is worth joining if the authorities do not seek to extract

revenues from inflation, an intuitive outcome. Equally intuitive is the result that the payoff of joining the EMS is ambiguous if the authorities value the inflation tax; the final outcome depending on the relative strength of the seigniorage, the present value of output loss due to inflation variability, and the tightness of the EMS regime.

Unfortunately, there are no empirical measures of the three forces that are critical in the determination of EMS membership. It is only through revealed reference that we can deduce that the seigniorage incentives are small enough, relative to the gain in reputation, to have made it worthwhile for France and Italy to remain in the EMS so far.

Benefits to the supplier of reputation

Let us turn to the second question raised earlier: What does Germany gain by being in the EMS? As a supplier of monetary credibility Germany provides an externality for which it appears there is no quid pro quo. Furthermore, the policy of high-inflation countries to export inflation makes the maintenance of low inflation at home more difficult. Once in the EMS, there is the additional problem of whether or not Germany would be able to dictate her terms; and if so, under what conditions.

The recent theoretical analysis by Begg and Wypsloz (1987) provides us with a useful vehicle to discuss these issues. In this paper there are two interacting economies--

one with high-inflation and the other with low-inflation--contemplating several alternative exchange-rate regimes. In these economies authorities want to minimize deviations of output from potential output and price inflation from desired inflation, subject to the following macroeconomic structure. To begin with, financial markets are integrated in the sense that differences in real rates of interest are equal to the expected real depreciation of the currency with the higher real interest rate. Aggregate demand responds positively to real exchange rate depreciation, and negatively to real rates of interest at home and abroad. Core or expected inflation adjusts slowly to changes in the actual inflation rate. The latter is a weighted average of changes in domestic prices and real exchange-rate depreciation: the depreciating country importing inflation from the appreciating country. Changes in domestic prices are determined by the expected inflation rate and output deviation from potential output. Finally, and importantly, one economy starts with a higher inherited inflation rate than the other.

The two countries can interact either with each monetary authority pursuing an independent policy or through an EMS-type arrangement. Two types of EMS are considered. There is a soft version, EMS(S), where exchange rates are fixed just before the economies have to adjust to steady state values of zero inflation and zero output

deviation; and a hard version, EMS(H), where the economies have to commit themselves to fixed exchange rates in the early going. The relative merits of the independent strategy, EMS(S), and EMS(H) are best appreciated with reference to Figures 1 and 2, which are adaptations of equivalent figures in Begg and Wypslosz.

The horizontal axis of Figure 1 measures the difference between the inflation rates of high-inflation France and low-inflation Germany; the vertical axis the world (i.e., the two countries') average inflation rate. The indicated ellipses represent the preference mappings of the two countries. Points F1 and G1 indicate the best positions for France and Germmany, respectively. In words, Germany prefers to have a lower world inflation than France; France's "best" is achieved, not only with a higher world inflation rate, but also with Germany inflating relative to France. The vertical lines EMS(H) and EMS(S) refer to the two types of EMS arrangements.

The independent strategy, free floating, is denoted by N as in Nash. Relative to N, France would like Germany to inflate more and, consequently, would prefer a higher world inflation. Germany, instead, would wish to distance herself more sharply from the French inflation rate, and would prefer a higher world inflation than it is implied by free floating (this result is ambiguous in the analysis). The shaded area represents the gain from cooperation. In

Figure 1 the vertical line EMS(S) runs through the shaded area. The critical assumptions there are that German aversion to inflation is low, initial inflation differences are high and the Phillips Curves are relatively flat in the sense that inflation is moderately sensitive to changes in output. Clearly EMS(S) is preferred to free floating and EMS(H). This is the case that is most consistent with casual observations of today's EMS.

Suppose Germany's aversion to inflation is very high, inherited inflation differences are small and the Phillips Curves are steep in the sense that inflation is very sensitive to changes in output. This outcome is depicted in Figure 2. EMS(H) is preferred to free floating: the high German aversion to inflation raises the desire to reduce disparities rapidly. But there is an intermediate case-- not shown in Figure 1-- where the shaded area would be to the right of EMS(S). Germany would prefer free floating to either EMS arrangement.

One of the key messages of the Begg-Wyplosz analysis is that free floating cannot be dismissed as an inferior solution to the EMS. The incentives of the low-inflation country to participate in the EMS depends on the weight authorities assign to inflation as well as on the initial conditions. As the authors put it (p.38) "an EMS formed to fight inflation might disintegrate once unemployment, not inflation, was the main concern, especially if both the

success on inflation and the extent of the unemplyment problem were unanticipated at the date the bargain took place to hammer out the operating rules of the EMS."

There are other payoffs for Germany for being in the EMS. The models we have considered give monetary authority the exclusivity to set priorities for the economy as a whole. In reality there are conflicts within branches of the executive. Germany, as represented by the Ministry of Finance, is more favorable to a DM real depreciation than Germany represented by the Bundesbank (see Tsoukalis (1987)). Indeed, as I have already mentioned in the introduction, Chancellor Schmidt's original decision to join the EMS--against the opposition of the Bundesbank--might have had less to do with monetary unification than searching for an expedient way to diffuse the brunt of heavy speculative flows into Germany (Brittan 1979). It is not surprising that German authorities have consistently pushed for the integration of financial markets, with France and Italy relaxing exchange controls. The unfolding of tighter financial integration ought to raise the substitutability between DM-denominated assets and assets denominated in French francs and liras. The benefit for Germany will be less vulnerability to changes in U.S. economic policies.[14]

[14] The asymmetries noted by Giavazzi and Pagano (1985) will have then disappeared.

Evidence on Reputation

Giavazzi and Giovannini (1987) address the issue of how important reputation has been in the EMS. These two authors test for the empirical size of reputation by employing the famous Lucas (1979) critique to econometric practice in a positive manner. Since the institution of the EMS represents a new policy regime, it follows that any well specified model of inflation estimated before the EMS will tend to overpredict inflation during the EMS period for counrtries borrowing reputation, and underpredict for reputation-supplying Germany. Giavazzi and Giovannini estimate vector-autoregressive models which act as "idealized" reduced-form equations for changes in the price level, nominal wages, and output. These variables are postulated to depend on their lagged values, money growth, changes in the relative price of imported raw materials and changes in the relative price of imported finished goods, as well as on a smattering of country-specific dummy variables.

The authors find only one significant change in the over-all values of the estimated coefficients before and after the establishment of the EMS; and that occurs for the French price inflation. As Giavazzi and Giovannini admit it (p.16), "this result might suggest that the EMS has not brought about any of the changes in expectations that we describe in the sections above, except for the price equation in France." Since the authors do not provide

statistics about the relative forecast accuracy of the models before and after the EMS, the issue of the effectiveness of the regime change cannot be explored more deeply.

What we are left with are graphs of the actual and predicted values of the models in the post-EMS period. These graphs, in the absence of formal statistics, become the evidence upon which the reputation hypothesis is evaluated. The graphs for Danish and German inflation "appear" to be consistent with the hypothesis. Germany, besides importing inflation from the other EMS countries, seems to be a loser on the real side of the economy as well: the systematic negative error of forecast in the output equation is consistent with the EMS having exerted a deflationary force on Germany.[15] This conclusion runs counter to the popular notion that Germany is a deflationary force on the system.

[15] The following table facilitates the interpretation of the empirical results of Giavazzi and Giovannini. The signs represent the systematic differences betweens actual and predicted values in the post-EMS period. Systematic is defined in a visual sense, that is, when it is obvious that the actual values are consistently above or below the predicted values. The question mark indicates inconclusiveness, again from an optical perspective.

| | Denmark | Germany | UK | France | Italy |
|---|---|---|---|---|---|
| price change | - | + | - | - (after 82.II) | ? |
| wage change | - | + | - | - | ? |
| output change | + | - (after 82.IV) | + | - (after 83.II) | + |

Curiously enough, the United Kingdom appears to have been able to have the cake and eat it too, with systematic negative forecast errors in the inflation rate and positive forecast errors in output. This result, at face value, vindicates Mrs. Thatcher's insistence in not being part of the EMS.

Bundesbank leadership

There is virtual unanimity in the literature that, despite the intentions of the founding fathers to create a democratic institution, the EMS behaves as if Germany were a price leader (cf., for example, Sarcinelli 1986). The theoretical justification for this outcome emerges from Figure 1, where Germany can set her preferred inflation rate (point G2) that is consistent with both countries being better off relative to the N solution. The alternative of France setting her preferred inflation rate (point F2) is not consistent with an improvement over the N solution. The implication is that France would accept the German inflation rate.

Having accepted the German inflation rate, however, does not prevent the high-inflation France and Italy from complaining and setting up strategies to alter the institutional mechanism of the EMS. This is no more evident than on the issue of intra-marginal interventions. Official interventions in the exchange markets of participating

countries are automatic and unlimited at the compulsory intervention rates, but are subject to prior authorization within the margins. Central banks extend to one another credit lines to finance the interventions (Very Short-term Financing Facility). Rules governing the use of these credit lines reflect the competing interests of debtor countries, who want adequate financing, and creditor countries, who worry about the money-creation consequences of interventions. Micossi (1985) points out that only a minor fraction of total interventions has occurred at the compulsory intervention limits. Since Germany seldom intervenes intra-marginally, some authors have concluded that that the burden of adjustment within the EMS has fallen on weaker-currency countries (e.g., Tsoukalis (1987).

France has been more than vociferous in denouncing the dominant role of Germany. In January 1987, before the latest realignment, France refused to intervene as the franc fell to the compulsory intervention floor; the Bundesbank had to intervene. Inspired by France, the Finance Ministers of the EC in September of 1987 modified the rules governing interventions and their financing.[16] The key change concerns

[16] Masera (1987) outlines the principal institutional changes of the September 12-13, 1987 decision by the EC Council of Finance Ministers: in addition to the change discussed in the text, there is a time extension of the Very Short-term Financing Facility, a larger role given to the "official" ECU, and an engagement to monitor exchange rates, external imbalances and monetary conditions in each of the EMS countries. The decision was written with unusually guarded language.

the access of weak-currency countries to automatic credit through the Very Short-term Financing Facility. Mr. Balladur, the French Finance Minister, has interpreted the change as meaning "a presumption of automaticity" (an oxymoron?), whereas Mr. Poehl has interpreted the September decision as giving the Bundesbank the discretion to decide case by case on its merit, the criterion being that "the main pre-condition will be that it does not threaten price stability in Germany" (The Economist 1987). It is too early to judge whether the institutional innovations pushed by France, and backed by other countries, will nudge the Bundesbank to alter its monetary policy. Much will depend on the Bundesbank's ability to sterilize interventions in the exchange markets.

## IV. CONCLUDING COMMENTS

The European Monetary System has not failed. The potential for an inflationary bias predicted by many economists has not materialized. So much is clear. Less clear is the matter of whether the EMS has been a success. The evidence marshalled in this paper indicates that the EMS has achieved lower exchange rate variability. Yet, intra-EMS trade growth has declined. The reduction in inflation rates, greatly praised by proponents of the EMS, turns out to be modest when compared to the reduction achieved by other countries. The stronger evidence pertains to the willingness

of high-inflation France and Italy to have used the EMS as a disinflationary mechanism. The real value of the franc and the lira has appreciated in relation to the mark, while the wedge between German real interest rates, on the one hand, and French and Italian real interest rates, on the other hand, has shrunk. The early reliance of France and Italy on exchange controls has given way to later efforts to open up their financial markets.

The preference of France and Italy to join the EMS, over a domestically driven disinflation, suggests that the Banque de France and Banca d'Italia are relatively weak institutions, lacking the reputation of the Bundesbank. By committing themselves to a policy of real exchange rate appreciations, France and Italy use the reputation of the Bundesbank in lowering the inflation rate at a lesser cost than would be possible through an independent monetary policy.

EMS participation poses a complex problem to Germany. As a supplier of credibility the Bundesbank receives no reward from the EMS. In fact, the workings of the EMS make it "natural" for Germany to import inflation from high-inflation countries. On the other hand, the EMS makes it possible for the Deutsche mark to have smaller real appreciations than would be true under free floating. This competitive advantage may justify why the German government has been more favorable towards the EMS than the Bundesbank.

The EMS may generate another benefit for Germany: the integration of financial markets in Europe and, hence, smaller German vulnerability to changes in foreign economic policy, especially U.S. policy.

Belgium, Luxembourg, the Netherlands and Denmark are small countries that have embraced, to different degrees, a Deutsche mark standard. The United Kingdom has refused to join the EMS for fear of losing independence of monetary policy. The evidence reviewed in this paper does not indicate that the United Kingdom has lost by staying out. Ireland, a small country not linked to the Deutsche mark area, remains a puzzle as to its gain from EMS participation.

The EMS so far has run as a German-dominated system. There are pressures to make the arrangement more democratic. It is too early to predict any fundamental changes. However, should democratization come about without an adequate amount of shared reputation, a great deal of the raison d'être of the EMS would have disappeared.

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*TABLE 1*
*Exchange Rate Realignments*
*Within the EMS*

| | | | DM | HFL | FF | BFR | LIT | DKR | IRL |
|---|---|---|---|---|---|---|---|---|---|
| 24 | Sept. | 1979 | +2.0 | --- | --- | --- | --- | -2.9 | --- |
| 30 | Nov. | 1979 | --- | --- | --- | --- | --- | -4.8 | --- |
| 23 | Mar. | 1981 | --- | --- | --- | --- | -6.0 | --- | --- |
| 5 | Oct. | 1981 | +5.5 | +5.5 | -3.0 | --- | -3.0 | --- | --- |
| 22 | Feb. | 1982 | --- | --- | --- | -8.5 | --- | -3.0 | --- |
| 14 | Jun. | 1982 | +4.25 | +4.25 | -5.75 | --- | -2.75 | --- | --- |
| 21 | Mar. | 1983 | +5.5 | +3.5 | -2.5 | +1.5 | -2.5 | +2.5 | -3.5 |
| 22 | Jul. | 1985 | +2.0 | +2.0 | +2.0 | +2.0 | -6.0 | +2.0 | +2.0 |
| 7 | Apr. | 1986 | +3.0 | +3.0 | -3.0 | +1.0 | --- | +1.0 | --- |
| 4 | Aug. | 1986 | --- | --- | --- | --- | --- | --- | -8.0 |
| 12 | Jan. | 1987 | +3.0 | +3.0 | --- | +2.0 | --- | --- | --- |

*Source:* *Commission of the European Communities*

*Note:* *The numbers are percentage changes of a given currency's bilateral central rate against those currencies whose bilateral parities were not realigned. A + denotes an appreciation and -a depreciation. On March 21, 1983 and on July 22, 1986 all parities were realigned.*

*BFR = Belgium/Luxembourg franc, DKR = Danish kroner,*
*DM = Deutsche mark, FF = French franc, LIT = Italian lira,*
*IRISH £ = Irish pound, HFL = Netherlands guilder.*

*TABLE 2*

*Percentage Change in Bilateral Parities from March 13, 1979 to January 12, 1987*

| | BFR | DKR | DM | FF | LIT | IRISH £ | HFL |
|---|---|---|---|---|---|---|---|
| BFR | | 2.94 | -27.18 | 10.13 | 18.30 | 7.48 | -23.29 |
| DKR | | | -30.12 | 7.19 | 14.75 | 4.54 | -26.23 |
| DM | | | | 37.31 | 45.48 | 34.16 | 3.89 |
| FF | | | | | 8.18 | -2.64 | -34.81 |
| LIT | | | | | | -10.82 | -41.59 |
| IRISH £ | | | | | | | -30.77 |

*Note:* *A + denotes a devaluation and - an appreciation of the currency shown in the column heading with respect to the currency shown in the row heading.*

*BFR = Belgium/Luxembourg franc, DKR = Danish kroner, DM = Deutsche mark, FF = French franc, LIT = Italian lira, IRISH £ = Irish pound, HFL = Netherlands guilder.*

*Source:* *Ungener et al. (1986, Table 6) and SanPaolo, ECU Newsletter, January 1987.*

*TABLE 3*

*Cumulative Bilateral Inflation Differential*
*Measured by the Wholesale Price Index*
*Over the Period 1979-1986*

| | BFR | DKR | DM | FF | LIT | IRISH £ | HFL |
|---|---|---|---|---|---|---|---|
| BFR | | 28.1 | -4.3 | 37.9 | 59.3 | 33.1 | -2.9 |
| DKR | | | -32.4 | 9.8 | 31.2 | 5.0 | -31.0 |
| DM | | | | 42.2 | 63.6 | 37.4 | 1.4 |
| FF | | | | | 21.4 | -4.8 | -40.8 |
| LIT | | | | | | -26.2 | -62.2 |
| IRISH £ | | | | | | | -36.0 |

*Note:* *A positive (negative) number indicates that the inflation rate of the country shown in the column heading is cumulatively higher (lower) than that of the country shown in the row heading.*

*BFR = Belgium/Luxembourg franc, DKR = Danish kroner,*
*DM = Deutsche mark, FF = French franc, LIT = Italian lira,*
*IRISH £ = Irish pound, HFL = Netherlands guilder.*

*Source:* *IMF, IFS, Yearbook 1987.*

*TABLE 4*
*Cumulative Bilateral Inflation Differential*
*Measured by the Consumer Price Index*
*Over the Period 1979-1986*

| | BFR | DKR | DM | FF | LIT | IRISH £ | HFL |
|---|---|---|---|---|---|---|---|
| BFR | | 17.7 | -18.8 | 27.0 | 65.0 | 69.6 | -15.8 |
| DKR | | | -36.5 | 9.3 | 47.3 | 31.9 | -33.5 |
| DM | | | | 45.8 | 83.8 | 68.8 | 3.0 |
| FF | | | | | 38.0 | 22.6 | -42.8 |
| LIT | | | | | | -15.4 | -80.8 |
| IRISH £ | | | | | | | -65.4 |

*Note:* *A positive (negative) number indicates that the inflation rate of the country shown in the column heading is cumulatively higher (lower) than that of the country shown in the row heading.*

*BFR = Belgium/Luxembourg franc, DKR = Danish kroner,*
*DM = Deutsche mark, FF = French franc, LIT = Italian lira,*
*IRISH £ = Irish pound, HFL = Netherlands guilder.*

*Source:* *IMF, IFS, Yearbook 1987.*

TABLE 5
Percentage Change in Bilateral
Real Exchange Rate Realignment
From March 13, 1979 to January 12, 1987

Wholesale Price Index

| | BFR | DKR | DM | FF | LIT | IRISH L | HFL |
|---|---|---|---|---|---|---|---|
| BFR | | -25.16 | -22.88 | -27.77 | -41.00 | -25.62 | -20.39 |
| DKR | | | 2.28 | - 2.61 | -16.45 | - 0.46 | 4.77 |
| DM | | | | - 4.89 | -18.12 | - 3.24 | 2.49 |
| FF | | | | | -13.22 | 2.16 | 5.99 |
| LIT | | | | | | 15.38 | 20.61 |
| IRISH 1 | | | | | | | 5.23 |

Consumer Price Index

| | BFR | DKR | DM | FF | LIT | IRISH L | HFL |
|---|---|---|---|---|---|---|---|
| BFR | | -14.76 | - 8.38 | -16.87 | -46.7 | -62.12 | - 7.49 |
| DKR | | | 6.38 | - 2.11 | -32.55 | -27.36 | 7.27 |
| DM | | | | - 8.49 | -38.32 | -34.64 | 0.89 |
| FF | | | | | -29.82 | -25.24 | 7.99 |
| LIT | | | | | | 4.58 | 39.21 |
| IRISH 1 | | | | | | | 34.63 |

Note: A positive number indicates a real depreciation of the country's currency shown in the column heading with respect to the country's currency shown in the row heading. The real exchange rate changes were obtained by subtracting the cumulative inflation differences of Table 3 and Table 4 from the cumulative nominal parity changes shown in Table 2.

BFR = Belgium/Luxembourg franc, DKR = Danish kroner,
DM = Deutsche mark, FF = French franc, LIT = Italian lira,
IRISH £ = lrish pound, HFL = Netherlands guilder.

*TABLE 6*
*Variability of the Annual Growth*
*of the Effective Exchange Rate*

| | period 1974-78 | | period 1979-86 | | |
|---|---|---|---|---|---|
| *EMS countries* | *standard deviation* | *standard deviation / mean* | *standard deviation* | *standard deviation / mean* | *F ratio* |
| *Belgium* | *1.40* | *0.53* | *4.68* | *3.78* | *11.15* |
| *Denmark* | *1.61* | *3.36* | *3.68* | *1.77* | *5.19* |
| *France* | *5.73* | *3.31* | *3.77* | *2.04* | *0.43* |
| *Germany* | *2.15* | *0.45* | *3.32* | *1.14* | *2.38* |
| *Ireland* | *2.02* | *0.63* | *4.25* | *1.81* | *4.43* |
| *Italy* | *4.31* | *0.44* | *3.03* | *0.82* | *0.50* |
| *Netherlands* | *0.91* | *0.28* | *3.42* | *1.81* | *14.09* |
| *Sum EMS* | *1.55* | *5.33* | *2.72* | *13.69* | *3.07* |
| *Austria* | *1.34* | *0.49* | *1.54* | *0.74* | *1.34* |
| *Switzerland* | *6.50* | *0.61* | *3.14* | *1.07* | *0.23* |
| *United Kingdom* | *5.17* | *0.83* | *6.00* | *11.64* | *1.34* |
| *Sum Euro non-EMS* | *4.11* | *1.44* | *4.18* | *16.27* | *1.04* |
| *Canada* | *6.16* | *2.21* | *2.98* | *1.31* | *0.23* |
| *Japan* | *9.83* | *1.88* | *10.51* | *2.18* | *1.14* |
| *United States* | *4.64* | *5.31* | *1.42* | *1.35* | *0.09* |
| *Sum non-Euro non-EMS* | *2.41* | *5.34* | *4.81* | *2.77* | *3.99* |

*Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.*

*Note: F ratio is the ratio of the variance of the 79-86 period to the variance of the 74-78 period. The value of the F(7,4) statistic at the 1 percent level = 14.98; at 5 percent level = 6.09.*

TABLE 7
EMS vs. Non-EMS Countries:
A Comparison of Inflation and
Money Growth Rates

| | Annual Percentage Change Consumption Deflator | | | Annual Percentage Change Money Stock | | |
|---|---|---|---|---|---|---|
| Countries | 74-78 | 79-86 | Difference | 74-78 | 79-86 | Difference |
| Belgium | 8.54 | 5.53 | -3.01** | 11.77 | 6.14 | -5.63* |
| Luxembourg | 7.49 | 6.03 | -1.46 | - | - | - |
| Denmark | 10.37 | 7.79 | -2.58 | - | 15.87 | |
| France | 9.93 | 8.57 | -1.36 | - | 9.79 | |
| Germany | 4.66 | 3.43 | -1.23 | 8.83 | 5.92 | - 2.91* |
| Ireland | 14.87 | 11.00 | -3.87 | 17.14 | 10.96 | - 6.18 |
| Italy | 16.12 | 13.17 | -2.95 | 19.05 | 12.89 | - 6.16* |
| Netherlands | 7.65 | 3.75 | -3.9 * | 12.07 | 7.05 | - 5.02** |
| EMS Countries | 9.04 | 7.10 | -1.94 | - | - | - |
| European non-EMS Countries[a] | 12.40 | 7.15 | -5.25* | 4.91 | 11.63 | 6.72* |
| Non-European Countries[b] | 8.04 | 5.24 | -2.80** | 10.30 | 8.75 | -1.55** |

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.

a = Austria, United Kingdom and Switzerland

b = Canada, Japan and the United States

* Statistically different from zero at the 5 percent significance level (t distribution, 11 degrees of freedom)

** Statistically different from zero at the 10 percent significance level (t distribution, 11 degrees of freedom)

TABLE 8
Growth of the Monetary Base in the EMS Countries
(Quarterly Data 1974:2-1986:4)

| | Own Growth Rate | | | Relative Growth Rate | | |
|---|---|---|---|---|---|---|
| Countries | 74-78 | 79-86 | Difference | 74-78 | 79-86 | Difference |
| Belgium | 6.00 | 2.40 | -3.60 | -1.38 | -5.3 | -3.92 |
| Denmark | 11.58 | 12.37 | 0.79 | 4.39 | 5.06 | 0.67 |
| France | 0.34 | 8.19 | 7.85 | -9.88 | 1.04 | 10.92*** |
| Germany | 4.84 | 4.00 | -0.83 | -3.86 | -5.37 | -1.51 |
| Ireland | 16.83 | 7.59 | -9.24*** | 9.59 | 0.13 | -9.46*** |
| Italy | 21.46 | 13.97 | -7.49*** | 17.44 | 8.03 | -9.41* |
| Netherlands | 8.88 | 5.78 | -3.10 | 1.69 | -1.82 | -3.51 |
| Sum EMS | 7.32 | 7.46 | 0.14 | | | |
| Rest of the World | 8.07 | 7.25 | -0.82 | | | |

Source: International Monetary Fund, International Financial Statistics, line 14, various issues

Note: The first three columns refer to the annual percentage change of the monetary base of the indicated country; the second three columns refer to the difference between the country's growth rate and the rest of the EMS'. Rest of the world is defined as the weighted sum of Canada, Japan, the United Kingdom and the United States.

* Statistically different from zero at the 5 percent significance level (t distribution, 49 degrees of freedom)

*** Statistically different from zero at the 20 percent significance level (t distribution, 49 degrees of freedom)

Table 9
EMS vs. non-EMS Countries:
A Comparison of Real Interest Rates

OECD Data

| | 1974-1978 | | 1979-1986 | | | |
|---|---|---|---|---|---|---|
| | mean | std | mean | std | t stat | F ratio |
| Belgium | 1.31 | 2.03 | 6.11 | 1.35 | -4.61 | 0.44 |
| France | -0.13 | 1.32 | 3.61 | 3.49 | -2.14 | 6.99 |
| Germany | 1.33 | 1.27 | 4.27 | 1.91 | -2.80 | 2.26 |
| Ireland | -4 | 2.99 | 3.17 | 4.51 | -2.90 | 2.28 |
| Italy | -1.58 | 2.2 | 3.65 | 4.73 | -2.13 | 4.62 |
| Netherlands | -1.09 | 1.75 | 4.02 | 1.44 | -5.26 | 0.68 |
| EMS countries | 0.08 | 1.04 | 4.04 | 2.63 | -2.96 | 6.40 |
| European non-EMS countries | -2.85 | 1.95 | 3.51 | 2.48 | -4.48 | 1.62 |
| Non-European Countries | 0.1 | 0.28 | 2.45 | 1.12 | -4.23 | 16.00 |

HARRIS BANK Data

| | 1974-1978 | | 1979-1986 | | | |
|---|---|---|---|---|---|---|
| | mean | std | mean | std | t stat | F ratio |
| Belgium | 0.206 | 3.718 | 5.87 | 3.08 | -63.06 | 0.69 |
| France | -1.26 | 2.07 | 4.18 | 4.25 | -57.43 | 4.22 |
| Germany | 0.22 | 2.34 | 3.25 | 2.61 | -45.16 | 1.24 |
| Ireland | N.A. | | | | | |
| Italy | -4.49 | 7.94 | 1.51 | 5.44 | -34.11 | 0.47 |
| Netherlands | N.A. | | | | | |
| UK | -4.91 | 6.25 | 3.18 | 5.78 | -50.54 | 0.86 |
| Canada | -0.98 | 3.09 | 4.42 | 2.76 | -69.55 | 0.80 |
| Japan | -2.65 | 5.41 | 2.84 | 3.87 | -44.99 | 0.51 |
| USA | 1.7 | 2.2 | 3.44 | 86.12 | -0.98 | 1532.37 |

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes;
and Harris Bank, Weekly Review, various issues.

t statistic: the critical values with 11 degrees of freedom (OECD Data) are 2.2 (5 per cent) and 1.8 (10 per cent); with 154 degrees of freedom (Harris Bank Data) 1.98 (5 per cent) and 1.65 (10 per cent).

F statistic: the critical values with (7,4) degrees of fredom (OECD Data) are 14.98 (1 per cent) and 6.09 (5 per cent); with (92,62) degrees of freedom (Harris Bank Data) approximately 1.71 (1 per cent) and 1.46 (5 per cent).

TABLE 10
EMS vs. Non-EMS Countries:
A Comparison of Output Growth
and Unemployment Rates

| Countries | Annual Percentage Change Of Real GNP | | | Unemployment Rate | | |
|---|---|---|---|---|---|---|
| | 74-78 | 79-86 | Difference | 74-78 | 79-86 | Difference |
| Belgium | 2.31 | 1.42 | -0.89 | 5.25 | 10.75 | 5.5 * |
| Luxembourg | 1.18 | 2.28 | 1.1 | 0.37 | 1.24 | 0.87* |
| Denmark | 1.55 | 2.31 | 0.76 | 5.16 | 8.69 | 3.53* |
| France | 3.03 | 1.52 | -1.51** | 4.42 | 8.41 | 3.99* |
| Germany | 2.00 | 1.74 | -0.26 | 3.54 | 6.30 | 2.76* |
| Ireland | 3.77 | 0.55 | -3.22* | 7.72 | 12.56 | 4.84* |
| Italy | 2.12 | 1.99 | -0.13 | 6.38 | 9.14 | 2.76* |
| Netherlands | 2.55 | 1.04 | -1.51*** | 5.15 | 11.45 | 6.3 * |
| EMS Countries | 2.38 | 1.66 | -0.72 | 4.62 | 8.18 | 3.56* |
| European non-EMS Countries[a] | 0.99 | 1.70 | 0.71 | 3.46 | 7.76 | 4.3* |
| Non-European Countries[b] | 2.81 | 2.54 | -0.27 | 5.76 | 6.57 | .81 |

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.

a = Austria, United Kingdom and Switzerland

b = Canada, Japan and the United States

* Statistically different from zero at the 5 percent significance level (t distribution, 11 degrees of freedom)

** Statistically different from zero at the 10 percent significance level (t distribution, 11 degrees of freedom)

*** Statistically different from zero at the 20 percent significance level (t distribution, 11 degrees of freedom)

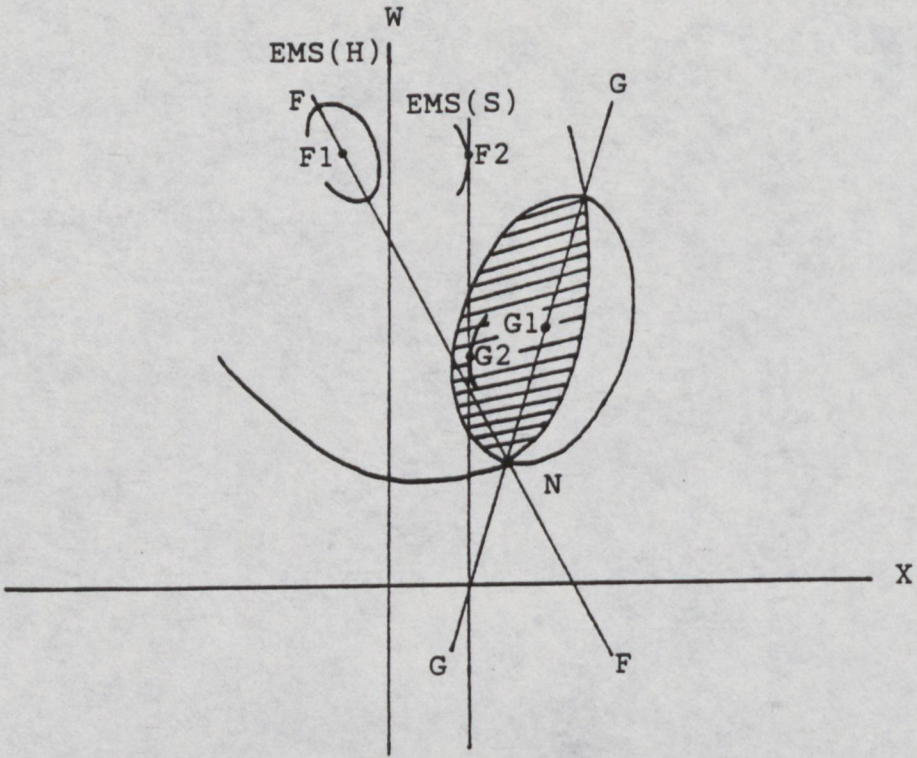



FIGURE 1: SOFT COOPERATIVE STRATEGY

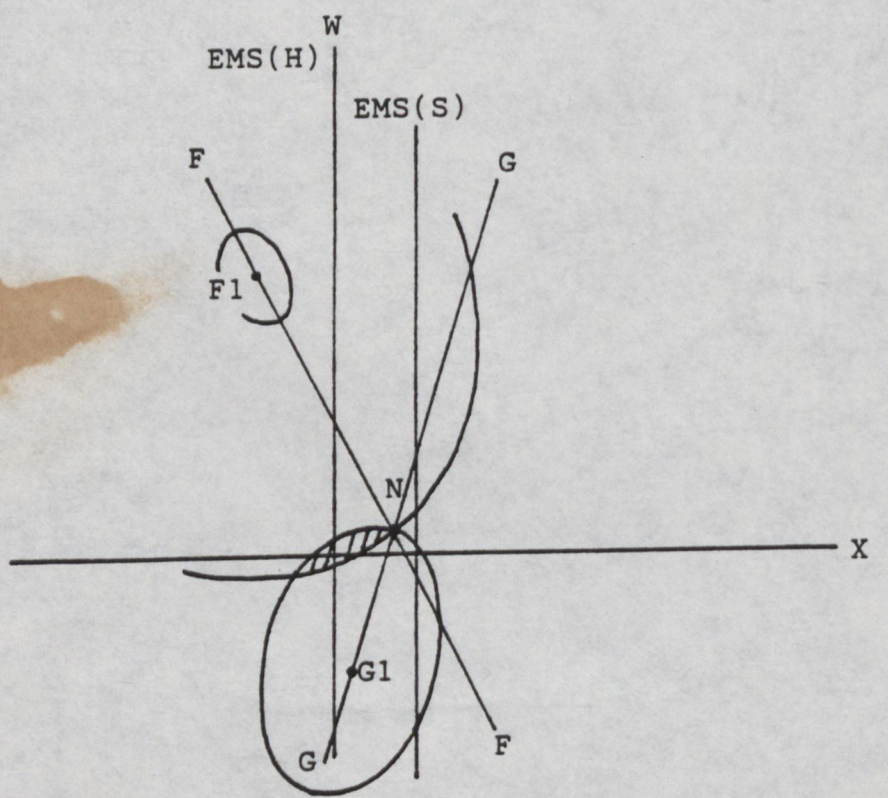



FIGURE 2: HARD COOPERATIVE STRATEGY

X= FRENCH INFLATION RATE MINUS GERMAN INFLATION RATE

W= AVERAGE OF FRENCH AND GERMAN INFLATION RATES

SECRET AND PERSONAL

GL3CDE
6

SUBJECT cc MASTER

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

27 July 1987

EMS

The Chancellor this morning raised with the Prime Minister the question whether the UK should now become a full member of the EMS. I am sending this record for the Chancellor's and your information.

The Chancellor noted that the Government had for some time maintained that the UK would become a full member when the time was right, and the Prime Minister had said that the first year of a new Parliament would be the right time. The reserves were now much stronger. Membership would give as much exchange rate stability as it was possible to achieve. It would help business confidence and confidence in the marketplace. The Treasury was working to achieve changes in the technical arrangements for the EMS in the autumn and this would provide a good opportunity. The Chancellor said he was not himself a great believer in UK membership of the European Community, but this was one of the few areas where membership had benefits to offer.

The Prime Minister said that the Government had built up during eight years a well-founded reputation for prudence. Membership would amount to saying that we could not discipline ourselves, but we needed the restraint provided by Germany and the Deutchmark. Membership would reduce the room for maneouvre on interest rates, and it would introduce a new uncertainty because no-one would know how the Government would react when the currency was tested. Interest rates would be higher at times of pressure than they would be if we were outside the ERM. Mr. Edward Heath had said in the early 1970s that membership of the European Community would help to discipline the trades unions. This had not happened and the attempt to use membership of the EMS to influence the expectations of management and workforces would be an equal failure. It would also be difficult for the UK to be seen to be joining at a time when we were criticising other member countries for their failure to exercise discipline over the Community budget. By blocking off changes in the exchange rate membership would tend to lead to higher unemployment. Overall, when things were going smoothly membership of the EMS would add nothing to economic policy making, and when things

were going badly membership would make things worse.

The Chancellor rejected this analysis. Germany had discipline on its own policies and the Government was not in any case a free agent: it was bound by the reactions of business and the markets. Membership had clearly helped France during its difficulties. The Prime Minister argued that business would hate the higher and more volatile interest rates which would come with membership and that France did not enjoy the record for prudence which the British Government had now built up. The fluctuations in oil prices and our open financial system were also relevant factors.

The Chancellor said he would wish to discuss this further with the Prime Minister in the autumn. The Prime Minister said she would not be prepared to hold meetings of the kind which had been held in the autumn of 1985 and that she would not wish to hold a further discussion with the Chancellor until the new year.

DAVID NORGROVE

Alex Allan, Esq.,
H.M. Treasury.

2

10 DOWNING STREET

Prime Minister

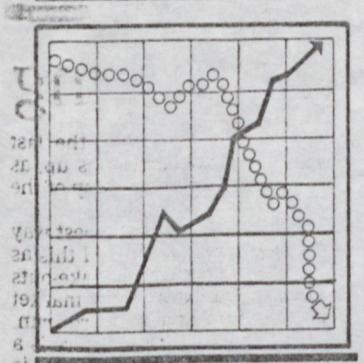
Here is the Guardian article I mentioned.

NLW

D.Y

FINANCIAL GUARDIAN

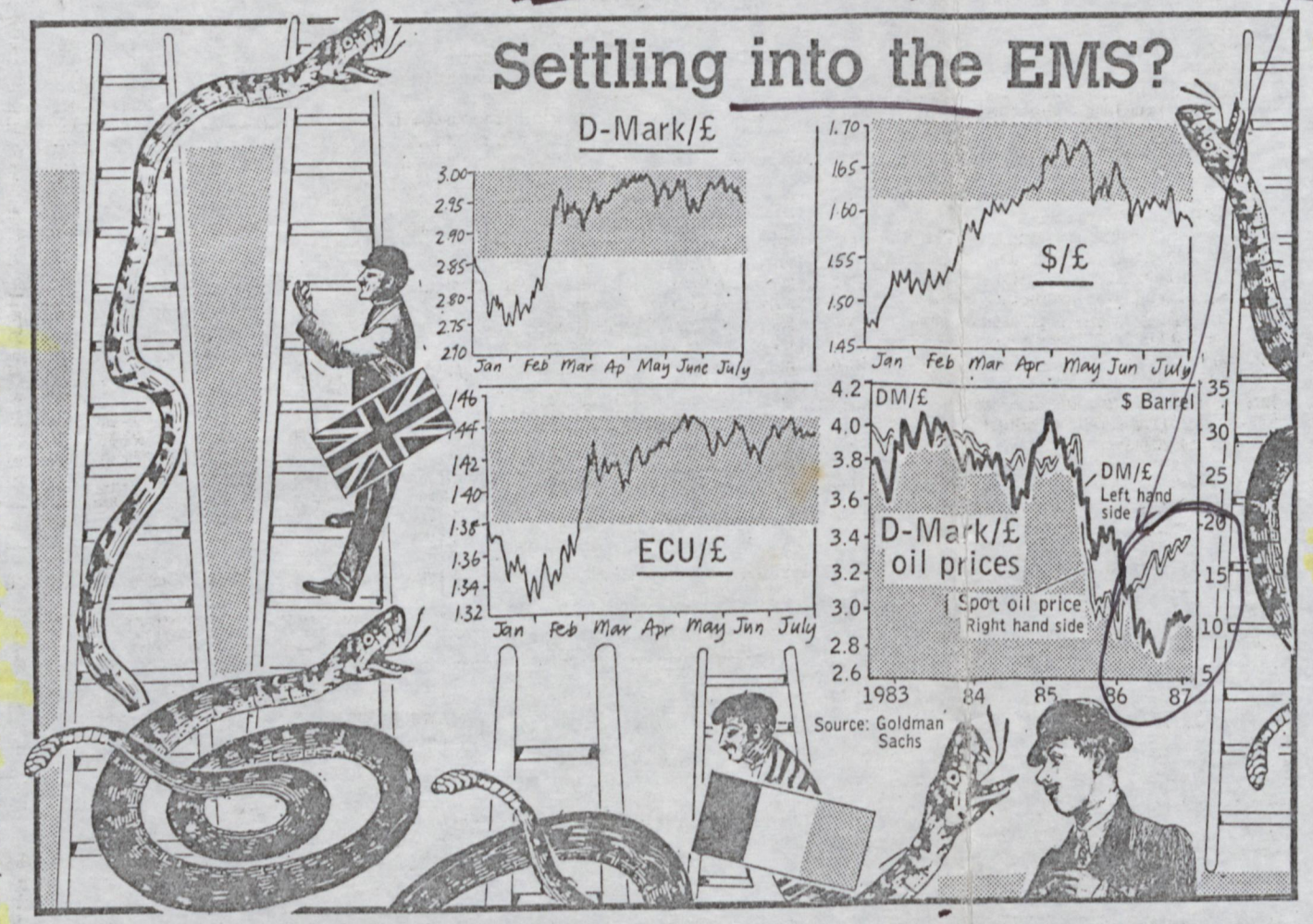
B NB Hedwergence



ECONOMICS

Christopher Huhne

# Lawson's secret membership card




THE CHANCELLOR'S secret monetary policy — closet membership of the European Monetary System — is about to undergo a baptism of fire. The death of the Iranian pilgrims in Mecca and the associated political fall-out are the type of circumstances which critics of EMS membership believed that the petro-currency pound would not weather if it were a member.

However, the pound is now almost a participating member of the exchange rate mechanism, as the graphics show. Since early March, the pound has stayed within 2.25 per cent intervention limits, not only against the Deutsche-mark but the European Currency Unit and the French franc too.

Indeed, the Bank of England has excelled itself, for the pound has stayed well within the range.

There are two other pieces of evidence for shadow membership of the EMS. The official foreign exchange reserves have become suddenly much more variable, building up sharply from $21.9 billion to $34.9 billion on yesterday's figures. Given the degree of political massage to which the reserve figures — particularly the underlying figures — are subject, this is tantamount to advertising large-scale intervention in the markets in neon.

Indeed, the Chancellor said as much to the CBI annual dinner on May 19, when he pointed out that he had let sterling fall to reflect the loss of oil revenues last year and that his actions in the sharp reserve build-up of March to May showed that he was committed to keep it there.

"I share the overwhelming view of British industry that a period of exchange rate stability is now highly desirable" he said.

Also, the easing of British interest rates, despite rapid rates of credit growth was clearly in part the result of trying to keep a relatively strong exchange rate within a target range.

Nor is this stability of the pound against the EMS currencies merely an accidental by-product of the agreement(the details of which are secret) concluded by the Group of Five / Group of Seven finance ministers at the Louvre on February 22. All of the major currencies have been more stable since the Louvre accord, but the graph shows that the variability of the dollar has broken the 2.25 per cent intervention limits of the EMS on several occasions. (In all cases, the limits merely take the observed highs over the post-February period as the permitted ceiling of the notional target range).

Certainly, the pound was the unexpected ( and unintended ) beneficiary of the Louvre Accord, because the markets perceived that the downside risk in holding sterling had been removed while UK returns — interest rates — were still very high. But the rally was capped early in March by intervention and interest rate cuts: since then, the pound has behaved like a very good European currency.

One of the advantages of shadow membership of the EMS, from the Chancellor's point of view, is that it commits him publicly to nothing. He can change target parities (or central rates) overnight without consulting his EEC partners — as we would have to do if we were a declared member of the EMS — or he can decide to let the pound float where it will.

He does not have to battle periodically with the advocates of full membership — in London and the rest of the EEC — since he can effectively say it is on trial. He has avoided the unpleasant task of finally deciding whether the "time is ripe" to join, or abandoning the pretence that it would ever happen, as he must have done had there been no change in policy after the election.

Yet he can also meet the Prime Minister's desire to keep those Europeans at the nether end of a long boat hook.

In short, closet EMS membership admirably suits a Chancellor bent on keeping his options open.

The disadvantage, compared with full membership, is that it really is not the same. The public commitment to fixed rates of a group of finance ministers who collectively control the supply of their currencies ( and thus their relative prices) is qualitatively entirely different to a private practice of one minister which can be changed on a whim.

The benefit for domestic policy of attempting to hold a particular exchange rate is similar except that it is less likely to persuade exporters to invest on the basis of its permanance. There will be less benefit, too, from running a lower level of interest rates for a given exchange rate target because of the public confidence engendered by declaration.

The Chancellor may well feel, however, that he is sacrificing little given that the rapid growth of credit and market fears of an "overheating" economy would probably forestall interest rate cuts anyway.

So we have a classic British compromise: milk and water EMS membership. Moreover, the Chancellor has so far been successful in reconciling his domestic objectives with his shadow target range. But the fact that the pound has been behaving as if it was an EMS member for five months does not, of course, mean that it will go on doing so. We have seen relatively prolonged periods of stability against the other Europeans before under the Government ( notably in 1983 and then again in 1984.) The next year may not be so easy, requiring either a shift in parity or an end to the shadow.

One threat is external. The financial markets have not yet taken a firm view of the latest events in the Gulf. They may mean a stronger oil price because production will be disrupted, or a weaker one because the Iranians and the Saudis will find it more difficult to reach agreement on the quotas which have determined the renaissance of OPEC's power in the oil market.

A shift either way is likely to yank the pound in the opposite direction to the German Mark, simply because Germany is a big oil importer and Britain is a net oil exporter. Higher oil prices improve Britain's balance of payments current account relative to Germany's. The Germans pay out more marks for their oil, and thus force down their value to persuade foreigners to hold on to them.

As a result, there has been a loose relationship between the price of North Sea oil and the price of the pound against the German Mark, as the fourth graphic shows. It is becoming less important in part because of the lower level of oil prices compared with the early eighties, and in part because Britain's net oil exporting position is eroding. But it is still there.

(The recent strength of oil prices and the support which that gives to the pound may be one explanation for the build-up in official reserves during July, when many in the markets had expected to see a fall as the Bank intervened to support sterling after the poor May trade figures released on July 22. Indeed, the strengthening oil price so far this year has probably been the main reason behind the demand for sterling.)

Another threat to shadow EMS membership — or at least current target ranges — is that domestic objectives will get in the way. The Chancellor has two conflicting objectives for the early part of his second term: keeping inflation down ( which means tightening policy at some point over the next year, unless he is to do a U-turn on incomes strategy) and giving away money in tax concessions in the next budget, if only as a lubricant to the losers from tax reform.

However, the rise in oil prices ironically helps him out of that particular conflict, since for Britain it is to all intents and purposes similar in domestic economic effects to a rise in indirect taxation such as VAT or excises. Much of the marginal rise in oil prices goes straight from the consumers' pockets to the government in extra North Sea oil revenue, damping consumer demand and improving government finances.

The only snag is the fillip rising oil prices also give to domestic inflation, at a time when other inflationary pressures are already mounting. Factory gate prices are rising well ahead of unit wage costs, implying widening profit margins. Earnings are edging upwards, reflecting high profits. Commodity prices ( not just oil) are rising.

The odds on the Chancellor holding on to his shadow EMS membership are if anything narrowing. He may even want to tighten policy a notch or two by raising his exchange rate target.

Alternatively, he may want to raise interest rates and hold the current target range if this summer's trade figures show that May was not just an aberration.

Mr Lawson is a rather practised rider of the electoral economic cycle, and it is another four years at least to an election.

5

PRIME MINISTER

EMS

You will want to discuss your position on the EMS with the Lord President: he will have the key role in this.

I suggest you tell him that you remain firmly opposed to membership and that your position will not be shaken by the Chancellor, the Foreign Secretary and the Governor. You will be willing to discuss the EMS with the Chancellor but you see no point in another large meeting involving a wider group of colleagues. The Chancellor should be discouraged from expecting one. Anything which the Lord President can do to reduce the Chancellor's expectations would be helpful.

In explaining your opposition to the membership of the EMS I recommend you not to emphasise the size of UK reserves or the fact that there are capital controls in France and Italy. The strength of these objections is gradually falling over time and a major liberalisation by France in particular could be announced at a time in future which might undermine your case. Indeed arguably the weaker the capital controls within Europe, the greater the risk of de-stabilising capital flows.

I suggest that the main arguments against membership are as follows:

(i) the Government should not rely on an external discipline as the basis of its economic policy. Policy should be based on self-restraint;

(ii) membership could well prove de-stabilising; investors and companies would be unable to predict how the Government would react to severe exchange

rate pressure and there would be greater volatility of interest rates;

(iii) with the core rate of cost growth in the UK higher than that in Germany, there is likely to be a gradual erosion of competitiveness; to tie ourselves to Germany would cause output and employment to take the strain;

(iv) the exchange rate should not be the subject of haggling in Brussels;

(v) the behaviour of the EMS with a major addition like sterling, with large and open financial markets, cannot be predicted with confidence.

I attach the record of your meeting with Sir Alan Walters.

D.R.N.
20 July 1987

PMMADD

4

PRIME MINISTER

EMS

The Chancellor has in the last few weeks from time to time pressed me about the best way from his point of view of taking forward discussions on the EMS. I have discouraged him from approaching you directly or through the Lord President at this stage. But he will undoubtedly return to this in the autumn, if not in the next week or two, and you might like to take half an hour to talk this through. There may be a gap after E(EP).

In this context you might like to look at the papers enclosed in the folder which I have gathered over the past few weeks. The note on capital controls is based on a paper of November 1986, so it is somewhat out of date.

DLW

(DAVID NORGROVE)

14 July 1987

3

pa ENS.

SECRET

## Estimated level of currency reserves

| | $ billion | Equivalent in numbers of weeks imports |
|---|---|---|
| Japan | 61 | 24½ |
| Germany | 55 | 14 |
| France | 35 | 13½ |
| Italy | 21 | 10 = |
| UK | 23 | 9 = |
| Netherlands | 11 | 7 |
| Canada | 4 | 2½ |
| US | 17 | 2 |

SECRET

pa EMS.

INFORMAL ECOFIN 3-5 APRIL ANNEX A3

LIBERALISATION OF CAPITAL MOVEMENTS: RESTRICTIONS IMPOSED BY MEMBER STATES

1. Community legislation on liberalisation of capital movements, to implement Article 67 of the Treaty is enshrined in the 1960 capital movements Directive, as amended by Directives of 1962, 1985 (accompanyiny the Directive on UCITS) and 1986 (implemented 28 February 1987).

2. For liberalisation purposes, Community legislation divides transactions as follows:

(a) those subject to unconditional liberalisation, (unless covered by a specific derogation);
(b) those in effect subject to voluntary liberalisation. This includes a category of transactions which member states are supposed to liberalise unless liberalisation could be an obstacle to their economic policy objectives, and a category for which there are no liberalisation obligations.

3. In broad terms, unconditional liberalisation (2(a)) applies to direct investments, new issues of securities, most operations in securities, investment in real estate, commercial credits (where residents participate), and most personal capital movements. The main transactions to which voluntary liberalisation (2(b)) applies relate to short term capital eg Treasury bills and bank deposits.

4. Information on individual member states is given below. This is taken largely from a Commission paper of November 1986 prepared for the Monetary Committee.

GREECE

5. On 2(a) above, Greece currently has a derogation under Article 108(3) of the Treaty of Rome, agreed as part of the Community Loan package in November 1985 to help Greece with balance of payments problems. The derogation covers direct investments, investments in real estate, and some personal capital movements ( which may be made subject to prior authorisation), and some operations in securities (which may be prohibited or made subject to prior authorisation). It is intended to last until November 1988.

6. Greece also maintains some restrictions on transactions under 2(b) involving in some cases prohibition and in others need for authorisation.

7. Greece is likely to be cautious about full liberalisation, stressing the need for step by step progress depending on other factors such as convergence and supporting the availability of safeguard provisions and support facilities. At the November 1986 ECOFIN, when the 1986 Directive was adopted, Greece made a statement for the Council minutes stressing the dangers of free movement of capital for the weaker economies and currencies, and the need for better co-ordination of economic policies.

SPAIN

8. On 2(a), Spain has a derogation under the Accession Treaty, covering direct investment, investments in real estate, and some operations in securities. This derogation lasts until 1988 - 1990 (depending on the type of transaction). Further, Spain does not have to implement the 1986 Directive until 1989 - 1990 (depending on the type of transaction).

9. Spain also maintains some restrictions on transactions under 2(b) mainly involving need for authorisation.

10. Spain seems to be moderately enthusiastic about liberalisation. According to the Commission's November paper, some of Spain's recent liberalisation measures on portfolio investment have gone beyond those necessary to comply with the Accesssion Treaty. At the October ECOFIN, when it was tacitly agreed that Spain and Portugal could delay implementation of the 1986 Directive, Solchage said that for Spain this delay was not a matter of practice but of principle.

FRANCE

11. On 2(a), France's balance of payments derogation under Article 108(3) of the Treaty of Rome was rescinded by the Commission in June 1986. This was made possible because of liberalisation measures taken at the end of 1985 (in respect of direct investments) and in May 1986 (notably in respect of acquisition of foreign securities - the ending of the devise titre system, immovable investments abroad, and certain personal capital movements).

12. France still maintains some restrictions on transactions under 2(b) mainly involving need for authorisation or use of approved intermediaries. According to the Commission's November paper, France has, during 1986, taken measures towards liberalised exchange controls in respect of some commercial and financial operations of enterprises, and some transactions by residents. French residents, though, remain unable to hold foreign currency bank deposits.

13. Thus France is at the moment fairly enthusiastic about liberalisation. However discussion in the Monetary Committee suggests that they would want to move gradually (with the next stage perhaps full liberalisation for companies) and with the possibility of safeguard provisions.

IRELAND

14. On 2(a), Ireland still has a balance of payments derogation under Article 108(3) of the Treaty of Rome, covering some operations in securities, to last until end 1987.

15. On 2(b), Ireland also maintains some restrictions on transactions under 2(b) involving mainly need for authorisation (which for some transactions may only be given in certain circumstances).

16. Like Greece, Ireland is likely to be fairly cautious about full liberalisation.

ITALY

17. On 2(a), Italy still has a balance of payments derogation under Article 108(3) of the Treaty of Rome, to last till end 1987. In broad terms, this derogation permits the imposition of non interest bearing bank deposits for residents investment in real estate abroad (15%), and for acquisition of foreign securities (15%). The Commission have recently tightened up this derogation (the deposit percentages used to be somewhat higher) in line with Italian moves to relax some of their restrictions on capital movements.

18. On 2(b), Italy still maintains some restrictions on transactions including some prohibitions as well as requirements for authorisation.

19. Despite their recent moves towards it, Italy is likely to be cautious about full liberalisation of capital movements. At the November ECOFIN when the 1986 Directive was adopted, Italy made a statement for the Council minutes, about the possible destabilising effects of free capital movements on the EMS, and on the need for co-ordination of economic policies and policies on financial markets and instruments, and for measures to help with balance of payments and other problems which might arise.

PORTUGAL

20. Portugal has a derogation under the Accession Treaty, covering direct investment, investment in real estate, personal capital movements over a certain amount , and some operations in securities. These provisions last until up till 1992 (depending on the type of transaction). Further, Portugal does not have to implement the 1986 Directive until 1990 - 1992 (depending on the type of transaction).

21. Portugal also maintains some restrictions on transactions under 2(b) mainly involving need for authorisation.

22. Portugal may also be fairly cautious about full liberalisation.

OTHER MEMBER STATES

23. None of the other member states has a derogation of any sort on transactions under 2(a). Nor on the whole do they maintain restrictions under 2(b), although:

(a) according to the Commission's November paper, Denmark still has prior authorisation provisions on some transactions. However, Denmark is regarded as being substantially liberalised.

(b) Germany still has restrictions on certain transactions in ecus. (At the last informal ECOFIN, Stoltenberg said that Germany would consider full recognition of the private ecu if there was progress on liberalisation of capital movements, but nothing concrete has happened on this.)

(c) Belgium operates a dual exchange market, which separates purchases and sales of currencies for investment purposes from commercial flows. The 1986 Directive has in principle tightened up on this: for all transactions subject to

unconditional liberalisation, the exchange rates applied "must not show any appreciable and lasting differences from those ruling for payments relating to current transactions".

23. All these countries are likely to support moves towards full liberalisation. Belgium is likely to be the most cautious of the group: when the new initiative was discussed at ECOFIN in June 1986, Eyskens mentioned the difficulties which full liberalisation would cause for some member states, and linked it with completion of the EMS.

SECRET

2

From : D L C Peretz
Date : 7 July 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr C W Kelly

EMS

You asked whether there are any changes in the working of the ERM that we should be seeking; and if so whether there is anything on which we could make common cause with the French. Sir G Littler, Mr Kelly and I have discussed this, and pooled our ideas.

**Background**

2. As you know, the Monetary Committee of the EC (on which Sir G Littler represents the Treasury) has been looking at a series of ideas for "strengthening" the operation of the ERM, with some background work carried out in the "Alternates Committee" (on which I have been representing the Treasury). Tietmeyer gave an interim progress report at the last ECOFIN; and the exercise is due to be completed in time to report to the September ECOFIN.

3. The French contribution to these discussions has at times been a little unfocused, starting with an 11 page memorandum of proposals for change (tabled in February with some press publicity), which was however subsequently presented in the Monetary Committee as just some "ideas put forward for discussion". It has, however, become reasonably clear what changes the French would like to see, and what the national line up on these is. What is less clear is what changes if any they might (as has been suggested) be expecting us to want to see before joining the ERM.

4. Our own assumption hitherto has been that if we were to join we would join the system as it stands. We think that should remain the assumption. Although one or two ideas for change have

emerged in the course of the Monetary Committee review to which we would probably want to give mild support, there is nothing that we would see as of sufficient importance to want to insist on before joining.

**French Ideas**

5. The original French paper contained the following :-

a) some rather vague ideas about a more co-ordinated European contribution to the G5/G7 moves towards more stable exchange rates, with regular discussions by EC Finance Ministers and Governors of the dollar and yen. This is a traditional French preoccupation.

b) better ERM realignment procedures.

c) various proposals for improving the technical working of the ERM :-

i) rethinking the divergence indicator;

ii) greater mutual surveillance of monetary and economic policies in EMS countries;

iii) increasing resources available for intervention within the ERM, in particular by :-

- making the very short-term financing facility (VSTFF) available to finance intra-marginal intervention as well as marginal intervention.

- merging the two longer-term financing facilities (that is the MTFA and CLM); and possibly increasing the effective total available.

## Monetary Committee Discussions

6. Tietmeyer's report for the 15 June ECOFIN (copy attached for reference) gave the then state of play. There has since been further discussion at the Monetary Committee; and a further meeting of the Alternates Committee. In making the UK contribution to these discussions we have had very much in mind what our interests would be were we to be full members of the ERM.

7. There is a reasonable list of changes in the way the ERM works in practice that we would (or in some cases would not) like to see, some of which, I suspect, would in any case be given a new impetus were sterling to become a full member :

i) better prepared, conducted and less public realignment procedures. Everyone is in favour of that. The question is how to make it happen in practice.

ii) greater readiness to use short-term interest rate differentials alongside intervention in exchange rate management. As exchange controls are dismantled and capital flows increase this will become more important for existing ERM countries (as it is already for the Dutch). We have always assumed that is how we would need to operate within the ERM. It does, of course, require better co-ordination of domestic monetary and other policies between ERM countries. This strand of thought has got pretty widespread support in recent discussions, and indeed the Monetary Committee has now instituted regular discussions of interest rate and monetary policies in member countries.

iii) greater readiness to use movements of exchange rates within the margins to keep speculators guessing. Again there is a reasonable consensus on this.

iv) abolition of capital controls within the Community. This is, of course, agreed in principle. But there are still plenty of arguments to come about the extent to which there should be safeguard clauses to allow reimposition of controls (and the conditions in which

they can be triggered); and the extent to which capital liberalisation should be matched by an increase in EMS medium-term financing facilities, to help the weaker members through the transition.

v) no new revamped role for the Divergence Indicator. This was originally constructed to give a signal of when pressures are building up within the system and which were the divergent currencies whose authorities might reasonably be expected to do something about it.. But in reality the signal can be any combination of exchange rate movement within the permitted bands, interest rate movements, or intervention. So the divergence indicator actually performs no useful function : there seems to be a fair consensus on this too.

vi) an acceptance that on occasion intra-marginal intervention makes sense, and should to some degree qualify for financing under the very short financing facility (the VSTFF). The Germans and Dutch have so far been opposed to this.

should we go much further?

vii) a removal of any artificial inhibitions there may be on cross holdings of Community currencies in national reserves. Again there is a certain amount of German and Dutch resistance to this.

vi) and vii) are both issues on which we might to some degree be able to ally ourselves with the French - though on both they want to go further than we would.

**Intra-marginal Intervention**

8. Our position is a pragmatic one. We accept that it will sometimes make tactical sense to try to prevent the exchange rate reaching the margin, and to use intra-marginal intervention for the purpose; just as on other occasions the right approach would be to let the rate move towards the margin fairly quickly. The German attitude to this is coloured by the monetary problems

caused for them by intervention that involves selling DM. Making access to DM borrowing under the VSTFF available for intra-marginal intervention (as it is, automatically, for intervention at the margin) would they think simply add to these monetary problems. To some degree we should share this German worry. Sterling could on occasion be the strong currency within the system, and we might find large scale sterling drawings by, for example, the Irish creating problems of domestic UK monetary management. On the other hand we deal with such problems rather better, technically, than does the Bundesbank. On balance we would I think support access to the VSTFF for intra-marginal intervention, but within some kind of limits. Or perhaps on terms that make it slightly less attractive to the borrower than drawings to finance marginal intervention : for example VSTFF drawings for intra-marginal intervention might have to be settled entirely in the currency of borrowing, rather than up to 50% in ecu as is the present rule for intervention at the margin (this too is under review).

**Cross Holdings of Each Others' Currencies**

9. Again our position is a pragmatic one. Greater cross holdings of currencies seem likely to be make for smoother intervention operations in some circumstances. This is true in the wider international context, as well as in the ERM. Consider, for example, the problems the Bundesbank had recently in acquiring the yen it needed to sell in a concerted intervention operation.

10. Moreover, with sterling in the ERM it would seem pretty likely that the Irish would want to hold significant sterling balances (as they have in the past) : and we would probably want to let them do so. The present rules limit cross holdings to working balances, except with explicit permission of the other central bank. The Germans and Dutch would like to remain pretty restrictive on this. The French on the other hand seem to have in mind some kind of idea of a "political" initiative to promote cross holdings - no doubt they see this as a way to lend some support to the weaker ERM currencies.

11. We certainly would not want to be forced to hold currencies in our own reserves where that served no practical purpose, or where we thought they represented a poor investment. But we might go some way to meet the French, by supporting a move to a more permissive regime : allowing cross holdings to develop naturally where that seemed sensible to the central banks concerned.

**Italian 6% Band**

12. If sterling joined the ERM on the narrow margins, that would almost certainly add to pressures on the Italians to move to a narrow margin too. The 6% band is, we know, a source of some irritation to their partners. We would no doubt be happy to support any pressure on the Italians in such circumstances (though it could lead to a bumpier ride for the ERM as a whole).

**Conclusion**

13. In short, there are two areas currently under discussion in the Monetary Committee where we might be able to make some kind of common cause with the French : intra-marginal intervention and cross holdings of Community currencies. In neither case would we want to go as far as the French, though. Nor would we actually attach any great importance to either. Indeed we cannot think of any change in the operation of the ERM that we would want to insist on before joining.

14. Finally, I should say that we have had it in mind for some time that Chris Kelly and I might pay a short visit to France, of the kind that Joe Grice and I paid to Germany in May. (In France we would aim to spend more time with the Tresor and less with the Central Bank). Sir G Littler will speak to Lebegue about this later this week. If we could arrange the visit fairly soon it might provide an opportunity to get a little closer to the French ~~Ministry~~ thinking on these issues, and to explore how far our interests coincide.

D L C PERETZ

Attachment to Brief B

ALL MEMBERS OF THE MONETARY COMMITTEE

THE [redacted] FOLLOWS THE TEXT APPROVED BY MR TIETMEYER WHICH HE INTENDS TO DELIVER TO THE ECOFIN ON JUNE 15. SINCE THIS IS A STRICLY ORAL STATEMENT NO WRITTEN TEXT WILL BE DELIVERED TO THE COUNCIL IN ADVANCE. SHOULD YOU HAVE A FUNDAMENTAL RESERVATION THERE IS A POSSIBILITY OF CONTACTING THE SECTETARY BY TELEPHONE UNTIL NOON ON THURSDAY 11 JUNE.

A. KEES
COMEU B

STRENGTHENING THE EMS
- STATE OF DISCUSSIONS AND WORK IN THE MONETARY COMMITTEE
ORAL REPORT BY THE CHAIRMAN
TO THE ECO/FIN MEETING OF 15 JUNE

FOLLOWING THE REQUEST EXPRESSED BY THE FINANCE MINISTERS AT THEIR INFORMAL MEETING AT KNOKKE, THIS REPORT, WHICH IS PRESENTED BY THE CHAIRMAN ON HIS OWN RESPONSIBILITY, GIVES AN OVER-VIEW OF THE PROGRESS MADE BY THE COMMITTEE IN ITS WORK ON THE STRENGTHENING OF THE EMS. AS ALREADY MENTIONED AT KNOKKE, THE SUGGESTIONS IN THE FRENCH MEMORANDUM AND IN OTHER WRITTEN CONTRIBUTIONS HAVE BEEN TAKEN INTO ACCOUNT. THE SECOND PART INDICATES THE DIRECTION BEING TAKEN BY WORK ON A NUMBER OF OPEN QUESTIONS. THE COMMITTEE WILL DEAL WITH THESE AT ITS NEXT THREE MEETINGS AND INTENDS TO PRESENT SOME OF THE SOLUTIONS WHICH MIGHT BE ENVISAGED TO MINISTERS AT THEIR INFORMAL MEETING IN SEPTEMBER.

I. PROGRESS AND NEW APPROACHES

COOPERATION IN INTEREST RATE POLICIES

1. FOR WELL OVER A YEAR, THE EMS HAS BEEN CHARACTERIZED BY INCREASING CONVERGENCE OF FUNDAMENTAL FACTORS, WHILE CAPITAL WAS BECOMING MORE MOBILE AND SOME MEMBER COUNTRIES WERE RELAXING THEIR EXCHANGE CONTROLS. AT THE SAME TIME THE TENDENCY TO USE INDIRECT INSTRUMENTS IN THE EXECUTION OF MONETARY POLICY BECAME GENERALLY STRONGER. IN THESE CIRCUMSTANCES THE STABILITY OF EXCHANGE RATES IN THE EMS HAS FOR SOME TIME BEEN HEAVILY DEPENDENT ON THE DEVELOPMENT OF INTEREST RATES AND OF INTEREST RATE POLICIES. FURTHER, THIS IS ALSO TRUE AT PRESENT OF EXCHANGE RATES AGAINST THE US DOLLAR.

2. IN THE OPINION OF THE MONETARY COMMITTEE, SINCE PRICE AND COST DEVELOPMENTS IN PARTICULAR CONTINUE TO DIFFER, EMS CENTRAL RATES CAN BE KEPT STABLE ONLY IF APPROPRIATE INTEREST RATE DIFFERENTIALS ARE MAINTAINED. WHEREAS PREVIOUSLY THE POLICY DEBATE OFTEN FOCUSED EXCLUSIVELY ON A GENERAL REDUCTION OF INTEREST RATES, THE PRIME CONCERN AT PRESENT, IF EXCHANGE RATE STABILITY IS TO BE RESPECTED, MUST, IN THE VIEW OF THE MONETARY COMMITTEE, BE TO ENSURE THAT THE DIFFERENCES BETWEEN THE INTEREST RATES OF EMS COUNTRIES ARE ADEQUATE, NOT LEAST IN ORDER TO MAKE THE EMS SECURE AGAINST EXTERNAL INFLUENCES. INTEREST RATE POLICY, HOWEVER, CANNOT BE CONDUCTED WITHOUT TAKING DUE ACCOUNT OF THE CENTRAL OBJECTIVES OF MONETARY POLICY. IN PARTICULAR THE ACHIEVEMENT OF STABILITY OF THE DOMESTIC PURCHASING POWER OF CURRENCIES ON A LASTING BASIS. IT MUST BE INTEGRATED INTO A GENERAL POLICY WHICH SEEKS THE CONVERGENCE OF FUNDAMENTAL ECONOMIC FACTORS.

3. WHILE SCRUPULOUSLY RESPECTING THE ALLOCATION OF RESPONSIBILITIES IN THE INDIVIDUAL COUNTRIES. THE MONETARY COMMITTEE HAS MADE NEW ARRANGEMENTS WHEREBY IT STUDIES

CAREFULLY THE MOST RECENT EXCHANGE AND INTEREST RATE DEVELOPMENTS AT EACH MONTHLY MEETING AND DISCUSSES SUCH CONCLUSIONS AS CAN BE DRAWN FOR OFFICIAL ACTION. THESE DETAILED DISCUSSIONS MAY MAKE AN IMPORTANT CONTRIBUTION IN THE FUTURE TO CLOSER COOPERATION IN THIS AREA.

THE FULL USE OF THE FLUCTUATION MARGINS

4. LASTING STABILITY OF INTRA-EMS EXCHANGE RATES CAN ALSO BE MADE MORE PROBABLE IF MONETARY AUTHORITIES MAKE MORE FLEXIBLE USE OF THE FULL FLUCTUATION MARGINS OF THE EMS THAN THEY DID IN THE PAST.

THE OBJETIVE OF THE FULL USE OF THE BAND MUST BE TO ENSURE THAT SPECULATION IS A TWO-WAY RISK. IT MUST BE MADE CLEAR THAT THE AUTHORITIES WHOSE CURRENCIES HAVE MOVED IN ONE DIRECTION WITHIN THE BAND ARE WILLING TO ACCEPT THAT THEIR CURRENCIES SUBSEQUENTLY MOVE IN THE REVERSE DIRECTION. THIS APPROACH WILL BE ALL THE MORE EFFECTIVE BECAUSE THE IMPROVEMENT OF FUNDAMENTAL FACTORS IMPLIES THAT FUTURE REALIGNMENTS SHOULD BE SMALLER THAN THE MARGIN OF MANOEUVRE AVAILABLE WITHIN THE BAND. THEY WILL THEREFORE NOT GENERALLY RESULT IN IMMEDIATE CHANGES IN THE MARKET VALUES OF CURRENCIES. BY USING THE FULL EMS BAND IN THESE WAYS. THE AUTHORITIES CAN, IN TIMES OF HIGH CAPITAL MOBILITY, GIVE THE MARKETS A CLEAR INDICATION THAT SPECULATION IS A MATTER OF HIGH AND IMPONDERABLE RISK. ON THIS QUESTION ALSO THE COMMITTEE WAS ABLE TO IDENTIFY A GROWING AREA OF CONSENSUS AS WELL AS CHANGES IN OFFICIAL PRACTICE.

EXCHANGE RATE POLICY TOWARDS THE USA AND JAPAN

5. THE LOUVRE AGREEMENT, WHICH MADE WIDER INTERNATIONAL MONETARY ARRANGEMENTS AT THE TIME MORE CONCRETE, ALSO HAS IMPLICATIONS FOR ALL EMS COUNTRIES. THE MONETARY COMMITTEE

THEREFORE REGULARLY REVIEWS THE DEVELOPMENT AND THE CONSEQUENCES OF THESE ARRANGEMENTS IN THE LIGHT OF THE DEVELOPING STANCE OF ECONOMIC POLICY. AT ITS MAY MEETING, THE COMMITTEE COULD NOT BUT TAKE NOTE THAT THE US DOLLAR HAS HAD TO BE SUPPORTED IN RECENT MONTHS BY HEAVY INTERVENTION WHICH IN TOTAL ACTUALLY EXCEEDED THE US CURRENT ACCOUNT DEFICIT. A SUBSTANTIAL PART OF THIS INTERVENTION WAS UNDERTAKEN BY A NUMBER OF CENTRAL BANKS WHO WISHED TO REPLENISH THEIR RESERVES AND IT IS DIFFICULT TO KNOW FOR HOW LONG THEY WILL CONTINUE TO WISH TO DO SO. THIS INCREASES THE IMPORTANCE OF THE RISE WHICH HAS SINCE OCCURRED IN THE INTEREST RATE DIFFERENTIAL BETWEEN THE USA AND THE EMS COUNTRIES. THIS RISE MAY BE EXPECTED TO HAVE A SIGNIFICANT EFFECT ON AUTONOMOUS CAPITAL FLOWS TO THE DOLLAR AREA AND THUS ON THE CONTINUED STABILITY OF THE EXCHANGE RATE OF THE US DOLLAR.

SURVEILLANCE ON THE BASIS OF MACRO-ECONOMIC INDICATORS

6. TENSIONS WITHIN THE EMS CAN BE COUNTERED MORE EFFECTIVELY IF THERE IS A MORE EFFECTIVE MEDIUM-TERM COORDINATION OF THE COURSE OF ECONOMIC POLICY, AND IF INCOMPATIBILITIES ARE REVEALED AT AN EARLIER STAGE. THE MONETARY COMMITTEE IS OF THE OPINION THAT THIS IS NOT TO BE ACHIEVED BY A RIGID PROCEDURE, BUT ONLY THROUGH THE PRACTICAL ASSESSMENT OF THE MACROECONOMIC INDICATORS RELEVANT IN EACH SITUATION. THE COMMITTEE WILL HOLD THE FIRST OF ITS TWICE-YEARLY EXAMINATIONS OF THE COMPATIBILITY OF THE INDICATORS IN JULY, ON THE BASIS OF SUPPORTING DOCUMENTATION FROM COMMISSION STAFF.

II. THE DIRECTION TAKEN BY CURRENT WORK

7. BEYOND THIS PROGRESS AND THESE NEW APPROACHES IN THAT COORDINATION OF ECONOMIC POLICY WHICH IS OF DECISIVE IMPORTANCE TO THE EMS, THERE REMAINS A NUMBER OF QUESTIONS WHICH FOR THE MOST PART CONCERN FEATURES OF THE EMS MECHANISM. DISCUSSION OF THESE SUBJECTS IS STILL DEVELOPING AND WILL NOT PERMIT DEFINITIVE JUDGEMENTS TO BE MADE UNTIL SEPTEMBER. FURTHER, SOME OF THESE MATTERS COME EXCLUSIVELY UNDER THE AGREEMENT BETWEEN CENTRAL BANKS. THE MONETARY COMMITTEE WILL NEVERTHELESS ENDEAVOUR, IN THE THREE MEETINGS WHICH IT WILL HOLD BEFORE THE NEXT INFORMAL MEETING OF FINANCE MINISTERS, TO DEVELOP, SO FAR AS MAY BE POSSIBLE, CONCRETE PROPOSALS AND SUGGESTIONS FOR THEIR RESOLUTION.

THE DIVERGENCE INDICATOR AND THE QUESTION OF A CONVERGENCE INDICATOR

8. THE DIVERGENCE INDICATOR WAS REVIEWED IN THE INTERIM REPORT AT KNOKKE. AS REQUESTED BY MINISTERS, THE COMMITTEE IS NOW UNDERTAKING SOME ADDITIONAL TECHNICAL ANALYSIS AND IS STUDYING, WITH THE AID OF SIMULATIONS, SOME SLIGHTLY DIFFERENT DEFINITIONS OF THE INDICATOR, AND THE POSSIBLE ADOPTION OF A LOWER DIVERGENCE THRESHOLD. HOWEVER, EVEN IF CERTAIN TECHNICAL MODIFICATIONS ARE ADOPTED, THE DIVERGENCE INDICATOR SHOULD BE REGARDED AS A USEFUL BUT NOT AS A PRIVILEGED SOURCE OF IMFORMATION. THERE WILL ALSO BE FURTHER STUDY OF THE POSSIBILITY OF ESTABLISHING A CONVERGENCE INDICATOR, BUT THERE ARE SUBSTANTIAL DOUBTS AS TO WHETHER IT WILL BE POSSIBLE TO CONSTRUCT A USEFUL SINGLE INDICATOR FOR THIS PURPOSE. CONVERGENCE CAN BE ASSESSED BETTER IN THE CONTEXT OF THE MACROECONOMIC INDICATORS, PARTICULARLY AS THE MORE COMPREHENSIVE NATURE OF SUCH AN EXERCISE GUARANTEES THE NECESSARY DEGREE OF FLEXIBILITY.

THE FINANCING OF INTRA-MARGINAL INTERVENTION WND THE REMOVAL OF THE ECU ACCEPTANCE LIMIT.

9. THE CENTRAL QUESTIONS HERE ARE WHETHER THE VERY SHORT TERM CREDIT FACILITY CAN BE MADE AVAILABLE FOR FINANCING INTRA-MARGINAL INTERVENTION., AND THE RELATED ONE OF THE ACCEPTANCE LIMIT FOR THE OFFICIAL ECU.

ON THE ONE HAND, IN THE VIEW OF SOME MEMBERS THE VERY WIDESPREAD USE OF THIS TYPE OF INTERVENTION IN RECENT YEARS MIGHT MAKE IT SEEM REASONABLE TO TREAT INTRA-MARGINAL INTERVENTION ON A PAR WITH OBLIGATORY INTERVENTION AS FAR AS ITS FINANCING IS CONCERNED. SUCH A DEVELOPMENT WOULD NOT, IN THEIR VIEW, NECESSARILY INVOLVE EITHER AN INCREASE OF THE TOTAL AMOUNT OF ALL INTERVENTION OR A WEAKENING OF THE DISCIPLINARY EFFECT OF THE EMS.

ON THE OTHER SIDE, IT WAS ARGUED IN THE COMMITTEE THAT STEPS IN THIS DIRECTION WOULD REPRESENT A DAMAGING SHIFT OF THE FUNDAMENTAL RELATIONSHIP BETWEEN THE ADJUSTMENT AND THE FINANCING OF DEFICITS, AND THUS OF THE SYSTEM'S CHECKS AND BALANCES. FURTHER, THE PRACTICE OF PARTNER CENTRAL BANKS IN GIVING THEIR CONSENT WOULD PROBABLY BECOME MORE HESITANT IN THESE CIRCUMSTANCES, AND MIGHT ACTUALLY RESULT IN A REDUCTION OF THE VOLUME OF INTRA-MARGINAL INTERVENTION.

ON THE OTHER HAND THERE ARE SIGNS THAT IT WILL BE POSSIBLE TO REACH A MEASURE OF AGREEMENT ON CHANGES TO THE ECU ACCEPTANCE LIMIT.

10. OTHER POINTS, SUCH AS THE HOLDING OF EMS CURRENCIES IN OFFICIAL RESERVES, AN INCREASE OF THE FECOM SWAPS AND THE QUESTION OF AN EXTENSION OF THE ECU MOBILIZATION MECHANISM ARE AT PRESENT STILL AT THE EXAMINATION STAGE. THE COMMITTEE HOPES THAT IT WILL BE ABLE TO STATE ITS VIEW ON THESE QUESTIONS IN SEPTEMBER.

THE EMS AND THE FULL FREEDOM OF CAPITAL MOVEMENTS

11. THE FULL FREEDOM OF CAPITAL MOVEMENTS WILL HAVE IMPORTANT IMPLICATIONS FOR THE EMS. ON THE ONE HAND THE GREATER NEED TO ADJUST ECONOMIC POLICIES WILL HELP TO MAKE THE SYSTEM SECURE ON A LASTING BASIS. ON THE OTHER HAND, THE TRANSITION TO THE COMPLETE FREEDOM OF CAPITAL MOVEMENTS IS NOT WITHOUT RISK.

12. THE COMMITTEE BELIEVES THAT THE PROCESS OF LIBERALIZING CAPITAL MOVEMENTS WILL BE ACCELERATED BY THE PRESENTATION OF A DRAFT DIRECTIVE IN OCTOBER. SOME MEMBERS HAVE ARGUED THAT THE OPENING-UP PROCESS SHOULD BE SUPPORTED BY PRECAUTIONARY MEASURES. THE COMMITTEE'S DISCUSSIONS HAVE EXTENDED TO THE FOLLOWING FIELDS.

- THE PROCESS OF COMPLETING THE FREEDOM TO PROVIDE FINANCIAL SERVICES, IN THE CONTEXT OF THE ESTABLISHMENT OF THE SINGLE DOMESTIC EUROPEAN MARKET, WILL RAISE A NUMBER OF ISSUES CONCERNING THE SUPERVISION OF FINANCIAL INSTITUTIONS. THE COMMITTEE'S CONCERN IS TO IDENTIFY ISSUES TO WHICH IT IS ABSOLUTELY NECESSARY TO GIVE PRIORITY.

- SOME MEMBERS CONSIDER THAT FISCAL ARRANGEMENTS WILL HAVE TO BE ADAPTED IN SOME RESPECTS.

- WITH REGARD TO SAFEGUARD CLAUSES, SOME MEMBERS HAVE ARGUED THAT THE EXISTING CLAUSES (108, 109 AND 73) COULD NOT, AT THE TIME WHEN THE TREATY WAS NEGOTIATED, BE DRAWN IN A WAY WHICH IS APPROPRIATE TO THE MONETARY NEEDS OF A SITUATION IN WHICH CAPITAL FLOWS ARE GROWING RAPIDLY AND ARE EXTREMELY MOBILE. THESE MEMBERS ARGUE THAT THE DRAFT DIRECTIVE SHOULD INCLUDE AN ESCAPE CLAUSE WHICH WOULD ENABLE ACCOUNT TO BE TAKEN OF EXCEPTIONAL MONETARY DISTURBANCES. IN THIS CONNECTION THE COMMITTEE WILL CONSIDER WHETHER THE 1972 DIRECTIVE ON REGULATING INTERNATIONAL CAPITAL FLOWS NEEDS TO BE AMENDED.

- THE DETAILED REPORT TO MINISTERS IN SEPTEMBER WILL ALSO COVER THE QUESTION AS TO WHETHER, AND, IF SO, TO WHAT EXTENT, AMENDMENTS OF THE PRESENT MEDIUM TERM COMMUNITY CREDIT ARRANGEMENTS ARE NECESSARY FOR THE ACHIEVEMENT OF THE FULL FREEDOM OF CAPITAL MOVEMENTS.

RA3.89

SECRET

FROM: A C S ALLAN
DATE: 22 June 1987

MR KELLY

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman

**EMS**

In the light of the French interest in improving the working of the EMS, the Chancellor would be grateful for a quick note about what improvements we should be seeking. He feels it would be helpful if we could get a common front with the French; and now may be a good moment to secure such changes.

ACSA

A C S ALLAN

15/3070F

pa EMS.

SECRET & PERSONAL

JOINING THE EUROPEAN EXCHANGE RATE MECHANISM

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

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

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

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

(iii) Sterling is particularly vulnerable to external pressures; with its international status, large money and capital markets, absence of exchange controls. Petro-currency factors have added further to the currency's variability. Moreover the UK status as a net oil exporter means that if the price of oil moves substantially then some corresponding movement in

sterling is both necessary and desirable. In some circumstances membership of the ERM might serve to reduce potential speculative pressures; but in other circumstances defending particular margins for sterling could be difficult, particularly against the DM which shares sterling's status as a major internationally traded currency.

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

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

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

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

(b) G5 and G7 moves towards achieving a period of wider exchange rate stability (including the yen and dollar

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

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

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

(e) We shall in any case need to consider the way in which we have operated our monetary policy, and the

implications for funding. Membership of the ERM would provide a much simpler basis for this.

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

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SECRET AND PERSONAL

JOINING THE ERM : TIMING

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

2. The main factors are as follows:-

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

(b) Cabinet could be told of the decision on the Thursday preceding realignment. Given the risk of leaks this assumption may need further consideration. In any

event it is not a real constraint since Cabinet always meets when Parliament is sitting except when the Prime Minister is away.

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

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

price suffered.

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

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

Summary

3. So the prospects look like this:-

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

DMARK/STERLING EXCHANGE RATE AND THE ERM

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

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

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

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

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

a. **The Real Exchange Rate**

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

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

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

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

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

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

further, a "high" sterling rate against the mark was needed to give a satisfactory effective rate index from the point of view of monetary conditions.

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

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

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

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

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

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

pressure on money GDP.

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

b. The Rate appropriate for maintaining downward pressure on inflation

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

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

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

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

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Table 1

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

8

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

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

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

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

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

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

c. The Balance of Payments Outlook

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

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

**UK Current Account: FSBR Projections**

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

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

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

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

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

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

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

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

Conclusion

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

(i) the movements in both sterling's real effective rate

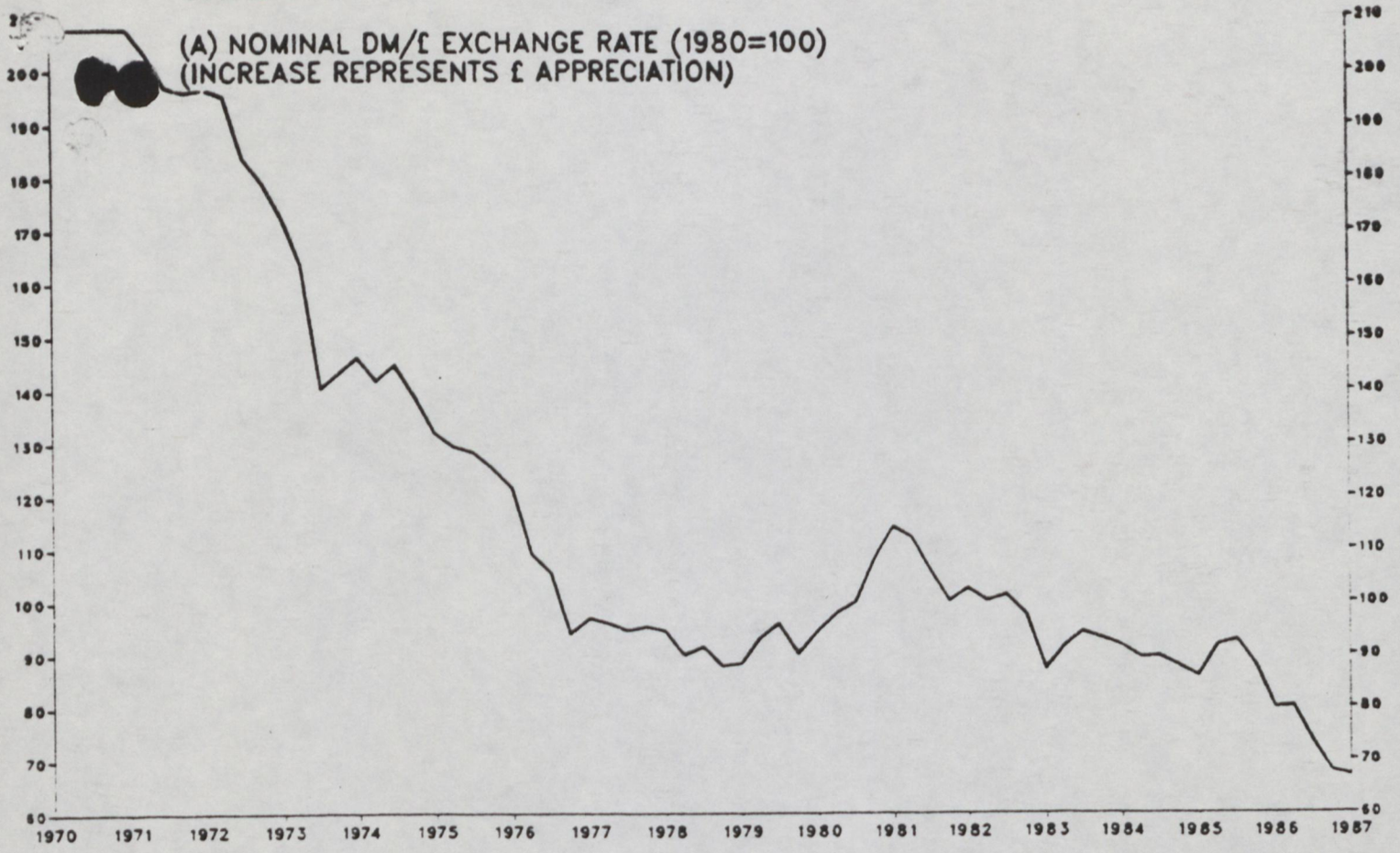
index and the real rate against the mark, in relation to their historical averages, suggest that there it would be wrong to look for a substantially lower rate than current market rates for sterling to join the ERM.

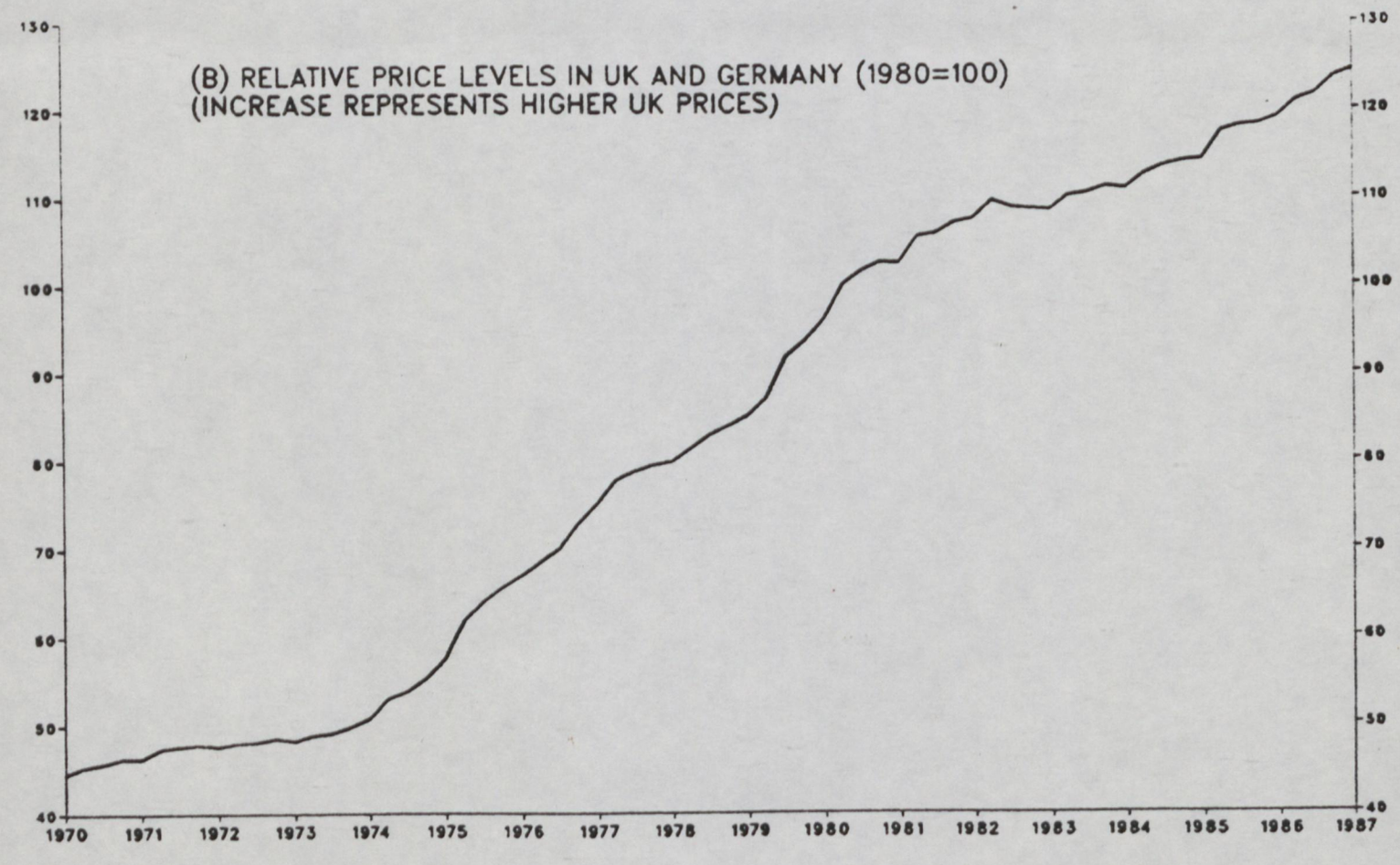
(ii) were sterling to join the ERM at a rate of around DM 3.05 - 2.95, that would appear consistent with the overall exchange rate level which in the last few months has appeared compatible with keeping monetary conditions on track. The situation would have to be reassessed if the mark appreciated further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

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

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

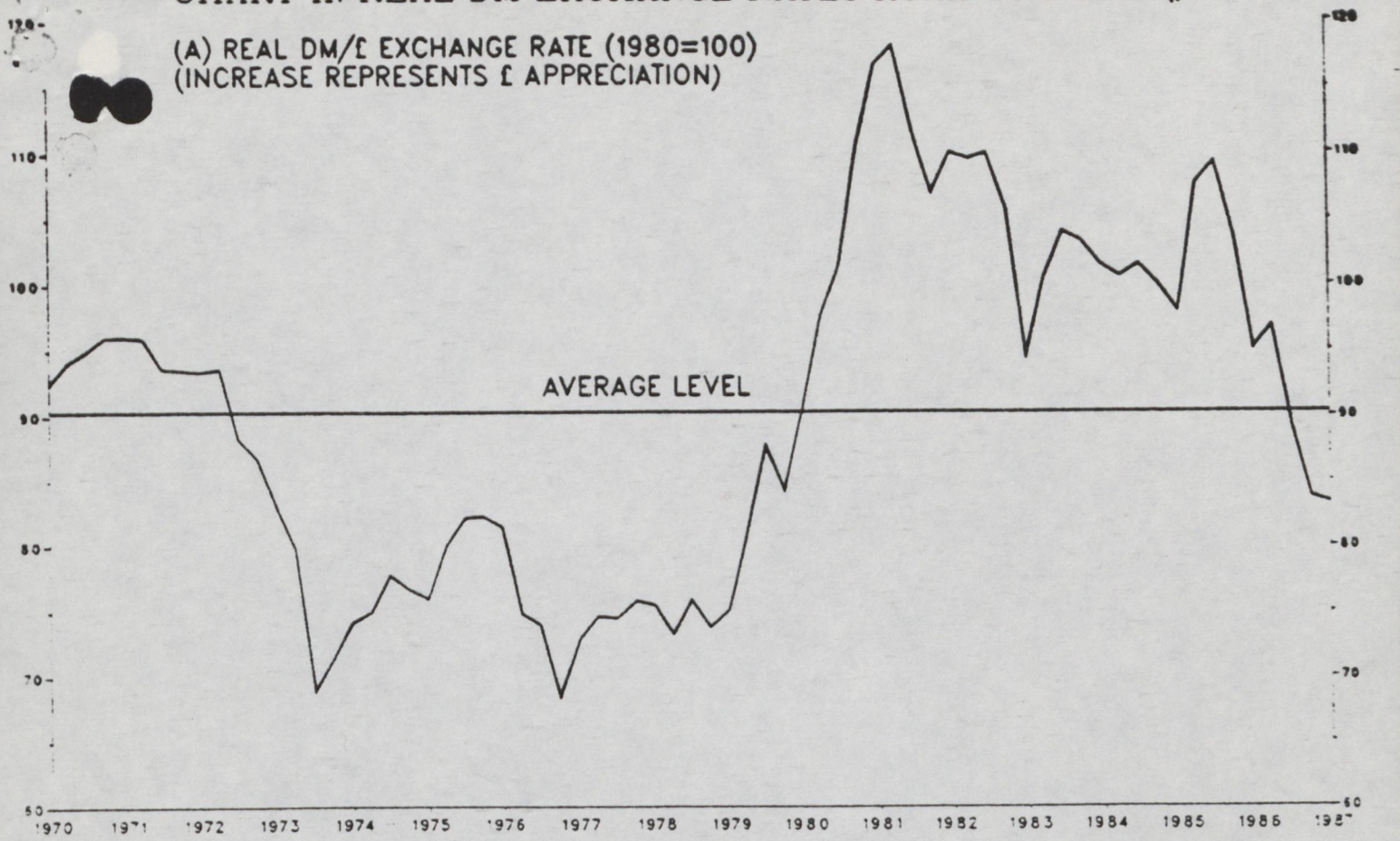
# CHART I:

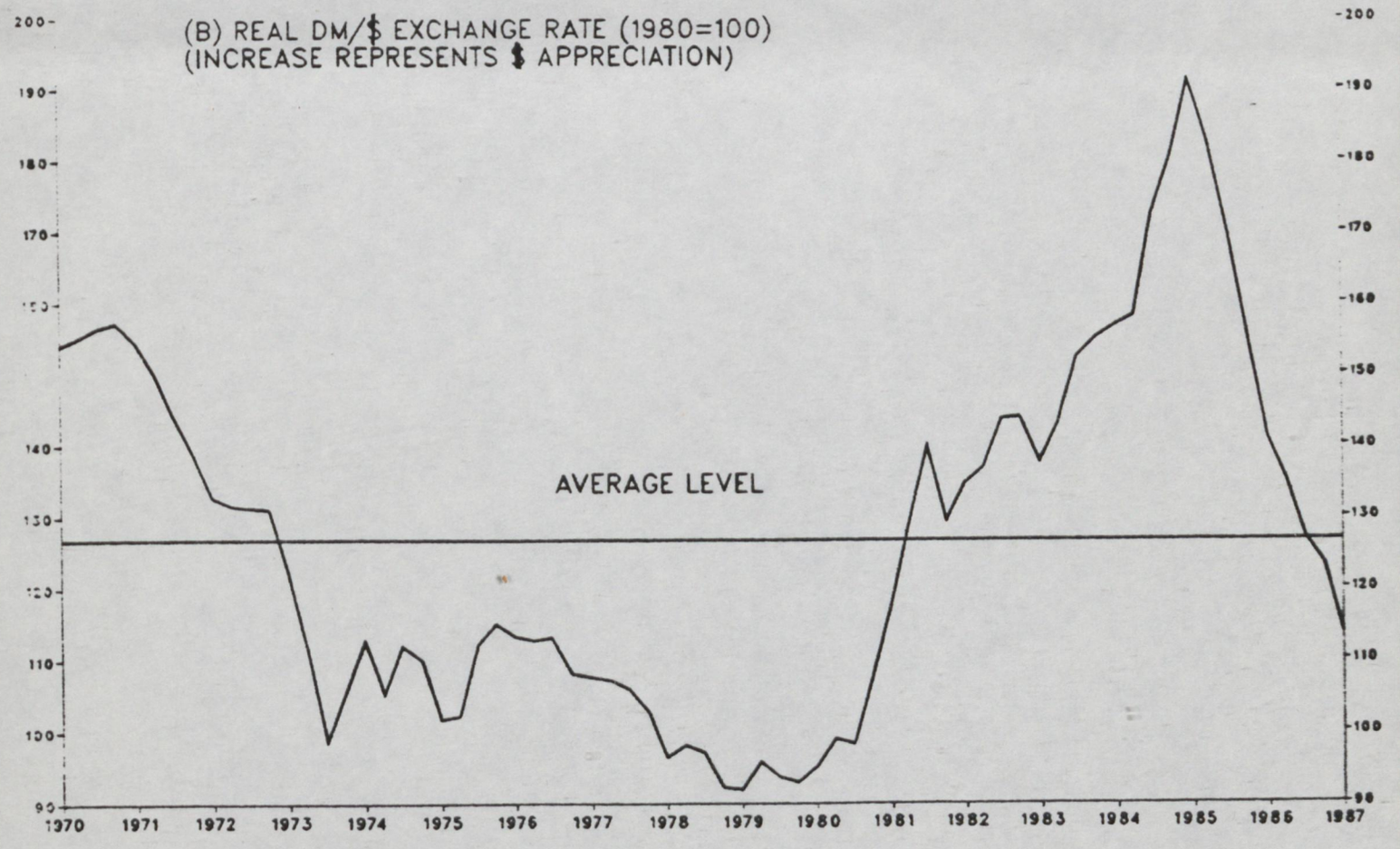



THE PRICE DATA RELATE TO CONSUMER PRICES.

# CHART II: REAL DM EXCHANGE RATES AGAINST £ AND $

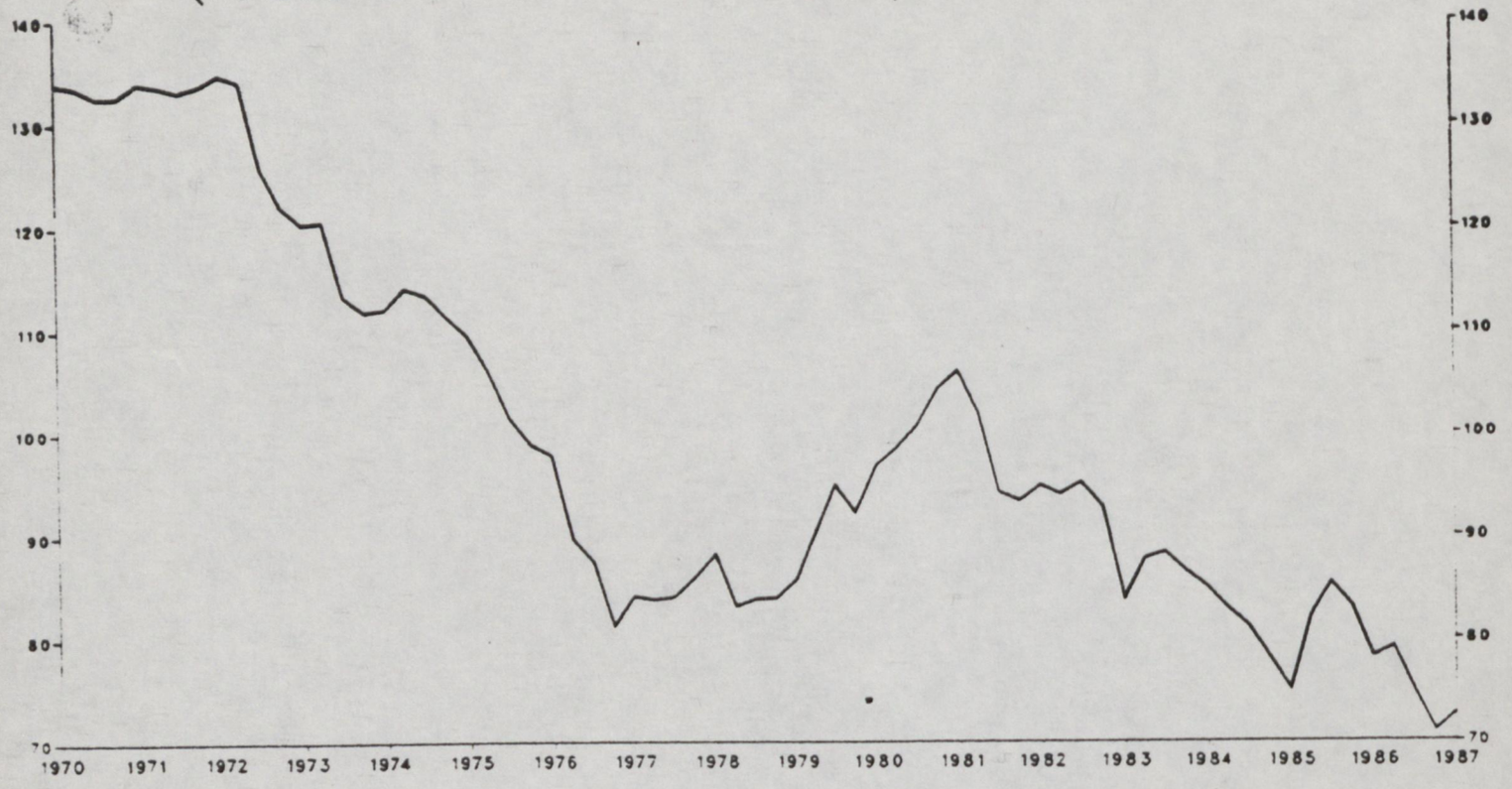


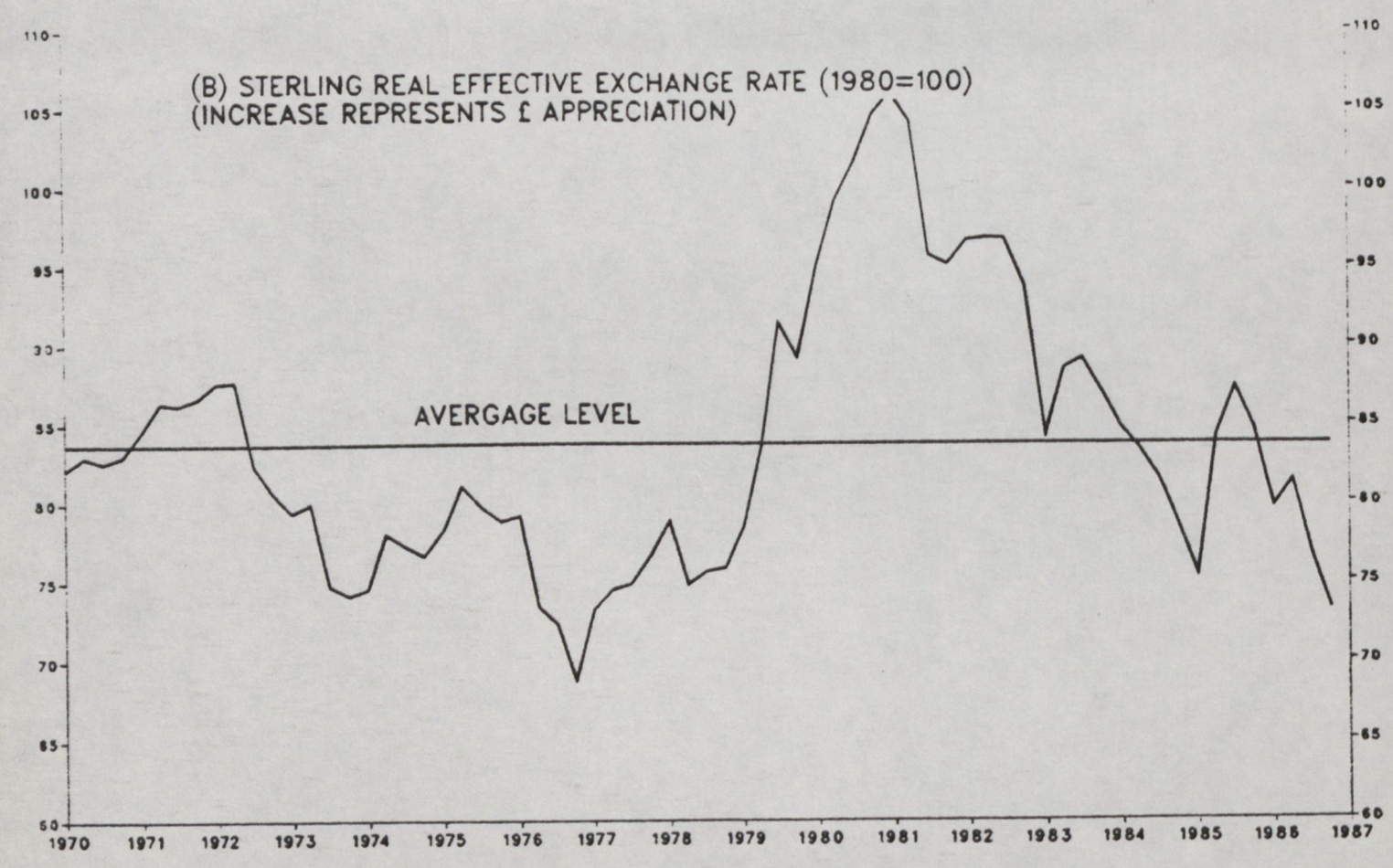

REAL EXCHANGE RATES ARE CALCULATED ON THE BASIS OF RELATIVE MOVEMENTS IN CONSUMER PRICES

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

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




(B) STERLING REAL EFFECTIVE EXCHANGE RATE (1980=100)
(INCREASE REPRESENTS £ APPRECIATION)




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

Subject ce Master

CONFIDENTIAL

NOTE FOR THE RECORD

MEETING WITH SIR ALAN WALTERS

The Prime Minister yesterday met Sir Alan Walters. Professor Brian Griffiths was also present.

Conversation focussed mainly on the advantages and disadvantages of full membership of the EMS. Sir Alan said that he was even more strongly opposed to full membership than he was before, if that were possible. His main points were as follows:

- full membership would be a gift to speculators; it would give them a one way option and this explained why the City was so enthusiastic;

- it would increase uncertainty rather than reduce it because investors and companies would be unable to predict how the Government would react to severe exchange rate pressure and there would also be greater volatility of interest rates;

- in recent years the major members of the EMS, Germany, France and Italy, had grown substantially slower than the UK and their membership had no doubt contributed to this;

- the Government's economic policy already had great credibility arising from its record of success;

- the French and others had retained substantial capital and credit controls; at a recent conference Dornbusch and others had argued in favour of maintaining such controls as a means of putting "grit" in the international financial system.

There was also a brief discussion of how the UK could reduce its core rate of inflation to the 1½ per cent or so which Sir Alan regarded as being effectively stable prices. Sir Alan

CONFIDENTIAL

argued that a gradual reduction in the rate of growth of the monetary base would achieve this, without a significant cost in terms of lost output. But it was essential that there should be tighter control of public expenditure to release resources for the private sector and to remove the brake on growth which public expenditure itself tended to impose.

DAVID NORGROVE
2 July 1987

EL3CAJ

E.R.

Mr Norgrove

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CC BG

PRIME MINISTER

EMS

There is a widespread expectation that we shall become full members of the EMS after the election. It will be a priority for the Chancellor. You will want to give early thought to the merits and handling of this decision.

The Chancellor's position

The Chancellor will undoubtedly argue as before that:

(i) full membership would provide an anchor for Government economic policy, and give assurance that policy will continue to be operated responsibly and prudently;

(ii) the obligations of membership would be understood by management and workforce alike, and would influence pay and price expectations; Doubtful

(iii) the result of these first two factors would be lower interest rates on average; or higher if under pressure

(iv) a more stable exchange rate would help business.

He will probably also say that the grounds for opposing full membership are now weaker than they were in autumn 1985 when this was last discussed:

(v) the oil factor is much less important because the exchange rate has already adjusted to a sharp fall in oil prices;

(vi) our foreign exchange reserves are in a healthy state;

We haven't picked up enough this month to meet outgoings

MT

(vii) other European countries, including particularly France and to a lesser extent Italy, have removed many of their exchange controls;

(viii) the election is out of the way, so there need be no fear of pre-election sterling jitters;

(ix) the Government is already committed to holding the exchange rate at about its present level and in recent months has done so very successfully.

A further possible argument is that there is a widespread expectation that the UK will now become a full member. To disappoint it could lead to a movement out of sterling. To join now would in contrast show conviction in the new strength of the British economy.

Arguments against membership

Lower oil prices, higher reserves, lower exchange controls in other countries and the passage of the election all ease the way to full membership. But they do not affect the major objections:

(i) full membership would reduce flexibility, causing the entire weight of exchange rate pressures (in either direction) to be taken on the reserves and interest rates; less volatility in the exchange rate is likely to mean greater volatility of interest rates;

(ii) the influence of EMS membership on pay bargainers is likely to be slight; with cost pressures higher here than in Germany and less scope for exchange rate depreciation the strain would be taken sooner or later in higher unemployment;

(iii) the entry of sterling into EMS could well substantially change its character, both because of the size of our financial markets, and the continuing importance of oil;

(iv) EMS membership would cede to other countries, particularly Germany, a major role in Britain's economic policy; this would be in some ways a sign of weakness, not strength, and the process of EMS realignments is itself messy and undignified.

The relative stability of the exchange rate in recent months is an argument which works both ways: if we can achieve stability outside the EMS, why do we need to join?

**Next steps**

The Chancellor is likely to press for an early discussion and decision, and the markets and many financial commentators more than half expect it. The handling of the decision needs careful thought, to achieve the outcome you want with minimum difficulty.

You will want first to decide your own position. If you are now in the last resort prepared to accept full membership the procedure could be reasonably straightforward: a meeting with the Chancellor, the Governor, the Foreign Secretary and Lord Whitelaw to settle the principle and perhaps one or two more technical matters (e.g. whether sterling's central rate should be the market rate or below it), followed by a week-end meeting of EMS members.

If you remain adamantly opposed to full membership - and the fundamental arguments have not changed - a meeting of colleagues could well prove exceptionally difficult. The position of those who argued in favour of membership in autumn

1985 is likely if anything to have hardened since then. You could again find yourself isolated.

Avoiding a meeting would require you to be prepared to tell the Chancellor that you remain opposed to full membership, and that you are not prepared to hold a meeting to discuss the possibility. You will want to consider whether that would be a sustainable position, in view of the support the Chancellor would receive from the Foreign Secretary and possibly others also.

If you decide to hold a meeting you will want those attending to know your own views in advance.

The Chancellor could raise this question at your first bilateral next week (not yet fixed). You may like to have a word about it beforehand.

(D.R. NORGROVE)

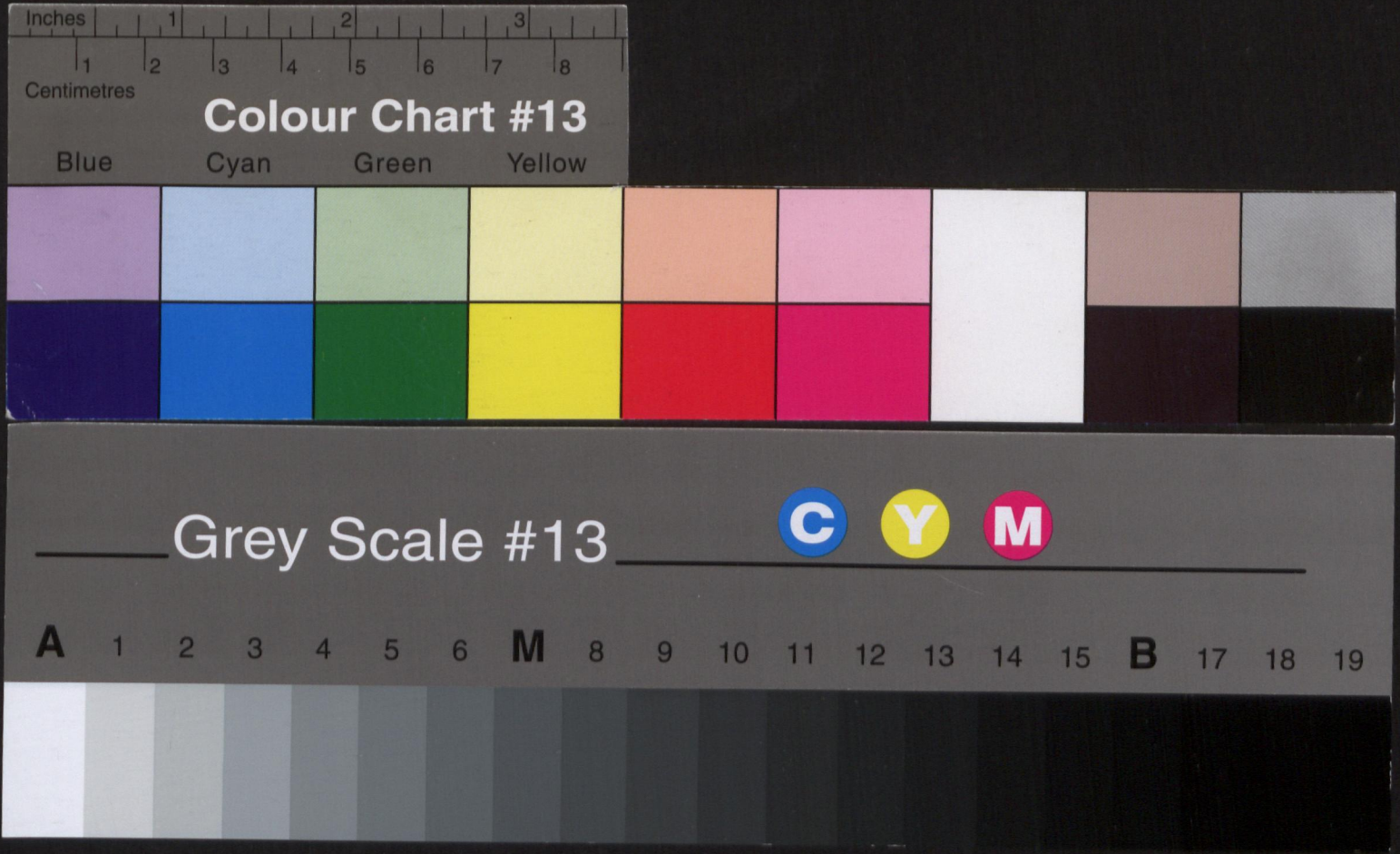
10 June 1987

PART 2 ends:-

Bonn Tel No 009 7.1.87

PART 3 begins:-

DN to PM 10.6.87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