Part Seven

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Confidential Filing

EUROPEAN POLICY

Pt 1: June 1979

Pt 7: May 1990

European Monetary System (EMS)
Economic and Monetary Union
Folder: Papers presented to PM by Keith Joseph on EMS including Salamon Brothers Bulletin [Economic Consequences of Fixed Exchange Rates]

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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PREM 19/2983

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Part SEVEN

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See Part 6

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PART 7 ends:-

BP to Gieve 27.6.90

PART 8 begins:-

Hunt to PM 2.7.90

SECRET AND PERSONAL

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SUBJECT DA
cc: MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 June 1990

Dear John,

UK ENTRY INTO THE ERM

At today's bilateral the Chancellor and the Prime Minister discussed possible dates when the UK might join the Exchange Rate Mechanism.

I would be grateful if you could ensure that no copies of this minute are taken and that it is seen by others only with your personal authorisation.

The Chancellor said there was no perfect date for entry - there would always be some uncertainty about the state of financial markets at any time. But he was convinced that entry could not be delayed until next year - which might be the year of a general election. The Government could not afford turbulence as the pound bedded down within the ERM.

Dates for entry later this year were not satisfactory either. To go in as late as December before the Inter-Governmental Conference would look like an act of political necessity. To join in November might look a little better - but as the public expenditure round and the Autumn Statement might be deemed unsatisfactory by markets, entry at that time would be regarded as an act of weakness.

In his view the choice lay between entry in September and at the end of July. The few Treasury senior staff consulted were unanimous that the underlying economic conditions were satisfactory given it was agreed policy that the UK should enter the ERM on the wide bands. There was a strong case for entry in July. It would represent an unexpected yet strong political initiative by the Government; it would close out the risks of a fall in the exchange rate from the current level which was right for entry; and it would remove the prospect of a Labour Party debate on entry before the end of the session. Many of the same arguments applied to entry in September; but there was greater risk of less favourable market conditions. The pound had risen as the Government's popularity had increased in recent weeks; but there was a risk of less favourable market conditions if entry were delayed.

The Madrid conditions on inflation would not strictly have been met with entry in July. But inflation would peak soon and

SECRET AND PERSONAL

then come down. Moreover the Madrid conditions had been constructed on the assumption of entry on the narrow bands - not the wide bands now proposed. And in any case attention would focus on the favourable reaction to entry, not on whether the strict Madrid conditions had been met. The date of entry had to be judged as much on political as economic criteria.

The Prime Minister said the UK should join the ERM once its economic policies were seen to be working and the Government was clearly on top of the economic problems. If the UK entered when RPI inflation was rising to around 10%, it would be clear that the Madrid conditions had not been met; and it would look like the UK was clutching at entry as a support. The Prime Minister would prefer to join the ERM when interest rates could be reduced on the basis that the economic fundamentals were right, not simply as a result of a short term "honeymoon" benefit of entry into ERM. The Chancellor had suggested that there were institutional or other obstacles in the way of particular entry dates: but if the economic fundamentals were right, then the time would be right and such obstacles could be brushed aside. The Prime Minister accepted that it would be difficult to calibrate any honeymoon period and thus reach a precise judgement on optimal dates of entry. In her view the UK must be able to join the ERM on the merits of the Government's stewardship of the economy. Such an approach might be consistent with entry as early as September or dates later in the year.

Summing up a brief discussion, the Prime Minister said time had not permitted all the issues to be explored. It would be necessary to return to the discussion soon.

Yours ever,

Barry

BARRY H. POTTER

John Gieve, Esq.,
HM Treasury.

REF: JG/21 9

Copy No. 1 of 7

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Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

... I attach the note I promised on the options for our entry into the ERM.

2. As you will see, it suggests that the main 'windows' for entry are before the party conference and after the 1991 Budget. If we decide to go in early, there is also a choice between July or September/October.

3. There are arguments for holding back until next year but dangers as well. The headline rate of inflation at any rate should be lower then and we could be contemplating a reduction in interest rates for domestic reasons. It might also reduce the risk of the pressures on sterling reversing before an election with consequent upward pressure on interest rates. However, I think these economic arguments would carry much more weight if we were proposing to enter with the narrow band which, of course, we are not. Entering early with wide margins should allow us to keep monetary conditions tight for long enough to get inflation moving down and give us the flexibility to take temporary adverse market pressures on the exchange rate rather than on interest rates.

4. On the other side, I think there are strong market reasons for joining early rather than late. Our joining has been anticipated by the markets. Sterling has risen despite some unpromising economic news, particularly on the money supply, inflation and the balance of payments, and much of its strength reflects the markets' perception that the Government no longer has reservations about the principle of joining the ERM; the issue is

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solely one of timing. The higher exchange rate has not only provided a welcome tightening in our monetary stance. It has reduced the risk that, at present interest rates, the exchange rate might seek to move outside the top of a wide band after entry.

5. A somewhat higher exchange rate still would suit us quite well. As we have decided to join with wider margins there is scope for a further rise in the sterling rate before we should be under pressure either to reduce our interest rates or revalue. Alternatively, if there was strong upward pressure on the exchange rate from present levels we might be able to contemplate a small reduction in interest rates. If this were justifiable it would, of course, have benefits for the RPI.

6. Conversely, I would certainly be very apprehensive about postponing entry beyond the party conference and the Mansion House speech in the following week. I think that to bypass both these events would badly disappoint expectations. As a result, we could face a falling exchange rate and upwards pressure on interest rates in the run-up to the Autumn Statement, the IGC and the new Parliamentary session. That would bring political as well as economic difficulties. However, in addition, I do think there are real political gains to be made from taking the initiative with an early entry.

7. I have discussed the timing with Sir Peter Middleton and Sir Terence Burns who believe that we face a favourable set of conditions and that we should take advantage of them while the markets are on our side. Provided we join with wider margins (as I am sure we should) these market factors are more important than the precise monthly profile of inflation. I will be sending you our latest forecast next week but I expect it will show the headline RPI peaking a little above 10 per cent in August. The

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underlying inflation rate should also peak then at around 7½ per cent and then decline gradually.

8. Against this background there is a lot to be said for seizing the initiative and going for a date in July. I have considered, therefore, whether that is ruled out by German Monetary Union. The initial effects of union on the German economy are already largely discounted in the markets and the full effects will continue to develop gradually over a long period.

9. However we cannot rule out the possibility that GMU will unsettle market conditions early on. Whether and to what extent that occurs should become apparent fairly quickly so July 20th remains a possible date and I may wish to come back to you with a proposal to take that opportunity. In any event I believe we should plan for a time before the Party Conference when we might hope to combine favourable market circumstances with a favourable political opportunity.

10. I am anxious that no hint of our discussions on this should reach the press so I am sending copies of this only to Sir P Middleton, Sir T Burns, Mr Wicks and Mr Scholar.

John M.

[J.M.]
26 June 1990

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THE TIMING OF STERLING'S ENTRY INTO THE ERM

This note lists the considerations relevant to the timing of sterling's entry into the ERM. It assumes, for the reasons described in the Chancellor of the Exchequer's minute to the Prime Minister of 8 June, that entry would be at the wider (6%) band. Very different considerations would underlie a decision to enter the narrower band.

2. It is helpful to consider possible times for entry within two broad time bands:

- between now and next year's Budget (earlier entry);
- thereafter (later entry).

Earlier entry boils down to entry:

- between now and the end of July (pre-recess);
- between the beginning of September and the end of October (or probably in practical terms before the beginning of the Conservative Party Conference on 9-12 October) (September/early October).

November and December would be more difficult: Autumn Statement; electricity (distribution companies) privatisation in November; IGC begins in December. Dates in February are ruled out by electricity (generating companies) privatisation, and more generally it would be difficult to join in the period between Christmas and the Budget.

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Earlier or later entry?

3. The main **arguments in favour of earlier entry** are as follows:

(i) The Government is pledged to enter: with wide margins delay is unnecessary. Dates which presently seem open could be closed by unforeseen developments in the economy or elsewhere.

(ii) The longer the delay, the greater the likelihood of cynicism about our firmness of purpose and the consequent risk of unwelcome downward pressure on the exchange rate. This in turn could make it harder to join at the right exchange rate.

(iii) The longer entry is delayed, the longer the delay in receiving the benefits from the financial discipline which ERM membership brings, in particular a firmer exchange rate would be welcome on monetary policy grounds and it could help to influence the autumn pay round.

(iv) The longer entry is delayed, the greater the difficulty of maintaining credibility of entry into the wider, as opposed to the narrower, band.

4. The main **arguments in favour of later entry** are:

(i) It could reduce the pressure for premature reductions in interest rates.

(ii) The benefits of entry in terms of a higher exchange rate and reduced pressure to raise interest rates might begin to wane after we have been in the ERM for a while, leaving a risk of having to raise interest rates

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at a politically sensitive time, for example if inflation or trade figures were bad.

(iii) It would have greater credibility if inflation was on a clear downward trend.

If earlier, when should entry be?

5. There are two options for early entry, pre-recess or in September/early October.

6. The **arguments in favour of entry before the recess** are:

(i) Sterling is in calm waters and at an appropriate level for entry. There can be no certainty that this will continue until after the recess. Indeed, as time goes by disappointment about non-entry might have adverse market consequences.

(ii) It would coincide, and could be so presented, with the beginning of Stage 1 which the UK Government support.

(iii) It would send the Government's supporters home for the recess with an element of political uncertainty dispelled.

(iv) It would forestall any Labour parliamentary motion just before the recess criticising the Government's failure to enter.

7. The **arguments in favour of entry in September/early October** are:

(i) The economic and market effects of GEMU are already with us and will continue to develop over a long

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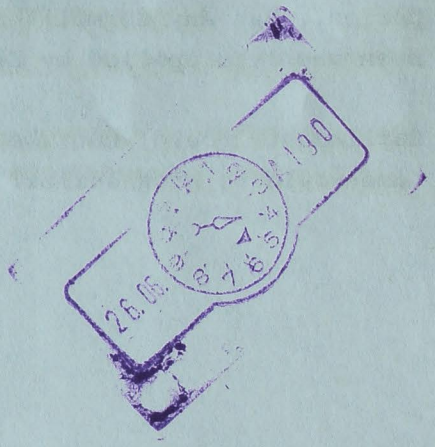
period. But any turmoil after July 1st should have been wholly dispelled by September if not by end-July.

(ii) Parliament would not be sitting and the presentation time would be much easier.



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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

The Chancellor wishes to discuss the date of entry into the ERM at tomorrow's bilateral.

I attach his minute to you covering a background Treasury paper. The papers are disappointing: they are not an objective appraisal of different entry dates.

Treasury Case

The Chancellor's minute identifies three "windows" for entry:

- next month (20 July)

- September/October

- After the 1991 Budget.

The Chancellor considers that the UK should join the ERM either in July or September/October. His line of argument is driven by two considerations.

a. The exchange markets have clearly anticipated early UK entry into the ERM. The strong Effective Exchange Rate is helping to tighten the monetary stance; the rate is at the right level for entry now into the ERM; but that rate is not sustainable for more than a few months - unless the UK joins the ERM.

b. Whatever domestic upsets may arise e.g. adverse inflation figures, wage settlements, balance of payments etc, and whatever the external shocks e.g. disruption to the ERM following GEMU, they can be accommodated providing the UK joins within the wider

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bands.

Assessment

Several aspects of this reasoning seem distinctly unsatisfactory.

First, are these "windows" genuinely the only possibilities? It is not clear for example that November and December are ruled out by the existence of the Autumn Statement in November and the Inter-Governmental Conference in December. Nor is the Treasury line that the high exchange rate could not be sustained convincing. The pound has, in effect, been talked up in recent weeks: it should not be difficult to heighten expectations of imminent entry in the months after September/October, if the exchange rate were to come under downward pressure.

Clearly, if entry is delayed too long, markets might come to doubt the UK's intentions; and it might then not be possible to sustain the exchange rate, if the fundamentals on inflation, balance of payments etc were adverse. But the timing and size of any such confidence effect is much less clear than implied in the paper. And the economic fundamentals are expected to begin improving from early autumn.

Judicious statements about intention to join the ERM should allow the choice of a wide range of dates between November and February 1991.

Secondly the Treasury case for joining in July looks to be little more than opportunism on the back of the (inspired) rise in the exchange rate. There are three good reasons for not going in next month which also need to be taken into account.

a. One of the Madrid Conditions was that the Government wanted to get inflation down before the UK joined the ERM. In July, the latest RPI figures will be for June: it is quite likely that the RPI rate will be higher than this month's 9.7 per cent annual increase; and the underlying rate is still rising. Quite simply the Madrid Conditions would not have been

met.

The corollary is the strong argument for delay at least until September or October. The nominal RPI year on year rate should have turned down and the underlying rate should be steadying. With a new wage round getting underway then it is important to stiffen the resolve of employers to resist high wage settlements - though it can be argued that the mere expectation of entry might be sufficient to do that.

b. The Government might well be criticised for political opportunism - taking the UK into the ERM when the exchange rate was high, despite adverse economic fundamentals. And you may consider that there are political reasons for delaying any announcement beyond the end of the present session.

c. The paper argues that the impact of GEMU has been discounted in advance by the exchange markets. The recent weakness of the DM would suggest that sentiment is right. But it is by no means clear that all the adjustment of the Deutschmark, following GEMU, within the ERM is complete. Nor, as the Chancellor's paper implies, can we be sure that any such adjustment would be complete within three weeks of entry to GEMU.

Thirdly, the background paper correctly identifies the danger of "backlash" some months after entry - with the UK coming under pressure to raise interest rates etc. After a honeymoon period, UK entry to the ERM will imply rising unemployment and difficulties for the business sector as price expectations are painfully brought down. You will wish to avoid this adjustment at a politically sensitive time.

But the Treasury paper offers no views on how long this honeymoon period might be; it does not therefore work out whether any backlash might be timed in July or October 1991. In short, it does not explore the political dimension.

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CONCLUSION

You may wish to ask the Chancellor to probe some of the above factors more thoroughly. (I attach an earlier brief which provides a longer list of relevant considerations than in the Treasury note.) In the meantime, you may judge that the Chancellor should be discouraged from considering entry to the ERM as early as next month. (I might add that no newspaper article and no-one of the City is expecting entry before the early autumn).

BHP

BARRY H. POTTER
26 June 1990

c:\wpdocs\economic\erm (kw)

EMU

Pohl says UK proposals would not solve problem of achieving economic and monetary union in Europe

UK proposals widely welcomed as positive contribution to debate on EMU.

President of the Bundesbank said British proposals should be discussed in relevant EC committees. My Rt Hon Friend the Chancellor of the Exchequer, and the Governor of the Bank of England who has been fully involved in preparing UK's proposals, will look forward to explaining our ideas further;

Herr Pohl expressed strong reservations about the Commission's latest prescription for EMU. He said the latest Commission proposals were "unrealistic and will not work". Government entirely agrees with that. Our evolutionary approach the right way forward.

PM has agreed to intergovernmental conference, starting December?

House will want to hear Prime Minister's own report on outcome of Dublin European Council. Understand reached agreement to start IGCs on EMU and on institutional reform in mid-December. Government has always made clear it will take full part in IGCs: we do not believe in an empty chair policy.

Two-speed EMU?

Do not believe many in Community would want two-speed EMU. Whole point of IGC is to discuss way forward as 12. Hope we will reach common agreement.

ERM: Pohl said time not yet right but may be soon

UK will join ERM when Madrid conditions met.

Single currency one day?

Simply cannot say now. Chancellor said in speech:

> "In time the ecu would be more widely used: it would become a common currency for Europe. And in the very long term - if people and governments so choose - it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be".

Pohl says UK proposals raise same problems as Delors prescription: how ensure independence of central bank?

Key difference between our proposals and Delors prescription: European Monetary Fund managing hard ecu would not have discretion to follow inflationary policies. Would be bound by its obligation

to keep its currency at least as strong as the strongest national currency.

UK proposal too complicated: responsibility for monetary policy divided between EMF and national central banks?

No. National monetary authorities would remain fully responsible for their own currencies. Hard ecu would be further currency, managed by EMF, by its nature setting a stiff standard for competition between national monetary policies. Entirely beneficial.

BACKGROUND

1. In an interview with The Times today (attached), Herr Pohl, President of the Bundesbank, said that

   - a parallel currency has more disadvantages than advantages;

   - it would not solve the real problem, which is also posed by the Delors proposals: how to achieve a genuinely independent central bank? In sharp contrast to the UK, Pohl considers that the Commission's latest ideas do not go far enough in creating an independent/Eurofed. (and centralised)

   - however, the UK proposals should be discussed in the relevant EC Committees;

   - a two-speed EMU is possible: all EC countries might sign an EMU Treaty, but they could enter the arrangements at different speeds in the same way as the EMS had been set up.

2. The Chancellor's speech on EMU has been widely reported in Europe. Most reactions are:

   - welcome for UK's positive approach in putting forward these proposals:

   - some scepticism about the idea of building up the hard ecu as a parallel or common currency, rather than the Delors prescription for moving (via a transitional stage) straight to locked exchange rates and a single currency managed by a single Community central bank.

HM Treasury
26 June 1990

THE TIMES Tuesday, June 26, 1990

Pohl rejects Major's plan for hard ecu

By Robin Oakley and Michael Binyon in Dublin

Thatcher edges towards monetary union

THE president of the West German Bundesbank, Karl Otto Pohl, yesterday rejected British proposals to introduce a hard European currency unit as the continent's common money.

Plans put forward last week by John Major, the Chancellor of the Exchequer, for an ecu to run alongside national currencies were greeted with widespread interest at the European Council in Dublin yesterday, according to Douglas Hurd, the foreign secretary, and British officials.

In an exchange with Mrs Thatcher, President Mitterrand of France gave some encouragement to the plan as marking a British advance towards a single European currency. But West German officials were totally dismissive, saying it was irrelevant to the real debate and had not even been discussed by Bonn.

Charles Haughey, the Irish prime minister and host to the summit, said: "Everyone accepted that the British proposals were a clear indication of a positive and constructive approach by the British government to the whole question of EMU (European monetary union) and a commitment to the EMU goal – though not necessarily along the lines outlined in the Delors report."

West German scepticism of the Major plan, cited by officials in Brussels as soon as it was announced, was one of the main reasons why most European Commission sources suggested it would not be adopted. Their feelings were clearly reflected in an interview with *The Times* yesterday by Herr Pohl. He said that a parallel currency had more disadvantages than advantages and "would not solve any real problem".

The Major plan called for management of the ecu by a European monetary fund, but Herr Pohl said the creation of a central bank which left national and central banks in charge of monetary policy was impractical. He declared: "The non-divisibility of responsibility is the decisive argument."

While Mrs Thatcher was arguing in Dublin for the need to write into the EC constitution the doctrine of subsidiarity – that community institutions did not do things which national authorities could do for themselves – Herr Pohl said: "In monetary policy the principle of subsidiarity does not apply."

He was insistent that the problems of European currencies could not be solved by the creation of an additional currency, the essence of Mr Major's plan.

Mr Haughey described the summit discussion as "very good, positive and philosophical". The decision to hold an inter-governmental conference on EMU and on political union had been taken unanimously, with Mrs Thatcher agreeing that enough preparatory work had been done.

She told her EC partners she did not envisage a single currency within 20 years. But Mr Haughey said this was just a figure of speech and Britain's position was well known.

Other summit participants accepted that she is edging towards ultimate acceptance of monetary union, including plans for a central bank and single currency. Noting how she has continued her conciliatory tone towards European institutions and closer integration, they saw this confirming a change in her confrontational approach first apparent at the Strasbourg summit last December.

At one stage during yesterday's discussion, the Prime Minister and President Mitterrand indulged in one of their jocular sparring sessions, a feature of these meetings. He said of the hard-ecu plan that the policy was good as long as it did not stop the EC from going further. "Maybe that's her aim." She replied: "I don't have arrière-pensées. I can't hide my intentions." He countered: "You don't have a record for your arrière-pensées."

The decisions to hold two inter-governmental conferences starting in Rome on December 14 came before a private discussion over dinner of possible Community aid to the Soviet Union – one of the few devisive issues of this summit.

Mr Haughey said beforehand that all the Twelve had a deep concern that President Gorbachev should overcome his economic and political problems and a real interest in seeing that perestroika was not derailed. He added: "To that extent the community must look at any possible way in which we could be supportive." But so far it had received no analysis of the real extent of the Soviet problems.

The summit broke for dinner shortly before the end of the World Cup football match between Ireland and Romania which virtually shut down Dublin for the afternoon. Mr Haughey, who had promised to go and watch the Republic in Rome if they went on to the next round, broke off a briefing to watch the final decisive penalties. But finding the tension too much he turned away from the screen, erupting seconds later in a whoop of joy along with everyone else in Dublin Castle.

He then danced an Irish victory jig in the courtyard before driving off to talk about South Africa, the Soviet Union and the vexed but still unsettled question of where to site the various European agencies looking for a home.

● The Bank of England, which did much of the technical work on the "hard ecu" proposal, was understood to be disappointed by Herr Pohl's remarks (Colin Narbrough writes). Robin Leigh-Pemberton, the Governor, will seek to explain details of the proposal to his fellow central bankers at a meeting in Basle on July 10.

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Leading article, page 13
Pohl interview, page 23

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THE TIMES Tuesday, June 26, 1990

Flexibility by Thatcher on the EC's path to union

From MICHAEL BINYON IN DUBLIN

EUROPEAN Community leaders yesterday formally launched two conferences on political and monetary union, a move described by the French as setting Europe on the road to a federal destination.

The 12 leaders agreed on the first morning of their summit to call an inter-governmental conference on political union on December 14 in Rome, immediately after the next European Council summit. A similar parallel conference on economic and monetary union will open at the same time, with both aiming to conclude by the end of 1992.

Margaret Thatcher, bowing to the inevitable, put a brave face on the decisions, raising no objections and promising vigorous British participation.

Douglas Hurd, the foreign secretary, said the session had been "good humoured". Britain still did not think the timing ideal because "we have enough on our plate", but he said the proposals for political union were really about practical ways to improve the workings of the community. "A lot of the rhetoric has been flushed out," he said.

Mrs Thatcher praised the report he and fellow foreign ministers presented, which outlined the questions to be answered on political union. She said it respected the separate identities and institutions of member states, reaffirmed that the Council of Ministers would remain the decision-making body, and underlined the principle of subsidiarity – leaving to national governments everything that did not need to be decided at community level.

This principle, she argued, should be written into any changes in the Treaty of Rome. Until now there had been much lip-service paid to subsidiarity. But on such questions as social policy it was not respected. It was ridiculous that decisions on part-time work and night work should be taken in Brussels. She insisted that the Twelve were still sovereign nations and would yield sovereignty only on the basis of joint decisions.

On economic and monetary union, she showed equal flexibility. She again praised John Major's plans for a hard ecu and a European monetary fund, which Mr Hurd said provoked more interest than he expected. Britain was an enthusiastic supporter of the first stage of the Delors plan for EMU, which comes into force on July 1. And, dropping the hard line she showed a year ago at the Madrid summit, she agreed there had been "full and adequate preparation", although she wanted to see further work by finance ministers.

Britain was at pains to show its partners that it did not rule out an eventual common currency. Mrs Thatcher insisted that the widely differing economies of the Twelve demanded flexibility, and a single currency ran the risk of breaking down, like the Bretton Woods fixed exchange rate system did in the early 1970s. And, in a teasing variation on her assertion that this would not come in her lifetime, British sources suggested it would not be possible before 10 or 20 years.

EC leaders decided yesterday to use their foreign ministers' report on political union as the agenda for the inter-governmental conference. There was little detailed discussion yesterday of the ideas that will be broached in December. Mrs Thatcher did not put forward her call for an EC ombudsman or British proposals for strengthening the role of the European Court of Justice.

The report on political union identifies four issues as the main themes for debate: the further transfer of competence to the community; the need to ensure more democratic accountability, including a strengthening of the European parliament and greater involvement of national parliaments; increased efficiency of EC institutions, including more majority voting in council meetings and better enforcement of decisions; and the working out of a common foreign and security policy, with a proper definition of the European Commission's role.

For the first time, an outsider was invited to attend the summit. Lothar de Maizière, the East German prime minister, was invited to lunch with the 12 leaders.

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THE TIMES Tuesday, June 26, 1990

A hard ecu poses same problems says Pöhl

BRITISH proposals for a hard European currency unit (ecu) as Europe's common currency will not achieve monetary union, Bundesbank president Karl Otto Pöhl claims.

The proposal was made last week by John Major, the Chancellor of the Exchequer, and endorsed by Margaret Thatcher and Robin Leigh-Pemberton, Governor of the Bank of England. It envisaged the establishment of the ecu as a 13th European currency.

In an interview with *The Times*, Herr Pöhl said the proposals would not solve the problem of achieving monetary union for Europe. "A parallel currency has more disadvantages than advantages and would not solve the real problem. The real problem if you create a genuine ecu – not just a basket ecu – is that you get the same problems which you would have with a single European bank and currency; that is, questions like the bank's independence that would need to be decided. But I would like to add that we will discuss the British proposals in the relevant committees."

In his proposal, outlined last week, the Mr Major proposed the establishment of a European Monetary Fund (EMF) to act as a currency board and supply member states with "hard ecus" in exchange for their national currency.

The EMF's responsibility would be to manage the hard ecu and ensure it stayed within its margins in the exchange-rate mechanism. In case of a realignment within the ERM, the hard ecus would not be devalued. The Chancellor said this proposal, unlike other previously floated ideas of parallel currencies, had the advantage of being evolutionary and anti-inflationary.

Herr Pöhl rejects this ideas as impractical: "Once you create a central bank which does not have the instruments and the opportunity to conduct efficient monetary policies, national and central banks will still be in charge. It is the non-divisibility of responsibility for monetary policy which is the decisive argument.

"In monetary policy, the principle of subsidiarity does not apply. I believe this represents a widespread mistake in the current debate. The responsibility for monetary politics cannot be divided.

"There is also a lack of clarity in the most recent proposals by the EC Commission. There, an impression is being created that the European central bank would formulate only the general principles, while it would be up to national central banks to implement them. This concept is unrealistic and will not work."

He also said the establishment of the hard ecu would ignore the rationale of EMU: to reduce the power of the Deutschmark. "A process of competition of currencies would lead to one currency – and no prizes for guessing which one that is – which would dominate a system. That's the whole philosophy behind this argument. You can't solve the problem by creating an additional currency to the 12 we have already."

Herr Pöhl also stressed that a parallel currency, in hard and soft forms, had been rejected in the Delors Report, which set out the three stages towards monetary union. Herr Pöhl stressed the report had been signed by all EC central bank governors, including Mr Leigh-Pemberton.

Herr Pöhl's comments indicate that the Chancellor's proposals may not prove to end the deadlock between Britain and the rest of Europe in the debate on European Montary Union, as was hoped last week. The West German government and the Bundesbank favour a single European currency only on the condition that a European central bank would enjoy independence in the day-to-day conduct of its monetary policy.

Herr Pöhl said: "If we are to have a European monetary régime, then it has to be as good as, for example, the Bundesbank's. And a European central bank can only achieve price stability if it is independent in its monetary policies of the EC institutions and governments."

Mrs Thatcher again rejected last week the concept of a single European currency on the grounds of national sovereignty.

Herr Pöhl repeated comments made last week that in the event of a delay towards an agreement on monetary union, some nations could progress more rapidly than others: "It is conceivable that the treaty will be ratified by all members, but also that some who are unable or do not want to participate straight away, are invited to take part at a later stage. This is not new in Europe. The EMS, too, was founded in this manner.

"As far as monetary union is concerned, it is evident there are some countries which do not want that or cannot do that. The Delors Report also mentions this explicitly under paragraph 44."

He also said the "time is not yet ripe" for Britain to join the exchange-rate mechanism, but said the situation could change soon. "The success [of reducing inflation] is a result not of membership of the exchange rate mechanism, the success is a result of changes in policies. But Britain already conducts such a [anti-inflationary] policy. I am optimistic that the rate of inflation will be reduced to a degree, which will enable Britain to enter the system without creating tensions for the system itself."

Wolfgang Münchau
Frankfurt

Karl Otto Pöhl: more disadvantages than advantages

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DUBLIN FOR SECRETARY OF STATES PARTY

MY TELNO 768 : CHANCELLOR'S SPEECH ON EMU

SUMMARY

1. DEPUTY PRESIDENT OF THE BUNDESBANK DOUBTS THAT UK PROPOSALS CAN ACHIEVE THEIR STATED AIMS. BUT THE BUNDESBANK WILL CAREFULLY ANALYSE THE CHANCELLOR'S SPEECH AND HE IS OPEN TO FURTHER ARGUMENT.

DETAIL

2. MINISTER CALLED ON SCHLESINGER AT THE BUNDESBANK ON 25 JUNE. DUDLER (HEAD OF MONEY AND CAPITAL MARKETS DIVISION) ALSO TOOK PART IN THE DISCUSSION WHICH LASTED NEARLY AN HOUR AND A HALF. SCHLESINGER HAD BEFORE HIM THE TEXT OF THE CHANCELLOR'S SPEECH TOGETHER WITH THE BANK OF ENGLAND EXPLANATORY STATEMENT. HE SAID THAT THE BUNDESBANK PRESIDENT, POEHL, WOULD PROBABLY REFER TO THE PROPOSALS WHEN HE SPEAKS IN LONDON ON 2 JULY BECAUSE HE COULD NOT DO OTHERWISE, BUT HE WOULD NOT SAY MUCH (SCHLESINGER DID NOT MENTION POEHL'S CALL ON THE PRIME MINISTER).

3. SCHLESINGER NOTED THAT WHILE THE CHANCELLOR HAD CONCENTRATED ON STAGE 2, HIS PROPOSALS AFFECTIVELY WENT INTO STAGE 3. GOING THROUGH THE TEXT IN DETAIL WITH DUDLER AND THE MINISTER, HE THEN SET OUT RESERVATIONS ON THE FOLLOWING FRONTS.

4. FIRST, AND MOST IMPORTANT, HE WAS PREDICTABLY WORRIED ABOUT THE EFFECT ON THE D-MARK OF A PARALLEL CURRENCY, EVEN IF IT WERE QUOTE HARD UNQUOTE. THIS TOOK THE FORM OF SAYING THAT HE DID NOT SEE HOW THE PROPOSED SYSTEM COULD GUARANTEE THAT THE HARDEST CURRENCY WOULD REMAIN AS STRONG AS IT WOULD OTHERWISE BE. THIS WAS BECAUSE HE WAS SCEPTICAL ABOUT THE ABILITY OF THE SYSTEM TO REMAIN NON-INFLATIONARY. EMPHASISING THAT HE WAS NOT SURE HE FULLY GRASPED HOW THE EMF WAS INTENDED TO WORK, HE MADE THE FOLLOWING SUBSIDIARY

POINTS CONCERNING THE EXTENT TO WHICH HE SAW THE DISCIPLINES OF THE SYSTEM BEING EVADED.

- HE NOTED THAT IN THE EMS, AN OBLIGATION TO PURCHASE OWN CURRENCY ALREADY EXISTED WHICH WAS NOT ALWAYS ADHERED TO.

- HE THOUGHT THE OBLIGATION TO PURCHASE OWN CURRENCY, IF MET, ITSELF ADDED TO LIQUIDITY POTENTIALLY AVAILABLE TO GOVERNMENT WHICH WOULD NOT NECESSARILY BE NEUTRALISED. HE NOTED THAT IN ANY CASE CONTROLS SUCH AS A REQUIREMENT FOR MINIMUM RESERVES AND REDISCOUNT QUOTAS, TO WHICH HE ATTACHED MUCH IMPORTANCE, DID NOT EXIST IN ALL MEMBER STATES.

- A THIRD DIFFICULTY WAS THE POSSIBILITY OF THE EXTENSION OF BORROWING WITHIN A MEMBER STATE WHICH EITHER EQUALLED OR EXCEEDED THE CONTRACTIVE EFFECT OF THE OBLIGATIONS OF THE MONETARY SYSTEM. HE DID NOT THINK BRITISH IDEAS WERE NEARLY DEVELOPED ENOUGH TO GUARD AGAINST THIS REAL DANGER OF INFLATIONARY PRESSURE.

5. SCHLESINGER NOTED THAT THE EMF WOULD HAVE POWERS (AND DUTIES) OF INTERVENTION VIS A VIS THIRD CURRENCIES. HE MADE TWO POINTS. FIRST, THIS POWER MEANT THAT CURRENCIES, ONCE THEY HAD GOT ONTO THE INTERNATIONAL MARKET, HAD EFFECTIVELY ESCAPED THE CONTROL OF THE SYSTEM. SECONDLY, HE DID NOT SEE HOW, WITH THE LIMITED POWERS AT ITS DISPOSAL, THE EMF WOULD EFFECTIVELY MANAGE INTERVENTION.

6. SCHLESINGER REFLECTED THE BUNDESBANK'S WELL-KNOWN SUSPICION OF THE ECU. HE DID NOT THINK THAT AN ECU WOULD EVER BE ATTRACTIVE, HARD OR OTHERWISE, PARTICULARLY TO INVESTORS WITHIN THE D-MARK ZONE. HE ARGUED THAT A REAL LIVE HARD CURRENCY ALREADY EXISTED AS WELL AS AN ECONOMICALLY CONVERGENT BLOC IN WHICH IT, THE D-MARK, WAS ALREADY DOMINANT. THE BELGIANS WERE MAKING THE LAST NECESSARY MOVES AND IF THE FRENCH WERE TO ALTER THEIR INTEREST RATE POLICY, THE PROBLEM OF A WEAK FRANC WOULD BE DEALT WITH. HE THOUGHT THE MOMENTUM TOWARDS A SINGLE MARKET WAS NOW GREAT ENOUGH FOR THIS PRECONDITION FOR MAKING FURTHER PROGRESS TO EMU TO HAVE BEEN NEARLY MET. AGAINST THIS BACKGROUND, HE DISMISSED THE ADVANTAGES OF A HARD ECU ON SUCH ISSUES AS TRANSACTION COSTS, SAYING THESE WERE ALREADY LOW WITHIN THE AREA WHERE EXCHANGE RATES HAD BEEN STABLE FOR THREE AND A HALF YEARS. ALL IN ALL HE THOUGHT THE CHANCELLOR'S IDEAS NEARER FRENCH THAN GERMAN THINKING.

COMMENT

7. RUNNING THROUGH SCHLESINGER'S COMMENT WAS THE BELIEF THAT MEMBER STATES SIMPLY WOULD NOT PURSUE POLICIES OF PRICE STABILITY LEFT WITH THE DEGREE OF FREEDOM ALLOWED THEM IN BRITISH PROPOSALS. HE DID NOT USE THE WORD SOVEREIGNTY ONCE AND WAS NOT INTERESTED IN THIS ASPECT. NOR DID HE GO INTO INSTITUTIONAL QUESTIONS. HE WAS INTERESTED PURELY IN THE ABILITY OF THE BRITISH PROPOSALS WITHIN THEIR OWN TERMS TO LIVE UP TO THEIR CLAIMS. HE WAS VERY DOUBTFUL. HE MADE CLEAR HOWEVER THAT HE WOULD LIKE FURTHER CLARIFICATION OF HOW BRITSH IDEAS WOULD WORK IN PRACTICE AND THAT HE WAS OPEN TO FURTHER ARGUMENT (BEYOND THE EXTENSIVE DISCUSSION ALREADY CONDUCTED WITH HIM). HE SAID THE WOULD WELCOME SEEING THE MINISTER AGAIN BEFORE THE CENTRAL BANK GOVERNORS MEET ON 9-10 JULY. SCHLESINGER UNDOUBTEDLY WISHES TO SEE THE UK STAY IN PLAY. AT ONE POINT HE SAID THAT HE HAD NOT CHANGED HIS VIEW THAT EMU SHOULD NOT BE BUILT WITHOUT THE UK. THIS HOWEVER CAME AFTER HIS ASSESSMENT IN PARA 6 AND IT SEEMED CLEAR THAT HE ACCEPTED THAT A SMALLER GROUP OF STATES COULD AND MIGHT MOVE AHEAD MORE QUICKLY THAN THE REST.

8. SEE SEPARATE TELEGRAM (NOT TO ALL) ON SUGGESTION FOR FOLLOW UP.

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10 DOWNING STREET
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From the Private Secretary

Seen by
DM
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20/6

Prime Minister

EMU

This is the text of the speech which the Chancellor will give tonight, launching our proposals on EMU. It reflects comments which I have made on an earlier version. I think it is fine: it suggests moving to the hard écu via the Treasury's

original proposal. It makes clear that we cannot accept Delors Stage 3. It makes no reference to opting-in. The only point you will want to reflect on is that-in the very long term and by national choice - the hard ecu could itself become a single currency. That seems logical if unlikely.

The Chancellor needs clearance by mid-morning. Content?

C.D.P. 20/6

chex.jp/mw/4 CONFIDENTIAL 10.00 pm Tuesday

EMU BEYOND STAGE 1: THE UK APPROACH

[Revised speaking note]

I am very pleased to be here this evening and grateful to you for accepting a switch of speaker at the last minute. I offer my commiserations to those who were present at the German Chamber of Commerce Lunch last Tuesday, and who are therefore faced with the same speaker twice in one week. But I hope there will be at least some consolation in hearing the next instalment of the story, for it is the ideas I began to spell out on that occasion which I wish to take further.

2. Tonight, I want to deal with the future of economic and monetary union in Europe. It is a hugely controversial subject, but I know of no other that is of such importance to the future direction and influence of the Community. The Delors Report on EMU, with its 3 stage model, is at the centre of that debate but it does not present a universally acceptable prescription for the future and certainly cannot be the final word.

3. But that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage I.

4. Of course Stage I is vitally important. It starts in ten days time, and will entail the construction of a Single Financial Area in the Community, with a single market in all financial services, and wholly free movement of capital. That is a massive task - by any yardstick - which will mean an enormous amount of hard work on the ground. But it is a task to which we in the UK are wholly committed. And our commitment is not merely expressed in words, but also - and more importantly - in deeds. [Record of single market implementation.]

5. Stage I also involves the completion of the exchange rate mechanism. The UK is just as firmly committed to taking sterling into the exchange rate mechanism of the EMS. This we shall do, as I have made plain on innumerable occasions, when our well-known conditions are met. I restate that commitment tonight.

6. But the starting point for my remarks tonight is a world where Stage I is in place. For the debate about what comes then is moving rapidly forward. In a few months' time an inter-governmental conference will begin to consider how best to take forward the process of economic and monetary integration in the Community. That is a perilously short time when the Community is so far from reaching agreement on the practical steps needed to develop the Community's institutions. We need

to debate these matters fully and constructively and reach conclusions that take all of Europe's nations forward together. Tonight I would like to indicate some fresh developments in our thinking.

7. Our approach builds on the paper I published last November that set out principles which should guide the future development of economic and monetary integration in the Community. We believe that any change:

- should be gradual and evolutionary;
- should work with the grain of markets;
- should respect the principle of subsidiarity;
- and should strengthen the forces making for stable prices.

8. We do not believe the Delors report meets these criteria and we continue to have fundamental reservations about the approach it sets out. The core of our concern is that we do not believe that a single monetary policy and a single monetary authority will deliver the economic performance and inflation performance that the Community will need in the future. Moreover, a Central Community Bank - a Eurofed - would not be accountable to elected Governments even though

the electorate would look to these Governments to ensure their economic wellbeing. These are significant disadvantages that cannot lightly be brushed aside. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. But this does not mean that some form of EMU is not desirable - it clearly is - or that there are not other - better - ways of achieving convergence and low inflation, Europe-wide. And this could well involve institutional and currency development. That is the theme of my proposals tonight.

9. In particular they address the very practical question of where the Community should be looking to go once Stage 1 has been completed. It is generally recognised that this was one of the weaker points in the Delors report. But it is a no less crucial question for that. For this reason, I have to say I view with concern recent suggestions from some quarters that the Community could do without Stage 2 altogether. [It would be like moving from infancy to adulthood with no intermediate stage.]

10. It may well be that this latest outbreak of Big-Bangism has been triggered by events in Germany, where a very rapid transition to monetary union is envisaged. We all, of course, welcome the momentous changes in Germany. But we must beware of drawing false

parallels with events on the broader European canvas. What is happening in German monetary union is that a large and healthy economy, and a strong currency, is absorbing the declining economy and weak currency of the GDR. It is - to all intents and purposes - a takeover, willed by both sides. EMU is a much bigger, and wholly different, proposition.

11. One of our main concerns about the idea of an EMU "big bang" is that it presumes a far greater degree of convergence of economic performance than is yet available, or in prospect. I might add that it is far from self-evident that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences that exist at present between the economies of the Community probably require that for our performances to converge, our monetary policies must diverge - as indeed they do at present. That does not suggest a swift move to a single European monetary authority; indeed it argues strongly against it.

12. All those who are most anxious to set in place successful movement towards economic and monetary union should hold fast to this: without greatly increased convergence, economic and monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both

economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening. It would be tragic indeed if the desire to intensify European unity were to turn against itself.

13. What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, East and West. We have already seen how membership of the Community has strengthened the democracies and economies of existing member states. Several of the newly democratising countries in Eastern and central Europe see very clearly the benefits of membership of the Community. In due course we should welcome this prospect, when their political and economic systems are ready. We should develop a form of EMU that permits them to join us and does not put up barriers against it.

14. To my mind that argues even more powerfully for a gradualist and evolutionary approach, and against any attempt to move to a rigid and closed structure. It suggests that we should look for arrangements that promote convergence - and particularly convergence on low inflation - while retaining flexibility and choice.

15. We believe that we can now see a way forward which does precisely this. We believe that whatever the outcome of the debates about the longer-term, in the short and medium-term there are steps the Community could - and should - be taking which are valuable and useful in their own right and which would take the process of economic and monetary integration further. The issue need not be so divisive.

16. The key is to build on Stage I further steps to promote convergence, low inflation and stable exchange rates. And to do so by building up our existing common currency - the ecu.

17. A first practical step towards this might be to encourage the use of the existing ecu by issuing ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The Fund, acting as a currency board, would provide ecus on demand in exchange for Community currencies. This would be done in such a way as to avoid increasing the Community's total supply of money. We should insist that the board could only issue ecu notes that were fully backed by its own holdings of the various currencies which make up the ecu. So there would be no new money creation, and no threat to inflation. Interest rates on ecu deposits and loans would be determined, as now, by the weighted

average of interest rates on the ecu's constituent currencies and so the currency board would play no role in setting interest rates.

18. Ecu banks notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of largescale markets in ecu deposits.

19. But I think we could and should go further than that limited step. In my view, the best approach is the creation of a new "hard ecu". Under this approach the ecu would no longer be defined as a basket of currencies but as a currency in its own right - a new and international currency - which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Committee under their Chairman, Sir Michael Butler. My own ideas are rather different, but I readily acknowledge the debt they owe to his.

20. Under my approach, the European Monetary Fund would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. It would set interest rates on hard ecu. Initially, it would do this by setting rates on

the deposits it took, probably largely from commercial banks. Later on, as the private hard ecu market developed and commercial banks built up hard ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

21. A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose - indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the hard ecu bank for hard currencies. This repurchase obligation would ensure that the combined effect of the bank's own money creation - through the issue of hard ecu liabilities and the influence it exerted on money creation by national central banks - was not inflationary.

22. It will be noted that both these ideas for developing the ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed

to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the central Bank Governors Committee and the existing European Monetary Cooperation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could manage it.

23. It might also take on the essential task of coordinating intervention against third currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This coordination would not involve member states giving up part of their foreign currency reserves. Instead, intervention would be coordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

If we leave this all in a single sentence the head-line will be "Chancellor proposes single currency". It must be taken in longer time. Suggest it is divided into at least 2 sentences.

" In time the ecu would be more widely used: it could become a common currency for Europe. In the very long term, ~~provided~~ if people and governments so chose it could develop into a single currency. But that is a decision we should not take now for we cannot yet forsee what the size or circumstances of the new Europe will be."

24. All these are key functions that will be vitally necessary in the world beyond Stage I. It makes practical sense to have an EMF to carry them out.

25. There is much discussion ~~is bound to continue on~~ about the final stages of EMU. And more than one version of it. In these discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening - for promoting greater economic and monetary integration beyond Stage 1 - must be fully considered. They offer a way forward around which all Europe should be able to unite.

26. They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally (from stage 1) and have the potential to evolve further. The ecu could become in time much more widely used: a common currency for Europe - and in the very long term - if people and governments so choose - a single European currency. In addition the development of a hard ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they

represent a practical and sustainable way forward for all Europe.

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Treasury Chambers, Parliament Street, SW1P 3AG
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20 June 1990

Stephen Wall Esq LVO
PS/Secretary of State for
Foreign and Commonwealth
Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

CM

Dear Stephen,

ECONOMIC AND MONETARY UNION

As you know, the Chancellor will be launching some further ideas for the evolution of economic and monetary union building on Stage 1 and our Evolutionary Approach paper in a speech to the German Industry Forum in London this evening. These ideas are designed to promote convergence, low inflation and stable exchange rates by building up the Community's existing common currency, the ecu, through the establishment of a new European Monetary Fund. The Chancellor will be discussing these ideas further with his Community colleagues over the coming weeks. I attach a copy of the Chancellor's speech, a Press Notice and some Q&A briefing for the use of Ministers and Press Officers, although detailed questions should of course be referred back to HM Treasury.

I am copying this letter to the Private Secretaries of Ministers in the Cabinet, Sir Robin Butler and the Governor or the Bank of England.

Yours ever Tarkowski

T TARKOWSKI
Private Secretary

chex.jp/mw/4

(Embargoed until 9.00 pm.)

CHANCELLOR'S SPEECH TO GERMAN INDUSTRY FORUM: 20 JUNE 1990

ECONOMIC AND MONETARY UNION: BEYOND STAGE 1

Tonight, I want to deal with one of the most important issues on the current political agenda: the future of economic and monetary union in Europe. It is a hugely controversial subject, but I know of no other that is of such importance to the future direction and influence of the Community.

2. The Delors Report on EMU, with its 3 stage model, is at the centre of that debate but it does not present a universally acceptable prescription for the future and certainly cannot be the final word. But although we have substantial objections to the Delors prescription, that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage 1.

3. Of course Stage 1 is vitally important. It starts in ten days' time, and will entail the construction of a Single Financial Area in the Community, with a single market in all financial services, and wholly free movement of capital. That is a massive task - by any yardstick - which will mean an enormous amount of hard work for many people. But it is a task to which we in the UK are wholly committed. And our commitment is not merely expressed in words, but also - and more importantly - in deeds. A Commission report at the end of March found that the UK and Germany lead the rest of the Community in this respect, the UK having enacted all but 9 of the single market measures due for implementation by then, and Germany all but 11. Some other member states have as many as 30 or even 50 measures outstanding. I need hardly make the obvious point that we need faster progress than that.

4. Stage 1 also involves the completion of the exchange rate mechanism. The UK is firmly committed to taking

sterling into the exchange rate mechanism of the EMS. This we shall do, as I have made plain on innumerable occasions, when our well-known conditions are met. I restate that commitment yet again.

5. But the starting point for my remarks tonight is a world where Stage 1 is in place. For the debate about what comes then is moving rapidly forward. In a few months' time the economic and monetary inter-governmental conference will begin. That is a perilously short time when the Community is so far from reaching agreement on the practical steps needed to develop the Community's institutions. We need to debate these matters fully and constructively and reach conclusions that take all of Europe's nations forward together. Tonight I would like to indicate some fresh developments in our thinking.

6. Our approach builds on the paper I published last November that set out principles which should guide the future development of economic and monetary integration in the Community. We believe that any change:

- should be gradual and evolutionary;

- should work with the grain of markets;

- should respect the principle of subsidiarity - namely that functions should not be carried out at Community level when they can satisfactorily be carried out at national level;

- and we believe that any change should strengthen the forces making for stable prices.

7. We do not believe the ideas currently being worked on meet these criteria and we continue to have fundamental reservations about them. The core of our concern is that a

Central Community Bank - a Eurofed - would not be accountable to elected Governments even though the electorate would look to these Governments to ensure their economic wellbeing. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. Moreover we do not believe that the single monetary policy and the single monetary authority that are envisaged would deliver the economic performance and inflation performance that the Community will need in the future.

8. These are significant disadvantages that cannot lightly be brushed aside. But this does not mean that some form of EMU is not desirable - it clearly is - or that there are not other - better - ways of achieving convergence and low inflation, throughout Europe. And this could well involve institutional and currency development. That is the theme of the ideas I shall be putting forward tonight.

9. In particular they address the very practical question of where the Community should be looking to go once Stage 1 has been completed. It is generally recognised that this is one of the weaker points in the current debate. But it is a no less crucial question for that. For this reason, I have to say I view with concern recent suggestions from some quarters that the Community could do without Stage 2 altogether. I do not think that is practical.

10. It may well be that this latest outbreak of Big-Bangism has been triggered by events in Germany, where a very rapid transition to monetary union is envisaged. We all, of course, welcome the momentous changes in Germany. But we must beware of drawing false parallels with events on the broader European canvas. What is happening in German monetary union is that a large and healthy economy, and a strong currency, is absorbing the declining economy and weak currency of the GDR. It is - to all intents and purposes - a

takeover, willed by both sides, and with economic consequences primarily affecting Germany. EMU is a much bigger, and wholly different, proposition.

11. One of our main concerns about the idea of an EMU "big bang" is that it presumes a far greater degree of convergence of economic performance than is yet available, or in prospect. I might add that it is far from self-evident to me that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences in inflation between the economies of the Community probably require that for our inflation performances to converge, our interest rates must diverge - as indeed they do at present. That does not suggest a swift move to a single European monetary authority; indeed it argues strongly against it.

12. All those who are most anxious to set in place successful movement towards economic and monetary union should hold fast to this: without greatly increased convergence, monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening.

13. What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, East and West. We welcomed to Community membership some of the newly democratic countries in Southern Europe. Now several of the countries in Eastern and central Europe see very clearly the benefits of membership of the Community. In due course we should welcome this prospect, when their political and economic systems are ready. We should develop a form of EMU

that permits them to join us and does not put up barriers against it.

14. To my mind that argues even more powerfully for a gradualist and evolutionary approach, and against any attempt to move to a rigid and closed structure. It suggests that we should look for arrangements that promote convergence - and particularly convergence on low inflation - while retaining flexibility and choice.

15. We believe that we can now see a way forward which does precisely this. We believe that whatever the outcome of the debates about the longer-term, in the short and medium-term there are steps the Community could - and should - be taking which are valuable and useful in their own right and which would take the process of economic and monetary convergence further.

16. The issue need not be so divisive. The key is to build on Stage 1 further steps to promote convergence of economic performance, low inflation and stable exchange rates. And to do so by building up our infant common currency - the ecu.

17. A first practical step towards this might be to encourage the use of the existing ecu by issuing ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The Fund, acting as a currency board, would provide ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the Fund could only issue ecu notes that were fully backed by its own holdings of the various currencies which make up the ecu. So there would be no new money creation, and no threat to inflation. Interest rates on ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the ecu's constituent

currencies and so the Fund would play no role in setting interest rates.

18. Ecu bank notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of largescale markets in ecu deposits.

19. But these are modest steps, and I think we could and should go further. In my view, the best approach is the creation of a new "hard ecu". Under this approach the ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right - a new and international currency - which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their Chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

20. Under our approach, the European Monetary Fund which I have suggested would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue ecu deposits or notes in exchange for national currencies. It would set interest rates on hard ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard ecu market developed and commercial banks built up hard ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

21. A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose - indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the Fund's own money creation - through the issue of hard ecu liabilities and the influence it exerted on money creation by national central banks - was not inflationary.

22. It will be noted that both these ideas for developing the ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the central Bank Governors Committee and the existing European Monetary Cooperation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

23. It might also take on the essential task of coordinating member states' intervention against external currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This coordination would not involve member states giving up part of their foreign

currency reserves. Instead, intervention would be coordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

24. All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution - an EMF - to carry them out.

25. There is much discussion about the final stages of EMU. And more than one version of it. In these discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening - for promoting greater economic and monetary integration beyond Stage 1 - must be fully considered. They offer a way forward around which all Europe should be able to unite.

26. They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally from stage 1 and have the potential to evolve further. In time the ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be. In addition the development of a hard ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they represent a practical and sustainable way forward for Europe.

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CHANCELLOR'S STAGE 2 SPEECH: Q & A BRIEFING

GENERAL

Q1. Further UK paper?

A1. No: speech a contribution to debate.

Q2. Will Prime Minister say more at Dublin?

A2. Will certainly refer to our ideas, but not expecting substantive EMU discussion. Our ideas a contribution to preparatory work for IGC, being coordinated by ECOFIN.

Q3. Delaying/diversionary tactic?

A3. Certainly not. Need to consider how we can build on the Stage 1 arrangements and our Evolutionary Approach paper, with constructive ideas for institutional change. Very little discussion of what should follow Stage 1 in Community so far. Hardly addressed in Commission's papers.

Q4. All too late, surely: other countries have rejected a substantive Stage 2?

A4. Not at all. Preparatory discussions leading up to IGC still continuing. Plenty of opportunity for UK to influence the debate. A direct move from Stage 1 to 3 is being discussed by some - and hotly contested by others.

Q5. Bid to avoid two-speed EMU?

A5. UK hopes 12 will come to a common conclusion. Several in Community (eg. Italy, Spain) not happy with Mr Pohl's suggestion of two-speed Europe. A step by step approach makes sense.

Q6. But you don't accept Stage 3. Why bother with Stage 2?

A6. Whatever the outcome of the discussion on the final stages of EMU and in the IGC, strong case for considering on their own merits, as part of evolutionary process advocated by UK, some further ideas for promoting greater monetary integration beyond Stage 1.

Q7. Why not produced ideas sooner? Disagreements within UK Government?

A7. Recent press reports wholly misleading. Prime Minister indicated some time ago that we would have ideas to put forward ahead of IGC. We've already contributed positively to debate about Stage 1 and about economic arrangements beyond Stage 1. Now contributing ideas on monetary arrangements to follow Stage 1.

Q8. More ideas to follow?

A8. Will continue to play constructive part in preparations for IGC, and subsequently in the IGC itself.

Q9. Ideas supported by Bank of England?

A9. Ideas fully discussed and agreed with Bank of England. Bank will be explaining these further to other EC central bankers. Further detailed work on ideas will need to be done by central bank governors committee.

RELATIONSHIP TO EVOLUTIONARY APPROACH PAPER

Q10. Change from Evolutionary approach?

A10. Development of it. Same underlying principles:

- evolutionary;
- work with grain of markets;
- respect principle of subsidiarity;
- strengthen forces making for stable prices.

The Chancellor now proposes institutional and currency developments beyond Stage 1 which respect these principles.

Q11. The Evolutionary Approach paper said that "To try to decide now - even before Stage 1 has begun - precisely how later stages of the progressive realisation of EMU should be carried forward is both hazardous and unnecessary." Are we not now reneging from that position, by putting forward specific ideas for Stage 2?

A11. At Strasbourg last December the European Council decided that an IGC on the later stages would start by the end of this year. The task now is to ensure adequate preparations for it, covering all aspects.

STAGE 1

Q12. Progress with Stage 1?

A12. Starts 1 July 1990. Key elements include

- completion of single market and single financial area: progress satisfactory, but much work still to be done. Not least implementing directives at national level: only 21 single market measures so far implemented in all member states out of total programme of nearly 300.

- all currencies to join ERM: clear UK commitment to do so when Madrid conditions met. Good progress on these, but not all met yet; need now to get domestic inflation down.

- strengthening competition: again, depends on progress at national as well as Community level in completing single market and strengthening competition policy.

STAGE 3/COMMUNITY DISCUSSIONS ON EMU

Q13. UK reservations about approach in Delors report?

A13. Delors report proposals for single monetary policy and single currency raise three main problems:

- loss of national responsibility for monetary policy: both main UK political parties agree this cannot be contemplated;

- central bank likely to pursue average anti-inflation policies, not best;

- pressure for massive budgetary transfers to peripheral regions, when experience shows this is not the way to solve regional problems.

Q14. Developments since Delors report?

A14. Madrid Summit (June 1989) considered Delors and decided to begin Stage 1 on 1 July 1990. Strasbourg summit (December 1989) agreed EMU IGC starting end-1990, preceded by preparatory work. Work in progress. UK maintains reserve on monetary union on Delors report lines. But considerable agreement on economic union (no monetary financing or bail out of member states in difficulty; strengthened economic surveillance; but no binding rules on size of budget deficits). Dublin summit in April agreed to aim to get national parliaments to ratify any new Treaty by end 1992.

Q15. Will UK accept Stage 3?

A15. The practical and progressive steps which the Chancellor has proposed evolve naturally from Stage 1 and have the potential to evolve further. The Chancellor said: "In time the ecu would be more widely used: it would become a common currency for Europe. And in the very long term - if people and governments so choose - it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be."

STAGE 2 AND EMF

Q16. Why need a separate "Stage 2"?

A16. Need arrangements which continue process of convergence begun in stage 1. Could have long Stage 1, and minimal Stage 2. But many in Community will want to make arrangements for a further step beyond Stage 1, while acknowledging that convergence process will take time. That's why UK has suggested possible institutional arrangements which will promote further economic and monetary integration, while still keeping responsibility for monetary policy in national hands.

Q17. But control over national monetary policy already in practice ceded to Bundesbank?

A17. No - Huge difference between choosing close cooperation with Bundesbank and surrendering control of national monetary policy to independent Community institution.

Q18. What is required in "Stage 2" ?

A18. Arrangements which will:

- promote wider use of ecu
- encourage competition between national monetary policies;
- thus promote greater economic and monetary convergence.

Q19. What advantages will wider use of ecu and greater economic and monetary convergence being to the UK?

A19. Will build on creation of single market and single financial area which are part of Stage 1 programme. Benefits should include increasing stability of prices and exchange rates, lower transactions costs, and increasing free movement of goods, capital and labour. All adds up to greater competitive opportunities for British industry, and better-served consumers with more choice.

Q20. How would EMF promote ecu?

A20. Chancellor outlined two possible approaches:

(i) First practical step: EMF would act as currency board, issuing ecu bank notes in exchange for Community currencies. Ecu still basket of currencies. Could provide natural currency for tourists and business travellers and in time help development of large scale market in ecu deposits.

(ii) Preferred option: create a new "hard ecu". No longer a basket of currencies but currency in own right. Would be managed by EMF to ensure never devalued against other Community currencies. Could become widely used if businesses and individuals preferred it to existing currencies.

Q21. Why called European Monetary Fund?

A21. Because the title matches the functions, which go wider than those of a bank or currency board: eg co-ordinating intervention against third currencies, co-ordinating any medium term balance of payments lending by Community to individual member states.

Q22. Advantages of "hard ecu" compared to "basket" ecu?

A22. "Hard ecu" a new currency, which would hold its value against any other EC currency. Strong attractions - highly stable currency. Would offer genuine competition to other 12 Community currencies. "Basket" ecu, by contrast, simply moves in line with the other 12 currencies.

Q23. EMF a toothless wonder: will not convince those who want to take the bold step to a full-blown ESCB?

A23. Our ideas for an EMF are not toothless: in particular, the idea of a "hard ecu" is a practical and positive proposal. In our view, Community simply not ready to cede extensive powers to a ESCB: bold steps have to be practical as well.

Q24. Could an EMF develop eventually into an ESCB?

A24. Perhaps. But no need to decide on that now. As Chancellor's speech makes clear, responsibilities and powers of EMF could certainly evolve - and be extended - over time.

Q25. Surely an EMF would simply replicate functions already carried out elsewhere in the Community (eg. by the Commission, EMCF, Monetary Committee, etc.)?

A25. To some extent an EMF would be a very useful consolidation of existing arrangements. But an EMF would go <u>much</u> further than existing arrangements: in particular, creation of the hard ecu would be a major step forward.

Q26. Wouldn't the "hard ecu" proposal lead to money creation and inflation?

A26. No strong safeguards would be provided to ensure hard ecu remains as strong as the strongest national currency. And it would be issued only in substitution for national currencies. So it could not lead to extra money creation. It could lead to lower inflation than otherwise if the hard ecu were widely used. But on no account could it add to inflation.

Q27. Chancellor's ideas same as Sir Michael Butler's (Chairman of British Invisible Exports Council)?

A27. A version of the Chancellor's approach has been canvassed in a recent paper by the BIEC. Chancellor's ideas rather different. For instance, our proposal envisages that EMF would play a major role in actually issuing new currency to the public via commercial banks: BIEC scheme says little about that aspect. But readily acknowledge Sir Michael Butler's contribution.

Q28. Other technical questions

A28. [Posts: please consult Treasury London: Mr Grice (270 5509)
or Mr Peretz (270 4460)]

Q29. Would the EMF be highly centralised?

A29. No. The EMF would have certain central functions but responsibility for monetary policies would continue to rest firmly in national hands.

Q30. When would EMF be set up?

A30. Too early to say; depends on progress on Stage 1 and discussions in IGC.

Q31. Would setting up an EMF have to await the end of Stage 1; or could a start be made sooner?

A31. Some part of the function of an EMF would involve the consolidation of existing Community activities (eg. carried out by the Commission, Monetary Committee, Committee of Central Bank Governors, EMCF, etc). No reason why an early start should not be made in such areas.

Q32. Any support for UK ideas?

A32. Others in Community also raising question of arrangements to follow Stage 1. Ideas circulating in France, Italy [academic and government ideas for progressive narrowing of ERM bands and UK [eg. Butler]. Delors report envisaged substantive transitional period. Monetary Committee currently discussing the question.

Q33. Why not set up new central bank ready for transition to Stage 3?

A33. Widespread agreement in Community that embryo central bank, operating alongside national banks, could lead to serious confusion about responsibility for monetary policy and have destabilising effects in markets. Chancellor deliberately suggesting arrangements which would preserve clear responsibility for monetary policies in national hands, whilst promoting wider use of ecu. Offers opportunity for progressively closer economic and monetary integration, but avoids prescriptive approach.

Q34. "Hard ecu" would require issuing bank setting own monetary policy. How different from a Community central bank?

A34. "Hard ecu" would be a "common" or "parallel" currency, competing with national currencies. Central bank envisaged by Delors would <u>replace</u> national monetary authorities.

Q35. Would UK adopt hard ecu as its currency?

A35. Whole idea is for ecu to compete alongside national currencies. Conceivable that UK - or any other member state - might adopt hard ecu if it became widely used by businesses and individuals. Equally conceivable that competition with hard ecu would lead to successful anti-inflation policies in member states and increasing convergence of prices and exchange rates amongst national currencies.

Q36. Idea of parallel currency acceptable to Bundesbank?

A36. We believe the safeguards against money creation which are an integral part of our "hard ecu" ideas should make them acceptable to the Bundesbank. The basic UK approach emphasising the importance of economic convergence as a prerequisite for further advance, is of course the Bundesbank's also.

COMMUNITY ENLARGEMENT AND EASTERN EUROPE

Q37. Experience with GEMU demonstrates that rapid transition to full EMU/ESCB feasible and desirable?

A37. GEMU very different. Ex-GDR economy small proportion of total unified Germany.

Q38. UK arguing for early Community enlargement?

A38. UK's position clear. Next step is to reach Association Agreements with East European countries, to encourage further economic and political cooperation. Full membership not immediate prospect. But in due course will welcome prospect of membership by East European countries, when their political and economic systems are ready.

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PLEASE NOTE EMBARGO

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 21.00 BST ON 20 JUNE 1990

20 June 1990

BEYOND STAGE ONE

In a speech today to the German Industry Forum the Chancellor, the Rt Hon John Major MP, announced new Government ideas on how economic and monetary union (EMU) could evolve beyond Stage 1 as described in the Delors report. These ideas build on the suggestions contained in the Treasury's paper 'An Evolutionary approach to Economic and Monetary Union', published last November. He reaffirmed that we would join the ERM when our well-known conditions are met.

2. The UK is fully committed to Stage I - which includes the single market programme and all member states joining the ERM - but has fundamental reservations about the prescription for full economic monetary union proposed in Stage 3 of the Delors Report. However, the Government has made it clear that it will play a constructive part in the forthcoming Inter-Governmental Conference (IGC) on EMU which will start in December. These new ideas are designed to influence the debate in the EC in the run up to that Conference.

3. In his speech, the Chancellor advocates the setting up of a new institution, the European Monetary Fund (EMF) which would initially:

- manage the ERM

EMBARGOED UNTIL 9.00 pm ON 20 JUNE 1990

Chancellor said at the end of his speech "... they represent a practical and sustainable way forward for Europe."

Notes for editors

1. The Delors report on possible ways towards European Economic Monetary Union was published in April 1989 and presented to the Madrid European Council in June 1989. It envisaged a three-stage process towards EMU.

2. Stage I, to which the UK is committed, is based on consolidating the single market. It involves, among other things,

- the complete removal of physical, technical and fiscal barriers;

- strengthening of competition policy and the reduction of state aids;

- closer co-ordination of economic and monetary policies;

- deregulation of financial markets and the establishment of a single financial area;

- all Community countries joining the ERM on equal terms;

- the removal of all impediments to the private use of the ecu.

The Madrid European Council agreed that Stage I should begin on 1 July 1990.

3. In the Delors plan, Stage II was envisaged as a transitional phase towards Stage III. The Stage III proposals would involve a move to irrevocably locked exchange rates, binding constraints on national budges and pushing responsibility for the formulation and implementation of monetary policy to a European System of Central Banks.

- co-ordinate exchange rate intervention with external currencies such as the dollar and the yen:

- help manage medium term balance of payments lending, to the extent that the Community is involved in this.

- manage and promote the ecu

4. As regards the ecu the first practical step on this route would be to encourage its greater use by issuing ecu bank notes for general circulation in the Community. Acting as a currency board the EMF would only issue notes that were fully backed by its own holdings of various EC currencies so there would be no new money creation and hence no threat to inflation.

5. The Chancellor's preferred option would be to go further, extending the EMF's powers to allow it to:

introduce a hard ecu, a new, international currency which would be initially identical to the ecu but would never devalue, against other community currencies. The EMF would control the supply of hard ecus to ensure it stayed within narrow margins against the other community currencies.

It would also set the interest rate on hard ecus.

6. The further step of issuing hard ecus would not be inflationary as there would be an obligation on all member states' central banks to repurchase their own currencies from the EMF for hard currencies. Indeed it would put pressure on every EC country to pursue non-inflationary policies to ensure that their own currencies were not displaced by the hard ecu.

7. These ideas offer a practical way of promoting greater economic and monetary integration beyond Stage I. Most important of all, they retain choice, diversity and flexibility. As the

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 June 1990

Chancellor's Speech on EMU

I have shown the latest draft of the Chancellor's speech tonight on "EMU Beyond Stage One: the UK Approach" to the Prime Minister. She is well content with it. Her only comment relates to the fifth sentence of paragraph 26 ("The ECU could become in time ... a single European currency"). She thinks there are too many thoughts compressed into a single sentence, with the risk that the Press will make a headline of "Chancellor Proposes Single European Currency". I think the Prime Minister's concern would be met if you will consider the following redraft, developing the thought rather more fully:

"In time the ECU would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be".

I hope you will feel able to accept this point.

C. D. POWELL

John Gieve, Esq.,
H.M. Treasury.

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AT 21/6

PRIME MINISTER

cc Mr. Powell
Mr. Potter

OBJECTIVE STANDARDS

You have been thinking about objective standards such as a commodity standard in three contexts

- as an alternative to EMU
- as a way of operating an EMU where one established
- as the basis for a new monetary order.

(i) An alternative to EMU

The aim was to find an alternative model to which other Community countries can turn if they begin to develop doubts about the Delors model. But they are not going to down tools on the IGC to look at something which is as embryonic as the Commodity Standard. But in any case we have now come up with something better, i.e. the hard ECU. This grows out of existing Community constructs and can also be seen as a development of the UK's paper on competing currencies. It is flexible - it can be a parallel currency, countries can adopt it individually or they can use it in groups as a common currency.

(ii) A basis for operating EMU

Alan Walters' paper envisaged his ECOM as the way the monetary policy of an EMU might be operated. It would also deal with the problem of accountability. You have objected to a Eurofed of twelve persons determining monetary policy but being inadequately accountable to Parliament. If, however, they were required to operate an automatic framework they would have little discretion and hence little to account for. But there is no mileage for you in pressing objective standard in this context as you oppose a single currency. Your position is an absolute not a conditional one; you do not want it for this country in the foreseeable future; it is not that it would be acceptable if operated differently.

(iii) A basis for a new monetary order

You have wondered whether to launch the idea of an objective standard in Houston. There is, however, an important pitfall here. The term objective standard has echoes of the gold standard. It will therefore be interpreted as a proposal about exchange rates. With the French proposal for a new Bretton Woods

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in the air, observers may conclude that you are proposing a new regime of fixed exchange rates between dollar, yen and the EMS, only using a commodity index as the basis rather than gold.

You have always taken a sceptical view of attempts to fix exchange rates between the major currencies, including attempts such as Plaza and Louvre to do so informally, and I do not see any reason for you to depart from that now. You have argued that the major currencies should run their monetary policies in a firm way but that having done that they should allow exchange rates to adjust freely. If monetary policy succeeds in keeping inflation low and major savings/investment imbalances (fiscal deficits) are not allowed to develop, the resulting exchange rate movements should not be excessive.

It would be important, therefore, to make clear that the purpose of objective standards is to provide a guide to the conduct of monetary policy in individual countries, not directly as the basis for a new system of fixed exchange rates. With payments imbalances as large as they are, to fix exchange rates would be positively harmful. — agreed.

Given the scope for misunderstanding, I think it would be unwise to float the idea publicly at Houston. It would look too much like a specific operational proposal for exchange rates. It would fit better in a philosophical speech about monetary policy and inflation where the arguments about discretion versus rules could be rehearsed.

The question that will then need to be answered is why given the choice between having monetary policy run by Alan Greenspan and/or placing it in a predetermined framework, one should choose the latter — as an earnest of good faith that each of us is doing our utmost to curb inflation & run sound monetary policies. We do not then need more.

AT

ANDREW TURNBULL
20 June 1990
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ANDREW TURNBULL
20 June 1990
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Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

19 June 1990

CDB2076

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Charles

EMU

Following the Prime Minister's meeting this morning, the Chancellor has worked up the attached draft of a speech spelling out our new ideas on what should follow Stage 1 of EMU. Provided the Prime Minister is content with this, he plans to deliver the speech tomorrow evening. Since we need to set up the occasion and brief both the press and posts abroad during the course of the day, I would welcome a very early response.

I am sending copies of this to Stephen Wall (FCO), Martin Stanley (DTI), and Paul Tucker (Bank of England).

Yours

JG.

JOHN GIEVE
Principal Private Secretary

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chex.jp/mw/4

EMBARGOED UNTIL 9.00 pm - WEDNESDAY, 20 JUNE

CHANCELLOR'S SPEECH TO GERMAN INDUSTRY FORUM: 20 JUNE 1990

ECONOMIC AND MONETARY UNION: BEYOND STAGE 1

Tonight, I want to deal with one of the most important issues on the current political agenda: the future of economic and monetary union in Europe. It is a hugely controversial subject, but I know of no other that is of such importance to the future direction and influence of the Community.

2. The Delors Report on EMU, with its 3 stage model, is at the centre of that debate but it does not present a universally acceptable prescription for the future and certainly cannot be the final word. But although we have substantial objections to the Delors prescription, that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage 1.

3. Of course Stage 1 is vitally important. It starts in ten days' time, and will entail the construction of a Single Financial Area in the Community, with a single market in all financial services, and wholly free movement of capital. That is a massive task - by any yardstick - which will mean an enormous amount of hard work for many people. But it is a task to which we in the UK are wholly committed. And our commitment is not merely expressed in words, but also - and more importantly - in deeds. A Commission report at the end of March found that the UK and Germany lead the rest of the Community in this respect, the UK having enacted all but 9 of the single market measures due for implementation by then, and Germany all but 11. Some other member states have as many as 30 or even 50 measures outstanding. I need hardly make the obvious point that we need faster progress than that.

4. Stage 1 also involves the completion of the exchange rate mechanism. The UK is firmly committed to taking

sterling into the exchange rate mechanism of the EMS. This we shall do, as I have made plain on innumerable occasions, when our well-known conditions are met. I restate that commitment yet again.

5. But the starting point for my remarks tonight is a world where Stage 1 is in place. For the debate about what comes then is moving rapidly forward. In a few months' time the economic and monetary inter-governmental conference will begin. That is a perilously short time when the Community is so far from reaching agreement on the practical steps needed to develop the Community's institutions. We need to debate these matters fully and constructively and reach conclusions that take all of Europe's nations forward together. Tonight I would like to indicate some fresh developments in our thinking.

6. Our approach builds on the paper I published last November that set out principles which should guide the future development of economic and monetary integration in the Community. We believe that any change:

- should be gradual and evolutionary;

- should work with the grain of markets;

- should respect the principle of subsidiarity - namely that functions should not be carried out at Community level when they can satisfactorily be carried out at national level;

- and we believe that any change should strengthen the forces making for stable prices.

7. We do not believe the ideas currently being worked on meet these criteria and we continue to have fundamental reservations about them. The core of our concern is that a

Central Community Bank - a Eurofed - would not be accountable to elected Governments even though the electorate would look to these Governments to ensure their economic wellbeing. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. Moreover we do not believe that the single monetary policy and the single monetary authority that are envisaged would deliver the economic performance and inflation performance that the Community will need in the future.

8. These are significant disadvantages that cannot lightly be brushed aside. But this does not mean that some form of EMU is not desirable - it clearly is - or that there are not other - better - ways of achieving convergence and low inflation, throughout Europe. And this could well involve institutional and currency development. That is the theme of the ideas I shall be putting forward tonight.

9. In particular they address the very practical question of where the Community should be looking to go once Stage 1 has been completed. It is generally recognised that this is one of the weaker points in the current debate. But it is a no less crucial question for that. For this reason, I have to say I view with concern recent suggestions from some quarters that the Community could do without Stage 2 altogether. I do not think that is practical.

10. It may well be that this latest outbreak of Big-Bangism has been triggered by events in Germany, where a very rapid transition to monetary union is envisaged. We all, of course, welcome the momentous changes in Germany. But we must beware of drawing false parallels with events on the broader European canvas. What is happening in German monetary union is that a large and healthy economy, and a strong currency, is absorbing the declining economy and weak currency of the GDR. It is - to all intents and purposes - a

takeover, willed by both sides, and with economic consequences primarily affecting Germany. EMU is a much bigger, and wholly different, proposition.

11. One of our main concerns about the idea of an EMU "big bang" is that it presumes a far greater degree of convergence of economic performance than is yet available, or in prospect. I might add that it is far from self-evident to me that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences in inflation between the economies of the Community probably require that for our inflation performances to converge, our interest rates must diverge - as indeed they do at present. That does not suggest a swift move to a single European monetary authority; indeed it argues strongly against it.

12. All those who are most anxious to set in place successful movement towards economic and monetary union should hold fast to this: without greatly increased convergence, monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening.

13. What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, East and West. We welcomed to Community membership some of the newly democratic countries in Southern Europe. Now several of the countries in Eastern and central Europe see very clearly the benefits of membership of the Community. In due course we should welcome this prospect, when their political and economic systems are ready. We should develop a form of EMU

that permits them to join us and does not put up barriers against it.

14. To my mind that argues even more powerfully for a gradualist and evolutionary approach, and against any attempt to move to a rigid and closed structure. It suggests that we should look for arrangements that promote convergence - and particularly convergence on low inflation - while retaining flexibility and choice.

15. We believe that we can now see a way forward which does precisely this. We believe that whatever the outcome of the debates about the longer-term, in the short and medium-term there are steps the Community could - and should - be taking which are valuable and useful in their own right and which would take the process of economic and monetary convergence further.

16. The issue need not be so divisive. The key is to build on Stage 1 further steps to promote convergence of economic performance, low inflation and stable exchange rates. And to do so by building up our infant common currency - the ecu.

17. A first practical step towards this might be to encourage the use of the existing ecu by issuing ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The Fund, acting as a currency board, would provide ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the Fund could only issue ecu notes that were fully backed by its own holdings of the various currencies which make up the ecu. So there would be no new money creation, and no threat to inflation. Interest rates on ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the ecu's constituent

currencies and so the Fund would play no role in setting interest rates.

18. Ecu bank notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of largescale markets in ecu deposits.

19. But these are modest steps, and I think we could and should go further. In my view, the best approach is the creation of a new "hard ecu". Under this approach the ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right - a new and international currency - which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their Chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

20. Under our approach, the European Monetary Fund which I have suggested would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue ecu deposits or notes in exchange for national currencies. It would set interest rates on hard ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard ecu market developed and commercial banks built up hard ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

21. A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose - indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the Fund's own money creation - through the issue of hard ecu liabilities and the influence it exerted on money creation by national central banks - was not inflationary.

22. It will be noted that both these ideas for developing the ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the central Bank Governors Committee and the existing European Monetary Cooperation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

23. It might also take on the essential task of coordinating member states' intervention against external currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This coordination would not involve member states giving up part of their foreign

currency reserves. Instead, intervention would be coordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

24. All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution - an EMF - to carry them out.

25. There is much discussion about the final stages of EMU. And more than one version of it. In these discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening - for promoting greater economic and monetary integration beyond Stage 1 - must be fully considered. They offer a way forward around which all Europe should be able to unite.

26. They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally from stage 1 and have the potential to evolve further. In time the ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be. In addition the development of a hard ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they represent a practical and sustainable way forward for Europe.

SUBJECT cc MASTER

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File

cc PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

19 June 1990

Dear John,

EUROPEAN MONETARY UNION

The Prime Minister met with the Chancellor, the Foreign Secretary and the Trade and Industry Secretary this morning to discuss how to handle the item on EMU at the forthcoming European Council in Dublin.

This letter contains matters of a sensitive nature and should receive a very limited distribution only.

The Prime Minister said that the main issue to be decided was when and in what manner our proposals for the second stage of EMU should be announced. Looking beyond that, there was agreement that we could not subscribe to a Delors Stage III including a common currency and a European Central Bank, but disagreement on the most appropriate tactics for handling this aspect. She has herself put forward some ideas for an objective reference standard for currencies and for a wider transatlantic free trade area. She was grateful for the written comments from the Chancellor and the Trade and Industry Secretary. These issues were more suitable for discussion at the Economic Summit in Houston than at the European Council.

The Prime Minister expressed her concern about recent stories in the press, purporting to give details of the Government's deliberations on these matters. It was agreed that they were most unfortunate and any repetition must be avoided.

Stage II

In discussion, it was agreed that we should table the so-called Butler proposals for Stage II, involving a hard ecu. The Chancellor emphasised that our ideas were likely to receive a fairly cool reception in the Community, in particular from the Germans who were opposed to a parallel currency. But some fresh problems had recently emerged within the Community over EMU, following the President of the Bundesbank's proposal for a two-tier approach, and it was possible that our ideas would pick up

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more friends than we had earlier expected. The Governor of the Bank of England was fully in support of the proposal, and it would be helpful to be able to cite the close involvement of the City in working it up. It would be for the Governor to pursue the technical aspects of our ideas in the Committee of Central Bank Governors. The Trade and Industry Secretary suggested that we should also make use of the argument that our proposal was easier to reconcile with future enlargement of the Community than the common currency envisaged in Delors Stage III.

Turning to the mechanics of our tabling our proposal, it was agreed that the best vehicle would be a speech by the Chancellor. Ideally this should be for delivery before the European Council: but, if not, it should be very shortly afterwards. Either way, the Prime Minister would need a form of words for use at the Council itself. We should consult closely with Sir Michael Butler on presentation and handling. We should need to do some active missionary work, both with the media and with other European Governments, to get as much support for it as possible. The Prime Minister emphasised that our proposal should be presented not as Stage II, but as the most that could reasonably be decided about future EMU at this point.

Stage III

The Chancellor reported that other member states were increasingly committing themselves to the goal of full EMU as proposed in Delors Stage III. He continued to believe that the best way for us to retain influence over the debate, while avoiding any commitment by the United Kingdom to such an outcome, was to propose an opting-in mechanism.

In discussion, it was pointed out that the other eleven member states were quite likely to reach a conclusion in this sense by the middle of 1991. It could cause serious political problems ('a smash') for the Government if we were left in an eleven to one situation. That would go down badly with many of the Government's own supporters, would be exploited by the Opposition who were moving increasingly towards acceptance of EMU, and would be regarded with dismay by the United States and our other allies.

Against this it was suggested that the permanently fixed exchange rates envisaged in Delors Stage III were unworkable, and that we could not surrender the degree of sovereignty over economic and monetary policies which would be involved. The House of Commons had already expressed its views on this. Moreover, massive subventions to the poorer EC countries would be required and we could not contemplate any increase in the already excessive sum which we paid over to the EC. We should argue our objections to Stage III vigorously and should not be too concerned about being left in a minority of one. Indeed we could gain certain advantages from that, and should do some contingency work on how to handle such an outcome in terms of domestic politics.

The Prime Minister concluded that the position remained that we would not, at the European Council or subsequently, hold out any prospect that the United Kingdom would be prepared to subscribe to a treaty amendment providing for a common currency or a Central Bank.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Martin Stanley (Department of Trade and Industry) and Sonia Phippard (Cabinet Office).

Yours ever,

C. D. POWELL

John Gieve, Esq.,
H. M. Treasury

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FROM UKREP BRUSSELS

FOREIGN AFFAIRS COUNCIL, 18 JUNE 1990
PREPARATION FOR EUROPEAN COUNCIL: EMU

SUMMARY

1. PRESIDENCY TO AMEND THE PAPER ON EMU FOR THE EUROPEAN COUNCIL TO TAKE ACCOUNT OF COMMENTS. YOU MADE CLEAR THE NEED TO COVER OUR RESERVATION ON THE CONCLUSIONS OF THE ASHFORD CASTLE MEETING. DELORS SUPPORTED BY DUMAS WAS PROVOKED INTO A LENGTHY DIATRIBE ABOUT THE IMPOSSIBILITY OF FURTHER PROGRESS BY THE ECOFIN COUNCIL.

DETAIL

2. VAN DEN BROEK (NETHERLANDS) SAID HE WAS UNHAPPY WITH THE REFERENCE IN PARA. 4 TO ''WIDESPREAD AGREEMENT ON THE OVERALL DESIGN OF A SYSTEM''. HE DID NOT AGREE WITH THE FIRST SENTENCE OF PARA. 5. MONETARY POLICY SHOULD BE GEARED TOWARDS PRIACE STABILITY, WITHOUT FURTHER QUALIFICATION. THE SENTENCE SHOULD READ ''... A SINGLE MONETARY POLICY GEARED TOWARDS PRICE STABILITY. SUBJECT TO THE FOREGOING, MONETARY POLICY SHOULD ACT IN SUPPORT OF GENERAL ECONOMIC POLICY.'' A REFERENCE TO SUBSIDIARITY SHOULD BE INCLUDED IN PARAGRAPH 7 AND IN PARAAGRAPH 6 IT SHOULD BE MADE CLEAR THAT ALL BAILING OUT, NOT JUST AUTOMATIC BAILING OUT, SHOULD BE PROSCRIBED.

3. PINHEIRO (PORTUGAL) THOUGHT PRICE STABILITY WAS A MEANS TO ECONOMIC AND SOCIAL PROGRESS, NOT AN END IN ITSELF. THERE SHOULD BE REFERENCES TO THE EQUITY PRINCIPLE, TO THE NEED FOR THE TWELVE TO PROGRESS TOGETHER AND GREATER EMPHASIS ON THE ROLE OF THE EUROPEAN COUNCIL. SAMARAS (GREECE) WANTED THE REPORT TO INCLUDE REFERENCES TO PARALLELISM, SUBSIDIARITY AND DIFFERENTIATION. A TWO-SPEED EUROPE WOULD BE A SETBACK. EMU WOULD NOT BE VIABLE WITHOUT CONVERGENCE, WHICH REQUIRED STRONGER COORDINATION AND COHESION AND A LARGER COMMUNITY BUDGET. THE FOREIGN AFFAIRS COUNCIL SHOULD HAVE A STRONGER

COORDINATING ROLE ON THIS SUBJECT AND RESPONSIBILITY FOR THE ISSUE OF DEMOCRATIC CONTROL OF THE ECSB.

4. YOU SAID THE PRESIDENCY PAPER WAS A USEFUL STOCKTAKING. YOU AGREED WITH VAN DEN BROEK ON THE NEED FOR THE PAPER TO ACKNOWLEDGE OUR RESERVATION AT ASHFORD CASTLE. PARA. 5 SHOULD REFER TO MOST MINISTERS BEING BROADLY AGREED. YOU ALSO THOUGHT IT WOULD BE USEFUL TO INCLUDE A REFERENCE TO SUBSIDIARITY. FERNANDEZ ORDONEZ (SPAIN) SAID THERE HAD BEEN MORE PROGRESS ON THE MONETARY THAN THE ECONOMIC SIDE. MORE WORK WAS NEEDED ON STRUCTURAL POLICIES AND COHESION. HE AGREED WITH PINHEIRO THAT PRICE STABILITY WAS A MEANS NOT AN END. THE FAC SHOULD DEAL WITH THE CONTROL OF THE CENTRAL BANK. DIFFERENT RATES OF PROGRESS AND DIFFERENT TRANSITIONAL PERIODS, AS IN THE CASE OF THE EMS, SHOULD NOT BE RULED OUT. MRS ADAM-SCHWAETZER (FRG) SAID THE PAPER PROVIDED A BASIS ON WHICH AGREEMENT COULD BE REACHED ABOUT THE SETTING UP OF THE IGC AT THE ROME EUROPEAN COUNCIL. BUT MUCH TECHNICAL WORK WOULD BE NEEDED IN 1991 IF RATIFICATION AT THE END OF 1992 WAS TO BE ACHIEVED. THERE SHOULD BE MORE PREPARATORY WORK IN THE RUN UP TO THE ROME EUROPEAN COUNCIL BY A SEPARATE BODY FROM THAT CONSIDERING THE POLITICAL UNION IGC.

5. DELORS (COMMISSION) DISAGREED WITH REFERENCES TO A TWO-SPEED EUROPE. THERE WAS A DANGER OF CONFUSING TWO CONCEPTS. IT WAS POSSIBLE THAT SOME MEMBER STATES WOULD REFUSE PARTICIPATION IN A COMMON POLICY IN WHICH CASE THERE WOULD BE VARIABLE GEOMETRY BUT HE COULD NOT ACCEPT THE PERJORATIVE CONNOTATIONS OF TWO-SPEED EUROPE. POEHL'S REMARKS HAD BEEN PROVOCATIVE. ALTERNATIVELY SOME MEMBER STATES MIGHT NEED TRANSITIONAL PERIODS: THIS WAS A WELL-TESTED DEVICE, WHICH DID NOT IMPLY A TWO-SPEED EUROPE EITHER. HE ALSO TOOK ISSUE WITH THOSE WHO SAID THAT PREPARATION HAD NOT BEEN FULL AND ADEQUATE. THERE WAS NO FURTHER SCOPE FOR PROGRESS BY FOREIGN MINISTERS. THERE WERE SIX ISSUES WHICH NEEDED TO BE DISCUSSED BY THE IGC:
(A) SHOULD THERE BE A SINGLE MONETARY POLICY? ONE MEMBER STATE WAS HESITATING.
(B) WHAT SHOULD BE DONE ON THE ECONOMIC SIDE? THIS COULD ONLY BE DECIDED IN THE IGC.
(C) HOW SHOULD ECONOMIC AND SOCIAL COHESION BE DEALT WITH? THE COMMUNITY WOULD BE REVIEWING ITS POLICIES ON COHESION IN 1992.
(D) HOW SHOULD DEMOCRATIC ACCOUNTABILITY BE ASSURED? THIS WAS NOT A TECHNICAL MATTER.
(E) SHOULD THERE BE A SECOND STAGE? THIS WAS A POLITICALLY EXPLOSIVE ISSUE AND THERE WAS NO POINT IN DISCUSSING IT IN ADVANCE OF THE IGC.
(F) THE ROLE OF THE ECU? THIS WAS DIVISIVE AND HE AGAIN SAW NO

PROSPECT OF PROGRESS OUTSIDE THE IGC.
FOR THESE REASONS HE FAVOURED DELETING PARA. 8 OF THE PAPER REFERRING TO FURTHER DISCUSSION WITH A VIEW TO FULL AND ADEQUATE PREPARATION.

6. DUMAS (FRANCE) ALSO THOUGHT PARA. 8 OF THE PAPER SHOULD BE DROPPED. THERE WAS NO MORE FOR ECOFIN TO DO. HE THOUGHT THE PAPER MADE TOO CLEAR A DISTINCTION BETWEEN THE MONETARY AND ECONOMIC SECTIONS: THE TWO SUBJECTS SHOULD BE LINKED. IT ALSO SAID TOO LITTLE ABOUT THE INSTITUTIONAL ASPECTS. IT WOULD BE FOR FOREIGN MINISTERS TO PICK UP THESE ISSUES AND EXAMINE THE LINKS BETWEEN THEM AND THE POLITICAL UNION IGC. VAN DEN BROEK SAID HE WOULD WANT TO RETAIN PARAGRAPH 8 AND REPEATED HIS PROPOSED AMENDMENT TO PARAGRAPH 5. COLLINS SAID THE PRESIDENCY WOULD CONSIDER ALL THE COMMENTS MADE AND WOULD REVISE THE PAPER FOR THE EUROPEAN COUNCIL. HE NOTED IN PARTICULAR THE NEED FOR FOREIGN MINISTERS TO PROVIDE A LINK BETWEEN THE TWO IGCS.

CAMPBELL

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chex [redacted] **PERSONAL AND CONFIDENTIAL**

Chancellor

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

WITH BP ?

I have seen Nick Ridley's minute of 14 June. As you know, I share his view that we need to face up to the issues posed by the forthcoming inter-government conference on EMU and determine our position as soon as possible.

My starting point is very similar to his. The House of Commons will not accept a treaty which commits the United Kingdom to move to the final stages of an EMU which involves a single currency and a European Central Bank. I not only accept that, I entirely agree with it.

But I do not agree with Nick's view that we can stand aside and be indifferent to the nature and speed of change in the economic and monetary field in the Community. Whether we explicitly dismiss the ideas of the other eleven members or simply stay silent, the evidence suggests that, in all probability, the eleven will go ahead with their own separate treaty. This process would start in December and would continue right up to a General Election. If that occurs, I do not think that either the economics or the politics are attractive. The market response would almost certainly be sharply adverse at an appallingly difficult time and, to the dismay of many of our supporters (inside and outside Parliament) and of much of industry and the City, we would be seen as opting out of having serious influence in the Community. I am convinced we would also suffer in the longer term a price in lost inward investment and more generally in loss of influence. The converse is also true: handled skilfully we can maximise our influence in Europe and wholly wrong foot our political opponents.

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My solution to the difficulties we face explicitly does not involve abandoning the Government's present position in any way. I wish to join in the negotiations precisely to ensure that nothing damaging to our interests is done. If we have ideas to offer we should promote them. If we have nothing, we may get nothing. I want to put forward the sensible proposals for Stage 2 that we agreed in order to avoid a headlong rush on the part of others to Stage 3 with Britain seen as isolated and irrelevant - a position which cannot be in our interests. This objective will be difficult to achieve, such is the momentum to Stage 3. But the reaction from a number of Governments to Poehl's recent suggestion of a two speed union shows that we may well find support for an approach in which all 12 members can participate.

If we want to pursue this possibility, we must move quickly. We have so far failed to influence the debate because of a lack of a clear position and because we have consistently been behind the game. Hence my proposal that we should enter the negotiations with the object of securing a treaty which would become operational for member states only when they opted in, and which would retain the right to decline to opt in indefinitely. This fully protects the position of Parliament. I am no Euro-enthusiast but I would have no difficulty in defending that position. It means that we should have to negotiate within the ambit of the Delors definitions. But in my view that is preferable to the only alternative - neither to take part in the drafting of the treaty nor to sign it.

I am sending copies of this to Nick and Douglas Hurd.

JOHN MAJOR

18 June 1990

PERSONAL AND CONFIDENTIAL

Prime Minister
To note. Agree to take action as in para 7?

AT 18/6

Ref.AO90/1421

MR TURNBULL

Yes ok

EMU: Press Stories

You drew my attention to the Financial Times story by Philip Stephens this morning, and I have discussed this with Sir Peter Middleton. There have also been two other stories over the weekend which show more knowledge than ought to be available to the Press about Ministerial discussions. One was in the Independent on Friday - "Cabinet Battle over EMU" - and the second was in The Observer on Sunday - "Walters gives PM a way out on EMS". I attach copies of all three articles.

2. All three articles contain clues to their provenance, although there is no conclusive evidence and what follows is speculation. The story in the Independent is written from a DTI standpoint and quotes a Ministerial source: there is a temptation to identify the Ministerial source with John Redwood.

3. The story in the Observer focuses on Sir Alan Walters as the source of the idea of a North Atlantic free trade area. It also quotes "Sir Alan's close colleagues". It is tempting to think that this is a confidant of Sir Alan, perhaps in the area of the Centre for Policy Studies. It could just possibly be Sir Alan himself, though I doubt it.

4. The article by Philip Stephens in the Financial Times this morning has a Foreign Office slant. The source appears to know about discussions between the Foreign Secretary and The Chancellor (although not about the details of the latest ideas being discussed) and the reference to John Kerr by name, as well as the general line of the article, suggest that it comes from

PERSONAL AND CONFIDENTIAL

someone who sees things from an FCO angle, but not from the Foreign Secretary himself who is (I gather from Sir Patrick Wright) furious about the story.

5. All three articles are written by political correspondents.

6. What seems to me evident about these three articles is that they all contain some information which should not be known and are written from the angle of different players. We are therefore close to having the very important and sensitive debate on EMU again being conducted in the columns of the Press. This is bound to make all the participants suspicious of each other and to risk provoking even further talk, as well as the strains which ended so disastrously last autumn.

7. In these circumstances, what seems to me necessary is for the Prime Minister to say at her meeting with her Ministerial colleagues tomorrow that she has seen these articles and that they are bad for the Government and for relations with colleagues, as well as potentially disruptive to the financial markets. Her Ministerial colleagues should give firm instructions to (a) their junior ministers, (b) their special advisers and (c) their departments that absolutely nothing further is to be said to the Press about these discussions.

8. I suggest that it would also be wise for you to speak to Sir Alan Walters on the same lines and ask him, on the Prime Minister's behalf, to avoid being provoked himself and to ask any friends to refrain from commenting.

N Davidson

pp ROBIN BUTLER
(Approved by Sir Robin and signed in his absence)

18th June 1990

inexpected resistance from the US and were restricted to a 1-0 win..... Page 32

'Independent' sales

The average daily sale of *The Independent* in May was 417,000, up by 3,000 on April.

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Miners terrorise Bucharest

From Marc Champion
in Bucharest

MINERS armed with wooden clubs and coshes swarmed into central Bucharest in the early hours of yesterday morning, savagely beating anyone suspected of opposing the government, in a ruthless attempt to teach the capital a lesson after its long night of senseless destruction.

The death toll from the mob violence rose to at least 11. The government newspaper, *Adevarul*, and a communiqué from the army said the riots were caused by "fascists in uniform" and had amounted to an attempted coup.

The opportunity was taken to close down the city's only mass circulation newspaper to have openly challenged the government, *Romania Libera*. The headquarters of the two main opposition parties, the National Peasants and the National Liberals, were ransacked and their contents piled up and burnt outside.

When plainclothes policemen appeared in force to help to clear University Square of *golani* demonstrators at 4am on Wednesday, it was the first time since December's revolution that Securitate officers had been seen openly performing their duties. That was the first of two post-revolutionary taboos broken; the second was to fire live ammunition at protesters.

Invited by President Iliescu, the miners began to arrive in the square at 5am yesterday, barely an hour after the last rioters had left. As they swirled around the square like enraged warrior ants searching for prey, the most suspect were young men resembling students, but women and the elderly were also thought suitable for beating.

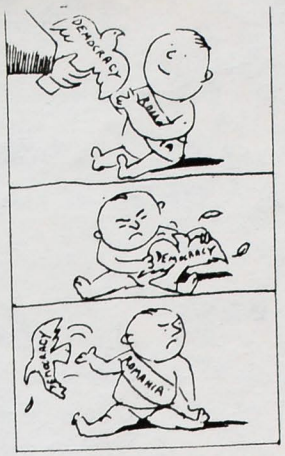
The streets yesterday morning were more frightening to walk than the barricades the night before, under sporadic fire from automatic rifles. The miners worked in tandem with the police and army.

They seized whomever they pleased and then frog-marched them the length of the square to waiting jeeps or, in most cases, ambulances. The victims were punched, kicked and lashed with clubs as they ran the gauntlet.

One miner with a megaphone marched around the square giving instructions. Workers from factories around the country also came to give moral support. They marched through University Square and on to Victory Square in columns of 100 or 200, a placard with the name of their factory at the head of each. As they passed they waved and sang.

The witch-hunt continued all day long. By evening there were 277 casualties in the emergency hospital. The leader of the Students' League, Marian Munteanu, was in intensive care after a half-hour beating. "The miners were not guilty for this, they were just tools," he said. His comment reflected a growing feeling that the government may have planned the whole riot.

Mr Iliescu's statement put the blame for the disorder on the Interior Minister, Mihai Citsac, and then ordered his replacement. The government spokesman said yesterday morning that the miners would be asked to go home and the police would regain control.



But by last night there was no sign of either happening.

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Leading article, page 18
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Cabinet battle over EMU

By Colin Brown
Political Correspondent

NICHOLAS RIDLEY, the Secretary of State for Trade and Industry, is fighting an increasingly bitter battle within the Cabinet against accelerating moves towards European economic and monetary union (EMU), being pressed forward by John Major, the Chancellor of the Exchequer, and Douglas Hurd, the Foreign Secretary.

The Prime Minister's view will be decisive, and *The Independent* has learned that she wrote passages of a recent speech to the Bruges Group by Mr Ridley which was intended as a warning shot against EMU. One minister said: "We've all been told that anything we say on the subject has to be cleared first by Downing Street. Nick's speech was cleared, but the Foreign Office want us to go quiet on the issue."

Mr Ridley's supporters within the Government fear Margaret Thatcher will be persuaded by the Chancellor and the Foreign Secretary to drop her gut objections to EMU for electoral advantage. Mr Ridley fears that the arguments within a Cabinet committee about stage two of the Delors plan proposing closer alignment between European currencies have gone by default.

"Nick is fighting a rearguard action. The Prime Minister's view is going to be crucial, but he is very worried that the debate seems to have skipped stage two of Delors and is now concentrating on stage three [full monetary union]. He is saying, 'Hold on a minute – we haven't completed stage one yet,' " a ministerial source said.

"Nick is very disappointed with Major. He thinks Major is doing it either because it could create an electoral window to reduce interest rates next year, or to shoot Labour's fox so that we can say, 'OK, we've joined the ERM [Exchange Rate Mechanism] – what have you got left?' That's the sort of argument that might just convince the Prime Minister; but it's no way to run an economy."

Background, page 21

'Is Melvyn Bragg vain? Is the Pope Catholic?'

ON SUNDAY

"THE NEXT thing that strikes me is that Melvyn Bragg is quite peculiarly, unexpectedly nervous; he keeps writhing in his chair and squeezing his arms down between his legs – not at all the bland, sunny soul he appears on television.

"But this real-life twitchy, neurotic Melvyn is in my view infinitely more interesting than the smug bit of thinking woman's crumpet that fronts *The South Bank Show*. Is he vain? As soon as I mention his looks, he becomes defensive: 'First of all – I know this is hopeless to say – I have got no opinion of the way I look at all and that's the truth. I actually think that people who are plain have a better time on television, because more people sympathise with them, and identification is everything. But there you are . . . that's the truth, and I think you'll find that everyone who knows me will agree . . .' But I *did* ask someone who knew him and he laughed, 'Is Melvyn vain? Is the Pope Catholic?' "

Lynn Barber talks to Melvyn Bragg in *The Independent on Sunday* this weekend

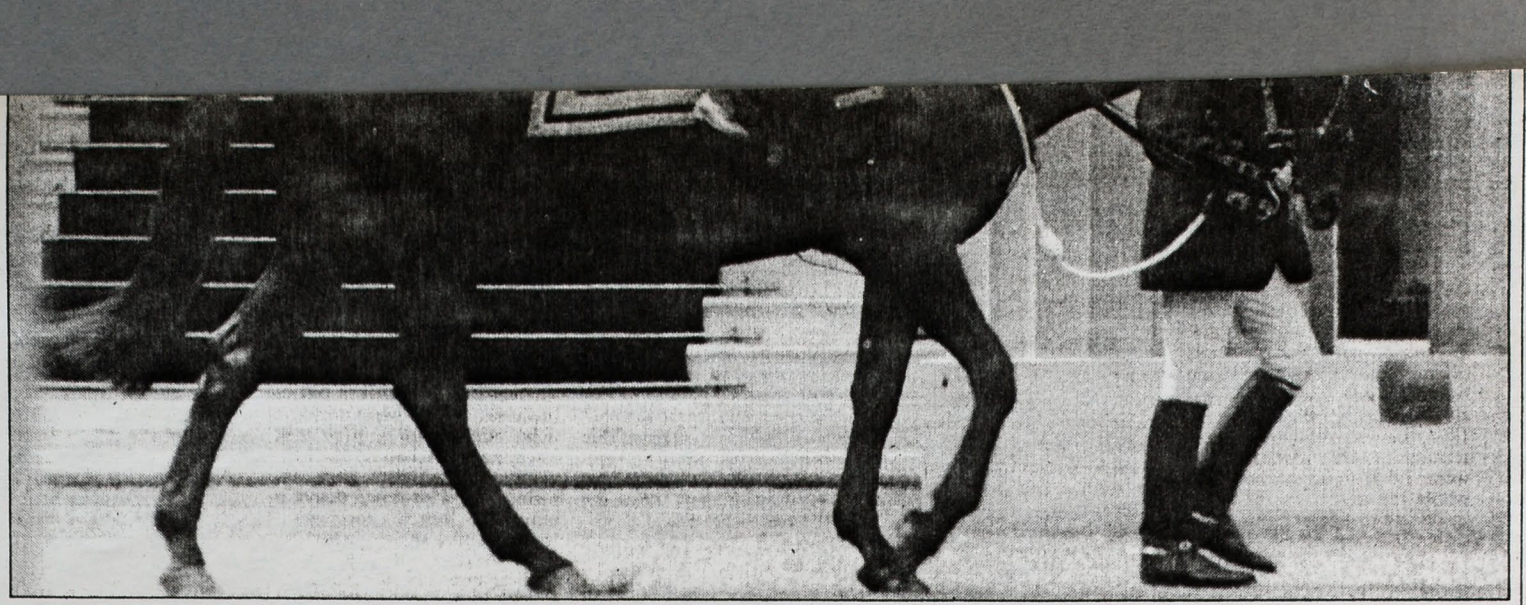
Virgin's honour at stake in World Cup drama

HER NAME is Isabella, her purity has been impugned, and she is said to have a

From Jonathan Foster in Cagliari

story. At least three newspapers pursued her across daunting language barriers and

by the hotel manager, brought the police to the hotel. One reporter had his passport



Prince Harry mounts his own parade after the Tropping of the Colour in London yesterday to mark the Queen's birthday. After the formal ceremony the Queen laughed as Harry, his brother William and their cousins played 'trooping' in her Ivory Phaeton./Photograph by Tony Ward.

Walters gives PM a way out on EMS

Nicholas Wapshott
Political Editor

MRS THATCHER is planning to counter moves towards European monetary union at the EC Summit in Dublin next week.

She remains unconvinced by the Delors plan for monetary union and will arrive at the inter-governmental conference in Rome in December with a British alternative based upon an idea of Sir Alan Walters, her former economic adviser.

In Rome she will put forward a detailed proposal rejecting monetary union, a common European currency and a combined central bank in favour of a much wider and looser currency regime which would embrace the dollar.

Sir Alan's plan is related to an idea suggested by the US Secretary of State, Jim Baker, to convert Nato from a purely defence organisation into a broader political and economic forum.

Sir Alan proposes that the EC, the United States and Canada should form a common free trade area with a currency regime similar to the ERM.

A Nato-based free trade area would allow other countries, such as the European Free Trade Area (Efta) members and Hungary, to join quickly.

Most importantly to Mrs Thatcher, such a free-trade area would involve no loss of economic or political sovereignty for the nations involved.

Mrs Thatcher confirmed the direction of her thinking in Moscow last week when, in a little reported interview on TV-am, she said:

'I think that Nato should be the forum for our main transatlantic relationship between the United States, Canada and Europe and we should enlarge that forum from a defence forum to a political forum. And there is no reason why we should not have much closer associations with the United States, maybe a free trade area between the United States, Canada and the Community.'

The return of Sir Alan as an instigator of economic policy is bound to cause acute political embarrassment to the Government.

Mr Nigel Lawson, the former Chancellor, resigned from the Government last year because he thought Sir Alan's influence upon Mrs Thatcher was sending contradictory signals about Britain's economic policy to the markets. Sir Alan resigned from his unpaid post at the same time.

It was confirmed by Mrs Thatcher in the Commons last week that Sir Alan is once again advising her on economic matters. Mr Neil Kinnock, the Opposition Leader, caused the Prime Minister to complain that she was entitled to see which 'family friends' she liked.

Far from embarrassing the Prime Minister, however, Sir Alan's close colleagues think that Mrs Thatcher is grateful to Mr Kinnock for making their meetings public.

As one put it: 'What was awkward before was the suspicion that he was giving advice in private. Now that it has been brought out into the open and there has been no complaint from Mr Major [the Chancellor of the Exchequer], the relationship can continue without embarrassment.'

EMS euphoria, page 33

East and West join the fight against pollution

Polly Ghazi

AN HISTORIC agreement was safety and air and water pollution affecting the region.

The EC Environment Commissioner Carlo Ripa di Meana said life expectancy in his country was seven years lower than in Western Europe, pollution monitoring and control with Western assistance and a code of environmental con-

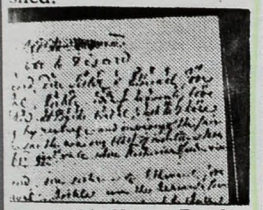
further £144m has been agreed for East Germany, Czechoslovakia, Yugoslavia, Bulgaria and

...pt to overcome his writing ...blems by composing hun...ds of poems. These verses, ...ch have been deciphered for ...first time and will be pub...ed to coincide with a Tate ...lery exhibition opening on ...June, provide a new insight ...his paintings.

...Turner's poetry emphasises ...love for the landscape along ... Thames. For him the ...mes had a powerful sym...c importance,' according to ...rew Wilton, keeper of the ...'s British Collection.

...lthough Turner jotted ...n poetry in many of his ...chbooks, the most impor... collection of his writings is ...is Verse Book. This note...s, which still belongs to the ...ner family, has seldom been ...bited. Rosalind Mallord ...ner, whose great-grandfa... inherited the verses book, ...at last transcribed it. 'Al...gh it has been in our family ... generations, it was ex...ely difficult to decipher,' ...aid.

...e problems of reading ...er's poetry explain why it ...never been systematically ...ed. For the most part writ... a barely legible scrawl for ...artist's own satisfaction, ...isolated verses have been ...shed.



...dle of the Verse Book.

...urner normally wrote in ...l, which has now faded, ...in some cases the writing ...een damaged by flooding. ...he most difficult problem ...esult of his dyslexia,' ac...ng to Wilton.

...slexia, a disorder which ...rs the abi...y to read and ..., was only ...cognised as a ...al condit...n in the late ...enth ce...ury. Turner, ...ied in 185... was therefore ...are of the ...ason he found

1953 ... the ... tant ... post... Flee... and ... Hi... the ... who ... of t... Geor... small... advis... TJ (a... *server*... cal h... Rams... ley Ba... tors. ... He ... Schola... liol, ... joined ... One o... was D... owned ... David ... father... His ... Elphin... acciden... ing the ... ted hi... youthfu... father ... he cou... by this ... He le... the Hit... first ma... munist ... Duri... trooper... Horse ... Germa... second ... from Ea... In th... *The Ob...* editor, ... on the ... was a... writer), ... manage... TJ m... sources ... econom... Bucking... wander... ing off li... 'Trist... ing mo... strategi... Richard ... *David* ...

Choosing lanes in a two-speed Europe

Philip Stephens on a clash of advice to Mrs Thatcher on moves towards monetary union

As Mrs Margaret Thatcher prepares for the European Community heads of government summit in Dublin next week, the tense debate which led to last year's political upheavals over her approach to the EC is being rehearsed again in Whitehall.

Mr John Major, Chancellor of the Exchequer, and Mr Douglas Hurd, Foreign Secretary, have been preparing a set of proposals designed to ensure that Mrs Thatcher's ingrained antipathy towards European integration does not leave Britain isolated in Dublin.

A year ago, Mr Nigel Lawson, then Chancellor, and Sir Geoffrey Howe, then Foreign Secretary, entered 10 Downing Street with a warning and an ultimatum.

The Prime Minister was told then that Britain faced a grave risk of being left behind in a two-speed Europe. If it wished to be taken seriously in the debate over economic and monetary union (EMU), it had to give a firm commitment to take up full membership of the European Monetary System. The implicit ultimatum was that if Mrs Thatcher refused to budge, she risked not only isolation in Europe but the loss of her two most senior ministers.

From that meeting, which was preceded by a lengthy official minute signed by both ministers, came the conditions Britain set out at the Madrid summit for participating in the EMS exchange rate mechanism. From it too stemmed Sir Geoffrey's enforced departure from the Foreign Office in July and Mr Lawson's angry resignation from the Cabinet in October.

Over the past few weeks the senior officials they left behind must have been experiencing a sense of déjà vu.

Mr Hurd and Mr Major have had private breakfasts at the Foreign Secretary's London residence at No 1 Carlton House Gardens, and lengthy meetings at No 10 Downing Street.

The aim has been to nudge Mrs Thatcher sufficiently far in the direction of a commitment to Emu to prevent Britain from being consigned, from the start, to the slow lane in Europe.

In the background, Mr Nicholas Ridley – this year as last – has been trying to pull her in the opposite direction. The Trade and Industry Secretary opposes membership of the ERM as well as any move beyond that towards monetary union.

John Major (left) and Douglas Hurd: In a stronger political position than Nigel Lawson and Sir Geoffrey Howe, yet temperamentally much less inclined to seek a showdown with Mrs Thatcher

The circumstances, of course, are different from those of last year. The confrontation with Mr Lawson and Sir Geoffrey came at the end of a series of increasingly bitter rowsIt was the last throw of the dice for two ministers whose relationship with Mrs Thatcher was close to breakdown.

Mr Hurd and Mr Major are both in stronger positions and yet temperamentally much less inclined to seek a showdown with Mrs Thatcher. The conventional wisdom at Westminster is that she could not sack either without seriously jeopardising her own position, but equally neither will force her hand.

Nor are they entirely at one on how far they should seek to nudge her in the direction of her European partners. Mr Major is said to be more cautious than Mr Hurd about just how far she should and can be pushed.

Coincidentally, Mr John Kerr, the same Foreign Office mandarin who drafted the fateful Lawson-Howe minute before Madrid, has been co-ordinating the preparations for Dublin. There has been tension this year, but not the same air of intrigue and conspiracy generated last year

Mrs Thatcher too has changed, albeit reluctantly. The original suggestion last year was that she should give a firm pledge at the summit to take sterling into the ERM within six months. That was watered down to the commitment enshrined in the famous Madrid conditions embracing closer convergence of British and European inflation rates and completion of the single market.

The Prime Minister has accepted the inevitability of ERM membership within a much tighter timescale, though her colleagues are constantly fearful that she might change her mind. In spite of the denials, officials have been scanning Whitehall diaries for a suitable date during the autumn.

She is said also to have been impressed by Mr Hurd's success in bringing talks within the Community on political union down to earth.

A positive tone and a few, distinctly modest, proposals of its own have allowed the Government to throw at least a temporary bridge between the ambitious rhetoric of its partners and its own innate scepticism.

The substance of Mr Hurd's careful negotiations with Mr Major, however, are focused on what they both regard as the most serious challenge to Britain's place in Europe.

Their starting point is a deep concern that their partners will use the Dublin Summit and the subsequent intergovernmental conference on Emu in December to accelerate further their timetable for the creation of a single European currency and central bank.

Whitehall's nightmare, according to one senior insider, is that President François Mitterrand might pass around a piece of paper committing each leader to the eventual replacement of national currencies with a single EC currency; the other 11 heads of state might sign with Mrs Thatcher refusing to do so.

This fear has led Mr Major to develop proposals to signal that if Mrs Thatcher is not ready to commit herself to the final goal then she will allow constructive steps in that direction.

So far he has suggested that Government, hitherto committed to only the first phase of the three-stage process outlined in the Delors report, is prepared to move on to the second stage.

Britain will suggest the creation of institutions to manage monetary policy in the ERM countries and, perhaps, to oversee the development of the European Currency Unit into a widely-used parallel currency.

But the Foreign Office is getting the message from Paris and Bonn that full union must been seen from the outset as a certainty rather than a possibility.

One suggestion in Whitehall is that the Government signs up for that final goal but reserves the option of withdrawing later. Mrs Thatcher is being told that similar commitments have been made by Britain in the past.

The Prime Minister has so far described such a strategy as "dishonest," citing clear, bi-partisan, majorities in the House of Commons against full monetary union. Mr Hurd and Mr Major will have to work overtime if they are to square the circle before she flies to Dublin next Sunday.

Reports urge monetary union, Page 8

EC may act after Romanian crackdown

By Judy Dempsey in Bucharest and David

Construction

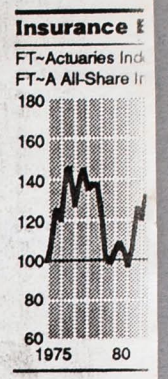
THE LEX

Researcl wrong

Scarcely a day goes by without the City's short-termism being blamed for some evil or other. Last week a Department of Trade and Industry report pointed the finger at Britain's under-investment in research and development. This subject is bedevilled by assertions with little evidence to back them. British industry has a much lower R & D spend than many of its rivals and British companies pay out a higher proportion of their earnings in dividends than those in other countries. Showing a causal link is another matter.

The DTI report points out that there is a vast difference between the R & D spending rates of the pharmaceuticals sector and the rest of British industry. But if the City were such a constricting factor on R & D spending, one would expect the sector to be at a discount to the market. In fact, it stands at a premium of more than 50 per cent. Nor has the City proved unwilling to back long term projects such as Eurotunnel. Perhaps it is easier for companies to sell "high concept" projects such as wonder drugs and cellular phones to the City than the more mundane business of widget-making. But previous studies suggest that, rather than lacking the means or opportunity to invest, industry lacks the confidence in being able to bring investments to a profitable conclusion. That raises issues not about the markets, but about the standard of British management, the education system and its links with industry.

The difficulty in tackling those long-term problems may explain the search for short-term solutions such as changes to the Takeover Code. But comparison with takeover-proof continental companies like Philips, which spends hugely on basic research to little apparent purpose, suggests



ings. Even with Willis Faber's sh news of its plans Corroon & Blac nearly 14. Ratin assume more t nent upturn in erty/casualty in For the long ha that brokers are tures, with the c potential of a Gl ness. Given Sed of no dividend 1986, this is not whatever one th lis/Corroon short-term imp deal's underlyi that the golden a ioned broking i their need to m months of wha been difficult t Willis and its partner, Johnson decade ago, the c a weak pound, rates, cowboy tac margin Lloyd's reinsurance bro keep the UK-ba earnings moving down-cycles. Mos tors no longer market still rat though they do.

The best way is to stop pricin kers by refere

PRIME MINISTER

MEETING WITH THE CHANCELLOR, FOREIGN SECRETARY AND TRADE AND INDUSTRY SECRETARY

You have a meeting tomorrow with the Chancellor, the Foreign Secretary and the Trade and Industry Secretary to discuss the line you are to take on Economic and Monetary Union at the forthcoming European Council. In fact there is a chance that discussion there will be quite limited, concerned mainly with setting a date for an IGC. But we shall anyway need agreement on the line that the Chancellor and his officials take in continuing discussion in ECOFIN and elsewhere.

In practice, I think there are three distinct issues, and there may not be time tomorrow to discuss all of them:

- when and how we launch our proposals for what should follow Stage I of EMU. There is agreement in principle that we should put forward the Butler proposals, but disagreement on whether we present them as all that is necessary and can reasonably be decided now for what should follow Stage I: or whether we have to put them forward as a step on the road to eventual full EMU. Since you and the Trade and Industry Secretary cannot accept the latter, they can only in practice be put forward as a self-standing proposal. The question is whether to do so before the European Council, at the Council or subsequently. It is probably too dense and detailed a proposal to put forward in its entirety at the Council itself. It may be enough for you to announce an impending proposal with an agreed form of words: and for the Chancellor then to spell it out subsequently in a speech.

- how we deal with the increasing propensity of the other member states to agree on Stage III? There are three points of view:

  - the Chancellor and the Foreign Secretary think we have to go along, but with an opting-in mechanism,

otherwise the Eleven will go ahead without us:

- the Trade and Industry Secretary takes the view that it doesn't much matter if they do, we should anyway be looking to a wider Community in which different combinations of countries come together for different purposes:

- and your own suggestion that we should try to widen the discussion by proposing an objective reference standard, which would also take in the dollar and the yen.

This issue is not going to be resolved tomorrow morning, but discussion may centre on the objective reference standard, of which the Chancellor's minute is fairly damning. As you point out, however, some of the arguments which he deploys against an objective reference standard could be used to rule out our joining the ERM. Where he may be on stronger ground is in arguing that we shall not succeed in diverting others from Stage III EMU by proposing an objective reference standard: they are just too far along the road.

It seems to me that you should play for a goal-less draw tomorrow:

- you are not prepared to accept Stage III at Dublin or subsequently, or to propose an opting-in mechanism:

- we should start to consider what tactics and arguments we could use to delay the conclusion of an IGC until after an election in this country:

- and we need further work on how to promote and refine an objective reference standard on its own merits (not just as a diversion).

- how to take forward your ideas on avoiding blocs and creating a wider free trade area? There is unlikely to be time to get on to this. The Trade and Industry Secretary

makes a powerful case for concentrating on the GATT round for now, but starting to look at what might follow it, in particular sectoral agreements to liberalise areas like aviation and financial services. The most important task is the need to break the deadlock on the agricultural issue at the Houston Economic Summit. You will need to speak to this point at the Dublin European Council.

You will find papers by the Chancellor and the Trade and Industry Secretary and the folder. You have read these. There are further notes by the Chancellor and the Foreign Secretary which you have not yet seen.

C D.P.

CDP

18 June 1990

jd c:chancellor

Foreign Sec.

(2)

Prime Minister

CDP
18/6.

PM/90/038

PRIME MINISTER

Economic and Monetary Union

1. I have read with considerable interest the Trade and Industry Secretary's minute of 14 June, and I agree with the paper he enclosed. I think this offers some admirable suggestions for bridging the Atlantic. I am, however, concerned about two aspects of his analysis of what might follow if we were now to kick over the EMU table.

2. First, I agree that there is much to be said for EFTA countries joining the Community. I have said as much. But we should not delude ourselves that they would not want to join EMU as well. Some of them - the Norwegians and Austrians - have already sought to join the ERM. The Austrian Schilling is already closely tied to the DM. The Swiss have the economic strength for EMU, and would have far less political difficulty with it than with e.g. free movement of persons or even full Single Market participation. If Norway and Denmark were in EMU, I doubt if the Swedes would stay out. I do not know about Finland and Iceland: I suppose they might stick with us, together with the Greeks and Portuguese, and perhaps ex-COMECON countries like Poland, if they were to join the EC in the longer term. But the bulk of EFTA would surely move straight into the upper tier.

3. The whole notion that new entrants to the Community would be opposed to further integration is fashionable but flawed. The Spanish example is worth pondering.

4. Second, I do not agree that the Japanese and the Americans are concerned only with the Single Market, and that their perceptions of us would not change if we chose to distance ourselves now from any EMU development, whether alone or in the company of a few others on the Community's periphery. UK self-exclusion would I think damage US (and Japanese) perceptions of our likely future role and influence on the Continent, and hence our clout in Washington (and Tokyo), and US and Japanese investment here. That is one of the reasons why I welcomed your decision on 31 May that the Chancellor should table proposals for a substantial Stage II.

4. I am copying this minute to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry.

(DOUGLAS HURD)

Foreign and Commonwealth Office
17 June 1990

R 19/6.

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Mr Potter

Page 4 ~~the~~ exemplifies a strand of thinking on EMU/EMU. While Govt wants to extend Stage 2 and postpone Stage 3, there is a respectable argument for getting from 1 to 3 in the shortest possible time AT 29/6

15 June 1990

Andrew Turnbull
10 Downing Street
London SW1

Dear Mr. Turnbull,

I thought you might be interested in the draft of a paper I will present to the French Treasury seminar on EMU next week. It will probably be amended in the light of the discussions and formally published in two to three weeks.

Yours sincerely.

Graham Bishop

Graham Bishop

I felt this follows on from our conversation a few weeks ago. Perhaps it would be useful to have a discussion after this seminar.

Ministere de l'Economie et des Finances

Colloque sur l'UEM

THE CREATION OF A EUROPEAN COMMUNITY "HARD MONEY" UNION

by

Graham Bishop
Salomon Brothers International Limited

21 June 1990

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THE CREATION OF A EUROPEAN COMMUNITY "HARD MONEY" UNION

Introduction

The creation of a successful European Community (EC) "hard money" union hinges on the control of public debt. In discussing monetary union, many commentators focus on the needs of the state that will issue the debt and pay little attention to the welfare of those who will purchase it. This report examines monetary union from the perspective of the electors who will be trying to preserve the value of their hard-earned savings by investing in public debt.

Savers are the owners of public debt, both directly and through the institutions that collect up the savings of the individuals of the Community and channel them into sound investments. The Single European Act, following from the spirit of the Treaty of Rome, specified free movement of capital and services. The financial part of the Single Market programme amounts to no more than governments trusting the people with their own money. There is a natural consequence: citizens will vote with their money more easily and continuously than they can "vote with their feet" - although in the Single Market they will also have the freedom to do that.

I believe strongly that, in a properly designed structure, investors can exert the necessary discipline on public debt. This discipline will show, initially, in a widening of the differential in the price of the debt of the deteriorating debtor compared with the European average. Then there is the inevitable, ultimate sanction of market discipline: the markets may no longer be willing to provide credit at any reasonable price.

A rigorous pursuit of this approach will have profound political implications, because it will make governments continuously accountable for their financial behaviour to their electorate. If citizens are indeed fit to be trusted with their own money, then democratic governments should willingly accept the verdict rather than try to create covert mechanisms to negate the electors' choice. That portion of the electorate who are also savers will notice a formal default on public debt, but creeping default - by inflation - escapes attention all too easily. 1989 witnessed a revolution in Eastern Europe as citizens struggled for democracy and economic freedom. 1990 sees Western Europe calling for democratic accountability to be enhanced within the EC. A "hard money" union will help provide this.

Our approach leads to the need for a set of rules for both the issuer and the investor, especially the financial institutions that are the intermediary for the bulk of savings. Neither group can be ignored, because they are simply the two sides of the same coin.

THE IMPACT OF SAVERS ON THE THREE STAGES OF MONETARY UNION

The principal features of a monetary union are straightforward and the Delors Committee Report restated the 1970 Werner Report's conditions:

- "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 second condition is no more than the fulfilment of the Single Market programme for financial services, because formal exchange controls have already been abolished by the major member states. The first and third conditions will be met most completely when there is a single currency throughout the EC.

The policy target of economic and monetary union (EMU) is now undoubted, if there ever was any doubt; the paper submitted to the April EC Finance Ministers meeting at Ashford Castle in Ireland states, under "the likely benefits of EMU ... i) the advantages of price stability" and, that EuroFed "should be explicitly committed to price stability."

The method of achieving EMU is set out in the Delors Committee Report in three stages. Looked at from the point of view of the saver, these are:

Stage One - A Process of Liberalisation

Stage One is "the initiation of the process" of EMU and starts on July 1, 1990. The key steps in Stage One are:

- "In the economic field ... a complete removal of physical, technical and fiscal barriers ... completion of the internal market would be accompanied by a strengthening of Community competition policy."
- "In the monetary field the focus would be on removing all obstacles to financial integration. Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented. Secondly, it would be important to include all Community currencies in the EMS exchange rate mechanism. Thirdly, all impediments to the private use of the ECU would be removed."

A Single Financial Area Is Being Created...

Considerable strides have been taken in these areas in recent months, and even weeks. Thus, the completion of Stage One looks inevitable. Nonetheless, the timescale could be lengthy. The "full implementation" of all the liberalisation measures by means of national enabling legislation may take a couple of years from the dates stated in the Directives - often January 1, 1993. Regrettably, but realistically, it may be 1995 before Stage One can legitimately be declared complete, if the current rate of progress is maintained.

A convenient test of a member state's true commitment to monetary union might well be their record on (i) negotiating Directives which genuinely match the objectives of both the Werner and Delors Reports and (ii) implementing them in national law. These Directives should impose controls on investment flows only to the extent that public policy requires prudent regulation to ensure a stable financial system. This entails removing regulations whose underlying intention is to compel financial institutions to keep their assets - the people's savings - within specific member states.

...But Covert Exchange Controls Are Still In Force...

An example will illustrate the point. In most member states, life insurance is the largest part of long-term savings by individuals. To ensure the safety of these institutions, there are generally rules to ensure a congruency between the type of risks inherent in the liabilities (the insurance policies sold to the public) and the assets. If these insurance policies promise to pay a fixed sum of money in the future, then it is reasonable for the permitted assets to exclude unhedged foreign currency holdings. There is circularity to this argument: if the rules disallow "inflation-linked" assets, then a company cannot offer an "inflation-linked" policy. Which was cause and which was effect will only be of interest to historians.

The practical result is that even the EC's 1988 Second Directive on Non-Life Insurance enshrines these congruency principles in its "matching rules." This requires a currency matching of assets and liabilities, with minor exceptions and one significant one: "this [matching] requirement shall also be considered to be satisfied when up to 50% of the assets is expressed in ECU." **But how many member states have followed through the spirit of Stage One and implemented such relatively minor concessions in their own national law?**

Stage Two - An Irresistable Force

Stage Two is the transition period where "the results achieved through the implementation [my emphasis] of the Single Market programme would be reviewed..." The Ashford paper recommends "that the Community prepare for a relatively rapid passage from the beginning of Stage One to the definitive EMU, including a common currency." This would correspond to Stage Three of the Delors Committee proposals, but the Ashford paper makes a crucial distinction: a market-driven approach to the regulation of public finances.

Potential Instability

The rationale for this swift move through Stage Two is compelling: "as capital movements are fully liberalised and as this potential is realised by the completion of the internal market in financial services, there will be an increasing sensitivity of exchange rate pressures..., the progressive achievement of the goals of Stage One therefore both undermine the efficiency of national policy instruments and make the magnitude of their task more formidable..., strong analytical evidence and historical experience confirms that such a position is not durable".

Interestingly, this analysis of the instability of the transitional phase closely parallels the criticisms made by Sir Alan Walters - former economic adviser to UK prime minister Mrs Thatcher - in a recent speech at the City University in London. The "EMS plus free capital movements" is criticised by both friends and foes for good reason. **The quantity of capital which may flow will dwarf any conceivable European monetary fund and the speed of developments will test any monetary co-operation arrangements to destruction.**

The Impossibility Of A Two-Speed Europe

The dangers of Stage Two stem from "the EMS + free capital movement." The same combination will face any state that chooses the slow lane in a two-speed Europe. Effective free capital movement has two components: absence of exchange controls and liberalisation of financial services. Spain, Portugal, Greece and Ireland have derogations from the requirement to abolish exchange controls. Once financial services are liberalised, it may become difficult and highly illogical to enforce these controls. However, the notional constraints will remain to put a barrier in the way of money flows, so that a lower speed is feasible.

Once there is effective freedom of capital movement, it is impossible to envisage a state moving at a different speed for any length of time, without being subject to the risk of such destabilising flows that it will effectively have to move in synchronisation with the faster speed. This is true for the UK now; it will apply to the other four states once effective capital freedom occurs.

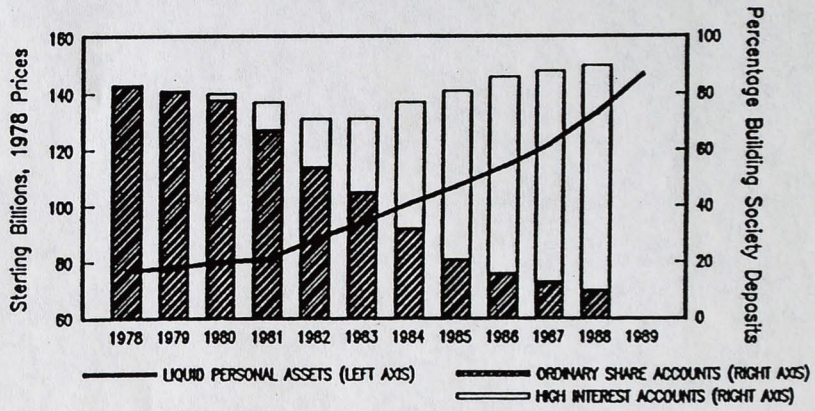
The Power Of The Saver

There should be little doubt that the single market in financial services will promote revolutionary changes over a period, which will only start once the Directives have been implemented in national law. This corresponds to the completion of Stage One. The Single Market is intended to promote competition and in this environment, where traditional boundaries will become blurred and even disappear, two selling points remain: efficient service and investment performance. We believe that the steady rise in consumer sophistication will be matched by a drive for higher performance. This may take the form of either higher returns/avoidance of risk with assets, or minimising the cost of borrowing.

Example One: UK Building Societies

British consumers have demonstrated substantial sophistication with their assets. Figure 1 provides an example of citizens' readiness to act to their own advantage.

Figure 1. Liquid Personal Assets Versus Building Society Holdings, 1978-89



Sources: Building Societies Association, Financial Statistics (CSO).

The line in Figure 1 shows that the personal sector's holding of liquid assets have roughly doubled since 1981, after allowing for the effects of inflation. Liberalisation of the banking system since 1980 exposed building societies to competition. Their customer base is regarded as financially unsophisticated, yet, once given the opportunity, savers switched almost entirely from "ordinary share accounts" paying interest at a discount of 30% or more to the market rate, into "high interest" (read market rate) accounts. Ordinary share accounts have now virtually disappeared - from 80% of funds to nothing in one decade.

The consequences of applying this degree of sophistication to their borrowings could be dramatic once the UK joins the Exchange Rate Mechanism and will increase exponentially as monetary union itself approaches.

Example Two: UK Mortgages

The "stock" of UK residential mortgages is £220 billion outstanding and their actual life, in contrast to the original 20-25 year term, is relatively short. Historically, each contract has had an average life of about seven years, but at the peak of the 1988 housing boom this had fallen to only five years. Thus the "flow" from the origination of new mortgages was over £50 billion that year. UK mortgages are floating rate - typically resulting in a rate of Libor + about 100 basis points. This gives a total borrowing cost of 16% at present. If the Government made a binding commitment to maintain the Sterling/Deutschemark rate unchanged - first, by joining the ERM and second, by signing a treaty of monetary union - there can be little doubt that a rising proportion of the electors would trust the Government's word. As a result, they would refinance their sterling mortgages with Deutschemark loans at 9%-10%.

If this were happening during a lengthy Stage Two when the UK was still attempting to pursue an independent monetary policy, then the potential capital flows would be dramatic. Most of the £250 billion stock of mortgages would be refinanced within a few years. This would create a flow so colossal that it seems unlikely that a buffer fund, or monetary cooperation, would survive intact. This extreme instability would have been caused by (a) trusting the UK citizens to make their own borrowing decisions, in the light of their elected government's pledges and (b) the failure to move rapidly to a uniform and stable monetary regime where such flows would be unnecessary. Such huge flows can hardly be described as "speculative attacks" - they would merely be individual electors rationally seeking to maximise their standard of living.

There is an implication for the conduct of UK monetary policy from this example. Once it is seen as "safe" (because it rests on the Government's pledge) to borrow in foreign currencies, UK monetary policy will cease to have any substantial effect. The citizens will simply by-pass the "high interest rate" policy - and let no one doubt that they would do so.

Example Three: Italian Public Debt

Another example illustrates again the potential scale of the instability of Stage Two. The Italian Government's debt maturity is relatively short, at about 2½ years. Given the size of the debt - close to 100% of GNP - this means that monthly redemptions of around $32 billion amount to almost 4% of GNP. Now that exchange controls have been abolished, if there were an unexpected crisis, this volume of liquidity placed back into the hands of savers each month could easily flow out of the currency as they try to protect their savings. The scale of such flows would rapidly overwhelm buffer funds and cooperation. **Again, the solution to such potential risks is to eliminate them by moving rapidly through the risky and unstable transitional phase to the stability of a single currency.**

At the Dublin Summit in April, the Heads of State made a commitment, which fell just short of an absolute deadline, to "the objective of ratification [of a treaty] by member states before the end of 1992." If that is achieved, then all the mechanisms will be ready for the start of Stage Three, and the risks of instability will rise steadily and rapidly as savers (and borrowers) begin to utilise the new freedoms which start, or should start, in 1993. Much of Stage Two amounts to enhanced cooperation between national central banks. This is already developing rapidly so that, in reality, **Stage Two will be concurrent, rather than consecutive, with Stage One.** Therefore, it is still technically possible that, by the end of 1993, the laggard member states could have implemented all the Single Market legislation and Stage Three can be implemented with the irrevocable locking of exchange rates.

Stage Three - The Search For High Quality Investments

Stage Three is the culmination of the whole process of monetary union - with a single currency issued by the European Central Bank, EuroFed. If this monetary union is to work properly and be durable, two issues must be completely resolved:

- **First, how much money is printed and who controls it.** This depends on what system is chosen for the central bank and its control, and investors can have no influence on whether this system works. I discuss this topic later.

- **Second, who is responsible for public debt.** If a country decides to spend recklessly, will the rest of the Community's taxpayers have to foot the bill? The rising reluctance of West German taxpayers to countenance a substantial tax increase to pay for East German needs suggests a very limited tolerance of such burdens.

The second question raises two interlinked issues and it is the solution of these that requires a framework of rules.

The Sovereignty Issue

Both the Delors Committee Report and the Ashford Paper highlight the need to preserve the "principle of subsidiarity" which entails leaving the maximum amount of power at the local level, rather than moving it to the Community level.

Sovereignty To Spend...

Thus, the debate on economic and monetary union has brought with it a debate on sovereignty. The proposal in the Delors Committee Report to set "binding budgetary rules" has aroused strong reactions, both for and against, because of its impact on sovereignty - implicitly, the sovereignty to spend. This follows from the elementary linkage: spending = taxation + money creation + borrowing. The proposals for monetary union would affect each of these three elements.

- The Single Market's goal is to give the citizens of Europe the four freedoms: free movement of people, goods, services and capital. If a state's tax regime is seen by its citizens as oppressive, then they will have the freedom to "vote with their feet." Thus, the Single Market will put an effective cap on oppressive taxation. Interestingly, that should not worry the current UK government, given the present composition of the tax structures - yet that government complains most forceably of lost sovereignty.

- The power to create money will now reside with EuroFed, the European Central Bank, subject to one priority task; the maintenance of price stability. It is agreed that there will be no monetary financing of public deficits.

- As borrowers, the public sector will no longer represent the perfect credit risk: the power to avoid formal default by printing more currency will have been removed from national central banks, and the latest plans for monetary union have made it crystal clear that there will be no Community bail-out of the profligate borrower. Thus, the ability to borrow will (i) depend on a state's creditworthiness, and (ii) be the residual component of the power to spend.

...Will Depend On Ability To Borrow

The result of this process is that the sovereign power of a member state to spend is ultimately limited by its creditworthiness - in other words, market discipline will be implemented by cutting off supplies of new credit ultimately. That is the moment when the elector - or the intermediary financial institution - is no longer prepared to risk further hard-earned savings.

Not Competing Currencies...

There has been much talk about competing currencies. Although "competing currencies" has a neat ring, the economic argument is really about competing "money" - debts that citizens are prepared to accept as being effectively interchangeable with currency.

A currency has two distinct roles: (i) as a method of paying for goods and services - the "medium of exchange", and (ii) as a convenient way of holding long-term savings - the "store of value". The "1992" programme emphasises the first role, because twelve separate media of exchange are obvious and substantial obstacles to a Single Market.

(Even in the UK, a single currency can be envisaged - Chancellor of the Exchequer John Major, in a recent Wall Street Journal interview, "conceded that he could even imagine the issuance of notes with the ECU value printed on one side and the pound value on the other." Interestingly, the United States is an extreme example of this type of monetary union. Warren Weber, of the Minneapolis Federal Reserve Bank, recently (WSJ 26 April 1990) pointed out that banknotes are issued by each of the twelve district Federal Reserve Banks and are specifically identifiable. However, there is "the assurance of total and irreversible convertibility", so the notes are treated as interchangeable.)

...But Competing Monies

Although the Single Market logically requires the simplicity of a single medium of exchange, or **currency**, there is still real scope for competing **monies**. States will compete to provide savers with the best store of value: the competition will be won by the state whose debt offers the highest chance of avoiding a loss in real value. (Whether this loss is caused by inflation or a formal default is of minor consequence to the saver: it is still a real loss, even though the formal default is much more noticeable). Thus the credit quality of a state's debts will determine the use of its money as a store of value, and therefore the interest rate that must be paid.

Therefore, citizens will have to look at the currency/money trade-off with new eyes. As a medium of exchange, EuroFed's single currency will be the obvious solution, because it can be used easily and cheaply throughout the world's largest economic bloc; moreover, it will probably be very acceptable in many other places as well. When savers look for a money that is a safe store of value, they will consider the risk of default. The risk of a surreptitious default-by-inflation will be common throughout the Community. If EuroFed fails in its priority task, the decision may be simple - look for a store of value outside the Community.

For savings purposes, the public is unlikely to be interested in public debts that do not pay interest, i.e. notes and coin - the traditional currency. Instead they may look at the "public money" that will compete with bank money [in the UK, National Savings versus building society deposits,] for example. Different countries have different boundaries for the final maturity of debts that may be called "money", but the improved efficiency of financial markets will blur these boundaries even more and extend the maturity range of debts considered marketable enough to be used as money. Therefore, for an increasing part of a state's debts, savers will assess the return they require on the basis of the credit risk involved in holding the public money issued by that state.

A Rolling Referendum On "Hard Money"

The result of this competition amongst the major countries could be surprising. Only the UK has a budget surplus and its indebtedness - measured by debt as a percentage of national output - is already below that of Germany, although above that of France. With Germany embarking on the unquantifiable venture of unification, the public money issued by the UK should look at least as attractive a store of value as any other. Even if EuroFed only succeeds in creating the monetary conditions that allow an inflation rate at the low end of the current European range, then there would be a major gain for the UK from this competition of monies. Eventually, the saving on the annual interest cost of the National Debt could be 3% or more - more than £5 billion annually.

This example shows the benefit of monetary union to the UK. It also shows that the UK's sovereignty to spend would be limited only by the need to keep faith with the savers of the UK, and the EC as a whole. Savers will have stored their value in UK public money, because they recognised the current sound state of public finances. If savers ever have any doubts about the soundness, they will be free to protect themselves against the risk of a formal default by withdrawing their savings from this particular store.

This rolling referendum on "hard money" policies would operate in all member states and would certainly enhance democratic accountability throughout the EC.

PRUDENTIAL RULES FOR A "HARD MONEY' UNION

"Who is responsible for public debt?" seems a simple question, but full and unambiguous answers go to the heart of the political system as well as the financial. The notes and coins of public debt have two sides: on the one side are printed the rules about issuing it; on the other, the rules governing the investors who purchase it. These rules must be designed to enhance market discipline to ensure that it operates slowly and progressively, rather than abruptly and catastrophically.

For the Issuer of Public Debt

The guiding principle is that the public finances of member states should be sufficiently sound that they cannot destabilise the EC's political and financial system.

This statement of principle immediately invites a definition of "sound." Regrettably, it is impossible to frame a numerical definition that is applicable to all member states, at all times. If debts had been incurred solely to finance long-lasting and readily marketable assets, such as houses, then the analytical approach to a company's balance sheet would be useful. At the other extreme, the debts might have financed the payment of pensions and therefore be nothing but a transfer between generations. The credit standing of these debts would then hinge only on the willingness of the next generation to pay the bill they have inherited.

The real world is a complex, and shifting, blend between these extremes. Even if we could define the type of debts, what is the "right" debt/income ratio? What is the maximum ratio? There is much alarm about Italy's debt, at 100% of GNP, but surprisingly little comment on Belgium's 135% debt/income ratio. Should more attention be given to true measures of credit quality, such as debt service ratios?

There are a number of key points for the regulation of the issuer:

Provision Of Full Information

Information on the full magnitude of a debtor's obligations must be available in order to assess its debt servicing capacity. This must include the contingent liabilities of entities beyond the central governments, such as public sector and state-guaranteed bodies. The Prospectus Directive (89/298/EEC) already requires publication of "information necessary to enable investors to make an informed assessment of the financial position of the issuer." However, Articles 2 and 5 exempt Member States and their subsidiary bodies from this requirement.

The position of commercial trading entities owned by the state - in particular, banks and insurance companies - must also be considered, as should that of private banks whose major business is gathering retail funds, purchasing government debt and holding it to maturity. The risk weighting system for bank assets, set out in the Solvency Ratio Directive, already requires a careful clarification of the exact status of these entities.

Accounting conventions and practices must be standardised sufficiently so that fully comparable data can be published promptly - perhaps by the European Commission. Prior to a common currency, the exact status of liabilities represented by notes and coins may present a problem, but that will be removed once they become the liability of the new central bank.

Surveillance

Administrative budgetary rules will be more difficult to develop and apply. At a minimum, they should require EC finance ministers to exert peer group pressure by vigorously, and publicly, warning on budgetary excesses.

Prudential Standards for Public Debt Maturity

"Prudential supervision" of public debt portfolios will be necessary. The "average life" of the debts will be the critical factor: as the maturity of a debt portfolio shortens, the risk of a sudden liquidity crisis rises correspondingly. In some case, confidence can be shaken by events that are completely outside the control of the debtor, who then will have difficulty in rolling over maturing debt, resulting in a rapidly deepening liquidity crisis; the New York City crisis of 1975 was a classic example. The risk of a liquidity crisis is particularly difficult for markets to price, because the burden, while in itself acceptable, may be poorly structured. As New York City discovered, once the liquidity crisis had struck, it proved impossible to sell significant quantities of debt even at twice the yield offered by other municipalities.

Perhaps five years might be an appropriate minimum average life. The occasional tremors of a liquidity crisis in Italy suggest that an average life of less than three years is definitely too short.

The maturity structure of public debt should be one of the specific items subject to surveillance by the EC finance ministers. If a member state allows its maturity structure to fall below the agreed minimum standards, this judgement should be publicised and lenders be obliged to recognise the decline in the quality of their assets.

EuroFed To Be Prohibited From Holding Public Debt

EuroFed should be prohibited from holding public sector debt. This would prevent its open-market operations from masking the emergence of a credit spread between different Member States and would remove completely any risk of direct monetary financing of government deficits. While an absolute prohibition may seem severe, it would remove temptation. The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money.

The risk of monetary financing can be removed entirely (as advocated by paragraph 32 of the Delors Committee Report) by this prohibition.

No Market Privileges For Public Authorities

The Ashford paper states there is "virtual consensus" that there should be no market privileges for public authorities and that this rule "could feature in the treaty." The nature of these privileges was not spelled out but various types are readily identifiable:

- Taxes - whether withholding, income, capital or turnover
- Special uses - collateral for loans from the central bank, requirements that a proportion of assets of life insurance funds, for example, be held in public debt (see page 3 above), eligible asset for banks' mandatory liquid assets. This type of regulation is at the heart of the operation of the financial system and careful thought will be required to equalise access to the financial markets, yet maintain a balance of prudent regulation.
- Special support mechanisms - the central bank's role in "stabilising" the market in public debt. Stabilisation arrangements run the risk of negating market signals and so does the surreptitious provision of monetary finance (see the section on EuroFed above).

The abolition of such privileges will have far-reaching consequences for the structure of the financial system, but, if market discipline is intended to work, then it is essential that investors are not induced, or obliged, to invest in government debt **on any grounds other than creditworthiness.** Otherwise the market's early-warning signal of a widening credit differential will be blunted - if not offset entirely. Moreover, an investor who has been legally obliged to purchase a particular asset has a strong moral case for compensation from those who imposed the obligation, if there is a default. This would create the risk of the crucial no-bail out principle being progressively undermined.

These requirements appear to be merely technical measures for the efficient functioning of the financial system. However, they do go to the heart of the political system as well, quite separately from issues of sovereignty.

For the Purchasers of Public Debt

The liberalised market in financial services must be soundly regulated.

Apart from the new risk to the financial system of public sector defaults, the "old" risks stemming from commercial mistakes will not have vanished. In reality, the competition unleashed by the Single Market is likely to reinforce those risks. The freedom to gain market share carries the reciprocal freedom to lose it. As the citizens of Europe are offered new financial services and then progressively utilise those opportunities, there will be many surprising developments. These will need the right balance of regulatory vigilance to maintain the stability of the financial system yet not stifle innovation.

However, there are direct and explicit implications for the regulation of financial markets flowing from the implementation of Stage Three. Financial systems are normally structured on the assumption that central government debts, if not those of the public sector as a whole, are free of credit risk. This assumption, explicitly restated in the Cooke Committee rules for the capital adequacy standards of banks, has been incorporated into Community law through the Solvency Ratio Directive.

In the final analysis a government can always print money to repay the nominal amount of its debts. (The consequences for the real value of the debts are a separate issue). **However, the essence of monetary union is that Member States will lose this power to create money to repay their debts,** thus eliminating a fundamental tenet of current financial regulation.

The Ashford paper talks of "virtual consensus" that there would be no monetary financing of public deficits and no bailing-out of the fiscally imprudent. However, the financial system must then be strong enough to cope with a default by a public sector borrower, or no-one will believe that the "no bail-out" rule will be applied in practice. There are some basic requirements:

Large exposure rules

The prudential regulation of any financial institution generally involves a limit on the exposure to any single debtor (or group of associated debtors): at a certain threshold of exposure, separate reports to the supervisor are often required, and exposure above the level where a loss would be catastrophic to the whole institution is prohibited.

Currently, the EC does not apply exposure limits to central government debts, which are seen as free of credit risk. **The crucial, and essential, change is the recognition that, in a European monetary union, public debt will involve credit risk.** Hence, some limits should be applied, even though public debt will remain the best credit within the Community.

Exposure limits would be set out in the directives governing the particular type of institution. Two examples illustrate how this could be done by amending existing texts:

- Article 22, paragraph 1 of the UCITS Directive (85/611/EEC), which liberalises mutual funds, limits the exposure to any one entity to 5%. Paragraph 3 raises this to 35% for "securities issued by a Member State...", while Article 23 raises the limit for such securities to 100%, but "in accordance with the principle of risk-spreading," exposure to this one debtor must be in at least six different securities.

- The Recommendation on Large Exposures of Credit Institutions (87/62/EEC) proposes a limit of 40% of own funds in Article 4, paragraph 1. Paragraph 4 then states that "the competent authorities may fully or partially exempt... the public authorities of any of the Member States..."

The recognition that public debt carries some risk, even if only a small degree, argues that these exemptions from accepted prudential standards of risk diversification be removed.

Given the aggregate of the cash value of these limits on each institution, a Member State should have adequate borrowing power within the Community. As a broad concept, the financial institutions within a given Member State might have an aggregate limit equivalent to 60% of that state's gross national product (GNP) - providing that the corresponding individual institutional limits were not so large that default would undermine the institution. As the existing debt levels of the Community average out at 60% of GNP, institutions within a "prudent" Member State would not be compelled to change their behaviour. A further substantial percentage of GNP as an aggregate credit limit for that Member State might be spread amongst the financial institutions elsewhere in the Community. What this percentage should be is a matter for further study, but the explicit intention is that no financial institution should be endangered through its own over-exposure to the partial default of a state.

An institutional financing envelope equal to, say, 120% of GNP - nearly matching the heaviest debt burden within the Community currently - might seem lax. In reality, however, this would represent a major obstacle. Once a state had used up its domestic credit limits, its total reliance on nondomestic institutions would be a powerful brake on further borrowing. Even under the best conditions, a major state rarely has had a substantial proportion of its total debt held by foreigners. Spreading limits of even 60% of GNP around the rest of the EC would probably imply quite low limits at individual institutions, reducing the risk to the Community's financial system of a default.

Because total exposure limits would be based on GNP, the financing of a reasonable annual deficit should face few impediments. A state's relative debt burden would rise only if its new deficits exceeded the growth rate of its GNP. Thus, this approach would create a cumulatively tougher financing problem for "excess" deficits, but only if these were sustained for several years.

If a Member State wished to be ever more indebted, then it would have to raise the funds from non-Community institutions (or directly from individuals) - a difficult and expensive process. External creditors would be on notice, from the public warnings of the group of EC finance ministers, and would undoubtedly demand a significant premium.

Marking To Market Of Public Debt

If the price of a country's debt begins to deteriorate, then all financial institutions should be obliged to recognise this immediately, marking the asset down to the new market price and deducting the loss from their capital bases. Member States would have to be encouraged to issue debt in a marketable form, so that the market for such debt would be genuinely liquid and substantial and the market price would be seen as a reliable indicator. All nonmarket debt would be valued using the appropriate rate interpolated from the yield curve. For valuation purposes, nonmarket debt should be valued at a penal yield premium, perhaps one percentage point above the corresponding market yield. The same principle could be applied to nonmarket debt outside the Member State's own currency. The applicable yield curve would simply be that of the domestic government.

Provided that the market price accurately reflects the risk of default, then the financial system would adjust continuously, and the actual event of default would not create a shock; the loss provisions would have been made every day along the way.

The Delors Committee Report took the view that a rigorous application of market discipline could be "too sudden and disruptive." The application of large-exposure and mark-to-market rules should ensure that a debtor is progessively shut out of the financial markets but, historically, sudden crises have stemmed from illiquidity. An excessively short maturity debt portfolio heightens this risk, hence, the importance of the peer group pressure of EC finance ministers being applied to debt maturity, under the surveillance procedures.

A Sliding Scale Of Write-Offs For Debt of Substandard Average Life

There is also a case for introducing a sliding scale of required write-offs for all financial institutions, not just the banking system. The appropriate sliding scale is a matter of debate, but the clear intention would be to force the financial system to write down asset values sufficiently such that a serious default would already have been fully provided for in the capital of those institutions holding the debt. Therefore, the threat of a disastrous default - as an alternative to a forced bail-out - would be widely recognised as hollow.

Naturally, compulsory write-offs against capital would be a major disincentive to any financial institution considering the provision of further funds to a country sliding towards a liquidity crisis and a correspondingly heightened risk of default - even if only a partial default. As soon as such write-offs become significant, institutions would require a yield premium to compensate them for the loss. Thus, the sliding scale of write-offs should induce a progressive rise in interest costs as the debts' average life declined.

Amendation Of Capital Adequacy Rules For Banks

There is a specific problem which will have to be resolved. Otherwise, there will be a paradoxical and perverse result: the prudential rules on bank capital adequacy standards will turn out to be an engine of market **indiscipline.**

This result will stem from the Solvency Ratio Directive - which enacted the Cooke Committee rules of the BIS. On the assumption that central government debt is risk free, the Directive assigned a zero risk-weighting to this debt. Therefore, if a state's creditworthiness declines to the point where its Treasury bills yield in excess of Libor then the return on the zero capital requirement for banks will be infinite. This perverse mechanism will generate huge supplies of short-term funds at yields only slightly above Libor. In other words, the cost may be a blow to national pride but will not represent a fiscal problem. Thus the banking system's search for a high return on capital will lead the debtor straight into a liquidity trap and expose the banking system to dramatic losses. Recent history underlines, all too vividly, the banking system's capacity to over-exploit these opportunities.

As EC public sector debt will no longer be risk free, this weighting system must be changed or it will short-circuit any process of market discipline and could lead to catastrophe for the debtor, even if the banks are protected by rules against "large exposures."

This plan is based upon a matrix approach. Along one axis is a set of exposure limits for Community financial institutions. These limits would be low enough to ensure that the default of a public borrower would not undermine any institution. On the other axis of the matrix is the price effect. Taking a level playing field approach to all financial institutions, the marking to market of all public debt would progressively freeze out of the credit markets those countries about whose creditworthiness the market became concerned for any reason. Hence, at the moment of threatened default, the financial system would already have written off the problem, so the threat could then be viewed entirely in the political context.

This plan is designed primarily to protect the saver from the consequences of public indebtedness, but all these mechanisms would merely serve to put all parties - politicians, regulators, electors, and investors - on notice that a problem is growing. They would create a series of ever-tougher credit crunches. Ultimately, they would ensure that the final sanction of withdrawing further credit supplies is not catastrophic for the financial system of the Community. They would not withdraw the right of any Member State to slide down the bumpy slope to fiscal ruin.

THE CENTRAL BANK - EUROFED

The creation of a successful EC "hard money" union hinges on the control of public debt. The degree of control exercised by member states will determine their success in competing to have their debt used as 'money' which the citizens of Europe can use on a store of value. However, the common factor throughout Europe will be the stability of prices. This will determine whether non-Community 'money' will be even better. Investors cannot influence whether the system works but its success is just as important as the prudence of public finance.

There are three aspects to the structure of EuroFed:

Its Tasks

There is complete agreement that "...it should be explicitly committed to price stability. Subject to this priority, the policy should support the general economic policy objectives..."

An Appropriate Constitution

The Ashford paper suggests that the "stance of monetary policy" be set by the EuroFed Council, which would consist of:

- the 12 Governors of the national central banks;
- a Board of professional staff with long, secure terms - numbering less than 12 and including the chairman;

In addition the President of the European Commission and the President of the European Council would "be present" at the EuroFed Council meetings. Democratic accountability is stressed and would be achieved by:

- periodic reports to the European Council;
- periodic reports to, and hearings with, the European Parliament.

There is stress on the need for independence - both in the conduct of policy and of the Governors from their national authorities. However, there is silence on the key question of who appoints the Board: should it be the European Parliament, the European Council or some other system?

The problem of achieving independence may be easier in practice than in constitutional theory.

First, the Community-wide abolition of exchange controls has brought into operation the market mechanism of automatic stabilisers - of capital flows. There will be no impediments to well-informed investors - either individually or collectively through financial institutions - moving their capital out of the European Community if it becomes clear that EuroFed is failing in its priority task: price stability.

This capital outflow will automatically tighten internal monetary conditions and will have a critically important role because EuroFed will not be able to "sterilise" such flows very easily. In an existing national system, an unwelcome inflow of liquidity can be sterilised as far as the private sector is concerned, by absorbing it via additional sales of government debt. This presents no problem when the government has no need to be concerned about its credit standing. However, governments may be loath to issue unnecessary debt when this is being carefully scrutinised by the markets. In particular, a government already close to a visible deterioration of creditworthiness may be disinclined to accept an additional burden. In the case of an outflow of capital, the situation is reversed. If EuroFed were prevented by its "rules" from creating additional money, then monetary conditions would be automatically tightened. In effect, the structured absence of a simple method of sterilisation will have re-introduced one of the best features of the Gold Standard - an automatic system to draw the economy back to stability.

Secondly, independent behaviour by the EuroFed Council - both collectively and individually - will be greatly encouraged by borrowing another feature of the US Federal Reserve Board - publication of policy decisions, the rationale for them and the voting record of members. Correspondingly, reports to the European Council and Parliament, together with all hearings, should be public. If there are any shortcomings in the independent pursuit of price stability, such publicity will immediately put investors on alert and enable them to take protective action.

The Necessary Powers

The central banks of Europe have evolved over the centuries in reponse to widely varying circumstances. The persistent analogies with the development of the US Federal Reserve System do not consider whether that particular balance of historical forces - principally those operating in the first third of this century - are relevant to the Europe which will be emerging a century later.

The supervision of banks and of the payments system are issues for separate discussion. Historically, these two roles have conflicted with the conduct of sound monetary policy. Hence, separate technical agencies may be better placed to perform these regulatory functions. If the level playing field concept spreads to all financial intermediaries, the complexities of regulation will grow.

This raises the risk that the principle of subsidiarity will be compromised. Already the "Ashford paper" seems to have slipped into this trap: advocating that "the national central banks would remain responsible for the smooth functioning of the national systems of payments" yet also stating that "it is clear that it should be based on the ability of EuroFed to have ... ultimate responsibility for the payment system". Therefore it is appropriate to limit the role of EuroFed solely to that which is strictly necessary to achieve its priority task: price stability. This limitation will enable the EuroFed Council to focus exclusively on its one task and remove the risk of dilution and confusion by extraneous, technical matters.

Monetary Policy

In the conduct of monetary policy, EuroFed will have "the freedom from obligations to take actions which would undermine the basic objective of stability". If Monetary Union is to be presented to the electors of Europe as a mechanism carefully designed to ensure price stability, then this formulation is too weak. It appears to leave the EuroFed Council with a voluntary opportunity, rather than "obligation", to undermine stability. There should be a formal prohibition on such actions. This would correspond to the tough proposition - on which there is 'virtual consensus' - that there be "no monetary financing of public deficits or market privileges for the public authorities".

The practical way of achieving this intention is simple: EuroFed should be prohibited from holding public sector debt. The fungibility of money means that newly created money could still flow into public debt but only through the market's willingness to purchase the debt at a price which reflected credit perceptions. The prohibition would serve to prevent EuroFed's open-market operations ["regulation of money conditions should generally be made by ...mainly open market operations"] from masking the emergence of a credit spread between different member states. It would remove completely any risk of direct monetary financing of government deficits. A prohibition may seem severe but it removes all temptation.

The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money. There will be a greater credit risk but it would not be the first time that taxpayers have lost money, whether through foreign exchange intervention or other direct policy actions such as subsidies.

Foreign Exchange

Foreign exchange policy seems a particularly grey area, perhaps reflecting the diversity of formal legal ownership of the national foreign exchange reserves - is it the Treasury or Central Bank? Nonetheless, the "Ashford paper" comes down firmly, and correctly, in favour of "foreign exchange interventions ... should not be in contradiction with the final objective of monetary policy ie price stability" As a result, it concludes that "the decision on intervention in foreign exchange markets and the day-to-day management of exchange reserves should rest with EuroFed..".

Undoubtedly, this topic has the potential to spark furious bureaucratic debate but perhaps it will turn out to be a minor issue - more contentious in constitutional theory than in practice. A common currency in the Community will, by itself eliminate a large proportion of current foreign exchange intervention. In the United States, direct intervention in the foreign exchange markets is minimal. The external value of the currency is influenced, more powerfully and permanently, by the conduct of monetary policy. Even if this conflict of ownership is not resolved unambiguously, the discipine of the financial markets will act as a stabiliser - any confusion and conflict of purpose in foreign exchange policy will be seen as a sign of weakness in pursuing the priority goal: price stability. Investors will draw their own conclusions and the capital outflow will bring into action the "Gold Standard" type of automatic stabilisers.

Memorandum

An implication of this analysis is that EuroFed will be a minimalist organisation. There will be a modest staff to support the Board, but execution of policy will be delegated to existing organisations in line with the principle of subsidiarity. There is a clear analogy with the policy-making Federal Reserve Board in Washington and the various Federal Reserve Banks, such as New York, which execute policy. The Board is less than one tenth of the size of the combined Banks (measured by staff costs), and this includes supervisory and technical functions which would be entirely outside the role of EuroFed.

The absence of an executive function focuses the market's attention on the true significance of the board and its policy-making discussions and decisions. In a world of modern communications, the physical location of such a minimal organisation is not a matter for the committment of national prestige. It certainly does not imply that the financial markets will migrate to wherever EuroFed's boardroom is located.

* * *

OTHER TITLES IN THE "1992 AND BEYOND" SERIES

Fortress Europe?, October 1988. Examines the potential problems facing Japan in its trade relationships with Europe.

Banking -- Will Liberalisation Itself Lead To A Common Currency?, February 1989. Genuine liberalisation of financial services will unleash market forces, which will, by themselves, create effective monetary union.

The Long March To European Monetary Union -- Two Practical Steps, May 1989. In part, a response to the Delors Committee Report, pointing out that monetary union was possible without binding rules. Also detailed the barriers to free capital flows caused by regulations such as the West German restrictions on the investment of insurance assets.

The Madrid Summit -- European Monetary Union IS Coming, July 1989. An analysis of EC measures on financial liberalisation and the linkage with monetary union. Discusses achievements to date and what remains to be done.

Market Discipline CAN Work In The EC Monetary Union (with Dirk Damrau and Michelle Miller), November 1989. The lessons from other monetary unions (Canada, Australia, West Germany); the New York City crisis of 1975. The market can be a more effective sanction on fiscal profligacy than binding rules.

Creating EC Monetary Union with Binding Market Rules, February 22, 1990. A plan to ensure that market discipline is certain, yet operates slowly and progressively. This plan proposes specific measures to strengthen the structure of the financial system sufficiently that a Member State's default is not disastrous.

Italian Public Debt at the Dawn of Monetary Union -- A Foreigner's View, February 1990. An analysis of Italy's debt problems, highlighting the short maturity and proposing a major foreign borrowing programme in other EMS currencies to stabilise the stock of debt.

Higher Bank Capital = Securitisation, March 1990. The combination of higher bank capital adequacy requirements and the creation of a "level playing field" for all financial services in the EC will produce spectacular change in the next five years. An inevitable result will be the emergence of a major market in asset-backed securities.

When Will Sterling Join the ERM -- Domestic Versus European Timetables (with Malcolm Roberts), March 29, 1990. An analysis of the UK domestic timetable for lowering inflation and interest rates ahead of an election, in the context of ERM membership. The European timetable has accelerated beyond ERM issues and the EC plans a common currency soon, posing a dilemma for the UK.

Eastern Europe and the European Community, June 15, 1990 (with Ann O'Kelly). Outlines the rapidly evolving relationships between the principal European blocs: the EC and Eastern Europe on the one hand, and the EC and the European Free Trade Association (EFTA) on the other.

* * * * *

Today, the EC's economic success contrasts with Communism's economic failure. EC membership has been beneficial to the countries involved: it has brought considerable economic convergence to the six original members (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany), and an increase in living standards across the Community. The EC now rivals Japan and the US as an economic power, and its importance will increase with the completion of the Single Market.

The Benefits of the Structural Funds

The EC aims to promote economic convergence between its members. GNP per head for the EC's poorest member, Portugal, is only around a quarter of that of the richest member, Denmark. To reduce these disparities in conjunction with the Single Market plan, the EC's structural funds are being doubled in size from ECU7.2 billion in 1987 to ECU14.5 billion ($17.7 billion at present exchange rates) in 1992 — equivalent to one quarter of the Community budget. A major programme is underway for resource transfers to the four least-advanced countries — Portugal, Greece, Spain and Ireland. The impact will be significant: in 1992, the transfers will represent between 2.5% to 3.5% of these countries' GNP. These transfers should increase GNP per head substantially.

If there were a mechanism to enable Eastern Europe to participate in the EC, then the next generation could look forward to a standard of living three or four times greater than their parents' current standards. The EC's original insight that economic links will promote political stability remains relevant today in the enlarged Europe.

EFTA

A Halfway House?

It has been suggested that the European Free Trade Association (EFTA) could represent a halfway house for Eastern European countries intending to join the EC. EFTA — comprising Austria, Finland, Iceland, Norway, Sweden and Switzerland — operates a free trade area for industrial goods only. It does not have a central executive authority, so each EFTA country has a bilateral free trade agreement with the EC. However, comparing per-capita GNP in Figure 1, it is difficult to envisage the countries of Central and Eastern Europe joining up with EFTA, where the average GNP per head is *above* that of the EC.

European Economic Space

In 1984, EFTA and the EC agreed to form an 18-nation European Economic Space (EES). Little progress has been made on the EES, in contrast to the 1985 plan for a 12-nation Single Market by 1992, whose success has caused some consternation in EFTA countries. Negotiations are due to begin shortly on extending the "four freedoms" — freedom of movement of goods, services, capital and people — throughout the EES. However, although the April Summit stated that *"the Community attaches great interest in, and will work actively for, early agreement with our EFTA partners on the establishment of a European Economic Area,"* negotiations are unlikely to be speedy or straightforward. The EC is preoccupied with its internal organisation and its reaction to the emerging East European countries. It fears that EFTA's lack of a central executive authority will necessitate detailed negotiations with six different EFTA countries — EFTA has requested a large number of exemptions from EC rules. EFTA, on the other hand, wishes to remain a simple trading bloc and is unwilling to form a central decision-making authority. It is also loath to take over a large amount of EC secondary legislation without a say in the shaping of future EC policies. However, the EC is unlikely to grant a share in the decision-making process to nonmembers.

As the success of the Single Market becomes more apparent, EFTA countries increasingly fear being shut out: the EC and EFTA are important trading partners, accounting for about 70% of all exports and 65% of all imports of the 18 nations combined. Increasing numbers of EFTA companies are establishing footholds in the EC by either setting up subsidiaries here or purchasing EC companies.

In July 1989, Austria applied for EC membership. If the EES negotiations fail, other EFTA members may follow Austria's move.

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European Business Analysis

1992 and Beyond

Salomon Brothers

June 15, 1990

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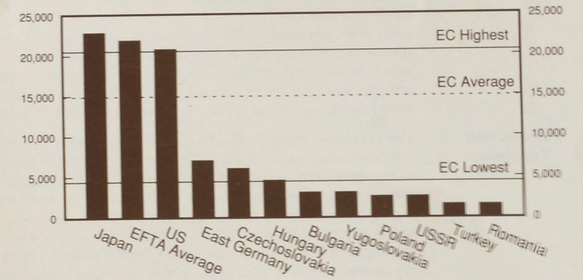
Eastern Europe and the European Community

Europe has entered a stage of rapid evolution. Over the past year, the monolith of "Eastern Europe" has broken with startling rapidity into individual, independent, newly-democratic states. The European Community (EC), on the other hand, has quickened its pace towards eventual union: January 1, 1993 now heralds not only the completion of the Single Market, but perhaps also the next stages of economic, monetary — and political — union.

The enlarged Europe contains countries of widely differing economic strength, as shown in Figure 1. If a mechanism can be found that allows Eastern Europe to share in the growing prosperity of the West, then the long-term impact could be dramatic. This report outlines the rapidly evolving relationships between the principal European blocs: the EC and Eastern Europe on the one hand, and the EC and the European Free Trade Association (EFTA) on the other.

Figure 1. GNP Per Head, 1989 (Dollars in Thousands)



GNP Gross national product.
Sources: OECD, Salomon Brothers Inc estimates.

The Evolving EC

The changes in the Eastern bloc have had a considerable impact on the EC. Although the 1987 Single European Act set a long-term goal of "European Union," the immediate preoccupation was the completion of the Single Market in 1992, followed by a measured progress towards economic and monetary union (EMU). The events in Eastern Europe over the past year have changed this timetable. Paradoxically, moves towards monetary and political union have been accelerated. The need to respond rapidly and flexibly to the changing European situation has made it clear that institutional changes are necessary in the EC structure.

The decisive stimulus came from the reunification of Germany and the wish to bind the two Germanies together under a "European roof." (Interestingly, the wish to bind postwar West Germany to a wider, peaceful Europe led to the formation of the EC's forerunner, the European Coal and Steel Community.)

In April 1990, West Germany's Chancellor Kohl and France's President Mitterrand added political union to the EC agenda: *"Given the profound changes in Europe, the establishment of an internal market and the realisation of economic and monetary union, we believe it is necessary to accelerate the political construction of the 12 [EC countries]. We believe the time has come to 'transform the nature of relations between the member states into a European Union and to give this the necessary means of action,' as stated in the Single European Act."* The special EC Summit on Eastern Europe, held in Dublin on April 28, concurred: *"a point has now been reached where the continued dynamic development of the Community has become an imperative. . . . The European Council therefore agrees that further decisive steps should be taken towards European Unity."*

Economic and Monetary Union

The first stage of EMU starts on July 1, 1990. An Intergovernmental Conference (IGC) opens in December 1990 to draft changes to the Treaty of Rome in order to facilitate the next stages of EMU. The April Summit has now accelerated the IGC's deliberations by setting *"the objective of ratification by Member States [of Treaty changes] before the end of 1992."* Given general agreement that Stage Two of EMU be brief, it could even be possible that 1993 might see a common currency and a European central bank.

Political Union

The April Summit *"reaffirmed its commitment to political union"* and stated that *"the Community will act as a political entity on the international scene."* EC foreign ministers are to carry out a detailed examination of *"the need for possible treaty changes with the aim of strengthening the democratic legitimacy of the union, enabling the Community and its Institutions to respond efficiently and effectively to the demands of the new situation, and assuring unity and coherence in the Community's international action."* EC foreign ministers are to prepare proposals for the Dublin Summit at the end of June, which looks likely to call *"a second intergovernmental conference to work in parallel with the conference on EMU with a view to ratification by Member States in the same timeframe,"* i.e., before the end of 1992.

Democratic Legitimacy

The proposals being worked out by foreign ministers are likely to involve institutional changes in the EC's structure. Although the Community is devoted to the democratic ideal and a commitment to democracy is a precondition for entry, its own structure shows a considerable "democratic deficit." An increasing proportion of the laws governing EC citizens originates in Brussels and is approved by the Council of Ministers in closed session, often in late-night "horse-trading" sessions. Commissioners, appointed by national governments, swear allegiance to the Community when they take office, but have little democratic accountability — the 17 Commissioners may be sacked as a group by the European Parliament (EP), but not individually. The directly elected EP has little power: it can amend legislative proposals, but may not originate them, and in some countries, institutional links between the national parliament and the EP are inadequate.

Options being floated for institutional changes include a greater role for the EP, perhaps including the power to elect the President of the Commission, an increased use of majority voting in the European Council, and the formation of an "EC Senate" from members of national parliaments.

The next few years are likely to see considerable changes in the EC from the completion of the Single Market and from the steps taken towards union. However, in view of the historic changes in the rest of Europe, the EC may need to guard against letting its internal preoccupations create a "Fortress EC" within Europe.

The Breaking Up of the Eastern Bloc

In 1989, the "Year of Revolution," the Communist monopoly of power disappeared in Central and Eastern Europe. The new democratic governments are turning to the West for assistance with vast economic and structural problems.

Western Aid

Substantial aid from the G-24 group of Western industrialised nations is being coordinated through the European Commission — $12 billion has been pledged so far, mainly to Poland and Hungary. The EC itself is giving ECU500 million ($610 million) in aid to Central and Eastern Europe this year, ECU850 million ($1.04 billion) in 1991 and ECU1 billion ($1.2 billion) in 1992. The European Bank for Reconstruction and Development (EBRD) has been set up, with a capital of ECU10 billion ($12.2 billion) provided by 40 different countries, of which 51% is from the EC. At least 60% of annual lending will be to the private sector.

However, aid from the G-24 governments — whether bilaterally or via the EC — should only be a small part of the capital that could flow into Eastern Europe under the right conditions. Eastern European countries will need to make radical economic changes and develop more sophisticated financial systems. Sensibly, these systems are being created so that the Eastern European countries can easily be subject to EC "mutual recognition" standards. This change should enable EC private sector capital flows — both debt and equity — to move autonomously to fund projects that offer good economic returns.

Trade Agreements

The EC has just signed "first generation" bilateral trade and economic cooperation agreements with Poland, Hungary, the Soviet Union, Czechoslovakia, East Germany and Bulgaria. (The EC gained formal recognition by the Eastern bloc only in 1988.) These agreements gradually remove quotas on imports to the EC and promote economic cooperation. At present, Eastern European countries account for only around 3% of total EC trade — a slightly lower percentage than when the Community was founded.

Association Agreements

The EC is now planning "second generation" association agreements. The April Summit stated that *"discussions will start forthwith . . . on Association Agreements with each of the countries of Central and Eastern Europe, which include an institutional framework for political dialogue. The Community will work to complete Association negotiations with these countries as soon as possible on the understanding that the basic conditions with regard to democratic principles and transition towards a market economy are fulfilled."*

The agreements would possibly involve a customs union with the EC and improved access to EC finance. However, in view of the uncertainty of economic development in Central and Eastern European countries, the EC is unwilling for the agreements to include an explicit commitment to eventual membership. (A similar commitment in Turkey's 1963 association agreement is felt to have tied the Community's hands.) Poland, Hungary and Czechoslovakia are eager for association negotiations to start and all have expressed a wish to join the EC — Czechoslovakia hopes to fulfil the conditions for membership before the end of the decade.

Who Can Join the EC?

According to Article 237 of the Treaty of Rome, *"any European State may apply to become a member of the Community."* Democratic government is a precondition — Greece, Portugal and Spain were considered for membership only after the restoration of democracy. The conditions of admission must be approved unanimously by the European Council and by an absolute majority of the EP. Agreement must then be ratified by all the contracting states.

Negotiation of membership is a lengthy process, because new members are required to accept not only all the provisions of the EC Treaties, but also the entire *acquis communautaire* — that is, all the secondary legislation. Negotiations deal mainly with the length and nature of the transitional period during which the applicant state must modify its existing laws, and the provisions that are to be included in such transitional arrangements. (For example, Portugal and Spain applied in 1977, signed the Treaty of Accession in 1985 and became members on January 1, 1986, with a seven- to ten-year transition period for aligning import duties and the Common Agricultural Policy.) However, Central and Eastern European countries will in any case need to make radical structural changes; if legislation and manufacturing standards compatible with those of the EC are adopted, there will be less need for a long transition period.

Two applications for EC membership are already pending: Turkey applied in 1987 and Austria in 1989. The EC has stated that it does not intend to consider enlarging the EC until after the completion of the Single Market.

Economic Compatibility

The EC is also not eager to admit new members with an economic level well below that of the EC. Turkey's economic backwardness is one of the reasons cited for deferring negotiations on its entry application. Turkey's GNP ($1,500 per head) is around one third of that of the EC's poorest member and is also below that of all Eastern European countries, except Romania. (However, Eastern European GNP data are less than reliable.) On the evidence of Figure 1, East Germany, Czechoslovakia and Hungary are nearest to being possible candidates for EC membership — the success of Poland's economic experiment will not be clear for some time.

East Germany

East Germany is a special case: it will be incorporated in the EC through its reunification with West Germany. Economic, monetary and social union between the two Germanies has been fixed for July 1, 1990. Formal reunification will probably take place under Clause 23 of the West German Constitution, whereby the reconstituted East German *Länder*, or regions, vote to adhere to the Federal Republic. According to the April Summit, *"integration [in the EC] will become effective as soon as [German] [re]unification is legally established. . . It will be carried out without revision of the [EC] Treaties."* Reunification costs are being borne by West Germany without recourse to the EC, and there will be a transitional period for the introduction of EC regulations.

The Lure of the EC

The fundamental attraction of the EC for Eastern Europe is its economic success. The EC was set up at a time when Central and Eastern Europe were under Communist rule and a new society was being constructed according to Marxist-Leninist rules. The 1951 European Coal and Steel Community (ECSC), and its 1957 successor, the EC, were founded to knit Western Europe together as a counterbalance to a perceived threat from the East. Despite its name, the ECSC had far-reaching ideals: *"to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts."* Its goals were *"economic expansion, growth of employment and a rising standard of living in the Member States."*

Please send up to file:

1

PRIME MINISTER

ECONOMIC AND MONETARY UNION: OBJECTIVE REFERENCE STANDARD: NORTH ATLANTIC FREE TRADE AREA

I attach a contribution from the Trade and Industry Secretary on Economic and Monetary Union, and on ideas for a wider transatlantic free trade area.

I also attach a Treasury note on an objective reference standard, as an alternative to EMU.

Both are relevant to the meeting with the Chancellor, Foreign Secretary and Trade and Industry Secretary which we hope to squeeze in on Tuesday morning. But the main purpose of that meeting will be to decide whether and when to launch our proposals for Stage II of EMU (the 'Butler' proposals).

Ridley Paper

Mr. Ridley's ideas on EMU can be summarised as follows:

- the UK would not be much disadvantaged from the point of view of trade and investment if we remain outside EMU. It's the Single Market which really matters.

- anyway, we should work on the assumption that the Community will be enlarged after 1992: we should be able to contemplate with equanimity a 'variable geometry' structure, with different groupings within the Community for different purposes.

- meanwhile we should make a virtue out of necessity and seek political benefits from standing out against EMU and fighting for our independence.

On the trade side, Mr. Ridley's view is that our first priority has to be to complete the Uruguay Round and we should not float any other proposals for fear of distracting attention from that over-riding objective. Once that is achieved, we should focus on sectoral arrangements to bring about further liberalisation,

e.g. of financial services, aviation and public sector procurement. He does not see any future for a North Atlantic Tree Trade Area as such, more because it is not negotiable than because it is not desirable.

The Treasury paper is dismissive of an objective reference standard. It would involve the loss of national monetary discretion: interest rates would move automatically and might overshoot in a big way: price stability could not be guaranteed: and anyway there is no realistic chance that by launching a proposal of this sort, we could head off EMU - the others are too committed to it, and would see our proposal as a wrecking tactic. Anyway, you can have a single European currency and an objective standard.

The Chancellor's conclusion is that this is not a way out of the fix we are in on EMU. The only satisfactory course is that recommended in his earlier paper: i.e. agreeing to the objective of EMU but with an opting-in mechanism.

You will want to read the papers and form your own judgement. But the following points strike me:

(i) Mr. Ridley may well be right that a free trade agreement with US and Canada may not be the best way to develop freer trade;

(ii) the Chancellor may well be right that there is no prospect at present of interesting anyone in an objective standard and particularly in Alan's extreme form of ECOM which removes all discretion from monetary policy; and that in any case it is more likely to be seen as the development of EMU than an alternative to it. But

(iii) that does not have to lead you unavoidably back to the Chancellor's negotiating stance on EMU. On this, Mr. Ridley is surely correct: before all this happens, we shall have joined the ERM and our isolation will be less apparent: and anyway we shall be in a very different sort of Europe. That may mean parting company with the Eleven if they insist on taking

decisions now, which will only be implemented under conditions which they cannot now foresee. It will probably all look very different. We should not allow this to be a defeat but as a stand for a wide, variable geometry Europe.

We will put up briefing for your Tuesday meeting after the weekend. Realistically, I don't think you are going to get very far with radical ideas before the European Council in ten days time. You need to develop them in slower time as part of the wider 'Bruges' vision of Europe's future, rather than as something operational in the short term. What we really need is one or two good articles and publications to flesh out the ideas. The IEA and the CPS might be able to do something: you could also talk to Jimmy Goldsmith. Your speech in Aspen would be an occasion to develop the thinking.

C.D.P.

CHARLES POWELL
15 June 1990

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PRIME MINISTER

AN OBJECTIVE STANDARD AND EMU

I have been reflecting on the idea which we discussed at our meeting on 31 May of the linking of currencies to some objective reference standard, for instance a commodity index which would work automatically, with the possibility of extending such a system to the dollar and the yen.

... I attach a short note on the proposal and a more detailed analysis by our economists. It shows that, while it has some attractions, it seems a very mixed blessing.

In particular, such a system would involve the loss of national monetary discretion. There would be no need for a central institution in the purer forms of these rule based systems. But, equally, national governments would retain no control over their interest rates which would rise automatically to whatever rate was needed to bring inflation down. Interest rates could rise very sharply and to high levels if there were shocks to the system. The effect on interest rates would be immediate so long as there was inflation in the system whereas the effect of interest rates on inflation would remain subject to long and uncertain lags. There would thus be a prospect of interest rates overshooting in a big way. To abate these effects would require an arrangement for overriding the rules which would undermine the whole purpose of the scheme.

le Alan's ECOM

In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs in operating them. A commodity indexed reserve asset system might avoid the latter but it exists at present only in theory and to establish such a system would require an immense amount of work. There is no certainty that an operational scheme could be devised or, if it could, that governments would find it acceptable and the public find it credible.

Turning to tactics, I very much doubt whether launching such a proposal would succeed in leading the Community's current EMU endeavour off in a different direction for a number of reasons.

To the extent that the approach has merits there is no reason why we or others should not adopt it now. Yet no major country (nor any minor one so far as I know) has shown interest in such an initiative as a practical proposition. That is not to say that they could not be persuaded to look at it. But even getting them to address the issue could take quite some time, almost certainly beyond the beginning of the IGC.

Secondly, there is no inconsistency between a single European currency and an objective reference standard. Indeed, there would be those who would argue that the most certain route towards linking the major currencies to an objective reference standard would be through the creation of a single European currency managed by a European central bank which was required to minimise inflation. This would create a tripolar currency world of the dollar, yen and ecu which could then be linked through an objective reference standard. That is certainly not the route forward that we would have in mind.

More important, the attachment in other EC Members - for political and economic reasons - to the ultimate goal of EMU as now

conceived is very strong. An initiative for a commodity index would be seen either as irrelevant to that or, more probably, as a deliberate wrecking tactic.

All this leads me back to the difficult conclusions described in my minute of 24 May. Short of circumstances that are difficult to conceive, eleven Member States are intent on agreeing Treaty amendments for a single monetary policy and monetary authority. To let a Treaty of Eleven be signed would, I think, have grave economic and political consequences for our country as well as causing difficulties with many of our supporters at a crucially sensitive electoral time. Yet to sign a Treaty committing the UK to a single monetary policy and all that went with it is impossible. So I continue to believe that the course I proposed in my minute of 24 May is the least bad way forward.

We agreed on 31 May that we could make public our detailed ideas for Stage 2 at a suitable time. The Bank are proposing to put them forward for discussion in the Central Bank Governors' Committee and I am working on a speech which I will send you shortly.

I am sending a copy of this minute to the Secretary of State for Foreign and Commonwealth Affairs and to the Secretary of State for Trade and Industry.

[J. M.]
14 June 1990

CONFIDENTIAL

EMU: OBJECTIVE REFERENCE STANDARDS

The attached paper discusses possible objective reference standards to which European currencies and perhaps the dollar and the yen could be linked so as to provide an alternative monetary system to Delors Stage 3. The main features of such systems and their advantages and disadvantages are summarised below. The discussion is at a simplified level: the details are potentially very complicated and, given the lack of experience of such systems, would take a lot of work to develop.

What are objective reference standards?

2. The paper considers three broad possibilities: the gold standard, the commodity standard and a standard based on an index-linked reserve asset (ILRA). In each case the basic idea is that currency is issued to the extent of the value of assets in the hands of the monetary authority.

3. In such systems the value of money moves in the long term inversely with the availability of the asset which backs the currency. More gold (or commodities, or ILRAs) will devalue money, that is raise prices. Thus the general price level will depend on the amount of the reserve asset in existence. Although history suggests that the supply of gold and commodities can be sufficiently stable over long periods of time to produce a reasonable degree of price stability, there is no guarantee of this. Moreover, prices could fluctuate in the shorter term in response to fluctuations in the gold or commodity markets. ILRAs can be created by governments, but the real value of the reserve asset is constant by definition.

How do objective reference standards work?

4. Price stability is not instantaneous. The mechanism by which it comes about in the long term is the same in most respects as with conventional monetary policy. In both cases a price rise,

for example because of an increase in the oil price, means that the real amount of money in circulation is reduced, and interest rates rise as people seek to obtain money to maintain their transactions. Higher interest rates reduce activity in the economy and eventually bring prices back into line.

5. Objective reference standards produce a more automatic response of interest rates than conventional monetary policy as people seek to exchange money for the reserve asset. Thus the initial rise in interest rates under an objective reference standard could be immediate and sharper, leading to a more severe recession. There might be overshooting of interest rates initially. Because monetary authorities in a conventional system have discretion over the speed and scale of any interest rate response, they are likely to choose a more gradualist route than would be automatically imposed by a system based on an objective reference standard. This point is closely related to that which arises in the monetary base control debate: the more automatic nature of this system of monetary control is similarly likely to lead to faster and sharper interest rate changes than conventional monetary control.

6. Discretionary behaviour by the monetary authorities could be grafted onto an otherwise automatic objective reference standard system. But some of the benefits would thereby be lost: the chances of achieving price stability in the long term would be weakened, and inflationary expectations in the private sector consequently less favourable. Moreover, if discretion is to be allowed anyway, there seems little point in introducing novel and untried objective reference standards only in order to override their mechanisms in practice. In practice, there would sometimes be very strong pressures on governments to override them.

Economic advantages and disadvantages

7. The essential choice between an objective reference standard and conventional monetary policy is therefore one between on the one hand the greater counter inflation certainty which,

subject to deviations caused by fluctuations in the supply of gold and commodities, they offer, and on the other hand the loss of the ability to react in a discretionary way to shocks, so that the monetary authorities just have to accept whatever movements in interest rates and the real economy the system throws up. Some might see this loss as an advantage because it removes governments' ability to pursue policies which could be inflationary. The debate about automaticity versus discretion in monetary policy is not a new one. Despite the short lived flirtation with monetary rules in the 1970s and 1980s by some monetary authorities, all major countries including the UK have clearly chosen discretion. It would be a major shift of direction to opt now for automaticity.

8. As between the three alternative versions of objective reference standards, the gold and commodity standards suffer from:

- their inability to guarantee price stability in the long term;

- their exposure in the short term to fluctuations in the supply and demand of gold and commodities;

- the costs of storing gold or commodities to act as backing to the currency.

On the other hand, an ILRA system has never been tried. An enormous amount of further analysis would be necessary before we could be sure that we could design an operational system which was both efficient and non-inflationary. And it would need to establish credibility before it could be expected to work well.

Objective reference standards in EMU and wider contexts

9. There are three main ways in which an objective reference standard could be introduced:

(a) the UK (or another country) could introduce it unilaterally;

(b) it could be introduced by a new institution as a parallel currency alongside all existing currencies;

(c) a new Community institution could introduce it as a new single Community currency to replace the existing 12.

10. The UK's evolutionary approach to EMU suggests that we should be arguing for going through all three stages in turn, or perhaps starting in the second stage with a view to moving onto the third stage. If we argued for starting in the second stage, we would be exposed to the challenge that, if we think objective reference standards are so good, why do we not introduce them in the UK first. Although there is a response to this (we are content with monetary policy as conducted by national monetary authorities now but Community systems need a new approach), it may not convince others. Another disadvantage of starting in the second stage is that there would be a serious risk that the new parallel currency based on an objective reference standard would never achieve critical mass and so not act as an effective competing currency.

11. Thus there are difficulties about moving gradually towards a European or wider system (ie embracing the dollar and the yen) based on an objective reference standard. On the other hand the UK would not find it easy, in view of our known scepticism about EMU, to argue credibly for moving straight to a new single currency. This third stage would involve a complete loss of monetary sovereignty, albeit to market forces operating through a set of rules rather than to a new institution.

12. More importantly, our Community partners have no interest at all in systems of this type. With one or two rare exceptions, Community governments and central banks have consistently and clearly favoured discretionary monetary policy over automaticity. They are also likely to be extremely wary of systems which are completely untried in modern circumstances. And they are anyway strongly committed to a conventional approach to monetary policy as embodied in the Delors proposals.

Conclusions

13. An objective reference standard could produce more counter inflation certainty than conventional monetary policies at either national or Community level. But it would be largely automatic and so would impose movements in interest rates and the real economy which governments and monetary authorities would have to accept. As with monetary base control, these movements could be sharp. In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs associated with operating them. An index-linked reserve asset system would be entirely new and would require time to establish the details and, more importantly, credibility. Without much more study we cannot be at all certain that it would work.

14. Other Community countries are unlikely to have any interest in this approach. They would have doubts about its desirability in principle, and would not be prepared to invest time and effort in working out operational arrangements given their commitment to conventional monetary policies within a Delors Stage 3 framework. Any UK initiative along these lines could well be regarded as a wrecking tactic and could damage our negotiating position in the IGC.

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EMU: OBJECTIVE REFERENCE STANDARDS

Introduction

1. The purpose of this paper is to consider possible schemes of monetary reform which involve the use of some objective reference standard, for example gold, to which the value of money would be linked. The main types of objective reference standard that might be considered are:

- gold;
- basket of commodities;
- index-linked reserve asset (ILRA);

2. Clearly there are a number of possible variants for each of these, both in terms of the standard itself and the way in which the schemes might work. What they have in common is that the unit of account is defined in terms of something - the objective reference standard - other than the medium of exchange itself.

3. There are two main reasons for seriously considering such schemes. Firstly, they may provide a better way of achieving price stability and preserving the value of money. Secondly, and for present purposes more importantly, they may provide a viable alternative to Delors stages 2 and 3 without the need either for a new monetary policy institution at Community level or for a single currency. A simple European standard could be envisaged in which all 12 currencies would be defined in relation to the chosen commodity. More complex schemes could also be accommodated within this framework. For example one of the schemes examined below involves setting up a new currency based on an index-linked reserve asset alongside national currencies.

4. This paper discusses alternative models as though they apply to the EC alone. But all could be extended to the dollar and yen without significant difficulties of principle. Indeed, if a scheme were working well with a high degree of credibility then it is possible that non-EC countries would wish to join. It therefore has an obvious advantage over Delors stage 3 where

participation in the currency scheme also implies full institutional integration.

5. The paper starts with a consideration of traditional gold and commodity standards, primarily to show the principles of how such schemes work. It then considers more modern versions based on index-linked reserve assets (ILRA) which in principle overcome some of the shortcomings of traditional commodity standards. A final section compares possible schemes with the single currency and European Central Bank of Delors stage 3.

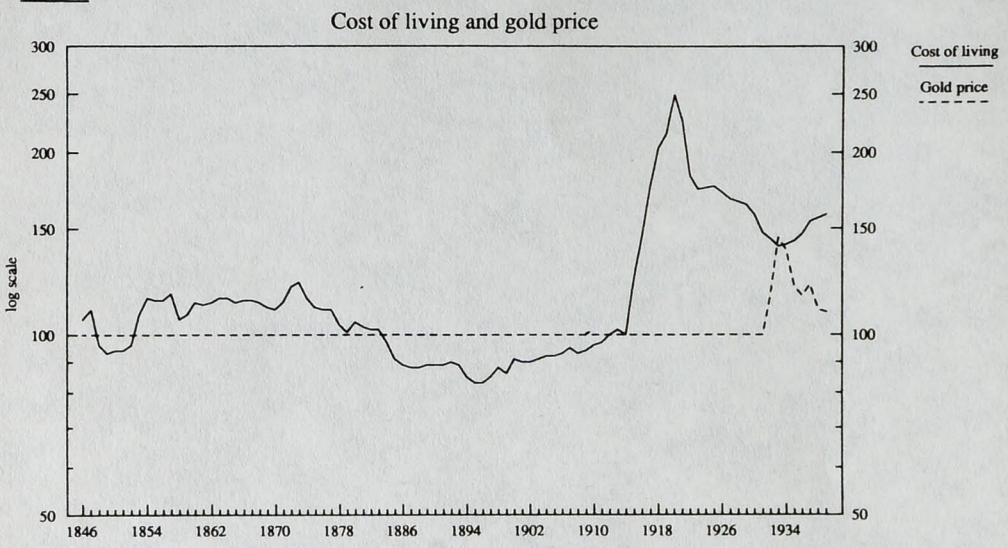
Gold Standard

6. There is a range of possible gold and commodity standards. Common to all is the fixing of the unit of account, e.g. a pound sterling, in terms of a fixed volume of gold or of a basket of commodities. Under the international gold standard system which operated between 1870 and 1914 Britain and most other countries operated a fully convertible system, with gold itself playing a vital role. Private individuals generally had the unrestricted right to buy gold from and sell it to the central bank, and to export and import gold. Thus there was full convertibility of sterling, and free movement of capital between countries. Each country fixed, de facto, the value of its own currency against gold. As a consequence exchange rates between currencies were fixed.

7. Under a pure gold standard there is a link between the aggregate supply of gold and the global inflation. With constant velocities of circulation, an expansion of gold supply leads to a fall in the price of gold relative to all other commodities, and hence a fall in the value of money. In other words the general price level rises. At the individual country level any tendency for prices to rise faster than elsewhere would lead to an outflow of gold as individuals found that a given quantity of gold bought more goods elsewhere. This in turn would reduce the money supply in the more inflationary country, and this process would continue until prices had been brought back into line.

8. Whether the pre 1914 gold standard actually worked in this way is still debated. In practice central banks exercised some discretion and changed interest rates so as to influence flows of gold. Credit conditions therefore changed both because of the automatic gold flow mechanism and also as a result of discretionary policy. But there is no doubt that price stability was quite good, as chart 1 illustrates.

CHART 1



9. Under the gold exchange standard system used during World War 1, and, in the UK, from 1925 to 1931, it was no longer possible to convert currency for gold, although its value remained fixed in terms of a quantity of gold. Also, reserves of dollars or other foreign currencies were held alongside gold, enabling countries to avoid the feed-through from changes in their reserves onto the domestic money supply. Similarly, gold inflows could be sterilized by open market operations. Thus much greater reliance was placed on discretionary action. The failure of both surplus and deficit countries to take appropriate action is sometimes cited as a reason for the breakdown of the system.

10. This brief description brings out some of the pros and cons of gold standard systems. In principle, in its pure form, it offers a system which could be fairly automatic in operation and give a high degree of price stability. In practice, a pure gold

standard would almost certainly be unworkable, either for a single country or group of countries, in present day conditions:

- The tightness of monetary conditions, and hence prices generally, would depend on the supply of gold. Producing countries such as South Africa and the USSR would have undue influence. The price of gold has fluctuated much more in recent years than it did pre-1914.

- There would be significant transactions costs, as gold was stored by and moved between central banks.

- Under difficult conditions, for example the oil price shocks of the 1970s, governments would find it hard to resist calls to override the system, either by changing exchange rate parities or interest rates.

11. It would therefore make little sense nowadays to revert to a purely gold based standard on an EC wide basis. Changes in the supply of gold, either newly-mined or from non-EC countries' existing stocks, would affect the value of the nominal anchor and hence prices in Europe in a way which bore no relationship to underlying fundamentals.

A modern day commodity standard

12. In the light of evidence that the real price of groups of commodities have been less volatile than those of gold or any single commodity, a better standard might be one based on a bundle of commodities. The goods chosen would need to be transportable and storable since it would be an important feature of the system that money could be redeemed for the commodity bundle, by governments and central banks if not individuals. Thus metals such as copper, and wheat and oil might be included, but not manufactured goods. For reasons of price stability the composition of the commodity bundle should ideally be such that the individual prices varied together as little as possible, and no single commodity had a dominant weight. It might in practice

be difficult to make this choice, there has been a tendency for most commodity prices to move together quite closely.

13. The advantages and disadvantages of a commodity standard compared with present day monetary systems are very similar to those of gold. However, compared with a gold standard it might give better price stability since supply factors might have less influence on monetary conditions than under gold. But there would be a price to pay for this advantage. Transactions and storage costs would be much higher. This would be especially so if perishable or bulky commodities, such as wheat or oil, were included. This is probably the main reason why in practice the idea of a commodity standard has found little favour. To our knowledge it has never been tried in modern times.

Index-Linked Reserve Asset (ILRA) system

14. An important shortcoming of traditional commodity standards is the requirement for money to be redeemed for the commodities which back the currency. As we have seen this would impose heavy transactions and storage costs. And it means that not all goods and services can be included in the commodity basket, so that the value of money will fluctuate. Some recent authors have proposed systems in which currency is defined in terms of some broadly based commodity basket, so that its value simply varies inversely with the price level. But there would be no redemption of currency for these goods. Such a system, it is argued, would have all the attractive features of a commodity system - especially stable prices and automaticity - without the disadvantages - high transactions and storage costs and sensitivity to choice and weights of the goods in commodity basket.

15. At the centre of this system would be a reserve asset (ILRA), issued by the central bank. Its market value would be index-linked to the price of a broadly based commodity basket while its par value would be fixed, as with a conventional Treasury Bill, in terms of currency. The index-linking ensures that the real value of the ILRA is constant. The currency itself, call it new pounds, would, analogously with the gold system, be

backed by ILRAs: it would always be possible to redeem currency for ILRAs of equal par value at the central bank. Although currency may be redeemed for ILRAs it is an important feature of the system that the latter cannot be used for transactions purposes, so they are not money. The final element of the system is the commodity basket whose price is used to index the market value of the ILRA. This should be as widely defined as possible, so a generalized basket of goods and services consumed in the economy might be chosen.

16. The central bank would be responsible for redeeming ILRAs for currency, and issuing notes and coins. So as to prevent too ready redemption it might do so at slightly below par, or do so only in very large multiples, thus effectively confining the redemption process mainly to commercial banks and other financial institutions rather than private individuals. It would not, for reasons explained below, be responsible for interest rate policy.

17. Under this system equilibrium would hold when 'new pounds' and the ILRA were equal in value, i.e. the ILRA was trading at par. To see how the system might work we can consider the case of a rise in the general price level of, say, 10 per cent, caused, say, by a rise in world oil prices. The market price of the ILRA also rises by 10 per cent, by virtue of its being index-linked. An opportunity for profitable arbitrage has now opened up. By redeeming one new pound at the central bank for one ILRA whose value has risen to 1.1 new pounds and then selling the ILRA, holders of cash can make a risk free capital gain of 0.1 new pounds. The opportunity for this arbitrage continues as long as the market value of the ILRA remains above the nominal value of the new pound. This will be so as long as prices in general remain above their initial, pre-disturbance, level. But it will not be in the arbitrageurs' interests to exploit this to the maximum possible extent, as explained later.

18. In practical terms, as already suggested, most of the arbitrage would probably be done by commercial banks. It is this fact which would cause interest rates in general to rise as cash is redeemed. This causes a change in the asset composition of

their portfolios, which are now less liquid because ILRAs have been substituted for cash. In order to rebuild their liquidity the commercial banks raise interest rates to attract more deposits, some of which will be in the form of cash. This rise in interest rates also reduces bank lending to the private sector. The commercial banks would therefore raise their interest rates to the point where the non-bank private sector had reduced its cash holdings by the same amount as the banks had redeemed at the central bank.

19. Interest rates would rise to the level at which the extra cost to the banks of attracting more cash from the non-bank private sector was exactly equal to the risk-free capital gain obtained from redeeming cash at the central bank. The rise in interest rates is therefore directly related to the size of the initial price increase. In practice interest rates would rise very quickly to their new level following any price rise.

20. In this light, the monetary policy transmission mechanism might in practice not be fundamentally different from that in place today. Higher interest rates would reduce expenditures, and holdings and hence inflationary pressures. The greater automaticity of the ILRA system might lead to favourable effects on expectations by enhancing the anti-inflation credibility of monetary policy. This in turn might reduce the lags between interest rates and inflation, and hence the real costs of disinflation.

21. There could be a danger that behaviour of the economy might be unstable under this system. Experience shows that the lags between interest rates, expenditure and prices are long, and that they differ among the various areas of the economy. This might mean, in the example above, that the rise in interest rates was so large that at some later date the deflationary impact would cause prices to undershoot their equilibrium level. This would initiate a rise in the money supply, as the original arbitrage process was reversed. Such instability would undoubtedly encourage the authorities to modify the system, perhaps by seeking a way to

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restore to the central bank some of its influence over interest rates.

22. The system has close parallels with that of monetary base control. Under the ILRA system the demand for new pounds would be closely limited by arbitrage through changes in interest rates. Under monetary base control the central bank varies interest rates in order to keep the growth of the monetary base in line with the target. In both cases interest rate changes would from time to time be much sharper than under conventional monetary policies. But an ILRA system has a number of essentially untried features, and it would therefore be a more risky innovation than monetary base control. Because in principle the system is automatic and depends on the behaviour of financial markets unfettered by the action of a central bank, adjustment might be more rapid and unstable than under monetary base control, where the rule for the monetary base is at the discretion of the central bank.

The ILRA system as an alternative to Delors 3

23. A number of alternative ways of introducing an ILRA system at an EC level can be envisaged.

(i) A single country could undertake a currency reform introducing an ILRA based system in place of its own currency. This would then become a competing currency, which might gradually displace other currencies with inferior price performance.

(ii) The ILRA system might be introduced as a parallel currency to be used as an alternative to national currencies anywhere in the EC. In this case there would need to be some central body to fulfil the role that the central bank would play in a domestic ILRA system. (This seems to be the idea favoured by Professor Walters.)

(iii) A single EC currency could be based on an ILRA using a Community wide commodity basket. A central EC institution would be required as in (ii).

Each of these would have significantly different properties, and pros and cons compared with Delors stage 3. In order to keep discussion manageable we discuss (ii) and (iii), with (ii) perhaps as a first step towards (iii) brought about by competition.

ILRA as a parallel currency

24. Probably the easiest way to establish this would be for national central banks to provide assets, which would be converted into ILRAs, in exchange for shares in the ILRA issuing authority. At the same time the new ILRA currency would be issued, redeemable for ILRAs and treated as legal tender throughout the Community. In this respect the ILRA currency would be another competing currency within Europe.

25. The ILRA currency would gain acceptability within the EC as and when it showed itself better able to hold its value than other currencies. Acceptability could not be guaranteed, and much would depend on whether the ILRA itself was a useful addition to private sector portfolios. There are existing financial assets with near certain real value, for example indexed gilts, and it might therefore be difficult for the ILRA to establish a niche.

26. Initially at least, it would seem unlikely that the market for ILRAs would be sufficiently large that the interest rate on them would have an influence on interest rates in general. So the macroeconomic effect of a 'competing currency' ILRA might be small, especially if its value proved to be volatile and its acceptability for international transactions limited. It is therefore unlikely that policy credibility, inflation expectations or price stability would be favourably influenced. The decisions of national central banks would still be the main influence on monetary policies. The main merit compared with Delors stage 3 of this form of ILRA would be the avoidance of the loss of sovereignty to the ESCB.

ILRA based single currency

27. In principle, under the parallel currency model, the ILRA might gradually displace other currencies. This is perhaps far fetched, and a single currency ILRA system is more likely to come about as the result of agreement between EC governments. Its virtues and drawbacks compared with Delors stage 3 would in many ways be similar to those of a modern day gold standard as described in paragraphs 6-11 above.

28. Arguments for the ILRA based system might include:

(i) greater price stability, essentially because of the link between the ILRA and the price level. This might be even greater than under a commodity standard, where there is always the possibility of a change in the price of the commodity bundle;

(ii) helpful effects on inflation expectations. This advantage would be stronger if the greater automaticity of the system led to greater credibility of policy. There would be diminished scope for political interference compared with the ESCB, provided of course that countries agreed that the ILRA issuing authority should stick to the rules, even under difficult conditions;

(iii) little or no loss of monetary sovereignty to the ESCB - the ILRA issuing authority would be confined to the task of redemption of currency and issuance. Of course, the loss of freedom of manoeuvre of monetary policy for individual countries is similar to that under Delors 3, but the loss could be to a set of rules rather than to the ESCB.

29. Arguments against an ILRA based version of Delors 3 might include:

(i) much tougher anti-inflation adjustment, with greater volatility of interest rates and/or monetary base, and hence greater instability of the real economy;

(ii) the automaticity of the ILRA would present a strong temptation to national governments, either individually or at the Community level, to override the system. Even if they did this only infrequently at times of major difficulties it would tend to undermine any possible credibility advantage;

(iii) much greater uncertainty as to how the system would work in practice. Without much more study, we cannot even be sure that it could be set up to produce guaranteed price stability in the long term. It has no close parallel in modern times. Its closest parallel, monetary base control, was adopted by the US between 1979 and 1981. The experiment was short lived mainly because of the greater volatility of interest rates that resulted. This suggests that countries are reluctant to pursue rigid rule based systems;

(iv) it would be difficult to devise and agree on a Community wide price index. Consumption patterns vary considerably between countries. It is difficult to know what implications this might have for the stability of the system.

30. Although an ILRA system might be the front runner amongst objective reference standards there are a number of powerful arguments against it as a serious alternative to Delors stage 3. It avoids the loss of monetary sovereignty inherent in the ESCB, although in terms of freedom of manoeuvre for the UK the gain might be small. It might also lead to greater price stability. But there would be no certainty in this. Governments have shown a willingness to interfere and mitigate the effects of very high or volatile interest rates. But the main argument against the system is that its macroeconomic consequences, for example for inflation and the stability of the economy, are very uncertain.

IF2 Division
HM Treasury

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PRIME MINISTER

ECONOMIC AND MONETARY UNION

I was interested to see the papers attached to Charles Powell's letter of 6 June.

His note of your meeting with John Major on 31 May records that John is determined 'not to commit the UK to a Single currency or a European System of Central Banks'. I strongly share that view. I am therefore concerned to see that the Treasury paper of 16 May says that, if we are outvoted at the IGC, we should virtually agree to do just that. I do not understand why our agreed views on the undesirability of EMU, strongly endorsed by Parliament, do not make it imperative for us stick with a refusal to join in any of these arrangements.

I quite see the desirability of finding wider and more liberal suggestions to pull our EC partners away from their overriding interest in EMU. I attach a paper on trade issues which officials from my Department and the FCO have prepared in response to the first remit in Charles Powell's minute. It makes the point, with which I agree, that we are already fully engaged with our North Atlantic trade partners in the Uruguay Round, so that anything more specifically in a North Atlantic context would have follow it, not come now. In any event, although we must always keep our eyes on the wider sphere, and encourage others in that direction, changes in trade relations are complementary to those in the monetary sphere, not alternatives or diversions from them.

I similarly look forward to seeing what the Treasury has to say on the linking of major world currencies to an objective reference standard. I am afraid that I also have my doubts

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about the capacity of any such proposals to divert attention from EMU for other than a very short while.

There may, of course, be more fruitful ideas for a diversion, but surely we should tackle our position with the EC head on? I prefer and recommend an alternative approach as follows.

The Community is bound to become larger, and one group of countries may opt into EMU, while another group will not. But neither group should be seen as inferior to the other. What is important, as I told the Bruges group last week, is that membership of the EC should become the basic foundation of a European club. Membership of that club should carry the obligation to engage in political co-operation, to operate the single market fully and firmly, and to accept the necessary obligation of enforcement. I said and repeat that tight economic and monetary union would make a wider Europe more difficult to achieve.

We should remember that one group of non Community countries (EFTA) has actually grown faster than the Community during the 1980's - by an average of 2.6% pa as opposed to 2.1% pa for the EC. We need to get these countries into the Community, but the Community should not insist that they join EMU in the development of which they will have no say.

We should continue to distinguish clearly between the Single European market and the EMU, for commentators often confuse the two. For the purposes of trade, access to markets and opportunities for investment it is the Single Market which matters, particularly for the Japanese and Americans. There is a tendency for them to think the UK will be disadvantaged for purposes of trade and industry investment if we do not join EMU, whereas the truth in that it is the Single Market which is essential for these purposes.

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We should therefore promote the idea of allowing various regional groupings or even currency agreements to emerge. Those who wished could form joint central banks to manage their currencies. But there should be no compulsion for others to join if their national instincts or economic circumstances made such a course unattractive. In our case, of course, the inability to let market movement of our exchange rate help us adjust to changing circumstances would be an enormous disadvantage and sacrifice.

Groupings in a wider Europe seems a far better approach than one in which, because we are likely to be outnumbered at the IGC, we run the risk of allowing ourselves to be manouvered into EMU by accepting the logic of a positive Stage II to the point that we should be also obliged to accept Stage III. The long-term price for short term harmony would be immeasurably greater than the short term political benefits to be derived from a day or two's respite from criticism in the Guardian - a newspaper which few read and most distrust.

To be alone in the 12 is not the end of the world, nor would we be alone if other candidates were allowed to join the EC. There is no need for any such arrangment to be seen as the "second tier of a two-tier Europe". Instead there is a political benefit in standing up for our own interests. The ERM may be a relatively harmless, although incorrect step. But there is a feeling in the country that, although we protest, we are being dragged inexorably first into the ERM, secondly into the negotiations on Stage II, thirdly into EMU itself. The British people do not want this. The important thing is to relate to the electorate by making it clear that we will have nothing to do with full EMU, and to evolve our strategy from there.

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I am sending copies of this letter to the Foreign Secretary and to the Chancellor of the Exchequer.

N R

14 June 1990

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EMU : TRADE AND GLOBAL INTERDEPENDENCE

Our Trade Objective

1 Greater transatlantic interdependence, through more open markets, would strengthen economic efficiency and political cohesion (eg helping to ensure a continuing US commitment to European defence). It would also contribute to the global aim of trade liberalisation, and, critically, should strengthen the multilateral trading system. However, the issue of closer economic links with the US cannot be separated from the Community's involvement with the wider world economy. The established forum for this is the GATT.

2 Our major current objective in trade is to ensure the success of the Uruguay Round negotiations. These involve over 100 countries representing more than 85% of world trade. They are due to be completed in December and constitute the most ambitious multilateral trade negotiation since the formation of GATT. More follow-up work will be entailed, particularly in the "new areas" such as services and intellectual property, where framework agreements will need filling out, as well as a possible remit from the December meeting to develop the exiguous organisation that is GATT into a stronger body. So there should be a substantial continuing workload facing GATT and its members from next January.

3 If the Round is successful, important new multilateral agreements and disciplines will be set up which should ease trade tensions between the EC and the US and give a big boost to these links. Any initiative should therefore be located in the context of the outcome of the Round, build on its positive elements and be consistent with GATT. This could cover further multilateral efforts and/or elements of a North American/EC Single Market approach. If the Round were to fail, we should need anway to look at alternative ways of developing EC/US trade relations.

A Europe/North Atlantic Free Trade Area (NAFTA)

4 Because of the overriding importance of completing the Uruguay Round, this is not the time to float a proposal for a NAFTA, since if it made any headway the attention of trade negotiations would be distracted from the Round at the crucial time. However, a NAFTA would be unlikely to be negotiable. The US would not be interested if agriculture were not included. But including agriculture would, in effect, mean the dismantling of the CAP and thus be

of course not!

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unacceptable to the EC (and to EFTA countries, who are themselves protectionist in agriculture). In fact, classical tariffs and quotas are not the principal barrier facing EC exports to North America. Product standards, government procurement, including defence, the free movement of services, particularly financial, and so on, would have to be considered. These issues would raise major institutional and constitutional questions relating to decision making procedures, public accountability and enforcement. The EC/EFTA dossier shows how acute the problems can be.

5 A NAFTA would be badly received by Japan, Australia/ New Zealand and the major NIEs like Korea and Singapore. They could not all be brought within a big FTA, and special arrangements for them would in any case evoke a hostile reaction from European and North American industry. Japan might be interested in FTA membership but would want agriculture excluded: Australia and New Zealand would insist on its inclusion. Yet to leave these countries out would appear to them a major and damaging step away from the multilateralism that the EC and US so frequently advocate: one result might be to stimulate closer Pacific co-operation and accentuate the drift towards regional trading blocs.

6 Thus our efforts should be within the context of GATT and strengthening the multilateral trading system. We need before too long to be considering further approaches to carry forward the process of liberalisation, particularly if the Uruguay Round looks like going badly.

Alternative Approaches

(i) Continuing GATT Business

7 Even a successful Uruguay Round will not be the end of the story. Just as the EC needed a special push to complete the Single Market, so the GATT has been extending the scope and complexity of its negotiating rounds. The Uruguay Round has been a major step in that direction. There is other major potential work for GATT - eg in restrictive business practices which can affect trade significantly but which have hardly been looked at internationally. It would serve us best if further work needed on the "new areas" fell to GATT. The Uruguay Round has also shown the need for a more fundamental look at some of GATT's existing rules, notably anti-dumping.

8 A major GATT exercise on these lines would require careful consideration, not least its timing. Initial work could not begin until after the end of the Uruguay Round. The Round's failure would mean prospects in GATT would be poor, at least in the short term. A successful Round would, however, provide a good springboard.

(ii) Sectoral Arrangements

9 The GATT already has a number of codes to which only some of its contracting parties have adhered (but almost all of the developed countries). These codes usually prescribe in detail how rather general GATT provisions such as for anti-dumping are to be applied or lay down particular arrangements as for the aircraft sector. It remains to be seen to what extent developing countries will adhere to Uruguay Round texts on the new areas in particular. If there were insufficient support for further major GATT negotiations (or indeed the Uruguay Round failed) that could lead to the negotiation of a number of specific arrangements to which would adhere those countries wishing to do so.

10 The GATT framework would be the natural home for agreements of this kind. However, they could be negotiated outside the GATT either directly between interested parties or within some other convenient organisation like the OECD: neither of these courses would prevent any agreements from being sponsored subsequently in GATT to secure wider adherence.

11 There is much scope for subsequent further liberalisation between the Community and other developed countries, in particular the US. This could, for example, cover:

(i) Financial Services

The EC is creating a Single Market in financial services, including banking and insurance. It will be open to non-EC firms established in EC. US arrangements are much less liberal. The aim might be EC/North Atlantic agreement to a "single passport" approach to financial services, ie licence to operate under one domestic authority would mean automatic access throughout the EC/US area. Subject to accommodating major differences in EC and others' prudential arrangements, this could apply to banking, investment services, unit trusts, and insurance.

(ii) Aviation

Liberalisation of transatlantic services with onward access to respective internal markets would benefit consumers and competitive airlines. There are no competence problems. But we would not wish

to erode the UK advantages of Bermuda 2, or detract from progress on internal EC liberalisation.

(iii) Standards

GATT will not produce major new agreements. EC and US are already co-operating on standard setting in Internal Market context. The next step is full mutual involvement in each other's standards making, eg CEN and CENELEC, although some of the bodies are industry based, outside government. Our ultimate objective should be to establish the principle of mutual recognition (Cassis de Dijon) throughout the North Atlantic Area, covering all manufactured goods (and processed foods). Depending on GATT outcome, phyto-sanitary standards might be included.

(iv) Public Sector Procurement

This is a sensitive area where agreed GATT conclusions are essential. But there will be scope for bilateral agreement to apply mutually-agreed rules throughout the area, particularly to utilities - telecommunications, energy, transport and water. Government procurement of services could also be included.

(v) Intellectual Property, Trade related Investment Measures and Subsidies

These are under consideration in GATT. Whatever the outcome there will be scope for wider action, eg a strengthened understanding on subsidies. It would be important to ensure a level playing field for aids and competition policy aspects.

(vi) Updating of the OECD codes on capital movements and invisibles, and the national treatment instrument

An important aim would be for the US and other federal systems to go beyond "best endeavours" for application of agreed measures to the lower tiers.

Eastern European Aspects

12 The importance of the EC's relations with Eastern

Europe make it necessary to take account of their needs. Their economies are not strong enough for them to play a full part in initiatives of the kind described above. They need help. Any initiatives in the trade field should reinforce the UK's open liberal approach to the Community and its external relations. It is therefore desirable that we build on current links with the emerging democracies, and set our proposals in the context of one Europe, whole, free and prosperous. The Single Market, EC/EFTA and EC/Eastern Europe develop this theme, and the UK has led.

13 The negotiation of individually tailored association agreements, with the aim of free trade as a major step on the road to eventual EC membership, should build on the more limited trade and economic co-operation agreements with the Central and Eastern European countries. To speed up this process the UK could propose that -

the Community consider adopting projections for import growth from these countries, as well as targets for the removal of all trade barriers. This would help increase pressure on protectionist elements;

the East Europeans be encouraged to set down for themselves, and make public, phased and targetted programmes for removing their own impediments to inward investment flows;

the negotiation, perhaps with OECD support, of a pan European charter for enterprise co-operation. This could set out rules on joint ventures, double taxation, investment protection, etc., to create a better framework for trade and investment.

Institutions

14 Following the Baker December initiative and the UK January response, the machinery of EC/US consultative partnership has been strengthened. It now includes more frequent meetings and consultation at all levels between the Commission and the US Administration; regular 6 monthly meetings between the US Secretary of State and Community Foreign Ministers, and between the US Administration and the Commission; and six monthly meetings between the US President and the EC Presidency. The importance of these new arrangements should be highlighted. They permit the trade relationship to be monitored and the scope for further liberalisation.

15 Similar formal tripartite (EC/US/Japan) arrangements would be well worth considering, both across the board and

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the department for Enterprise

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for specific areas of activity. The role of GATT will be much extended as a result of the Uruguay Round. Putting the organisation on a more formal legal basis would increase its authority, and secure more rigorous observance of GATT rules. But this should not be allowed to divert attention from the Uruguay Round.

DTI
FCO
13 June 1990

888-273

Barry

As promised

- matrix on ERM
- copy of Hansard - Treasury PQs
- copy of "Line to take".

Kate Caselton

chex.kf/kg/46

ERM

Join ERM?

- not question of whether but when
- conditions for joining well known and understood

What are conditions for joining?

Government committed to join

- when level of UK inflation significantly lower
- capital liberalisation in place throughout the Community
- real progress made towards completion of single market, freedom of financial services, and strengthened competition policy

What conditions have been fulfilled?

- significant progress on competition policy, liberalisation of financial services and particularly on capital liberalisation - exchange controls abolished recently in France and Italy
- progress is being made also on capital adequacy and investment services directives.

What inflation rate required?

- committed to reducing inflation
- key point is not reduction in rate itself, but that UK rate close to that of European partners on comparable basis (ie taking MIPs and community charge out).
- on this basis, UK April figure 6.5 per cent, EC average on comparable basis excluding UK for March (latest data) 4.7 per cent. [ERM members only 4.2 per cent]

Why do we want to join?

- an additional discipline bearing down on iinflation
- help bring welcome stability to exchange rates which will foster trade and investment

Exchange rate on entry?
Enter on wide or narrow bands?

- aim to join as support to policy to reduce inflation
- will decide details when time comes
- considering all options - not ruled any out, nor ruled any in.

Labour's pledges on ERM?

- bogus pledges: not worth the dinner tables they're uttered at in the RHG's "lunch for Labour" crusade
- say will use exchange rate policy to promote competitiveness of industry
- means pre-emptive devaluation of sterling as well as subsequent progressive devaluation
- other conditions, eg on EC wide commitments to expansionary policies, won't be acceptable to other EC countries
- ERM not panacea or easy option - eg John Edmonds (general secretary GMB) warned that when UK joins ERM, wage rises will lead to job losses "like night follows day" if not offset by productivity increases.

commitment in the Labour party's policy review document, the basic rate of income tax would have to be massively increased for everyone? Has not the Labour party always been the high-tax party and always will be?

Mr. Major: My hon. Friend makes his point entirely clearly. I am not sure that is wholly true to say that the Liberal Democrats have invariably opposed the tax decreases. I think that there was an occasion when they chose not to do so. My hon. Friend is being generous when he suggests that if a Labour Government were in power at the moment we should have a tax rate of 33p in the pound. It might well be noticeably higher. When, in due course, we get round to the detailed costing that Phillips and Drew has already attempted, we may be able to illustrate that it would be higher.

Mr. Beith: Will the Chancellor explain what he meant when he said that it was not prudent to achieve this objective of an income tax rate of 20p in the pound this year? Is he admitting that he is using the level of income tax as a tool of economic and fiscal management? Will not all Governments have to do that?

Mr. Major: The answer to the hon. Gentleman is that of course I am, as we have done and as I shall continue to do.

Mr. Arbuthnot: Is not it right that the Government have greatly increased personal allowances, so taking out of tax many people at the bottom of the income scale? Does not that give the lie to Opposition parties, which suggest that they are the only people who care about those on lower incomes?

Mr. Major: That is entirely true. By almost any measure—there are a variety that one can use—there has been a considerable increase in personal allowances at the bottom end of the tax scale. That is desirable. It is a deliberate act of policy and of course, it has kept many people out of tax who otherwise would have been in the tax net.

Mr. Nicholas Brown: This question seems to have been tabled as a direct attack on the Chief Secretary to the Treasury and I hope that the Chancellor will repudiate it. He will recall the Chief Secretary saying on BBC's "On the Record" on 13 May that the prospect of tax cuts at the moment does not look very good, that these things are always uncertain, but there is very little room for manoeuvre. Will the Chancellor explain to the House why, after 10 years of Conservative Government—a Government who have declared that a further reduction in income tax is their main objective—there is now very little room for manoeuvre? Will he confirm to the House that it is highly unlikely that there ever will be enough room for manoeuvre to enable 24 out of 25 taxpayers to pay income tax at a basic rate of 20p in the pound?

Mr. Major: Whatever else may happen in this Session of Parliament, the hon. Gentleman just won the palm for brass-necked cheek in his comments of the past few moments. There is no dislocation whatever between the comments of my right hon. Friend the Chief Secretary and those that I made at the Dispatch Box a few moments ago. One significant difference that is reflected in what the hon. Gentleman chooses to call the tax burden is that this Government tax honestly for their expenditure and do not tax for some, borrow for the rest and leave later generations to repay. When the borrowing requirement of the hon. Gentleman's party is taken into account, the tax burden in 1979 was sharply higher than it is today.

Mr. Irvine: Does my right hon. Friend agree that the Government have shown in the past that reductions in income tax stimulate economic growth and lead to an increase in overall revenue? Will my right hon. Friend take that very much into account when making his tax plans for the future?

Mr. Major: I can assure my hon. Friend that it is ever close to my mind that that virtuous relationship exists. As he may know, the top 5 per cent. of taxpayers will pay 30½ per cent. of total income tax this year compared with 24 per cent. in 1978-79 when the top rate of tax could have been as high as 98 per cent.

European Monetary System

3. **Dr. Moonie:** To ask the Chancellor of the Exchequer if he will make a statement on progress on the Madrid conditions for joining the exchange rate mechanism.

8. **Mr. Wallace:** To ask the Chancellor of the Exchequer which of the Madrid conditions concerning the United Kingdom entry into the exchange rate mechanism of the European monetary system have yet to be fulfilled.

17. **Mr. Bell:** To ask the Chancellor of the Exchequer when he expects that the conditions for the pound sterling's participation in the exchange rate mechanism of the European monetary system will be fulfilled.

Mr. Major: A good deal of progress has been made in a number of conditions for membership of the exchange rate mechanism, but they have not yet all been met.

Dr. Moonie: Will the Chancellor tell us which condition is likely to be satisfied first: a satisfactory reduction in our underlying rate of inflation or the achievement of a level playing field through the abandonment of subsidies by our European competitors?

Mr. Major: Significant progress has been made in recent months on a number of the external elements that we require before joining the exchange rate mechanism. We have made our position on domestic inflation perfectly clear and I stand by that.

Mr. Wallace: At a recent press conference the Chancellor seemed to suggest that our underlying rate of inflation was much closer to Community averages than a proper statistical approach would reveal. Was he using that figure to try to persuade the Prime Minister that we really should be joining the exchange rate mechanism, and on those grounds should Opposition Members keep quiet about the statistical flaws in his figures?

Mr. Major: It is always a distinct help to the Government if Opposition Members keep quiet, whichever part of the Opposition they may represent. In the remarks to which the hon. Gentleman referred, I was drawing attention to the fact that the British rate of inflation appears misleadingly unreasonable compared with those of our European partners simply because we contain within our inflation rate that which other countries do not, and it was in response to a question about that matter that I made the remarks to which the hon. Gentleman refers.

Mr. Bell: When we enter the exchange rate mechanism, as the Chancellor of the Exchequer proposes to do in the summer, will he go in on the tight band of 2½ per cent. or on the broader band of 6 per cent? Will he share his views on that with the House?

Mr. Major: I can neither confirm the date that the hon. Gentleman surreptitiously slipped into his question as an assumption, nor can I enlighten him on his substantive point.

Mr. Ian Stewart: Will my right hon. Friend assure us that, regardless of the specific matters spelt out in the Madrid conditions, he will not contemplate the entry of sterling into the exchange rate mechanism unless and until he regards it as fully compatible with the needs of domestic monetary policy and, in particular, that he will not do so at any time when it might mean that interest rates would have to be lowered more or more quickly than is necessary for the proper control of monetary conditions and the reduction of inflation?

Mr. Major: I am acutely conscious of the point to which my right hon. Friend rightly draws attention. The aim of joining the exchange rate mechanism is to support the policy to reduce inflation, not to damage it, and from that, my right hon. Friend will be aware of our policy.

Mr. Budgen: Will my right hon. Friend confirm that entry into the exchange rate mechanism is stage one of the Delors proposals? The Delors proposals are supported by all the Commission's bureaucrats and by all the nation states of Europe, with the exception of ourselves. Paragraph 39 asserts that entry into the first stage shall be taken as acceptance of all subsequent stages.

Mr. Major: My hon. Friend has made assertions about what the purpose of stage one might be and about the extent to which that falls within the Delors plan. The fact that the proposal is supported by what he calls the bureaucrats in Brussels does not in itself make it wrong. We have a series of sound economic reasons for joining the exchange rate mechanism. The Government set out the policy that they would join the exchange rate mechanism when certain conditions were met. That remains the policy and it will be in the interests of this country.

Mr. Tim Smith: Now that United Kingdom membership of the exchange rate mechanism has become the fig leaf behind which the Labour party has chosen to hide the private and unpleasant parts of its economic policy, would not we be better advised to join sooner rather than later so that those inadequacies can be exposed to the public for all to see?

Mr. Major: If, as my hon. Friend suggests, the exchange rate mechanism will hide the shortcomings of Labour policies, it will need to be a good deal larger than a fig leaf. It is perfectly clear that the conditions that the Labour party has set out under which it would join the exchange rate mechanism make that pledge——

Mr. Skinner: Not all of us in the Labour party.

Mr. Major: The hon. Member for Bolsover (Mr. Skinner) is correct. The conditions set out by the Labour Front Bench, without the support of the Labour Back Bench, for joining the exchange rate mechanism are essentially bogus, for the conditions mean that the Labour Front Bench could not enter.

Mr. John Smith: In the context of possible entry into the exchange rate mechanism, will the Chancellor tell us whether the sufficiency of any reduction in inflation will be assessed according to the retail prices index or according to the so-called "underlying" rate of inflation? May I have a direct answer, please?

Mr. Major: The direct answer, as I have often said, is that the rate of inflation will be assessed on the proximate rate of inflation, which means——

Mr. John Smith: The retail prices index or the underlying rate?

Mr. Major: I am coming precisely to the point. The rate of inflation will be assessed not on the RPI, but on a comparative basis to the measure in which European nations themselves assess inflation. I have repeatedly made that point clear for a long time.

Mr. Nelson: Does my right hon. Friend recall that when there were recent rumours that this country was about to become a full member of the exchange rate mechanism, the immediate effect was that the stock market rose, the exchange value of sterling became firmer and money market interest rates fell? In view of that positive response, which should have warmed my right hon. Friend's heart towards the idea of joining the exchange rate mechanism immediately, will he bear it in mind that if he felt it necessary to take an executive decision, even while the Prime Minister is abroad, to embark on that, he would earn the recognition of a grateful nation?

Mr. Major: I have had some attractive offers in my time. I am not entirely sure to what extent my hon. Friend's offer ranks among them.

I have made it entirely clear to the House now and on previous occasions that I have reached the judgment that, when the conditions that we have set out are met, it will be right for us to join the exchange rate mechanism. We must be aware of the point to which my right hon. Friend the Member for Hertfordshire, North (Mr. Stewart), drew attention some time ago, that the balance of advantage in due course is clearly to enter the exchange rate mechanism, and in due course that is what we shall do.

European Bank for Reconstruction and Development

4. **Mr. John P. Smith:** To ask the Chancellor of the Exchequer what position was taken by the United Kingdom Government in discussions on the European bank for reconstruction and development, in relation to the environmental consequences of any development undertaken.

The Economic Secretary to the Treasury (Mr. Richard Ryder): The United Kingdom, like all other potential members of the European bank for reconstruction and development, supports the promotion of economically sound and environmentally sustainable development in the full range of its activities.

Mr. Smith: The Chancellor and the Economic Secretary to the Treasury will be aware that Mr. Nicholas Bradley from the United States Treasury and other European Finance Ministers have taken the lead in calling for environmental objectives to be built into the role of the development bank. May we assume from the Minister's answer that the British Government will support them

Line to Take

'This is pure speculation. The Government is committed to joining the ERM when the Madrid conditions are met. As the Chancellor said in the House on 7 June, a good deal of progress has been made in a number of these conditions but they have not yet all been met.'

SECRET AND PERSONAL

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

14 June 1990

Dear John,

BILATERAL WITH THE CHANCELLOR

The Chancellor discussed the exchange rate mechanism with the Prime Minister yesterday evening.

I would be grateful if you could ensure that this letter is only seen by those with a strict need to know.

The Prime Minister said that she no longer had reservations about the UK joining the Exchange Rate Mechanism (ERM). The issue was when was the right time to join.

The Prime Minister said she had three particular concerns. First, it might be better to join at a time when key economic indicators, such as the RPI or the underlying rate of inflation, and wage settlements, were beginning to move in the right direction.

Second, GEMU might disrupt the stability of the ERM: it might be useful to wait and see how the Deutschmark settled after GEMU.

Third, there was expected to be an immediate bonus upon entry which could be taken in terms of a higher exchange rate or lower interest rates. But there was a risk that some months later, the markets might look less favourably upon sterling - for example if there were bad trade or inflation figures. It would be important to avoid having to raise interest rates at politically sensitive times during next year.

The Chancellor said Treasury officials were advising that the economic fundamentals were sufficiently satisfactory to permit the UK to enter ERM on the wide bands at a convenient opportunity. However, he had not yet reached a view on what the best time would be taking into account wider political considerations.

SECRET AND PERSONAL

In the light of the Prime Minister's comments, the Chancellor undertook to prepare a paper on the timing of entry into ERM and the factors which needed to be taken into account.

Separately, as I mentioned to you over the telephone, the Prime Minister indicated she would be interested to see the Treasury's month-by-month projection for the RPI over the next six months. (She is already aware of the wide margins of error attached to such forecasts.)

It might also be helpful if the Prime Minister could have an indication of the timing of wage rounds: is there any particular month or so which is important between now and mid-Autumn in terms of detecting any change in sentiment in wage settlements?

Yours ever,

Barry

BARRY H POTTER

John Gieve, Esq.,
H.M. Treasury.

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You are discussing the ERM with the Chancellor tomorrow. I have already provided a brief on the policy issues (FLAG A) covered in his paper (FLAG B).

The more interesting issue is that of timing. It may be useful to offer a few preliminary thoughts.

BACKGROUND

Both Alan Greenspan and Alan Walters have given broadly the same advice. Entry to the ERM is a political necessity; and properly timed and managed, it can give economic benefits. Both indicated that it would be desirable to wait a few months until the impact of GEMU and the position of the Deutschmark is clearer.

Alan Walters also made the point that, while there should be a short term economic bonus from joining the ERM, that would tend to unwind - with a danger of the exchange rate coming under pressure later on. So timing of the ERM is important in the context of the next election.

The Chancellor's position is not clear. Treasury officials have identified as technical possibilities dates from as early as next month. Press reports seem to indicate their preferred timing may be September/October of this year.

THE WAY FORWARD

It is too early to have a satisfactory discussion on timing. But it may be useful to refer now to factors that would need to be taken into account. These are many and varied in nature - internal, external, economic and institutional. They might be grouped as follows.

(i) **The timing of the next election**. Alan Walters' view was that too long a gap between entry to the ERM and the timing of the election risked the exchange rate and interest rates coming under pressure from capital outflows at the time of the election.

(ii) **The stability of the ERM**. This will be related to the stability of currencies both within the ERM and any wider international volatility in exchange rates - particularly the dollar and the yen. An important factor will be GEMU and whether the Deutschmark has reached a settled position after absorption of East Germany.

(iii) **The state of other financial markets.** For example, if world stock markets were showing volatility or at least instability, e.g. in Japan, that would restrict the freedom of manoeuvre. So would any actual or prospective shifts in world interest rates.

(iv) **The current UK economic indicators**. First it can be argued that these have to be, at least, pointing in the right direction. Secondly they ought to be converging towards, not diverging from, the broad EC average. Most important are the Retail Price Index (and the underlying rate of inflation) and wage settlements. Also relevant will be the latest assessment of demand and output growth. For example, it might be argued that early evidence of greater realism on wage settlements is necessary before the exchange rate can be constrained. Entering at too high a rate with domestic costs still accelerating will in the short term risk serious reversal for industry and rising unemployment.

(v) **Institutional Constraints**. The German election in December is likely to lead to some instability within the ERM in the weeks preceding the election, particularly if the outcome looks unclear. Developments on the IGC and EMU are also relevant.

(vi) **Timing Constraints**. The UK can only join over a weekend when the markets are closed. Discussions with

central bankers would be necessary on Saturday and Sunday. Certain weekends are not practical because of other commitments and European Summits.

CONCLUSION

A possible conclusion to a discussion might be that the Treasury should now prepare a paper looking at options on timing and how the above and other relevant factors influence possible entry dates.

Are you content for Brian Griffiths to attend the discussion?

Yes

BHP

BARRY H. POTTER
12 June 1990

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CDP 24/6

PERSONAL

Can we decide whether to do this at a meeting between John M Douglas H and me on Thursday? not

11th June, 1990

Prime Minister

CDP 11/6

Charles Powell, Esq.,
10, Downing Street,
London, S.W.1.

Dear Charles,

Second Stage of EMU

I was invited to talk to the Schmidt/Giscard Committee last week and saw a lot of the key players in the Italian and Commission teams. They are determined to press ahead very fast after 1st July in drafting the Charter of a European Monetary Fund (or Eurofed as the Commission like to call it - horrible word!). They foresee the actual Treaty amendments being very short indeed and they want to get them and the draft Charter ready to present to the I.G.C. for rapid approval in December.

I know this time-table would not suit the Prime Minister, still less the idea which is running undesirably well of a very short and almost pro forma Stage 2. The only way that I can see of slowing things down and getting the Central Bankers and Treasuries deeply involved in the substance is for the U.K. to table ideas along the lines of those I put to the P.M. People on the Continent are quite interested in them and I am sure that they would give rise to lengthy discussion, especially as they would divide the French and the Germans and possibly get the Italian Presidency on our side about Stage 2.

Could you please put it to the P.M. that time and influence are slipping away from us. If she would like another talk, I am, as always, at her disposal.

Yours ever
Michael

Sir Michael Butler

MDB/MML

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FRAME ECONOMIC

ECONFIN: 11 JUNE 1990

FROM UKREP BRUSSELS

ECONOMIC AND MONETARY UNION

SUMMARY

1. LENGTHY TOUR DE TABLE, INCLUDING CHAIRMEN OF CENTRAL BANK GOVERNORS, MONETARY AND ECONOMIC POLICY COMMITTEES AND PRESIDENT DELORS. EMPHASIS ON IMPORTANCE OF SUCCESSFUL STAGE 1, AND INCREASING PROMINENCE GIVEN TO QUESTION OF FORM OF STAGE 2. MOST SPEAKERS STRESSED IMPORTANCE OF ECOFIN ROLE, NEED TO INVOLVE FINANCE MINISTERS IN IGC AND FAVOURED ONE MEMBER ONE VOTE ON ANY ESCB BOARD. PRESIDENCY CONCLUDED THAT PROGRESS REPORT WOULD BE SUBMITTED TO EUROPEAN COUNCIL IDENTIFYING MAIN ISSUES FOR RESOLUTION.

DETAIL

2. MAJOR SET-PIECE DISCUSSION OF STATE OF PREPARATION FOR IGC ON ECONOMIC AND MONETARY UNION. REYNOLDS (PRESIDENCY) BEGAN BY ASKING THE COMMISSION TO INTRODUCE THEIR PAPER, AND THE CHAIRMEN OF THE BOARD OF CENTRAL BANK GOVERNORS, OF THE MONETARY COMMITTEE, OF THE ECONOMIC AND POLICY COMMITTEE AND OF COREPER TO REPORT ON THE WORK THEY HAD BEEN DOING.

3. DELORS SAID THAT THE COMMISSIION PAPER HAD NOW TO TAKE FULL ACCOUNT OF SEVERAL KEY POINTS: THERE HAD BEEN NO UNANIMITY AT THE INFORMAL ECOFIN ON THE FORM OF THE FINAL STAGE OF EMU: WORK WAS GOING ON IN OTHER FORA: AND THE EP'S VIEWS, MANY OF WHICH HAD BEEN REJECTED BY THE COMMISSION NEEDED TO BE BORNE IN MIND. HE STRESSED THAT SOME ASPECTS OF THE COMMISSION'S INSTITUTIONAL PROPOSALS WOULD NEED TO BE REVIEWED IF A SECOND IGC ON POLITICAL UNION WERE CONVENED.

4. STAGE 1 WAS VITAL IF ''LEARNING BY DOING'' DID NOT WORK, IT

WOULD BE DIFFICULT TO GO BEYOND STAGE 1. DELORS DIVIDED HIS COMMENTS ON NEXT STEPS INTO THREE CATEGORIES: MONETARY, ECONOMIC, AND THE RELATIONSHIP BETWEEN THE TWO. ON MONETARY UNION, THE COMMISSION FAVOURED A SINGLE CURRENCY, AND ITS PROPOSALS ON THE STRUCTURE OF THE EUROPEAN SYSTEM OF CENTRAL BANKS REFLECTED THE NEED FOR IT TO BE INDEPENDENT. THE COMMISSION WAS OPEN TO ARGUMENT ON VOTING STRUCTURES. THREE KEY PROBLEMS REMAINED: RESPONSIBILITY FOR EXTERNAL MONETARY POLICY, THE ROLE OF THE ECU: AND MOST DIFFICULT OF ALL, THE BALANCE BETWEEN POLITICAL ACCOUNTABILITY AND INDEPENDENCE.

5. ON ECONOMIC UNION, THE COMMUNITY BUDGET MIGHT MOVE FROM 3 PER CENT TO 5 PER CENT OF TOTAL PUBLIC EXPENDITURE, AND SAW THIS AS AN APPLICATION OF THE SUBSIDIARITY PRINCIPLE. THE COMMISSION'S POSITION ON BUDGETARY CONSTRAINTS WAS A MINIMALIST ONE, AND IT MIGHT BE NECESSARY TO GO FURTHER IN THE IGC. DELOR'S VIEW WAS THAT THE EUROPEAN COUNCIL NEEDED TO BE INVOLVED IN SETTING THE FRAMEWORK FOR ECONOMIC POLICY BUT THAT FINANCE MINISTERS SHOULD ATTEND RELEVANT EUROPEAN COUNCIL SESSIONS.

6. THE RELATIONSHIP BETWEEN ECONOMIC AND MONETARY UNION WOULD NOW BE ENHANCED IF THE CHAIRMAN OF THE ESCB ATTENDED ECOFIN DISCUSSIONS AND BOTH PRESIDENT OF ECOFIN, AND A COMMISSION REPRESENTATITVE WERE OBSERVERS ON THE ESCB.

7. POEHL (CHAIRMAN, COMMITTEE OF CENTRAL BANKERS) SAID THAT, AS PART OF STAGE 1, HIS COMMITTEE WAS DEVELOPING A COMMON FRAMEWORK FOR MONITORING NATIONAL MONETARY POLICIES, TO HELP CONVERGENCE AND AS A FORE-RUNNER OF THE CENTRAL BANK SYSTEM ITSELF. THEY WERE WORKING TOWARDS COMPATIBLE MEASURES OF MONETARY CONDITIONS TO ALLOW MONITORING OF PROGRESS.

9. HE CONFIRMED THAT HIS COMMITTEE WAS PREPARING A PAPER ON THE MONETARY POLICY ASPECTS OF SUBSEQUENT STAGES, IN WHICH HE INTENDED TO INCLUDE A DRAFT TEXT OF THE STATUTES FOR THE ESCB. HE SAID THAT THIS WAS BEING DRAFTED ON THE ASSUMPTION THAT NATIONAL GOVERNMENTS WOULD BE WILLING TO ACCEPT THE TRANSFER OF SOVEREIGNTY REQUIRED FOR A CENTRAL MONETARY POLICY, BUT EXPRESSED PERSONAL DOUBTS AS TO WILLINGNESS. HIS COMMITTEE WOULD HOPE TO COMPLETE THEIR WORK IN ADVANCE OF THE CONVENING OF THE IGC. THEY WOULD BE CONSIDERING A LONG LIST OF QUESTIONS AND HE COMMENTED ON TWO IN PARTICULAR: ON VOTING RIGHTS, HE THOUGHT IT WOULD BE PREMATURE TO TAKE A FIRM VIEW BEFORE BROADER DECISIONS ON STRUCTURE HAD BEEN TAKEN: AND ON THE ROLE OF THE ECU HE SAID THAT LOGICALLY A COMMON CURRENCY WAS THE LAST STEP, BUT HE HAD LEARNT OF INTERESTING IDEAS, EMANATING FROM

LONDON, ON A POSSIBLE ROLE FOR THE ECU IN EARLIER STAGES. HIS VIEW AS THAT THIS WAS NOT AN APPROACH THAT SHOULD BE TAKEN UP BY THE IGC, BUT WAS A MATTER FOR THE MARKETS.

10. SARCINELLI (CHAIRMAN, MONETARY COMMITTEE) COMMENTED ON PHASING AND INSTITUTIONAL ISSUES. THE MONETARY COMMITTEE WOULD PRODUCE A COMPREHENSIVE REPORT ON THE TRANSITION FROM STAGE 1 TO STAGE 3 IN TIME FOR THE SEPTEMBER INFORMAL ECOFIN. HE (AND THE TWO SUBSEQUENT SPEAKERS) NOTED THAT HIS COMMENTS WERE SUBJECT TO THE UK'S GENERAL RESERVE ON STAGE 3. THERE WERE TWO APPROACHES TO STAGE 2: SOME SAW A NEED FOR AN INTERMEDIATE STAGE, INVOLVING STRONG ECONOMIC POLICY COORDINATION, OTHERS CONSIDERED THAT THIS COULD ALL BE ACHIEVED AS PART OF STAGE 1, WITH NO NEED FOR AN INTERMEDIATE STAGE. THERE WOULD BE FURTHER DISCUSSION IN THE MONETARY COMMITTEE ON THESE ISSUES BUT HE STRESSED THAT: PARTICIPATION IN ANY STAGE 2, WHICH WAS ESSENTIALLY A TRANSITIONAL STAGE, IMPLIED A COMMITMENT TO STAGE 3 AND THAT HE EXPECTED ALL COUNTRIES TO MOVE AT THE SAME STIME TO STAGES 2 AND 3, THOUGH A TWO SPEED APPROACH COULD NOT BE RULES OUT.

11. ON INSITUTIONAL ISSUES, THE MONETARY COMMITTEE HAD DISCUSSED THE COMMISSION PAPER. THE COMMISSION PAPER GAVE INSUFFICIENT WEIGHT TO THE ROLE OF ECOFIN, AND THE COMMITTEE DID NOT ACCPET THE PROPOSAL THAT THE COMMISSION SHOULD HAVE THE EXCLUSIVE RIGHT OF INITIATIVE IN THE EXTERNAL MONETARY POLICY FIELD. EX-ANTE CONSULTATION WITH THE EP WOULD NOT ALWAYS BE POSSIBLE, AND THE ROLE OF NATIONAL PARLIAMENTS NEED TO BE BROUGHT OUT. ONE MEMBER ONE VOTE HAD BEEN FAVOURED BY THE COMMITTEE, TO UNDERLINE THE ESCB'S INDEPENDENCE, AND A LONGER TERM OF OFFICE OF FIVE YEARS FOR BOARD MEMBERS WAS DESIRABLE FOR THE SAME REASON.

12. MOLITOR (CHAIRMAN, ECONOMIC POLICY COMMITTEE) SAID THAT HIS COMMITTEE HAD LOOKED AT THE COSTS AND BENEFITS OF EMU AND THE REGIONAL POLICY IMPLICATIONS. EMU SHOULD LEAD TO LOWER INTEREST RATES, LOWER TRANSACTION COSTS AND HIGHER INVESTMENT. THERE WOULD BE STRUCTURAL ADJUSTMENT PROBLEMS, INCLUDING UNEMPLOYMENT, IN THE TRANSITIONAL STAGE, BUT THIS COULD BE SEEN AS MUCH AS AN EFFECT OF THE SINGLE MARKET AS OF EMU, AND THE DECISION TO DOUBLE THE STRUCTURAL FUNDS HAD BEEN TAKEN IN THE LIGHT OF THE LIKELY IMPACT OF THE SINGLE MARKET, THE EPC WOULD PRODUCE A FULL REPORT IN THE AUTUMN.

13. CAMPBELL (CHAIRMAN, COREPER) SAID THAT COREPER HAD DISCUSSED SIMILAR ISSUES TO THE MONETARY COMMITTEE, AND SIMILAR VIEWS HAD BEEN

EXPRESSED. ON INSTITUTIONAL ISSUES THE QUESTION OF ACCOUNTABILITY HAD BEEN DISCUSSED, AND THERE HAD BEEN SOME QUESTIONING OF THE RELATIVE ROLE OF THE EUROPEAN COUNCIL AND ECONFIN. THERE HAD BEEN A TENDENCY TOWARDS ONE MEMBER ONE VOTE. COREPER WOULD CONTINUE TO WORK TO MAINTAIN COHERENCE AND CONSISTENCY IN THE RUN UP TO THE IGC.

14. REYNOLDS INVITED COMMENTS, SUGGESTING THAT DISCUSSION SHOULD CONCENTRATE ON THE ROLE OF ECOFIN, AND THE STRUCTURE AND ACCOUNTABILITY OF THE ESCB. HE DID NOT THINK THAT THE TIME WAS YET RIGHT FOR DISCUSSION OF PHASING.

15. NONETHELESS, MOST SPEAKERS REFERRED TO THE QUESTION OF PHASING. KOK (NETHERLANDS) AND WAIGEL (GERMANY) SAW NO ECONOMIC CASE FOR STAGE 2, THOUGH HE UNDERLINED THAT RESPONSIBILITY FOR MONETARY POLICY COULD NOT BE SHARED. THE CHANCELLOR DREW ATTENTION TO HOW LITTLE WORK HAD BEEN DONE ON TRANSITIONAL ARRANGEMENTS, UNDERLINED THE RISKS ASSOCIATED WITH DISPENSING WITH STAGE 2, AND ARGUED FOR ARRANGEMENTS WHICH BUILT ON STAGE 1, AND ALLOWED THE PROCESS OF ECONOMIC CONVERGENCE TO CONTINUE. BEREGOVOY (FRANCE) AGREED THAT THE NATURE OF STAGE 2 NEEDED TO BE CLARIFIED.

16. ON INSTITUTIONAL ISSUES WAIGEL ARGUED STRONGLY THAT FINANCE MINISTERS SHOULD BE DIRECTLY INVOLVED IN THE IGC, AND SHOULD TAKE THE LEAD ROLE IN ITS PREPARATION. HE WAS SUPPORTED BY KOK, HELVEG PETERSEN (DENMARK), BEREGOVOY, CARLI (ITALY) AND THE CHANCELLOR. THE SAME SPEAKERS ALSO CONSIDERED THAT ECONFIN SHOULD HAVE A MORE PROMINENT ROLE IN ECONOMIC POLICY COORDINATION THAN PROPOSED IN THE COMMISSION PAPER.

17. KOK, HELVEG PETERSEN, MAYSTADT (BELGIUM), BELEZA (PORTUGAL), SOLCHAGA (SPAIN), WAIGEL, CARLI AND GEOGHAN QUINN (IRELAND) ARGUED FOR ONE MEMBER VOTE ON THE BOARD OF THE ESCB.

18. KOK AND WAIGEL ARGUED STRONGLY FOR CONCRETE AND BINDING CONTROLS ON NATIONAL BUDGETS, AND WAIGEL EXPRESSED SCEPTICISM ABOUT THE PROPOSAL BY THE COMMISSION ON COHESION.

19. KOK ARGUED THAT THE SAME TRANSITION CRITERIA SHOULD APPLY FOR THE MOVE FROM STAGE 1 TO STAGE 2 AS FOR THE MOVE FROM 2 TO 3. EVERYONE SHOULD BE GIVEN THE OPPORTUNTIY TO PARTICIPATE FROM THE OUTSET, BUT THOSE WHO DID NOT WOULD BE WELCOME AT A LATER STAGE.

20. WAIGEL STRESSED THAT MOVEMENT FROM STAGE 1 REQUIRED CONVERGENCE OF ECONOMIC AND MONETARY POLICY. INDEPENDENCE OF THE

ESCB COULD ONLY BE ASSURED IF NATIONAL CENTRAL BANKS WERE ALSO INDEPENDENT. THE QUESTION OF VOTING STRUCTURE COLD NOT BE RESOLVED UNTIL BROADER QUESTIONS HAD BEEN ANSWERED. THE COMMISSION'S PROPOSALS FOR MULTI-ANNUAL ECONOMIC POLICY FRAMEWORKS LOOKED SIMILAR TO THE UNSUCCESSFUL ATTEMPTS TO FINE TUNE ECONOMIC POLICY IN THE 1970S. FINANCE MINISTERS SHOULD BE INVOLVED IN BOTH IGCS, SINCE THE IGC ON POLITICAL UNION WOULD HAVE INEVITABLE REPERCUSSIONS FOR EMU.

21. IN ADDITIONAL TO HIS COMMENTS ON PHASING, AND NOTING THE UK'S GENERAL RESERVE ON PHASE 3, THE CHANCELLOR STRESSED THE IMPORTANCE OF APPLYING CLEAR PRINCIPLES AT ALL STAGES, INCLUDING MAINTAINING OPEN MARKETS, SECURING PRICE STABILITY, MAINTAINING BALANCED BUDGETS, AND AVOIDING UNNECESSARY CENTRALISATION. MOVEMENTS FROM ONE STAGE TO THE NEXT MUST DEPEND ON A HIGH DEGREE OF ECONOMIC CONVERGENCE, AND HE ASKED WHETHER, SINCE THAT CONVERGENCE WOULD TAKE TIME, THE COMMUNITY'S APPROACH WOULD BE TO MOVE FORWARD TOGETHER? IF NOT, WHICH COUNTRIES WOULD BE LEFT BEHIND, AND WOULD THEY EVER CATCH UP? HE UNDERLINED THE IMPORTANCE OF ENHANCING THE ROLE OF NATIONAL PARLIAMENTS, AND WELCOMED THE COMMISSION'S CONCLUSION AGAINST BINDING RULES ON BUDGET DEFICITS.

22. BEREGOVOY, IN A NUANCED INTERVENTION, STRESSED THE IMPORTANCE OF PROGRESS. ALL MEMBER STATES SHOULD GO FORWARD TOGETHER, AND IT WAS THEREFORE ESSENTIAL TO TAKE MEASURES TO PERSUADE ALL TO MOVE FORWARD AND TO HELP THE WEAKER ECONOMIES, INDPENDENCE AND POLITICAL ACCOUNTABILTY HAD TO BE RECONCILED, AND THERE WAS STIL CONFUSION OVER RESPONSIBILTY FOR EXTERNAL POLICY.

23. CARLI IDENTIFIED WHAT HE SAW AS THE KEY PROBLEMS TO BE RECONCILED: WAS INDEPENDENT MONETARY POLICY CONSISTENT WITH LEAVING EXTERNAL POLICY IN THE HANDS OF THE COUNCIL? COULD ESCB INDEPENDENCE BE RECONCILED WITH DEMOCRATIC ACCOUNTABILITY? WOULD NATIONAL PARLIAMENTS ACCEPT THE CONSTRAINTS ON THEIR BUDGETARY POWERS THAT WOULD BE NEEDED IN EMU?

24. GEOGHAN QUINN, CHRISTODOULOU (GREECE), SOLCHANGA AND BELEZA STRESSED THE IMPORTANCCE OF EXTRA REGIONAL SUPPORT THROUGH STRUCTURAL FUND SPENDING. CHRISTODOULOU ARGUED FOR A SUBSTANTIVE SECOND STAGE, AND FOR A STEP BY STEP APPROACH. SOLCHAGA (SUPPORTED BY KOK) ARGUED THAT THE COMMUNITY SHOULD HAVE A SINGLE REPRESENTATIVE IN EXTERNAL POLICY DISCUSSIONS. MAYSTADT, SUPPORTED BY BEREGOVOY, ARGUED THAT THERE WAS A LINK BETWEEN FISCAL HARMONISATION AND THE BUDGET DISCIPLINE REQUIREMENTS OF EMU, SINCE

IT WAS NECESSARY TO OUTLAW COMPETITIVE REDUCTIONS IN TAXATION, BY A MOVE TOWARDS THE HARMONISATION, IN ORDER TO PREVENT SERIOUS REVENUE LEAKAGE CREATING BUDGETARY PROBLEMS FOR MEMBER STATES. HIS PRIME MINISTER WOULD RAISE THE POINT AT THE EUROPEAN COUNCIL.

25. REYNOLDS CONCLUDED THAT ECOFIN SHOULD BE CENTRAL IN DETERMINING AND OPERATING THE ECONOMIC POLICIES OF THE COMMUNITY, ASKED THE EPC TO INTENSIFY THEIR WORK ON COHESION, AND SAID THAT THE PRESIDENCY WOULD PREPARE A PROGRESS REPORT ON PREPARATION FOR THE IGC FOR THE EUROPEAN COUNCL, INDENTIFYING THE MAIN ISSUES FOR RESOLUTION. (FULL TEXT IN MIFT).

CAMPBELL

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Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

ERM

... I promised you another paper on the ERM. This is now attached. It deals with three main issues:

- sterling's rate on entry;

- the width of the band sterling should join;

- the position of sterling within the band in relation to its central rate.

The covering note to the paper summarises the arguments and I will not repeat them here.

Sterling's Rate on Entry

2. On sterling's level on entry to the ERM, I take it as axiomatic that we want to enter at a rate which reinforces our objective of reducing inflation as quickly as possible. The paper attached argues that at its present levels sterling is, if anything, still a little on the low side for our inflation objective. But there has been some helpful strengthening of the rate in the last week or so, despite the publication of some decidedly mixed economic figures, partly as a result of market expectations of our entry into the ERM. I would not rule out some further modest strengthening on this and other grounds. But too

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large an increase in the rate would, I think, be unhelpful. To join at too high a rate, which is widely seen as unsustainable, and with the prospect of downward realignment, would be counterproductive in terms of its effect on policy credibility. On the other hand, joining at too low a rate and being faced with a rapid upward movement shortly after entry with consequent pressure for unwarranted reductions in interest rates to keep within the band would also be harmful to policy credibility.

Width of the Bands

3. There is considerable uncertainty in the economic and financial dynamics which will accompany sterling's entry. The exchange rate might rise, if entry is seen to help counter-inflationary policy, and interest rates might fall. But the size of these effects, or even whether they occur at all, is not clear. And we would not know immediately before entry whether and to what extent any such effect was already discounted in current exchange rates. In some circumstances the pressures could be in the opposite direction.

4. Nevertheless, if recent market behaviour of sterling is anything to go by, entry might be expected to be followed by upward pressure on the sterling exchange rate as foreign money moved heavily into sterling attracted by the 6¾ per cent interest rate differential over the deutschmark and 3½ per cent over the lira (currently the strongest currency in the narrow band). Clearly a rise in the exchange rate would not be unwelcome, provided the increase was not such as to push sterling up to the upper level of the band. The wider band would leave us with much more room for manoeuvre without having to contemplate either a revaluation or lower interest rates. It would thus give us much more flexibility over when we joined.

5. These arguments, I believe, point very firmly to joining the wide (±6 per cent) band rather than the narrow (±2¼ per cent) band. (For technical reasons explained in the note which my Private Office sent yours on 25 May the room for manoeuvre can be less than the total width of the bands.)

Sterling's Central Rate

6. If we were to join the wide band, I think we should probably join with a central exchange rate above, but not too far above, sterling's market rate immediately before entry. This would give sterling some latitude for depreciation, and thus some latitude against pressure for early upward movements of interest rates. But it would at the same time signal that we were not adopting broad bands to open the way to devaluation, since the asymmetry would give sterling a greater degree of latitude for coping with an appreciation of the rate; ie before the emergence of pressures, imposed by the upper limit of the band, for lower interest rates or a revaluation. In this way we would effectively bias our entry in an anti-inflationary direction by giving the signal, through the choice of central rate, that we judged that there was a greater prospect of appreciation than depreciation (while of course leaving some cautious scope for depreciation) and creating some new room for sterling to rise without generating pressure for a premature reduction of interest rates. We could reinforce this message by reaffirming our commitment in due course to move to narrower margins, as part of "Stage 1". I believe this is the right stance both for the markets and for our discussions with other Member States.

7. I have considered whether any of this analysis is affected by the beginning of GEMU on 1 July. There is a possibility that there could be an unsettled period in the markets in the weeks following GEMU, on 1 July. A successful start to GEMU could lead

to a strong DM (and hence a lower exchange rate for sterling against the DM). At the same time, fears of extra inflationary pressures may cause the Bundesbank to tighten policy. If the DM did not rise spontaneously, or fell, there could be an increase in German interest rates, which could in turn put upward pressure on sterling interest rates, or downward pressure on sterling. But all this is somewhat speculative and does not, in my view, alter the essentials of the analysis above. Even so, we clearly need to keep the markets under daily review for any signs of problems here.

8. I think we can now provisionally conclude that we ought to join the wide band; and that, if the present disposition of exchange rates persists, we should contemplate joining with a central rate at or somewhat above that indicated by the present level of market rates. Final decisions would have to wait until immediately before we join.

9. I should like to discuss all this with you next week. In the meanwhile I will be thinking further about possible entry dates.

John M.

[J.M.]
8 June 1990

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THE EXCHANGE RATE AT WHICH TO JOIN THE ERM AND THE WIDTH OF THE BAND

This note discusses the analytic considerations which bear on the exchange rate band at which it might be appropriate for sterling to enter the exchange rate mechanism (ERM) of the European Monetary System, if a decision was taken to join. It is based on four sets of evidence which are relevant to this issue:

a) the behaviour of the real sterling/deutschemark exchange rate over time (ie. movements of the exchange rate other than those that reflect differences in cumulative inflation in the two countries);

b) the level of the exchange rate which we have felt over the last year or so has been necessary to maintain monetary conditions appropriate to the Government's objectives;

c) the implications to be drawn from the outlook for the balance of payments;

d) French and Italian experience with realignments against the mark.

2. This evidence is reviewed in detail in the annex. On the basis of the conclusions to be drawn from it, this main note considers the characteristics of the band with which to join the ERM.

<u>The Background Evidence</u>

3. The conclusions from the evidence discussed in the annex can be summarised as follows :

(i) both the real effective rate and the real sterling/deutschemark rate are currently reasonably close to their historical average levels. If anything, they are a little below the average levels of the 1980s alone;

(ii) given the recent state of monetary conditions, there is a presumption that sterling's effective exchange rate should not fall from present levels - and perhaps should rise;

(iii) the prospects for the next few years are for a sizeable and continuing current account deficit. The deficit has been caused, however, primarily by domestic demand growth in the UK exceeding that in trading partner countries and not by lack of competitiveness. Its future course is unlikely to be greatly influenced by movements of a few percent either way in the level of sterling.

(iv) on the other hand, there are constraints on joining at too high a level, if this would widely be regarded as unsustainable within the context of the UK's external position. A downward realignment of the pound, forced by foreign exchange pressures, shortly after its entry into the ERM would obviously be an unattractive prospect.

(v) before realignments, it has often been necessary for interest rates in France and Italy to be much higher than in Germany to maintain the ERM commitment. But after realignments capital flows to the devaluing currency have put upward pressure on its exchange rate and downward pressure on interest rates. These pressures have not always been helpful but their scale is dependent on the width of the band. They are liable to be much more intense with a narrow band than a wide one.

Other Considerations

4. Developing these conclusions into a recommendation about the right band for sterling involves three other considerations :-

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(1) the behaviour and effect of interest rates when sterling joins;

(2) the interaction between the choice of band and the credibility of the Government's policies;

(3) the significance of the non-deutschemark currencies within the ERM and their exchange rates.

These are discussed in turn.

5. Interest Rates. Clearly, changes in short term interest rates would be one of the factors that could alter monetary conditions at whatever level sterling joined the ERM. There is a risk that the UK authorities would to be compelled to reduce interest rates and loosen monetary conditions in an effort to keep within an ERM band which with hindsight had been chosen at too low a level. (Some argue this was the Spanish experience; it is described in more detail in the attached Appendix).

6. In the long term, some fall in interest rates after entering might be consistent with the same downward pressure on inflation. That would happen, for example, if wage negotiations and price setters came to see ERM entry as bolstering or guaranteeing the Government's determination to defeat inflation. But it would take time for any such perception to grow. It would not be an effect of any significance at the time of joining or immediately afterwards.

7. Credibility and the Chosen Band. The effect of sterling's entry into the ERM will will be heavily influenced by the extent to which it alters the perceived credibility of the Government's policy.

- if the markets were sure that the Government would stick to it, a margin which allowed little room for sterling to fall would be preferable to one which gave wider scope. The narrower the scope for depreciation the more intense the

favourable effect on inflationary expectations. But this conclusion would not apply, and could even be reversed, if the band was so narrow that the Government proved unable to keep sterling within it. If it proved necessary to devalue the pound quickly after joining, then the effect on expectations would be counterproductive;

- there is considerable uncertainty in the economic and financial dynamics which will accompany sterling's entry. The exchange rate might rise, if entry is seen to help counterinflationary policy, and interest rates might fall. But the size of these effects, or even whether they occur at all, is not clear. And we would not know immediately before entry whether and to what extent any such effect was already discounted in current exchange rates. In some circumstances, the pressures could be in the opposite direction. Spanish experience on entry sheds only limited light on this as the peseta is not used much as an investment currency. The fact that the original members had to iterate by a series of realignments in the early days of the ERM to a broadly satisfactory set of central rates underlines the uncertainties that are involved.

- there is a clear asymmetry for monetary conditions from different directions of sterling's movements after joining. An upwards movement in the pound - provided it was not so great as to force an unwarranted cut in interest rates - would be more beneficial in underlining the counterinflationary thrust of policy than a depreciation. A fall in the pound after entry would be less satisfactory altogether.

8. The Non-Deutschemark Currencies. There is a technical but vital point to be made about the role of non-Deutschemark currencies in the operation of the band against the deutschemark. In most circumstances, it would not be possible for sterling to utilise the full range of its band width against the deutschemark, whatever that was chosen to be. This can be illustrated by

noticing that the lira is currently around 2 per cent above the deutschemark. The bands on sterling's joining now would have to take that into account. But, over time, it is reasonable to suppose that the lira will fall against the deutschemark. With the lira in the bottom part of its band against the mark, the latitude that sterling would have to appreciate against the mark would be curtailed because appreciation to the full extent allowed by the sterling/mark band itself would force the lira out of its band against sterling. This extra constraint could be of considerable practical importance.

9. A different, but probably longer term issue, is the likelihood that at some point there will be a further general realignment in the ERM, with the deutschemark rising against currencies like the French franc and lira. Some Bundesbank officials have expressed a preference for this in the past, though the French are opposed. If it happened, we could then find ourselves embroiled in a general realignment of the ERM that was not of our making.

The Choice

10. Deciding the central rate for sterling to join the ERM and the width of its band involves balancing up the previous considerations. By no means do they all point in the same direction but perhaps two features stand out :

(a) the complexity of the forces that might or might not bear on sterling (and the UK economy) on entry;

(b) the asymmetry of the key considerations. Both in terms of maintaining downward pressure on inflation and in the context of deriving maximum benefit to credibility, an appreciation of sterling on joining would be strongly preferable to depreciation.

11. The complexity of the forces at work points up the advantages of joining with a wide band, and the greater flexibility that would bring, at least initially :

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- a wide band may not lead to a big jump in the exchange rate or unmanageable downward pressure on interest rates;

- a wide band is less likely to produce very high short term interest rates if markets fear a realignment: a narrow band runs the risk of excessively low or high interest rates at inconvenient moments;

12. Of course, there is an argument the other way:

- to obtain the full benefits of the effect of improved inflationary expectations on interest rates or the exchange rate a narrow band is preferable;

13. This suggests a strategy of joining the ERM with wide bands at the outset. We could announce at the outset, if we wished, that we would move to a standard 2¼ per cent margin when circumstances permitted. We could also consider some intermediate step - for example, a 4 per cent band.

14. The balance of considerations also point to joining at a central rate above the exchange rates against the deutschemark that have prevailed over recent months. That would err on the side of caution in terms of keeping downward pressure on inflation and leave more headroom for sterling to rise. It would also help secure the maximum benefit to credibility.

15. But these same considerations also suggest that it could be helpful for sterling's chosen central rate to be a little above the actual rate on entry. That would allow greater scope for sterling to rise if the pressure turned out to be that way. Some net tightening in the monetary stance might in any case not be unwelcome. But if the appreciation were sufficiently large, interest rates could be reduced to the extent appropriate. Such an asymmetric arrangement would also be helpful so far as credibility was concerned, underlining the counterinflationary

thrust of policy. At the same time, by not overdoing the asymmetry, some scope would remain for sterling to fall a little without forcing an interest rate rise regardless of all other considerations.

16. Joining at the sort of rates implied by such a band would mean a real exchange rate well within historic experience, indeed not far from the average. Such rates would not therefore be likely to cause major balance of payments problems. This would remain true even taking into account the inevitable deterioration in UK competitiveness which will stem from our inflation being higher than in other ERM countries over the next year or two.

Summary

17. Joining the ERM with a central deutschemark exchange rate at or a little above current levels would imply a real exchange rate close to its historical average - well within previous ranges of fluctuation both against the mark and in effective rate terms. But both maintaining satisfactory downward pressure on inflation and deriving maximum credibility from joining suggest that a further appreciation would be much preferable to a decline after joining. That suggests the desirability of a mildly asymmetric band, permitting more appreciation than depreciation. Nevertheless, the pressures to which the UK economy and the pound will be subject after entry are manifold and complex and cannot be quantified with any precision in advance. Prudence would therefore indicate joining with a wide band, perhaps 6 per cent, rather than a standard 2¼ per cent interval, only moving towards a narrower one in the light of further experience.

ANNEX : THE BACKGROUND FACTORS

This annex considers :-

a) the behaviour of the real sterling/deutschemark exchange rate over time;

b) the level of the exchange rate which we have felt over the last year or so has been necessary to maintain monetary conditions appropriate to the Government's objectives;

c) the implications to be drawn from the outlook for the balance of payments;

d) the dynamics of interest and exchange rate movements that existing ERM members have faced at realignments.

A. The Real Exchange Rate

2. The natural starting point for the analysis is the past behaviour of sterling against the deutschemark, the linchpin of the ERM. Chart 1 shows that sterling has fallen secularly against the mark over the last 20 years or so: rapidly until 1976, followed by a period of stability and then recovery in 1979 and 1980; and then a gentler decline subsequently. Much, though not all, of this experience can be explained by differences in inflation performance over time. As Chart 2 displays, UK prices have risen against German ones throughout the period but they did so particularly pronouncedly over the period 1974-82.

3. Chart 3 gives the "real" sterling/mark exchange rate, ie. the movement in sterling which cannot be attributed to the differentials in cumulative inflation over time. This provides two different kinds of information. On the one hand, it indicates the extent to which sterling's rate is acting as a restrictive or permissive factor so far as domestic inflationary pressures are concerned. The lower the real exchange rate the greater the headroom for domestic producers to adjust their prices upwards to

Chart 1 : Nominal £/DM exchange rate (1985=100)

Increase implies £ appreciation

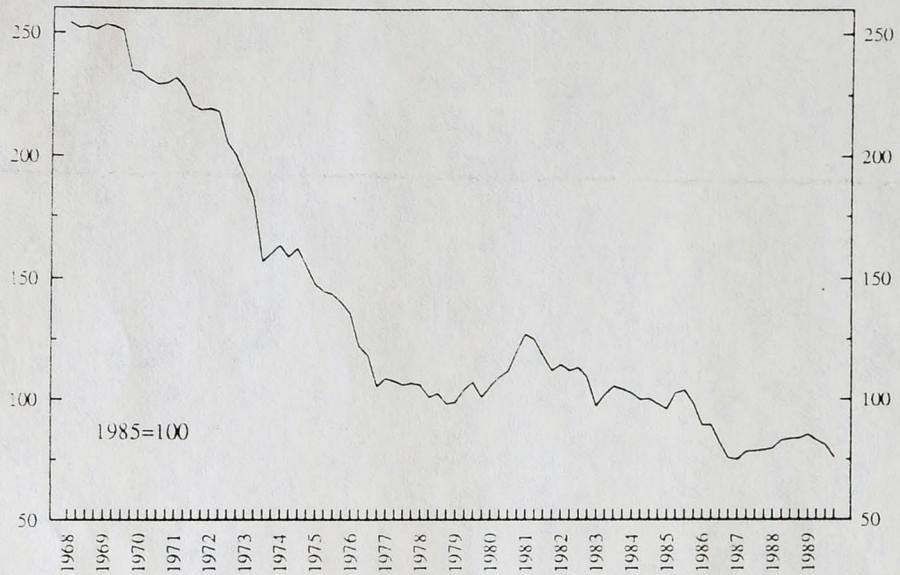


Chart 2 : Relative price levels in the UK and Germany

Increase implies higher UK inflation

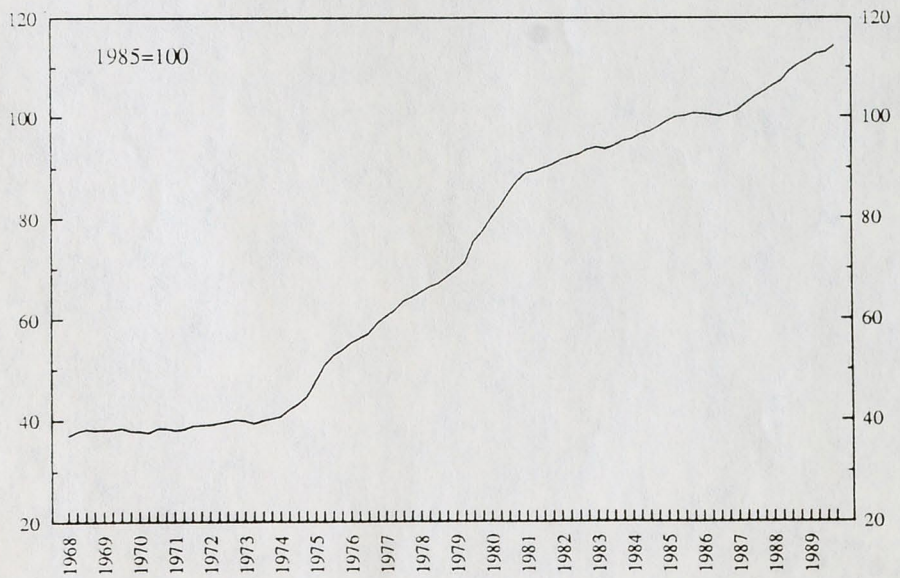


Chart 3 : Real £/DM exchange rate

Increase implies £ appreciation

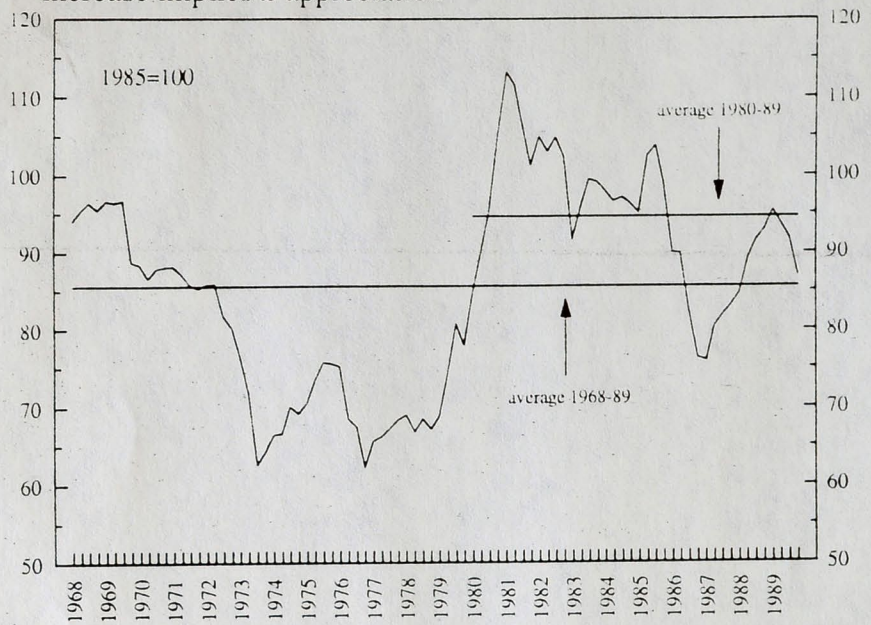
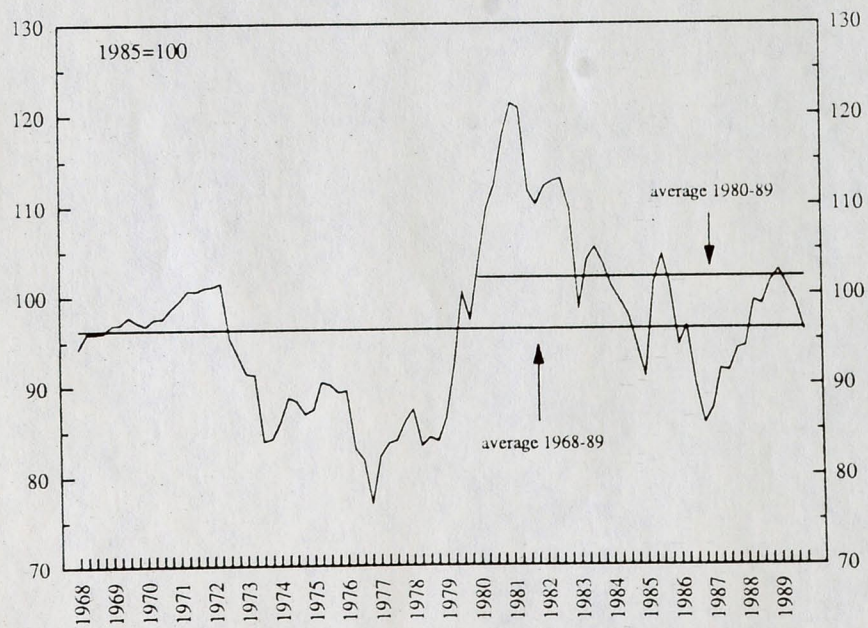


Chart 4 : Sterling's real effective exchange rate

Increase implies £ appreciation



world levels. Conversely, higher real exchange rates generate pressures to adjust domestic prices down to world levels. At the same time, the real exchange rate provides a measure of competitiveness. The higher the real rate the harder exporters will find it to compete in overseas markets and the easier it will be for importers to penetrate UK markets.

4. With this background, it is possible to make the following observations on the basis of chart 3:

i) the current real sterling/mark exchange rate is a little above the average observed over the last 20 years or so. However, the excess - 3 per cent or so - is small in relation to deviations which have occurred in the past;

ii) the average level is itself very dependent on the period considered. In particular, it is affected by experience between 1972 and 1978 when, by any standards, the real exchange was extremely low and by 1980-85 when it was generally very high. By comparison with its average over the 1980s alone - when pressures on UK inflation were mainly but not exclusively downwards - the current real exchange rate is somewhat below that point;

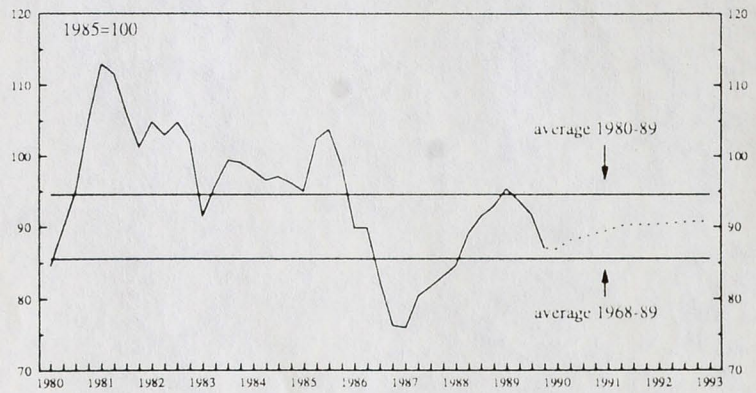
iii) earlier exercises considering the appropriate rate for sterling to join the ERM (for example, in September 1985) concluded that sterling should be expected to be some way above its long run average because of the "petrocurrency status" that it enjoyed from the late 1970s onwards. Since then, however, the sharp decline in oil prices and the falling away in production has probably reduced the importance of any such factor to near insignificance;

iv) on the other hand, one new factor which has emerged since 1985 is the advent of a substantial current account deficit on the balance of payments at the same time as long term capital outflows from sterling continue, reflecting domestic portfolio diversification. This might argue for joining the ERM at a discount to the average real rate

because this balance of payments disequilibrium will eventually need to be corrected. This is discussed further in section C below;

v) a further factor arguing for a low real rate on joining the ERM is the fact that UK inflation is currently significantly above German levels. German consumer prices have recently been rising at a 12 month rate of around 2¾ per cent. Underlying inflation in the UK is around 6¼ per cent on the same basis. This differential must be expected to persist for some time. Since joining the ERM represents a commitment to a fixed nominal exchange rate against the mark, the effect will be that sterling's real exchange rate will rise until either UK inflation falls to German levels or there is a realignment. The following chart shows the effect given current inflation projections and an unchanged nominal exchange rate;

Chart : The projected real £/DM exchange rate assuming a fixed nominal exchange rate.



vi) that said, the UK inflation rate is not independent of the real sterling exchange rate. But it is one of the factors which will determine whether and when UK inflation falls to German levels. Increasing the likelihood of a rapid decline, therefore, argues for joining at a higher than average real exchange rate.

5. Given the primacy that the Government attaches to defeating inflation, this last point is a crucial one. But it is not the real level of sterling against the mark which is directly relevant here, however, but the real effective rate more generally. To the extent that the deutschemark, for example, was itself misaligned against other international currencies, looking at the real sterling/deutschemark rate alone would give a misleading calibration of the extent to which the pound's level was permitting or constraining domestic inflation. This possibility can be checked upon by considering the real effective rate for sterling itself. This is shown in chart 4. Whilst the conclusions to be drawn are broadly the same as those from chart 3, it does suggest that the real exchange rate relevant for inflation is a little lower than the real sterling/mark rate. The real effective rate is very close to its average over the last twenty years and around 7-8 per cent below its average level in the 1980s alone.

6. This point is reinforced by noting the possibility, if not probability, that the yen is temporarily misaligned and must be expected to recover generally. Although the yen and associated currencies have a relatively small weight in sterling's effective rate index - around 9 per cent - this is non-negligible. If, in the medium term, the yen rises against all other currencies, then a constant real sterling/deutschemark exchange rate would imply a depreciating sterling effective rate. On the other hand, if as suggested in para 9 of the main paper, the French franc and lira were to be devalued within the ERM in the foreseeable future, this would be an offsetting factor.

B. Evidence from the Monetary Conditions needed to keep Downward Pressure on Inflation

7. Although sterling's real exchange rate is a key factor in determining future UK inflation, it is by no means the only influence at work. A range of other factors - the fiscal stance, the level of interest rates, the buoyancy or otherwise of domestic demand and so on - all have to be taken into account in appraising whether current monetary conditions are on track to defeat

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inflation. There is therefore likely to be no simple rule-of-thumb linking the level of sterling, real or nominal, to the extent of disinflationary pressure.

8. One way, however, to explore the matter further is to examine what exchange rates for sterling we have been happy with in recent months as being consistent with keeping downward pressure on inflation. The purpose of the ongoing Monthly Assessment, and the associated discussion at Sir Peter Middleton's regular meetings, is to conduct just the appraisal referred to in the previous paragraph. Looking back at these recent Assessments should therefore give some guidance.

9. To this end, table 1 shows the evolution of sterling's main exchange rates since the beginning of 1989, together with the behaviour of three-month interest rates and the attitudes towards the exchange rate as recorded by the various Monthly Assessments. Surprises in inflation have generally been on the up side over this period, so, if anything, the Assessments would probably have favoured rather firmer exchange rates, other things being equal, had they been made with the advantage of this hindsight.

10. On this basis, experience can be summarised as follows :

a. until the end of April 1989, sterling's ERI was around or a little over 95 and the rate against the mark steady at 3.18. Base rates were 13 per cent and three month rates close to that level. As judged by the Monthly Assessments, we were mainly content with the associated monetary conditions over this period, though with some flavour that tightening would be more welcome, should it occur, than a loosening;

b. during May 1989, sterling's ERI dropped quite sharply by over 3 per cent and then fluctuated within a band of about 91-91½ until the end of September. Base rates were increased by 1 per cent, to 14 per cent, on 24 May to compensate for this. By end-September, both the ERI and the sterling/mark rate had declined by around 4½ per cent compared with

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mid-April levels. On the evidence of the Monthly Assessments, we were again broadly happy with the monetary conditions obtaining over this period though with a rather sharper flavour of preferring tightening, from that position, to relaxation;

c. sterling took a further step downwards towards the end of October and into November. Base rates were raised to 15 per cent on 5 October in concert with the rises in other European interest rates on that day. But the Assessments were clear that the increase was, in any case, necessary to prevent the fall in the exchange rate from loosening monetary conditions inappropriately. Since then, the ERI has mainly remained in a range of 86-88 though it fell to below 86 briefly in November and in January rose temporarily to above 89. Monthly Assessments have displayed a slightly nervous acquiescence in the combination of interest and exchange rates that have prevailed since the end of September. Nevertheless, there has been some asymmetry in attitude. When the ERI fell below 86 in November, the Assessment concluded that monetary conditions were "precarious": when the pound displayed temporary strength in January, the Assessment was explicit that there was no case for a relaxation in the policy stance.

11. With this background, it would seem a reasonable starting point to suppose that entering the ERM at an effective rate some way above present levels would be desirable <u>if other factors bearing upon the tightness of monetary conditions remained unchanged</u>. More specifically if: (i) base rates remained at 15 per cent; (ii) joining the ERM has no effect, beneficial or otherwise; and (iii) there were no change in the fiscal stance, an ERI of 89-90 would probably be what was need to maintain downward pressure on inflation.

12. But the conditional clause in the previous paragraph is a key one. UK interest rates are currently well above the average in the major ERM countries - by a margin of some 5-7 per cent. After entry there may be pressures to reduce this margin. Joining at

too low a rate and being required, in consequence, to reduce interest rates to keep within the band, would be harmful to domestic monetary conditions. Equally, joining at too high a rate, widely seen to be unsustainable and with the prospect of an imminent downward realignment, could be counterproductive in terms of its effect on policy credibility. A central consideration in this respect will be the prospects for the balance of payments to which the next section now turns.

C. Prospects for the Balance of Payments

13. When the rate at which sterling might join the ERM was last assessed in May 1987, the prospect was of a small current account deficit, £2¾ billion, in 1987 improving steadily to a surplus of £1 billion by 1990. Current prospects are a large current account deficit of £15 billion this year and, despite some improvement, a deficit remaining in excess of £10 billion in 1993. The post-Budget forecast, from which these predictions are taken, also projects continuing sizeable "long term" net capital outflows - both on direct investment and portfolio investment accounts. Combined, these long-term net capital outflows might themselves exceed £10 billion a year.

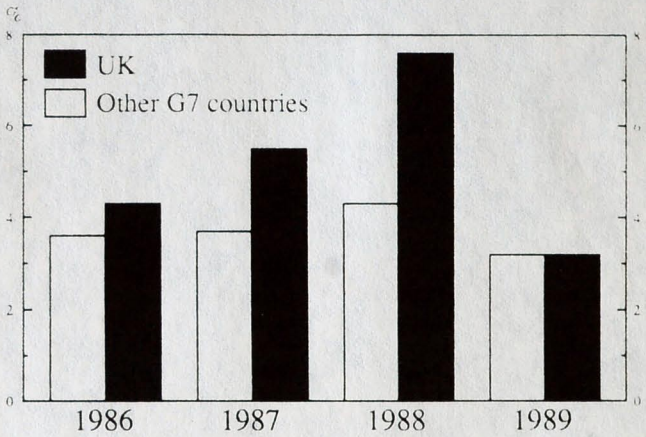
14. These predictions are made on the basis of an unchanged effective rate of 87.5 (very close to current rates) and an unchanged sterling/deutschemark rate. Clearly, on this basis substantial and cumulating short term capital inflows will be required to finance these continuing outflows.

15. In principle, in these circumstances, balance of payments difficulties, leading to downward pressure on the pound, could manifest themselves in several different ways. Eventually there could be a worsening in the current account itself if the real exchange rate were so high as to generate acute competitiveness problems. Similarly, there might be a greater outflow of long term capital than allowed for above, repelled by an exchange rate seen to be unsustainable in the medium run. Finally, there could be financing difficulties associated with insufficient short term

capital inflows to offset the long term outflows and current account deficit.

16. In practice, it is unlikely, however, that even a sizeable appreciation of sterling - say 5 per cent or so - would be sufficient to alter the current account prospect significantly in the absence of other policy changes (though no doubt it would affect exporters' profit margins to some extent). The important underlying point it that our current account deficit has not been caused by lack of competitiveness. The main factor has been growth in domestic demand at a faster pace than has happened in trading partner countries, as the following chart shows.

Chart: Real domestic demand growth in the UK and the other G7 countries



17. Again, the quantity of long term capital outflows would probably not be much affected by exchange rate changes of this order - being determined more strongly by slowly changing factors such as the pace of domestic portfolio diversification overseas. But where the level of sterling would be liable to have an effect is on the willingness, or otherwise, of short term investors to place funds in the UK. This could work in two different directions:

(a) if investors perceive that sterling has joined at too low a level then the prospect of sterling appreciation, coupled with its interest rate advantage, would make the pound very attractive. In consequence, it might be necessary to reduce interest rates to keep sterling in its band with the adverse domestic results mentioned earlier. That would not necessarily be disastrous since it would be possible for sterling to be realigned upwards with no great harm to credibility. But a realignment could not be arranged immediately and there could be a prolonged period of awkwardness;

(b) on the other hand, if investors fear a depreciation over time sufficient to outweigh the interest rate advantage that sterling enjoys, then their unwillingness to hold sterling will itself induce the depreciation that they anticipate. Even if short term investors were not positive sellers of sterling, merely not buyers, the current account deficit and long term capital outflows that we envisage occurring would themselves put downward pressure on the pound.

18. It is probably this last factor, therefore, which constitutes the major barrier, so far as the balance of payments is concerned, to joining the ERM at too high a level. With an interest rate differential of perhaps no more than 5 per cent to support it, investors would not be attracted by the prospect by sterling being realigned downwards by more than this amount in the next year or so. They would be inclined to take this view if they believed sterling had joined at too high an initial rate making it unsustainable.

D. The Interest Rate and Exchange Rate Dynamics on Entry

19. A further important set of considerations are the dynamics to be expected on entry : the pressures on sterling and the economy generally and the way that they manifest themselves in interest and exchange rate movements.

20. These dynamics are inevitably uncertain. Some simplification is necessary in presenting the possible alternative developments. However our best guess of the underlying pressure are likely to be as follows:

- although membership of the ERM can be expected to help to narrow the inflation differential with other ERM countries this will take time. There is likely to be a period of adjustment with periodic realignments. Based upon the example of France and Italy we might expect that a gradual adjustment would mean progressively longer intervals between realignments and smaller realignments;

- over time there will be a tendency for currencies with faster inflation rates to depreciate in nominal terms relative to low inflation currencies;

- on average interest rates on the high inflation currency will exceed those on the low inflation currencies by an amount roughly equal to the expected rate of depreciation - although it can be argued that the differential might be bigger to reflect the additional risk in the high (and probably variable) inflation currencies;

- however the effect of ERM membership on exchange rate expectations is likely to be very different in the period immediately before and after realignments;

- immediately following a realignment market participants will put a low probability on a further realignment in the short term. Therefore the risk of a substantial depreciation is reduced. As a consequence investors may divert capital into the currency with high short term interest rates, putting upward pressure on the exchange rate and downward pressure on interest rates;

- as time goes on the persistence of higher inflation increases the likelihood of a realignment. At a point of the realignment holders of the depreciating currency incur a substantial loss. Because of this they require high interest rates to compensate the possible loss in holding a devaluing currency. If the risk of realignment increases sharply, interest rates will have to rise - possibly sharply - or large scale intervention will be needed.

21. The scale of these pressures will be affected by the width of the band. In particular they are likely to be much more intense with a narrow band than with a wide band.

22. This is partly because the size of the margins affects the behaviour of the exchange rate at the time of realignments and therefore the risk of holding a currency if a realignment seems to be imminent. With narrow margins, realignments tend to mean no overlap between the new and old band; ie the new higher limit will be below the previous lower limit. Therefore the spot rate tends to jump down at the time of realignments with the risk of a significant capital loss. With wider margins the pattern is different and more in the nature of a "crawling peg": the realignment is less than the width of the band so that at realignments the spot exchange rate has tended not to change significantly.

23. There is also a difference immediately following a realignment. With a narrow band the scope for downward movement within the band is less; so the pressure for lower interest rates immediately following the realignment will be greater. With wide margins there is more scope for downward movement and less pressure to close interest differentials.

24. These effects show up in the experience of both France (2¼ per cent margins) and Italy (6 per cent margins until recently):

- Charts A1 and A2 show the movement of the DM/FF and DM/Lira in relation to their bands;

- of six realignments of the central DM/FF rate there was no overlap of the bands on four occasions

- on each of nine realignments of the central DM/lira rate there was some overlap and the new band included the rate existing before the realignment.

25. To examine the interaction between interest rates and exchange rates more closely, it is necessary to focus on daily observations for periods surrounding realignments (important effects are largely obscured in monthly data). Charts A3 and A4 show the movements in the DM/FF exchange rate and interest differential around a typical realignment (in April 1986). (Very similar movements are observed around other realignments) :

- the franc has shown a tendency to move to the top of the band after realignment and a strong tendency to depreciate below its lower band prior to the realignment;

- interest rate differentials have been high at the time of realignments and declined sharply afterwards.

However there has been no pressure to remove the interest differential entirely. Because the French franc has tended to settle at the top of its band following a realignment it has had room to depreciate by 4½ per cent before realignment is necessary. This leaves scope for an interest differential of 4½ per cent even if there is no further realignment for a year. The actual interest differential in the months following the realignment has averaged just a little less than 5 per cent.

CHART A1

DEUTSCHEMARK/FRENCH FRANC EXCHANGE RATES
AND ERM BANDS

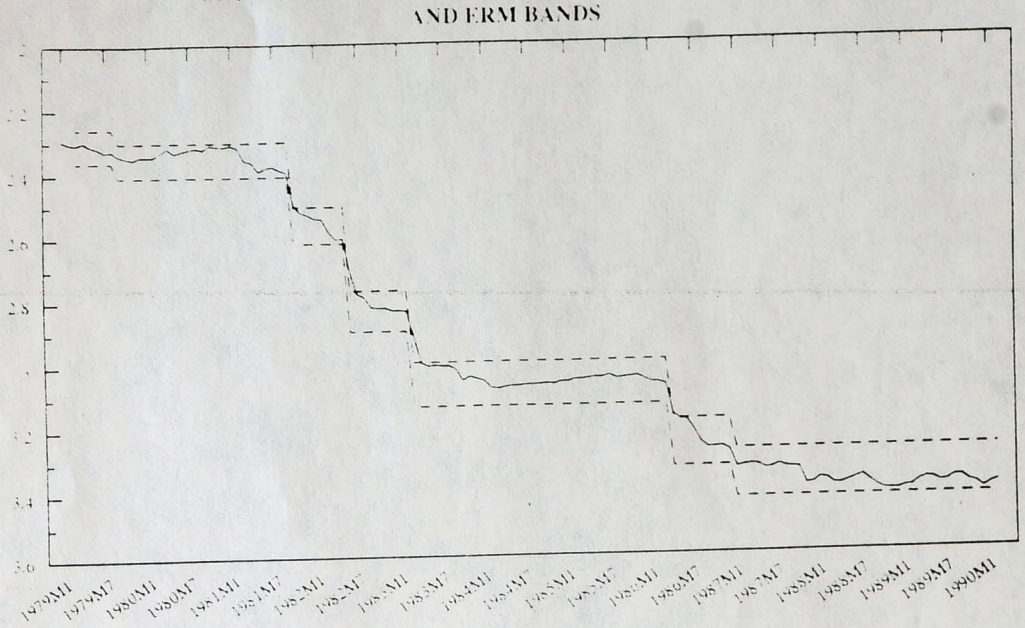


CHART A2

DEUTSCHEMARK/LIRA EXCHANGE RATES
AND ERM BANDS

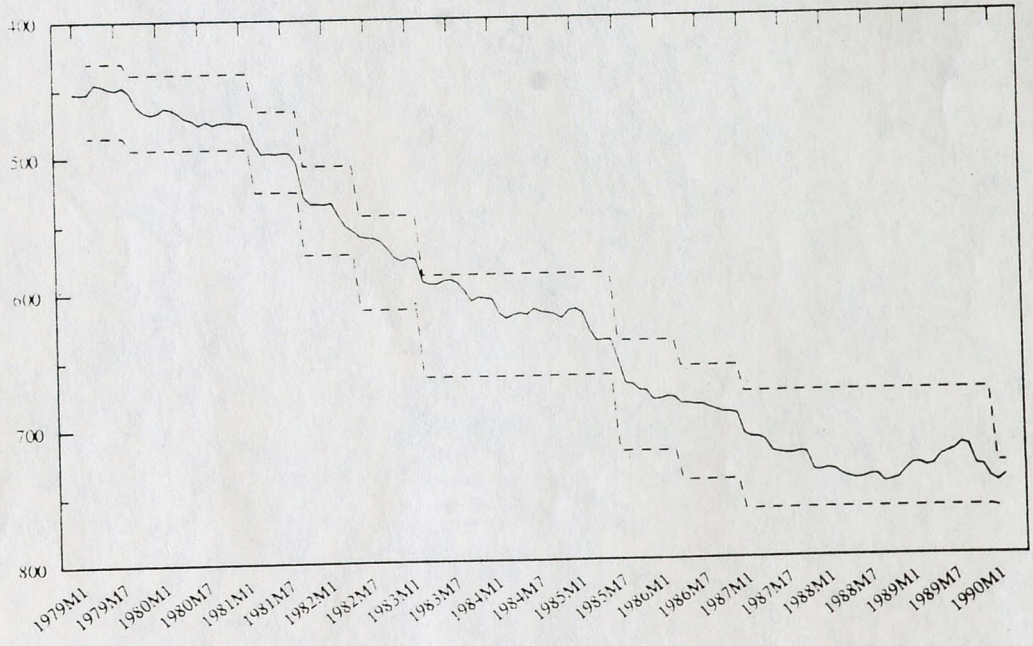


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CHART A3

REALIGNMENT OF 7 APRIL 1986

DEUTSCHEMARK FRENCH FRANC EXCHANGE RATE

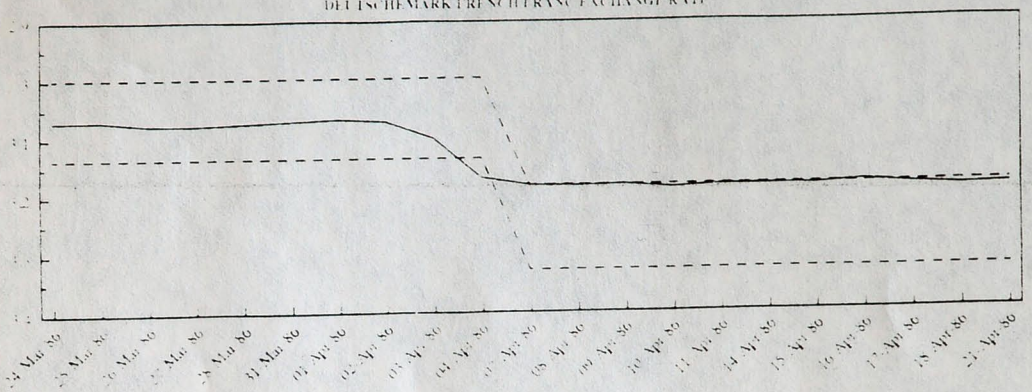
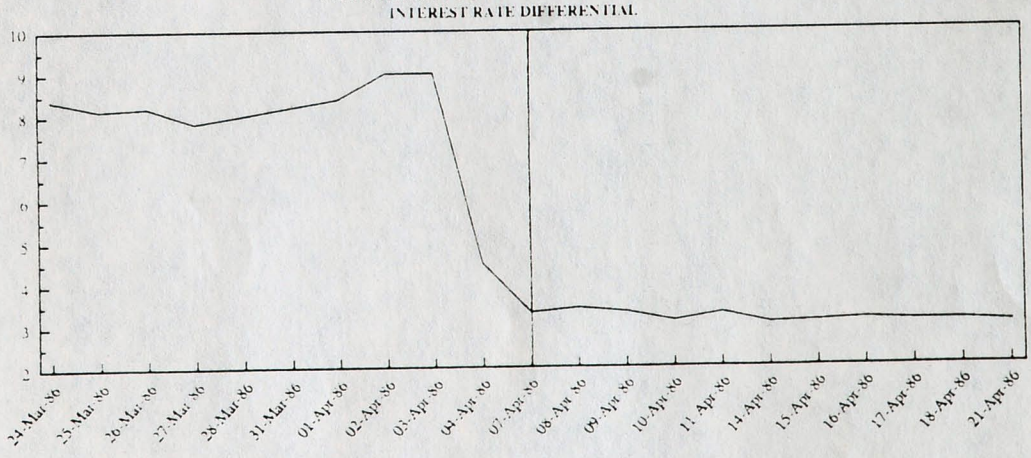


CHART A4

3 MONTH EURO FRENCH FRANC DEUTSCHEMARK
INTEREST RATE DIFFERENTIAL



B:)

CHART A5

REALIGNMENT OF 7 APRIL 1986

DEUTSCHEMARK LIRA EXCHANGE RATES

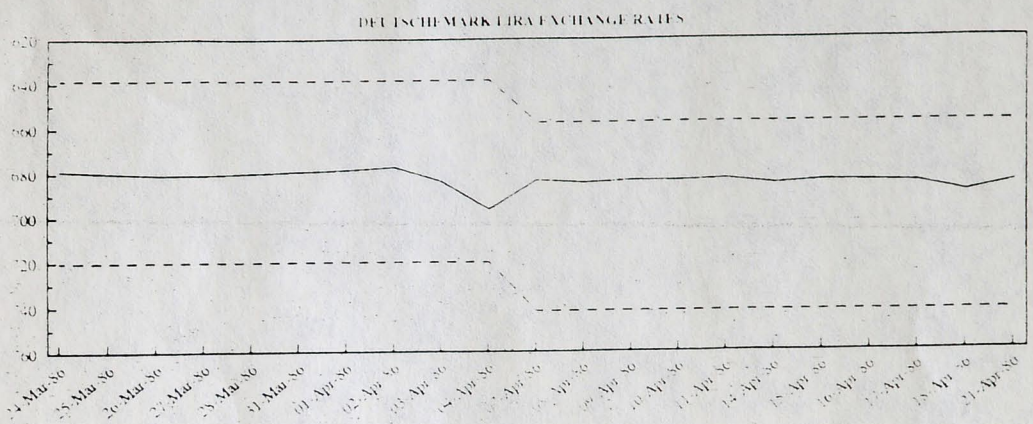
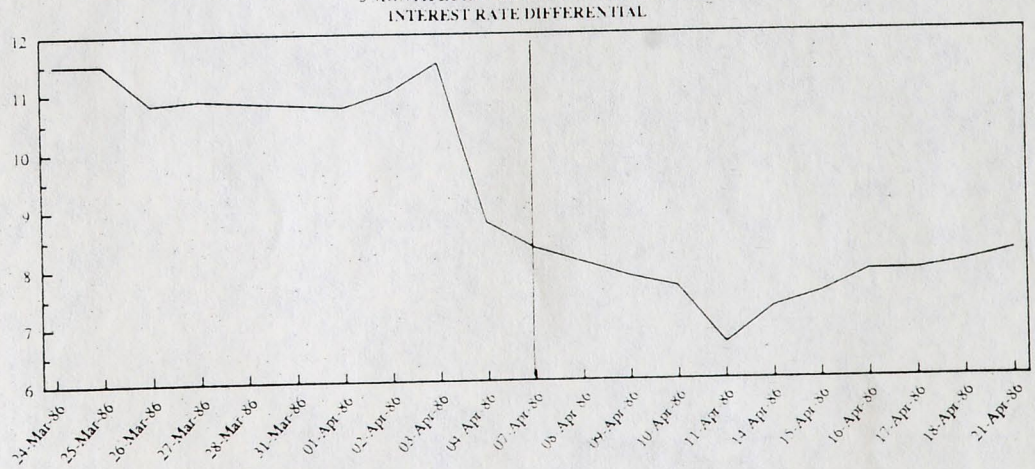


CHART A6

3 MONTH EURO LIRA DEUTSCHEMARK
INTEREST RATE DIFFERENTIAL



(i)

20. Charts A5 and A6 show similar information for the DM/lira exchange rate and interest differential:

- the lira has shown less of a tendency than the franc to go to the top of the band against the DM following a realignment. As already noted, realignments have meant that the new band has included the old rate. Therefore for the spot rate to go to the top would have required the rate to depreciate at the same time as the central rate depreciates;

- the lira has tended not to reach the bottom of the existing band before realignment. The Italian authorities have not used the full range of flexibility and the bands have acted as less of a constraint. As a consequence therefore it is likely to have been less of an influence on market expectations of future exchange rate movements.

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Table 1

Recent Monetary Conditions

	Exchange Rates			Interest Rates		Assessment
	ERI	Sterling/ Dollar	Sterling/ DMark	Base Rate	3 month I/B	
1989 Jan	98.0	1.75	3.27	13	12.9	Broadly satisfactory. No case for a reduction in interest rates but more confident of less need for further rise.
Feb	95.6	1.72	3.18	13	13.2	Need to defend the exchange rate at near to present levels.
Mar	95.5	1.70	3.18	13	13.1	Downward movement on the exchange rate would be unwelcome.
Apr	95.3	1.69	3.18	13	12.9	A policy response would be needed if the exchange rate came under downward pressure.
May	92.3	1.57	3.11	13/14	14.0	An appreciable further fall in the exchange rate would require a further rise in interest rates to maintain tight monetary conditions. (Base rate increased 24 May.)
Jun	91.9	1.62	3.06	14	14.0	If there was a further fall in the exchange rate, an increase in interest rates was recommended.
Jul	92.7	1.65	3.09	14	13.8	The rise in the exchange rate had been welcome, in tightening monetary conditions.
Aug	90.9	1.54	3.07	14	14.0	Policy should be tightened if the exchange rate fell sharply from these levels.
Sep	91.2	1.61	3.03	14	14.3	(No Assessment this month.)
Oct	88.0	1.57	2.89	14/15	15.4	Policy was on a tightrope. A further rise in interest rates was recommended if the exchange rate fell to ERI 85-86. (Base rates rose 5 October.)
Nov	86.5	1.58	2.79	15	15.2	Monetary conditions were precarious.
Dec	88.0	1.66	2.79	15	15.1	A further rise in the exchange rate would be welcome in the monetary conditions prevailing.

Table 1 (cont)

	Exchange Rates			Interest Rates		Assessment
	ERI	Sterling/ Dollar	Sterling/ DMark	Base Rate	3 month I/B	
1990 Jan	89.1	1.69	2.82	15	15.1	Need to wait on developments but no case for relaxing policy in these circumstances.
Feb	87.7	1.64	2.79	15	15.2	No case for a relaxation of policy.
Mar	87.9	1.64	2.79	15	15.2	The longer the ambiguity about the extent to which economic adjustment had occurred, the greater the case for tightening policy.
Apr	87.0	1.64	2.76	15	15.3	There was a case for and against raising interest rates in present circumstances.
May 22 (Latest figures)	88.8	1.69	2.82	15	14.9	-

APPENDIX

Spanish Experience of Joining the ERM

This note discusses the Spanish experience of entering the Exchange Rate Mechanism (ERM) of the European Monetary System in the middle of 1989.

Background

2. For some months prior to Spain's joining the ERM on 19 June 1989, the Spanish authorities were concerned by the balance of their policy stance. Had it been attainable, they would have preferred to have higher interest rates than those which were actually obtained, accompanied by the same or a weaker exchange rate.

3. Table AP1 summarises macroeconomic conditions in Spain and demonstrates why the authorities would have wished for such a different balance:

(a) inflation in Spain has been at high levels in recent years and, until 1988, was clearly accelerating. Despite beginning to ease back in 1989, it remains in double figures. A continued tight policy stance overall was therefore essential if there was to be a significant move towards price stability;

(b) the rapid inflation was perceived to be associated with the brisk and probably excessive growth in money and credit. The authorities therefore favoured high interest rates to bring monetary growth under control; but

(c) they were also concerned by Spain's balance of payments deficit which by 1989 had grown to substantial proportions - over 3 per cent of GDP. The peseta's nominal trade-weighted index had appreciated a little since 1987 and by mid-1989 was back to the levels seen in 1983 and 1984. But because Spanish inflation had consistently outstripped that of its competitors, the real peseta exchange rate - ie. movements other than would reflect differences in cumulative

(61)

inflation - had risen by around 20 per cent from mid-80s levels. The resulting lack of competitiveness worried the authorities.

4. Considerations (b) and (c) together define the dilemma that the Spanish authorities believed they faced. Whilst domestic monetary conditions warranted higher interest rates, external considerations acted as a constraint on the extent to which this was feasible. The fear was that ERM entry - with the need to prevent the peseta appreciating out of its band - would intensify the dilemma and precipitate a sharp and unwarranted fall in interest rates.

The Immediate Results of Spain's Entry into the ERM

5. The peseta joined the wide band of the ERM unexpectedly on 19 June 1989 at a central rate against the DM of 65 Ptas/DM, a rate below that on the previous working day (64.33 Ptas/DM), implying therefore a small devaluation. The immediate effect of entry was to put upward pressure on the exchange rate which rose to 63.20 Ptas/DM by 21 June 1989 (2.85 per cent above the central rate). The peseta has remained firm since joining the ERM and its current rate is 62.19 (4.3 per cent above the central rate against the DM, and about 5 per cent above its central rate against the French franc, the weakest ERM currency).

6. ERM entry had a small, but perceptible, effect on domestic interest rates with the three month rate falling from 14.97 per cent on the working day before entry to 14.37 per cent on the day after. However, by the 23 June the rate had returned to 14.90 per cent. Much larger effects were seen in the offshore markets with three month Euro-peseta rates falling from 14.60 per cent on the working day before entry to 12.00 per cent on the day after entry. However, these changes in both on-shore and off-shore rates were not sustained. The three month offshore rates rose from 13.8 per cent at the end of June to 14.6 per cent at the end of October, after being at 11.5 per cent at the beginning of the year. Similarly, the differential against deutschemark rates fell from 6.8 per cent at the end of June to 6.5 per cent at the end of

October, higher than the 5.6 per cent differential at the beginning of the year.

Appraisal

7. These considerations suggest that the fears about ERM entry, outlined above, proved largely groundless in the case of Spain. At most, it had only a limited impact in sharpening a real dilemma that the authorities faced. Indeed, the Spanish central bank are reported to believe that entry eased their difficulty to a degree. By its imposing a credible ceiling on the exchange rate, speculators were faced with a reduced possibility of capital gains from the peseta's appreciation. They were thus discouraged to that extent.

8. Nevertheless, it is important not to overstate this conclusion. It requires a number of caveats:

(i) ERM entry was accompanied by some upward pressure on the peseta, not sufficient to take it out of the ERM wide band it is in, but greater than would have been allowed had the peseta joined with a narrow band;

(ii) the underlying difficulty of external circumstances putting a constraint on interest rate increases desirable from a domestic viewpoint remains, notwithstanding the Bank of Spain's views noted in the previous paragraph. Monetary growth and inflation continue apace. ERM entry has not solved the dilemma even if it did not exacerbate it;

(iii) most importantly, it is not clear how far conclusions from Spanish experience can be generalised. Unlike sterling, for example, the peseta is not an investment currency and is not subject to capital flows of anything like the scale that sterling is. The pressures on the pound on entry could be much greater in either direction than those with which the Spanish authorities had to contend. On the other hand, some appreciation after joining would not be as unwelcome to us as it was to the Spanish.

Table AP1: Macroeconomic Conditions in Spain

	Exchange Rate(1) Nominal	Exchange Rate(1) Real	Interest Rate	Broad Money Growth (2)	Inflation Rate (3)	Current Account(4)
1983	104.4	102.5	19.4			- 2.7
1984	102.6	100.5	12.6			2.0
1985	100.0	100.0	11.6		13.7	2.9
1986	96.8	101.8	11.5	15.3	15.3	4.0
1987	96.2	106.9	16.1	14.4	14.4	- 0.2
1988	99.0	113.2	11.3	21.3	21.3	- 3.8
1989				16.9	16.9	-11.7
1989 J	103.3	120.9	12.4	19.4		
F	103.4	121.2	13.5	20.3		
M	103.8	121.9	13.9	20.5		
A	104.1	122.7	13.9	21.7		
M	102.9	121.7	14.0	16.7		
J	100.7	119.6	14.4	18.2		
J	103.4	120.8	15.1	15.5		
A	103.2	120.9	15.1	12.7		
S	103.3	121.1	15.0	16.9		
O	103.3	121.7	14.8	14.6		
N	104.1	123.1	15.2	13.1		
D	104.7	124.3	15.5	15.2		
1990 J	104.7	124.8	15.1	12.1		
F	105.0	125.4	15.1	13.0		

(1) Trade-weighted 1985 = 100

(2) 12 month growth rate, per cent

(3) Consumer prices

(4) Billions of dollars

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PRIME MINISTER

ERM

I attach a minute from the Chancellor covering a paper on ERM. This is intended for discussion at next week's bilateral on Wednesday. However, the Chancellor appreciates you are very busy next week: he would be content to postpone the discussion if you prefer.

It is a very useful paper on important policy/technical issues:

- exchange rate on entry to the ERM;
- the width of the band on entry;
- the position of sterling within the band.

The conclusions seem broadly sensible. If the UK is to enter the ERM, the aim must be to reinforce downward pressures on inflation. That means seeking a short term bonus on the exchange rate, providing that is consistent with underlying economic realities, ie. not putting too sharp a squeeze on industry. One might add that there is equally a need to avoid premature reductions in interest rates on entry - a point picked up in the background paper.

First, the paper indicates that the current DM/Sterling exchange rate is not much out of line with recent experience. The real exchange rate is within the broad range experienced over the 1980s, if a little on the low side.

The paper proposes that the UK should therefore aim to join at an exchange rate a little above the present: this is a sensible means of imparting an upward bias to the exchange rate - and a downward bias on inflation. But further consideration would have to be given to any proposed margin above the current rate (it would have to be fairly limited); and whether it should be done

would depend on economic circumstances at the time.

Second, again in order to impart an upward bias to the rate, it is necessary to have a sufficiently wide band so that the exchange rate has scope to appreciate. Immediately after entry the expected bonus of membership - essentially the safeguard which financial markets have against a substantial depreciation of the currency - can either be taken as a higher exchange rate or lower interest rates. (To some unknown extent, this bonus may be discounted in advance in the exchange rate prior to entry).

Monetary policy and hence interest rates need to be determined by domestic circumstances. Accordingly, the Government might wish to avoid any reduction in interest rates. This points to leaving a sufficient margin of flexibility to allow the exchange rate to rise. Accordingly, the Chancellor proposes the wider bands of +/- 6 per cent: this seems sensible.

Thirdly, there is the question of where within that band the exchange rate should be set. Again, consistent with the theme of upward bias it is proposed that the entry rate would be set marginally below the central rate within the band. That would be an anti-inflationary signal.

Finally, the paper discusses the implications of GEMU. It concludes that it is very difficult to determine in advance what the implications might be for the ERM.

Next Steps

I will of course provide further guidance as required before Wednesday, in consultation with Andrew Turnbull and Brian Griffiths. The initial impression on reading the paper, however, is that it addresses the important but mechanical policy issues: the real question is the timing of entry. The Treasury is now ready to move on to discuss that issue.

As you know, the timing of entry involves complex calculations about the possible timing of a general election; the expected short term financial impact on the exchange rate and inflation

(itself of uncertain strength and timing); the dangers of a later backlash, with money flowing out of the UK at an unfortunate stage.

Moreover, even putative entry to the ERM at various times over the next year may put constraints on the operation of economic policy. For example, any cut in interest rates in advance of joining the ERM will have implications for the entry rate and positioning within the band.

BHP

BARRY H. POTTER

8 June 1990

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(slh)

CONFIDENTIAL AND PERSONAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 June 1990

Dear Stephen,

ECONOMIC AND MONETARY UNION

The Chancellor of the Exchequer recently sent the Prime Minister a personal minute about the way ahead on Economic and Monetary Union: and the Prime Minister discussed it with him on 31 May. I enclose a copy of the minute and a copy of my record.

You will see that two ideas arise from the discussion which need further work. They are:

- linking of the major world currencies, including the dollar and the yen, to an objective reference standard, for instance a commodity index which would work automatically.

- the concept of giving greater emphasis and substance to the transatlantic relationship in the trade and economic field, so that EMU does not result in a narrow, tighter, more inward-looking European bloc.

The Treasury did some work last year on the possibility of an objective reference standard for exchange rates. They are now looking at this again, and the Chancellor intends to put a note to the Prime Minister on her return from the Soviet Union.

The other aspect falls more to FCO and DTI. As you will see from my note of the meeting, the Prime Minister wants to enlarge the discussion of economic and monetary union and give it a much broader context. She fears that without this, there is a risk that the world will increasingly divide into tight blocs of countries, whose instincts will be protectionist. She would like us to examine proposals for creating a much broader trade and economic area spanning the Atlantic (within Europe a start has already been made with the arrangements between the EC and EFTA). One possibility would be linking the EC, EFTA and the US/Canada in a free trade area, although this does of course raise all sorts of issues (free trade in agriculture as well?) Obviously such work has to take account of what is already in place, for instance the recently improved and institutionalised

links between the US and the European Community, as well as the GATT. The basic motivation is to strengthen free markets and free economic and monetary exchange: but there is also the tactical element of trying to overshadow EMU within the European Community, not so much in the expectation of derailing it but of leading it off in a rather different direction. The Prime Minister would be grateful if the FCO and DTI could do some work on this quite urgently and let her have a note, setting out some broad thoughts on which she might draw in discussion at the European Council, the NATO Summit and the Economic Summit.

Once some work has been done on both these aspects, the Prime Minister would like a discussion with the Foreign Secretary, the Chancellor and the Trade & Industry Secretary.

I am copying this letter and enclosures to Martin Stanley (DTI) and without enclosures to John Gieve (Treasury).

Yours sincerely,

CHARLES POWELL

J.S. Wall, LVO, Esq.,
Foreign and Commonwealth Office

Barry

The discussion of the commodity unit starts at page 83. It is not quite the same as Walters' ECOM as it uses the prices of actual commodities whereas he uses a pure price index.

AT

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Sir A Walters

MODELS OF ECONOMIC AND MONETARY UNION

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MODELS OF ECONOMIC AND MONETARY UNION

INTRODUCTION

1. This paper is mainly concerned with models of monetary union which could be put forward as alternatives to that in Delors Stage 3. Fiscal and regional policy issues are largely independent of the particular form of monetary union adopted and are discussed separately and only briefly.

2. The main monetary models considered are:

- Delors Stage 3;

- extending the exchange rate mechanism by:

  - having narrower bands;
  - a common dollar/yen policy;
  - greater co-ordination of monetary policies;
  - incorporating non-EC members;

- competing currencies, either official currencies alone or both official and private currencies;

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

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

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3. The Single European Act of 1986 - of which the UK is a signatory - referred in its preamble to the 1972 declaration in which "the Heads of State or of Government approved the objective of the progressive realisation of Economic and Monetary Union". Chapter 1 of the Single Act is headed "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". Both the Hanover European Council in June 1988 and the Madrid European Council in June 1989 reaffirmed the objective of progressive realisation of Economic and Monetary Union. The Single Act and subsequent declarations do not commit the UK to any specific definition of EMU. The Madrid Council agreed that the Delors Report "provided a good basis for further work."

4. By contrast with Delors Stage 3, most of the alternative models do not necessarily require either a single European monetary authority or a single currency. They would therefore not be recognised as forms of monetary union by many observers. (The mere existence of Delors' proposals - and the earlier Werner report - has, of course, conditioned ideas about what monetary union is.) Nevertheless, it should be possible to present each of them as a form of monetary union. It is important to be able to do this, since mere monetary cooperation would not be seen by our EC partners as fulfilling the commitment to progressive realisation of economic and monetary union.

5. The implicit basis of comparison for the alternative models is the situation when Delors Stage 1 is completed. In other words, it is assumed that all currencies are in the ERM with margins of 2¼ per cent, there are free capital flows, and the single market programme has been completed. It is important to recognise that this is likely to lead in time - when the private sector has adjusted - to a much greater integration of economies than at present. With free movement of goods, labour and capital, it could certainly be described as economic union. While a reasonable case could be made for also describing it as monetary union, the Community has clearly decided that the monetary union we are committed to represents something beyond Stage 1.

6. The paper is concerned with the final monetary union, and not with the next steps after Stage 1. However, possible transitional steps are briefly mentioned since they are relevant to a comparison of the models of monetary union.

7. The paper is largely a description of the alternative models, how they might work and their consequences. The concluding section compares them from various points of view:

- economic implications;
- sovereignty;
- how they can be presented as monetary union;
- transitional arrangements;
- acceptability to our EC partners.

These criteria need to be borne in mind in considering the alternative models.

8. The main part of the paper is devoted to the alternative monetary models. There are then brief sections on fiscal and regional policies and a concluding section. Further details on three of the models are in the annexes.

MONETARY MODELS

Delors' Stage 3

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

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

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

12. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions. For example, what monetary aggregates would be targeted? In the period before transition to a single currency, would as near as possible identical aggregates be targeted in each country or would existing national traditions be respected? How would allowance be made for differences in velocity trends and potential growth rates in allocating national monetary targets? Would the ESCB target bank reserves, would it go further and operate a monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

13. A more detailed discussion of Delors is at Annex 1.

Extending the ERM

14. The completion of Delors Stage 1 will represent a considerable strengthening of the discipline on national monetary policies exerted by the EMS. The abolition of capital controls and the advent of the single market in banking will increase market pressures on monetary authorities and cause monetary policies and inflation objectives to converge to a much higher degree than at present. The move to 2¼ per cent exchange rate bands for currencies now with 6% bands and the participation of all Community currencies in the ERM will impose additional convergent pressures on the countries concerned.

15. At that stage any remaining scope for independent monetary policies will stem largely from the possibility of currency realignments. The various ways discussed in this section of extending the ERM do not therefore include any significant curtailment of the freedom to realign. Partly for this reason, they do not greatly increase the convergent pressures that will exist at the end of Stage 1.

16. The first three options - narrower bands, a common dollar/yen policy and greater co-ordination of monetary policies - all involve somewhat increased convergent pressures whether exerted by the market or by Community agreements. The fourth, the incorporation of non-EC members, does not.

(i) Narrower bands

17. By the end of Delors Stage 1 all EC currencies will be operating within 2¼ per cent bands. This option for extending the ERM envisages a subsequent move to narrower bands of, say, 1 per cent. The move would best be made in one step: smaller and more frequent changes would add complication, without offering significantly greater flexibility.

18. The Delors Report envisaged such a move as a transitional step towards monetary union rather than the final position. It proposed that during Stage 2 not only should realignments become less frequent but "as circumstances permitted and in the light of progress made in the process of economic convergence, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero". Partly as a result of Delors' position, it will not be easy to argue that narrower bands on their own represent monetary union.

19. Monetary policy and targets would continue to be set, as now, at the domestic level. There would be no need for a Community monetary policy or Community monetary targets. Nor would institutional changes be necessary (although legal documents referring to 2¼ per cent bands would require amendment). But as the scope for exchange range fluctuation was reduced, the need for prior consultation about interest rate changes would correspondingly increase.

20. Narrower bands impose a tighter discipline on monetary authorities, forcing them to adjust policies earlier than they would have done with wider bands. They also reduce the monetary authorities' freedom of tactical action to some degree: they would be less able to "punish" speculators by allowing within-the-band variation of the exchange rate. There would therefore be greater pressure on governments to pursue convergent inflation objectives and monetary policies, and the frequency of realignments would fall to the extent that they responded appropriately.

21. The convergence of inflation rates would be crucial to the success of this model. As long as differences in inflation relativities between economies remained, it would be expected and desirable that nominal and real interest rates would differ as the process of adjustment worked through. If instability and disruption were to be avoided, the move to narrower bands would have to await the achievement of sustainably small inflation and interest rate differentials.

Same RPI index would be used

(ii) Common dollar/yen policy

22. This could take various forms. At the minimum, it might reflect an agreement on intervention arrangements, designed to ensure that when individual member states intervened vis-a-vis the dollar or yen, they did so consistently and that the market impact of one country's action was not immediately offset by the action of another ERM member. Mutually inconsistent intervention by major countries has occurred in the past but it has not usually involved two ERM members, since they have a common interest in ensuring a consistent outcome. This suggests that informal understandings already exist within the mechanism on how intervention should be undertaken against third currencies. These could perhaps be formalised but there is probably little scope for much further development in this area.

23. The Community could, however, go beyond this to form an agreed view on the implications of changes in dollar and yen rates against ERM currencies and on the appropriate response of individual member states in these circumstances. This view could be formulated with greater or lesser precision and the agreed response of individual ERM countries could be regarded as more or less binding.

24. A more formal variant would be for the Community to adopt specific exchange rate ranges in relation to the dollar and yen. As in the case of the Plaza and Louvre agreements, the ranges would probably be expressed only in terms of the deutschemark. No doubt there would have to be some burden-sharing agreement about intervention too and its implications for individual member states would have to be discussed in a Community forum.

25. An agreed common policy towards the dollar and yen would imply greater discussion of member states' monetary policies at Community level but monetary targets could continue to be set nationally, with no need for targets for the Community as a whole. There would, however, be pressure for more prior discussion before they were adopted. Advance consultation on interest rate changes

would also be desirable because of their implications for the mechanism's relationship with third currencies. This would mean that many monetary policy decisions would be taken on a collective basis rather than mainly by Germany (or whichever country or countries was dominant by the end of Stage 1).

26. No adaptation of the existing institutional arrangements would be strictly necessary. Strategic discussions about individual member states' monetary policies and the action to be taken in response to movements in the dollar and yen could be conducted within the Monetary Committee, as to some degree it already is. Day-to-day tactics would have to be co-ordinated by central banks but if particularly thorny issues arose in specific situations, Monetary Committee members could consult by telephone.

27. Although no institutional changes would be strictly required, the intensification of informal cooperation and coordination might well push the Community towards more formal arrangements. These could be limited to practical matters such as a common pool of reserves for intervention although difficulties could arise if policy decisions, for example on intervention, were taken elsewhere.. Or they could embrace policy-making machinery with an enhanced role for new or existing central institutions.

28. Any common dollar/yen policy which involved a formal role for the dollar and yen rates would require consultations with the US and Japan. For the purpose of this discussion it is assumed that these will not be different in substance from the types of consultation of recent years. However there would be a question of who would represent the Community in such consultations. The Germans would be extremely reluctant to lose their chair at G3 meetings but the Community as a whole would no doubt press to be represented collectively. If the central bank Governors developed an enhanced role there would be pressure for them also to be represented collectively. The Community would no doubt also wish to be represented at a political level. In theory, the Finance Minister of the country holding the Presidency could be invited but it is hard to imagine this would be acceptable to the

Americans and Japanese if one of the smaller member states were in the Community chair. Moreover, if Germany continued to attend as well, the US and Japan might feel that Europe was being accorded too great a voice in their discussions.

29. To sum up, the common dollar/yen policy might in practice amount to little more than an elaborate arrangement for sharing decision-making about the external value of EMS currencies rather than allowing Germany to make the decisions alone. The consequences would tend to be slightly inflationary because most governments outside Germany would prefer looser monetary policies than Germany would. There need not be any institutional changes although there would be closer co-ordination and there could be pressure for centralisation of the management of reserves intervention operations, or even decision making.. There would be no need for a transitional phase: the only step beyond Delors Stage 1 would be an agreement about taking the dollar and yen into account in a particular way.

(iii) Greater co-ordination of monetary policies

30. The common dollar/yen policy would involve closer co-ordination of monetary policies in order to make it work. An alternative approach is to define monetary union in terms of some particular form of institutional arrangement for closer co-ordination. There are a number of possibilities, ranging from an enhanced role for existing co-ordinating machinery (eg the Monetary Committee) to the creation of a new body. There are also different degrees to which responsibility for decision-making as opposed to co-ordination and monitoring could be transferred from national to Community level.

31. At one extreme, formal decisions on monetary policy would remain at national level although there would be greater co-ordination of monetary policy than in Stage 1. There would be full consultation even before monetary decisions were taken, and the aggregate implications of individual countries' policies would be monitored, but nothing beyond that. This model can be thought of as a perpetual Stage 2 of Delors.

32. No institutional changes would be strictly required. (The ESCB is set up in Delors' Stage 2 but partly to get into training for its central role in Stage 3.) If a new body were to be set up to assist in the co-ordination and monitoring of policies, it would be for consideration how independent it should be of existing institutions, and the balance of membership between central banks and Finance Ministers. The creation of a new institution would at least give the impression of a significant step forward, even if its work could equally be done by beefed up versions of existing Community institutions.

33. However, a new institution which was responsible only for co-ordination and monitoring might not be a stable situation. It might lobby for more power and complain that its expertise was not being fully exploited. Although the example of the OECD suggests otherwise, there is a risk that setting up a new institution would intensify pressures to transfer decision-making to it, ie to transform "perpetual Stage 2" into something like Stage 3.

34. Some of this pressure could possibly be headed off by endowing the new institution with carefully limited powers of its own from the start. One obvious example would be to authorise it to manage foreign exchange reserves and intervene in foreign exchange markets in pursuit of collectively agreed policies. This would make it similar to the European Reserve Fund as advocated by the French and discussed in the Delors Report. Member states would pool a limited proportion (say 10 per cent) of their official reserves on a permanent basis. This would provide resources for the Fund which might also be empowered to engage in swap operations with commercial banks for limited amounts. It would manage its own reserves and intervene with them against third currencies, as well as those within the mechanism, at the request of member states. It could also carry out the necessary co-ordination and monitoring of national monetary policies, although these functions would not have to be located in the Fund.

35. While a European Reserve Fund could in principle be restricted to a limited range of operations, this could lead to tensions between it and the governments and central banks taking the decisions. As the Plaza and Louvre experience demonstrated, the difficulty of arriving at agreed policy decisions can cause the operational body to be given insufficiently precise instructions, leaving it room to pursue its own view of what is best. On other occasions the Fund might disagree with the monetary policy decisions taken by governments and central banks. Over time the Fund might seek to expand its role, encouraged no doubt by some governments and/or central banks. Moreover, the fact that it was originally proposed by de Larosiere as only a first stage around which more ambitious functions could gradually accumulate makes it harder to present as a model of monetary union.

36. To conclude this section, a number of alternative models of enhanced co-ordination of monetary policy are in principle feasible. They can be distinguished in a number of ways

- by the extent to which responsibility for monetary policy decisions (as opposed to consultation and monitoring) and operations (eg intervention) is transferred from national to Community level;

- by whether new institutions (eg a European Reserve Fund) are created or not;

- by the nature of the control exercised over Community decision-making or operations (eg the role of Finance Ministers, central bank Governors, independent members etc).

37. In many cases the overall economic effect might be little different from that of Delors Stage 1. This would be so if the new decision makers pursued monetary policies that were just as tight as the Bundesbank would have followed. However there would

be a risk in some cases, especially those where national governments had more of a say, that the outcome would be more inflationary.

38. Given the impact of Delors Stage 3 on the debate, it will be difficult to argue convincingly that these models of enhanced coordination represent monetary union. The more "institutionalised" they are, the easier this may be. This points towards a model in which a new institution is created with some limited powers of its own but firmly under the control of national monetary authorities. The latter would continue to make all important policy decisions after full consultation at Community level in either the new institution (ie its board or a special committee), ECOFIN, the central bank Governors' committee, or the Monetary Committee. The transition to such an arrangement would require only two steps which could be taken in either order: the setting up of the new institution and the enhancement of monetary policy co-ordination.

(iv) Incorporation of non-EC members in ERM

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

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

In practice, none has applied to do so, although Norway, for one, has shown signs of interest from time to time; and an annual consultation procedure has been set up between the Chairman of the EC Monetary Committee and the Norwegian and Austrian authorities.

40. There would be no need to change the existing monetary arrangements - monetary targets and policies would continue to be set at the national level - and there are no significant institutional implications.

41. The perceived advantages and disadvantages of increased membership will differ according to the viewpoint:

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

(b) procedurally, having more members of the ERM would make future changes more difficult to agree. That could slow down movement towards monetary union. Alternatively, it could increase the tension sufficiently to generate multi-speed movements by different groupings within the enlarged ERM.

The inclusion of non-EC members would be seen by some to make it harder, rather than easier, to achieve full economic and monetary union on a Community basis (if defined to include, inter alia, the setting of monetary policy for the Community as a whole and perhaps centralised budgetary decisions). Those most enthusiastic for this form of EMU would therefore tend to regard this option as a wrecking amendment - even though it has a perfectly respectable Community basis in the 1978 Council Resolution.

Competing currencies: official

42. In this model there would be a system of competing official currencies each controlled by its own national monetary authority. People and companies throughout the Community would be free to use whichever of the available currencies they wanted. National monetary authorities would then compete to make their currency the most attractive and thus the most widely used.

43. An ecu issued by the authorities (national or European) could also compete with national currencies, but only if it was an independent currency and not a weighted average of the others (as the Delors report recognised). But for this there would have to be an independent monetary authority which would take it outside

the scope of models considered in this paper. (Nor does the paper discuss the issue of an ecu which was a weighted average of currencies, except briefly in Annex 1.)

44. The competing currency proposal was in fact made quite specifically in a European context by Hayek* in 1976 as a replacement for the monetary systems in place at the time. But underlying this proposal was one closer to his heart - that any agent who wished should be allowed to issue his own currency, again competing freely so as to make his product widely and profitably acceptable. The present section discusses the narrower competing national currencies model: the next section considers the more general version in which private currencies are free to compete with national ones.

45. The main requirement is that the legal and institutional framework allows willing parties to transactions - individuals, governments or companies - to use whatever national currency they prefer to make those transactions. Since competition is the driving force of this system, there should be as few barriers to free competition between currencies as possible.

46. On this criterion, it is possible to assess how far conditions in the European Community approximate to what would be necessary for a viable competing currency system and what further steps would need to be taken. In fact, to a very considerable extent, much of what would be required has already largely been achieved or will be implemented within the foreseeable future:

(a) with a few exceptions - not important in this context - the Capital Liberalisation Directive will ensure freedom of capital movements within the Community from 1 July 1990 for all member states other than Spain, Ireland, Greece and Portugal who have a more extended timetable for meeting its requirements;

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* Friedrich Hayek: "The Denationalisation of Money". IEA Hobart Paper No 70. 1976

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

47. While these measures will go a long way towards providing the necessary conditions for a competitive currency regime, some obstacles to the free use of Community currencies would remain in practice. In the UK, for example:

(i) Legal tender: At present where no contractual provision exists for repayment, debts have to be settled in legal tender, ie. sterling - if there is a dispute. If we were to remove all obstacles, we would therefore have to extend the definition of legal tender to cover all Community currencies. The best way to do this would be to require creditors to accept at least one Community currency in settlement of a debt but not any one. The disadvantage of permitting any Community currency that the debtor chose would be that transactions costs would be raised significantly (because creditors would insist on explicit agreements about the currency of settlement) and competition between currencies would be impeded.

An alternative way of removing the obstacle would be to abolish legal tender entirely. But that would mean that any contract - even ones usually left as implicit - would have to state explicitly what form of payment both parties would then be prepared to accept for the purposes of the transaction, and transactions costs could be very high.

(ii) Company accounts: This is important not only in itself but also because the choice of accounting currency will often make a difference to the total tax liability. The position in UK law is unclear and has never been tested. However, in practice, wherever a

company can reasonably argue that it would be appropriate to draw up its accounts in any currency other than sterling, it has been allowed to do so (eg. the oil companies are allowed to draw up their accounts in dollars). Presumably, if a company decided it wanted to denominate its accounts in another Community currency, it would be extending its use of that currency more generally, and so could meet this requirement. A draft Directive, currently scheduled to come into force on 1 January 1990 but unlikely to be agreed for a couple of years or so, provides for companies in the Community to draw up their accounts in ecu (but not other Community currencies) as well as domestic currency.

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

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

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

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

(ii) we have fought very hard so far to ensure that payments to and from the Community budget are made in sterling, retain control of the flows within the Treasury and deposit any excess sterling overnight with the PGO. No doubt, other Community countries display similar preferences for their own currencies.

50. Even in principle, it is not clear that it would be necessary or desirable to prevent governments from exercising bias in favour of their own currencies. Since the rationale of the system is one of competition, it is hard to see that national governments should be denied all opportunities to give a fillip to their own currencies. On the other hand, if the larger governments in particular became excessively protectionist,

insisting, for example, that all payments to them were made in their own currencies, that would stifle competition rather than intensify it. To prevent this, there might have to be some rules on governmental currency acceptance analogous to the EC public purchasing regulations.

51. Minimal institutional or structural changes would be required under competing currencies. The essence of the system would be that national monetary authorities would continue to administer their monetary policies and currencies just as at present, save for the additional competitive discipline of making sure that their currencies continued to be widely used and accepted. So there would be no need for extra administrative machinery or institutions.

52. Indeed, the approach would be more successful if there were some dismantling of the existing cooperative framework - not least the Exchange Rate Mechanism. If competition between currencies is the driving force:

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

(b) the ERM - fixing exchange rates between realignments - would also help blunt the required competition. For an extended period of time after a realignment had taken place, potential users of currencies would regard them as more or less equal in value. Normally, the competitive currency model is supposed to ensure that good currencies drive out bad ones. But during this temporary fixity there would be a tendency for the opposite to happen - Gresham's Law, bad money driving out the good. Fluctuations in exchange rates would be an important part of the mechanism through which competitive pressures were exerted.

53. Although this is necessarily an exercise in prediction, experience to date gives some guide as to what the eventual pattern of currency usage under a competitive currency system might be. Several observations seem relevant here:

(a) for transactors to work with a number of currencies means that they need more information than if they stick to a single currency. Some agents - large international firms, for example, - will be better placed to acquire this information than, say, individuals. Provided that their "domestic" currency is reasonably well-behaved, the latter are likely to stick with it even if some other currency is, in principle, a better one; related to this,

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

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

(d) "cocktail" currencies, such as the ecu, have so far not flourished as transactions currencies, though the ecu has done better as an investment currency. There has been little or no pressure for private cocktails based on privately agreed weightings of existing

currencies, even though there would be no constraint on transactions in such form if people wanted to make them.

54. Another source of information in this area is the extent to which currencies (and, for that matter, gold) have been well-behaved in the past. "Well-behaved" in this content probably means the extent to which individual currencies have neither depreciated sharply or erratically in value - to the detriment of creditors - nor appreciated sharply or erratically at cost to debtors. Currencies stable in value are the ones most likely to be preferred.

55. So far as pure currency is concerned - notes and coin - the extent of depreciation is easily measured by the rate of inflation, since by definition this money is non-interest bearing. As the following shows, there have been appreciable differences between the rate of depreciation of the major currencies over the last decade or so.

Domestic Value of Currencies, End 1988 **1979Q4=100**

Mark	74.3
Franc	50.2
Lira	35.0
Pound	53.5

Thus, because of inflation, the mark will now buy around three-quarters of what it would at the end of 1979 - an average annual depreciation of about 3¼ per cent. But the lira is now worth only about a third of its end 1979 value, equivalent to annual depreciation of nearly 11 per cent. On this criterion, therefore, the mark would be generally preferred as a transaction medium on account of its greater stability. The lira would be disadvantaged in this respect, while sterling and the French franc would be somewhere in between.

56. But most transactions balances are nowadays interest bearing; about nine-tenths in the case of the UK. So it may be that the effect on the value of the lira from greater Italian inflation is partly or wholly offset by the fact that Italian interest rates have normally been higher than in other major European countries. In fact, during the 1980s as a whole, the real rate of return to the lira has been greater than that of the other currencies:

Real rate of return **Per cent**

	Mark	Franc	Lira	Sterling
1980Q2 - 1988Q4	3.3	3.5	4.2	4.0
1980Q2 - 1984Q4	4.6	2.8	3.1	3.4
1985Q1 - 1988Q4	1.8	4.4	6.0	4.6

But in itself that would not necessarily mean that transactors would remain faithful to the lira. It might be attractive to creditors, but not to debtors. Even creditors would be discouraged by the uncertainty, which may explain the greater return.

57. In the context of measuring the relative attractiveness of each currency for transactions purposes, a better criterion might be the stability and predictability of the purchasing power of each currency taking account of both inflation and the compensation provided by the interest rate. Currencies whose real compensated value was stable would make good transactions vehicles; those which were volatile would not.

58. Volatility can be measured by the standard deviation of the quarterly percentage changes in the compensated real value of each currency. Perfect stability would be reflected in a standard deviation of zero; increased volatility would result in higher recorded standard deviations. The volatility measures turn out to be as follows:

Standard Deviations of Interest Compensated Real Values

	Mark	Franc	Lira	Per cent Sterling
1980Q2 - 1988Q4	0.501	0.746	0.888	0.762
1980Q2 - 1984Q4	0.455	0.924	0.962	0.818
1985Q1 - 1988Q4	0.280	0.345	0.524	0.683

59. These statistics suggest that there have been significant differences in the stability of the currencies. All currencies have become more stable in compensated value over time, probably consequent on the decline in inflation. But the mark has been relatively the most stable of the four throughout. Over the whole period, there would be little to choose between sterling and the French franc though over the last few years the franc's compensated value has been much the stabler of the two.

60. Assessing the above evidence as a whole suggests the following tentative conclusions:

(a) the inertia in the system suggests that, unless monetary authorities behave much more irresponsibly than they have in the past, national currencies would continue to be used in their own geographical domains (though there might be a question mark over some of the smaller ones);

(b) for larger transactions and especially for international transactions within the Community, one or two of the larger currencies and especially those perceived to be well-behaved might come to be increasingly dominant. The size of the economy for which the mark is already the local currency and its perceived stability would give it a clear advantage;

(c) it is just not clear how fast the tendency towards a small number of dominant currencies would manifest itself or whether the small number would be one or, say, two or three. Much would obviously depend upon the future behaviour of the competing national monetary authorities.

61. Even if the competitive pressures did result in a dominant single currency, this would not necessarily be a permanent state of affairs. Other currencies might re-emerge as their relative quality changed over time. In fact, there is some tension between:

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

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

Presumably the tension would be resolved by the competitive process being suspended when a winner had emerged. In that case, the winning monetary authority might be converted to a Community institution.

62. Competing currencies would permit monetary union in the sense of a single currency but would not necessarily bring it about. If a single currency did emerge, in the first instance it would be a Community currency controlled by a national central bank which, to the extent it was democratically accountable, would be accountable to a national government and parliament. That prospect would be viewed differently by different parties, much depending upon the identity of the winning currency and central bank. It would, as noted in the last paragraph, be possible to convert that central bank to a Community one responsible to the Community as a whole. But that might not be wholly straightforward to implement.

Competing currencies: private

63. The previous section considered a model in which national monetary authorities competed to make their own currencies the most attractive and thus the most widely used. Since stability would be one of the characteristics of the currency people would want to hold, that would be likely to be a feature of the eventual dominant currencies. But there would be no need to restrict entry into this competition to national monetary authorities. Indeed, introducing private sector competition would discourage national monetary authorities from colluding together and settling for a common positive rate of inflation. This was the underlying proposition in Hayek's original pamphlet.

64. There would be no great difference between the mode of operation of competing national currencies and a system where private institutions were also allowed to issue currency. (See Annex 2 for a fuller discussion.) A private currency would effectively be created when a bank or group of banks started to issue notes or to take deposits denominated in that new currency. The new currency would be freely exchangeable against existing currencies at floating rates of exchange. It could be called the private ecu (as in Riboud's scheme) but it would not, of course, have a fixed rate against the official ecu or any individual national currencies.

65. To make its currency attractive, the issuing institution would presumably undertake to render the value of its currency stable against a convenient and representative basket of goods and services. That would mean restricting the nominal value of its issue accordingly. It could then either:

(a) hold at least a fractional reserve of the basket of goods and services in its vaults and undertake to exchange the basket freely at the declared rate for its notes; or, more practically

(b) rely on its reputation such that its currency was perceived to retain a stable value against the basket of goods and services. The bank would then issue only as much currency as was consistent with this happening, given the demand that existed for its particular currency. Calculating the appropriate currency to issue would certainly be feasible in principle though it would involve some difficult technical judgements.

66. There would be a number of uncertainties and difficulties in such a system, discussed in Annex 2. This is inevitable since there is virtually no experience of such a system operating. In principle, these difficulties should be surmountable but whether they could be overcome in practice would remain to be seen.

67. Producing the conditions to allow the emergence of private currencies would probably not be very difficult, if there were private bodies which wanted to take advantage of the opportunity. Presumably the same steps would have to be taken as would be required to allow full competition between national currencies. In addition, it would be necessary to ensure - by Community Directive - that there was no discrimination in law between private currencies and existing national ones. The essence would be that economic agents should be allowed to express their preferences for private or national currencies freely.

68. There would also be no need for official institutional developments to allow the system to operate. However, just as with the national competing currency model, existing cooperative arrangements including the ERM would have to be dismantled if the competitive forces were to be given a favourable environment.

69. Since there is little or no experience of privately issued currencies to go on, it is largely speculation as to how well they might do - what their circulation might be - if they were allowed. But it seems clear that they would have a substantial initial disadvantage insofar as their circulation would have to build up from nothing. Just as Esperanto, despite its logical virtue, has not displaced the major existing languages, new private currencies

might have a hard time catching on - unless the proprietary monetary authorities of the national currencies began to behave in wholly irresponsible ways. In any other circumstances, it would take a long time - decades - for private currencies to acquire a large circulation, if it happened at all.

70. This option would probably be less acceptable than the competing national currencies model to other European countries. It would be open - but more acutely - to the same criticism that it would not necessarily bring about a single currency; and at best only with a very long time horizon. Other countries might also take the view that since national governments have invariably not been prepared to experiment with private currencies, it would be wrong to do so at a European level where the effects might be even less predictable.

The gold standard and related models

71. The presentation in this section is mainly in terms of gold, although in practice a broader commodity standard might well be better.

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

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

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

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

73. An EMS gold standard would require the determination of gold parities (plus bands) for each EMS currency at the outset. The credibility of the system would rest on the availability of some stocks of gold within Europe to cope with fluctuations in the private sectors' demand for gold; but providing EMS members were willing to vary interest rates as quickly and by as much as necessary to attract gold in when they needed it the system might be sustainable with a relatively small level of gold reserves.

74. Unless specifically prohibited from doing so, central banks would certainly choose to diversify their portfolios, ie to hold (interest-bearing) currency reserves as well. Faced with a would-be purchaser of gold, a central bank would in this case have the choice of either selling gold directly from its reserves or using currency reserves to buy more gold on the open market and satisfy its customer that way. If currency reserves were held on a large scale the system would be closer to what is normally described as a "gold exchange standard" - such as existed for a few years between the two world wars and, to some extent, in the Bretton Woods era - rather than the pure gold standard. (Even before the first world war, some currency reserves were held by participants in the international gold standard.)

75. As the Bretton Woods era demonstrated, a gold exchange standard without an effective constraint on currency reserve creation does not necessarily tie down the price level (US prices rose by more than half between the late 1940s and the end of the 1960s while the dollar gold parity remained fixed at $35 an ounce). Helped by the initial dollar shortage which concealed the

underlying situation and influenced by ideas that gold no longer mattered, the US was able to pursue inflationary policies for a very long time. By the early 1970s the monetary tightening that would have been required to maintain the original gold parity was more severe than could be realistically contemplated. The constraint of an EMS gold standard would bite at an earlier stage because there is no "deutschemark" shortage comparable to the dollar shortage, and it would therefore be more effective.

76. One possible way of economising on the need for gold reserves to run the system would be for European holdings of gold to be pooled and for individual countries to draw on the common gold reserves as needed up to a prescribed limit. This type of arrangement has the advantage of reducing the impact of transient disturbances - a temporary increase in private sector demand for gold in the particular country need have no effect on that country's interest rate - at the cost of delaying adjustments to more fundamental disequilibria.

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

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

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

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

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

82. The EMS members would presumably not attempt to fix their currencies to gold before achieving close convergence of inflation within Europe (at or near a zero rate). There would be a period, corresponding to Delors' Stage 1, in which all EMS participants would have joined the ERM, with parity changes still permissible but increasingly infrequent. There might be some build up of European gold stocks during this period if an increase in stocks was thought to be required for operation of the EMS gold standard: this would give some indication of the effect of the introduction of the gold standard on the world gold price, and reduce the risk of EMS gold parities being set initially at an incorrect level.

83. The risk of volatility in competitiveness would also arise in the case of a multi-commodity standard but might be less serious. Under such a standard the value of unit of a currency

would be defined as equal to so many ounces of commodity X plus so many ounces of commodity Y plus so many ounces of commodity Z, and so on; rather than equal to just a certain number of ounces of one commodity (gold).

84. The selection of commodities for inclusion in the basket and the choice of weights for these commodities could be based on the objective of getting as close as possible to zero inflation, or on minimising the expected impact of commodity price disturbances on the domestic European price level. The former objective would require a basket whose real price was not expected to change in the long term. One way of approaching the latter objective would be to simulate a model of the world economy, including a model of the determination of prices of individual primary commodities, subject it to various shocks, and see which commodity basket best stabilised prices in the face of these shocks. Further work would be required to investigate whether there were commodity baskets that produced a reasonable approximation to both objectives.

85. The optimal basket would not necessarily be the same as would be chosen as a forward indicator of inflation (as in the Chancellor's proposals to the 1987 IMF meetings): the basket would need to include those commodities which were important in determining domestic inflation rather than successful at predicting it. The basket would inevitably include oil, of which the UK has particularly large reserves by European standards.

86. The volatility of the total dollar value of the unit should be reduced as compared with the pure gold standard case. There should particularly be a reduction in volatility arising from supply conditions because fluctuations in the supply of different commodities are not closely correlated. Fluctuations in the dollar value of the unit would therefore reflect mainly world demand conditions. The EMS currencies would tend to appreciate against the dollar when world demand was high and depreciate when world demand was low: this would help to stabilise activity and prices in the European economies but destabilise the United States.

87. A further possible advantage of a multi-commodity standard as compared with a gold standard is that there is less danger of destabilising private sector speculation. The relatively high cost of storage would probably reduce the scale of private sector hoarding of commodities in periods of currency crises: with a gold standard fluctuations in private sector hoarding might be rather large in periods of crisis.

88. While either a gold or a multi-commodity standard should tie down the European price level it is impossible to say whether it would deliver exactly zero inflation over a run of years, or whether on average there would be a small positive or negative inflation rate. The fact that real gold prices have doubled since the late 1940s perhaps indicates that a pure gold standard would have been deflationary on balance over the post war period - more so than a wider commodity standard given the relative weakness of many primary commodity prices.

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

- it provides a nominal anchor for the system;

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

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

The disadvantages are:

- there would be no guarantee that it would produce zero inflation over the long term although in practice it might be just as good as the best of the other models;

- it would cause fluctuations in prices and activity;

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

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

91. The transition to a gold or commodity standard would have to be made largely in a single step on a particular day when the commitment to fixed parities against gold took effect. There would, of course, have been much preparation for this in agreeing the parities and deciding how the system would work, educating markets and public opinion and reallocating gold (or commodity) stocks.

The sterling area

92. According to the Treasury's 1958 evidence to the Radcliffe Committee, the Sterling Area originated in the early nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which prevailed in most of the colonies. Each local currency was statutorily regulated as a local version of the pound, printed or stamped with local symbols, but all representing the sovereign (or a fraction of it) and all backed with some obligatory holding of sovereigns or gold. Thus the sterling area at that time was essentially a special case within the gold standard. What

distinguished these countries was the closeness of their trading ties, their common use of the London capital markets, and in particular the use of sterling as the currency for their external transactions. The gravitation of foreign exchange income of the whole area to London was a natural consequence of normal business and banking practices. Effectively London acted as a clearing centre for the external transactions of the whole area, enabling economies to be achieved in lesser resort to physical gold shipments and eventually in the total holdings of external reserves for the countries of the area.

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

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

95. Further details of the operation of the sterling area together with other monetary unions and currency systems are provided in Annex 3.

96. If the sterling area is taken as a model for a European monetary area, the arrangement would have to be based on a strong national currency and the willingness of the rest of the Community to accept the monetary policy of the monetary authorities in that country. It is unrealistic to expect that sterling would be that currency within at least the next five or ten years. The deutschemark is the obvious candidate. The Treasury cited four fundamental features of the sterling area in 1958; expressed in terms of the deutschemark they are:

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

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

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

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

97. This would be one possible form of evolution from the present situation in which the policies of the Bundesbank already play a leading role in setting ERM interest rates. To some extent (d) applies already, and (c) would not be relevant with today's highly developed world capital markets. The transition to a deutschemark area would be relatively straightforward: a gradual increase in holdings and use of deutschemarks following agreement on the broad framework.

98. A move to a deutschemark area would formalise and hence strengthen the de facto situation of German dominance over monetary policy. Some countries (and academics) see considerable

advantages in the present situation which allows others to borrow the Bundesbank's reputation for monetary rectitude.

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

OTHER POLICIES

Fiscal policy

100. Delors' proposals for co-ordination of fiscal policy are discussed in Annex 1, which notes various difficulties about imposing mandatory budgetary guidelines in practice, even if one accepts the case that co-ordination may in principle yield a superior outcome compared with uncoordinated policies.

101. If mandatory central controls on national budgetary policies are not a necessary feature of the Delors Stage 3 model of monetary union, there is still less of a case for them in the alternative decentralised models considered in this paper. All the models will involve some form of constraint being put on national budgetary policies by the exchange rate regime itself.

Providing a dominant group of countries follows responsible budgetary policies, exchange markets will exert pressure on the other countries to adopt responsible policies as well.

Regional policy

102. The Delors report takes as read a need to increase regional and structural assistance in order to make EMU a success. It seems to have in mind both a permanent increase in such spending after the planned doubling by 1992, and also temporary official assistance "to reduce adjustment burdens temporarily" (paragraph 29). A related argument that is sometimes made (eg in the MacDougall Report of 1976) is that the size of the central budget should be substantially increased to introduce the sort of automatic stabilisers between countries that tax and benefit systems currently give rise to between regions of each country.

103. There are two distinct strands to the argument:

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

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

Similar arguments could be made in respect of all but one of the alternative monetary models considered in this paper, as they all reduce or remove the use of the exchange rate as an instrument of adjustment. The exception is competing currencies which requires exchange rate flexibility.

104. These arguments are not convincing, for the reasons set out in Annex 1. The only obvious reason (which of course the report does not mention) for expanding regional flows would be if the richer countries were determined to press ahead with EMU; the poorer countries needed to be bribed into participating; and the richer countries thought it worth the cost. By arguing the case

paras 12-18

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

CONCLUSIONS

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

Economic implications

106. The key economic question is how successful each model is likely to be in controlling inflation and providing a stable monetary framework. Recent history suggests that those models in which the German monetary authorities would have a central role would be relatively successful for the foreseeable future, although not necessarily for ever. This applies especially to narrower bands and the sterling area. It also applies to some extent to competing currencies. Here the aggregate EC inflationary outcome would depend on the degree of competition in practice and the strength of people's preferences for a sound currency. If the competitive forces were relatively weak, perhaps because of national preferences for national currencies or high transactions costs, the process whereby sound currencies (eg the deutschemark) would drive out unsound ones might take a very long time during which inflation could be significant.

107. By contrast, those models in which the influence of Germany over monetary policy was watered down by compromises with other EC countries might be more inflationary. This would probably be the case with the common dollar/yen policy and some of the versions of greater monetary coordination. As with Delors Stage 3 the outcome

on inflation would depend to a significant extent on how independent the monetary policy decision process was of political influences.

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

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

110. There are differences in economic efficiency between the models. Other things being equal, totally fixed exchange rates leading to a single currency are beneficial because of the reduction in uncertainty and risk. But other things are not equal: if monetary policy was conducted unwisely under, say, Delors Stage 3, the competing currencies model could be more economically efficient despite fluctuating exchange rates.

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

- an ERM with narrower bands would be sustainable only if inflation and interest rates had converged to at least as great an extent as the bands were narrowed;

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

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

Sovereignty

112. The institutional changes that are necessary range from creating new European institutions in the case of Delors Stage 3 and some of the variants of greater monetary co-ordination; through agreeing new rules in the case of competing currencies, the gold standard and the sterling area; to relatively little institutional change in the case of most of the options for extending the ERM. Any new institutions under greater monetary co-ordination could be watered down versions of the Stage 3 ESCB (eg an ESCB subject to control by national monetary authorities, an ERF with limited functions), or beefed up versions of existing arrangements, such as the Monetary Committee and the Committee of Central Bank Governors, or something similar.

113. Sovereignty is linked to institutional change, although the relationship is not one for one. Delors Stage 3 involves a considerable loss of sovereignty in the sense of control over monetary policy decisions by national monetary authorities. Some versions of greater monetary co-ordination are similarly affected (though to a lesser extent). While control over decisions remains at national level in all other cases, it is always heavily constrained. The constraints might be perceived to involve a greater loss of sovereignty in cases where other EC authorities - either collectively or the Germans in particular - have a say (ie common dollar/yen policy, greater monetary co-ordination, sterling area) than in cases where the constraint comes through the market (ie narrower bands, competing currencies and the gold standard).

114. The loss of sovereignty may also be perceived to be greatest in cases where the changes are least reversible. Those models which involve major institutional changes, such as Delors Stage 3,

fall into this category because reversing institutional change is a difficult process which would be resisted by most countries. On the other hand, those models (ie narrower bands, common dollar/yen policy, the gold standard, competing currencies and the sterling area) which rely on a commitment to a set of rules may be easier to reverse. Certainly history suggests that pressures can easily arise to cause systems like the gold standard and the sterling area to fall apart.

Definitions of monetary union

115. Given the commitment to monetary union, and the general agreement that it represents something beyond Delors Stage 1, it is important to be able to present alternative models as forms of monetary union. This will be easier for some than for others.

116. The various forms of extended ERM represent little more monetary union than in Delors Stage 1. If greater monetary co-ordination involved creating a new institution (eg a European Reserve Fund), it would be easier to present it as monetary union. The introduction of non-EC members into the ERM could even lead to less monetary co-operation, although there is the alternative possibility that it causes a sub-group of the 12 to press ahead towards a Delors-type union.

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

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

119. The gold standard does not represent monetary union in the form of a common currency or central monetary policy. However, there is an element of unity in the common acceptance of the rules of the game. Moreover, as time progresses and all countries'

monetary authorities react in identical ways to shocks, it might be a trivial step to lodge authority for monetary policy in a central EC institution which then issues a single currency.

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

Transitional arrangements

121. The paper has not discussed transitional arrangements in detail. The models fall into two broad groups: those in which the arrangements can evolve gradually, and those in which a sharp change has to take place at a particular stage.

122. The evolutionary models are the common dollar/yen policy, greater monetary co-ordination, incorporating non-EC members (although from the point of view of each new member the change is sharp) and the sterling area. It would not be necessary to make precise decisions at the beginning about exactly when and how to advance towards monetary union in these models.

123. With the others - narrower bands, competing currencies and the gold standard - sharp changes in the rules of the game are required at some stage. This may make them more difficult to negotiate.

Acceptability to EC partners

124. Other governments are most likely to be looking for models which show some advance on Delors Stage 1, in the general direction of Stage 3. Greater exchange rate stability and a Community-wide monetary policy are features of interest to them.

125. This tends to favour the more radical of the options for extending the ERM; narrower bands and a common dollar/yen policy probably do not go far enough for most countries. Competing

currencies, the gold standard and the sterling area are so different from Stage 3, especially in not having any central institutional machinery, that they will not be very attractive. However, the fact that previous French governments have flirted with the idea of the gold standard may mean it is an outside runner.

126. Models which strengthen the leading role of Germany will be unpopular among many countries. This applies to narrower bands, the sterling area and, in the long run, competing currencies. It does not apply to Delors Stage 3, the common dollar/yen policy, greater monetary co-ordination or the gold standard. While in some respects Germany (and perhaps one or two others such as the Netherlands) will take the opposite view,they may not act as an effective counter-weight because:

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

(b) in the case of the deutschemark area, they may be reluctant to create a system which encourages other EC countries to hold deutschemarks in their reserves;

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

127. Taking all these points into account, the easiest to sell to our partners as an alternative to Delors Stage 3 is greater monetary co-ordination, especially if it has some new institutional framework. The gold standard is a remote possibility.

Overall assessment of monetary models

128. In terms of the UK's broad objectives of minimising loss of sovereignty (ie retaining independent monetary policies and minimising institutional change) and controlling inflation, the most acceptable alternative models are narrower bands, a common dollar/yen policy, competing currencies and the gold standard. With the exception of the gold standard, none of these look much like monetary union and they are unlikely to be acceptable to our partners. If the gold standard is also ruled out, it may be necessary to fall back on greater monetary co-ordination with some institutional change as a compromise between Delors Stage 3 and the kind of full independence of monetary policy which we would prefer.

Fiscal and regional policies

129. Neither the mandatory central controls over national budgetary policies nor the extra official flows to poorer countries that are proposed by Delors are, in economic terms, a necessary part of Delors Stage 3. There may, of course, be other reasons for wishing to see a larger transfer of funds to the poorer countries - for example, a need to bribe them to accept the full package.

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

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ANNEX 1: DELORS PROPOSALS FOR ECONOMIC AND MONETARY UNION

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

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

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

(i) **Economic union**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13. There are two distinct strands to the argument:

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

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

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

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

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

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

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

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

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

(ii) Monetary union

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

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

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

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

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

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

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

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

26. Lastly, there are many questions relating to intermediate objectives and policy instruments that the report barely mentions. For example, what monetary aggregates would be targeted? Would the ESCB target bank reserves? Would it go further and operate a

monetary base system or would it rely solely on short-term interest rates for achieving the monetary targets? What responsibilities (if any) would it have for funding policy?

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

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

Alternatives to a European Central Bank

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

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

31. One type of solution is to select a nominal anchor that is external to the EMU system - eg gold or the dollar - and for all

currencies within EMU to peg to that nominal anchor. Another type of solution would be for one participant to peg to some nominal anchor - which could again be the dollar or gold, but could also be a domestic monetary aggregate or nominal income - and for other participants to conduct monetary policy so as to fix their exchange rates to the leading currency, as in the sterling area. In this way the nominal anchor for the leading currency would function as a nominal anchor for the whole system. A third solution would involve a system of co-ordination of independent monetary policies that took account of the aggregate impact on inflation (or nominal income) as well as the eventual consistency of the separate policies to the extent that the ERM did not enforce this. None of these solutions would require a European Central Bank, though the second and third would need some forum in which members of the Community could discuss policies and, in the second case, perhaps exercise pressure on the leading country's monetary policy.

ANNEX 2: THE HAYEK COMPETING CURRENCIES MODEL

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

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

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

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

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

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

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

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

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

Some Difficulties

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

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

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

11. A second difficulty is that the banks and the public would have to work out how to value each of the note issues that were made. One problem would be to define the standard basket of goods and services against which the currencies were to be defined. But assuming that such a basket would be universally agreed upon, there would still be difficulties. Even if the management of bank X had decided that it wanted to keep its issue of notes at a stable value, it would be faced with a difficult technical

calculation each day in deciding how many notes to print and to issue. The complication would arise from the fact that the demand for its issue would be in the first instance unobservable. If the issuing bank under-estimated this demand, then its issue would appreciate in terms of the basket: if the demand had been over-estimated,its issue would depreciate. The banks might try to error correct, modifying its issue in the light of observed appreciation/depreciation over time. But it could be a period of weeks or months before such information became available. So there would be a possibility of prolonged periods of fluctuating values for a currency whose issuer wanted to avoid that.

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

13. What would be needed to reach Hayek's objectives is that the currency exchanges established exchange rates consistent with the relative purchasing power parity for each pair. Yet in the foreign exchanges this happens only, if at all, in the longest term. Over shorter periods, the rates would be affected by factors such as the believed state of banks' loan books, and predicted changes in management structures causing issuing banks in future to be more or less prudent than was currently the case. Morses might appreciate this week because traders had perceived they had risen in previous weeks and were therefore bidding them up, and so on.

14. A third set of questions relates to the numbers of issuing banks which would be likely to result, or for that matter be desirable, under such a system. From the points of view of making

the system manageable, one might be looking for a smallish number. Hayek supposes, for example, that all shopkeepers would need to price their goods in at least the main available currencies. Because of the changing exchange rates, prices would have to be re-posted at least once a day and consumers would need at least a broad idea of what the pattern of exchange rates was so as to be able to check that they were not being faced with unfair relative prices. Households would need to budget and account separately for at least those of the available currencies that each chose to hold. Company treasurers would have to extend their foreign currency exposure control techniques to purely domestic transactions as well.

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

16. The final difficulties would stem from the fact that all of the currency under the Hayek plan would be liability of private companies. Notes and coin issued by the government are at least secured on the taxing power. Hayek does not discuss what would happen if one of his issuing banks were to fail as a result, for

example, of its using the proceeds of the issue for unwise investments or, for that matter, because of fraud on the part of the management. People choosing which currency issues to hold would evidently need to take a view about the soundness of each bank's assets as well as their relative intentions about the size of their note issues.

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

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

ANNEX 3: STERLING AND OTHER CURRENCY AREAS

The Sterling Area

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

2. There were no special arrangements to ensure that local monetary and other polices were consistent with the maintenance of exchange parities. In this sense the sterling area was no different from the wider group of countries on the gold standard. However, the closeness of trading ties and the common use of London's money and capital markets meant that policy changes in the UK were transmitted through the rest of the area relatively quickly. Because of unambitious economic policies of the overseas civil servants running the colonies, any thought of varying parities rarely occurred, and in any case a change would have required legislation. In other words, the idea that the colonies

would do other than accept the consequences of UK economic developments and policy (such as it was) did not really arise.

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

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

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

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

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

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

Hong Kong and Bahamas), or did change and then set about diversifying their reserves against a possible future decision to go in their own direction. There then followed a period of instability, with the sterling reserves under pressure from diversification but the speed of deterioration was moderated by various "sterling agreements" negotiated with members to maintain "minimum sterling proportions". It was only when the UK imposed exchange controls vis-a-vis the OSA in 1972 that the area finally broke up.

8. In 1958 the Treasury had seen the arrangements to be beneficial because UK citizens "could use their own currency over a large part of the world" and were "saved the inconveniences of operating in foreign currencies", and because of the profitable business the sterling system created for the City of London. But the Treasury also believed that the "cohesion and viability of the sterling area depend above all on the strengths of sterling", to which "a current account surplus in the UK balance of payments is of fundamental importance". In the end these conditions were not met and the sterling area came to an end. The reserve role of sterling was ended as a condition of the UK's entry into the EEC.

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

10. The sterling area was successful as long as sterling was a strong currency and the rest of the sterling area was willing to accept the monetary policy of the monetary authorities in that

country. The Treasury cited four fundamental features of the sterling area in 1958:

(a) the members use sterling as the normal means of external settlement;
(b) they hold the major part of their reserves in sterling;
(c) they look to London as a major source of external capital;
(d) they co-operate to maintain the strength of sterling.

Other monetary unions and currency systems

11. Unlike the sterling area, there are a number of other arrangements - notably in the French franc zone - still in existence.

12. The franc zone is a centralised concept in origin, depending on a fixed exchange rate relationship between the French franc and the subsidiary currencies. Within the system there are various individual and regional arrangements ranging from near-currency boards, where local currency is issued against French franc assets and managed by the Institut d'Emission d'Outre-Mer in Paris, to the large regional central bank zones in West and Central Africa with autonomous local management. The essential feature of the French African central banks is the continuing role played by France. In effect, it provides the equivalent of a gold standard, and individual countries' policies have to follow from that. This is an external constraint, not one established and maintained by the member countries themselves as a result of a process of discussion leading to a consensus on monetary policies. France still has directors on the boards of the African central banks and France is the dominant country economically as well as politically with a GNP 20 times that of all the African member states taken together.

13. The members of the franc zone each agree to hold at least 65% of their reserves with the French Treasury. Often they place more there, as the terms offered (SDR exchange guarantee and

Bank of France's intervention rate for interest) are attractive. The regional central banks each have an operations account with the French Treasury (as do other countries and zones participating in the franc zone arrangements). All transactions with France pass through this account, which may be in surplus or deficit, but in the latter case subject to an increasing disincentive in the shape of interest rate bands. The same principle applies within the regional central banking zones - individual governments may have a surplus or deficit with the bank, as do commercial banks. However the statutes of the central banks restrict their advances to the African Treasuries to 20% of the previous year's budgetary receipts when the operations account with the French Treasury is in deficit.

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

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

16. The two African regions are currently in bad shape and last year produced for the first time an overall deficit by both zones in their operations accounts. Usually, the different economies have tended to balance each other but the oil price fall has brought down the oil producers of Central Africa while soft tropical commodities have remained weak. In West Africa, the big change has been in the Cote d'Ivoire which has been hit particularly hard by lower oil prices and falls in coffee and cocoa prices and has not adapted domestic policies accordingly. Another feature has been, until last year, the fall of the dollar against European currencies including the franc at the same time

as commodity prices weakened in dollar terms. There is a clear case for a devaluation of the CFA franc but the difficulty in reaching agreement and perceptions of cost increases have prevented these proposals coming to the surface. Also, France has vested interests in maintaining confidence and French investment in these zones and in keeping exports from France cheap. However, France is effectively giving a foreign exchange subsidy to the system at present. Meanwhile, countries like the Cote d'Ivoire are having difficulty in moving exports and maintaining producer prices and have acute budgetary difficulties. Interest rate policy is not within their control and, unable to devalue, their only weapon is budgetary. A massive deflation is about to take place as producer prices are cut and salaries are held in inflationary conditions.

17. There have from time to time been <u>regional currency and monetary arrangements within the sterling area</u>. The Eastern Caribbean Central Bank (previously East Caribbean Monetary Authority) with a varying membership of small islands, and before that the British Caribbean Currency Board, which included the larger Caribbean territories, provide examples. They cannot be said ever to have worked well, the problem being the absence of agreement between governments generally and especially at times of crisis. The lack of consensus has, however, had the advantage of restraining the central authorities from moving exchange rates except when forced by external circumstances (eg, the collapse of the sterling arrangements) to do so. Some kind of price stability has therefore been maintained but slow economic growth, poverty and social unrest have been the norm.

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

19. Of these systems, the most successful in terms of unified policy has been the <u>South African rand area</u>, no doubt because of

positive, centrally controlled policy and stable political conditions. However, despite the relatively generous facilities offered by South Africa to its constituent members, independence has inevitably tended to lead towards disintegration, with Botswana withdrawing totally and Swaziland loosening the links.

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

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

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

identification with the currency is often one of the most difficult matters to deal with. Once that has been settled, the technical side can fall into place relatively easily.

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5 June 1990

Charles Powell Esq
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Dear Charles

ECONOMIC AND MONETARY UNION

Following his discussion with the Prime Minister last week the Chancellor has been reflecting on how to carry matters forward.

The Prime Minister suggested a three part initiative involving:

- the creation of an Atlantic Community free trade area, encompassing the European Members of NATO, the USA and Canada;

- building up NATO's political side, possibly to include some economic aspects;

- linking of the major world currencies, including the dollar and the yen, to an objective reference standard, for example a commodity index which would work automatically.

The Prime Minister envisaged launching the initiative at the NATO summit and the Economic summit which, together with the European Council, take place in the next six weeks. If it is to prosper she may wish to broach the matter in advance with selected heads of Government. The necessary work, therefore, needs to be done very quickly.

The Treasury did some work last year on the possibility of an objective reference standard for exchange rates, as you will

recall from the first paper on alternative to Delors which was sent to the Prime Minister on 5 September. The Chancellor has asked officials urgently to look at the matter again and will let the Prime Minister have a note on her return from the Soviet Union. He thinks it is for the Foreign Office and the Department of Trade and Industry to take the lead on the other two elements above and suggests that they should be asked to prepare an urgent note on the options and their relationship, in particular, to the Uruquay round.

All three notes should cover not only the content of the proposal but also how it could be presented in relation to EMU.

Alongside this further work, the Chancellor is considering how best to put forward the proposals for a substantial Stage II.

If the Prime Minister agrees, you may wish to circulate your letter of 31 May and the Chancellor's minute to the Foreign Secretary, the Secretary of State for Trade and Industry and the Cabinet Secretary and commission the further work.

Yours

JGh.

JOHN GIEVE
Principal Private Secretary

POLITICAL COLUMN

A long hot summer

Both the Tories and Labour are grasping at the ERM. But it's not an easy way out

R W Johnson

The local elections have produced a clear, if unwarranted, switch in political mood. The Tories have reacted as if they had staged a triumph and Labour, despite a 15 point poll lead, has found itself on the defensive. Michael Heseltine, finding Thatcher unexpectedly reinforced, has ducked back behind the parapet. Suddenly the word is that we will join the exchange rate mechanism by the end of the year and that the resulting currency stabilisation will allow a rapid fall in interest rates so that Mrs Thatcher will be able to go to the country in 1991 after all. The City's reaction has been euphoric.

All of which is absurd. The Tories, at 32 per cent of the local election vote, did just as badly as the polls had predicted. Labour's problems derive not from any fresh accession of Tory strength, but from its own unwillingness to face up to the need for opposition unity. Mrs Thatcher and the poll tax both remain fiendishly unpopular, the trade gap remains stubbornly huge and it is not even clear that high interest rates are slowing economic activity as much as was expected. Without doubt, the summer is going to see some horrid economic numbers coming through and it is still far too soon to rule out a Heseltine challenge for the Tory leadership in October.

Above all, the notion that ERM entry will provide a sort of magical three-card trick for the party that effects it is simply ludicrous. There is, indeed, a general failure to think about the European Monetary System sensibly. The fundamental fact is that the British are not great savers or investors; they are consumption-greedy. We have, for many years, had an apparently endemic tendency to consume more than we produce. So we tend to award ourselves wage increases that cannot really be justified in terms of higher production. Employers tolerate the consequent wage inflation because it is the easy way out and because they have been able to assume that when push came to shove, the pound would be devalued to restore our international competitivity. The thought is that the EMS will hold the pound steady and that employers, knowing there will be no easy way out via devaluation, will face down their workers—and not help themselves to large salary increases either.

Well maybe. But the idea that we are going to rid ourselves at all quickly of a habit as basic and deep-seated as consumption-greed (well, why mince words, let's just say greed) seems distinctly wishful. After all, if the old social habits remain and inflation gradually makes our goods uncompetitive abroad, any government can go to our EMS partners and negotiate a devaluation. The evidence from Italy and France is that such habits can be moderated over time, but only slowly and painfully—and they both have a much weaker trade union movement than we do, a not inconsiderable fact since getting used to life inside the EMS means a trial of strength with the unions.

In the old days if you ran a gigantic trade deficit like ours your currency plummetted. One of the great phenomena of the 1980s, however, has been the ability of currencies to buck this rule because of huge countervailing capital flows. Thus the early 1980s saw the dollar remain strong for years on end, despite huge and recurrent US trade deficits, because foreigners were willing to fund those deficits by pumping in huge amounts of capital to buy up US assets. The thing that makes it possible to defy gravity like this is the ever larger lump of mobile capital loose in the world markets—held for the most part by the pension funds of the world's rich nations. As these gigantic funds slop around, old-fashioned currency fluctuations (ie, those induced by trade deficits or surpluses) can find themselves simply submerged by a towering wall of money. International financial de-regulation and the opening up of stock markets from Bangkok to Warsaw has increased the potential mobility of these funds almost as fast as their sheer size has increased.

Without doubt, the summer is going to see some horrid economic numbers coming through

The biggest increase of all has been in foreign exchange (forex) dealings. A recent study by the Bank for International Settlements showed that in a given month (April 1989) total world trade in goods and services was $460.9 billion, but that forex trade was $14.79 trillion—more than 32 times as much. Moreover, forex trade has been growing explosively. Between 1986-89 it more than doubled—in Tokyo from $48 billion to $115 billion a day (yes, a day); in New York, from $58 billion to $129 billion; and in London from $90 billion to $187 billion.

Our own enormous trade deficit is being financed by just such hot money flows. We are not America—we don't have an unlimited stock of assets to sell off. Nor are we selling Treasury bonds the way the US is; indeed, we've been buying our gilts back. So most of the capital that comes in sits in cash, pulled in by our 15 per cent base rate. And we have to be nice to our big depositors. It is universally assumed in the City that the real reason why the government has allowed the Al-Fayeds to get away with the Harrods deal is simply so as not to annoy their backer, the Sultan of Brunei who, if angered, might withdraw his billions on deposit in London and collapse sterling on the way.

This reliance on cash deposits has to be borne in mind, for the trade deficit is not going to go away at all quickly. Thus the notion that if we enter the ERM we will achieve currency stability and be happily released from the need for high interest rates doesn't really hold water. For while those huge trade deficits last, we're going to need high interest rates to pull those cash deposits in. To be sure, the backing of the other European central banks will be a help—it might make the difference between, say, base rate at 13 per cent instead of 15. But don't forget that wall of money washing around out there—if you pull interest rates down too far or too fast, sterling will be hit by a financial tsunami that the central banks can't withstand.

The political significance of this is two-fold. One is that Labour had better realise that joining the ERM will not obviate the need for high interest rates and it will mean a series of bruising encounters with the unions. It could be one of those reforms which it would suit Labour best to have the Tories carry out. Another is that Tory euphoria is wildly misplaced. The government is still in deep, possibly terminal, trouble and any idea that ERM entry allows one of those "with one bound he was free" happy endings is just as shallow as the crass rationales which Nigel Lawson so liberally dispensed while getting us all into this mess.

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SUBJECT cc MASTER

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From the Private Secretary

31 May 1990

ECONOMIC AND MONETARY UNION (EMU)

The Prime Minister had a talk this evening with the Chancellor of the Exchequer about his minute of 24 May and accompanying paper on EMU. Sir Peter Middleton and Mr. Nigel Wicks were also present.

The Chancellor said that his starting-point was a determination not to commit the United Kingdom to a single currency or a European System of Central Banks. His preferred course would be to de-rail the Delors concept for Stage 3 of EMU completely. But after many months of discussion in the Community, he had concluded that this would only lead the other Eleven member states to go ahead and sign a separate Treaty without us. That would be damaging to Britain's interests and deprive us of any significant influence over future developments in the economic and monetary field in Europe. It would leave the field free for the Germans to dominate. Against that background, our tactics should be to win time for wider changes in Europe to affect views on EMU. The fact was that other member states were not looking to achieve full EMU now, but wanted to draw up a Treaty which would allow them to do so at some point in the future. In practice, it could only happen once there had been a much greater degree of economic convergence in the EC than existed at present and that would take a considerable time. Further enlargement of the Community was likely in that period, which would increase the practical difficulties of implementing full EMU.

The Chancellor continued that other European governments had worked themselves into a position where the outcome of the Intergovernmental Conference, starting in December, would almost certainly be Treaty amendment to establish the objective of full EMU with a single currency and a European Central Bank. That risked the isolation of the United Kingdom, which would not be welcome, particularly with the approach of the general election. To avoid such an outcome, we should not object to Treaty amendment establishing the aim of full EMU, but should insist on a provision which left to individual member states the decision whether and when to join. That would accommodate our refusal to

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be committed to moving to full EMU, which he entirely supported. At the same time, we should put forward proposals for a substantial Stage 2 of EMU, which would have the effect of delaying the implementation of Stage 3. He was convinced that our chances of derailing full EMU on the Delors model were better over a period of time than in the short term.

The Prime Minister said that she did not accept the inevitability of a move by other member states to full EMU. It was psychologically wrong to put ourselves in a frame of mind where we accepted that, rather than continuing to attack the whole concept. We frequently started in a minority of one in the Community, but by steady persistence ended by getting our own way (or much of it). The fact was that permanently locked currencies would not work. That had been amply demonstrated by the collapse of the Bretton Woods system. We should take every opportunity to point out the inherent weaknesses and contradictions of Stage 3 of Delors. With the Germans we could argue that it would involve dilution of the fundamental commitment to pursue anti-inflationary policies. We should bring home to the poorer countries that there would be no bailing out: and that without massive transfers of resources, EMU could be unsustainable for their economies. In short, we should do everything to get others round to our point of view, playing also on their fears of German domination. There were signs that some others were becoming more aware of the difficulties.

The Prime Minister continued that there were other reasons why we should not accept the objective of full EMU. It would involve a massive accretion of bureaucracy, at a time when other countries in Europe were moving away from central control. And for some in the European Community, it was a way of getting to a federal Europe by a back door. The Government could not put forward the proposals in the Chancellor's paper without further debate in Parliament, and she did not believe that the House would be ready to agree the objective of Stage 3 of Delors, because of the loss of sovereignty this would incur. She did not regard the opting-in mechanism proposed in the Chancellor's paper as an adequate defence against being drawn into full EMU. The same reasoning which led the Treasury to argue now that we had no alternative but to accept the objective of full EMU, would be employed when the time came to argue that we could not afford to be left out. Accepting the opting-in mechanism now would be tantamount to a commitment to join eventually and she was not prepared to make that commitment.

The Prime Minister continued that we should use the time between now and the IGC in December both to undermine the commitment of other member states to Stage 3 of Delors and to develop a wider vision of the way ahead. We should point out the dangers of establishing tight blocs of countries, which would inevitably become protectionist. We should build on the American proposals for strengthening the political aspects of NATO by suggesting a trade dimension to the Atlantic Community, bringing together the European members of NATO with the free trade area established between the United States and Canada. We should work up alternatives to the Delors proposals, for instance linking currencies to some objective reference standard such as a

commodity index which would operate automatically. We might propose extending such a system also to the dollar and the yen. In short, we should be more crusading in trying to knock out Stage 3 of Delors, and at the same time hold out a wider vision. There were plenty of opportunities for this, at the NATO Summit, at the Economic Summit and at the various European Councils between now and the end of the year. We could demonstrate that our ideas, going beyond a narrow Europe, were much more in tune with wider political developments.

In discussion, it was suggested that tabling new proposals at this stage of discussion would be seen by others as a wrecking tactic. It was unlikely to prevent them from going ahead with plans for EMU. We would do better to concentrate on putting forward ideas for a substantial Stage 2, either the Treasury proposals or the 'Butler' proposals or a combination of them. Even these had little chance of securing support unless we were prepared to accept Treaty amendment setting the ultimate goal of a single currency and a European Central Bank. But there was certainly merit in the idea of establishing an objective reference standard for European currencies. This could be presented as a non-discretionary monetary policy which would be more effective against inflation than a Central Bank which would have political discretion. It would not involve surrendering sovereignty to an institution, but committing ourselves to a mechanism which would function automatically.

The Prime Minister concluded that we should mount a substantial campaign over the next few months to instil doubts in the minds of other European Governments about the implications of full EMU. In parallel, we should argue the case for a much broader approach to economic and monetary cooperation, going beyond Europe, and proposals for this should be worked up in time for the NATO Summit and the Economic Summit. We should also refine proposals for a objective reference standard for European currencies. The Chancellor's proposal for an opting-in mechanism should not be put forward in this period, in which our efforts should concentrate on undermining the Delors concept. But he had discretion to table proposals for a substantial Stage 2 of EMU based on those described in the paper at Annex B to his minute.

C. D. POWELL

John Gieve, Esq.,
H.M. Treasury.

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: EMU

Your bilateral with the Chancellor tomorrow is to be devoted mostly to discussion of his paper on EMU. Sir Peter Middleton and Nigel Wicks will also attend.

You have read the Chancellor's note and attached paper by officials, as well as my covering note. You are not happy with the Chancellor's proposals because:

- you doubt whether the others would in practice go to Delors Stage 3 without us, not least because the French and Germans would baulk at having to make the vast additional transfers of funds which the poorer countries will demand as the price of full EMU;

- even if they did go ahead, you still do not believe that we should move in what we regard as a fundamentally wrong direction:

- you think the Chancellor underestimates the difficulties which signing up to Delors Stage 3, even on an opting-in basis, would cause with Parliament;

- more generally, you think the Treasury/FCO line is much too defeatist. The position of other member states is likely to shift as they come up against the real problems involved in Delors Stage 3. None of us know what the consequences of GEMU will be. Our own views will be given greater weight once we are in the ERM. So we shouldn't be too timid, but set out to do battle for a weaker definition of EMU: and to avoid a commitment to Delors Stage 3;

- we should table our own proposals for what should follow Stage I of EMU - probably the Butler proposals rather than the milder Treasury version - without indicating willingness to subscribe to the Delors concept;

- we should also consider some wrecking amendments e.g. by proposing that there could be no move to full EMU until all subsidies in all Member States have been abolished.

What you are saying in effect is that

- you are not going to accept a single currency and a Central Bank;

- that the Chancellor should continue to argue the case against full EMU and be prepared for a long war of attrition stretching through the Intergovernmental Conference;

- that he should float our ideas for the next stage of EMU as soon as possible;

- but he should not put forward his opting-in arrangement for the final stage of EMU.

Beyond that, you will want to encourage the Chancellor and his officials not to be mesmerized by the Delors scheme but to enlarge the terms of the debate and come up with some more imaginative and original alternatives. Ideas which you might try on them include some wider monetary link extending to the dollar and the yen, perhaps as part of a free trade area taking in the United States and Japan.

You will want to grind the Chancellor and his officials down so far as possible in this meeting. When the issue goes to wider ministerial discussion, you will want to ensure participation by the Trade and Industry Secretary to balance the Foreign Secretary (who agrees with the Chancellor).

C.D.P.

C.D. POWELL

30 May 1990

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Treasury Chambers, Parliament Street, SW1P 3AG
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30 May 1990

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
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Dear Mr Powell

EMU

Sir Michael Butler wrote to the Prime Minister on 23 April and again on 1 May spelling out his suggestions on EMU. He has now published his ideas in The Independent. As you know, the proposals for a "hard ECU" are discussed in the Chancellor's latest minute to the Prime Minister on this subject and officials are doing further work with the Bank of England on the concept.

I do not think that any substantive response to Sir Michael is needed at this point but, if you have not already do so, you may wish to send an acknowledgement on the attached lines.

Yours sincerely

Kate Gaselee

pp JOHN GIEVE
Principal Private Secretary

chex.jp/jg1/83

DRAFT LETTER FROM THE PRIME MINISTER

Sir Michael Butler
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EMU

I am most grateful for the further thoughts in your letter of 23 April. I have also seen the detailed note about how the scheme worked up in the paper by your European Committee would work in practice, which you sent to Charles Powell on 1 May. Your paper will be a most useful contribution to the debate, & we are thinking very hard about how best to proceed.

[illegible]

C

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1A

Treasury Chambers, Parliament Street, SW1P 3AG
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25 May 1990

Barry Potter Esq
Private Secretary to the
Prime Minister
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Dear Barry

HOW THE ERM WORKS

... You may be interested to see the attached note by officials here which sets out in a detailed, but we hope simple, way how the ERM works.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

B

The Exchange Rate Mechanism (ERM) : How It Works

1. The ERM came into operation, as part of the EMS, on 13 March 1979. There are eight participating currencies : those of Germany, France, Italy, Netherlands, Denmark, Belgium/Luxembourg, Ireland and Spain. The UK, Greece, and Portugal are members of the EMS but not of the ERM.

2. The decision leading to the establishment of the ERM was the European Council resolution of 5 December 1978. The rules for operating the system are set out in agreements among the central banks of the Member States (including the Bank of England) dated 13 March 1979, as amended in 1985 and 1987. This note describes the four main features of the ERM:

(i) the central exchange rates;

(ii) the margins within which those central rates may fluctuate;

(iii) the intervention rules and the credit facilities available to support intervention;

(iv) the arrangements for realignment of currencies.

The Central Rates

3. Each ERM currency has a central rate against each of the other currencies in the mechanism. In theory, when a currency joins the ERM or there is a realignment, each currency is given a central rate in relation to the ECU*, and this is used to establish the central rates against other participating currencies. In practice, at realignments, central rates are set against a "reference currency" (the one agreed to be least affected by the changes) and all the others follow. On joining

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* For description of ECU, see Annex A.

the ERM, a Member State would probably look at a specific bilateral rate (eg the Spaniards looked at the DM rate) and again all the others follow.

4. Central rates cannot be changed unilaterally. Changes can be made only by agreement with all the other ERM participants. (See paras 22-23 below on realignments).

The Margins

5. Seven of the eight member currencies are allowed to fluctuate within margins upto about 2¼ per cent* above or below their central rates. The exception is Spain, which is allowed wider margins of around 6 per cent either side*. (Italy also enjoyed 6 per cent margins until January this year). The 1978 Council resolution states that such wider margins "should be gradually reduced as soon as economic conditions permit". There is no binding provision compelling Member States to move to 2¼ per cent margins within any particular timescale, but Stage One of EMU will involve participation of all Community currencies "on the same terms", which is likely to mean with 2¼ per cent margins. (The margins have very occasionally been suspended temporarily, at the time of realignments).

6. Once a currency is fixed within 2¼ per cent margins, there is no provision in the 1978 Council resolution for it then to move to wider margins.

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* The actual margins are not exactly 2¼ per cent or 6 per cent. This ensures that, for any two currencies, the upper limit for one is the reciprocal of the lower limit for the other and is therefore consistent with it. Take the deutschemark and the French franc:

FF1 = DM.3049	upper limit (+ 2.275%)	
FF1 = DM.2982	central rate	DM1 = FF3.354
(-2.225%)	lower limit	DM1 = FF3.279

7. Let us assume, purely for the purposes of this note, that sterling were to enter the ERM with a central rate of DM 2.75. (This rate would, in turn, imply a central rate against all the other ERM currencies and the ECU). If we were to adopt the narrower 2¼ per cent margins, this would imply the following (approximate) rates:

Upper limit: DM 2.81
Central rate: DM 2.75
Lower limit: DM 2.69

That is, we would be obliged by intervention or other means (see below) to keep sterling at or above DM 2.69 and at or below DM 2.81.

8. If instead we were to adopt the wider 6 per cent margins, this would imply the following (approximate) rates:

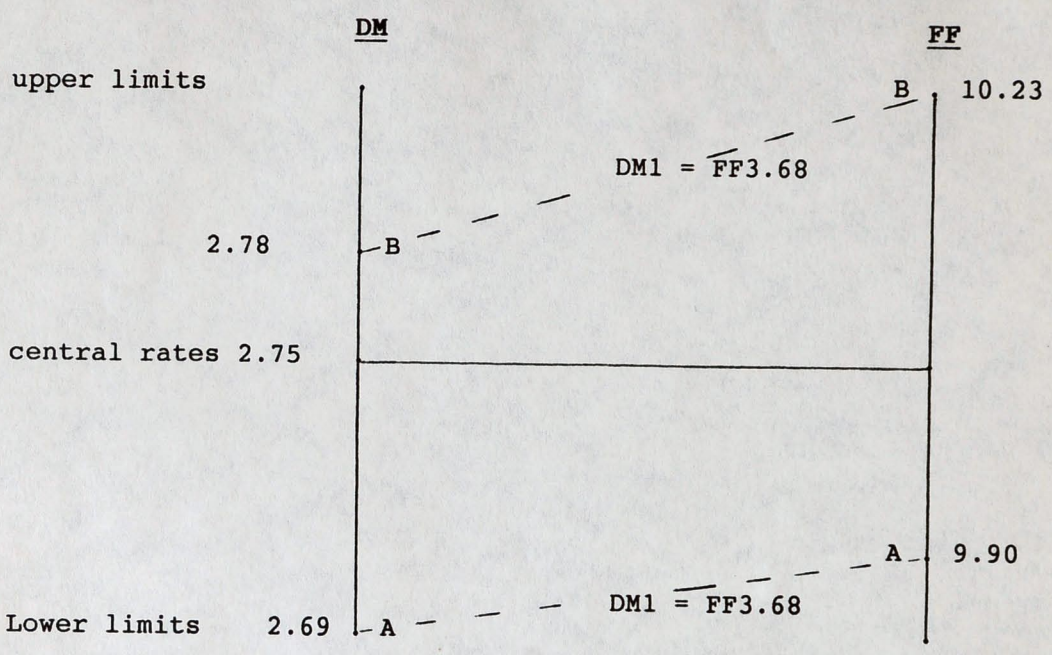
Upper limit: DM 2.92
Central rate: DM 2.75
Lower limit: DM 2.59

9. The figures in paragraphs 7 and 8 might seem to imply that, at the upper and lower margins, each currency has a total flexibility of 4½ per cent (narrow band) or 12 per cent (wide band) against another currency. In practice, this is not so. Maximum flexibility will be rather less, because of the presence of other currencies in the system. To give a simplified example, let us assume a three currency system with the following central rates and 2¼ per cent margins:

£1 = DM 2.75
£1 = FF 10.00
DM1 = FF 3.64

Let us also assume that sterling is at the bottom of its range against the DM (2.69), but just below its central rate against the Franc (9.90). Assuming the DM/FF relationship is unchanged,

sterling's maximum appreciation against the DM will be rather less than 4½ per cent because it will first hit its upper limit against the French franc (10.23). In this example, sterling's maximum value against the DM would be 2.78. The example is set out in the chart below:



Sterling starts at position A against the mark and the franc. Maximum appreciation against the franc takes it to position B. Assuming an unchanged cross rate between the mark and franc (shown in the dotted line), this means that sterling's maximum rate against the mark (at B) is below the theoretical upper limit.

10. Within its margins, each currency has a "divergence threshold", an indicator which is intended to give early warning of tension within the system. However, in practice, this has not worked. For the record, the provisions are outlined at Annex B.

11. While their currencies are trading within the margins, Member States can intervene in the foreign exchange market in order to keep them within these margins (so-called "intramarginal

intervention"). They can also use other policy measures to influence the exchange rate, such as interest rates. The table below shows the spread at (10 May 1990) of 3 month interbank rates (real and nominal) among the main ERM currencies:

	Nominal %	Real %	Inflation %*
Deutschemark	8.3	5.5	2.7
French franc	9.7	6.1	3.4
Dutch guilder	8.5	6.2	2.2
Italian lira	12.2	6.0	5.8

* Inflation rates are for 12 months to March 1990 except Italy (April). Real rates are arrived at by deflating the nominal rates by the inflation rates.

12. Once the margins are reached, intervention is compulsory, and, in principle, unlimited. If intervention and other policy measures fail to relieve pressure on the limits, the only escape from the obligation to intervene on an unlimited basis is a realignment (see paras 22-23 below). In principle, the central banks of both currencies at their margins - the strong currency and the weak currency - have an equal obligation to intervene. In practice, the main burden of intervention usually falls on the weak currency. This is partly because, in practice, most intervention is intra-marginal : Member States tend not to wait until their currencies are at the limits before taking action.

13. Member States tend to use intra-marginal intervention to slow down any precipitate movement of their currency in the band and where they wish to augment reserves. As their currency moves close to a limit (especially the lower limit), their intervention tends to grow. But the opinion is generally held that sizeable intervention is not worthwhile until close to the limit, where market players will tend to be moving in the same direction, unless they are expecting any early realignment.

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Intervention rules and the credit facilities to support intervention

14. Although rules about intervention and the use of credit facilities are set out in the central banks agreement, it is not easy for non ERM members to be sure about the detailed interpretation of these rules and the precise way in which they have been implemented. A certain amount of custom and practice is bound to have developed in the 10 or more years of the ERM's existence. What follows is therefore a summary of the key points, in so far as we understand them.

15. In general, the rules operate so as to put more pressure on Member States with weak currencies to take action rather than those with strong currencies. For example, in October 1989, when the Krone was at the bottom of the band and the mark at the top, the Danes had to spend $1,750 million of marks in intervention on one particular day, while the Germans bought only $9 million of Krone.

16. Article 2.2 of the central banks' agreement provides that intervention shall be in the currencies of the participating central banks though it is known that intervention in other currencies (notably the dollar) has taken place despite this rule, not least when the Bundesbank has refused permission to use marks.

17. Article 15 of the central banks agreement provides that "central banks may hold working balances in Community currencies within the limits laid down by the Committee of Governors" and that "these limits may be exceeded only with the consent of the central bank concerned". This applies to all EMS members, not only those in the ERM. We know that the Bundesbank takes this rule seriously and sometimes refuses consent for the limits on DM holdings to be exceeded or allows a smaller increase than requested by other central banks.

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18. In addition to its own reserves of foreign currency, each ERM member has access to four credit facilities which can be used to finance intervention:

(i) The Very Short Term Financing Facility (VSTF);
(ii) The Mobilisation Scheme;
(iii) Short Term Monetary Support (the "Soutien");
(iv) Medium Term Financial Support (MTFS).

19. None of the facilities has been used very much. The most important of them is the VSTF, under which each of the central banks makes available to the others short term credit facilities in its own currency. These facilities are automatically available in unlimited amounts when they are drawn on to finance intervention at the margins. They are also available, subject to conditions, for intramarginal intervention. Details of the facilities are given in Annex C.

20. The central banks' accounts used in the VSTF and other facilities are with the European Monetary Cooperation Fund (EMCF). The EMCF is essentially a book-keeping operation. It issues ECU to central banks in exchange for deposits by them of 20 per cent of their gold and dollar reserves. These swaps are renewed every three months. The gold and dollar reserves do not actually change hands and the central banks continue to manage and earn interest on their dollar deposits. The 'official' ECU created in this way can only be used for transactions between EMS central banks (and certain other monetary institutions), for example for settling the debts incurred between central banks in operating the ERM. All EMS members currently take part in the EMCF swap arrangements, although non-members of the ERM are not required to do so.

21. The board of the EMCF consists of the Governors of all the Community's central banks.

Realignments

22. There have been twelve realignments since the EMS began. The last was in January 1990, when Italy moved to 2¼ per cent margins.

Realignments have tended to become less frequent, as the ERM economies have converged and inflation differentials have been reduced. Member States are also perhaps less willing to devalue than they were.

23. Realignments have to be agreed by consensus among all ERM members. Member States seeking a realignment will usually sound out their partners to pave the way for an agreement. The Monetary Committee plays a key role in this preparatory process, and sometimes agreement can be reached in this forum. If not, a realignment conference of Finance Ministers, Central Bank Governors and the Commission will be necessary.

MG(1), 15 May 1990.

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ANNEX A

European Currency Unit (ECU)

The ECU is calculated with reference to fixed quantities (a 'basket') of Community currencies. These amounts are reviewed at least every five years. They were last changed in September 1989, when the basket was enlarged to cover the Spanish peseta and Portuguese escudo. All Community currencies are now included in the ECU basket, which contains:

0.6242	Deutschemark	0.008552	Irish pound
0.2198	Dutch guilder	151.8	Italian lire
3.431	{Belgian francs	0.08784	Pound sterling
	{Luxembourg franc	1.44	Greek drachmas
0.1976	Danish krone	6.885	Spanish pesetas
1.332	French francs	1.393	Portuguese escudos

At present exchange rates (14 May 1990), each currency has the following percentage weights:

ERM currencies	Deutschemark	30.5
	French franc	19.3
	Italian lira	10.1
	Dutch guilder	9.6
	Belgian franc	8.1
	Spanish peseta	5.4
	Danish Krone	2.5
	Irish punt	1.1
Non-ERM currencies	Sterling	11.9
	Portuguese escudo	0.8
	Greek drachma	0.7

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ANNEX B

The Divergence Threshold

1. Within its margins, each currency has a "divergence threshold" which is intended to give early warning of tension within the system. For this purpose, each currency has a Maximum Divergence Spread (MDS), the maximum permitted divergence from its central rate against the ECU. For any currency operating within the narrower margins, this MDS is always less than 2¼ per cent because it takes into account that currency's own effect on the movement of the ECU. A further complication is that non-ERM currencies are in the ecu (notably, of course, sterling), and their movements have to be taken into account. If a currency moves beyond 75 per cent of its MDS, the terms of the 1978 Council resolution provide that:

> ".. this results in a presumption that the authorities concerned will correct this situation by adequate measures, namely:
>
> (a) diversified intervention;
>
> (b) measures of domestic monetary policy;
>
> (c) changes in central rates;
>
> (d) other measures of economic policy.
>
> In case such measures, on account of special circumstances, are not taken, the reasons for this shall be given to the other authorities ....".

2. In practice, these provisions have been little used for two reasons. First, currencies have generally reached their bilateral limits before reaching the divergence threshold. Second, when the divergence threshold has been crossed first, action has rarely ensued - there is no obligation on participating central banks to act.

ANNEX C

CREDIT FACILITIES

(a) Very Short Term Financing Facility (VSTF)

1. Under the VSTF, credit is available between central banks to finance ERM intervention. The 1978 Council resolution and the central banks' agreements say that this credit is automatically available in unlimited amounts to finance obligatory intervention when a currency is at its permitted margins. In practice, a participating bank would not draw "unlimited" amounts from other members. In circumstances of very strong pressure on margins, other action possibly including a realignment, would be called for. The provision in the agreements of "automatic" and "unlimited" credit is there to ensure ready access to the facility for those who need it and to avoid the difficult question of the level at which a limit should be fixed.

2. When the intervention is intra-marginal, there is no automatic access but a presumption that VSTF will be available subject to certain conditions. In these circumstances, there is a limit on the amount equal to 200 per cent of quota under the short term monetary support mechanism (see below). And agreement is needed between debtor and creditor central banks before the intervention can be carried out.

3. For the purpose of operating the VSTF, each ERM member has an account (denominated in ECU) with the European Monetary Cooperation Fund (EMCF). Support is made available in participating currencies. Amounts drawn under VSTF are repayable after 2½-3½ months, though there are provisions for extending this period by 3 months and by a further 3 months for upto 200 per cent of quota.

4. The repayment provisions in the central banks agreement are not entirely clear. The creditor and debtor central banks may agree between themselves the currency or currencies in which VSTF debts are settled. And the creditor "reserves the right to

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request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking into account the reserve position of the debtor central bank". But the debtor is allowed to repay in ECUs as long as:

(a) this does not result in the creditor bank's reserves having an unbalanced composition, and

(b) no excessive net debtor and creditor positions in ECUs emerge.

These provisions are set out in Article 15 of the central banks agreement, as supplemented by the minutes of the Committee of Central Bank Governors on 10 November 1987. The minutes do not define "unbalanced composition" of reserves nor "excessive net debtor and creditor position in ECUs".

5. The interest rate payable on VSTF drawings is the weighted average of domestic money market rates in the ECU currencies. Interest on a line of credit has to be paid in ECUs.

6. The VSTF was last used in November 1987 when DM7 billion were sold for French Francs in intra-marginal intervention. This was some 17 per cent of total intervention by EMS central banks in the second half of 1987.

(b) **Mobilisation Scheme**

7. In addition to intervention facilities available under the VSTF, there is a currency mobilisation scheme for all EMS participants, not just those in the ERM. Under this scheme, EMS members needing currency for intervention may swap part of their official ECU holdings for spot dollars for a period of 3 months, renewable for a further 3 months. All participants have agreed to make available to their partners upto 20 per cent of their

dollar reserves if required ie those reserves which have been "swapped" with the EMCF in exchange for official ECUS. The UK already has access to this scheme (and the associated commitment to lend upto 20 per cent of our dollar reserves).

8. Little use has been made of mobilisation so far. Italy drew on the facility in 1985 and 1987, but no other Member States have done so.

(c) **Short term monetary support (the "Soutien")**

9. This is a central bank facility, available to all Member States, to provide support for temporary balance of payments difficulties. Each member has a borrowing limit and a lending commitment, which are reviewed at least every 5 years. The facility has been drawn on only once, by Italy in 1974.

10. Total "debtor quotas" are ECU 8.9 billion (about £6.4 billion), of which the Bank of England's effective quota is ECU 0.7 billion (about £0.5 billion). Over and above these quotas, the central bank Governors' Committee may decide to extend additional support ("debtor rallonge"). The Soutien quotas are used to determine the amounts which can be drawn for intramarginal intervention under the VSTF: each ERM member may draw upto twice its Soutien quota under VSTF.

(d) **Medium term financial support mechanism (MTFS)**

11. In 1988, this replaced two previous credit facilities (medium term financial assistance and the community loan mechanism) which had been little used. The MTFS has itself not so far been used.

12. The object of the MTFS is to make medium term financial assistance available for Member States in balance of payments difficulties or seriously threatened with them. A loan is conditional on the borrower adopting economic policy measures designed to re-establish a sustainable balance of payments position. Lending decisions are taken by the Council, including decisions on amounts, duration, and economic policy conditions.

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13. The total amount of loans which can be outstanding under this facility at any time is limited to ECU 16 billion (around £12.5 billion). Loans are to be financed usually by market borrowing, upto a limit of ECU 14 billion, arranged by the Commission on the Community's behalf. If market conditions are unsatisfactory or the amount available through market borrowing is insufficient, the loans can be financed in full or in part by Member States, subject to Council agreement. The UK's contribution to any loan would be a maximum of some ECU 2.7 billion (about £2 billion). Any call on the UK for this purpose would count as public expenditure.

CONFIDENTIAL

PRIME MINISTER

EMU/ERM

The Chancellor would like to discuss this at the bilateral next Thursday before opening it out to a wider group of colleagues. Content for him to bring Sir Peter Middleton and Nigel Wicks to that meeting? Yes MT

The option which the Treasury feel has most attractions has some similarities with ERM as that too was a system with a provision for latecomers. It will be argued that our arguments for a latecomer's provision will carry more weight if we have joined the ERM as this will be interpreted as evidence that we will join eventually and are not just seeking this provision in order to avoid ever entering EMU. It is a variant of the more general argument that we will carry more weight in the IGC having joined.

Conversely, to have joined the ERM will alarm those who oppose EMU fundamentally as they will draw the conclusion that one is always forced eventually to activate the latecomer's clause.

AT

ANDREW TURNBULL

25 May 1990

(1)

PRIME MINISTER

EMU

The attached paper conveys the Chancellor's latest thinking on EMU. You will find it unpalatable.

The Chancellor's analysis is that the other Eleven Member States will agree to amend the Treaty to provide for an eventual EMU on the Delors definition, ie single currency and Central Bank. They will not be satisfied with our expanded Stage 2 as a substitute for this, although may accept it as a way-station. If we refuse to sign up to their definition of EMU, they will go ahead with a separate Treaty of Eleven, creating a two-tier Community. This would happen at a politically embarrassing time, ie around the likely time of the next Election.

The Chancellor's conclusion is that, if we are to avoid relegation to Division Two, we have to go along with the definition of EMU, but build in a provision which enables Member States to decide for themselves whether and when to join. That would effectively leave the decision to Parliament. In parallel, we should put forward our ideas - either the Butler proposals or the less ambitious Treasury version - for Stage 2. Although this would not deter others from wanting to sign up to Stage 3, our scheme might in practice postpone the evil day.

The Chancellor wants to discuss the position with you first, then with a wider group of colleagues. He does not think we can delay taking a public position much longer.

There are a number of basic questions to be resolved.

Is the Chancellor's pessimistic analysis of the inevitability that the other Eleven will commit themselves now to the aim of Delors Stage 3 justified? No

One can only say that it reflects the unanimous view of Nigel Wicks and others dealing with this issue. There are widely

They are too clever by too timid.

differing views in the Community about when and under what conditions the transition to Delors Stage 3 would actually be made. But something close to consensus on the aim. This is a crucial difference with the debate on political union. The questions we have to ask are: are we being defeatist? Is there some combination of ingenuity, political will or nerve which can thwart the apparent resolve of the Eleven to commit themselves through Treaty amendment to Delors Stage 3? Is the Treasury analysis too much of a straight-line projection of current views, when in reality all sorts of developments eg GEMU may intervene to throw the others off course? There is a tendency in judging our tactics in the EC to over-estimate the real determination of our opponents. Things in the real world are rarely as simple as they appear. The choice seems unlikely to present itself in quite such stark terms as the Chancellor suggests. But the crucial point is that if we decide now to proceed as proposed by the Chancellor, we are throwing in the towel on substance of EMU and arguing only about tactics. Are we ready to do this? Or do we carry on trying to get a weaker definition of EMU?

What are the prospects for significantly diluting the Delors Stage 3 prescription in further discussion in the Community?

The Chancellor's minute does not really deal with this, presumably because he feels there is not much to be done. But surely this is the sort of guerilla warfare in which we excel in the community. Should we not have a tactical game plan for hobbling the Delors Stage 3 definition as extensively as possible?

Does it matter if the Eleven go ahead without us?

It would look bad. There would be a clamour from the City, who would fear the consequences of being outside the mainstream. How much it would matter in substance depends on the view one takes of the likelihood of the Eleven in practice going ahead with full EMU within the foreseeable future. In reality, nothing much would change for quite a while.

We have no authority to do so. Parliament is sacrosanct.

If we accept the Chancellor's analysis that we have no option but to subscribe to the goal of Delors Stage 3, can we negotiate provisions which would leave open not only when Member States would join, but whether they would do so?

This is crucial. One option would be to say that the move to full EMU could only take place on the basis of unanimity. This is perhaps too easily dismissed in the Treasury paper, on the grounds that others would suspect that we would use the device of unanimity to exercise an indefinite veto. But I would be quite surprised if countries like France and Germany would be ready to give up a veto on the timing of a move to full EMU. On the other hand, we could find ourselves isolated and under great pressure, in which case a clear commitment in advance that a decision whether to join is a matter for each Member State would be a better protection.

We don't want to table.

There is also the tactical question: should we put forward our opting-in mechanism early on or spring it on the others at a late stage? The choice can be argued both ways. If we table it early, we give too much time to the others to argue it down: while introducing it late would put them under more pressure to agree, so as to avoid a last minute break-down. Equally, tabling it late in the day would mean that we would appear to have no position during most of the IGC debate, and that would go down badly with the Government's supporters.

Is it worth tabling our proposals for the next Stage if doing so is not going to save us from having to subscribe to the goal of Delors Stage 3?

Yes - it may save us in the new unclear world.

There are two purposes in putting forward our proposals for the next stage: first, as an alternative to a commitment to Delors Stage 3 (or at least as a means of securing only a vague and tenuous commitment to Stage 3): second, if there is a commitment to Stage 3, to postpone in practice the day when it would be implemented in practice. The Chancellor is clear that the first aim cannot be achieved. Is it still worth tabling our proposals to achieve the second?

In that case, should we go for the more or the less ambitious of our proposals?

One could argue that since our proposal is unlikely to achieve much, there is little point in tabling the more ambitious one. On the other hand, the Treasury is so unambitious as to be scarcely credible. The Butler proposal would at least appear a more intellectually and politically credible effort: and if it were to be implemented, it is sufficiently substantial and complex to delay a move to Delors Stage 3 for a considerable time.

You may like to go over some of these points with the Chancellor initially. Thereafter, you might have a wider meeting of:

Chancellor
Foreign Secretary
Trade and Industry Secretary
Sir D Hannay
Nigel Wicks
Professor Griffiths

I will have a long talk with the Chancellor. This advisers.

Agree?

CDP

C. D. POWELL
25 May 1990

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Treasury Chambers, Parliament Street, SW1P 3AG
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NATO —

PRIME MINISTER

EMU

Following our talk on 18 April I have been thinking further about the way ahead on EMU in the coming months.

2. We are, quite frankly, cornered a bit by the IGC. My present judgement of the situation is as follows:

- the Eleven are determined to agree Treaty amendments providing for an EMU, on the Delors definition, a single monetary policy, locked currencies, (very probably) a single currency, and all to be administered by a European Central Bank;

- whatever support there is in the Community for a substantial Stage 2 (and it looks to be declining), it is certain that the Eleven will not be satisfied with a Treaty which deals only with Stage 2; but

- the House of Commons will not accept a Treaty which commits the United Kingdom to move to the final stages of an EMU on the lines described above; nor would we wish to recommend one;

Have not the right to commit 2 Parliaments ahead.

(1) Long time coming - but will come

Japs. & U.S.

Bad for Europe.

Have not the right to commit 2 Parliaments ahead.

(1) Long time coming - but will come

Japs. & U.S.

Bad for Europe.

- if we refuse to sign the Treaty likely to emerge from December's Inter-Governmental Conference, the Eleven will before too long go ahead with their own separate Treaty;

- a Treaty of Eleven would be seen by many as, and may indeed be, the beginning of a path to a two-tier Europe. At this crucial electoral stage the overwhelming majority of our supporters will, I believe, want to avoid our being confronted with this option;

- the timetable for the IGC on EMU is, in electoral terms, acutely embarrassing. It could well complete its work in the summer of 1991 with Parliamentary consideration of the amending Treaty, should we agree to put it forward, some time during the next 18 months.

3. If these judgements are correct we have got to find a way out of this hole, and we need to do so quickly. It is very likely that other Member States are already preparing drafts of Treaty amendments for December's IGC. Unless we are to be faced with a series of faits accomplis and a totally impossible negotiating position, we need to be ready to table our own amendments in a form where there is some prospect of their securing some support. In short, we need a formula for an amending Treaty which:

- permits the Community to proceed with Treaty amendment for EMU on the lines described in paragraph 2 above;

- allows us to agree such a Treaty; but

- does not require a commitment from this present House of Commons to make the transfer of sovereignty implicit in a single monetary policy, a single currency etc; and

keeps open the options for future Houses to remain outside the system if they wish; and

- avoids our having to make any decision about a two-stage Europe.

4. The paper attached at Annex A considers five options which might achieve that end. Of the five, the last is, I think, the only one which offers a prospect of negotiability and which would meet our objectives.

5. Under this option, the amending Treaty would provide that when a simple majority of Member States (or even less) had indicated that they were ready to proceed to full EMU, the appropriate provisions of the Treaty would come into effect. But they would apply only to the Member States which had opted in to that final stage. It would be essential to ensure that the Treaty made clear that Member States could decline to opt in to the final stages of EMU and that this right could be maintained indefinitely. We would also wish to make clear, I am sure, that any decision to opt in to these final stages would be taken at the national level and that, at least in the UK, our national Parliament would need to be fully involved. Unavoidably under this option we would have to accept the definition of full EMU, but as the note at Annex A explains, the only way of not accepting such a definition is not to sign the Treaty. The important point for us is that we want to avoid a Treaty which would commit us to moving to full EMU. We want an arrangement that would permit us to maintain that position indefinitely if that is what Parliament wanted. The fifth option in the paper at Annex A is intended to do that.

6. I believe that this option could be presented positively and in a way which makes clear the overriding importance which we attach to the position of Parliament. We could say justifiably

that the route chosen reserved the important decision regarding the transfer of monetary sovereignty to the Parliament of the day and gave that Parliament the freedom to decide. We could point out to our supporters that freedom of decision would not have been preserved either if we had presented Parliament with a Treaty which committed the UK to move to monetary union or if we had stood aside and let the Eleven sign a separate Treaty. In the first case Parliament would have been asked to concede the principle at the outset, perhaps years before the issue became a practical one, and in the second Parliament would have been deprived of exercising the option of moving to a single monetary policy etc should it ever choose to do so. The route outlined above - leaving the crucial decision to the Parliament of the day - is one which is sensible in itself and which preserves the freedom of Parliament.

7. We would need to think very carefully how we put this approach to the other Member States. One possibility might be to say that in practical terms no-one in the Community is ready to move now to full monetary union; the opting-in arrangement recognises this position. It would provide a means whereby the British people could, through a vote of the Parliament of the day, provide the necessary consent for a significant transfer of monetary sovereignty. If we put the issue in this way, we could take credit for what we have in mind and not be on the defensive. We also need to consider when we would make clear to the Community that an opting-in provision on the lines described above is essential for us. I believe that if we do not make clear our position at an early stage our presentation in the Community and in the UK would become impossible. To spring this on other Member States at a late stage would risk accusations of bad faith and in the meanwhile raise suspicions among our supporters in this country.

8. On the assumption that we can establish a viable negotiating position for the UK on the final stage of EMU, I have been considering whether we should float some ideas for the so-called Stage 2 of EMU. The essential distinction of this stage from the final stage is that responsibility for monetary policy would still remain in national hands. There are two broad reasons why a Stage 2 might be in our interest:

(i) Political: we want to postpone for as long as possible Member States' actual decision to move to the final stage. Directly Member States, or a group of them, take that decision, we will be faced with decisions about use of the opting-in provision described in paragraph 5 above. Provided it was of sufficient content, a Stage 2 could help in extending the time before we were confronted with such a decision. More generally, the other eleven will want to set up an institution in the near future and an EMF could satisfy that in a way that would be acceptable to us.

(ii) Economic: in view of the complexity of EMU there is much to be said for devising an approach which is both valuable in its own right and which provides, for those Member States wanting to go to the final end, a mechanism whereby the final stage can evolve out of Stage 2 rather than being a leap from Stage 1. An extended Stage 2 would also give time for the necessary economic convergence to take place.

Public justification for Stage 2 could, of course, rest only on the economic arguments. If other Member States believed that we were advocating a Stage 2 as a means of temporising, our ideas would be dead on arrival. This suggests that we should only float ideas for a Stage 2:

- within the context of our acceptance of an amending Treaty which would include provisions for the final stage; and

- if our Stage 2 ideas could be seen both as a transitional step on the way to the final stage and as a useful step in their own right (and which would not commit individual Member States to go all the way to full EMU).

9. Officials from the Treasury and Bank of England have set out in the paper at Annex B an assessment of the possibilities for a Stage 2. Two broad, but not necessarily conflicting, approaches are described, both of which involve the creation of a European Monetary Fund (EMF). They are: the creation of an ecu currency board with the objective of providing a mechanism for putting ecu bank notes into circulation without adding to monetary growth in the Community; and a more ambitious approach, based on Sir Michael Butler's paper, involving the creation of a new "hard" ecu which would never devalue against any Community currency at an ERM realignment. This latter approach is quite radical and intended to create an institution with embryonic monetary policy functions at the same time as monetary sovereignty is kept in national hands. But it is still essentially evolutionary in nature : individuals and companies would be free to choose between using this ecu or separately circulating national currencies. Safeguards need to be built in to prevent the process adding to total Community monetary growth and undermining national monetary policies. Providing this can be done the scheme should act as a further instrument of financial discipline in the Community. Further work is urgently in hand on these aspects in the Treasury and the Bank.

10. Both approaches can be coupled with additional features whereby the EMF could assume certain functions eg:

- in managing the ERM and the ecu;
- the co-ordination of intervention against third currencies; and
- playing a role in the granting of the Community's conditional balance of payments loans.

11. We know from their present positions that it will not be easy to convince the other Member States of the merits of our proposed EMF approach to beyond Stage 1. There have been indications since our meeting in April that the French, who appeared to see some attractions in a long Stage 2, are now ready to accept a short Stage 2. So (unsurprisingly) are the Commission. Even so the proposal for an EMF should attract some interest in the Community. To the extent that some elements of the proposal, including the "hard" ecu, add to financial discipline, it should have some attractions to the Germans. But they may argue that the scheme smacks too much of creating a parallel currency which they traditionally dislike. But, some members of the Community may see the approach as a useful means whereby the Central Banks can work together in the implementation of monetary policy in the stage after Stage 1 while keeping control of that policy in national hands. We could retain the currency board option described in the Interdepartmental Group's Report, possibly as an interim stage. We certainly could present both approaches as compatible with our evolutionary competing currency approach.

12. As I say, we cannot be sure the proposal would fly in the Community and the probability at the moment is that it would not have majority support. Even so, I believe it is worth floating in broad terms as a further constructive UK contribution to the

debate, provided we make our position clear on Stage 3 as I suggest above.

13. I recognise that these are all extremely difficult issues. But I see no way of avoiding them. Unless we can find a way through, we will face difficulties not only in the Community but also with many of our supporters in the House and in the country. Of course, we will need to consider very carefully the tactics for presenting all this to the Community and to the House of Commons especially in view of the likely discussion of these issues at ECOFIN on 11 June and later in the month at the European Council. But first I should like to discuss the substance with you when we might also consider how best to involve a wider group of colleagues.

I don't see the difficulty.

John M.

[J.M.]

24 May 1990

AN EMU TREATY: UK OPTIONS

Introduction

1. This note examines possible options for an EMU Treaty and the considerations affecting the UK's attitude to it.

2. Our main concern is to avoid a commitment to unacceptable monetary arrangements, including a single Community monetary policy and a single currency. Our attitude to a single EC central monetary institution would depend on whether membership carried any commitment to a single Community monetary policy in the UK. We expect to have less difficulty over economic union, provided binding rules on budget deficits can be avoided. The rest of this note therefore concentrates on monetary union (MU), on the assumption that the UK will secure its objectives on economic union.

3. The UK is already committed (most recently in the preamble to the Single European Act) to the general objective of "progressive realisation of Economic and Monetary Union". The nearest we have come to accepting a Delors-style definition of MU is in the preamble to the 1973 Regulation establishing the European Monetary Cooperation Fund (EMCF). However, these are both political, not legally enforceable, commitments since they appear only in the preambular paragraphs of Community legal documents.

4. Any EMU Treaty amendment will impose specific legal commitments on all member states. It is worth distinguishing between two different sorts of Treaty commitment:

(i) commitment to a detailed definition/specification of full MU;

(ii) commitment actually to move to full MU.

Some of the options considered below would enable the UK to avoid (i). Others would avoid (ii) but not (i).

5. There is a further distinction between a Treaty which gives individual member states the choice of :

a. whether to move to full MU; or

b. when to move to full MU.

The former would preserve discretion never to move to full MU, on grounds of principle. The latter would imply acceptance of the detailed definition, but would preserve the right to delay joining until the relevant economic conditions were met.

6. The Commission envisage Treaty amendment involving:-

(a) commitment to a detailed definition/specification for Stages 2 and 3, and commitment to move to both stages (but no timetable);

(b) the definition of economic pre-conditions for moves from one stage to the next, with arrangements to enable different member states to move at different speeds, but not to delay indefinitely.

All other member states will support (a). Most are likely to support (b), but none favour provision for indefinite delay.

Options for the UK

7. We have identified the following main options.

(i) No definition of full MU in the Treaty

8. This could in principle be achieved by

(a) limiting the Treaty to Stage 2 arrangements, with any further stage and any definition of full MU to be covered in a later Treaty. We do not believe that this option is negotiable. All other member states want a Treaty which provides for the final stage as well;

(b) blocking any new Treaty which defines full MU. We consider this would result in the other member states concluding a separate "Treaty of 11";

(c) restricting the MU provisions in the Treaty to Stage 2, with a protocol signed by the other 11 member states committing them to move subsequently to full MU. We think this option is unlikely; the 11 would probably prefer to conclude a separate Treaty if they could not carry the UK with them.

9. Both (b) and (c) above would exclude the UK from any Stage 3 arrangements and would rule out the option of joining. The terms on which any future accession could take place would have to be negotiated afresh.

(ii) Treaty defines full MU but UK does not accept that definition

10. The Treaty could in theory include a reservation clause enabling the UK to make clear that we did not accept those parts which defined full MU and provided for its implementation.

11. Such a device would be unprecedented in the Community and would be inconsistent with the Community-wide nature of EC obligations. We do not believe it would be negotiable with our Community partners. Again, they would almost certainly prefer to negotiate a separate Treaty of 11.

So be it - Germany - France would have to pay all the regional subventions - OR there would be NONE in which case the poorer nations would NOT agree [illegible]

****

12. Options (i) and (ii), or variants of them, are the only ways of avoiding a commitment to a detailed definition/specification of MU. Otherwise, if the UK signs a Treaty which defines full MU, it accepts that definition. The only way of not accepting the definition is not to sign the Treaty. The only way of subsequently changing the definition would be to renegotiate the Treaty.

13. The remaining options involve accepting the definition of monetary union, but preserve discretion on whether or when to move to full MU.

(iii) Sign Treaty, but ensure that no member state can move to Stage 3 without unanimous agreement

14. We could seek a Treaty which requires a unanimous vote by all 12 member states to trigger any move from one stage to the next. The UK could then exercise its veto indefinitely.

15. This option has attractions in theory, since it would ensure that the 11 did not enter arrangements from which the UK was excluded. Moreover, it would enable Ministers to assure Parliament that although they had in principle accepted the Treaty definition of full MU, there was full protection in practice against it ever being implemented. However, we judge that it would be extremely difficult if not impossible, to negotiate given others' awareness of the danger that the UK, or indeed any other member state, would exercise its veto.

(iv) Sign Treaty, but include specific provision that UK will never move to full MU

16. It might be possible to include in the new Treaty a permanent derogation or exclusion for the UK from Stage 3 arrangements. (This is an alternative version of the idea of a reservation discussed in option (ii) above. Although we would accept the definition of MU, we would be protected from ever moving to it).

17. For the same reasons as set out in paragraph 11, we do not think that this would be negotiable. Arguably it would not in any case be in the UK's interests, since it would not retain discretion for us to opt into full MU should we eventually wish to do so without a fresh negotiation.

(v) Sign Treaty, but retain discretion on whether and if so when UK would move to full MU

18. The Treaty could provide that when, say, a simple majority of member states (or even less) had indicated that they were ready to proceed to the relevant stage, the appropriate provisions of the Treaty would come into effect. They would apply only to the member states which had opted in.

19. As noted in paragraph 6, the Commission itself may well propose something on these lines. In itself it would not be enough to protect the UK's position. We would need to be satisfied on two further points.

20. First, the Commission's proposals would probably give member states the choice of when to move to MU, but would make clear that this was only a matter of time in order to meet the necessary conditions. We would want the Treaty to make clear that member states could decline to opt in to the final stages of MU, and that this right could be maintained indefinitely.

21. Secondly, the UK would wish to make clear that any decision to opt in to the final stages of MU would be taken at national level and that, at least in the UK, our national parliament would need to be fully involved. Ways of securing this might be:

a. the Government could make a declaration at the time of signing the Treaty that it would intend to secure Parliamentary approval before any decision to opt in to full MU. This would have strong political force although strictly speaking Governments cannot bind their successors.

b. the Treaty itself could provide for national opting-in decisions to be authorised according to national constitutional requirements. The UK would make that in our case this article meant an affirmative vote of both Houses of Parliament. This approach has the advantage of, effectively, building the requirement for Parliamentary approval into the Treaty itself. But it would be difficult to insist on such a provision if other member states were opposed to accepting constraints on their own opting-in procedures.

22. These mechanisms would register the need for Parliamentary approval of any decision to opt in. In addition it would be necessary to implement in our national law the further legal obligations flowing from the decision to opt in. This would require domestic legislation - probably a Bill - for instance amending legislation concerning the Bank of England.

23. An "opting-in" Treaty on lines satisfactory to the UK may be negotiable, though we cannot be sure. Much would depend on the precise language used about grounds for remaining outside full MU; the Community's interpretation of the spirit in which the UK proposal was put forward; and whether this was seen as the only way of avoiding a Treaty of 11. It would be more likely to be negotiable if member states believed it to be an arrangement whereby HMG was leaving it to the Parliament of the day to decide on this important issue. It would be less likely to be negotiable if they thought we had prejudged the issue now.

24. Various questions about the practicality of an opting-in Treaty arise. For instance, should opting in arrangements apply to Stage 2 as well as Stage 3? Could economic conditions for moving from one stage to the next be imposed if joining full MU were optional? Would non-optants be able to participate in some aspects of the new arrangements, even though they did not come within a single Community monetary policy? These issues will need further consideration.

Summary

25. The main options for the UK seem to be:

(i) Refuse to sign a new Treaty. This would ensure that we were not committed to a detailed definition of MU, nor to full participation in Stage 3. But we judge that the 11 would move to a separate Treaty.

(ii) Persuade our Community partners to restrict the Treaty provisions to Stage 2, possibly with a protocol signed only by the 11 committing themselves to move subsequently to full MU. This would also ensure that the UK was not committed to a detailed definition of monetary union, but we do not think it negotiable. The 11 would move forward to a separate Treaty without us.

(iii) Sign a Treaty which provides for the Community to move to full MU, but includes a reservation or permanent derogation for the UK. This is unprecedented in the Community and would almost certainly not be negotiable.

(iv) Sign a Treaty which requires a unanimous vote before any member state may move from one stage to the next. This would not avoid a commitment to the detailed definition of full MU, but would enable the UK to block anyone in the Community progressing to it. However it is most unlikely that it would be negotiable, since it would give the UK or any other member state a blocking device.

(v) Sign a new Treaty but insist on satisfactory opting-in arrangements based on separate decisions by individual member states. This commits the UK to a definition of full MU, but retains for us full discretion on whether/when to move to it. It is more likely to be negotiable; but in the last analysis there would be no way of preventing the 11 moving ahead without us.

(vi) Offer an alternative (1 or more) which none would accept.

HM Treasury
16 May 1990

EMU : A UK PROPOSAL FOR EVOLUTION OF INSTITUTIONS AFTER STAGE 1

Any proposal we make should if possible pass all the following tests :-

i) it has to meet the desire of many to make early progress in establishing new Community monetary institutions.

ii) it must leave responsibility for setting and operating national monetary policies clearly in national hands.

iii) it must not in any way compromise or weaken national policies to control inflation; ideally it should help to reinforce them.

iv) the development must be one that others can regard as a transitional step on the way to the eventual emergence of a single European currency, and monetary union; but which we can present as a useful step in its own right.

v) there would be both real and presentational advantages in promoting and popularising use of the ecu as a 13th common Community currency, circulating alongside national currencies.

2. Judged against these tests, there is little or no difficulty in giving a new institution, a European Monetary Fund (EMF), the following functions. Most of them are already performed by other bodies within the Community.

a) The various tasks involved in **managing the Exchange Rate Mechanism**, and its financing facilities, including the functions in this respect of the Central Bank Governors'

Committee and the existing European Monetary Co-operation Fund (EMCF).

b) **Managing the ecu.** For example agreeing any changes in the weighting of the ecu basket; generally overseeing and promoting the development of private ecu markets, and encouraging removal of barriers to its use; and possibly taking over responsibility for managing the ecu clearing and settlement system (a function currently undertaken by the BIS in Basle).

c) Taking over the key role in **managing Community medium-term balance of payments lending.** Final decisions on granting balance of payments loans would remain with the Council of Ministers, but the EMF could join with the Commission in setting conditions for loans; and the EMF's consent might be required before any loan was granted. This should help to strengthen financial discipline in the Community.

d) It could take on a new role of **co-ordinating intervention against third currencies** (the dollar and yen). By the end of Stage 1, all Community currencies will be members of the ERM. All member states will thus have a common interest in the value of their currencies against the dollar and yen. This co-ordination does not require pooling of reserves. Intervention can be financed by contributing dollars, or national currencies, as required, according to an agreed key. Nor does it require the EMF actually to undertake the intervention. This can be delegated or sub-contracted to individual national central banks.

3. The final element of our potential institutional package is more interesting, but also more difficult. Its aim is to go further in popularising use of the ecu, and developing ecu markets; and at the same time to develop the EMF in a way that others would see more obviously as a potential step towards the development of the Community central monetary institution that

they wish to see. For us it is crucial that any development should in no way compromise the operation of national monetary policy; this is also a key German requirement in any arrangement short of full monetary union. We and they both wish if possible to strengthen the incentive on member governments to follow sound policies designed to achieve low inflation. It will be essential to design the proposals in such a way as to overcome longstanding German opposition to a "parallel currency".

4. There are two versions of the proposal, which can be presented as two possibilities in a spectrum of ideas, possibly with one leading later on to the other.

5. The first version involves the creation of an **ecu currency board**. Under this proposal the ecu would remain defined as a basket of the 12 Community currencies. We could either retain the present definition, which allows for changes in the basket every 5 years. Or suggest adoption of the proposal in our evolutionary approach paper that the composition of the basket should be fixed for all time. This would lead to a gradual improvement of quality in the ecu, as the weaker Community currencies lose their value and hence take a lesser weight in the basket.

6. The objective is to provide a mechanism for putting ecu bank notes into circulation, but to do so without adding to monetary growth in the Community. Alongside this it would be natural for Community commercial banks to hold their ecu settlement accounts with the currency board, in the same way that UK banks hold their sterling settlement accounts at the Bank of England. The currency board would arrange for ecu bank notes to be printed and issued, in exchange for Community currencies. The operations could be sub-contracted to national central banks. It would continuously balance its books, buying and selling currencies in the market as necessary, keeping as assets in its balance sheet the exact basket of national currencies required to match the notes issued. These assets could be held as bank notes, or in accounts at the relevant central banks, ensuring no net increase in the Community's money supply.

7. The board therefore undertakes no currency risk. There is no money creation, and no threat to inflation.

8. Demand for ecu bank notes might be relatively small initially, although it could prove a natural currency for tourists and business travellers. But the idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of more important markets in ecu deposits, furthering progress on the evolutionary approach sketched out in the earlier Treasury paper. Interest rates on ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the ecu's constituent currencies. The currency board would play no role in setting interest rates.

9. The second version is more ambitious, and involves the development of a new **hard ecu**. This version could be combined with the issue of ecu bank notes, although that is not an essential element of it.

10. It involves creation of a new redefined ecu, the hard ecu, that would no longer be defined as a basket of Community currencies. It would be defined instead as a currency that never devalues against any other Community currency at an ERM realignment. The board of the EMF would therefore have an active job to do, managing the currency to ensure that between realignments it stayed within its margins against the other 12 currencies, and that at realignments it never devalued. Hard ecu interest rates would not be set automatically in the market, as they are with a basket currency. The EMF would itself intervene in ecu money markets (this presupposes sufficient development of money markets for the purpose) to establish ecu interest rates. The EMF would also be able to intervene, buying and selling ecus for other Community currencies, and possibly dollars as well.

11. It would issue new ecus mainly in exchange for national currencies. But no mixture of Community currencies held as assets could be guaranteed to maintain its value against the ecu liabilities of the institution. Arrangements or rules would be needed to prevent the EMF being forced to support weak Community

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currencies. The simplest version would be a rule prescribing a maximum holding for the EMF in each Community currency. If the, say, drachma were under pressure because of imprudent policies, the EMF would not be allowed to let the Greek authorities off the hook by providing large scale support.

12. This second version amounts to the creation of a true parallel currency, albeit one with good anti-inflation characteristics. There are difficult technical issues to address, including the question of how to prevent the operation adding to total monetary growth in the Community, and thereby possibly undermining other currencies. The definition of the hard ecu is no guarantee against weakness in all Community currencies. But it is possible that sufficient safeguards can be built in to overcome traditional German antagonism to such proposals. Work is continuing in the Bank of England on these technical aspects.

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COREPER (AMBASSADORS): 23 MAY
EMU: INSTITUTIONAL ASPECTS

SUMMARY

1. COMMISSION PRESENT REPORT (INSTITUTIONAL ASPECTS/UPDATE OF MARCH PAPER) FOLLOWING UP DELORS' PRESENTATION TO INFORMAL FOREIGN MINISTERS MEETING ON 19 MAY. PRELIMINARY VIEWS EXPRESSED BY SOME DELEGATIONS. FRG, PORTUGAL, DENMARK, LUXEMBOURG, NETHERLANDS, BELGIUM FAVOUR ONE MAN, ONE VOTE ON EUROFED COUNCIL. ON PROCEDURE, COREPER WILL PRESENT WRITTEN REPORT FOR THE JUNE ECOFIN IN ADDITION TO THE MONETARY COMMITTEE ORAL REPORT. PRESIDENCY WILL PRODUCE A SINGLE SYNTHESISED REPORT AFTER ECOFIN FOR THE FOREIGN AFFAIRS COUNCIL. FURTHER DISCUSSION IN COREPER NEXT WEEK.

DETAIL

2. CAMPBELL (PRESIDENCY) RECALLED THAT IN HIS INTERVENTION ON EMU AT THE INFORMAL MINISTERS MEETING ON 19 MAY, DELORS HAD RAISED SIX ISSUES: THE TRANSITION TO STAGE 3, PARALLELISM OF ECONOMIC AND MONETARY POLICIES, THE ROLE OF THE ECU, RULES ON NATIONAL BUDGET MANAGEMENT, THE INDEPENDENCE OF EUROFED, AND ITS DEMOCRATIC ACCOUNTABILITY IE THE INVOLVEMENT OF OTHER INSTITUTIONS. THERE WAS NO SUBSTANTIVE DISCUSSION. BUT SINCE THE NEW COMMISSION REPORT HAD BEEN PRESENTED TO FOREIGN MINISTERS, IT WAS APPROPRIATE FOR COREPER TO DISCUSS IT AT THIS STAGE. AFTER A PRELIMINARY DISCUSSION THIS WEEK, AND HOPEFULLY A MORE SUBSTANTIVE DISCUSSION NEXT WEEK, COREPER WOULD PRODUCE A WRITTEN REPORT TO THE JUNE ECOFIN ALONGSIDE THE ORAL REPORT FROM THE MONETARY COMMITTEE A REPORT FROM THE ECONOMIC POLICY COMMITTEE. IN THE LIGHT OF THE ECOFIN DISCUSSIONS, THE PRESIDENCY WILL PRODUCE A SYNTHESISED REPORT FOR THE FOREIGN AFFAIRS COUNCIL ON 18 JUNE, WHICH WOULD PREPARE THE DISCUSSIONS AT THE EUROPEAN COUNCIL.

3. WILLIAMSON (COMMISSION) INTRODUCED THE COMMISSION PAPER. THIS WAS IN TWO PARTS, AN UPDATED VERSION OF THE MARCH PAPER AND A NEW

SECTION ON INSTITUTIONAL ARRANGEMENTS. ON THE LATTER, THE PAPER DISTINGUISHED BETWEEN MONETARY POLICY, WHICH WOULD REQUIRE A NEW INSTITUTION, THE EUROFED, WHOSE TASKS AND STRUCTURE NEEDED TO BE DEFINED AND ECONOMIC POLICY WHERE EXISTING COMMUNITY INSTITUTIONS WOULD SUFFICE.

4. TRUMPF (FRG) GAVE A PRELIMINARY REACTION. HE DID NOT LIKE THE TERM ''EUROFED''. THE EUROPEAN CENTRAL BANK SHOULD BE FULLY INDEPENDENT. THE PROCEDURES FOR REPORTING TO THE EUROPEAN PARLIAMENT RECOMMENDED WERE THE MOST THAT THE FRG COULD ACCEPT.THERE SHOULD BE ONE MAN, ONE VOTE NOT WEIGHTED VOTING ON THE EUROFED COUNCIL, PROVIDED THAT ITS MEMBERS WERE FULLY INDEPENDENT. FIVE YEARS WAS NOT A LONG ENOUGH PERIOD OF OFFICE FOR MEMBERS AND PRESIDENT. TWELVE YEARS (NON-RENEWABLE) WAS MORE NORMAL IN THE FRG. ON ECONOMIC POLICY, THE RULES IN THE PAPER ON NO DEFICIT SPENDING AND NO BAILING OUT OF THOSE IN DEFICIT WERE NOT SUFFICIENT TO ENSURE BUDGETARY DISCIPLINE. THERE SHOULD BE LEGALLY BINDING COUNCIL DECISIONS ADOPTED BY QUALIFIED MAJORITY WITH PROVISION FOR PENALTIES TO BE IMPOSED ON OFFENDERS. THERE WAS TOO MUCH LOOKING BACK TO SEVENTIES/KEYNESIAN LANGUAGE. AS FOR COMMUNITY HELP FOR MEMBER STATES IN DIFFICULTIES, THE PRESENT SYSTEM OF BALANCE OF PAYMENTS SUPPORT WOULD BECOME MEANINGLESS AFTER STAGE 3. THERE WOULD NEED TO BE DIFFERENT INSTRUMENTS TO OVERCOME REGIONAL DISPARITIES. WAS IT DESIRABLE FOR THE EUROPEAN COUNCIL TO BE INVOLVED IN MULTIANNUAL ORIENTATIONS AND SETTING MEDIUM TERM PERSPECTIVES? SURELY ECOFIN MINISTERS WERE THE EXPERTS?

5. DE SCHOUTHEETE (BELGIUM) OBJECTED TO THE USE OF THE FRENCH WORD ''DIRECTOIRE'' (TO TRANSLATE ''BOARD'') AND TO ''EUROFED''. THE ROLE OF THE EP SHOULD BE STRENGTHENED. THE APPOINTMENT OF THE PRESIDENT AND MEMBERS OF THE EUROFED COUNCIL SHOULD BE SUBJECT TO EP APPROVAL, NOT JUST CONSULTATION. AMENDMENT TO ITS STATUTES SHOULD ALSO REQUIRE EP APPROVAL. HE AGREED WITH ONE MAN, ONE VOTE.

6. COELHO (PORTUGAL) STRESSED THE NEED FOR THE EUROPEAN CENTRAL BANK SYSTEM TO BE ANSWERABLE TO THE COUNCIL AND THE EUROPEAN PARLIAMENT. THERE SHOULD BE BALANCED DISTRIBUTION OF THE BENEFITS OF EMU. THERE MUST BE A MECHANISM TO RESPOND SWIFTLY TO ANY DETERIORATION IN EXISTING REGIONAL SYMMETRIES.

7. RYTTER (DENMARK) AGREED WITH ONE MAN, ONE VOTE. AT SOME POINTS THE PAPER TIPPED THE BALANCE TOO FAR IN FAVOUR OF THE COMMISSION AGAINST THE COUNCIL. WESTENDORP (SPAIN) HAD NO COMMENTS ON THE SUBSTANCE AT THIS STAGE. ON PROCEDURE, HE WAS CONCERNED THAT

COREPER, AS WELL AS MONETARY COMMITTEE DISCUSSION WOULD CONFUSE THE ISSUE.

8. I AGREED WITH WESTENDORP ON PROCEDURE. A SINGLE CHANNEL FROM THE MONETARY COMMITTEE TO ECOFIN TO THE FOREIGN AFFAIRS COUNCIL AND THE EUROPEAN COUNCIL WOULD BE BETTER. ON THE SUBSTANCE, I RECALLED THE FORMAL RESERVATIONS ON STAGE 3 ENTERED BY THE UK. I NOTED THAT THE PAPER DID NOT DEAL WITH THE THORNY ISSUE OF STAGE 2. WOULD THE COMMISSION BE PRODUCING A PAPER ON THIS AT SOME STAGE?

9. NIEMAN (NETHERLANDS) AND WEYLAND (LUXEMBOURG) ALSO FAVOURED ONE MAN, ONE VOTE. NIEMAN OBJECTED TO THE TERM ''DIRECTOIRE''. THE REPORT WAS NOT VERY EXPLICIT IN THE RULES GOVERNING BUDGET DEFICITS. WOULD TREATY REVISIONS BE NECESSARY.

10. WILLIAMSON NOTED THE OBJECTION TO THE TERMS ''EUROFED'' AND ''DIRECTOIRE''. IT WAS INTERESTING THAT ALL THOSE WHO SPOKE ON VOTING IN THE EUROFED COUNCIL (INCLUDING NOTABLY THE FRG) WERE IN FAVOUR OF ONE MAN, ONE VOTE. WAS UNANIMITY ON THIS POSSIBLE? IT WOULD BE USEFUL IF HE COULD REPORT TO THE COMMISSION ON THIS AFTER NEXT WEEK'S COREPER DISCUSSION. WILLIAMSON ACKNOWLEDGED THAT THE PAPER DID NOT DEAL WITH STAGE 2. A NUMBER OF MEMBER STATES TOOK THE VIEW THAT WE SHOULD BE CAREFUL NOT TO CREATE A FRAMEWORK FOR THE TRANSITION FROM STAGE 1 TO STAGE 3 IF IT WAS NOT GOING TO BE NECESSARY. IF STAGE 1 WAS A GREAT SUCCESS, STAGE 2 MAY NOT BE NECESSARY. THIS DID NOT MEAN THAT IT WAS NOT POSSIBLE TO DEFINE THE NECESSARY INSTITUTIONAL ASPECTS IN STAGE 3 NOW. IN ANSWER TO THE NETHERLANDS, TREATY CHANGES WOULD BE NECESSARY. HE NOTED THE FRG'S VIEWS ON BINDING COUNCIL DECISIONS AND PENALTIES ON BUDGET DEFICITS. THERE WAS A DIFFERENCE OF VIEW ON THIS IN THE COUNCIL, AND THE COMMISSION WAS NOT ATTEMPTING TO MAKE A FINAL JUDGEMENT IN ITS PAPER. BUT IT WAS DIFFICULT TO SEE WHAT PENALTIES WOULD BE APPROPRIATE, SINCE THESE WOULD BY DEFINITION BE IMPOSED ON A STATE WITH SERIOUS ECONOMIC PROBLEMS. THE COMMISSION DID NOT FAVOUR EG CUTTING OFF STRUCTURAL FUND PROVISIONS. THERE SHOULD BE NO DIFFICULTY WITH THE EUROPEAN COUNCIL SETTING MEDIUM TERM PERSPECTIVES AND TAKING MULTIANNUAL ORIENTATIONS ON ECONOMIC POLICY. DECISIONS ON THESE MATTERS NATIONALLY WERE TAKEN AT THE HIGHEST LEVEL. BUT ECOFIN WOULD DEAL WITH THE MONTH BY MONTH OPERATION OF ECONOMIC UNION.

11. CAMPBELL NOTED THAT NOT ALL WERE HAPPY WITH THE PROCEDURE, BUT RESTATED HIS INTENTION TO PROCEED AS AT PARAGRAPH 2 ABOVE. THERE WOULD BE A FURTHER COREPER DISCUSSION NEXT WEEK, ON THE BASIS OF

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WHICH COREPER WOULD REPORT TO ECOFIN.

COMMENT

12. WE WILL NOT BE ABLE TO AVOID A DISCUSSION OF SUBSTANCE IN COREPER NEXT WEEK. GRATEFUL FOR BRIEFING WHICH IN VIEW OF YOUR HOLIDAYS, WILL NEED TO BE WITH US BY THE END OF THIS WEEK.

HANNAY

YYYY

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with compliments

Sir Peter Middleton GCB

Permanent Secretary

HM Treasury
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London SW1p 3AG

Tel: Direct Line 071 270 4360
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BP

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FROM: R J EVANS
DATE: 22 May 1990
EXT: 4360

ALL THOSE ON THE ATTACHED LIST

ADSO SECURITY INSTRUCTIONS: SECOND EDITION

... Attached is an amended list showing those with access to information covered by the **ADSO** codeword. Requests for additions to the list should be directed to **Julie Todd** in this office in the first instance.

2. You will wish to be aware that Stationery now have a stock of pink folders marked "**SECRET _____LIST ONLY**" which may be used for **ADSO** distribution, together with a set of labels. But please do not refer to **ADSO** when ordering them - knowledge of the word is restricted to those on the list.

R J Evans.

R J EVANS
Private Secretary

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ADSO - ACCESS LIST

1. Ministers and Advisors

Chancellor
Chief Secretary
Mrs J Chaplin
Mr A Tyrie

2. Senior Officials

Sir Peter Middleton
Sir Terence Burns
Mr N Wicks
Mr M Scholar
Mr H P Evans
Mr J Odling-Smee

3. Private Offices

Mr J Gieve
Mr T Tarkowski
Mr R J Evans
Ms C Evans
Mr A R Lyons
Mr N Davis
Mrs P Spragg
Miss J Todd
Mr J Coker
Mrs M Henson
Mrs J Henser
Mrs V Brown
Mrs D Crane
Mrs E Davies
Mrs J Fane

4. MG

Mr D Peretz
Miss E Engledow (Secretary)
Mr P McIntyre
Mrs P Hubbard (Secretary)
Mr J Grice
Mrs J Wright (Secretary)
Mr N Williams

5. Other Treasury

Mr P N Sedgwick
Mrs E Hollyer (Secretary)
Mr C Riley
Miss P Collins (Secretary)

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6. **Bank of England**

Governor
Deputy Governor
Mr P Tucker (PS to Governor)
Mrs S Betts (APS to Governor)
Miss D Wells (APS to Governor)
Miss J Attridge (Secretary to Governor)
Mr C Briault (PS to Deputy Governor)
Miss B Dennis (Secretary to Deputy Governor)
Mr A Crockett
Miss J Harris (Secretary)
Mr A Coleby
Mrs S Hartnett (Secretary)
Mr M Foot
Mr J Flemming
Mr I Plenderleith
Mr W Allen
Mr J Arrowsmith

7. **Other Whitehall**

Miss J Wheldon	(Legal Secretary)
Ms E Wilmshurst	(Lord Chancellor's Department)
Mr A Turnbull	(No 10)
Mr B Potter	(No 10)
Mr C Powell	(No 10)
Professor B Griffiths	(No 10)
Mr M Blythe	(Treasury Solicitor's Department)

Miss M E Walker (Secretary)

1 (A-C)
B

SECRET AND PERSONAL

PRIME MINISTER

18 May 1990

ERM ENTRY : FOR AND AGAINST

The economic issues over UK entry to the ERM remain unchanged. The case for floating exchange rates is that they allow autonomy in the conduct of monetary policy. And the value of autonomy is that any unexpected developments can be absorbed by changes in exchange rates as well as interest rates. If we join the ERM, the impact will be taken mainly by interest rates.

The immediate danger of being in the ERM is that changes in the exchange market could move the rate to either the top or bottom ends of the band. We have seen how volatile sterling is in the last 48 hours. We would then be forced to intervene and bring interest rates down (at the top end), or raise interest rates (at the bottom end) - even though neither action would be the appropriate policy response to the behaviour of the monetary aggregates and the state of the domestic economy.

It is sometimes argued that UK interest rates would fall if we entered the ERM. This is most unlikely. The present behaviour of the monetary aggregates, and especially MO, is very worrying. A surge in confidence on entry would have to be taken on the exchange rate - as lower domestic interest rates would be a recipe for inflation.

This leads to one very important point. The intention of the EMS is that a country's exchange rate should move within fixed limits. But what if, shortly after entry and the announcement of good news

about the economy, sterling hits the top of the band? It is vital that we have the freedom to revalue. If you enter this year it is **absolutely critical** that, should the circumstances arise, it is possible that we are able to revalue. The argument which might be used in the negotiation for entry would be that given the large differential between sterling and DM interest rates and the disequibrium in the UK economy at present, we need extra flexibility to ensure that entry is not linked with inflation or deflation. If it was not possible to negotiate such a position, entry to the EMS would run the risk of fuelling inflation, even if only temporarily. But the timing of such a blip in inflation could be extremely embarrassing.

Another area of difficulty is the outlook for German inflation. The EMS is effectively a D-Mark area. Throughout the post-war years the anchor keeping inflation low in Germany was the experience of the 1923 inflation. As the Bundesbank has become more political, and in view of the financial pressures created by the integration of East and West Germany, it would be wrong to be over sanguine about the future course of inflation in Germany.

In terms of the economics of the joining the ERM, my personal view is that the case made for entry is still not very convincing. With a large band ($\pm$ 6%) for the exchange rate and the right to realign our exchange rate should we need to, we could cope in the ERM.

The real case for entry is **political**.

- You will be seen by the rest of the world as tying our economic future with that of Europe. The City and business will both be pleased and this will almost certainly underpin existing and future direct foreign investment, especially from Japan.

- It will spike Labour's guns;

- It will also remove one element of dvision within our own Party.

- It is frequently agreed that we gain more influence in the Community by being in the ERM though I am personally somewhat sceptical about this.

In addition to this your statement at Madrid was seen as the crossing of the rubicon. On the basis of that statement, there is a widespread expectation that the conditions for entry will be fulfilled before the next election and that therefore we will join the ERM. Subsequent statements by yourself and the Chancellor have been perceived as reinforcing this position.

Conclusion

On balance the economic arguments are still against joining; except that it is impossible to quantify the change in confidence which it might inspire (especially on direct investment), and providing we can realign upwards, if the exchange rate surges, we should have no problems in maintaining an anti-inflationary policy.

The political case is strongly in favour of entry and is becoming stronger.

On balance therefore I believe the UK should enter the ERM.

Entry raises many technical questions on which the Treasury are currently preparing a paper. Timing however is important. As the case for entry is political, the timing should be judged to secure maximum political advantage - certainly before the party conference, and probably either in September or July. Given the current buzz in the press and the markets, the Chancellor could well be seeking an early date.

BRIAN GRIFFITHS

chex.jp/jg1/76

CONFIDENTIAL

CDP 10/5

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

17 May 1990

Barry Potter Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Barry

with CDP.

GERMAN RESTRICTIONS ON THE ISSUE OF FOREIGN CURRENCY BONDS

Your letter of 30 April asked about German restrictions on the issue of foreign currency bonds. I attach a note on the subject. As you will see the restrictions served no useful monetary control purpose and were abolished in January of this year.

Yours

JGL

JOHN GIEVE
Principal Private Secretary

GERMAN RESTRICTIONS ON DOMESTIC ISSUES FOREIGN CURRENCY BONDS

These restrictions were lifted, in January 1990, and the Bundesbank now say they were serving no useful monetary policy purpose.

2. Between 1949 and 1961 there was an absolute prohibition on German residents holding or issuing foreign currency bonds. The purpose was to protect the deutschemark since there was a fear that German residents would wish to switch into dollars.

3. From 1961, however, German entities have been able to issue foreign currency bonds, providing they were issued through offshore subsidiaries. The Treasury note of 4 June 1989 suggested, on advice from the German IMF alternative director, that the restriction had been maintained for monetary policy reasons, to discourage the use of foreign currency by domestic residents. The Bundesbank now deny there was any monetary policy reason other than the original reason of external monetary policy, to help support the exchange rate. Once the prohibition on residents' holdings of foreign currency bonds was removed in 1961, and offshore issues were permitted, this effect will have been lost, and the Bundesbank say the restriction was only maintained because there was no pressure to lift it. It helped to direct business to London, but the effect was small: only DM6 billion equivalent of foreign currency bond issues were made by German companies abroad last year.

4. In January 1990, the Bundesbank liberalised the arrangements for domestic bond issues by giving a general consent for banks and corporations to issue foreign currency bonds direct to German investors. The move came after pressure from some German issuers who wanted the flexibility of being able to make domestic issues in foreign currency. The Bundesbank said that the liberalisation has been made in recognition of the globalisation of financial markets. There have been only a few issues of foreign currency bonds by resident issuers in Germany this year.

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FRAME ECONOMIC

SPEECH BY THE PRESIDENT OF THE BUNDESBANK TO THE EUROPEAN PARLIAMENT COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS, STRASBOURG, 15 MAY 1990

SUMMARY

1. POHL BRIEFLY ADDRESSED A SPECIALLY CONVENED (AND PRIVATE) SESSION OF THE COMMITTEE AND THEN ANSWERED QUESTIONS, WHICH CONCENTRATED ON THE IMPLICATIONS OF GMU, THE ROLE OF A EUROPEAN CENTRAL BANK AND PROSPECTS FOR EMU GENERALLY. HE ADMITTED A CERTAIN SCEPTICISM ABOUT THE PROSPECTS FOR EMU.

DETAIL

2. ON THE IMPLICATIONS OF GMU, POHL STRESSED THAT THE GERMAN PEOPLE WERE UNDERTAKING AN EXPERIMENT, THE RESULTS OF WHICH COULD NOT NECESSARILY BE PREDICTED ACCURATELY OR IN DETAIL. HE SUSPECTED THAT THE PROCESS WOULD STIMULATE INFLATION, ALTHOUGH HE STRESSED THAT THE IMPLICATIONS FOR THE INTERNATIONAL STANDING OF THE DEUTCHMARK SHOULD BE MANAGEABLE. AN INCREASE IN INTEREST RATES, WHICH WOULD SLOW DOWN DEMAND IN THE FRG, WOULD NOT NECESSARILY BE UNDESIRABLE. HE DECLINED TO COMMENT ON THE POSSIBILE NEED FOR TAX INCREASES, BUT NOTED THAT AS THE COSTS OF UNIFICATION HAD BEGUN TO BECOME APPARENT, SO OPINION IN THE FRG HAD FOCUSSED MORE SHARPLY ON THE PROS AND CONS. HOWEVER HE EMPHASISED THE LONG TERM ECONOMIC BENEFITS OF UNIFICATION. THE STATUS QUO WAS NOT COST FREE TO THE FRG.

3. ON THE ROLE OF A EUROPEAN CENTRAL BANK, HE EMPHASISED THE NEED FOR INDEPENDENCE. LINKING SOCIAL AND MONETARY POLICY WOULD NOT WORK. BUT WHILE THE BANK WOULD NEED THE POWER TO TAKE DECISIONS INDEPENDENTLY, THIS DID NOT MEAN THAT IT WOULD NOT HAVE TO JUSTIFY AND EXPLAIN WHAT IT WAS DOING. CENTRAL BANK GOVERNORS HAD ACCEPTED IN THE CONTEXT OF THE COX AND DONNELLY REPORTS ON STAGE I OF EMU THE

NEED TO INFORM THE EP. NATIONAL CENTRAL BANKS WERE WELL AWARE THAT THEY COULD NOT SIMPLY IGNORE GOVERNMENT POLICY. HE NOTED THAT A EUROPEAN CENTRAL BANK WOULD BE IN A RATHER DIFFERENT AND STRONGER POSITION BECAUSE NO SINGLE GOVERNMENT COULD THREATEN EVEN IN EXTREMITY TO OVERRULE ITS DECISIONS. BUT EVEN THEN HE SUSPECTED THAT IN MONETARY POLICY IT WOULD TEND TO AN APPROACH WHICH REFLECTED THE AVERAGE POLICY OF MEMBER STATES, RATHER THAN THE STRICTEST POLICY.

4. ON EMU HE EMPHASISED THE NEED FOR SUCCESS IN THE FIRST STAGE. THE NEXT STEP WOULD HAVE TO INVOLVE INSTITUTIONAL CHANGE, IE A EUROPEAN CENTRAL BANK RESPONSIBLE FOR MONETARY POLICY. HE DID NOT SEE ANY SCOPE FOR A HALF-WAY HOUSE. THE ULTIMATE GOAL WAS A SINGLE CURRENCY, BUT THIS CENTRAL ISSUE WAS A MATTER FOR POLITICAL DECISION. HE WAS VERY CLEAR THAT THE ECU, AS CONSTITUTED, WAS A BASKET OF CURRENCIES AND NOT AN EMBRYO SINGLE CURRENCY, ALTHOUGH THE NAME COULD BE ADOPTED FOR THAT SINGLE CURRENCY. MEMBER STATES HAD TO MAKE UP THEIR OWN MINDS HOW FAR THEY WERE PREPARED TO GIVE AUTHORITY TO A CENTRAL BANK. HE DID NOT THINK THAT IT WAS NECESSARILY PREMATURE TO THINK IN TERMS OF A SINGLE CURRENCY, BUT THIS WAS NOT TO SAY THAT THE FORTHCOMING IGC WAS SUFFICIENTLY WELL PREPARED TO REACH SENSIBLE CONCLUSIONS ON SUCH ISSUES. IT COULD EASILY RUN INTO THE SAND, OR COME UP WITH AN UNSATISFACTORY COMPROMISE. BUT THESE ISSUES WERE NOT STRICTLY THE PROVINCE OF THE BUNDESBANK.

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FRAME ECONOMIC

MY TWO IPTS: AGEC: ECONOMIC AND MONETARY UNION (EMU)

SUMMARY

1. POEHL HINTS AT THE POSSIBILITY THAT EMU COULD PROCEED WITH LESS THAN TWELVE MEMBERS.

DETAIL

2. THE HIGH POINT OF THE MEETING WAS A LUNCH AT THE BUNDESBANK ATTENDED BY POEHL, WHO SPOKE IMPROMTU FOR ABOUT HALF AN HOUR ON EMU AND THEN ANSWERED QUESTIONS.

EMU

3. REFERRING TO HIS ARTICLE IN ''THE EUROPEAN'' OF 11 MAY COPIES OF WHICH HE CIRCULATED, POEHL SAID THAT HE HAD BEEN WIDELY MISUNDERSTOOD. HE HAD NOT PROPOSED EMU: THAT WAS FOR THE POLITICIANS TO DO. HE HAD SIMPLY EXPLAINED HOW IT COULD BE DONE IF THE POLITICIANS DECIDED TO PROCEED. TWO OF THE THREE ELEMENTS NEEDED TO SUPPORT EMU WERE ALREADY ALMOST IN PLACE: AN INTEGRATED MARKET AND A SYSTEM FOR FIXING EXCHANGE RATES (ERM) WHICH HAD GONE A LONG WAY TOWARDS ACHIEVING FIXED PARITIES. THE THIRD ELEMENT, CO-DECISION, WAS THE POLITICAL CORE OF THE ISSUE: SHOULD THE DM BE REPLACED AS THE ANCHOR OF THE EMS BY A COMMON CURRENCY? HE UNDERSTOOD WHY THE FRENCH WANTED THIS, BUT THEY COULD ONLY HAVE IT THROUGH A EUROPEAN CENTRAL BANK (ECB) COMMITTED TO MAINTAINING PRICE STABILITY, AND THE COMMON CURRENCY COULD NOT BE THE ECU, WHICH WAS ONLY A BASKET INCLUDING SOME WEAK CURRENCIES.

4. AN ECB WOULD HAVE TO HAVE A MONOPOLY OF MONEY CREATION, WHICH MEANT THAT GOVERNMENTS WOULD HAVE TO GIVE UP SOVEREIGNTY IN THAT AREA. HE WAS STILL SCEPTICAL THAT ANY GOVERNMENT, INCLUDING FRANCE, WAS READY TO DO THIS. HE WAS NOT OPPOSED TO THE GERMAN GOVERNMENT DOING SO ON THE RIGHT CONDITIONS. HE DOUBTED WHETHER ALL TWELVE WOULD AGREE TO DO SO HOWEVER. SOME WERE INCAPABLE: OTHERS UNWILLING. THE RISK WAS THAT GOVERNMENTS WOULD AGREE INSTEAD ON A HARMFUL COMPROMISE, IE. A CENTRAL BANK WITH NO POWER AND THEREFORE

NOT ABLE TO PURSUE THE RIGHT-STRICT-POLICIES. SINCE SUCH AN OUTCOME WOULD AFFECT THE BUNDESBANK, HE WOULD RESIST THIS STRONGLY. ANOTHER POOR ALTERNATIVE, BUT ONE WHICH WAS NOT UNLIKELY, MIGHT BE AN ECB OUTSIDE THE EC TREATY WITH FEWER THAN TWELVE MEMBERS BUT WITH A STANDING INVITATION TO THE REST TO JOIN, LIKE THE ERM.

5. ASKED WHY HE THOUGHT THIS A POOR ALTERNATIVE, POEHL SAID THAT IT WOULD BRING ABOUT TWO SPEED EUROPE LEAVING SOME MEMBER STATES AFFECTED BY THE OPERATIONS OF THE MARKET OUTSIDE THE DECISION MAKING PROCESS.

6. THE SAME THEME HAD COME UP AT AN EARLIER STAGE OF THE MEETING, WHEN JELONEK (AUSWAERTIGES AMT) SAID THAT THE GERMAN GOVERNMENT WANTED TO PRESS FORWARD WITH EMU: THEY WERE NOT AIMING AT A SEPARATE TREATY OR AN INNER CAUCUS, BUT IF SOME COULD NOT PARTICIPATE FROM THE START, AN ARRANGEMENT MIGHT BE FOUND TO ENABLE THEM TO JOIN LATER. THE GERMANS WOULD PREFER EVERYONE TO JOIN, ESPECIALLY THE UK, BUT A DECISION COULD NOT BE PUT ON ICE INDEFINITELY. CROCKETT, BANK OF ENGLAND, AND EVANS, HMT, EXPLAINED THAT BRITAIN WOULD PARTICIPATE FULLY IN THE WORK OF THE IGC BUT THAT THE BRITISH GOVERNMENT DID NOT ACCEPT THE AIM OF A COMMON MONETARY POLICY NOR THE NEED FOR CENTRAL INSTITUTIONS.

ERM: BRITISH MEMBERSHIP

7. POEHL SAID HE HOPED BRITAIN WOULD JOIN THE ERM. BRITISH MEMBERSHIP WOULD GIVE THE SYSTEM MORE EQUILIBRIUM THAN WAS ACHIEVED BY FRANCO GERMAN DOMINATION. HE THOUGHT THE PRESENT STERLING/MARK EXCHANGE RATE WAS ABOUT RIGHT, BUT WE SHOULD WAIT UNTIL OUR INFLATION CAME DOWN SOMEWHAT.

COMMENT

8. IT IS A FREQUENT PLOY OF POEHL TO REPRESENT HIMSELF DISINGENUOUSLY AS THE HUMBLE TECHNICIAN WHO LEAVES POLITICAL DECISIONS TO GOVERNMENTS. FROM OUR POINT OF VIEW, THE DANGER OF HIS INSISTENCE THAT ONLY A CENTRALISED INSTITUTIONAL FRAMEWORK CAN DELIVER THE RIGHT POLICIES IS THAT, IN THE HANDS OF OTHERS, IT WILL SERVE TO FOCUS THE DEBATE ON INSTITUTIONS AT THE EXPENSE OF THE POLICY ISSUES. HE HIMSELF RECOGNISES THAT SUCH A DANGER EXISTS (PARAGRAPH 4): BUT IT IS LESS CLEAR THAT HE UNDERSTANDS THAT HIS OWN POSITION CONTRIBUTES TO IT. HE SEEMS INCREASINGLY TEMPTED TO SOLVE THE DILEMMA BY GOING FOR A SMALL MONETARY UNION INVOLVING ONLY THOSE COUNTRIES WHICH ARE LIKE MINDED ON POLICIES AND INSTITUTIONS DESPITE THE FACT THAT SUCH A UNION WOULD BE A DISTINCT SECOND BEST.

*filed in folder at back of file

PRIME MINISTER

Covert Exchange Controls

Lord Joseph has sent you a number of papers by Mr. Graham Bishop who is an economist working at Salomon Brothers who follows the European scene closely.*

At first sight, the papers appear to support the contention that, while Germany has no formal exchange controls, it has not removed a number of quasi exchange controls, that the Madrid conditions have therefore not been satisfied, and that the UK is justified in withholding its agreement to join the Exchange Rate Mechanism.

In a piece written in May 1989 - Flag A - Mr. Bishop outlined the current restrictions on the German insurance industry. These work by specifying permitted assets and the effect is that insurance companies cannot invest in foreign currency assets except where they match foreign currency liabilities. There are a number of objections to this system. First, the restrictions go beyond what is strictly necessary on prudential grounds. Insurance companies in most other Community countries manage to operate safely under much freer conditions. Secondly, it gives the German Government a source of relatively cheap finance as its debt is included on the list of permitted assets. Thirdly, the system discriminates against companies like Salomon Brothers, who find it difficult to break into the German securities market as they are unable to trade overseas equities with German insurance companies.

Lord Joseph appears to be steering you towards the conclusion that this situation provides a justification for not entering into the ERM and appears to be quoting Mr. Bishop in support of this conclusion. I doubt if the proposition can be supported and doubt also whether Mr. Bishop believes it either.

i. Although the rules do limit the flow across the exchanges through insurance companies, they are not very effective

in limiting total flows. As Mr. Bishop explains on page 9 of Flag A, German residents are free to purchase overseas bonds and have switched to them to a substantial degree. If the restrictions on insurance companies were having a material effect on total overseas flows, I would expect to see two results. First, there would be a difference between domestic DM interest rates and Euro DM rates as there was for the Franc and Lira before they began to dismantle exchange controls. This difference does not exist. Secondly, if capital outflow is to match the large current account surplus, one would expect to see a persistent tendency for the DM to appreciate, but what is remarkable is that, despite the large current account surplus and improving competitiveness, the DM has remained relatively undervalued.

ii Action is already in hand to change the position. The Commission is working on an insurance directive and the German Government has produced draft regulations - Flag B - which will liberalise the position. An improvement in the position seems assured. One would be putting a great deal of weight on the difference between implementation and decision in principle if one were to bring this into the ERM discussion.

In a piece written at the end of March - Flag C - Mr. Bishop considered whether the Madrid conditions had been satisfied. His conclusion, see page 8, was that "the Community component of the UK conditions for ERM membership can now be regarded as satisfied". Thus, contrary to the impression being given by Lord Joseph, he is not advocating making covert exchange controls a condition of the UK's decision.

I have since spoken to Mr. Bishop who has confirmed to me that this is his view. He believes the German insurance industry is an important Single Market issue, but not one that can plausibly be brought into the ERM debate. He draws a different conclusion. The liberalisation of the German insurance industry, when combined with the removal of French and Italian exchange controls, will mean that capital will move

more freely around the EMS and make it more difficult to operate than it has been over the past ten years. In consequence he believes that Stage 2 should be kept short and that locked currencies should be introduced as soon as possible.

A minor issue to come out of these papers is that the UK also has its own skeletons. PEPs extend tax relief to unit trusts investing mainly in UK equities - see page 5 of Flag A.

AT

ANDREW TURNBULL

4 May 1990

FILE DAS

cc FCO
HMT
CO.

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

4 May 1990

Dear Monsieur Giscard.

Thank you for your letter of 5 April enclosing copies of letters from you and Helmut Schmidt to the President of the Commission and the Taoiseach. I am grateful to you for keeping me up to date with the thinking of the Committee for the Monetary Union of Europe. As you recognise, the United Kingdom will continue to play a full and constructive part in the preparations for the IGC on economic and monetary union.

Kind regards.

Yours sincerely

Margaret Thatcher

M. Valéry Giscard d'Estaing

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1 of 10
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Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

4 May 1990

Barry Potter Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister
The Chancellor mentioned to you that the Treasury had done a note identifying possible windows for joining ERM. If you are looking for dates before the Conference 14 Sept and 5 Oct satisfy most of the constraints

AT 11/5

Dear Barry

JOINING THE ERM

It was agreed at the meeting on 17 April that the Treasury would let you have notes about the mechanics of joining the ERM.

... As a first instalment, I attach a note about possible dates for joining between now and the end of September. You will see that there are several possible dates in July and September. The Chancellor has been considering the arguments for and against joining while Parliament is in recess, and his initial view is that it would be possible to join during a Recess. He takes this view since joining the ERM is not a novel policy but simply the implementation of an established policy.

We are examining separately the question of the exchange rate at which we would want to join. This will have a bearing on timing, since the presumption must be that we join with central rates for the £ against the other ERM currencies that are close to the market rates at the time.

Yours

JG

JOHN GIEVE
Principal Private Secretary

b

POSSIBLE DATES FOR JOINING THE ERM

The attached table examines possible dates for joining the ERM up to the end of September 1990.

2. The following points should be noted :-

i) It is assumed that the procedure for joining would be triggered on a Friday, leaving a weekend - if needed - for settling the details, before markets open again on Monday. This is the timing followed for ERM realignments.

ii) The procedure is for the initial discussion of details to be between Finance Ministry and Central Bank representatives in the EC Monetary Committee. This means members of that Committee must be available for telephone consultation late on the Friday, and to meet, if necessary, on the Saturday. Since the German, Italian, French and UK Finance Ministry members of the Monetary Committee also attend meetings of the Summit Sherpas, the operation would be difficult on dates when there are Sherpa meetings. The Committee would have to meet without its Italian Chairman or UK, German and French Finance Ministry members.

iii) It is necessary to allow for the possibility of a full meeting of EC Finance Ministers and Governors in the course of the weekend.

iv) Dates during Parliamentary recess would be impossible if an immediate statement to Parliament were judged necessary. (The Chancellor believes it would not be.)

c

v) The Chancellor would need to be in the UK in the few days before and after joining. There would need to be ready contact with the Prime Minister, if she was overseas.

vi) It would be best, so far as possible, to avoid dates when exchange market turbulence can be predicted. A final decision on a date can however be left until very late - after, for example, it is known whether a set of monthly trade figures is likely to cause exchange market difficulties.

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S E C R E T

Date (Friday)	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments
4 May	Impossible	Bank holiday on 7 May	Not sitting on 7 May	Chancellor at IMF Spring Meetings in Washington, start Saturday 5 May.
11 May	Could be difficult	-	-	
18 May	Possible	-	-	Sherpas meeting in Paris on 18 May
25 May	Possible* (but would need a reason for cancelling Scottish visit).	Bank Holiday on 29 May	Whitsun Recess	Chancellor in Scotland on 24-25 May
1 June	Possible	Trade figures on 23 May. Public holidays France, Germany on 4 June.	Whitsun Recess ends on 1 June	-
8 June	Possible	-	-	Chancellor at ECOFIN on 11 June. Prime Minister in USSR.
15 June	Would be difficult	-	-	Sherpas meeting in USA.
22 June	Possible (but could be difficult depending on Trade Figures).	Trade figures on 22 June	-	-

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S E C R E T

Date	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments
29 June	Would be difficult	-	-	Sherpas meeting in USA.
6 July	Impossible	-	-	Chancellor/PM at Economic Summit on 9 July. Chancellor departs for Washington on 7 July.
13 July	Possible	French holiday on 14 July.	-	-
20 July	Possible	Trade Figures on 23 July.	-	ECOFIN on 23 July
27 July	Possible		Recess might have to be delayed.	-
4 August - 31 August	Impossible	Holidays in Europe.	Recess.	-
7 September	Would be difficult	-	Recess.	Informal ECOFIN on 8-9 September. Prime Minister at Balmoral.
14 September	Possible*	-	Recess	-

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S E C R E T

Date	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments
21 September	Impossible	Trade figures.	Recess.	G7 Governors and Finance Ministers in Washington.
28 September	Would be difficult*		Recess.	IMF/IBRD Annual Meetings do not end until 27 September.
5 October	Possible*		Recess	ECOFIN 8 Oct CONSERVATIVE PARTY CONFERENCE 9 Oct

* Impossible, if decided that Parliament must be sitting on the Monday after joining.

10

Sir M. Butler

8/5

file DTJ

1) 15/5

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

2 May 1990

EMU

I enclose yet another letter from Sir Michael Butler. You may wish to take account of it in any reply to his letter of 23 April.

C. D. POWELL

John Gieve, Esq.
H.M. Treasury

CEPC

Foreign and Commonwealth Office

London SW1A 2AH

2 May 1990

Dear Charles,

Committee for the Monetary Union of Europe:
Letter to the Prime Minister from M. Giscard d'Estaing

// The FCO received on 23 April a letter from M. Giscard d'Estaing to the Prime Minister dated 5 April. I enclose the top copy and a translation. Enclosed with the letter were copies of two further leters, jointly signed by M. Giscard and Herr Helmut Schmidt, to M. Delors and Mr Haughey.

Messrs Giscard and Schmidt are co-chairmen of the "Committee for the Monetary Union of Europe". Their letters report the Committee's work and argue that changes in East Europe demand rapid progress towards economic and monetary union; new monetary institutions should be in place by 1 January 1993; parallel discussions on institutional reform are also necessary.

/ M. Giscard's letter does not ask for a reply; but I enclose a short draft reply from the Prime Minister. Copies go to John Gieve (HM Treasury) and Sonia Phippard (Cabinet Office).

Yours ever,

Richard Gozney

(R H T Gozney)
Private Secretary

C D Powell Esq
10 Downing Street

SCANNED

DRAFT LETTER FROM THE PRIME MINISTER

To: M. Valery Giscard d'Estaing
PARIS

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Thank you for your letter of 5 April enclosing copies of letters from you and Helmut Schmidt to the President of the Commission and the Taoiseach. I am grateful to you for keeping me up to date with the thinking of the Committee for the Monetary Union of Europe. As you recognise, the UK will continue to play a full and constructive part in the preparations for the IGC on economic and monetary union.

JR

R 215
5

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 01-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

1st May 1990

Mr Charles Powell
10 Downing Street
London SW1

Dear Charles,

In paragraph 5 of my letter to the Prime Minister of 23rd April I promised a short paper on the effects of the proposals in the European Committee's Stage 2 paper in the field of resisting speculative attacks. It has taken a few days to iron out the bugs. But I now enclose a paper which ought, I hope, to pass muster with the experts. I should be most grateful if you would show it to the Prime Minister.

Yours ever

Michael

Maintaining parities against speculative attack
under the European Committee's Stage 2 proposal

Example I

Scenario.

Sterling interest rates need to be raised to deal with U.K. inflation. Dollars and yen as well as marks and francs are moved into pounds and there is upward pressure on the £/ecu parity. The rules of the EMF forbid revaluation of any currency against the ecu. The EMF has therefore to work with the Bank of England to counter the speculative flows.

Counter-action.

Initially, the Bank of England sells pounds for ecus in the market and adds the ecus to reserves to the extent necessary to hold the pound/ecu rate. But this process must not be allowed to go on too long or the U.K. money supply will increase to an undesirable extent. The EMF should see the force of this argument because of their commitment to price stability. So at this stage the EMF would raise ECU interest rates affecting all others in order that the ecu can remain as strong as sterling. If the flows into the ecu from outside the E.C. were considerable, the ecu would rise against the dollar and the yen, and the pound with it, for as long as the speculative flows continued. There is no reason why action so far should cause problems for the pound or the ecu. It might in time cause some problems, say, for the mark or the franc where either higher interest rates could be required to prop up the currency or the German or French Central Banks might have to sell ecus (or pounds or dollars) from their reserves. If essential, they could borrow ecus for the purpose from the EMF.

Example

Example II

Scenario.

The pound is weak despite relatively high interest rates. The economy is going into recession. Lowering U.K. interest rates provokes a run on the pound. It is agreed in the EMF that there is no case for devaluation on balance of payments/macro-economic grounds.

Counter-action.

The Bank of England uses some of its ecu and foreign exchange reserves to buy pounds for ecus in the market, if necessary also borrowing ecus from the E.M.F. for this purpose. The E.M.F. also buys pounds for ecus in the market, if necessary in large quantities, holding the pounds in its reserves. If necessary and provided all continue to be agreed that devaluation should be avoided, some of the other major central banks will also buy pounds.

Presumably we have to repay the ECU.

Defence against downward pressure is naturally less strong than against upward pressure (where under the rules the EMF cannot allow it to succeed in forcing a revaluation). But the EMF and other central bankers should bear some of the strain in the interests of maintaining stability.

This

Example II

Scenario.

The pound is weak despite relatively high interest rates. The economy is going into recession. Lowering U.K. interest rates provokes a run on the pound. It is agreed in the EMF that there is no case for devaluation on balance of payments/macro-economic grounds.

Counter-action.

The Bank of England uses some of its ecu and foreign exchange reserves to buy pounds for ecus in the market, if necessary also borrowing ecus from the E.M.F. for this purpose. The E.M.F. also buys pounds for ecus in the market, if necessary in large quantities, holding the pounds in its reserves. If necessary and provided all continue to be agreed that devaluation should be avoided, some of the other major central banks will also buy pounds.

Presumably we have to repay the ECU.

Defence against downward pressure is naturally less strong than against upward pressure (where under the rules the EMF cannot allow it to succeed in forcing a revaluation). But the EMF and other central bankers should bear some of the strain in the interests of maintaining stability.

This

This scenario assumes that the speculative flows against the pound do not arise from irresponsible behaviour by the British authorities contrary to the rules of EMF, either creating additional sterling to replace pounds changed into ecus or monetary financing of budget deficits. But let us assume that Greece finds itself under speculative attack because of irresponsible behaviour and yet the EMF consensus is that devaluation is not the appropriate response. For such a case, under our proposals as now refined, action to protect the drachma against speculative attack would be accompanied by:-

(a) a warning to Greece from the EMF and ECOFIN to rectify its irresponsible behaviour;

(b) if this warning is not heeded, enforcement of an obligation by Greece (applicable to all member states) to reconvert some or all of the drachma added to the EMF's reserves into ecus;

(c) in the last resort, suspension of convertibility of drachma into ecus.

Conclusion.

These defences for the pound would be considerably stronger than the existing ERM defences, which have in practice so far proved more effective than expected, and would probably be sufficient in most normal circumstances. Once the new Stage 2 system had achieved credibility in the markets, such speculative attacks would be rare. In the last resort, devaluation of sterling might become unavoidable but, judging by experience with the ERM, a far smaller devaluation would do the trick than would be needed if the pound was floating.

More generally, the proposed hard ecu system would also provide more effective sanctions against irresponsible behaviour by other member states than now exist.

0011L MDB/MML
23rd April, 1990

PART 6 ends:-

Lord Joseph to RH 30.4.90

~~RH to HMT~~ 27/4/90

PART 7 begins:-

Hambros Bank

~~RH~~ to CDP 2/5/90