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PREM 19/2984

Part 8

Major 452

Confidential Filing

SECRET

European Monetary System (EMS)
Economic and Monetary Union

EUROPEAN POLICY

Part 1: June 1979

Part 8: July 1990

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~4.7.90~~							
~~19.7.90~~							
~~23.7.90~~							
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~~26-10-90~~							
30-10-90							
PT 8							
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PREM 19/2984

PART 8 ends:-

HMT note 31-10-90

PART 9 begins:-

Pöhl Speech @ 8/11/90

bd/89-90 Sess

EMU file

OCCASIONS WHEN THE C/EX SPOKE IN THE HOUSE DURING THE 1989-90 SESSION :

8 First Order Questions

30/11/89; 18/1/90; 15/2/90; 15/3/90; 26/4/90; 7/6/90; 5/7/90; 25/10/90.

5 Debates

28/11/89 - Economic day of Debate on the Address

23/1/90 - Debate on Autumn Statement

26/3/90 - Wind up Budget Debate

24/7/90 - Opposition Day: ' Govts. Mismanagement of the Economy'

23/10/90 - Debate on Sterling's Entry ~~to~~ ERM

2 Statements

20/3/90 Budget

15/10/90 Sterling's Entry ~~to~~ ERM

3 Appearances before the TCSC

4/12/89 - Autumn Statement

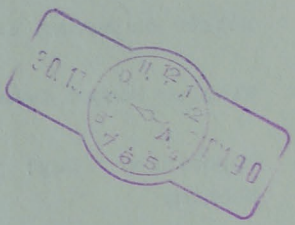
3/4/90 - Budget

5/7/90 - EMU

T. Lyer

31.10.90

XT. 4520



EMU file

Chancellor to German Industry Forum 20/6/90.

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.

PM at No 10 5/10/90.

QUESTION:

Have you changed your stance on Stages 2 and 3 of Delors?

PRIME MINISTER:

Not in any way at all! Stage 2: we have, as you know, tried to find a fundamental compromise with the European Community because they know full well we are totally against a single currency and so is our Parliament - Government and Parliament are at one! This would make fundamental inroads into the very purpose of Parliament and we remain totally against a single currency.

X

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21 OCTOBER **Bank Directors**

Mr. Campbell-Savours: To ask the Chancellor of the Exchequer whether a Treasury Minister, or person appointed by the Government, or any Treasury official had any contact with any member of the board of either Barclays Bank, Barclays de Zoete Wedd, Salomon Brothers specifically, or any other bank, in the 36 hours prior to the announcement of ERM entry on 5 October; and if he will make a statement.

Mr. Maude: Treasury Ministers, persons appointed by the Government, and Treasury officials have frequent contacts with board members of British and overseas banks. We do not generally publish details of such meetings. I have no evidence that any such contacts led to premature disclosure of the Government's intention that sterling should join the exchange rate mechanism. If the hon. Member has any such evidence, he should present it forthwith to the appropriate authorities.

19 OCTOBER **Bank Directors** (A)

Mr. Campbell-Savours: To ask the Secretary of State for Trade and Industry whether he will list on what occasions Ministers in his Department met directors or non-executive directors of banks between Monday 1 October and 10 am on Thursday 4 October inclusive.

Mr. Redwood: No.

Mr. Campbell-Savours: To ask the Secretary of State for Trade and Industry whether a member of his Department or any official of his Department had any contact with any member of the board of either Barclays Bank, Barclays de Zoete Wedd, Salomon Brothers specifically, or any other bank, in the 36 hours prior to the announcement of ERM entry on 5 October; and if he will make a statement.

Mr. Redwood: DTI Ministers, persons appointed by the Government, and DTI officials have frequent contacts with board members of British and overseas banks. The Department does not generally publish details of such meetings. I have no evidence that any such contacts led to premature disclosure of the Government's intention that sterling should join the exchange rate mechanism. If the hon. Member has any such evidence, he should present it forthwith to the appropriate authorities.

22 OCTOBER **Leaks**

Mr. Campbell-Savours: To ask the Prime Minister (1) how many persons elected to the office of Member of Parliament, office holders and non-office holders, other than the Chancellor of the Exchequer and the Prime Minister knew, prior to 4 pm on Friday 5 October, of the Chancellor of the Exchequer's intention to announce in October either a cut in base rates or entry into the exchange rate mechanism;

(2) whether she will institute a full leak inquiry into how information relating to the cut in base rates and exchange rate mechanism entry was known to individuals in the City of London more than one and a half hours prior to the statement by the Chancellor of the Exchequer at 4 pm on Friday 5 October;

(6) How many civil servants knew prior to 4 pm on Friday 5 October of the Chancellor of the Exchequer's intention to announce in October either a cut in base rate or entry into the exchange rate mechanism.

The Prime Minister: Only those with an operational need to know were informed prior to 4 pm on Friday 5 October of the Chancellor of the Exchequer's intention to announce a cut in base rates and the Government's decision to enter the exchange rate mechanism on Monday 8 October.

I have no evidence to suggest that information relating to the cut in base rates and entry in to the exchange rate mechanism was known to anyone in the City of London outside the Bank of England prior to the Chancellor of the Exchequer's statement. If the hon. Gentleman believes that he has such evidence he should make it available to the appropriate authorities.

22 OCTOBER **Leak Inquiry**

Mr. Campbell-Savours: To ask the Secretary of State for Trade and Industry (1) whether he will call for information from the London Intermediate Futures Exchange on dealings with the LIFE short sterling contract market, the gilt futures market and the TSE 100 futures market in the 90 minutes immediately prior to the Chancellor of the Exchequer's statement of a cut in base rates and Exchange Rate Mechanism entry at 4 pm on Friday 5 October;

(2) whether he will call for information from the London International Futures Exchange on dealings in the LIFE market in the 90 minutes immediately prior to the Chancellor of the Exchequer's statement of a cut in base rates and exchange rate mechanism entry at 4 pm on Friday 5 October.

Mr. Redwood: The London International Financial Futures Exchange is conducting a review of trading on 5 October before the announcement of entry into the exchange rate mechanism. This review has not yet been completed. However, the exchange has told me that the trading records of the individual firms and of the market as a whole provide no evidence of any prior knowledge of the announcement.

22 OCTOBER

Mr. Campbell-Savours: To ask the Secretary of State for Trade and Industry whether he will call for information from the stock exchange surveillance department on dealings in the stock exchange in the 90 minutes immediately prior to the Chancellor's statement of a cut in base rates and exchange rate mechanism entry at 4 pm on Friday 5 October.

Mr. Redwood: The International Stock Exchange has conducted a review of equity trading on 5 October before the announcement of entry into the exchange rate mechanism. It has told me that the trading records of individual firms and of the market as a whole provide no evidence of any prior knowledge of the announcement.

NB A question similar to (A) has been put to the Treasury. It will be answered by the Financial Secretary at 3.30pm Tuesday 27th in the same terms – ie "No".

PRIME MINISTER

HARD ECU

You mentioned the other day the mechanism which would ensure that the issue of hard ecus would not add to the money supply. Could I clarify the position. You need to distinguish:

i. the liabilities of the European Monetary Fund (EMF), which can be thought of as the central bank of the non-existent Eculand;

ii. ecu deposits with commercial banks around the Community.

The liabilities of the EMF will be of three kinds:

a. Commercial banks will be required to deposit with the EMF a small proportion of the ecus deposited with them, perhaps half a per cent. These are equivalent to the operational deposits which banks in this country keep with the Bank of England. Their purpose is to provide a float for clearing deficits and shortages between the banks. The fact that banks need to keep these deposits up to a certain minimum level gives the central bank leverage in operating in the money markets.

b. Ecus deposited directly with the EMF by customers. There is no equivalent of this with the Bank of England as it now operates almost entirely in a wholesale way, dealing only with other banks. As the ecu market develops, the EMF might withdraw to a wholesale role.

c. National currencies deposited with the EMF by banks who buy ecu notes and coin to be supplied to their customers.

The sum of a + b + c is in effect the monetary base or MO of Eculand. The provision that ecus cannot be issued unless national currencies are withdrawn applies only to (c) as this is the only point at which there is a direct exchange between ecu and national currencies.

Ecu deposits with commercial banks will grow at the rate at which the market determines. Such deposits will be many times larger than the liabilities of the EMF in the same way that M4 is many times larger than M0. There is no requirement that ecu deposits can be created only if an equivalent amount of deposits in national currency is cancelled. The safeguarding of the non-inflationary ecu is provided by the EMF's duty to ensure that the ecu cannot depreciate against other Community currencies. If ecu deposits are expanded too fast, the ecu will begin to sag against other currencies and the EMF will be required to raise the ecu interest rate. This will increase the demand for ecu assets and reduce the supply of ecu liabilities and ecu credit as fewer people will want to borrow in ecus.

Pages 3 and 4 of the article the Treasury published recently on the hard ecu explain these points further. You may like to look at the whole piece which explains:

- what the hard ecu is;
- how it helps to ensure low inflation conditions;
- how the hard ecu might develop from a common currency towards a single currency.

ANDREW TURNBULL
26 October 1990

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PRIME MINISTER

EMU

I think you need to study carefully the speech John Smith made in yesterday's debate. Most of it was devoted not to ERM but to EMU. He has compared a number of the statements made by the Government and is clearly looking for discrepancies, difference of nuance. His aim, shared we believe by some press commentators, is to establish a division between you and the Chancellor which can be presented as a re-run of difficulties with his predecessor.

The various formulations the Chancellor has used have avoided ruling out EMU in the sense of single currency on grounds of principle and as something to be resisted at all costs. He clearly leaves open the possibility that it could come about in the distant future if the British people have come to want it. Your statements are seen as root and branch opposition.

You will be pressed on these differences at Questions tomorrow and in the Debate on the Address. I believe it is possible to set out a position to which you and the Chancellor can subscribe. The argument could run as follows.

> "Cannot foretell what future Parliaments will decide. In 1950 would not have foreseen degree of unity and co-operation now existing in Europe. But it is clear that adoption of a single currency in the foreseeable future would be extremely damaging economically and highly divisive politically. The degree of convergence in our economies required to make it success is far from being achieved, and feelings of nationhood and sovereignty are too strong for the federal Europe which a single currency implies to be acceptable.
>
> Community should concentrate on goals which are achievable, e.g.

- further development after 1992 of a genuine Single Market

- further improvement leading to convergence at a high standard of living

- development of closer links with the half of Europe which is outside the Community.

Wrong to set goal of single currency, still less to prescribe a timetable, when conditions necessary for it to work are so far from realisation.

We have set out a different approach. Our hard ecu idea is evolutionary, but where change is driven by choice and markets, not by arbitrary timetables. It does not preclude those who want to adopt it in substitution for their own national currency from doing so but I doubt if that is a step that this Parliament would want to take."

You could be asked, as Mr Lamont was, how the hard ecu can be evolutionary if you do not know what it evolves to. But that is the difference between evolution and transition. Evolution is a process of continuous adaptation to the environment to an unknown destination. Delors is talking about a transition process, determining an outcome and deriving the steps to reach it from where we are now.

In addition to strengthening the Government's position, you need to attack the evasions in the Opposition's. Mr Kinnock said at one point that the other eleven would go ahead but failed to say whether, in his view, the UK should join them. He implied that it should be subject to four conditions

- joint growth strategies
- fiscal co-ordination
- regional policies on an unprecedented scale
- a European Central Bank that is accountable.

The first two are re-runs of their conditions for ERM entry and serve to destroy the anti-inflationary bias that most of those who support EMU see as its main attraction. If by regional policies he means the UK's old regional policies or the current structural funds of the Community the new schemes are no more likely to be successful than the old. If he means income transfer through revenue pooling or a common social security system as operate within the UK at present, the likelihood is that the UK would be a net loser.

But the main point of attack should be the last. How can a federal central bank be accountable to national parliaments? Accountability only makes sense at the federal level. The US Fed is not accountable to State Governments but to Congress. This must imply a transfer of the responsibility for monetary policy from national ministers and national parliaments to Community institutions.

AT

Andrew Turnbull
24 October 1990

c: EMU (MJ)

what was going on in the Community in competition policy and liberalisation of capital movements had been met, but that the United Kingdom monetary aggregates were giving the right signals about a declining trend in inflation. Both sterling M0 and sterling M4 were giving those signals, which induced a feeling of confidence that we would be moving in at the right time and that the discipline imposed by the exchange rate would reinforce the downward inflationary curve. That strikes me as right and proper, and, in my view, disposes of the Opposition's attempt to launch a bogus dispute about whether the Madrid conditions had been fulfilled.

For those who do not support ERM entry, the real question is, what would have happened if we had not joined? In fact, most of the horrors with which they have taxed us now that we are in the system would have existed in considerably greater magnitude had we stayed outside. Strangely enough, the loss of sovereignty that is generally considered to be a consequence of ERM membership is far greater if rates are allowed to float freely: in those circumstances, the Government's domestic fiscal and monetary policies would be constantly undermined. We should do better to accept that a firm discipline provides better guidelines.

What are the next steps? Without question, we must continue to urge on our European partners the Government's plan for a hard ecu. There is far too much divergence within the Community for any single currency system to be imposed. The hard ecu, reinforced by the European monetary fund, will provide member Governments with a benchmark discipline; economies may then converge and we shall have a chance to establish whether the ultimate use of the ecu will provide a common currency—one day, perhaps, a single currency.

We must not allow the Delors option to be imposed on us; we must allow the market to impose its own solution, with the widest possible use of a new, hard ecu. I urge the Government to continue to press that argument in all quarters within the Community.

9 pm

Mr. John Smith (Monklands, East): We have had a most interesting debate. At times, I reflected that we had heard some of the arguments on other occasions over the past 20 years when we have debated European Community matters: some Conservative Members saw the Community as a model of newfangled socialism come to torment them in the future, while some of my right hon. and hon. Friends detected the brutalities of the market place at their worst, to be reinforced by our own participation.

We have heard a series of interesting speeches about the effect on our industrial economy of ERM membership, and about what is likely to happen in the difficult circumstances in which we find ourselves after 11 years of Conservative Government. Perhaps the most notable feature of the debate, however, was not to be observed in any of the speeches—some of them excellent—that we heard from hon. Members on both sides of the House. What was most notable, surely, was the absence of a speech from one right hon. Member who has signally declined every suggestion, invitation and exhortation to address the House; it was the absence of a speech from a head of Government who was unwilling to account to Parliament, in this important debate, for policies in which she had been involved more intimately and more directly than any other member of her Administration.

The right hon. Member for Blaby (Mr. Lawson) is more obviously aware of that than anyone else. The right hon. Gentleman chose not to accept an intervention from me —I do not think that he has ever done that before—but that, perhaps, was just as well, because he must have known what I was going to ask him: I was going to ask who stood in the way of the policies that he advocated for so many years, thinking that they would be advantageous to the country. He knows the answer; the answer is the missing Prime Minister, who will not come to the House to give us her explanation.

My point is not merely that we are discussing what many hon. Members have agreed is a momentous decision, and that it would be appropriate for the head of Government to come and tell us about it. The Prime Minister was so closely involved that she lost not only a Chancellor but a Foreign Secretary, as well as a family friend, as a result of the issue. No doubt the right hon. Member for Blaby is scribbling his account of five years of her Government in his memoirs day by day. I understand that he will not publish them before the next general election, and I expect that that will come as a great relief. It is not my task to act as an advertising agent for the right hon. Gentleman—who seems to be quite good at acquiring jobs for himself without any assistance from my good self —but he must be able to hear the sounds of enthusiasm emanating from the Benches behind me. My hon. Friends are keen for him to advance the date of publication. Indeed, may I suggest—using a word with which the Chancellor is very familiar—that he publish them in "prospective" serial form, to titillate the nation and, perhaps, inform us a little before the time comes for the next election?

I was very sad when the right hon. Gentleman announced that soon he would no longer be with us. Having been locked in combat with him for so many years, I have almost a feeling of affection for him. Now and again, one must allow one's better instincts to come to the surface. I assure my right hon. and hon. Friends that I do not intend to make that a habit, but I was genuinely sad when I heard that the right hon. Gentleman had decided to leave us. We shall miss him in our deliberations.

Having listened to what the right hon. Gentleman said today—and he has made explosive speeches undermining the Government, from whom he has departed, on more than one occasion—perhaps some of his right hon. and hon. Friends wished that he had applied for the Chiltern Hundreds rather than taken the City thousands— *[Interruption.]* One hon. Member suggests the right hon. Gentleman should call his new house "Unassailable".

The right hon. Gentleman's main purpose in this debate was to tell the Government something that the markets already knew—that there is cynicism about the reasons behind the Government's actions. In view of the importance of that, would not it have been all the more appropriate for the Prime Minister to come to the debate and settle the question of credibility and, by a stout and resolute performance, settle the worries and the fears about the motives behind Britain's entry into the ERM?

It is felt—and this is not unique to the Opposition as it is felt in all quarters—that the final decision to join the ERM was taken for blatantly political reasons. That was in character with the history of previous Government

[Mr. John Smith]

actions. The Prime Minister wanted to reduce the burden on industry before the Conservative party conference. She discovered that that could not be done without joining the ERM because otherwise there would be pressure on Britain's currency, so the deed was done. That is wholly in keeping with the right hon. Lady's confused, irresolute, highly partisan and politically opportunist technique of dealing with affairs of state. Few people have found her explanations convincing. The right hon. Member for Blaby gave it away, and if he is convinced that the operation was cynical, it must have been so. I think that he knows quite a bit about that sort of operation.

At the beginning of his speech the Chancellor sought to throw away the Madrid conditions as though they had never been uttered. Indeed, one Conservative Member suggested that it was almost in bad taste to reiterate them. Let me remind the House of them. They were not forced on the Prime Minister by the other members of the European Community in some late-night haggle in Luxembourg, Strasbourg or somewhere else in Europe. They were not even the subject of negotiation between the Prime Minister and other member states. They were negotiated between the Prime Minister and the members of her Cabinet. The Madrid conditions were, first, that Britain would not enter the ERM until inflation had come down. It was not whether it might come down, whether it would come down or whether it was likely to come down; it was whether it had come down. Right hon. and hon. Members have reminded us of the detail of that and other conditions.

The Prime Minister described prescribed other conditions that required action by others. I seem to remember that during the famous Walden interview she invented a new condition as each minute passed, until the programme was littered with new conditions. However, as she said rather disarmingly during Prime Minster's Question Time recently, "We had all these conditions, and they have all been fulfilled except one." The interesting point is that all those other conditions had to be fulfilled by other people, and they were. Only one had to be fulfilled by the right hon. Lady, but it was not. The right hon. Lady thought it to be some sort of victory—a triumph over the conditions that had been set, as a result of which she could, boldly go forward into the ERM.

Underlying all that, and at the heart of the credibility question, is the right hon. Lady's well-known aversion to joining the ERM. Why else, during the revealing Walden interview, would she have described it as the "higgledy-piggledy set of rules."?

I do not profess to know quite what she meant by that, but generally such an expression is not meant to be favourable. It has what might be called a marginally pejorative tone about it. We certainly did not feel that she was straining at the leash to join the ERM. But there we are, strange things happen. Opportunities and pressures are such that the Prime Minister will do almost anything to keep power and to oblige the narrow party political interests of her party. Inflation was to be the major condition.

The Chancellor was not quite as brass-necked as that. He tried to find a way out. I shall be drawing the attention of the House to the way in which the Chancellor uses words. Before the Treasury and Civil Service Select Committee in April, he said that the Government were looking for approximate rate of inflation between ourselves and the Community. I think that he went on to define what he meant by approximate, saying that Dr. Johnson had described it as meaning "near to".

I do not know whether the members of the Committee needed such education. They seemed pretty educated to me. My hon. Friend the Member for Hackney, South and Shoreditch (Mr. Sedgemore), who made an extremely skilful speech, did not need such education.

By September the same year, in his speech to the IMF, the Chancellor had further refined his choice of words. He realised that not only would the Government not get anywhere near the rate of inflation; they would not even get proximately near it, so they had to change the time scale. Therefore, he said that what matters was the prospective movement. The Chancellor, not quite so brazen as the Prime Minister, gradually sought to wriggle out from his commitments; she just threw them aside.

Whatever the Prime Minister did, this was a humiliating u-turn for a Prime Minister who had set her face in another direction. She abandoned commitments and, in the process, displayed an underlying lack of conviction, which has worked its way through into the market place.

The decision having been taken, we are now in the difficulty that the Prime Minister's economic policies have left Britain in a weaker position than other member countries, less well able to face the opportunities and challenges that the single market offers, especially now that it is to be operated within the confines of membership of the ERM.

In this debate, and in debates that we shall have in the months to come, we must consider what has to be done now; what policies should be adopted. The Opposition never believed for one moment that it would be enough to enter the ERM. That has to be accompanied by a strong supply side policy directed to building a strong economy.

Before I consider the matters at the heart of the debate, we need, as the Chancellor did, to look at what is proposed for the next steps in the consideration of European economic and monetary affairs.

Mr. Norman Tebbit (Chingford): The right hon. and learned Gentleman has been dealing with the conditions set out by the Prime Minister at Madrid some time ago, but he will recollect that this afternoon the right hon. Member for Bethnal Green and Stepney (Mr. Shore) asked how many of the conditions set out by the right hon. and learned Gentleman in his Labour party policy document 12 months ago had been satisfied. Does not he think that he should reply to his right hon. Friend?

Mr. Smith: If the right hon. Gentleman will forgive me, I shall make my speech in my own way. But he must understand one thing. We advocated entry into the ERM and we said that it should be accompanied by Government negotiation on certain conditions. I did not conduct the negotiations; they were conducted by the Government. That point must be evident. It is evident to me, to the right hon. Member for Chingford (Mr. Tebbit) and, I am sure, to my right hon. Friend the Member for Bethnal Green and Stepney (Mr. Shore)—I made the point last Monday in the House, but I do not know whether the right hon. Member for Chingford was present; he has been here only intermittently today—that the regional policy conditions have not been fulfilled. The Government made no attempt

to strengthen our European regional policy. I shall go on because what I have to say might interest the right hon. Gentleman and he should pay particular attention to it.

We have not heard much from the Chancellor about the central banking system. My right hon. Friend the Leader of the Opposition argued clearly the need for political accountability. Nor did the Chancellor say much about the single currency and the arguments that there will be about that. No doubt the Chief Secretary will deal with that in his reply. All those matters are brought together conveniently by the Government under the so-called hard ecu proposal. That is the Government's new response. It may help the House to know what the Government have been saying about the hard ecu, how they have moved in respect of the ERM, and the techniques that they have used in the manipulation of language.

Before I do so, I am bound to be asked what the Opposition's view is on a central bank and a single currency. My right hon. Friend the Leader of the Opposition made clear our belief that a system of central banks must be politically accountable. At this time, when the gap between Britain's performance and that of other members of the Community is so wide, it would not be prudent to commit ourselves to an irrevocable exchange rate or to a single currency. We want to play an active, participative role in the European Community. We are already in the single market and have advocated membership of the ERM. We shall now work for a stronger regional policy.

Conservative Members are as foolish about regional policy at home as they are about it within the Community, but such a policy is vital in building a strong Community that operates fairly in respect of all its member states. We shall work to support the social action programme, which is vital to the balance between economic success and social cohesion. The need for that is understood by many countries in the Community, but not by Conservative Members—*[Interruption.]* Government Members keep asking about Labour party policy, but they will not listen when I explain what it is.

We shall all the while seek to close the gap between our economic performance and that of the rest of the Community, and between our social standards and those of the rest of the Community.

Mr. Cash: The right hon. and learned Gentleman has not said a thing.

Mr. Smith: The hon. Member for Stafford (Mr. Cash) should listen to what I have to say.

The Chancellor of the Exchequer said that the hard ecu is based on market choice and will evolve into a parallel currency. He said that it was the choice of Governments and of people. However, the "Treasury Bulletin" published yesterday set out the argument in more detail. I remind the House that it is proposed that a European monetary fund is to be established to act as the monetary authority for a new currency—the hard ecu. The distinguishing characteristic of that new currency is that it will never be allowed to devalue against any other Community currency. The "Treasury Bulletin" explains that

"the hard ecu would always be at least as strong as the strongest currency"—

and we can guess which one that will be, although the bulletin adds disarmingly,

"whatever that happened to be."

It adds:

"It would be the responsibility of the EMF—a fundamental one enshrined in Community law"—

members of the Bruges group please note—

"to ensure that hard ecu devaluation never occurred."

The hard ecu was first presented by the Chancellor as a form of common or parallel currency that would be useful to exporters and people engaged in foreign trade, but nothing terribly exciting for the rest of us. It was just viewed as a useful device. I understand—and the Chief Secretary can tell me whether this is true—that the concept was sold to the Prime Minister by Sir Michael Butler, a former ambassador and a permanent United Kingdom representative to the Community. He is also chairman of the British Invisible Exports Council. Sir Michael's technique was to argue that the hard ecu was a market-led resolution of the problem. If one says the magic words to the Prime Minister she just rolls over. The process of ratiocination may have stopped, but the magic words were said, and the right hon. Lady thought that since it was a market solution, it must be all right. The Prime Minister should take a little more care.

The difficulty of judging the hard ecu proposal is knowing whether it is designed to fail or to succeed. At a cynical level, one could understand the proposal if it were designed to fail. That would take time, which would allow the Government to say something at meetings of the intergovernmental council. However, if we take the proposal at face value and accept that it is meant to succeed, thhe House should examine it carefully. It was surprising that the Chancellor did not tell us more than he did. The first impression gained was that the hard ecu is an alternative vehicle for exporters, but the way that it has been described by different Ministers puts me on my guard.

There is the belief in the House, and probably in the country, that the Prime Minister is against all this stuff —that she is a resolute defender of sovereignty and an even more resolute defender of parliamentary accountability. *[Laughter.]* That is her stock in trade. One might think it odd that, at this stage in this debate, one should be reflecting on her habit of constantly mentioning parliamentary accountability. The fact remains that she has said it.

The question that I want to ask the Chief Secretary to the Treasury is this: is the hard ecu an alternative to a single currency which would avoid our having to face questions of sovereignty and accountability? Or is it another route to a single currency—perhaps even a convenient transitionary mechanism through stage 2 of Delors, which unavoidably raises questions of sovereignty and accountability but seeks to keep them suppressed and to move them away from our consideration?

Listeners must have been alerted by the Chancellor's use of words at the Conservative party conference—in the euphoria of those heady days? What a long time ago it seems since the Chancellor was in Bournemouth. He must be reflecting on how one should enjoy the plaudits of the Conservative party while one may. Certainly, the financial markets seem to be a corrective to some of the political feelings that were expressed there. The Chancellor said to the conference:

"Joining the exchange rate mechanism does not mean that we are now on a road leading inexorably to a single currency."

That a word "inexorably" flashed up in lights for the benefit of anyone who was paying attention. Why use that

[Mr. Smith]

word? Was it accidental? Did the right hon. Gentleman simply think, "This is the day for being inexorable"? I think that he chose it with some care.

I used to think that the Foreign Office was the Department of weasel words, but the Treasury is getting pretty smart at them too. It has certainly never before had such a willing user of them as the present Chancellor. The right hon. Member for Blaby would scorn that kind of thing. We got it pretty straight from him. It was not very nice when we got it, but we got it fairly straight. One can either do what the right hon. Gentleman did or one can wriggle one's way round the issues with weasel words.

Only a few days ago, in his Mansion house speech, the Chancellor said:

"Joining the exchange rate mechanism did not commit us to adopting, and cannot oblige us to accept, the imposition of a single currency in Europe."

I do not know how one adopts an imposition. The Treasury might care to have a look at that infelicity, before it sets out to equip the Chancellor with his next set of words for avoiding answering questions on these matters. But perhaps I fuss too much. That apart, what on earth does it mean that we are not to have a common single currency forced upon us? In what conceivable circumstances would we have it imposed upon us? If we were going to have a single currency, we should have to agree to it. We should have to go along with it. I have no doubt that, if it came to making a decision in the House, there would be fierce arguments about it. No one would be imposing it on anyone, so I do not know quite what the Chancellor meant in that speech.

The right hon. Gentleman went on to say:

"the hard ecu could ultimately evolve towards a single currency if it were the wish of Governments and peoples that it should be used in preference to their own currencies."

That leaves the door open, but the use of the word "ultimately" suggests that there is still some time to go, so the Bruges group should not get too worried just yet.

One is led to wonder what the Prime Minister was thinking about the question when she came back from the Dublin summit, at which the question was aired, and reported to the House on 28 June this year. When asked about the hard ecu, she said:

"I do not believe that that formula could develop into a single currency."—[*Official Report*, 28 June 1990; Vol. 175, c. 493.]

The Prime Minister tells us that she does not think that the hard ecu could develop into a single currency while the Chancellor tells us that it will, or would, if people decided to follow that route.

What is the latest position? Alerted to the question, I have been examining matters with some care over the past few days. The new addition to the Treasury team, the Financial Secretary who, I am sorry to say, is not with us tonight, was speaking at the EMU seminar of the British Invisible Exports Council on the 10th of this month. Describing the hard ecu, he said:

"It would be a genuine common currency and one which could easily develop into a single currency as Governments and peoples decided."

Even more interesting is the report in today's *Financial Times* to which my right hon. Friend the Leader of the Opposition has already referred. I shall quote from the *Financial Times* report of the evidence that the Minister gave to the House of Lords Committee on economic and monetary union:

"Mr. Frances Maude, the minister responsible for European Affairs, put the Treasury's case succinctly in evidence earlier this month to a House of Lords committee. The hard Ecu, he said, offered a direct route to a single European currency."

He added:

"I would argue personally that the next stage of having a single currency could actually happen more quickly going down this path."

We have moved from that potential, useful device for exporters and other curious people to another route by which we could achieve a single currency not only feasibly, but easily and quickly. Things have moved quite a bit.

The Chancellor said that we should consider the next steps and he wanted a careful definition of the Opposition's position. However, in the light of all the contradictory advice to which I have just referred, the Chief Secretary to the Treasury should explain what is happening.

Mr. Tony Marlow (Northampton, North): Will the right hon. and learned Gentleman give way?

Mr. Smith: No. The hon. Gentleman is doing well enough listening to me. I am sure that he will find my comments illuminating.

The "Treasury Bulletin" states that if the hard ecu catches on, the circulation of weaker currencies will fall and national monetary authorities will have to take action by pursuing tighter monetary policies. They will be forced to keep up. There is also a requirement to reimburse the EMF against exchange losses on devaluation. That is a strong disincentive to depreciate, as the "Treasury Bulletin" makes clear.

We need to be more clear about the constitution of the European monetary fund. Who is accountable for it? How does it work? To whom does it report? All those issues raise sovereignty and accountability questions. If the Government believe that I am making too much of a fuss about that, I shall quote Mr. Gavyn Davies of Goldman Sachs who examined the hard ecu and concluded:

"All of the problems associated with accountability and independence of the Eurofed, which have so exercised Mr Major, would apply in equal measure to his alternative European Monetary Fund."

I was put even more on the alert by a statement made by Sir Michael Butler, to whom I referred at an earlier stage in this saga. He has been thinking about the issue and how to incorporate the proposal into the treaty. He realises that there must be treaty amendments if the EMF and hard ecu are to be adopted. I know that this is not Government policy yet, but it is an interesting proposal. At a seminar at Hambros bank on 11 October, Sir Michael Butler proposed a treaty amendment that would

"create a European System of Central Banks consisting of the twelve national Central Banks and a European Monetary Fund owned and run by the Central Banks, to be operational from day one of Stage 2".

Clearly the EMF is linked with a system of central banking.

Sir Michael then states that a treaty amendment should

"lay down the aim of price stability for the whole EMU process and of permanently fixed parities leading to a single currency in Stage 3".

Is that Government policy? If the Prime Minister was here, she could clear all this up. If I could get the Prime Minister

to answer my questions, I should not be quoting Ministers. She could speak on behalf of the whole Government—at least one would hope that she might.

These are important sovereignty and accountability issues and I hope that the Chief Secretary will consider them. The House will not let the matter drop. We have seen how the Government twist and turn, how they say one thing and do another and how they profess principles and then so easily abandon them.

The crucial point about the debate, to which all hon. Members have referred, is what we do from here. After having entered the exchange rate mechanism, we have been left with the weakest economy of the member states. The right hon. Member for Blaby may disagree, but we hear no more from him about the so-called economic miracle under which we were to have overtaken Germany and be pressing hard on Japan. Germany is now well ahead; France is significantly ahead; Italy is overtaking us and Spain is coming up fast behind, and all of that after this Government have been in power for 11 years with large majorities and huge oil resources.

We have an ailing economy that has been damaged by the Government's policies over the past 11 years. As our amendment states, what we need now is what we have argued for in debate after debate, day after day—we shall do so in the House and in the country. To build a strong economy and a fair society, we need a vigorous regional policy, a new drive to provide British industry with the best of modern technology, a proper infrastructure, good social services, a good transport system, and, above all, an education and training system that gives our people the chance to compete. In the new Europe we have the opportunity to compete. We shall have to compete.

An hon. Member asked whether the other member states were partners or competitors. They are both—they are partners and competitors. We have opportunities and great challenges. We shall be able to realise them only if one thing above all is comprehended—that is that the crucial determinant of success in a modern economy is the way in which we utilise the skills of our people. That is what the next Labour Government will be committed to do. We shall make a success of our economy and our society, even with the difficult inheritance that will be our unfortunate and unhappy lot.

9.30 pm

The Chief Secretary to the Treasury (Mr. Norman Lamont): I agree with the right hon. and learned Member for Monklands, East (Mr. Smith) at least on one thing, and that is that this has been a remarkable debate. We have heard some strong and powerful speeches, many of which have certainly cut across party lines.

The right hon. Member for Bethnal Green and Stepney (Mr. Shore) made a remarkable and passionate speech in which he declared his strong opposition to fixed exchange rates. He said that, when he was a Minister, he had experienced the constraints of fixed exchange rates, which —I hope that I do not sound impertinent by saying this —is one reason why some of us have come round to being in favour of them.

Hon. Members also heard a powerful speech by my right hon. Friend the Member for Blaby (Mr. Lawson). I express my sadness that my right hon. Friend announced his decision yesterday to retire at the next election. His departure will represent a great loss both to the House and to my party. The debate is a bitter-sweet moment for my right hon. Friend as a long-standing advocate of the ERM. He made his views very clear today. Also, the House was interested to hear his comments about EMU. Although he is a strong opponent of EMU, my right hon. Friend urged the Conservative party not to fear too much stage 3 of EMU on which he had doubts, for example, whether it was a real threat and would happen.

Hon. Members also heard an eloquent speech by my right hon. Friend the Member for Shropshire, North (Mr. Biffen). He joined the right hon. Member for Bethnal Green and Stepney in opposition to fixed exchange rates. There was one point on which I sharply disagreed with my right hon. Friend. He referred to entry into the ERM as a sort of European incomes policy. I do not think that that is the effect of the ERM. If it were, I certainly would not be in favour of it. As my right hon. Friend the Member for Blaby explained, it is a monetary framework. Just as the control of monetary aggregates is a framework of which wage bargainers must take account, so will wage bargainers have to take account of the new regime of fixed exchange rates.

My right hon. Friend referred to what the Chancellor said about wage claims. My right hon. Friend the Chancellor was not urging an incomes policy; he was just drawing the attention of wage bargainers to the consequences for employment and for themselves if wage claims were excessive. That is certainly very different from an incomes policy which in the past has been designed to control inflation, but, of course, never has controlled inflation.

My right hon. Friend the Member for Shropshire, North made most of his remarks, however, about his clear preference for floating exchange rates. I remember, as he will remember, the occasion when a former Chancellor of the Exchequer, Lord Barber, came to the House and announced that the pound was to float free. I take a different view from my right hon. Friend. The consequences of that decision have not been as beneficial and as benign as they then appeared to be. The period of floating exchange rates worldwide has been one of higher inflation. Looking back, the period under Bretton Woods and the fixed exchange rate was a period of greater stability and lower inflation.

The temptation to let exchange rates depreciate has always been powerful for Governments. However, that temptation has not brought any benefits because the effects of depreciating the currency have been short lived in terms of promoting output and competitiveness, but have been lasting in terms of inflation. That is one of the reasons why the Government concluded that it would be right to join the ERM.

Another part of the debate has dealt with whether joining the ERM should lead automatically to European monetary union. My hon. Friend the Member for Stafford (Mr. Cash) and my right hon. Friend the Member for Blaby referred to that. It is very much the Government's view that joining the exchange rate mechanism does not mean that we have to go down the road of the Delors plan towards European monetary union. The House was interested to hear the speech of my right hon. Friend the Member for Blaby who has always been strongly in favour of the ERM, but who, as everybody knows, has always been passionately opposed to EMU. It was interesting that my right hon. Friend quoted Mr. Volcker saying that he did not think that we could have a single currency without

chex.ps/tt/89

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

22 October 1990

T Sutton Esq
Privy Council Office
68 Whitehall
LONDON SW1B 2AT

Dear Tim,

SCRUTINY DEBATE ON ECONOMIC AND MONETARY UNION

The Chancellor wrote to the Lord President on 13 July suggesting that there should be a debate in the Autumn on economic and monetary union; this followed a recommendation of the House of Commons Select Committee on European legislation, which had carried out a scrutiny on a Commission report on the subject.

The Chancellor would like to pursue the possibility of a substantive debate (on a 'to take note' motion) before the Inter-Governmental Conference begins on 13 December. His preference is for a debate in the week beginning Monday, 26 November, or failing that, the week beginning 3 December. The wording of the motion could be considered nearer the time.

I am copying this letter to Charles Powell, Murdo MacLean, and the Private Secretaries of L Committee members, and Sir Robin Butler.

Yours ever,

T TARKOWSKI
Private Secretary

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

22 October 1990

Murdo MacLean Esq
PS/Chief Whip
Chief Whips Office
12 Downing Street
LONDON
SW1

Dear Murdo,

MOTION FOR ERM DEBATE 23 OCTOBER

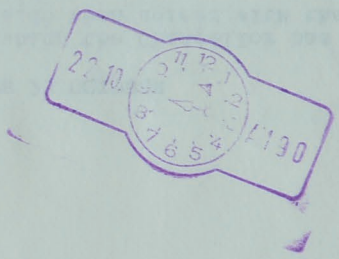
Below is the motion which the Chancellor has agreed for tomorrow's debate. This has also been agreed with the Prime Minister's and Lord President's offices.

> "This House congratulates the Government on joining the ERM of the EMS. The House notes the clear evidence that the Government's tight monetary and fiscal policies are reducing inflationary pressures in the economy; and believes ERM membership will reinforce the Government's counter-inflationary strategy and help to strengthen the framework for a sustained improvement in economic performance."

I am copying this letter to Dominic Morris at No.10 and to Tim Sutton at the Lord President's office.

Yours,

S M A JAMES
Private Secretary



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FRAME ECONOMIC

PARIS TELNO 1252: EMU

SUMMARY

1. KOHL'S MOVE TO SET A DATE FOR STAGE 2 WILL HAVE PLEASED THE EUROPEAN LOBBY AND DISPLEASED THE FINANCIAL COMMUNITY.

DETAIL

2. WE ASKED THIELE, FEDERAL CHANCELLERY, FOR AN EXPLANATION OF THE CHANCELLOR'S MOVE. WHY HAD KOHL PLUMPED FOR 1994, NOT 1993 AS SOME WERE DEMANDING ?. WHAT WAS THE POINT OF DECIDING WHEN TO BEGIN THE SECOND STAGE WHEN ONE DID NOT YET KNOW WHAT IT WOULD CONTAIN ?. WAS THE COMMITMENT TO MOVE FORWARD ON 1 JANUARY 1994 ABSOLUTE OR WAS IT GOVERNED BY PRECONDITIONS ?.

3. THIELE SAID THAT THE CHANCELLOR HAD CONSIDERED SETTING 1 JANUARY 1993 ON THE DATE BUT HAD THOUGHT IT WISE TO ALLOW MORE TIME FOR NEGOTIATIONS AND RATIFICATION OF A TREATY AMENDMENT. HE HAD NOT WANTED IT TO APPEAR THAT THE COMMUNITY WAS ACTING UNDER UNDUE TIME PRESSURE. ON THE OTHER HAND, HE HAD WANTED TO SET A TIMETABLE WHICH WOULD GIVE THE EC SOMETHING TO AIM FOR AND ENCOURAGE IT TO GET A MOVE ON. ADMITTEDLY SETTING A DATE BEFORE KNOWING THE CONTENT OF STAGE II MIGHT APPEAR TO PUT THE CART BEFORE THE HORSE: BUT ONE HAD TO ASK WHETHER DOING THINGS THE OTHER WAY ROUND WOULD IN FACT HAVE HELPED REACH EARLY AGREEMENT IN THE COMMUNITY ON THE NEXT STEP. THE CHANCELLOR HAD FELT THAT IT WOULD NOT.

4. AS TO THE CONTENT OF STAGE II, THAT REMAINED TO BE WORKED OUT IN THE IGC NEGOTIATIONS. THIELE SAID THAT THE GERMANS WOULD WANT TO ENSURE THAT THERE WAS A REAL SUBSTANTIVE DIFFERENCE BETWEEN THE SECOND AND THE FIRST STAGE, BUT JOKED THAT IF THERE WAS NOT MUCH DIFFERENCE, THEY WOULD DO THEIR BEST TO MAKE IT SEEM AS IF THERE WAS. HE WOULD NOT BE DRAWN ON WHETHER THE DATE WAS ABSOLUTE: CLEARLY THERE WERE CONDITIONS, INCLUDING A COMMITMENT TO AN INDEPENDENT CENTRAL BANK AND BROAD CONVERGENCE OF ECONOMIES AND FISCAL POLICIES.

FULL CONVERGENCE COULD NOT BE ACHIEVED BY 1994, BUT THE MEMBER STATES SHOULD BE THEN BE ON THE RIGHT GLIDE PATH TO REACH THE RUNWAY.

COMMENT

5. BY AGREEING TO SET A DATE KOHL WILL HAVE PLEASED THE EUROPEAN LOBBY IN PARIS AND BRUSSELS. HIS INTENTION WAS TO DEMONSTRATE TO THEM THAT GERMANY'S INTEGRATIONIST CREDENTIALS WERE INTACT. THE GERMAN FINANCIAL COMMUNITY, WHO WERE ARGUING FOR CAUTION AND THE AVOIDANCE OF TIMETABLES WILL BE LESS PLEASED. KOHL CAN ARGUE THAT HE HAS SET PRECONDITIONS FOR MOVING FORWARD AND THAT HE HAS GIVEN NOTHING AWAY ON THE SUBSTANCE OF THE MOVE OR ON THE TIMING OF STAGE III. BUT THE OPPONENTS OF HASTE, INCLUDING POEHL, MAY WELL THINK THAT THEY ARE BEING SOLD A PIG IN A POKE.

MALLABY

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CHANCELLOR KOHL ON EMU
SUMMARY
1. THE GERMAN CHANCELLOR FAVOURS 1 JANUARY 1994 AS THE STARTING DATE FOR STAGE 2 OF EMU.

DETAIL
2. IN AN INTERVIEW WITH FRENCH TELEVISION ON 17 OCTOBER, KOHL SAID THAT IN HIS VIEW STAGE 2 OF EMU SHOULD BEGIN ON 1 JANUARY 1994. HE DESCRIBED THIS AS ''A REASONABLE COMPROMISE'' WHICH HAD BEEN SUPPORTED BY THE SPANISH GOVERNMENT.

3. ON THE PROPOSED EUROFED, KOHL SAID THAT IT WOULD ONLY BE ACCEPTABLE IF IT WAS NOT DEPENDENT ON INSTRUCTIONS FROM ANY GOVERNMENT AND IF IT DEVOTED ITSELF EXCLUSIVELY TO MONETARY STABILITY.

4. IN AN EARLY REACTION, BEREGOVOY WELCOMED THE CHANCELLOR'S REMARKS AS OFFERING A POSITIVE PERSECTIVE WHICH THE FRENCH GOVERNMENT WOULD ASSESS IN THE DAYS AHEAD. HE REPEATED THE INCREASINGLY ENUNCIATED FRENCH VIEW THAT POLITICAL UNION AND EMU SHOULD ADVANCE IN STEP.

LLEWELLYN SMITH

YYYY

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ADDITIONAL 1

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FRAME ECONOMIC

MIPT: EMU: VISIT BY FINANCIAL SECRETARY

SUMMARY

1. BUNDESBANK PRESIDENT DISCUSSES OVER LUNCH THE ROLE TO BE PLAYED BY HARD ECU PROPOSALS. IN THE DOMESTIC DEBATE OVER THE TIMETABLE, POEHL BELIEVES THAT KOHL'S ATTENTION WILL FOCUS ON PRECONDITIONS RATHER THAN DEADLINES.

DETAIL

2. IN THE MARGINS OF THE BDI SYMPOSIUM, MR MAUDE HAD CONVERSATIONS OVER LUNCH WITH HAHN, THE CHAIRMAN OF VOLKSWAGEN, AND POEHL, PRESIDENT OF THE BUNDESBANK. HAHN BEGAN BY SAYING THAT THE KEY POINT ABOUT EMU FOR GERMAN INDUSTRY WAS THAT NEW ARRANGEMENTS MUST NOT BE LESS EFFECTIVE IN COMBATING INFLATION THAN THE PRESENT ARRANGEMENTS IN GERMANY. WHEN I ASKED HOW GERMAN INDUSTRY COULD ENSURE THIS OUTCOME, HAHN SAID THAT THEY RELIED HEAVILY ON THE BRITISH GOVERNMENT TO MAKE SURE THAT MISTAKES WERE NOT MADE.

3. MR MAUDE POINTED OUT THAT FRANCE, WHEN TALKING OF THE NEED TO SHARE RESPONSIBILITY FOR MONETARY STABILITY IN EMU, REALLY WANTED TO DILUTE THE DISCIPLINE CURRENTLY INDUCED BY THE BUNDESBANK, IF THERE WAS A RECESSION AND THINGS BECAME UNCOMFORTABLE. NEITHER HAHN NOR POEHL SOUGHT TO DISPUTE THIS. POEHL SAID THAT EVERYONE CLAIMED THAT THEY WANTED AN INDEPENDENT CENTRAL BANK BUT NO-ONE HAD REALLY CONSIDERED WHAT THAT WOULD MEAN, FOR INSTANCE WHAT KIND OF GENERAL GUIDELINES FINANCE MINISTERS MIGHT GIVE TO A EUROPEAN SYSTEM OF CENTRAL BANKS.

4. POEHL SAID THAT THE BRITISH PROPOSAL OF THE HARD ECU HAD COME BOTH TOO LATE AND TOO SOON. IT WAS TOO LATE TO INFLUENCE THE GENERAL DEBATE, WHERE THE DELORS REPORT HAD CAPTURED THE HIGH GROUND, AND

TOO SOON TO BE THE SOLUTION TO A DEADLOCK IN THE IGC. I SAID THAT THE BRITISH PROPOSAL COULD STILL PLAY THE LATTER ROLE. IT WAS THE ONLY PROPOSAL WHICH MANAGED TO ACHIEVE PROGRESS IN MONETARY COOPERATION WITHOUT RISKING GREATER INFLATION. POEHL SAID THAT GENSCHER HAD JUST MADE A SPEECH DECLARING THAT PHASE 2 OF EMU MUST BEGIN ON 1 JANUARY 1993. I ASKED WHAT THAT COULD MEAN IN REALITY. POEHL SAID THAT GENSCHER MIGHT ONLY MEAN THAT A DECLARATION SHOULD BE MADE ON 1 JANUARY 1993 THAT PHASE 2 WAS BEGINNING, LEAVING AGREEMENT ON WHAT EXACTLY IT SHOULD CONSIST OF TO BE REACHED DURING THE PHASE. POEHL LAUGHINGLY MADE CLEAR THAT THIS WAS AN EXTREME INTERPRETATION OF GENSCHER'S INTENTIONS.

5. POEHL AGREED THAT THE ARGUMENT IN GERMANY BETWEEN THE REALISTS AND PROFESSIONALS LIKE HIMSELF AND THE EUROPEAN IDEALISTS LIKE GENSCHER WOULD CONTINUE ALL THE WAY THROUGH THE IGC. HE AGREED THAT KOHL WAS LIKELY TO TRY TO SQUARE THE CIRCLE BY ACCEPTING GENSCHER'S VIEW THAT A SINGLE CURRENCY AND A SINGLE CENTRAL BANK SHOULD BE ACHIEVED AS SOON AS POSSIBLE BUT ACCEPTING POEHL'S VIEW THAT PROGRESS SHOULD BE ACHIEVED ONLY AS FAST AS WAS RESPONSIBLE AND NOT DESTABILISING. POEHL SAID THAT KOHL WOULD BE MORE LIKELY TO THINK IN TERMS OF CONDITIONS THAT MUST BE MET BEFORE EACH STEP FORWARD THAN IN TERMS OF ARBITRARY, HORTATORY DEADLINES.

6. THE FLAVOUR OF POEHL'S PRIVATE VIEWS ON EC AND EMU WAS CONVEYED IN ANOTHER INFORMAL CONVERSATION I HAD WITH HIM AFTER A DINNER ON 16 OCTOBER. HE SAID THAT IT HAD BEEN A MISTAKE EVER TO LET THE ARCH-TACTICIAN DELORS INTO MONETARY AFFAIRS. BRITAIN SHOULD HAVE JOINED THE ERM SEVERAL YEARS AGO AND THUS EXERCISED MORE INFLUENCE ON DISCUSSION OF EMU. OUR IDEA OF A HARD ECU WAS CLEVER BUT FRANKLY WAS NOT TAKEN SERIOUSLY BY THE PROFESSIONAL FRATERNITY OF CENTRAL BANKERS. I ARGUED THAT CENTRAL BANKERS OUGHT TO BE INTERESTED IN A PROPOSAL THAT SOUGHT TO MAINTAIN STABILITY OF CURRENCY WHILE MAKING PROGRESS ON MONETARY COOPERATION. I SAID THAT UNARGUED DISMISSIVENESS WAS NOT HELPFUL. POEHL OUGHT TO BE MORE CONSTRUCTIVE IN LOOKING AT OUR PROPOSAL. POEHL SAID THAT HE WAS PESSIMISTIC ABOUT THE OUTCOME OF THE STRUGGLE BETWEEN HIMSELF AND GENSCHER FOR KOHL'S HEART ON EMU. KOHL WOULD PROLONG THE APPROACH TO EMU AS LONG AS POSSIBLE BUT AT THE END OF THE DAY WOULD PROBABLY ACCEPT A FUDGE ON THE SUBSTANCE.

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HM TREASURY FOR PS/FINANCIAL SECRETARY.

FRAME ECONOMIC

EMU: VISIT BY FINANCIAL SECRETARY TO BONN, 15 OCTOBER

SUMMARY

1. MR MAUDE ADDRESSED A HIGH-LEVEL SYMPOSIUM ON EMU IN BONN ON 15 OCTOBER. PRESIDENT OF GERMAN INDUSTRY FEDERATION EMPHASISED THAT STABILITY MORE IMPORTANT THAN TIMETABLE. POEHL TOO WARNED AGAINST A HASTY APPROACH. ACCOUNT OF INTERESTING LUNCHTIME DISCUSSION IN MIFT. COMMENT IN MY 2ND IFT.

DETAIL

2. MR MAUDE ADDRESSED AN AUDIENCE OF SOME 150 LEADING FIGURES FROM THE FINANCIAL AND INDUSTRIAL COMMUNITIES AT A SYMPOSIUM ON EMU ORGANISED BY THE BUNDESVERBAND DER DEUTSCHEN INDUSTRIE (CBI EQUIVALENT) IN BONN ON 15 OCTOBER. OTHER MAIN SPEAKERS WERE POEHL, NECKER, THE PRESIDENT OF THE BDI, AND LAGAYETTE, DEPUTY GOVERNOR OF THE BANK OF FRANCE. OVER LUNCH MR MAUDE DISCUSSED THE UK HARD ECU PROPOSAL WITH POEHL AND HAHN, CHAIRMAN OF VOLKSWAGEN. HE LATER HAD NEARLY AN HOUR WITH FRAU ADAM-SCHWAETZER, MINISTER OF STATE AT THE AUSWAERTIGES AMT. THIS TELEGRAM OUTLINES THE MAIN POINTS MADE BY POEHL AND OTHER GERMAN REPRESENTATIVES AT THE SYMPOSIUM.

3. SPEAKING FIRST, NECKER ARGUED THAT MONETARY STABILITY WAS IMPORTANT FOR THE FUTURE OF EUROPE. THE GOAL OF EUROPEAN INTEGRATION WAS A COMMON CURRENCY, BUT THIS WOULD NOT FIND POPULAR ACCEPTANCE IN GERMANY UNLESS IT WAS AS STABLE AS THE DMARK. AS LONG AS STABILITY WAS NOT GUARANTEED, NATIONAL CURRENCIES MUST REMAIN. CERTAIN CONDITIONS MUST BE FULFILLED TO MINIMISE THE RISKS BEFORE THE FIXING OF DATES FOR THE SECOND AND THIRD STAGES. QUOTE WE SHOULD PUT OURSELVES UNDER THE PRESSURE OF QUALITY AND NOT THE PRESSURE OF A TIMETABLE UNQUOTE. A EUROPEAN CENTRAL BANK SYSTEM MUST HAVE THE

INDEPENDENCE TO PURSUE A STRONG MONETARY POLICY WITHOUT POLITICAL INTERFERENCE. INDEPENDENCE OF THE ECBS MUST BE BASED ON AUTONOMY FOR NATIONAL CENTRAL BANKS. MONETARY FINANCING OF PUBLIC SECTOR DEFICITS SHOULD BE PRECLUDED BY STRICT LIMITS ON PUBLIC SECTOR BORROWING. COMPETENCE FOR EXCHANGE RATE POLICY MUST ALSO BE TRANSFERRED TO A FUTURE EUROPEAN CENTRAL BANK: QUOTE MONETARY POLICY IS NOT DIVISIBLE UNQUOTE.

4. POEHL PRODUCED A TOUR DE FORCE IN HIS CHARACTERISTICALLY INFORMAL STYLE, ARGUING AS USUAL THAT PRICE STABILITY WAS THE MAIN ESSENTIAL AND THAT IT COULD ONLY BE GUARANTEED THROUGH THE INDEPENDENCE OF A EUROPEAN CENTRAL BANK. HE SAID THAT THE AMENDMENT TO THE EC TREATY MUST BE DETAILED AND CONCRETE ON THIS ISSUE. HE ANNOUNCED THAT THE CENTRAL BANK GOVERNORS WOULD PRODUCE DETAILED DRAFT STATUTES FOR A EUROPEAN CENTRAL BANK BY MID-NOVEMBER. HE NOTED THAT THE IGC WOULD HAVE TO ADDRESS SOME DIFFICULT PROBLEMS, NOT LEAST THE NEED FOR NATIONAL AUTHORITIES TO CEDE SOVEREIGNTY OVER MONETARY POLICY. THE NATURE OF BINDING RULES ON BUDGETARY DEFICITS WULD ALSO HAVE TO BE CONSIDERED. THE CONFERENCE SHOULD LEAVE NO BIG STRATEGIC DECISIONS UNRESOLVED. POEHL REPEATED HIS WARNING ABOUT AN OVER HASTY APPROACH TO EMU. ASSERTING THAT IN REALITY DIFFERENT MEMBER STATES HAD FOR A LONG TIME MOVED AT DIFFERENT SPEEDS WITHIN THE COMMUNITY, HE THOUGHT THAT THE SAME WOULD BE TRUE OF EMU. HE DOUBTED WHETHER ALL MEMBER STATES WOULD BE READY FOR STAGE 2 TO START ON 1 JANUARY 1993.

5. POEHL NOTED THAT THE IDEA OF A PARALLEL CURRENCY HAD BEEN CONSIDERED AND DISMISSED BY THE DELORS COMMITTEE. A 13TH CURRENCY MADE LITTLE SENSE. HE WELCOMED STERLING'S ENTRY INTO THE ERM BUT DETECTED NO SUBSTANTIAL CHANGE IN THE UK POSITION REGARDING EMU. STERLING'S PARTICIPATION IN THE ERM DID NOT MAKE MONETARY POLICY ANY EASIER FOR THE BUNDESBANK QUOTE NOW THERE IS ANOTHER ELEPHANT IN THE BOAT UNQUOTE.

6. IN AN INTERVENTION IN THE AFTERNOON PANEL DISCUSSION, KOEHLER, STATE SECRETARY AT THE FEDERAL FINANCE MINISTRY, REPEATED AN OLD BUNDESBANK ARGUMENT, NAMELY THAT THE FEDERAL GOVERNMENT WAS AGAINST EMBARKING ON THE ROAD TO EMU WHILE LEAVING THE FINAL DESTINATION OPEN. THE COMMUNITY HAD TO KNOW WHERE IT WAS GOING. HE ALSO REFLECTED THE FRENCH THESIS THAT MOVEMENT TOWARDS MONETARY UNION WOULD ITSELF BE A STABILISING ELEMENT IN THAT IT COULD BRING ABOUT GREATER DISCIPLINE.

7. THE MAIN THEMES OF THE SYMPOSIUM HAVE BEEN WIDELY REFLECTED IN THE PRESS. MR MAUDE'S STRONG DEFENCE OF THE UK HARD ECU PROPOSALS

WAS REPORTED ALONGSIDE DETAILED COVERAGE OF REMARKS BY POEHL AND NECKER. THE UNREMARKABLE SPEECH BY LAGAYETTE ATTRACTED LITTLE ATTENTION EXCEPT FOR HIS REFLECTION OF THE FRENCH POSITION, VIEWED WITH SUSPICION HERE, THAT THERE WILL NEED TO BE A BODY TO GIVE THE EUROPEAN CENTRAL BANK POLITICAL GUIDELINES. PRESS COMMENT AGREES WITH THE CAUTIOUS APPROACH ADVOCATED BY POEHL AND THE NEED TO ENSURE STABILITY.

8. SEE MIFT.

MALLABY

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Following Personal for Charles Powell
From Sir Michael Butler

Copies Personal to Michael Jay, Nigel Wicks, Andrew Crockett and John Kerr UKRep Brussels

EMU

1. I had an informal discussion with Padoa Schioppa yesterday. He stressed that he was speaking as an old friend who wanted to reach agreement in the IGC and not as a representative of the Presidency. His assistant was considerably more hostile towards the UK.

2. Padoa Schioppa said that the preparations for the IGC were nearly complete. With the British entering a general reserve and then participating intelligently in the discussion, agreement had virtually been reached in the Central Bank Governors' and ECOFIN frameworks on the arrangements for Stage 3. It only remained to discuss transitional arrangements in November, in accordance with normal EC practise. Draft Treaty language reflecting this large measure of agreement would be put to the IGC. The European Council on 27 October would presumably confirm this approach.

3. When I said that the Prime Minister would presumably want to discuss Stage 2, he said that even with heroic efforts on her part, going over to the offensive in a positive spirit instead of first entering reserves, he doubted whether she could now persuade her colleagues to reverse the order and discuss Stage 2 before Stage 3. In later stages of the conversation he and his assistant (more brutally) returned to this theme as far as the IGC was concerned. The IGC would first concentrate on Treaty language for Stage 3.

4. In response to my probing he admitted that:

a) the fast-track, short Stage 2, route to Stage 3 advocated by the Commission did not (not) have majority support;

b) the present Bundesbank concept of a long Stage 2 without institutional development would not pass either.

There would have to be a proper Stage 2 and here proposals such as those I had put to the Hambros Seminar last week, which he had had from Biancheri, would come in useful. (He is quite favourable to the hard ECU and the EMF as a way of getting from Stage 1 to Stage 3). When I argued that it would be logical to deal with first things first, he repeated that he was afraid that it was difficult to conceive of the eleven now agreeing to reverse the order.

5. He said that one interpretation being given, perhaps optimistically, to the British position was that the Prime Minister would agree to stand aside and allow the consensus among the eleven to be reflected in the Treaty, with Britain remaining outside for the time being. I said I knew of no support for this view in London, in or out of Government.

6. Touching on the Prime Minister's opposition to a Single Currency, he said that in his personal view that was not the essential point. The European Council had only confirmed that full EMU was the aim, ie

permanently fixed parities and a Single Monetary policy. But he wondered if that would be helpful? I said that it might be, but only to a very modest extent.

Comment

7. Despite what he and his assistant said, I think that there would still be a fair chance of getting out of trench warfare and into a campaign of movement, with hope of getting some support from different Member States for different parts of our position, if the Prime Minister were to table institutional and Treaty proposals for Stage 2, even without any reference to the Single Currency, and argue in favour of discussing first things first.

chex.kf/kg1/51

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

15 October 1990

Andrew Turnbull Esq
Principal Private Secretary
to the Prime Minister
10 Downing Street
LONDON
SW1

Dear Andrew

CHANCELLOR'S STATEMENT ON ERM

I attach a copy of the Statement which the Chancellor proposes to make to the House of Commons this afternoon on sterling's entry to the ERM.

I am copying this to the Chief Press Secretary, and to the Private Secretaries to the Governor of the Bank of England and Lord Hesketh.

Yours sincerely
Kate Gaseltine

MISS K GASELTINE

15 OCTOBER 1990

EXCHANGE RATE MECHANISM: ENTRY OF STERLING

Mr Speaker, I should like to make a statement about sterling's entry to the exchange rate mechanism of the European Monetary System, which took effect on Monday 8 October. I understand the House will soon be able to discuss economic affairs, but I wanted to take the first available opportunity to make a statement about this important step.

2. Sterling now has a fixed central rate against each of the other currencies in the ERM. The entry rate is set against the ecu and translates to a central rate against the deutschemark of DM2.95. This was marginally above the market level when the decision to enter was announced on Friday 5 October and is a little below the current market rate.

3. Sterling is able to move by a maximum of 6 per cent above or below the central rates. Our choice of the wider 6 per cent margins is intended to allow sterling to settle into the system, and follows recent precedent. In due course we will move to the narrow band of $2^{1}/_{4}$ per cent margins. The terms of entry we have agreed with our partners are those we sought.

4. Mr Speaker, the Government has long made it clear that sterling would enter the ERM during Stage 1 of EMU which began in July. It has now done so at the earliest appropriate time. I would like to explain how our decision fits into the Government's wider economic strategy.

5. It has become abundantly clear that policy is now reducing inflationary pressures in the economy. Monetary growth on all measures has fallen sharply, and the growth of narrow money is within its target range. The growth of demand has slowed. Although the rise in oil prices will continue to feed through for a while, the prospect is for a substantial reduction in inflation over the coming year. This will be so both in absolute terms and in relation to inflation in other European countries. It was for these reasons that we felt able to reduce interest rates by one per cent.

6. A firm exchange rate is a vital part of our policy to maintain tight monetary conditions in order to reduce inflation. As I have repeatedly made clear, membership of the ERM will be an additional discipline for the UK economy. In no sense is it a soft option.

7. Monetary policy will remain tight. I must emphasise that I will not make a further reduction in interest rates until I am sure that it is safe and prudent to do so.

8. Membership has important implications for British companies and their employees. They must contain their costs. If they fail to do so, they will not be bailed out by a devaluation of the currency. This is the key message for those engaged in pay bargaining this Autumn and subsequently.

9. But in addition to acting as a discipline on costs, membership of the ERM offers significant benefits for British industry. It will help to provide greater stability of exchange rates with our main trading partners and thus the certainty which business needs to plan for the future. It will also make Britain even more attractive for inward investment.

10. Although entry to the narrow band of the ERM will fulfil our obligations under Stage 1 of EMU, it does not imply any change in our opposition to the imposition of a single currency. In the IGC in December we shall continue to argue against that plan and for the proposals I first set out in June. As the House knows, these propose an evolutionary and market-based approach, based on the creation of a new European Monetary Fund and a common currency, the "Hard ecu".

11. In summary, Mr Speaker, the mechanism has a proven record of success over recent years in producing greater stability of exchange rates and lower inflation. The Government believes that

Britain too will benefit from membership. The ERM will reinforce our counter-inflationary policies, help to provide the stability and certainty that industry needs, and will set the right framework for a resumption of soundly-based and non-inflationary growth.

15.10. 90

E. R.

PRIME MINISTER

Mr. Kinnock has responded to your letter declining to open a debate on ERM. He has changed his ground. His first letter argued that you should do this on grounds of propriety as you had spoken on the subject outside Parliament. He is now arguing that you should do so purely according to the importance of the subject.

I interpret the letter as a letting off of steam rather than as a serious appeal in the expectation that you might change your mind. This is confirmed by his final reference to arrangements for the debate. I think the correspondence can be left to rest at this point.

Content?

AT Yes

ANDREW TURNBULL

10 October 1990

HOUSE OF COMMONS
LONDON SW1A 0AA

The Office of the
Leader of The Opposition

October 10th 1990

Dear Prime Minister,

Thank you for your letter of October 10th. I am glad that you have responded to my request by agreeing that the House should debate your Government's decision to put Sterling into the Exchange Rate Mechanism.

I have to tell you, however, that many will share my view that it is extraordinary that you do not see fit to lead in a debate on a matter that has such great significance for the country.

It is also strange that you intend to avoid the obligation to set out your reasons - as Prime Minister - for the Government's decision and for its timing and to give your view of the implications for the United Kingdom and its people. On an issue of this magnitude the reason that you give - that it is more "appropriate" for the Chancellor of the Exchequer to lead - is, frankly, unconvincing.

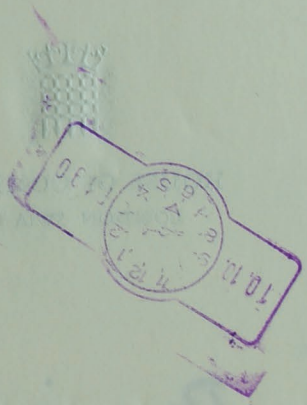
I look forward to hearing further arrangements for the debate.

Yours sincerely,

Neil Kinnock

Neil Kinnock

Rt. Hon. Margaret Thatcher M.P.,
Prime Minister,
10 Downing Street



cc Press

Mr Turnbull

As foreshadowed this afternoon. I do not think that this needs a reply - and there are disadvantages in doing so. But in case you think one is needed a draft is also attached.

DM

HOUSE OF COMMONS
LONDON SW1A 0AA

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Leader of The Opposition

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I look forward to hearing further arrangements for the debate.

Yours sincerely

Neil Kinnock

Neil Kinnock

Rt. Hon. Margaret Thatcher M.P.,
Prime Minister,

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

10 October 1990

Dear Charles

I enclose a fax copy of the Prime Minister's reply to Mr. Kinnock's letter of 8 October. I will send across the top copy as soon as it arrives from Bournemouth.

Yours sincerely

Dominic

DOMINIC MORRIS

Charles Clark, Esq.,
Office of the Leader of the Opposition.

cc CWO
LPO
HMT

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

10 October 1990

Dear Mr. Kinnock,

Thank you for your letter of 8 October. I agree it is right that the House should have a chance to debate entry into the Exchange Rate Mechanism when Parliament returns. I understand that discussions are already taking place through the usual channels about the timing and length of such a debate.

Your letter is, however, based on a misconception. I did not announce the decision to apply for membership of the ERM. This was announced, as is appropriate for an important matter of economic policy, by the Chancellor of the Exchequer. It follows that it should be for the Chancellor to open for the Government.

Yours sincerely

Margaret Thatcher

The Right Honourable Neil Kinnock, M.P.

E. R.

CONFIDENTIAL

PRIME MINISTER

OPPOSITION REQUEST FOR DEBATE ON ERM

I have consulted the Lord President, Chancellor and the Chief Whip about Mr. Kinnock's request for a debate. They all agree that the Government should allow opportunity for entry into the ERM to be debated; it would be a pity to cloud the favourable response to entry by appearing at all reluctant. They agree also that it should be for the Chancellor to open for the Government and he is entirely content to do so. Their suggestion is that the Opposition should be offered the business for the first half day back on Monday 15 October, previously announced as a debate on the Adjournment about Financial Services and the Single Market. This would become a debate on the Adjournment about ERM entry.

It remains to be seen whether the Opposition accept this as it gives them only part of what they are after. It is only a half day and is not on an amendable motion. It is, however, in Government time. The alternatives would be for them to use their Opposition day in the following week or to agree with the Government that the PAC debate on Thursday should be dropped. Mr. Kinnock has reacted to the approaches through the usual channels by professing to be "deeply shocked" that you are not prepared to defend in the House such a major decision when you are prepared to defend it at the Conference. He is threatening that there will be "all hell to pay" if you do not take the debate.

I see no reason for you to respond to this which probably reflects rivalry between Mr. Kinnock and Mr. Smith, and Mr. Kinnock's wish to get even after the way the announcement squashed the coverage of his conference. He cannot accuse you of interfering in the business of other Ministers and, at the same

time, complain when you leave your colleagues to take the limelight.

I attach a draft letter to Mr. Kinnock.

ANDREW TURNBULL
9 October 1990

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

Thank you for your letter of 8 October. You are clearly under a misapprehension. Our decision to apply for membership of the ERM was announced by the Chancellor of the Exchequer at 1600 on 5 October, not by me.

You will no doubt pursue the Opposition's request for a debate through the usual channels. Since the subject matter concerns our economic policy the Chancellor of the Exchequer would naturally open for the Government.

The Right Honourable Neil Kinnock, M.P.

CONFIDENTIAL

JS/aw

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

9 October 1990

Dear Andrew,

DEBATE ON STERLING'S ENTRY INTO THE ERM

Thank you for your letter of 8 October enclosing one that the Prime Minister had received from Mr Kinnock.

The Lord President and the Chief Whip have discussed how best to respond to Mr Kinnock, in the light of the Chancellor's views which John Gieve passed to us yesterday evening.

They recommend that the business for the first half day back, on Monday 15 October, previously announced as a debate on the Adjournment about Financial Services and the Single Market, should be changed to a debate on the Adjournment about ERM entry. The Chancellor is entirely content to open such a debate on that day. His view, with which the Lord President and the Chief Whip entirely agree, is that it would be a pity to cloud the favourable response to our entry into the ERM by appearing at all reluctant to let the House debate the matter at an early opportunity. This will provide for a half day's debate only, (since opposed Private Business is fixed for 7 pm on 15 October). The Business Managers feel it would be difficult to make a full day available, unless the Opposition gave up their allotted day the following week: we judge that most unlikely.

If the Prime Minister is content, I suggest that the second paragraph of a reply to Mr Kinnock should say:

> "Of course it is right that the House should have a chance to debate the matter when Parliament returns. I understand that discussions are already taking place through the usual channels about the timing and length of such a debate."

I am copying this letter to John Gieve and Murdo Maclean.

Yours ever,
T. Sutton

T J SUTTON
Principal Private Secretary

Andrew Turnbull Esq
PS/Prime Minister

CONFIDENTIAL

HOWE

Prime Minister

Andrew

You will recognise all the not-very-coded signals. CDP

EMBARGOED UNTIL 1800 HOURS TUESDAY, 9TH OCTOBER, 1990

EXTRACT FROM A SPEECH BY RT HON SIR GEOFFREY HOWE QC MP, LORD PRESIDENT OF THE COUNCIL AND LEADER OF THE HOUSE OF COMMONS TO THE CONSERVATIVE SMALL BUSINESS BUREAU, MARSHAM COURT HOTEL, RUSSELL COTES ROAD, BOURNEMOUTH, ON TUESDAY, 9TH OCTOBER 1990 AT 1800 HOURS.

ERM: MAKING THE MOST OF MEMBERSHIP

"The decision to enter the ERM is entirely in line with the central thrust of the Government's economic policy through the last decade. That is why I so warmly applaud the decision - one which I have long believed would be in the best interests of our nation.

The defeat of inflation, the achievement of price stability, remains our central objective. The key instruments remain, as they must, monetary discipline and fiscal prudence.

But from now on, the exchange rate, always a factor in monetary policy, assumes a more prominent role. It does so, not as a substitute, but as a buttress, for monetary and fiscal policy.

For some years now the day-to-day reality of British monetary policy has reflected that relationship. 'You can't buck the market' has tended in practice to mean 'You can't ignore the Deutschmark'.

The more explicit link within the ERM between the Pound Sterling and the Deutschmark should not, therefore be seen - still less denounced - as some fresh or shameful 'surrender of British sovereignty to the dominance of the Deutschmark'.

Last week's decision should be seen rather as a firm commitment to share in the joint management of a system, which will give to Britain (as to the other members) the best prospect of long-term price and exchange rate stability.

This has been the lesson of the last decade. Germany's price stability has been exported, through the operation of the EMS, to a wider and wider circle of European economies. Most notably, in 1983 France was persuaded by Finance Minister Jacques Delors to adjust to, indeed to accept, the full disciplines of the EMS.

Experience suggests that it is thus possible to lock on to a virtuous circle of enjoying lower inflation at the same time as more stable exchange rates.

Because depreciation is no longer an option, governments in Europe have been obliged to choose between politically embarrassing and very public re-alignments, or imposing tighter monetary disciplines that will stabilise the currency over time.

Over the years, governments have increasingly chosen the latter, and use EMS obligations as a justification for imposing sensible, financially-conservative monetary policies. The long-term results, in terms of low inflation and sustainable growth, speak for themselves.

All this makes it crystal clear that ERM membership is anything but a soft option. No-one, least of all myself, has ever argued that it was or should be any such thing.

All too often in the last half century the British body politic has welcomed some new economic feature, some fresh policy development, as though it was some kind of 'magic box' - some painless cure for all our long-standing woes.

Nuclear power, North Sea gas, the 'Common Market', North Sea oil: not one of these has effected the painless cure, not one of them has turned out to be a magic box. No more will the EMS.

But the EMS <u>does</u> represent a framework of discipline. It should make it easier for us to know what we should be doing. And it should make it easier too for us to know when, or if, we are going wrong.

That is why we should recognise entry into the ERM as an extension of the philosophy which inspired and underpinned the Medium Term Financial Strategy, which I sought to put in place just ten years ago.

That was a strategy that we designed for ourselves. If it is now to be absorbed, as it is, in the wider framework of European self-discipline, then we need likewise to play our part in designing and developing the new, wider system.

That is the importance of our commitment to take part in the forthcoming Inter-Governmental Conference on Economic and Monetary Union. This is why it would not make sense, as some critics suggest, to try to 'draw a line under' last week's decision.

If the French, and other Community partners, wish to play their part in sharing German stewardship of Europe's monetary discipline - as they do - then so do we. If the Germans, and yet other Community partners, wish to play their part in maintaining the primacy of price stability at the heart of that discipline - as they do - then so do we. If all our Community partners wish to work together to strike the right balance between those and other considerations - as they do - then so do we.

Last week's decision to place the Pound Sterling within the ERM of the European Monetary System has been widely welcomed as a decision to turn our previous 'country membership' into full membership of the Club. We intend to play that part in good faith and to the full. Only that way shall we derive the full benefits from the discipline of the system.

However difficult the road may be - and starting where we are it may not always be easy - there can and should, if I may coin the phrase, be 'no turning back' from the historic commitment that was announced last Friday."

ENDS.

For more information, please contact Anthony Teasdale on 0860 611189.

HOWE

Prime Minister

Another

You will recognise all the not-very-coded signals. CD?

EMBARGOED UNTIL 1800 HOURS TUESDAY, 9TH OCTOBER, 1990

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That is the importance of our commitment to take part in the forthcoming Inter-Governmental Conference on Economic and Monetary Union. This is why it would not make sense, as some critics suggest, to try to 'draw a line under' last week's decision.

If the French, and other Community partners, wish to play their part in sharing German stewardship of Europe's monetary discipline - as they do - then so do we. If the Germans, and yet other Community partners, wish to play their part in [illegible] the primacy of price stability at the heart of that [illegible] as they do - then so do we. If all our Community partners wish to work together to strike the right balance between [illegible] and other considerations - as they do - then so do we.

Last week's decision to place the Pound Sterling within the ERM of the European Monetary System has been widely welcomed as a decision to turn our previous 'country membership' into full membership of the Club. We intend to play that part in good faith and to the full. Only that way shall we derive the full benefits from the discipline of the system.

However difficult the road may be - and starting where we are it may not always be easy - there can and should, if I may coin the phrase, be 'no turning back' from the historic commitment that was announced last Friday."

ENDS.

For more information, please contact Anthony Teasdale on 0860 611189.

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FRAME ECONOMIC

FROM UKREP BRUSSELS

ECOFIN COUNCIL: 8 OCTOBER: EMU

SUMMARY

1. PRESIDENCY INTEND TO PRODUCE BRIEF, IMPRESSIONISTIC REPORT FOR THE EUROPEAN COUNCIL. UNCLEAR WHETHER IT WILL BE CIRCULATED FOR DISCUSSION IN ADVANCE. GERMANS, DUTCH, DANISH, SPANISH PRESS FOR EXTRA ECOFIN BEFORE OR AFTER EUROPEAN COUNCIL, BUT NO AGREEMENT ON THIS. GENERAL CONGRATULATIONS ON UK'S ERM ENTRY WITH SOME GRUMBLES ON PROCEDURE. ONLY SARCINELLI (ITALY) SPOKE WITH ANY HOSTILITY.

DETAIL

2. EMU WAS TAKEN OVER LUNCH. CARLI (ITALY) OPENED BY STRESSING THE IMPORTANCE OF THE INDEPENDENCE OF THE PROPOSED EUROFED AND THE NEED FOR ECONOMIC AS WELL AS MONETARY UNION.

3. SOLCHAGA (SPAIN) THOUGHT THAT THERE WAS A GROWING CONSENSUS ON THE OBJECTIVE CRITERIA FOR MOVING TO STAGE 2 AND ON THE TIMING - 1993/4. THERE WAS HOWEVER NO AGREEMENT ON THE DURATION OR CONTENT OF STAGE 2. KOEHLER (GERMANY) THOUGHT THAT THE SPANISH AND DUTCH PROPOSALS WERE A GOOD BASIS ON WHICH TO TAKE DISCUSSION FORWARD. THERE SHOULD BE FURTHER ECOFIN DISCUSSION BEFORE THE PRESIDENCY REPORT TO THE EUROPEAN COUNCIL TO TRY TO GET MORE AGREEMENT ON THE DETAIL. WOULD THE PRESIDENCY REPORT BE CIRCULATED IN ADVANCE?

4. BEREGOVOY (FRANCE), PETERSEN (DENMARK) AND KOK (NETHERLANDS) THOUGHT THAT FURTHER ECOFIN DISCUSSION BEFORE THE IGC TO GENERATE MORE AGREEMENT WOULD BE USEFUL. KOK BELIEVED THAT COMPROMISE ON THE BASIS OF THE DUTCH AND SPANISH PROPOSALS WAS POSSIBLE.

5. MAYSTADT (BELGIUM) AGREED THAT MUCH PROGRESS HAD BEEN MADE TOWARDS AGREEMENT ON THE CRITERIA AND DATE FOR MOVING TO STAGE 2.

BUT THERE WAS STILL MUCH DISAGREEMENT ESPECIALLY OVER THE CONTENT OF STAGE 2. THE PRESIDENCY REPORT TO THE EUROPEAN COUNCIL SHOULD NOT GIVE THE IMPRESSION THAT ALL THAT MATTERED WAS THE DEGREE OF AGREEMENT ON MOVING TO STAGE 2. BELEZA (PORTUGAL) NOTED THAT PORTUGAL HAD ONE OR TWO DIFFICULTIES WITH THE SPANISH AND DUTCH PROPOSALS. CHRISTODOULOU (GREECE) SAID THAT THE PRESIDENCY REPORT SHOULD MAKE CLEAR WHERE THERE WAS DISAGREEMENT ALSO.

6. CARLI FELT THAT A BRIEF, IMPRESSIONISTIC REPORT WOULD BE BETTER THAN ONE WHICH ATTEMPTED TO NAIL DOWN AGREEMENT ON THE DETAIL. THE REPORT WOULD SHOW WHERE THERE WAS POTENTIAL FOR AGREEMENT BUT WOULD SET OUT DELEGATIONS POSITIONS CLEARLY. THE UK RESERVE ON STAGE 3 WOULD BE NOTED. THE CHANCELLOR SUPPORTED THE IDEA OF A MORE IMPRESSIONISTIC REPORT.

7. THERE WERE GENERAL CONGRATULATIONS ON UK ENTRY INTO THE ERM, WITH SOME GRUMBLES FROM KOK, BEREGOVOY AND DELORS ON THE WAY IN WHICH ENTRY HAD BEEN ANNOUNCED. BEREGOVOY NOTED THAT HIS CONCERNS ON THIS WERE VERY MUCH SECONDARY TO HIS PLEASURE AT UK ERM ENTRY. ONLY SARCINELLI (PRESIDENCY) MADE A SOMEWHAT SANCTIMONIOUS AND HOSTILE INTERVENTION. THERE HAD BEEN GENERAL CRITICISM IN THE MONETARY COMMITTEE OF THE UK ANNOUNCEMENT. SOME HAD FELT THAT STERLING SHOULD HAVE ENTERED AT A HIGHER RATE. MORE CONVERGENCE WITH OTHER EC COUNTRIES ON KEY ECONOMIC ELEMENTS, INCLUDING INFLATION, WOULD HAVE BEEN DESIRABLE BEFORE ERM ENTRY. THE CHANCELLOR FIRMLY REBUTTED THESE REMARKS, SAYING IN PARTICULAR THAT IN TERMS OF CONVERGENCE, SOME ELEMENTS EG FISCAL POLICY OF UK ECONOMIC PERFORMANCE WERE AS GOOD AS ANYTHING IN EUROPE.

COMMENT

8. IT WAS UNCLEAR WHETHER THE PRESIDENCY'S REPORT WOULD BE CIRCULATED FOR DISCUSSION IN ADVANCE OF THE EUROPEAN COUNCIL. GIVEN THE DISAGREEMENT ABOUT WHETHER IT SHOULD BE BRIEF AND IMPRESSIONISTIC OR LONG AND DETAILED, IT SEEMS MORE LIKELY THAT IT WILL NOT. ON THE QUESTION OF AN EXTRA ECOFIN TO DISCUSS THE EMU IGC PREPARATION ALONE, THE CHANCELLOR FORMED THE IMPRESSION THAT THE GERMANS, DUTCH, DANES AND SPANISH IN PARTICULAR WOULD PRESS THIS, BUT, THAT, IF IT HAPPENED, IT WOULD PROBABLY BE AFTER THE EUROPEAN COUNCIL.

CAMPBELL

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YOUR TELNOS 554 AND 555 TO ROME: UK ENTRY TO THE ERM:
GERMAN REACTIONS

SUMMARY

1. GERMANS WELCOME UK ENTRY TO THE ERM. PRESS CLAIMS MOTIVES POLITICAL AS WELL AS ECONOMIC. SOME COMMENTATORS EXPECT THE MOVE TO STRENGTHEN RESISTANCE IN GERMANY TO RAPID EMU.

DETAIL

2. REACTIONS IN BONN AND FRANKFURT HAVE BEEN POSITIVE. BUNDESBANK PRESIDENT POEHL WELCOMED STERLING'S ENTRY AND DESCRIBED IT AS AN IMPORTANT CONTRIBUTION TO THE FIRST STAGE OF EMU. FINANCE MINISTER WAIGEL ALSO WELCOMED THE MOVE AS INDICATIVE OF THE BRITISH GOVERNMENT'S DETERMINATION TO FIGHT INFLATION. THE FRANKFURT FINANCIAL COMMUNITY REACTED MORE CAUTIOUSLY. THE HEAD OF THE COMMERZBANK VOICED CONCERN ABOUT THE POSSIBLE PRESSURES ARISING WITHIN THE EMS IF UK INFLATION WAS NOT BROUGHT UNDER CONTROL. NEVERTHELESS, STERLING TRADED STRONGLY IN FRANKFURT TOUCHING DM 3.05 BEFORE EASING BACK LATER.

3. THE MOVE HAS BEEN WIDELY REPORTED AND COMMENTED ON IN THE GERMAN MEDIA. THE GENERAL TONE IS ONE OF WELCOME, TINGED WITH SOME SPECULATION ABOUT THE POLITICAL AND ECONOMIC MOTIVES BEHIND THE TIMING OF THE ANNOUNCEMENT. SEVERAL PAPERS, PRESUMABLY REFLECTING BRUSSELS BRIEFING, DESCRIBE THE DECISION AS A CHESS MOVE. A FEW REFER TO IT AS A PANIC MEASURE.

4. THE LEADING FINANCIAL DAILY, HANDELSBLATT, ASCRIBES THE MOVE MAINLY TO ELECTORAL CONSIDERATIONS, POINTING TO ITS COINCIDENCE WITH THE PARTY CONFERENCES. IT ALSO CLAIMS THAT THERE HAS BEEN A SWITCH IN THE UK POSITION WHICH, IT SAYS, PREVIOUSLY FOCUSSED ON THE NEED TO REDUCE INFLATION BEFORE JOINING THE ERM BUT HAD NOW APPARENTLY REVERSED THESE ELEMENTS. THE INFLUENTIAL SPECIALIST STOCK EXCHANGE DAILY, BOERSENZEITUNG, REPORTS THAT THE CHANGE IN THE BRITISH POSITION TOOK THE FINANCIAL COMMUNITY BY SURPRISE AND LED

TO A RISE IN THE VALUE OF STERLING AND A BOOM IN STOCKS AND SHARES. OTHER PAPERS SUCH AS THE GENERAL ANZEIGER (INDEPENDENT AND WIDELY READ IN GOVERNMENT CIRCLES) AND THE FRANKFURTER ALLGEMEINE ZEITUNG (CONSERVATIVE), COMMENT ON THE DISCIPLINE WHICH ERM MEMBERSHIP WILL IMPOSE ON BRITISH INDUSTRY AND TRADES UNIONS. THERE IS SOME SPECULATION ABOUT THE INCREASED DIFFICULTY OF MANAGING THE ERM AGAINST THE BACKGROUND OF HIGHER UK INFLATION AND INTEREST RATES.

5. MOST REPORTS LINK THE UK MOVE TO THE DEBATE ON EMU AND SOME COMMENT THAT ERM MEMBERSHIP DOES NOT HERALD ANY WEAKENING OF UK RESERVATIONS ON THIS SCORE. THE SUDDEUTSCHE ZEITUNG (INDEPENDENT) AND HANDELSBLATT EXPRESS THE FIRM BELIEF THAT STERLING'S ENTRY WILL BOLSTER THE OPPOSITION OF THE FEDERAL FINANCE MINISTRY AND THE BUNDESBANK TO EARLY PROGRESS TOWARDS EMU.

COMMENT

6. ERM MEMBERSHIP HAS PUT THE UK IN A BETTER POSITION TO INFLUENCE THE GERMAN DOMESTIC DEBATE OVER EMU. WHILE THE GERMANS REMAIN SCEPTICAL ABOUT THE HARD ECU PROPOSALS, MANY SYMPATHISE WITH OUR VIEW THAT A RUSHED APPROACH TO EMU WOULD BE A SERIOUS MISTAKE. MR MAUDE SHOULD BE ABLE TO BUILD ON THIS AT THE BDI SYMPOSIUM ON 15 OCTOBER.

7. FCO PLEASE PASS TO PS/CHANCELLOR OF THE EXCHEQUER AND PS/FINANCIAL SECRETARY.

MALLABY

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

8 October 1990

Dear Tim,

DEBATE ON STERLING'S ENTRY INTO THE ERM

The Prime Minister has received the attached letter from Mr. Kinnock. She takes the view that this decision was an element of economic policy which falls within the responsibility of the Chancellor of the Exchequer. Should there be a debate it would fall to him to lead for the Government. She would, however, welcome advice on whether to make time available for such a debate.

The Prime Minister is minded to reply in the following terms:

> "Thank you for your letter of 8 October. It is based on a mis-conception. I did not announce the decision to apply for membership of the ERM. This was announced, as is appropriate for an important element of economic policy, by the Chancellor at 1600 hours. It follows that it would be for the Chancellor to open for the Government.
>
> [You will no doubt pursue the Opposition's request for a vote through the usual channels.]
> Or
> [The Government is ready to find time for such a debate. The timing should be for discussion through the usual channels.]
> Or
> [The Government is willing to make time for a debate on...]"

BF

Mr. Kinnock has released his letter to the press who will no doubt want to hear of the Government's reply. The Prime Minister would welcome advice as soon as possible.

I am copying this letter to John Gieve (HM Treasury) and Murdo Maclean (Chief Whip's Office).

Yours sincerely,

Andrew Turnbull

(ANDREW TURNBULL)

Tim Sutton, Esq.,
Lord President's Office.

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F8/1.

HOUSE OF COMMONS
LONDON SW1A 0AA

The Office of the
Leader of The Opposition

October 8th 1990

Dear Prime Minister,

The Government's decision to put Sterling into the Exchange Rate Mechanism clearly has immense immediate and future consequences for all aspects of our economy.

I believe that the decision should be fully debated in the House of Commons at the earliest possible opportunity. I am therefore writing to ask you to arrange for a debate in government time and on an amendable motion as soon as practicable after the House returns next week.

I am sure that since you announced the Government's decision outside 10 Downing Street last Friday you will want to present the Government's policies to the Commons yourself.

I am copying this letter to Sir Geoffrey Howe, Leader of the House.

Yours sincerely

Neil Kinnock

Neil Kinnock

Rt. Hon. Margaret Thatcher M.P.,
Prime Minister,
10 Downing Street

F8/1.

HOUSE OF COMMONS
LONDON SW1A 0AA

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Neil Kinnock

Neil Kinnock

Rt. Hon. Margaret Thatcher M.P.,
Prime Minister,
10 Downing Street

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CC QS

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

8 October 1990

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

Dear Stephen

will request it rsgd.

ERM

Further to Tancred Tarkowski's letter to you of 5 October, I attach revised Question and Answer briefing which takes account of developments since last Friday's announcement.

I am copying this letter and the attachment to the Private Secretaries to all members of Cabinet, to the Governor and Deputy Governor of the Bank of England, to Lord Hesketh and Sir Robin Butler.

Yours sincerely

Kate Gaseltine

MISS K GASELTINE
Assistant Private Secretary

ERM ENTRY BRIEF: AFTER TERMS AGREED

FACTUAL

(i) Sterling joined the exchange rate mechanism of the European Monetary System with effect from the start of business in London on Monday 8 October. Base rates have been reduced at the same time by 1 per cent, to 14 per cent.

(ii) Sterling has entered the mechanism with a central rate against the DM of exactly 2.95 compared to a market rate of just under 2.95 before the announcement of entry at 4.00 pm on Friday 5 October.

(iii) Agreement was reached on the terms proposed by the Chancellor for sterling's entry into the ERM on 6 October. The resulting bilateral central rates of sterling against the other currencies are:-

Belgian Franc	60.8451
Danish Kroner	11.2526
Deutschemark	2.95000
Peseta	191.750
French Franc	9.89389
Irish Punt	1.10118
Lira	2207.25
Luxembourg Franc	60.8451
Dutch Florin	3.32389

(iv) Sterling has entered the mechanism with 6% bands around its central rates.

(v) The communique issued by the Ministers and Central Bank Governors of the Member States of the Community said:

> "The Ministers, the Governors and the Commission warmly welcome the participation of the pound sterling in the exchange rate mechanism, which marks a significant advance in the economic and monetary integration of the European Community. At the outset of Stage 1 of economic and monetary union, they take today's decision as a strengthened commitment by the British authorities to pursue a firm anti-inflationary policy based on an appropriate policy-mix, in line with the discipline of the ERM. They emphasize also that the enlargement of the ERM underlines the need for continued efforts and close cooperation among EEC countries to secure convergence".

(vi) The bilateral central, selling and buying rates advised by the Bank of England on Monday 8 October are attached at annex 1.

(vii) Sterling Exchange Rates

	£/ERI	$/£	DM/£	FFr/£
1985 Av.	100	1.30	3.78½	11.5495
1986 Av.	91.5	1.47	3.19	10.1569
1987 Av.	90.1	1.64	2.94	9.8369
1988 Av.	95.5	1.78	3.121/3	10.5969
1989 Av.	92.6	1.63¾	3.09	10.4476
1990 Av. (to Oct 3)	90.3	1.7333	2.8596	9.6335
4.00 pm Friday 5 October*	94.1	1.9185	2.9482	9.8754
Open London Monday 8 October	97.2	1.9830	3.0528	10.2185

* At time of announcement of ERM entry.

(viii) Sterling's central rate of DM 2.95 is quite close to its historic average real effective exchange rate and real rate against the deutschemark.

(ix) Conditions for sterling's entry to ERM spelt out by Prime Minister at Madrid Summit: Government committed to join ERM when level of UK inflation is significantly lower, there is capital liberalisation in the community and real progress has been made towards completion of single market, freedom of financial services and strengthened competition policy.

(x) UK inflation rates cf Europe excluding mortgage-interest relief and community charge:

	UK	ERM AVERAGE
12 months to		
April	6.5	4.0
May	7.0	3.9
June	6.9	3.9
July	7.0	3.8
August	7.9	4.3

(xi) UK inflation since Madrid

	HEADLINE	EXCL MORTGAGE INT PAYMENTS & COMMUNITY CHARGE	EC
June 1989 (Madrid)	8.3	5.8	5.5
July	8.2	5.7	5.6
August	7.3	5.5	5.2
September	7.6	5.7	5.3
October	7.3	5.9	5.4
November	7.7	5.9	5.4
December	7.7	6.0	5.4
January 1990	7.7	5.9	5.2
February	7.5	6.0	5.3
March	8.1	6.2	5.4
April	9.4	6.5	5.4
May	9.7	7.0	5.5
June	9.8	6.9	5.5
July	9.8	7.0	5.5
August	10.6	7.9	6.0
September	-	-	-

(xii) Evidence that monetary policy working/interest rate cut justified. (More detailed evidence in annexe 2 attached).

(a) Monetary aggregates have slowed in recent months, with MO moving back well within its target range and with M4's 12 month growth rate in August at 15.5%, the lowest figure for nearly three years.

	MO	M4
JANUARY	-	18.4
FEBRUARY	-	18.1
MARCH	-	17.5
APRIL	7.3	17.5
MAY	6.9	17.3
JUNE	6.5	16.9
JULY	5.5	16.3
AUGUST	4.9	15.5
SEPTEMBER	Estimated at around 4¼	-

(b) Retail sales down 1 per cent in latest 3 months over previous three months and only 1½ per cent up on a year ago.

(c) New car registrations 14 per cent lower than a year ago.

(d) Housing market flat.

(e) CBI report output, orders sharply down.

(f) Imports have slowed down as have exports, with three month on three month comparisons showing both clearly slowing.

(xiii) Text of Chancellors Statement on 5 October

"It has become increasingly clear that the Government's sustained policies of high interest rates and firm budgetary control are now reducing inflationary pressures in the economy. Monetary growth has fallen very sharply to within its target range and the growth of demand has slowed and continues to do so. The rise in oil prices will continue to feed through for some time but the prospect is for a substantial reduction in inflation over the coming year both in absolute terms and in relation to inflation in other European countries.

In these circumstances, a reduction in interest rates is now justified; so the Bank of England is announcing that its minimum lending rate on Monday will be 14 per cent, one per cent below the current level of banks' base rates.

A tight monetary policy and a firm exchange rate remain essential to bring inflation down. To reinforce our framework of monetary discipline, we have decided that the UK should now join the Exchange Rate Mechanism of the European Monetary System. We have proposed, therefore, to our European Community partners that, as part of the common procedure, we should join the ERM on Monday morning with a central exchange rate at around DM2.95 and initially with 6 per cent margins."

(xiv) Text of Prime Ministers Statement (given at Start of Interview outside No.10 on Friday 5 October).

You will, of course, have heard the announcement that the interest rates are to be reduced by 1 percentage point on Monday and that we have applied this week-end to join the Exchange Rate Mechanism.

The fact that our policies are working and are seen to be working have made both these decisions possible. They are seen to be working from the CBI surveys, from the fall in retail sales, from the fall in the sale of cars, above all from the monetary conditions and all of those make it quite clear that we are in a position to reduce the interest rate from 15 percent to 14 percent. That same clarity enables us to apply for the Exchange Rate Mechanism which at the same time will underpin our anti-inflationary stance.

The most important thing is to get inflation down and these two policies are right for the times and therefore it was right to take the decisions that we did this week-end.

POSITIVE

(i) Participation in exchange rate mechanism

- will reinforce Government's counter-inflationary policy.

- will help avoid volatility in European exchange rates - giving UK business greater confidence to plan ahead in Europe.

- confirms Government's commitment to stage 1 of Economic and Monetary Union.

(ii) Very clear signals from economy that tight monetary policy working (money supply, retail sales, manufacturing orders all sharply down) therefore appropriate to reduce base rates at the same time as entry to ERM, which will add to UK monetary discipline and continued fight against inflation.

(iii) Experience in recent years suggests that the ERM has helped participants to reduce inflation. Change in inflation 1979-1990 (to July)

ERM Countries *	-5.7
cf European OECD * excl. ERM	-3.0
OECD excl * ERM	-4.7

* For the purposes of this comparison Spain is excluded from the ERM and included in the OECD figures (Spain was outside the ERM for most of the period 1979-90).

(iv) The ERM has helped to bring greater stability to European exchange rates. Since the ERM has been in operation

there have only been 12 realignments and these have become more infrequent.

(v) Government committed to join ERM as part of stage 1 of EMU. Have now done so within 4 months of commencement of stage 1 (1 July 1990). Taken together with most liberalised capital markets in Europe and the UK's first place in implementation of single market measures, UK can fairly claim to be in lead on putting stage 1 into effect.

(vi) Wide band gives markets time to adjust before sterling enters narrow band. Intend to move to narrow band, with agreement of partners as soon as conditions permit, once sterling has settled in system.

DEFENSIVE

(i) **Why join now?**

Conditions for entry have been broadly met. Satisfied that further progress (eg on inflation) can now be achieved better within the mechanism than outside.

(ii) **Timing of Entry Political?**

[Interview with Walden 7 October].

Limited number of dates on which entry possible for operational reasons (eg assembling Monetary Committee). Weekend 5/8 October could have been last possible date for significant period of time. Conditions met, exchange rate stable at appropriate level, would have been wrong to risk further delay.

(iii) **When was decision to enter taken?**

Has been policy to join for a long time. A number of possible dates had been identified. These were kept under review in the light of progress on the Madrid conditions and the state of the foreign exchange markets. Against that background the final decision could be taken very quickly, once circumstances were right.

(iv) **Madrid Conditions Met?**

Yes. There has been significant progress on all the key European fronts - free movement of capital, the single market, competition policy and liberalisation of financial services. And on inflation there are now clear signs that the Government's tight monetary policy is feeding through to the real economy. We are confident that inflation will be sharply lower next year. Further progress, on inflation in particular, will be more easily achieved in the ERM rather than outside.

(a) **Inflation?**

[Madrid Condition: 'When level of inflation is significantly lower'; Chancellor in margins of OECD 30 May; 'wish to be certain that UK inflation is on a downward trend and a little bit closer to that of our Community partners': Chancellor 7 June; 'Inflation will not be assessed on the RPI but on a comparative basis to the measure in which European nations themselves assess inflation': Chancellor 26 September "But what matters here is less the difference between headline figures; which measure what has happened over the last 12 months, than the prospective movements in price levels from now on"].

The Government's tight monetary policy is now clearly feeding through to the real economy and we expect that inflation will peak soon and then decline sharply next year. Clearly would have liked more progress. But satisfied that monetary conditions now tight and that further progress on inflation will be more easily achieved within the ERM rather than outside.

(b) **Free Movement of Capital?**

All those countries required to abolish their exchange controls by 1 July under the 1988 Capital Liberalisation

Directive have done so. Remainder bound to do so by 31 December 1992, though for Greece and Portugal this may be extended for up to three years, if Commission accept case for more time.

(c) **Real progress towards Single Market?**

More than 60 per cent of measures necessary for completion of internal market have now been adopted or agreed in principle. Continued effort needed to maintain momentum, but considerable progress already made.

(d) **Real progress towards Freedom of Financial Services?**

Second Banking Directive provides freedom to establish branches and provide cross border services anywhere in EC for banks authorised in their home state. Investment Services Directives, which will provide similar freedom for investment business, under discussion. Non-Life Framework directive for Insurance tabled by Commission in July. Clearly more to be done, but real progress is being made.

(e) **Strengthened Competition Policy?**

Commission acting to reduce state aids and ensure those that remain are fairer. Since September commission has power to block largest mergers which inhibit competition. Commission has proposed action programme to reduce barriers to takeovers across EC. Good progress made but vigorous enforcement of competition rules needs to be maintained.

(v) **Interest rate cut too soon**

No. Monetary indications and evidence from real economy both pointing firmly to a significant slowdown in activity which justifies a cut in rates now. Confident that inflation will fall sharply next year.

(vi) **Interest rate cut too late?**

Important that government takes no risks with inflation. Time is right for the modest reduction announced, in light of all recent evidence of domestic economic slowdown.

(vii) **Further cuts to come?**

Government firmly committed to maintaining tight monetary policy. Present cut only possible because of added discipline of ERM. No expectation of further early reduction in rates.

(viii) **Reverse interest cut if necessary?**

[Interview with Walden 7 October].

Chancellor has said that if he thought that the economy and, in particular, the money supply were going out of control, then if necessary he would put interest rates up again.

(ix) **How does ERM help monetary policy?**

Makes quite clear that Government committed to a strong exchange rate: so no hope of bail out for companies who fail to control costs and wages by a depreciation of sterling.

(x) **Prime Minister reluctant to enter-forced on her by Europeans in Cabinet?**

No. Prime Minister fully behind decision to enter ERM and with proposed entry terms. Said "we [Prime Minister and Chancellor] have been working extremely hard together to ensure this result and we are both very pleased".

(xi) **Deal between PM and Chancellor**

Both Chancellor and Prime Minister agreed that circumstances warrant a modest interest rate reduction coupled with the added discipline of ERM. Interest rates must remain at what is

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(xi) Deal between PM and Chancellor

Both Chancellor and Prime Minister agreed that circumstances warrant a modest interest rate reduction coupled with the added discipline of ERM. Interest rates must remain at what is

historically a high level: we cannot take any chances with inflation.

(xii) **Has cabinet agreed terms**

Membership of ERM Government policy for a long time. Detailed terms matter for Chancellor in consultation with European Colleagues.

(xiii) **Joined too soon:**

(a) **Should have waited for further progress on Madrid Conditions**

Matter of judgement. Key point is that progress being achieved in all areas covered by Madrid Conditions, including inflation where the Governments tight monetary policy is now clearly feeding through to the real economy.

(b) **Should have waited until inflation much lower?**

Would have liked to have made further progress. Economy clearly slowing down and we confidently expect rate of UK inflation to fall sharply next year. Satisfied that further progress in continuing fight against inflation will be better achieved in ERM.

(xiv) **Joined too late**

(a) **Another example of UK joining late on worse terms than if joined at start?**

ERM not the sort of arrangement where early joiners necessarily have an advantage over others. When a new currency joins it is in everybody's interest that it does so at a sustainable rate and in appropriate band.

(b) **Inflation would have come down significantly by now if we had been in ERM before?**

Impossible to say. Experience suggests that ERM has helped participants achieve lower inflation rates. But ERM not a substitute for sound monetary policy.

(c) **UK Interest rates would now be lower if in ERM earlier?**

ERM entry not a soft option. Present cut only possible because of impact of high interest rates on real economy over a long period and added discipline of ERM entry.

(d) **UK proposals on EMU unlikely to be taken seriously outside ERM - Chancellors proposals prejudiced by late entry?**

Government made clear intention to join ERM in stage one of EMU. Have done so right at start. Can be no doubt about UK's commitment to stage one. Look forward to opportunity to discuss further the Chancellor's proposals for evolutionary approach beyond stage one with European partners.

(xv) **Entry rate too high**

Government clearly committed to a strong pound. Firm exchange rate essential part of fight against inflation. Proposed Central rate close to historical real levels.

(a) **UK industry will be uncompetitive?**

Key to competitiveness is restraint of unit costs not devaluation of currency. Continued high inflation relative to UK competitors itself threat to competitiveness in long run. Participation in ERM at firm rate will help bear down on inflation.

(b) **Rate cannot be sustained?**

Believe fundamental strength of UK economy supports entry rate.

(c) **Interest rates will have to go back up again to sustain exchange rate?**

No reason why exchange rate cannot be sustained at lower interest rates, given the clear evidence of slowing in the economy and the prospect that inflation will fall sharply next year.

(xvi) **Entry rate too low**

(a) **Monetary conditions too lax will fuel inflation?**

UK real interest rates remain at high levels and at a central rate of DM 2.95 exchange rate also firm. Government will not take risks with inflation.

(b) **Signals further fall in interest rates?**

Government determined to maintain firm monetary policy to bear down on inflation. And will continue to set interest rates at the level necessary to achieve that.

(c) **If sterling goes to the top of its band is realignment an option?**

Ridiculous to talk about realignment now. We have just committed ourselves to maintain sterling's value within this band. Of course in an exchange rate system like the ERM, realignments are not ruled out. But our intention and our EC partners' intention, is to maintain the grid of parities agreed this weekend.

(d) **Reduce interest rates instead?**

Central banks have a range of techniques at their disposal to ensure they meet their commitment to hold their currencies within the agreed ranges. The Bank of England has the whole weight of the ERM Central Banks directly behind them now as they operate so as to honour that commitment.

(xvii) **Band too wide?**

Appropriate to be cautious and give markets time to adjust before entering narrow band. Intend to move to a narrow band, with agreement of our partners, as soon as conditions permit, once sterling has settled within the system.

(xviii) **Views of other Member States?**

Confident other ERM members will welcome sterling's entry. Participation by second most widely traded European currency clearly strengthens ERM.

(xix) **Implications for EMU?**

Government fully committed to stage 1 of EMU as shown clearly by our decision to join ERM. But believe further progress best by market-led, evolutionary change. Look forward to debate on UK's proposals this autumn.

(xx) **Loss of Sovereignty - eg in exchange rate and monetary policy?**

Exchange rate always has been one factor in assessing monetary conditions and setting interest rates. Within ERM exchange rate policy for all participating currencies is agreed by all participating countries. But overall UK monetary policy remains sole responsibility of UK Government.

(xxi) Sterling now 'tied' to Deutschemark

Sterling now linked to all 9 member currencies. DM clearly plays major role - but as a strong, low inflation currency that is all to the good. With the accession of sterling, system overall now much stronger.

(xxii) Interest rates now bound to converge on DM rates irrespective of UK monetary conditions?

No. Experience shows that the system has worked with differences between interest rates for member currencies.

(xxiii) ERM membership will be deflationary?

ERM membership not a substitute for sound monetary policy but it will help bear down on inflation. That is all to the good.

(xxiv) ERM membership will cause unemployment?

Membership will reinforce anti-inflationary policy and thus have favourable effects on economy, including employment, in long run.

(xxv) How will sterling be kept within band?

Believe band reflects reasonable level for sterling in medium term. But if sterling reaches limits, the normal ERM commitments to buy/sell sterling to keep it in its band will apply. ERM arrangements for coordinated intervention, including mobilisation of funds of member central banks, provides effective mechanism for deterring short term fluctuations in exchange rates.

(xxvi) Government would realign rather than increase/decrease interest rates?

Ridiculous to begin talking about realignment now.

(xxvii) Should have been opportunity for Parliament to debate entry

Simply not practical to give advance warning of entry date. The Government's intention to join the ERM has been well known for some time, and there have been a number of opportunities for both Houses to discuss the ERM over the last year or so. A statement was made in the Lords on Monday (8 October).

(xxviii) Labour Party views

[Should join with 'sustainable' (competitive) exchange rate, expansion of social and regional funds and joint growth strategy].

Labour wish to join ERM only on terms which would impart inflationary bias to system. Wholly inappropriate to do so and, quite rightly, no prospect of other members agreeing. Reduction of inflation is only firm basis for sustainable growth.

(xxix) What will happen to mortgage rates now?

Matter for banks and building societies.

(xxx) What happens if Germany raises Interest rates now were in ERM?

Hypothetical question.

(xxxi) Previous shadowing of DM caused severe difficulties? Will happen again?

Sterling has not been in ERM before. Confident that a central rate of around DM 2.95 is appropriate and sustainable.

(xxxii) What are the government's forecasts for inflation in the UK next year, compared with inflation in other ERM countries?

The headline inflation rate in the UK will probably peak soon and diminish noticeably through next year. And before long the tight monetary policy stance should deliver a lower underlying rate of inflation. New forecast will be published in Autumn Statement.

rn0395

BILATERAL CENTRAL RATES AND SELLING AND BUYING RATES IN THE EMS EXCHANGE RATE MECHANISM
FROM 8 OCTOBER 1990

		B Fc L Fc 100 =	D Kr 100 =	Fr.fc 100 =	DM 100 =	If£1 =	Lit 1,000 =	Fl 100 =	Pts 100 =	£1 =
BELGIUM/LUXEMBOURG:	S	-	553.000	628.970	2109.50	56.5115	28.1930	1872.15	33.6930	64.6050
	C	-	540.723	614.977	2062.55	55.2545	27.5661	1830.54	31.7316	60.8451
B.Fc/L.Fc	B	-	528.700	601.295	2016.55	54.0250	26.9530	1789.85	29.8850	57.3035
DENMARK:	S	18.9143	-	116.320	390.160	10.4511	5.21400	346.240	6.23100	11.9479
	C	18.4938	-	113.732	381.443	10.2186	5.09803	338.537	5.86837	11.2526
D.kr	B	18.0831	-	111.200	373.000	9.9913	4.98500	331.020	5.52600	10.5976
FRANCE:	S	16.6310	89.9250	-	343.050	9.18900	4.58450	304.440	5.47850	10.50550
	C	16.2608	87.9257	-	335.386	8.98480	4.48247	297.661	5.15981	9.89389
Fr.fc	B	15.8990	85.9700	-	327.920	8.78500	4.38300	291.040	4.85950	9.31800
GERMANY:	S	4.95900	26.8100	30.4950	-	2.74000	1.36700	90.7700	1.63300	3.13200
	C	4.84837	26.2162	29.8164	-	2.67894	1.33651	88.7526	1.53847	2.95000
DM	B	4.74000	25.6300	29.1500	-	2.61900	1.30650	86.7800	1.44900	2.77800
IRELAND:	S	1.85100	10.00870	11.3830	38.1825	-	0.510246	33.8868	0.609772	1.16920
	C	1.80981	9.78604	11.1299	37.3281	-	0.498895	33.1293	0.574281	1.10118
If£	B	1.76950	9.56830	10.8825	36.4964	-	0.487799	32.3939	0.540858	1.03710
ITALY:	S	3710.20	20062.0	22817.0	76540.0	2050.03	-	67912.0	1222.30	2343.62
	C	3627.64	19615.4	22309.1	74821.7	2004.43	-	66405.3	1151.11	2207.25
Lit	B	3546.90	19179.0	21813.0	73157.0	1959.84	-	64928.0	1084.10	2078.79
NETHERLANDS:	S	5.58700	30.2100	34.3600	115.2350	3.08700	1.54000	-	1.84050	3.52950
	C	5.46286	29.5389	33.5953	112.6730	3.01848	1.50590	-	1.73345	3.32389
Fl	B	5.34150	28.8825	32.8475	110.1675	2.95100	1.47250	-	1.63250	3.13050
SPAIN:	S	334.619	1809.40	2057.80	6901.70	184.892	92.2400	6125.30	-	203.600
	C	315.143	1704.05	1938.06	6500.00	174.131	86.8726	5768.83	-	191.750
Pts	B	296.802	1604.90	1825.30	6121.70	163.997	81.8200	5433.10	-	180.590
UNITED KINGDOM:	S	1.74510	9.43610	10.7320	35.9970	0.964240	0.481050	31.9450	0.553740	-
	C	1.64352	8.88687	10.1073	33.8984	0.908116	0.453053	30.0853	0.521514	-
£	B	1.54790	8.36970	9.5190	31.9280	0.855260	0.426690	28.3340	0.491160	-

S = Exchange rate at which the central bank of the country in the left hand column will sell the currency identified in the row at the top of the table.
C = Bilateral Central rate
B = Exchange rate at which the central bank of the country in the left hand column will buy the currency identified in the row at the top of the table.

ANNEX 1

ANNEX 2

I. Activity

1) Growth in money GDP fallen significantly over past year. Close now to growth rates consistent with Government's objectives for inflation (see table 1).

2) More recent evidence points to continued deceleration in demand.

On the consumer side

a) retail sales show fall of 1 per cent in latest three months compared to previous three months. Annual growth rates well below earlier levels (see chart 1);

b) as measured by EC Survey, consumer confidence remains at historically low levels (see chart 1);

c) new car registrations 14 per cent lower than year ago and no sign of turnaround (see chart 2).

On the company side

i) business investment fell by 2 per cent in 1990Q2 after long period of buoyancy. Companies destocked by some £¾ billion;

ii) commercial vehicle registrations May-July fell by some 22 per cent on year earlier (see chart 3);

iii) in 3 months to July new commercial construction orders down 11 per cent on year earlier (see chart 4);

iv) manufacturing output fell by ½ per cent in July, third successive month of decline (see chart 5);

v) CBI indicators show further weakening of orders in September and of output expectations (see chart 6);

vi) housing starts still weakening (see chart 4).

n the Labour Market

a) unemployment rose by 22,000 in August, fifth successive monthly rise (see chart 7);

b) overtime working has been falling. In July was 4½ per cent lower than a year before (see chart 7);

c) vacancies fell in August to lowest level since January 1986.

II. Monetary and Financial Developments

Monetary and financial data supports activity indicators in portraying decelerating demand.

Amongst the monetary data

i) M0 - good indicator of current conditions in economy - has decelerated significantly over last few months. Now comfortably within target range (see chart 8);

ii) broad money growth, M4, also fallen steadily over last few months (see chart 9);

iii) retail deposit growth, M2, growing at rates well below previous ones (see chart 9);

iv) bank/building society lending shows continued deceleration (see charts 10/11).

Amongst other financial data

a) equity prices, though remaining at healthy levels by historical standards, have fallen by 20 per cent since the peak in July 1989 (see chart 12);

b) company trading profits fell 8 per cent in 1990Q2 (though real rates of return remain sound). Recent results eg. ICI (unchanged dividend), BTR (4 per cent increase), Barratt (dividend halved) suggest more modest future dividend growth after long period of strong growth;

c) exchange rate been strong in recent months reflecting tightness of monetary stance (see chart 13).

III. But inflation remains high and worsening?

1) "Headline" RPI inflation has been rising and wage settlements tending to follow (see chart 14).

2) But this overstates inflationary picture:

a) RPI distorted by inclusion of mortgage interest payments. Producer output prices give better underlying guide. Inflation on this basis pretty flat (see chart 15);

b) deceleration in economy and fall back in overtime working will reduce impact of higher settlements on earnings growth (earnings growth flat in July at 10 per cent after period of rises).

3) Key point is that inflation turns down a little after economy has decelerated and inflationary pressure abated. That is normal pattern (see chart 16).

4) Already evidence of inflation turning down in some sectors:

a) house prices virtually stable after period of rapid growth (see chart 17);

b) construction output price inflation has fallen from 15 per cent 18 months ago to 6½ per cent on latest figures. Tender price inflation has fallen to zero.

These falls in inflation must be expected to spread throughout the economy in coming months.

IV. Oil price increases make it wrong time to cut interest rates?

Certainly higher oil prices unwelcome development in environment for defeating inflation. But

a) strength of sterling has moderated effect on UK inflation;

b) UK economy like other developed economies, much better able to cope with rise than at time of previous oil shocks.

c) non-oil commodity prices have fallen in sterling terms - by some 14 per cent over last year. Provides some offsetting beneficial effect (see table 2).

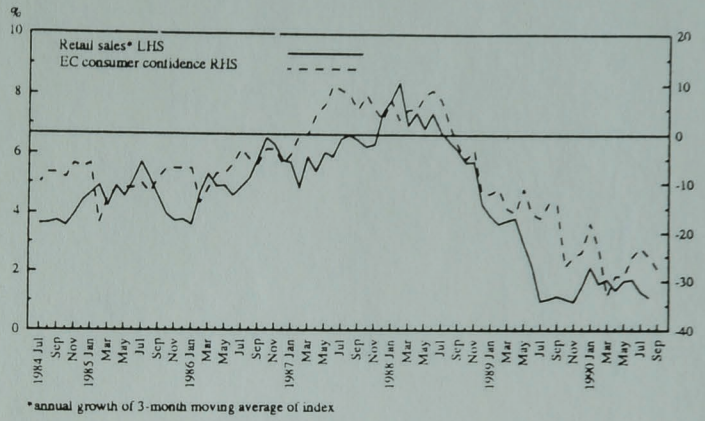
Table 1 : Economic Activity

		Half Years: Percentage Change on a Year earlier	
		Nominal GDP	**Real GDP***
1988	I	11.7	6.0
	II	11.5	5.1
1989	I	10.8	4.3
	II	7.7	2.0
1990	I	7.6	1.5

* Excluding North Sea oil

Chart 1 : Retail sales and consumer confidence

■ **Both retail sales growth and consumer confidence well below earlier levels.**



*annual growth of 3-month moving average of index

Chart 2 : Car registrations

■ **Car registations around 15 percent lower than a year ago.**

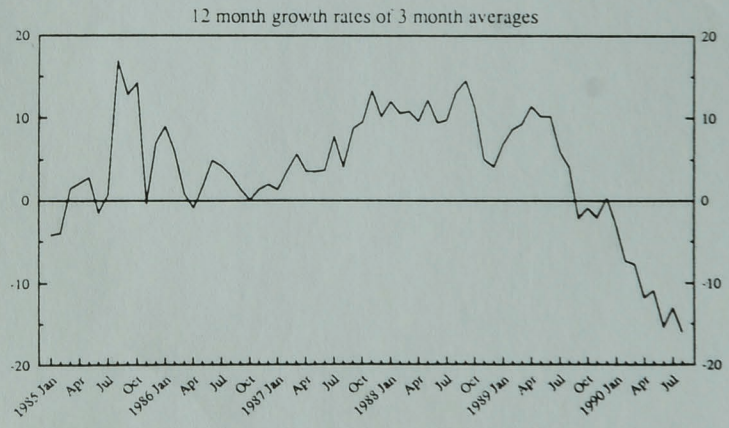


Chart 3 : Commercial vehicle registrations

■ **Commercial vehicle registrations in the three months to August were about 25 percent lower than a year earlier.**

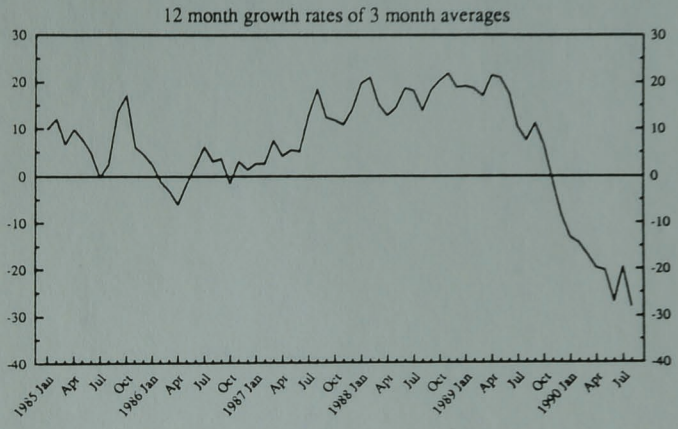


Chart 4 : Housing starts and construction orders

■ **Both housing starts and construction orders have fallen to low levels since the boom of 1988.**

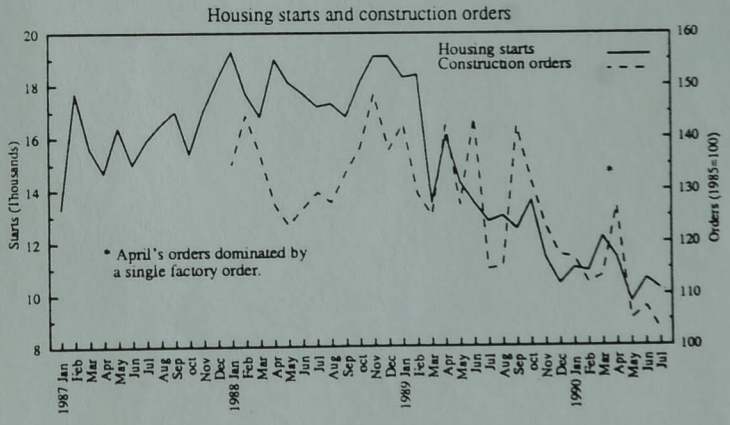


Chart 5 : Manufacturing output growth

- **Manufacturing output growth slowed during 1989 and has remained low in 1990.**

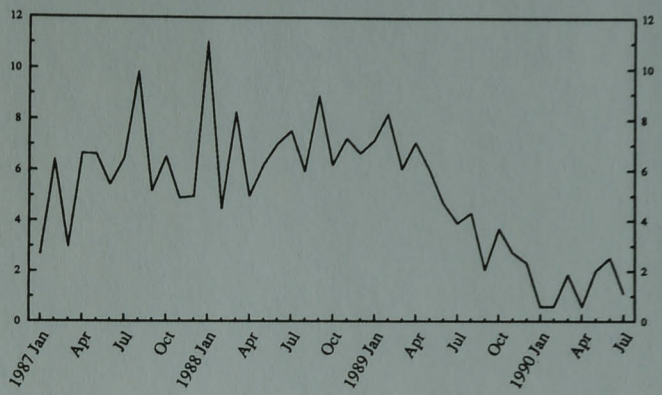
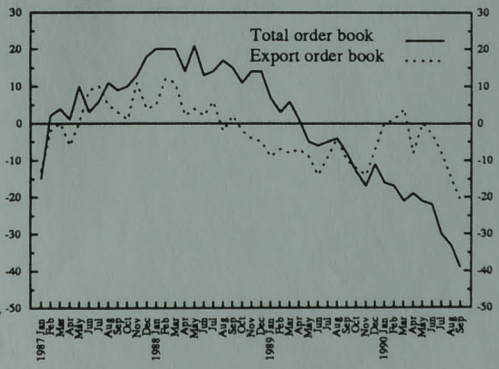


Chart 6 : CBI monthly indicators

- **Balance on total orders has fallen markedly since early last year.**
- **Export orders have held up relatively well.**



- **Balance of firms expecting higher output has been around zero for several months**
- **Balance of firms with at least adequate stocks has climbed steadily since low point at end 1988**

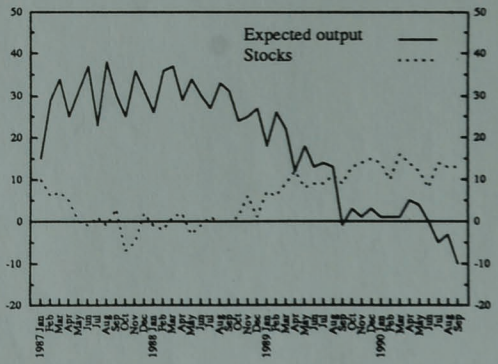
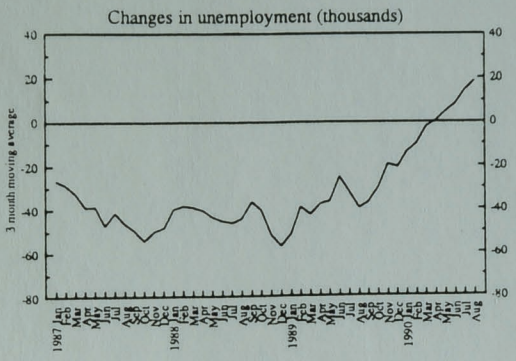


Chart 7 : Unemployment and overtime

- **Unemployment - a lagging indicator of the state of the economy - has recently started to rise, having earlier fallen for over 40 months in a row.**



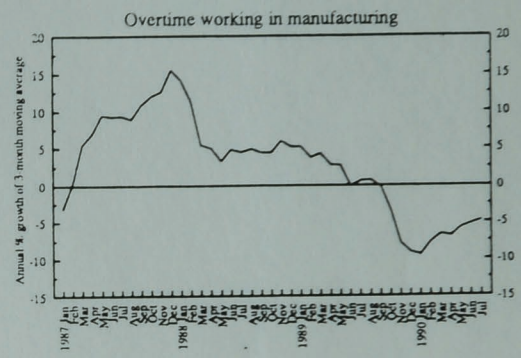


Chart 8 : M0 growth

- **M0 growth now back in target range after a period above it**

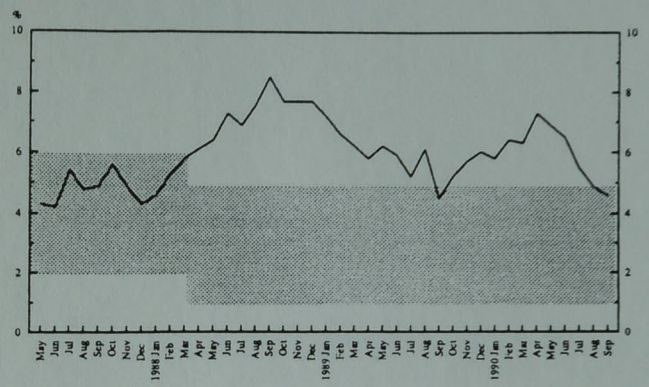


Chart 9 : Broad money growth

- **Broad money growth has now fallen back decisively.**
  M4 12 month growth rate in August was the lowest since November 1987.

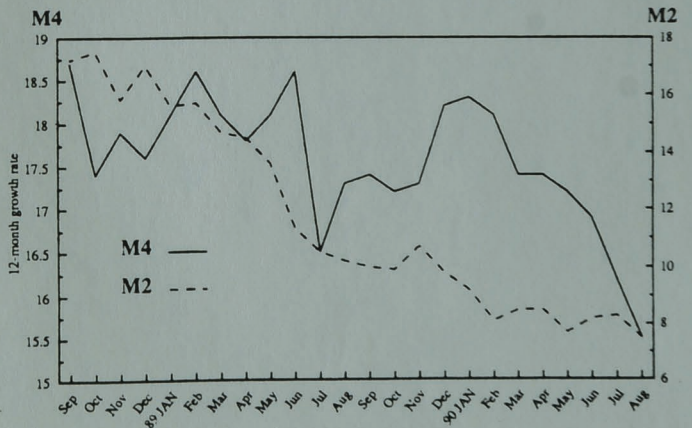


Chart 10 : Bank and building society lending

- **Lending growth has been falling for well over a year. August's figure was the lowest since May 1986.**

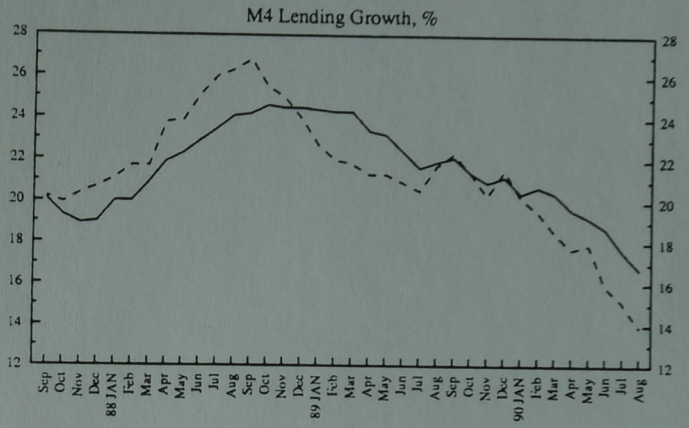


Chart 11 : Sectoral lending

- **Lending growth has slowed in all sectors.**

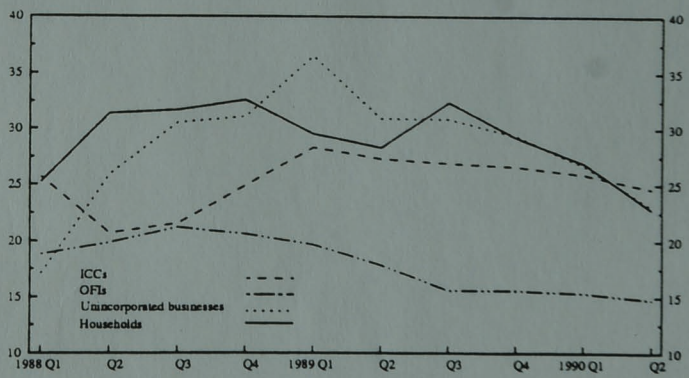


Chart 12 : Equity prices

■ **Equity prices, though at healthy levels, have fallen 20 per cent since the July 1987 peak.**

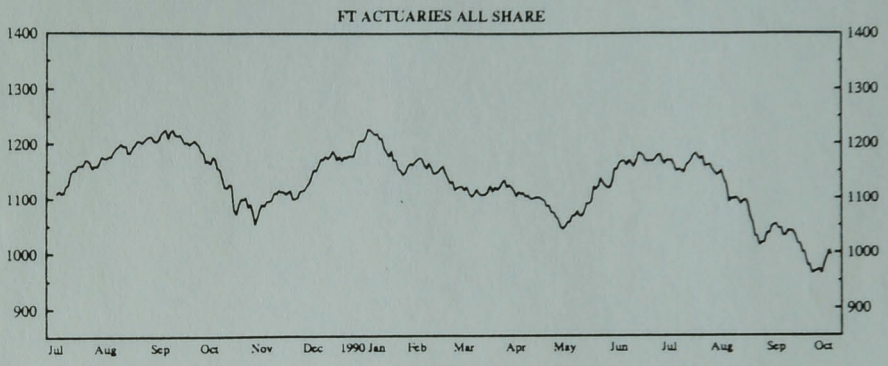


Chart 13 : Exchange rate

■ **ERI strong in recent months reflecting tightness of monetary conditions.**

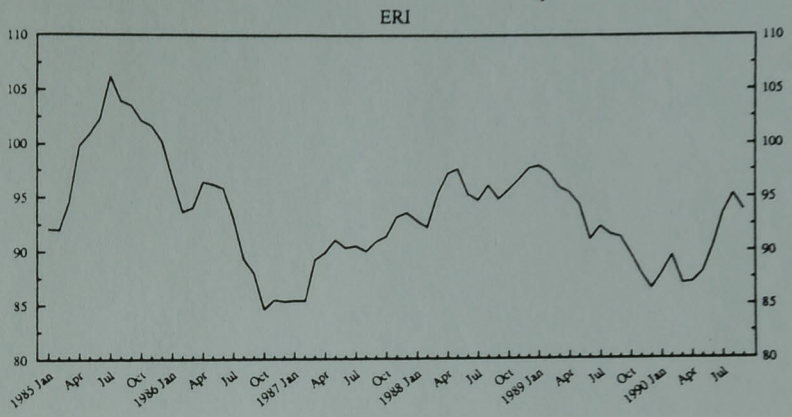


Chart 14 : Headline inflation

- **Headline RPI inflation has been rising with wage settlements tending to follow.**

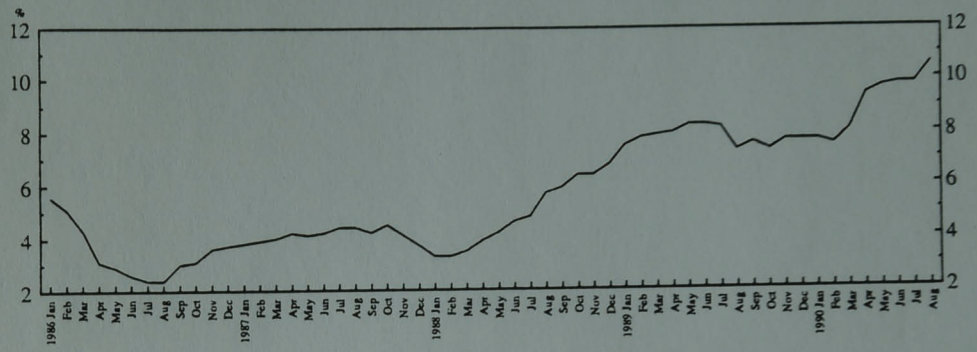


Chart 15 : Producer output inflation

- **Producer output inflation has been relatively flat.**

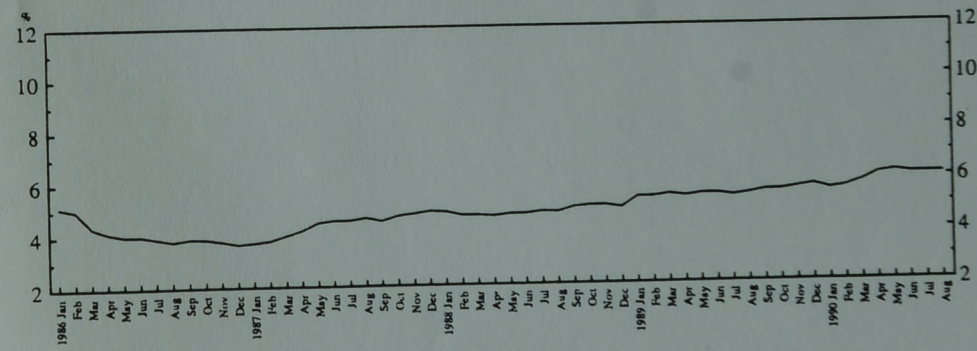
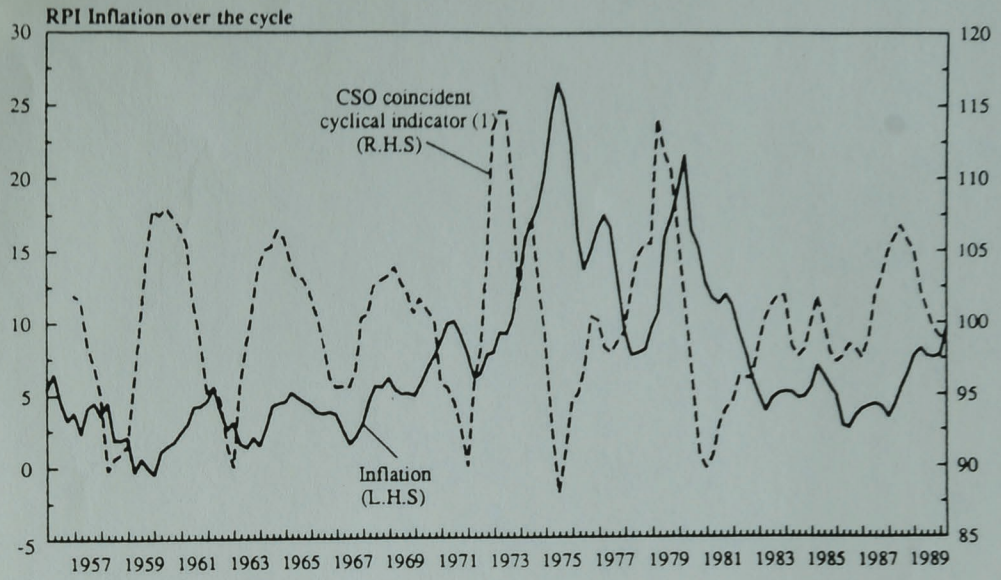


Chart 16



(1) - Long term trend = 100

Chart 17 : House prices

- **House price inflation reached nearly 35 percent at the end of 1988. Over the last year house prices have fallen nearly 2 percent.**

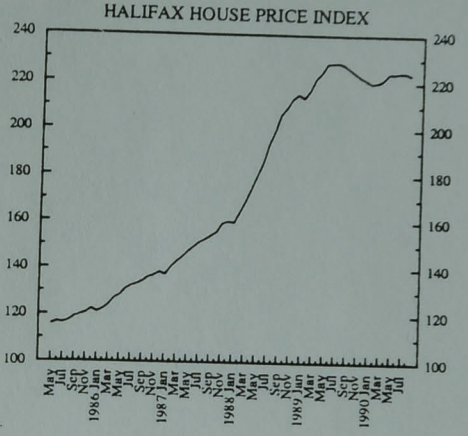


Table 2: COMMODITY PRICE INDICES (1985=100)

	SDR indices			All items
	Food	Non-food Agriculturals	Metals	Sterling
1984	112.3	111.6	106.2	107.2
1985	100.0	100.0	100.0	100.0
1986	92.4	89.9	85.4	86.4
1987	73.0	103.3	100.6	82.2
1988	85.7	109.6	156.2	103.3
1989	85.6	108.9	153.4	101.6
1988 Q1	77.6	105.5	133.4	95.9
Q2	84.0	115.1	169.1	109.1
Q3	92.9	114.0	157.9	111.7
Q4	88.3	103.6	164.4	107.7
1989 Q1	90.4	107.1	172.4	114.4
Q2	91.3	108.8	158.9	106.3
Q3	83.1	111.7	147.1	97.9
Q4	77.7	107.9	135.3	90.6
1990 Q1	76.9	106.3	120.1	96.1
Q2	80.0	109.4	129.0	99.4
1989 Sep	81.4	112.1	148.2	107.6
Oct	78.3	109.1	145.2	105.8
Nov	79.3	108.7	135.0	104.4
Dec	75.5	105.8	125.6	99.0
1990 Jan	75.2	104.8	115.2	94.0
Feb	75.5	106.0	113.8	91.9
Mar	80.1	108.0	131.4	102.4
Apr	81.5	109.6	129.6	101.8
May	81.4	110.0	129.7	100.9
Jun	77.1	108.6	127.8	95.6
Jul	73.4	105.7	128.2	90.0
Aug	70.6	99.3	136.8	87.5
Sep	70.7	98.0	142.1	90.8
Sep 04	70.6	98.9	138.7	89.5
Sep 11	72.3	99.4	149.3	94.5
Sep 18	70.5	97.4	146.0	90.6
Sep 25	69.5	96.2	134.5	88.6
Oct 2	68.7	95.9	133.9	87.4
% ch. on one yr	-13.2	-12.5	-8.2	-17.1

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AND TO DESKBY 080800Z LUXEMBOURG

FOLLOWING FROM PRIVATE SECRETARY
LUXEMBOURG FOR KERR AND CHANCELLOR OF THE EXCHEQUER'S PARTY ON ARRIVAL

UK ENTRY TO THE ERM

1. SITTING TOGETHER AT LUNCH DURING THE EC FOREIGN MINISTERS' INFORMAL WEEKEND AT ASOLO ON 6 OCTOBER, THE SECRETARY OF STATE HAD A WORD WITH M. DELORS ABOUT THE LATTER'S REACTION TO THE ANNOUNCEMENT IN LONDON ON 5 OCTOBER THAT THE UK WAS APPLYING TO JOIN THE ERM.

2. THE SECRETARY OF STATE SAID THAT HE HAD HEARD DELORS' INTERVIEW ON THE BBC ON 5 OCTOBER, IN WHICH HE HAD WELCOMED THE BRITISH DECISION. HOWEVER, THE CHANCELLOR HAD BEEN PUZZLED BY RATHER FIERCE REMARKS WHICH DELORS HAD MADE TO HIM ON THE TELEPHONE THAT DAY.

3. DELORS SAID THAT THE ANNOUNCEMENT HAD CAUSED HIM THREE DIFFICULTIES:

A. HE HAD THOUGHT THAT THE PROCEEDURE WAS WRONG. THE FINANCE MINISTERS SHOULD HAVE BEEN SUMMONED TO A MEETING THIS WEEKEND.

B. HE THOUGHT THE BAND WAS TOO WIDE. A FOUR PER CENT BAND, RATHER THAN A SIX PER CENT BAND, WOULD HAVE BEEN ENOUGH. THE SECRETARY OF STATE SAID HE WAS SURPRISED TO HEAR THIS. GIVEN THAT THERE WAS BOUND TO BE SOME RISK INVOLVED IN STERLING JOINING THE ERM EVEN WITHIN A WIDE BAND, AND GIVEN THE TURBULANCE OF THE MARKETS AS A RESULT OF THE GULF CRISIS, A WIDE BAND SEEMED SENSIBLE. DELORS CLAIMED THAT HMG UNDERESTIMATED THE DIFFICULTIES THEY FACED FROM PRESSURE FOR HIGHER WAGES. A WIDE BAND FOR STERLING WOULD NOT PROVIDE ENOUGH DISCIPLINE TO CONTROL THE PRESSURE FOR WAGE RISES. THOUGH HE REALISED THAT POLITICALLY THE TIMING WAS SHREWD, IN ECONOMIC TERMS HE FELT IT WOULD HAVE MADE MORE SENSE FOR HMG TO HAVE GOT WAGE SETTLEMENTS DOWN BEFORE JOINING THE ERM.

PRIME MINISTER

MEETING OF THE EUROPEAN MONETARY COMMITTEE

At 1600 today the Monetary Committee issued a communique reporting that agreement had been reached that sterling should enter the ERM with a central rate of DM 2.95 and margins of 6%. The text which accompanied this read as follows:-

> "Ministers, Central Bank Governors and the Commission warmly welcome the participation of the £ in the ERM, which marks a significant advance in economic and monetary integration of the European Community. At the outset of Stage I of Economic and Monetary Union, they take the decision as a strengthened commitment by the British authorities to pursue a firm anti-inflationary policy based on an appropriate policy mix, in line with the discipline of the ERM. They emphasise also that the enlargement of the ERM underlines the need for continued efforts and close co-operation among EC countries to secure convergence."

ANDREW TURNBULL

6 October 1990

020

CE N°10

6 October 1990

C O M M U N I Q U E

Ministers and Central Bank Governors of the Member States of the European Community, following a decision by the British government to join the exchange rate mechanism of the european monetary system, have decided by mutual agreement, in a common procedure involving the Commission and after consultation with the Monetary Committee, on the terms on which the pound sterling will participate as of 8 October 1990.

The Ministers, the Governors and the Commission warmly welcome the participation of the pound sterling in the exchange rate mechanism, which marks a significant advance in the economic and monetary integration of the European Community. At the outset of Stage 1 of economic and monetary union, they take today's decision as a strengthened commitment by the British authorities to pursue a firm anti-inflationary policy based on an appropriate policy-mix, in line with the disciplines of the ERM. They emphasize also that the enlargement of the ERM underlines the need for continued efforts and close cooperation among EEC countries to secure convergence.

The new ecu central rates are the following (in units of national currency per ecu)

FB	42.4032
Dkr	7.84195
DM	2.05586
Pta	133.631
FF	6.89509
Irl	0.767417
Lit	1538.24
Flux	42.4032
Hfl	2.31643
UKL	0.696904
Dr	205.311
Esc	178.735

The bilateral central rates of the pound sterling against the other currencies of the exchange rate mechanism will be

FB	60.8451
Dkr	11.2526
DM	2.95000
Pta	191.750
FF	9.89389
Irl	1.10118
Lit	2207.25
Flux	60.8451
Hfl	3.32389

Fluctuation margins of 6 % will be observed around the bilateral central rates of the pound sterling for a transitional period. All other bilateral central rates and intervention rates within the exchange rate mechanism remain unchanged. The decision on the pound sterling's participation has only marginal agri-monetary consequences.

The compulsory intervention points in the exchange rate mechanism will be communicated by the central banks in time for the opening of foreign exchange markets on 8 October 1990.

FROM JAMES LEE FOR COI RADIO TECHNICAL SERVICES

TRANSCRIPT OF DOORSTEP INTERVIEW
GIVEN BY THE PRIME MINISTER, MRS. THATCHER,
IN LONDON,
ON FRIDAY, 5 OCTOBER 1990

PRIME MINISTER:

Good afternoon, Gentlemen! May I say a few words first!

You will, of course, have heard the announcement that the interest rates are to be reduced by 1 percentage point on Monday and that we have applied this week-end to join the Exchange Rate Mechanism.

The fact that our policies are working and are seen to be working have made both these decisions possible. They are seen to be working from the CBI surveys, from the fall in retail sales, from the fall in the sale of cars, above all from the monetary conditions and all of those make it quite clear that we are in a position to reduce the interest rate from 15 percent to 14 percent. That same clarity enables us to apply for the Exchange Rate Mechanism which at the same time will underpin our anti-inflationary stance.

The most important thing is to get inflation down and these two policies are right for the times and therefore it was right to take the decisions that we did this week-end.

Would you like to ask some questions?

oooOooo

QUESTIONS AND ANSWERS

QUESTION:

Were you afraid that it would lead to recession? Have you done this to avoid one?

PRIME MINISTER:

We have the interest rate which we put up just almost a year ago this week-end to 15 percent to tackle inflation. Tackling inflation is tough; it leads to tough times for some people, but you have to do it to take the inflationary pressures out. There are clear signs inflationary pressures are being reduced and therefore it is time to take the interest rate down.

QUESTION:

But have you done this so that you have got some good news to give the Tory Conference next week?

PRIME MINISTER:

No. We have done it because the policy is right. I don't think you can accuse us of doing it for the Tory Party Conference because you could hardly accuse us last year of putting the interest rate up at the same week-end because there was a Tory Party Conference. We have done both things because they are right for the economy at the present time.

QUESTION:

But you said, Prime Minister, that you wanted our inflation rate to be more in line with that of our European partners.

PRIME MINISTER:

I think that you will find that those of our European partners are also rising. They are also affected, perhaps even worse than we are in a way, by the oil crisis and therefore I think that we will move in the coming months nearer to the European average. We do not know precisely how the oil price will affect the Retail Price Index because we do not know what will happen to the supply and demand position there. Our Retail Price Index is, of course, calculated on a different basis from that of Europe, which gives a higher apparent rate but the underlying rate is nearer to the average than the Retail Price Index indicator seems to say.

QUESTION:

Have you had a lot of encouragement from your European partners, Prime Minister? Is everybody happy to see Britain enter it?

PRIME MINISTER:

They were always expecting us to join at some time because it was fifteen months ago at Madrid that we confirmed that commitment that we would join when the time was right. We clearly wanted to be on top of our own policies as far as inflation was concerned and to have evidence that the 15 percent interest rate was

in fact working and, as I have indicated, there is multiple evidence to that effect.

Is there someone else who would like to ask a question? Can I cope with the television first? Are there any other television people that would like to ask a question? No! We are through with television! Could you shout?

QUESTION:

Do you now feel that the pound might come under pressure on the foreign exchanges?

PRIME MINISTER:

The pound has gone up since the announcement was made.

QUESTION:

Prime Minister, do you think the Madrid conditions have now been fulfilled?

PRIME MINISTER:

Yes, I think the Madrid conditions not only have now been fulfilled but the conditions which enable us to put down interest rates have been seen to be fulfilled.

If you look at the Madrid conditions, during the interim fifteen months since we announced those conditions, there has been a good deal of freeing-up of financial services in Europe - that was vital; there has been a good deal of freeing-up of competition although there is in fact further to go. We are all affected in

the same way by the oil price rise except that we might be slightly better off than our European partners as far as that is concerned.

QUESTION:

But Prime Minister, aren't all the indications that our inflation rate is going to go up against next week?

PRIME MINISTER:

We cannot foretell what the Retail Price Index will be because we do not know quite in fact what the changes in the price of oil will be. That, of course, we could not have foreseen when the Madrid conditions were set down. We do think that the increased price of oil will affect all our partners in Europe. We might, in fact, be better placed than they are because after all, we have access to our own oil whereas they do not have access to any.

QUESTION:

Have you changed your stance on Stages 2 and 3 of Delors?

PRIME MINISTER:

Not in any way at all! Stage 2: we have, as you know, tried to find a fundamental compromise with the European Community because they know full well we are totally against a single currency and so is our Parliament - Government and Parliament are at one! This would make fundamental inroads into the very purpose of Parliament and we remain totally against a single currency.

Some of our partners still wish to go towards that and therefore the Chancellor and a group of people worked out the possibility of a common currency, which is different from a single currency, based on what is called a "hard" ECU and we hope that our European partners will agree to that as the next stage because we could not go to a single currency.

QUESTION:

Prime Minister, you have applied to join on Monday. When can we expect to become members?

PRIME MINISTER:

You have to apply to join at a week-end, as you know, and I would expect that we would become members on Monday and I hope that they would agree to the central rate of 2.95 which was the one which we thought appropriate and, of course, we have a 6 percent latitude, as you know.

QUESTION (inaudible)

PRIME MINISTER:

I think I would be satisfied with what you have got for the time being. We look to see what the real conditions in the economy are and what the monetary indicators are signalling. Both of those things are what determines the interest rate that we have and how inflation is behaving in the real economy.

QUESTION (inaudible....and is that the reason for the cut today?)

PRIME MINISTER:

Inflation, if it were to continue, would in fact produce recession because as you know, in the days when some people thought inflation and unemployment were alternatives, it was very clearly said that if inflation continues, in the longer run that produces far worse unemployment than any which you might see from adjustments in bringing down inflation.

QUESTION (inaduible)

PRIME MINISTER:

I am very careful in forecasting these matters for the simple reason that I do not know what will happen to the oil market, which is very much a supply and demand situation - we do not know quite how much. First, it depends upon how much is being lifted, how quickly it gets to market and how people are using up any reserves they may have and how they are economising because of the increase in price. An increase in price inevitably leads people to economise and that, of course, has a down-effect on the requirements of the market.

QUESTION:

Prime Minister, can I ask you what you think the implications of these decisions are for people paying mortgages?

PRIME MINISTER:

I think the implications for these decisions will be that the building societies will think fit to reduce the mortgage rate at the time when they normally do that and that varies from building society to building society. That is what we would confidently expect.

QUESTION:

Has the Gulf crisis had anything to do with your decisions today?

PRIME MINISTER:

The Gulf crisis has something to do with the price of oil, which therefore has something to do with the Retail Price Index. It affects, I think, most of the economies of Europe similarly and also that of the United States, although the United States - like us - has access to a certain amount of oil of its own, but the real thing that made this decision possible was the uncontestable signs that the economy is working in the way we intended it to in reducing inflationary pressures and that means that we were able to take the interest rate down by 1 percent and it also opened the way to apply to join the Exchange Rate Mechanism.

Gentlemen, I think your questions are going round in a circle. I think we have come to the beginning of them again, so I think that will see you through the next News programme.

The Chancellor will be doing quite a lot of broadcasting. I must say we have been working extremely hard together to ensure this result and we are both very pleased.

(END OF TRANSCRIPT)

STATEMENT BY THE PRIME MINISTER

We have always been committed to joining the ERM when economic conditions are right.

We have concluded that the time has arrived and that we are now in a position to make a success of full membership of the European Monetary System.

It is clear that our firm financial policies are working and that inflationary pressures are beginning to ease. Recent evidence from CBI surveys and retail sales confirm that demand is slowing down.

Monetary growth is now within the target range. So the prospect is for a marked fall in inflation over the next year.

The Bank has therefore announced a one per cent cut in interest rates and, to underpin our counter-inflationary policy, we have also applied to join the ERM immediately. The Government is now fulfilling its long-standing commitment.

We are determined to defeat inflation. I am confident that our tough monetary policy, supported now by full membership of the European Monetary System, will bring that about.

chex.ps/jg/90 **SECRET: ADSO**

Ref: JG/45
Copy: 9 of 11
20a-c

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

5 October 1990

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1A 2AA

Dear Andrew

CHANCELLOR AND PRIME MINISTER'S STATEMENTS

... I attach a revised draft of the Chancellor's 4.00 pm statement this afternoon which has been agreed with the Bank and incorporates your earlier comments.

... I also attach a form of words that the Prime Minister might use when she talks to the media.

We will be letting the No.10 Press Office have the same briefing pack that we are preparing for our own information department and Mr O'Donnell will discuss the line for Mr Ingham directly with him.

Yours

JG

JOHN GIEVE

copied to BF

5

Text of HM Treasury Press Notice to be issued at 4.00 pm on Friday, 5 October 1990

UK REDUCTION IN INTEREST RATES AND ENTRY TO ERM

At 4.00 pm today the Chancellor of the Exchequer, the Rt Hon John Major MP issued the following statement:

"It has become increasingly clear that the Government's sustained policies of high interest rates and firm budgetary control are now reducing inflationary pressures in the economy. Monetary growth has fallen very sharply to ~~well~~ within its target range and the growth of demand has slowed and continues to do so. The rise in oil prices will continue to feed through for some time but the prospect is for a substantial reduction in inflation over the coming year both in absolute terms and in relation to inflation in other European countries.

In these circumstances, a reduction in interest rates is now justified; so the Bank of England is announcing that its minimum lending rate on Monday will be 14 per cent, one per cent below the current level of banks' base rates.

A tight monetary policy and a firm exchange rate remain essential to bring inflation down. To reinforce our framework of monetary discipline, we have decided that the UK should now join the Exchange Rate Mechanism of the European Monetary System. We have proposed, therefore, to our European Community partners that, as part of the common procedure, we should join the ERM on Monday morning with a central exchange rate at around DM2.95 and initially with 6 per cent margins."

5

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pso.jt/Evans/4.5.10.90

SECRET - ADSO

DRAFT

C

Statement by the Prime Minister

I am delighted with the announcement we have made today.

As full members of the European Monetary System we shall have the right framework within which to continue the battle against inflation.

It is clearer and clearer every day that our firm financial policies are working, cutting into the inflationary pressures which had built up in the economy. These pressures have been very considerable and it is going to take some time to squeeze this inflation completely out of the system.

This will not be an easy or painless process. It never is, inside or outside the European Exchange Rate Mechanism. I am determined to defeat inflation, and confident that our tough monetary policy, buttressed now by full membership, will bring that about.

chex.ps/jg/86

SECRET: ADSQ

19a-c

FROM: JOHN GIEVE
DATE: 4 October 1990
EXT: 4330

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr Scholar
Mr P R C Gray
Mr O'Donnell
Mr McIntyre

PS/Governor - BE

Mr Turnbull - No.10

CONTACT LIST FOR FRIDAY, 5 OCTOBER

... I attach a list of contacts we should try to make during the course of Friday and some suggestions on who should deal with whom. I would be grateful for comments first thing tomorrow and any further suggestions.

JG

JOHN GIEVE

SECRET: ADSQ

chex.ps/jg/86

SECRET: ADSQ

19a-c

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DATE: 4 October 1990
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JG

JOHN GIEVE

SECRET: ADSQ

1

PEOPLE TO BE CONTACTED ON 5 OCTOBER 1900

Foreigners (angst-ridden and others)

Sarcinelli/Carli	-	Chancellor to ring at 8.30 am
Monetary Committee	-	Convened by Sarcinelli
Governors Poehl and Larosiere	-	Contacted by Deputy Governor am
Rubio	-	Contacted by Deputy Governor early pm
Other Central Bank Governors	-	Teleconference at 4.00 pm with Deputy Governor
Other Community Finance Ministers, Commissioners Delors, Brittan, and Christophersen, Other G7 Finance Ministers, Managing Director of IMF	-	Letter from the Chancellor to be sent by fax at 4.00 pm. [UKREP to contact Commissioners]
Greenspan/other G7 Central Bank Governors	-	Deputy Governor to speak after 4.00 pm

UK Ministers

Sir Geoffrey Howe	-	Chancellor to inform at 3.15 pm
Chief Whip		Chancellor to inform at 3.45 pm
Mr Baker		Chancellor to inform at 3.50 pm
Other Treasury Ministers + Lord Hesketh		Chancellor to inform at 3.30 pm
Other Cabinet Ministers	-	To be informed by No.10 ringing round Private Offices at 4.00 pm

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Other MPs

Terence Higgins, David Howell, William Clark, Peter Hordern, [Nigel Lawson Ian Stewart, Edward Heath]	)	To be contacted ASAP after 4.00 pm by Treasury Ministers
Nicholas Ridley	-	To be contacted by C Powell

Journalists

Reuters, Knight Ridder, Telerate	)	Statement released at 4.00 pm
National and regional press	-	Press release released at 4.00 pm
Sam Brittan	-	Sir T Burns
Simon Jenkins	-	Foreign Secretary
Sarah Hogg	-	Sir T Burns
Martin Woolf/ Richard Lambert		Sir P Middleton
Other.....	-	Mr O'Donnell + No.10 Press Office

Financial Institutions

Building Societies Association	-	4.00 pm by Mr Scholar
Chairman of Stock Exchange	-	After 4.00 pm by Mr Scholar

SECRET: ADSO

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18a-b

Timetable

Friday 5 October

Early AM	[Mr Turnbull to speak to Palace]
Early AM	Mr Wicks speaks to Chairman of Monetary Committee (Sarcinelli) and tells him proposed central rate, margins and interest rate cut. Sarcinelli discusses proposal on the telephone with other Monetary Committee members. Decides whether to call meeting (preferably Friday evening). Bank of England simultaneously consults other central banks. Shortly after Wicks' call to Sarcinelli, Chancellor rings Carli. Then faxes other ECOFIN members, Sarcinelli, Commissioner Christopherson, Chairman of Central Bank Governors.
[Shortly before 4pm	Chancellor tells selected Cabinet Ministers of decision; or is this too risky?].
Shortly before 4pm	UK Director IMF (Mr Peretz) told of decision
4.00 pm	Treasury releases statement (draft attached) by Chancellor on interest rate cut and ERM decision. Immediately placed on Reuters and Knight Ridder wire services.
Shortly after 4pm	Bernard Ingham briefs journalists with statement by Prime Minister.

After [illegible]pm	Text of 2 statements telegrammed to Posts
After 4pm	Bank of England intervenes as necessary, in London or through the Fed in New York, if exchange rate threatens substantial movement.
Early evening	Prime Minister speaks to press outside 10, Downing Street.
Early evening (possibly may be delayed till Saturday)	Monetary Committee meets in Brussels (unless Monetary Committee has agreed our proposal by telephone).
Late Friday evening (if possible; otherwise as soon as agreed)	Chancellor announces agreed central rates.
<u>Saturday</u>	
am (if necessary)	Finance Ministers meet in Brussels, followed by Chancellor statement.
<u>Monday</u>	Statement in Lords by Government spokesman.

chex.kf/kg1/34 **SECRET - ASDO**

COPY NO 1 OF 7
ref 3G 212

17a-e

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

PRIME MINISTER

EXCHANGE RATE MECHANISM

At our discussions yesterday you asked for a note on the mechanics which would be required if you were to announce at your Conference Speech on 12 October that we were joining the ERM that weekend.

... 2. I attach a note which sets out in schematic form possible alternative forms of words for you to use together with the different sequences of events which would be required in each case.

John M.

[j.m]

4 October 1990

pf.dc.oct.3.msc2

SECRET - ADSO

b

OPTION 1

Prime Minister simply announces entry - interest rate cut follows later.

Alternative A: PM's announcement in Conference Speech takes limited form - says government committed to joining, ERM membership a tough anti-inflationary policy, "time is rapidly approaching when we will join".

Sequence of events:

(i) PM's announcement at say 3.00pm; afterwards possible Bank intervention to keep market rate close to [£1 = DM2.95].

(ii) Around that time N Wicks (in Washington) sounds out Chairman of EC Monetary Committee who sounds out other members as to whether they can agree our request, with central exchange rate at [£1 = DM2.95] and 6 per cent margins without a meeting; or whether meetings (in Brussels on Saturday/Sunday) required.

(iii) Simultaneously Bank of England phones other central banks to secure their agreement.

(iv) Chancellor speaks to Carli; faxes sent to other ECOFIN Ministers, Commission, Chairman of Central Bank Governors' Committee etc.

(v) Cabinet Ministers contacted if possible, and told, shortly before

(vi) Chancellor confirms after markets' close (10pm) we have applied and terms agreed/under discussion.

(vii) If Monetary Committee/ECOFIN have to meet Chancellor announces result once agreed.

(viii) Chancellor statement to Commons on Monday 15 October.

SECRET - ADSO

(ix) Probable interest rate cut either soon after entry following £ strength; or somewhat later following £ stability.

Alternative B: PM's announcement more precise: says "applying to join, at a central rate of [£1 = DM2.95] and 6 per cent margins".

Sequence of events:

(i) PM's announcement; afterwards, possible Bank intervention to keep market rate close to [DM2.95]; shortly before speech Cabinet colleagues told in Bournemouth.

(ii) N Wicks consults as in Alternative A(ii); his task more awkward (Monetary Committee treated as a rubber stamp) but judged manageable.

(iii) Bank of England phones other central banks to secure their agreement.

(iv) Chancellor speaks/faxes as in Alternative A(iv).

(v) Chancellor confirms result of Monetary Committee/ECOFIN's deliberations as to rate and terms.

(vi) Chancellor statement to Commons on Monday 15 October.

(vii) Probable interest rate cut either soon after entry following £ strength; or somewhat later following £ stability.

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OPTION 2

Involves combined announcement of ERM membership and 1 per cent interest rate reduction on 12 October.

Alternative A: (i) Bank announces 1 per cent interest cut before speech at one of regular dealing times;
(ii) PM announces ERM membership in speech, in following terms:

- disappointing September RPI; continuing oil price problems;

- but clear signs inflationary pressures now in check eg MO, low demand. Inflation will fall sharply next year;

- so scope for modest interest rate reduction today;

- but must keep policy tight;

- therefore have decided to join ERM now to reinforce firm anti-inflationary discipline. Proposing to member states rate [close to] [DM2.95] plus 6 per cent margins.

(iii) Bank intervenes to try to keep rate close to [DM2.95]; very difficult to achieve in interval between interest rate cut and ERM membership announcement.

(iv) [Shortly before speech Cabinet colleagues told in Bournemouth; or is this too risky?]

2

(v) N Wicks/Bank/Chancellor telephoning and faxing follows same arrangements as in Option 1; but weekend meetings much more likely because proposition more complex;

(vi) Chancellor announces result of Monetary Committee/ECOFIN deliberations as to central exchange rate and terms.

(vii) Chancellor statement to Commons on Monday 15 October.

Alternative B: (i) PM announces interest rate cut and ERM membership in speech in same terms as in Option 2, Alternative A.
(ii) Bank intervenes as necessary after speech to try to keep rate close to [DM2.95]; success cannot be guaranteed.
(iii) N Wicks/Bank/Cabinet Ministers/Chancellor telephoning faxing and weekend statement as in Option 2, Alternative A.
(iv) Chancellor Statement to Commons on October 15.

Alternative C: (i) PM announces ERM membership in speech in same terms as in Option 2, Alternative A, except that she omits passage on interest rate cut;
(ii) Bank intervenes as necessary after speech to try to keep rate close to [DM2.95]: success cannot be guaranteed.
(iii) N Wicks/Bank/Cabinet Ministers/Chancellor telephoning and faxing as in Option 2, Alternatives A and B; but negotiations with EC much more difficult, perhaps not deliverable, than with a fait accompli on interest rates.
(iv) Chancellor announces results of EC deliberations plus interest rate cut on Sunday.
(v) Chancellor statement to Commons on October 15.

chex.ps/jg/84

SECRET: ADSO

16 a-b

cc CDP
BP
BI

FROM: JOHN GIEVE
DATE: 4 October 1990
EXT: 4330

SIR P MIDDLETON

cc Sir T Burns
Mr Wicks
Mr Scholar
Mr P R C Gray
Mr O'Donnell

PS/Governor - B/E

HM TREASURY PRESS NOTICE

Following the discussion with the Prime Minister and some comments ... from the Chancellor, I attach a redraft of the press release which reflects discussion with Messrs Wicks, Scholar and Gray. I would welcome very quick comments so that I can send it for approval to the Prime Minister's office by 8.30 am on Friday.

JC

JOHN GIEVE

SECRET: ADSO

b

Text of HM Treasury Press Notice to be issued at 4.00 pm on Friday, 5 October 1990

UK REDUCTION IN INTEREST RATES AND ENTRY TO ERM

At 4.00 pm today the Chancellor of the Exchequer, the Rt Hon John Major MP issued the following statement:

"It has become increasingly clear ~~[in recent months]~~ that the Government's tough policies of high interest rates and firm budgetary control are having their effect in reducing inflationary pressures in the economy. Monetary growth has fallen sharply and the growth of demand has slowed ~~markedly~~. ~~Although prices are still rising under the impact of the increase in oil prices~~, the prospect is for a substantial reduction in inflation ~~next~~ year both in absolute terms and in relation to inflation in other European countries.

In these circumstances, a reduction in interest rates is now justified, so from Monday morning the Bank of England will reduce interest rates by 1 per cent to 14 per cent.

A tight monetary policy and a firm exchange rate remain essential to bring inflation down. To reinforce our framework of monetary discipline, we have decided that the UK should now join the Exchange Rate Mechanism of the European Monetary System. We have proposed therefore to our European partners that we should join the ERM on Monday morning with a central exchange rate around DM2.95 and with 6 per cent margins."

SECRET AND PERSONAL - ADSO 15a-b

Bank of England
London EC2R 8AH

The Governor

4 October 1990

The Rt Hon Margaret Thatcher MP
Prime Minister
10 Downing Street
London
SW1A 2AL

Dear Prime Minister,

I am very sorry not to be able to attend your meeting this afternoon but John Major and I have come to the conclusion that it is probably wiser, from the security point of view, that I should stick to my established programme for my tour to Japan and the Far East. I hope, however, that it may be useful if I try to summarise my views to you on paper.

I think that entry into the ERM on the right terms will be seen as a strong policy signal by the market and this will, in turn, provide a good chance of an outstanding result and success for the Government. I mean by this that the exchange rate will strengthen and will provide an opportunity for an early, but justifiable and sustainable, cut in interest rates. Such an outcome cannot obviously be guaranteed and it is possible that the exchange rate will not rise immediately and the interest rate cut might consequently have to be delayed, although it is my personal opinion that it will not have to be delayed long.

I regard the chances of a reversal for policy - namely, a fall in the exchange rate putting upward pressure on interest rates - as small. I do, however, think that there is a risk that the policy signal to the markets would be seen to be weak if an emphasis on lower interest rates is made by cutting them first, or at the same time, as ERM entry. The markets would be confronted with two

conflicting but simultaneous influences; strengthening of the exchange rate arising from ERM entry and weakening of the exchange rate flowing from the lower interest rate. In this situation I think there will be only very little chance of seeing the exchange rate strengthen and the best that we could hope for would be that it would be reasonably steady.

But there is a strong chance that such a move would produce downward pressure in the exchange market and this would increase the risk of pegging into the ERM at a rate which locked inflation into the economy. A prior or simultaneous lowering of interest rates would certainly complicate the entry negotiations, create confusion in the financial markets with consequent accusations that we had bungled an important policy move and there would be a chance, that we could not ignore, that we would have to reverse the interest rate cut.

I see the fall in interest rates as a deserved and justifiable dividend from entering into the ERM and one that could well be distributed quite promptly after the event. I do think, however, that we should avoid distributing the dividend before we have been seen to have "earned" it.

I am copying this letter to John Major.

Yours ever,

Robin

ADSO – SECRET

14

10 DOWNING STREET

From the Private Secretary

Prime Minister

Mechanics of ERM Entry

The Treasury's note raises three separate issues

(i) The forward

Option 1A suggests "time is rapidly approaching ...." This is hopeless. What does Bernard say between 3pm and 10pm? Could be misinterpreted as meaning within the next three weeks. You must say we have applied today.

(ii) Is the new central rate specified?

The Treasury would prefer not so that discussion in Monetary Committee is not preempted. The case for is that it will condition market expectations and reduce risk that exchange rate moves strongly in either direction, thereby minimising need for intervention

(iii) Should interest rates be cut then or later?

The argument for is that it allows a full statement of Government policy and gives the market all the information it needs in one go. The argument against, set out in the Governor's letter, is that the risks are asymmetrical. A fall in the exchange rate in response to the cut would do more damage than a rise on the back of the announcement. I have now come down in favour of later as otherwise sterling is dangerously exposed between 3pm when the cut is announced and 10pm when statement is issued following consultations with partners. If the cut is announced at 3pm I think it would be better to announce the proposed rate as well in order to minimise scope for fall.

Central rate

AT
4/9

chex.ps/adso/20 **SECRET AND PERSONAL:**
ADSO UNTIL 4.00 PM FRIDAY, 5 OCTOBER
then UNCLASSIFIED

13

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

5 October 1990

Barry Potter Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Barry

ERM

... I attach a copy of the Chancellor's statement and question and answer briefing.

Yours ever Tarkowski

T TARKOWSKI
Private Secretary

chex.ps/jg/88

ERM AND INTEREST RATE REDUCTION

Key facts

- Central rate around DM2.95
- Initial 6 per cent margins, like Spain

Inflation

- Made clear in Washington that headline figures less important than prospective movements from now on
- Tight monetary policy now clearly feeding through; expect inflation to peak soon and then decline sharply next year
- Satisfied that further progress now more easily achieved within ERM discipline than outside

Other Madrid conditions

- Substantial progress on all key European fronts - free movement of capital, single market, competition policy and liberalisation of financial services

Move to Narrow Band?

- Intention, as soon as conditions permit and with agreement of partners, to move to a narrow band

Level of Exchange Rate

- Real effective exchange rate and real £/DM rate are both close to average over the 1980s

Interest rate cut

- 14 per cent still very high figure
- Determined to keep monetary conditions tight. Now reinforced by ERM discipline; not a soft option
- Small easing justified by money figures. M0 12 month rate 4.9 per cent in August and has stayed in range in September. M4 12 month rate has fallen steadily since January to 15½ per cent in August, lowest since November 1987
- Clear signs that economic activity has slowed
  - * manufacturing output falling for three months
  - * retail sales 1 per cent lower in latest quarter over previous quarter
  - * car sales 14 per cent down on last year
  - * housing market flat
  - * CBI survey shows low confidence
  - * unemployment has stopped falling and started to rise

Political move pre-Conference?

- No. Interest rate reduction fully justified by latest indicators - indeed we have moved later than many wanted
- Repeatedly made clear our intention to join ERM. Had to wait until certain that economy had entered disinflationary phase.

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ERM ENTRY BRIEF: BEFORE TERMS AGREED

FACTUAL

(i) Sterling will be joining the exchange rate mechanism of the European Monetary System with effect from the start of business in London on Monday 8 October. Base rates will be reduced at the same time by 1 per cent, to 14 per cent.

(ii) Sterling will enter the mechanism at a central rate against the DM of around 2.95 compared to market rates of 2.93 at close of business on Thursday 4 October in London and at 10.00 am today (Friday) of just under DM 2.94.

(iii) Sterling will enter the mechanism with 6% bands around its central rate.

(iv) Details of the entry rate and intervention limits are subject to agreement by our Community partners.

(v) Precise details of sterling's central rate and upper and lower intervention limits against each of the other member currencies will be announced once agreement has been reached with our Community partners.

(vi) Sterling Exchange Rates

	£/ERI	$/£	DM/£	FFr/£
1985 Av.	100	1.30	3.78½	11.5495
1986 Av.	91.5	1.47	3.19	10.1569
1987 Av.	90.1	1.64	2.94	9.8369
1988 Av.	95.5	1.78	3.121/3	10.5969
1989 Av.	92.6	1.63¾	3.09	10.4476
1990 Av. (to Oct 3)	90.3	1.7333	2.8596	9.6335
Close Thursday 4 October (London)	93.7	1.9087	2.9318	9.8164
10.00 am Friday 5 October	93.9	1.9112	2.9379	9.8408

(vii) Conditions for sterling's entry to ERM spelt out by Prime Minister at Madrid Summit: Government committed to join ERM

when level of UK inflation is significantly lower, there is capital liberalisation in the community and real progress has been made towards completion of single market, freedom of financial services and strengthened competition policy.

(viii) UK inflation rates cf Europe excluding mortgage-interest relief and community charge:

	UK	ERM AVERAGE
12 months to		
April	6.5	4.0
May	7.0	3.9
June	6.9	3.9
July	7.0	3.8
August	7.9	4.3

(ix) At DM 2.95 sterling's real effective exchange rate and real rate against the deutschemark are both quite close to their historic average levels.

(x) UK inflation since Madrid

	HEADLINE	EXCL MORTGAGE INT PAYMENTS & COMMUNITY CHARGE	EC
June 1989 (Madrid)	8.3	5.8	5.5
July	8.2	5.7	5.6
August	7.3	5.5	5.2
September	7.6	5.7	5.3
October	7.3	5.9	5.4
November	7.7	5.9	5.4
December	7.7	6.0	5.4
January 1990	7.7	5.9	5.2
February	7.5	6.0	5.3
March	8.1	6.2	5.4
April	9.4	6.5	5.4
May	9.7	7.0	5.5
June	9.8	6.9	5.5
July	9.8	7.0	5.5
August	10.6	7.9	6.0
September	-	-	-

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(xi) Evidence that monetary policy working/interest rate cut justified.

(a) Monetary aggregates have slowed in recent months, with MO moving back well within its target range and with M4's 12 month growth rate in August at 15.5%, the lowest figure for nearly three years.

	MO	M4
JANUARY	-	18.4
FEBRUARY	-	18.1
MARCH	-	17.5
APRIL	7.3	17.5
MAY	6.9	17.3
JUNE	6.5	16.9
JULY	5.5	16.3
AUGUST	4.9	15.5
SEPTEMBER	Estimated at around 4¼	-

(b) Retail sales down 1 per cent in latest 3 months over previous three months and only 1½ per cent up on a year ago.

(c) New car registrations now 13 to 14 per cent lower than a year ago.

(d) Housing market flat.

(e) CBI report confidence, output, orders sharply down.

(f) Imports have slowed down as have exports, with three month on three month comparisons showing both clearly slowing.

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(xii) Band Width?

We have proposed a band width of plus or minus 6% from its central rate against each of the other currencies. This is in line with the initial band width adopted for other currencies which have joined the ERM.

POSITIVE

(i) Participation in exchange rate mechanism

- will reinforce Government's counter-inflationary policy.

- will help avoid volatility in European exchange rates - giving UK business greater confidence to plan ahead in Europe.

- confirms Government's commitment to stage 1 of Economic and Monetary Union.

(ii) Very clear signals from economy that tight monetary policy working (money supply, retail sales, manufacturing orders a sharply down) therefore appropriate to reduce base rates at the same time as entry to ERM, which will add to UK monetary discipline and continued fight against inflation.

(iii) Experience in recent years suggests that the ERM has helped participants to reduce inflation. Change in inflation 1979-1990 (to March)

ERM Countries	-4.9
cf European OECD excl. ERM	1.7
OECD excl. ERM	-2.7

(iv) The ERM has helped to bring greater stability to European exchange rates. Since the ERM has been in operation there have only been 12 realignments and these have become more infrequent.

(v) Government committed to join ERM as part of stage 1 of EMU. Have now done so within 4 months of commencement of stage 1 (1 July 1990). Taken together with most liberalised capital markets in Europe and the UK's first place in implementation of single market measures, UK can fairly claim to be in lead on putting stage 1 into effect.

(vi) Wide band gives markets time to adjust before sterling enters narrow band. Intend to move to narrow band, with agreement of partners as soon as conditions permit, once sterling has settled in system.

DEFENSIVE

(i) **Why join now?**

Conditions for entry have been broadly met. Satisfied that further progress (eg on inflation) can now be achieved better within the mechanism than outside.

(ii) **Madrid Conditions Met?**

Yes. There has been significant progress on all the key European fronts - free movement of capital, the single market, competition policy and liberalisation of financial services. And on inflation there are now clear signs that the Government's tight monetary policy is feeding through to the real economy. We are confident that inflation will be sharply lower next year. Further progress, on inflation in particular, will be more easily achieved in the ERM rather than outside.

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(a) Inflation?

[Madrid Condition: 'When level of inflation is significantly lower'; Chancellor in margins of OECD 30 May; 'wish to be certain that UK inflation is on a downward trend and a little bit closer to that of our Community partners': Chancellor 7 June; 'Inflation will not be assessed on the RPI but on a comparative basis to the measure in which European nations themselves assess inflation': Chancellor 26 September "But what matters here is less the difference between headline figures; which measure what has happened over the last 12 months, than the prospective movements in price levels from now on"].

The Government's tight monetary policy is now clearly feeding through to the real economy and we expect that inflation will peak soon and then decline sharply next year. Clearly would have liked more progress. But satisfied that monetary conditions now tight and that further progress on inflation will be more easily achieved within the ERM rather than outside.

(b) Free Movement of Capital?

All those countries required to abolish their exchange controls by 1 July under the 1988 Capital Liberalisation Directive have done so. Remainder bound to do so by 31 December, though for Greece and Portugal this may be extended for up to three years, if Commission accept case for more time.

(c) Real progress towards Single Market?

More than 60 per cent of measures necessary for completion of internal market have now been adopted or agreed in principle. Continued effort needed to maintain momentum, but considerable progress already made.

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(d) Real progress towards Freedom of Financial Services?

Second Banking Directive provides freedom to establish branches and provide cross border services anywhere in EC for banks authorised in their home state. Investment Services Directives, which will provide similar freedom for investment business, under discussion. Non-Life Framework directive for Insurance tabled by Commission in July. Clearly more to be done, but real progress is being made.

(e) Strengthened Competition Policy?

Commission acting to reduce state aids and ensure those that remain are fairer. Since September commission has power to block largest mergers which inhibit competition. Commission has proposed action programme to reduce barriers to takeovers across EC. Good progress made but vigorous enforcement of competition rules needs to be maintained.

(iii) Interest rate cut too soon

No. Monetary indications and evidence from real economy both pointing firmly to a significant slowdown in activity which justifies a cut in rates now. Confident that inflation will fall sharply next year.

(iv) Interest rate cut too late?

Important that government takes no risks with inflation. Time is right for the modest reduction announced, in light of all recent evidence of domestic economic slowdown.

(v) Further cuts to come?

Government firmly committed to maintaining tight monetary policy. Present cut only possible because of added discipline of ERM. No expectation of further early reduction in rates.

SECRET : ADSO

(vi) How does ERM help monetary policy?

Makes quite clear that Government committed to a strong exchange rate: so no hope of bail out for companies who fail to control costs and wages by a depreciation of sterling.

(vii) Deal between PM and Chancellor

Both Chancellor and Prime Minister agreed that circumstances warrant a modest interest rate reduction coupled with the added discipline of ERM. Interest rates must remain at what is historically a high level: we cannot take any chances with inflation.

(viii) Has cabinet agreed terms

Membership of ERM Government policy for a long time. Detailed terms matter for Chancellor in consultation with European Colleagues.

(ix) Joined too soon:

(a) Should have waited for further progress on Madrid Conditions

Matter of judgement. Key point is that progress being achieved in all areas covered by Madrid Conditions, including inflation where the Governments tight monetary policy is now clearly feeding through to the real economy.

(b) Should have waited until inflation much lower?

Would have liked to have made further progress. Economy clearly slowing down and we confidently expect rate of UK inflation to fall sharply next year. Satisfied that further progress in continuing fight against inflation will be better achieved in ERM.

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(x) Joined too late

(a) Another example of UK joining late on worse terms than if joined at start?

ERM not the sort of arrangement where early joiners necessarily have an advantage over others. When a new currency joins it is in everybody's interest that it does so at a sustainable rate and in appropriate band.

(b) Inflation would have come down significantly by now if we had been in ERM before?

Impossible to say. Experience suggests that ERM has helped participants achieve lower inflation rates. But ERM not a substitute for sound monetary policy.

(c) UK Interest rates would now be lower if in ERM earlier?

ERM entry not a soft option. Present cut only possible because of impact of high interest rates on real economy over a long period and added discipline of ERM entry.

(d) UK proposals on EMU unlikely to be taken seriously outside ERM - Chancellors proposals prejudiced by late entry?

Government made clear intention to join ERM in stage one of EMU. Have done so right at start. Can be no doubt about UK's commitment to stage one. Look forward to opportunity to discuss further the Chancellor's proposals for evolutionary approach beyond stage one with European partners.

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(xi) **Entry rate too high**

Government clearly committed to a strong pound. Firm exchange rate essential part of fight against inflation. Proposed Central rate close to historical real levels.

(a) **UK industry will be uncompetitive?**

Key to competitiveness is restraint of unit costs not devaluation of currency. Continued high inflation relative to UK competitors itself threat to competitiveness in long run. Participation in ERM at firm rate will help bear down on inflation.

(b) **Rate cannot be sustained?**

Believe fundamental strength of UK economy supports entry rate.

(c) **Interest rates will have to go back up again to sustain exchange rate?**

No reason why exchange rate cannot be sustained at lower interest rates, given the clear evidence of slowing in the economy and the prospect that inflation will fall sharply next year.

(a) **Monetary conditions too lax will fuel inflation?**

UK real interest rates remain at high levels at DM 2.95 exchange rate also firm. Government will not take risks with inflation.

(b) **Signals further fall in interest rates?**

Government determined to maintain firm monetary policy to bear down on inflation. And will continue to set interest rates at the level necessary to achieve that.

(xii) **Band too wide?**

Appropriate to be cautious and give markets time to adjust before entering narrow band. Intend to move to a narrow band, with agreement of our partners, as soon as conditions permit, once sterling has settled within the system.

(xiii) **Prime Minister reluctant to enter-forced on her by Europeans in Cabinet?**

No. Prime Minister fully behind decision to enter ERM and with proposed entry terms. Has issued statement to that effect.

(xiv) **Views of other Member States?**

Confident other ERM members will welcome sterling's entry. Participation by second most widely traded European currency clearly strengthens ERM.

(xv) **Implications for EMU?**

Government fully committed to stage 1 of EMU as shown clearly by our decision to join ERM. But believe further progress best by market-led, evolutionary change. Look forward to debate on UK's proposals this autumn.

(xvi) **Loss of Sovereignty - eg in exchange rate and monetary policy?**

Exchange rate always has been one factor in assessing monetary conditions and setting interest rates. Within ERM exchange rate policy for all participating currencies is agreed by all participating countries. But overall UK monetary policy remains sole responsibility of UK Government.

(xvii) Sterling now 'tied' to Deutschemark

Sterling now linked to all 9 member currencies. DM clearly plays major role - but as a strong, low inflation currency that is all to the good. With the accession of sterling, system overall now much stronger.

(xviii) Interest rates now bound to converge on DM rates irrespective of UK monetary conditions?

No. Experience shows that the system has worked with differences between interest rates for member currencies.

(xix) ERM membership will be deflationary?

ERM membership not a substitute for sound monetary policy but it will help bear down on inflation. That is all to the good.

(xx) ERM membership will cause unemployment?

Membership will reinforce anti-inflationary policy and thus have favourable effects on economy, including employment, in long run.

(xxi) How will sterling be kept within band?

Believe band reflects reasonable level for sterling in medium term. But if sterling reaches limits, the normal ERM commitments to buy/sell sterling to keep it in its band will apply. ERM arrangements for coordinated intervention, including mobilisation of funds of member central banks, provides effective mechanism for deterring short term fluctuations in exchange rates.

(xxii) If Intervention does not succeed/is prolonged have to increase/decrease interest rates?

Hypothetical question. Decisions on interest rates will continue to be taken, as now, on the basis of a wide range of factors. [If pressed: Exchange rates always have been one factor in assessing monetary conditions and appropriate level of interest

rates. But other factors, in particular the growth of monetary aggregates, are also relevant].

(xxiii) **Government would realign rather than increase/decrease interest rates?**

Ridiculous to begin talking about realignment now.

(xxiv) **Should have been opportunity for Parliament to debate entry**

Simply not practical to give advance warning of entry date. The Government's intention to join the ERM has been well known for some time, and there have been a number of opportunities for both Houses to discuss the ERM over the last year or so. A statement will be made in the Lords on Monday.

(xxv) **Labour Party views**

[Should join with 'sustainable' (competitive) exchange rate, expansion of social and regional funds and joint growth strategy].

Labour wish to join ERM only on terms which would impart inflationary bias to system. Wholly inappropriate to do so and, quite rightly, no prospect of other members agreeing. Reduction of inflation is only firm basis for sustainable growth.

(xxvi) **What will happen to mortgage rates now?**

Matter for banks and building societies.

(xxvii) **What happens if Germany raises Interest rates now were in ERM?**

Hypothetical question.

(xxviii) Previous shadowing of DM caused severe difficulties? Will happen again?

Sterling has not been in ERM before. Confident that a central rate of around DM 2.95 is appropriate and sustainable.

(xxix) What are the government's forecasts for inflation in the UK next year, compared with inflation in other ERM countries?

The headline inflation rate in the UK will probably peak soon and diminish noticeably through next year. And before long the tight monetary policy stance should deliver a lower underlying rate of inflation. New forecast will be published in Autumn Statement.

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I. Activity

1) Growth in money GDP fallen significantly over past year. Close now to growth rates consistent with Government's objectives for inflation (see table 1).

2) More recent evidence points to continued deceleration in demand.

On the consumer side

a) retail sales show fall of 1 per cent in latest three months compared to previous three months. Annual growth rates well below earlier levels (see chart 1);

b) as measured by EC Survey, consumer confidence remains at historically low levels (see chart 1);

c) new car registrations 14 per cent lower than year ago and no sign of turnaround (see chart 2).

On the company side

i) business investment fell by 2 per cent in 1990Q2 after long period of buoyancy. Companies destocked by some £¾ billion;

ii) commercial vehicle registrations May-July fell by some 22 per cent on year earlier (see chart 3);

iii) in 3 months to July new commercial construction orders down 11 per cent on year earlier (see chart 4);

iv) manufacturing output fell by ½ per cent in July, third successive month of decline (see chart 5);

v) CBI indicators show further weakening of orders in September and of output expectations (see chart 6);

vi) housing starts still weakening (see chart 4).

In the Labour Market

a) unemployment rose by 22,000 in August, fifth successive monthly rise (see chart 7);

b) overtime working has been falling. In July was 4½ per cent lower than a year before (see chart 7);

c) vacancies fell in August to lowest level since January 1986.

II. Monetary and Financial Developments

Monetary and financial data supports activity indicators in portraying decelerating demand.

Amongst the monetary data

i) M0 - good indicator of current conditions in economy - has decelerated significantly over last few months. Now comfortably within target range (see chart 8);

ii) broad money growth, M4, also fallen steadily over last few months (see chart 9);

iii) retail deposit growth, M2, growing at rates well below previous ones (see chart 9);

iv) bank/building society lending shows continued deceleration (see charts 10/11).

Amongst other financial data

a) equity prices, though remaining at healthy levels by historical standards, have fallen by 20 per cent since the peak in July 1989 (see chart 12);

b) company trading profits fell 8 per cent in 1990Q2 (though real rates of return remain sound). Recent results eg. ICI (unchanged dividend), BTR (4 per cent increase), Barratt (dividend halved) suggest more modest future dividend growth after long period of strong growth;

c) exchange rate been strong in recent months reflecting tightness of monetary stance (see chart 13).

III. But inflation remains high and worsening?

1) "Headline" RPI inflation has been rising and wage settlements tending to follow (see chart 14).

2) But this overstates inflationary picture:

a) RPI distorted by inclusion of mortgage interest payments. Producer output prices give better underlying guide. Inflation on this basis pretty flat (see chart 15);

b) deceleration in economy and fall back in overtime working will reduce impact of higher settlements on earnings growth (earnings growth flat in July at 10 per cent after period of rises).

3) Key point is that inflation turns down a little after economy has decelerated and inflationary pressure abated. That is normal pattern (see chart 16).

4) Already evidence of inflation turning down in some sectors:

a) house prices virtually stable after period of rapid growth (see chart 17);

b) construction output price inflation has fallen from 15 per cent 18 months ago to 6½ per cent on latest figures. Tender price inflation has fallen to zero.

These falls in inflation must be expected to spread throughout the economy in coming months.

IV. Oil price increases make it wrong time to cut interest rates?

Certainly higher oil prices unwelcome development in environment for defeating inflation. But

a) strength of sterling has moderated effect on UK inflation;

b) UK economy like other developed economies, much better able to cope with rise than at time of previous oil shocks.

c) non-oil commodity prices have fallen in sterling terms - by some 14 per cent over last year. Provides some offsetting beneficial effect (see table 2).

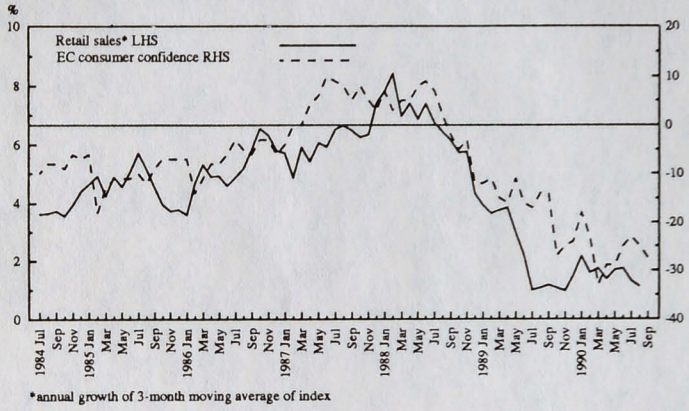
Table 1 : Economic Activity

		Half Years: Percentage Change on a Year earlier	
		Nominal GDP	Real GDP*
1988	I	11.7	6.0
	II	11.5	5.1
1989	I	10.8	4.3
	II	7.7	2.0
1990	I	7.6	1.5

* Excluding North Sea oil

Chart 1 : Retail sales and consumer confidence

■ **Both retail sales growth and consumer confidence well below earlier levels.**



*annual growth of 3-month moving average of index

Chart 2 : Car registrations

■ **Car registations around 15 percent lower than a year ago.**

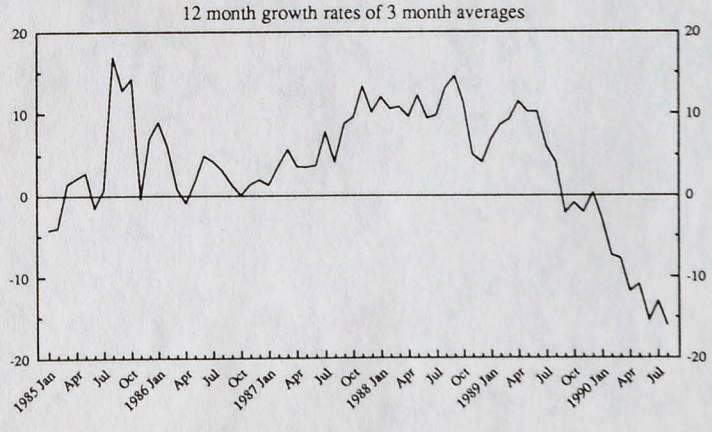


Chart 3 : Commercial vehicle registrations

■ **Commercial vehicle registrations in the three months to August were about 25 percent lower than a year earlier.**

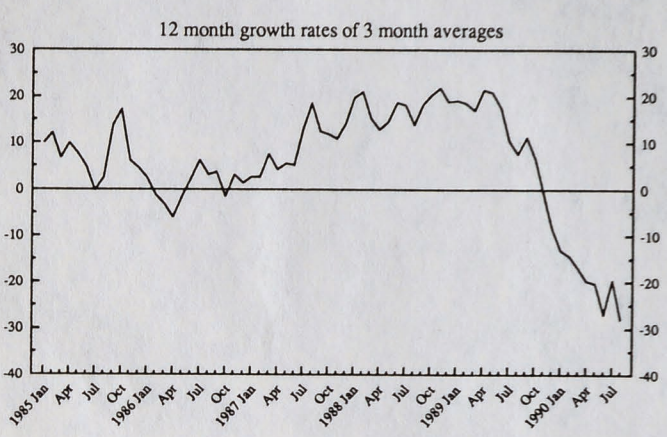


Chart 4 : Housing starts and construction orders

■ **Both housing starts and construction orders have fallen to low levels since the boom of 1988.**

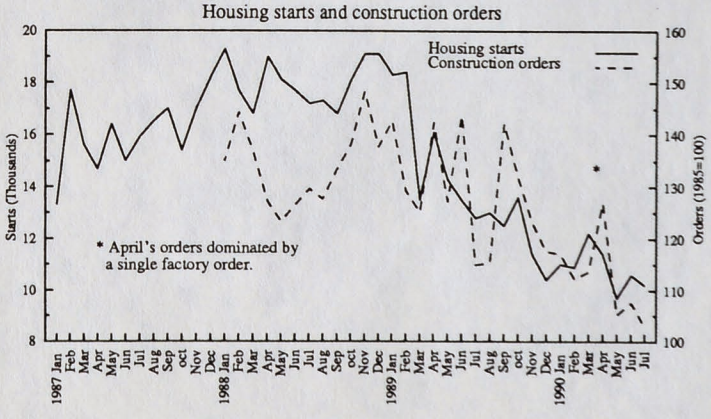


Chart 5 : Manufacturing output growth

- Manufacturing output growth slowed during 1989 and has remained low in 1990.

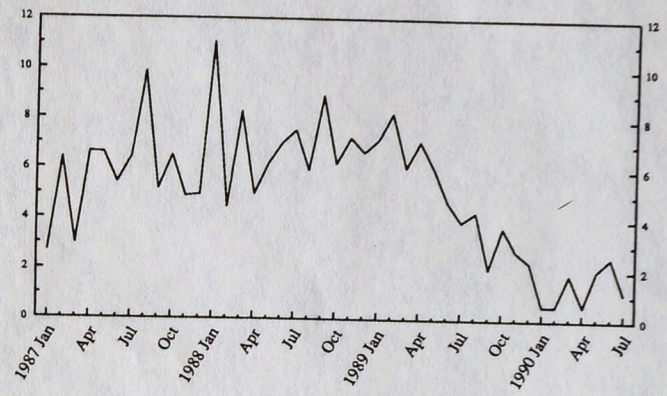
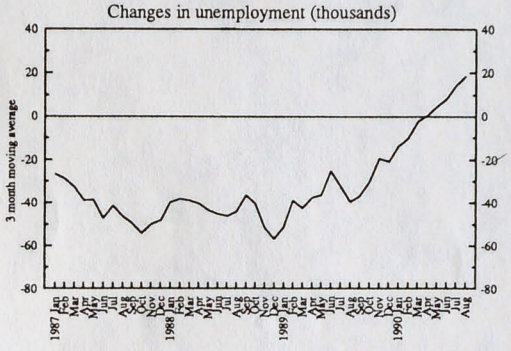


Chart 6 : CBI monthly indicators

- Balance on total orders has fallen markedly since early last year.
- Export orders have held up relatively well.
- Balance of firms expecting higher output has been around zero for several months
- Balance of firms with at least adequate stocks has climbed steadily since low point at end 1988

Chart 7 : Unemployment and overtime

■ **Unemployment - a lagging indicator of the state of the economy - has recently started to rise, having earlier fallen for over 40 months in a row.**



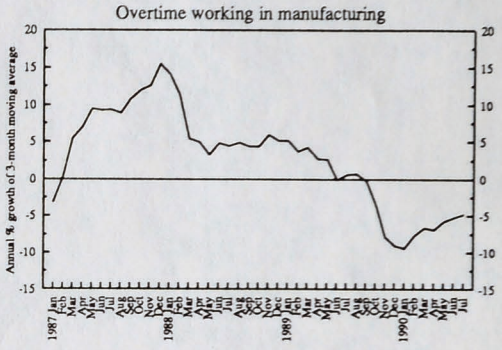


Chart 8 : M0 growth

■ **M0 growth now back in target range after a period above it**

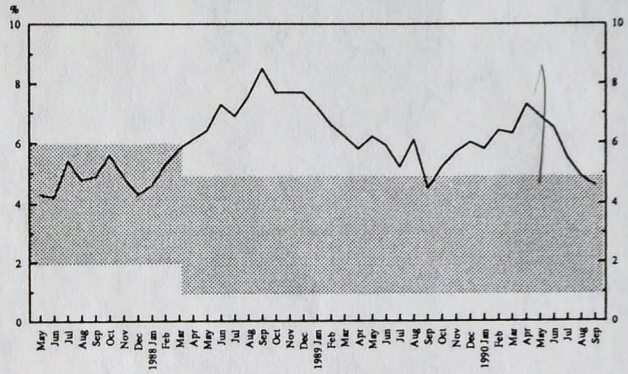


Chart 9 : Broad money growth

■ **Broad money growth has now fallen back decisively.**
M4 12 month growth rate in August was the lowest since November 1987.

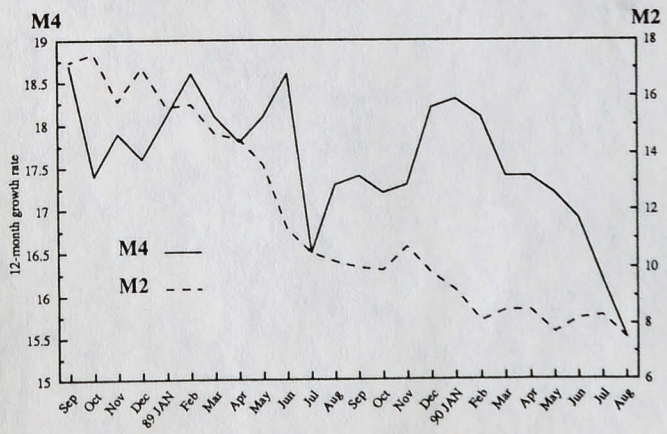


Chart 10 : Bank and building society lending

■ **Lending growth has been falling for well over a year. August's figure was the lowest since May 1986.**

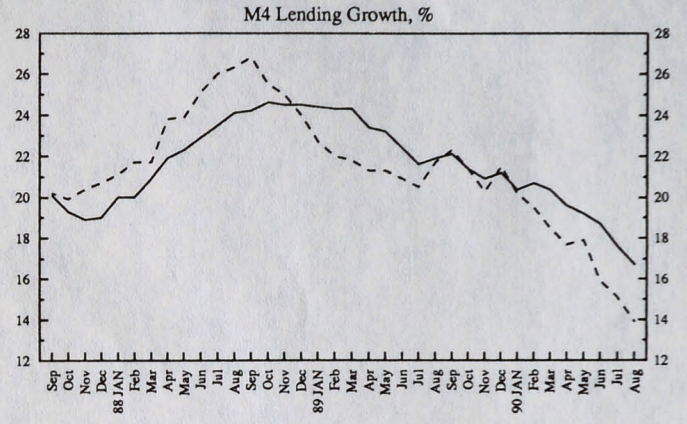


Chart 11 : Sectoral lending

■ **Lending growth has slowed in all sectors.**

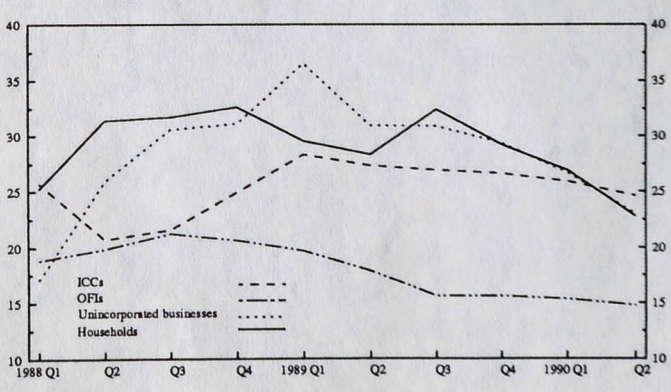


Chart 12 : Equity prices

■ **Equity prices, though at healthy levels, have fallen 20 per cent since the July 1987 peak.**

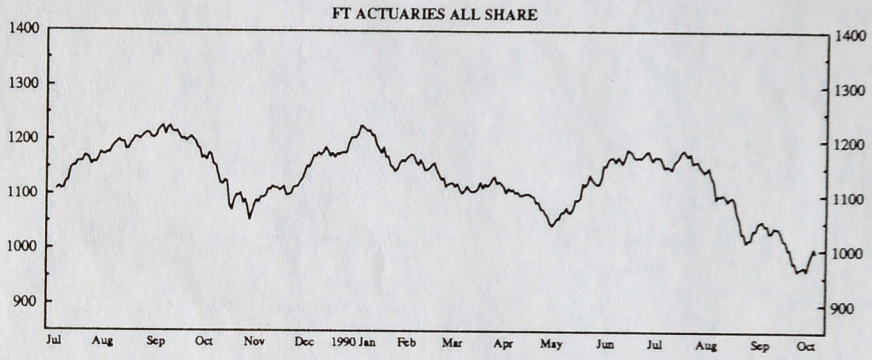


Chart 13 : Exchange rate

■ **ERI strong in recent months reflecting tightness of monetary conditions.**

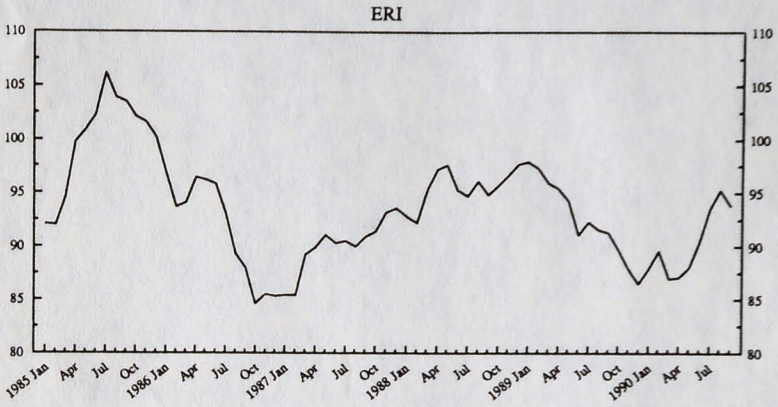


Chart 14 : Headline inflation

■ **Headline RPI inflation has been rising with wage settlements tending to follow.**

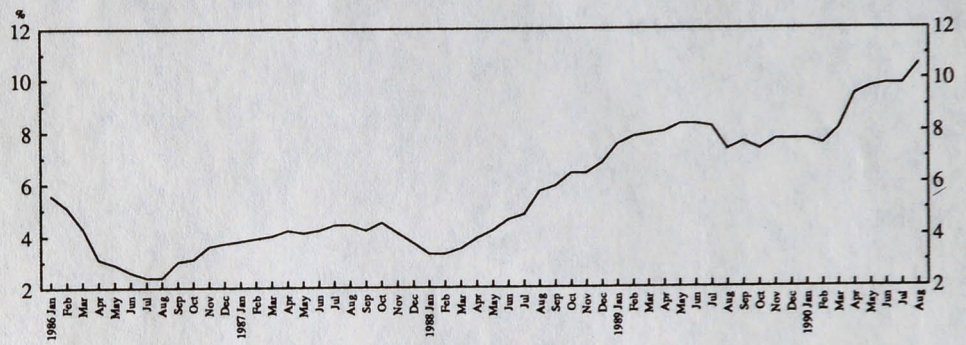


Chart 15 : Producer output inflation

■ **Producer output inflation has been relatively flat.**

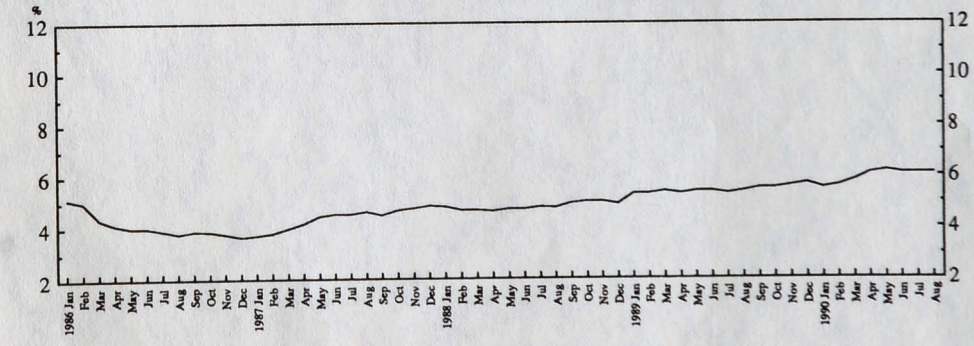
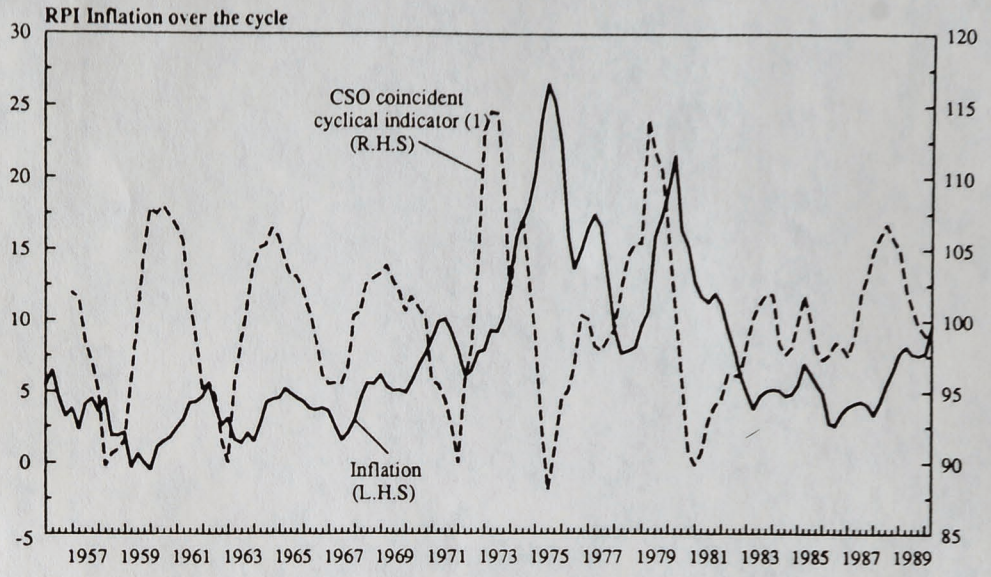


Chart 16



(1) - Long term trend = 100

Chart 17 : House prices

■ **House price inflation reached nearly 35 percent at the end of 1988. Over the last year house prices have fallen nearly 2 percent.**

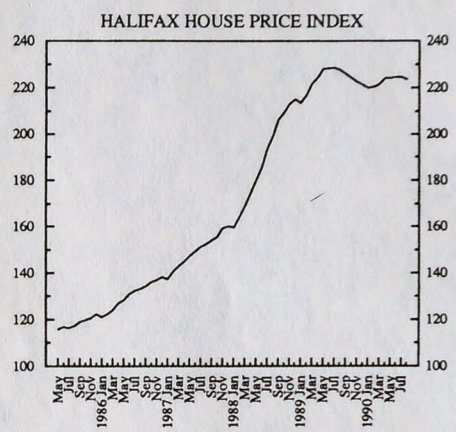


Table 2: COMMODITY PRICE INDICES (1985=100)

	SDR indices			All items
	Food	Non-food Agriculturals	Metals	Sterling
1984	112.3	111.6	106.2	107.2
1985	100.0	100.0	100.0	100.0
1986	92.4	89.9	85.4	86.4
1987	73.0	103.3	100.6	82.2
1988	85.7	109.6	156.2	103.3
1989	85.6	108.9	153.4	101.6
1988 Q1	77.6	105.5	133.4	95.9
Q2	84.0	115.1	169.1	109.1
Q3	92.9	114.0	157.9	111.7
Q4	88.3	103.6	164.4	107.7
1989 Q1	90.4	107.1	172.4	114.4
Q2	91.3	108.8	158.9	106.3
Q3	83.1	111.7	147.1	97.9
Q4	77.7	107.9	135.3	90.6
1990 Q1	76.9	106.3	120.1	96.1
Q2	80.0	109.4	129.0	99.4
1989 Sep	81.4	112.1	148.2	107.6
Oct	78.3	109.1	145.2	105.8
Nov	79.3	108.7	135.0	104.4
Dec	75.5	105.8	125.6	99.0
1990 Jan	75.2	104.8	115.2	94.0
Feb	75.5	106.0	113.8	91.9
Mar	80.1	108.0	131.4	102.4
Apr	81.5	109.6	129.6	101.8
May	81.4	110.0	129.7	100.9
Jun	77.1	108.6	127.8	95.6
Jul	73.4	105.7	128.2	90.0
Aug	70.6	99.3	136.8	87.5
Sep	70.7	98.0	142.1	90.8
Sep 04	70.6	98.9	138.7	89.5
Sep 11	72.3	99.4	149.3	94.5
Sep 18	70.5	97.4	146.0	90.6
Sep 25	69.5	96.2	134.5	88.6
Oct 2	68.7	95.9	133.9	87.4
% ch. on one yr	-13.2	-12.5	-8.2	-17.1

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Subject cc Master

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

4 October 1990

Dear John,

EXCHANGE RATE MECHANISM

Prime Minister and the Chancellor of the Exchequer discussed possible entry in the ERM. Also present were Sir Peter Middleton, Sir Terry Burns and Mr. Wicks (HM Treasury) and Mr. George (Bank of England).

There was agreement that conditions in the economy, whether judged by monetary indicators or indicators of activity, were such that a reduction in interest rates would be justified sometime in the next few weeks. But it was also agreed that to make such a reduction independently before any move on ERM risked causing the exchange rate to fall. Lower interest rates and a lower exchange rate posed an unacceptable risk to inflation.

The discussion then turned to whether a reduction in interest rates should be made simultaneously with the announcement of ERM entry, or whether entry should be announced and with the reduction in interest rates to be held back, to be implemented, it was hoped, a few days later if there were no adverse reaction to the announcement.

Mr. George said that the Governor's letter of 4 October set out the case for the second course. The Bank felt that a simultaneous announcement would convey a weaker message. In addition the risks were not symmetrical; if after the announcement the exchange rate rose, the case for a cut in interest rates would be strengthened. However, there was a probability, albeit a low one, that the balance of the upward pressure from the entry announcement could be outweighed by the consequence of the lower interest rate. If the exchange rate fell it would risk locking in at a lower central rate, with adverse consequences for inflation. It would be better to hold back the interest rate cut until the response to entry could be gauged.

The Prime Minister argued for acting simultaneously. She wanted to avoid the impression that the cut in interest rates was a bonus flowing from ERM entry - it was better to present it as fully justified by domestic conditions, with ERM entry providing an essential underpinning of counter inflationary policy. After

discussion it was agreed that the announcement of ERM entry and an interest rate reduction of 1 per cent should be made together.

Discussion then turned to the mechanics of putting this into effect. At this point the meeting was still envisaging that the announcement should be made in the Prime Minister's speech to the Party Conference. The Prime Minister did not think the formulation of "the time is rapidly approaching when we will join" suggested in Option 1A of the Treasury note of 4 October provided sufficient clarity. It would be better to say that the Government had decided to join over the following weekend and would be applying to do so at a central rate of X with margins of 6 per cent. One possibility would be to set a figure; another to say it would be close to present market rates. Either way, it was important to give the market a clear indication of the Government's intentions.

The meeting then considered the pros and cons of acting on Friday, 12 October, the day of the Prime Minister's speech to the Conservative Party Conference, or of accelerating the timetable to the next day, Friday, 5 October. The later announcement would come after the RPI figure for September (expected to be 10.9 per cent), and would to some extent divert attention from it. But the balance of advantage lay with acting as soon as possible. The exchange markets were stable, and the current exchange rate of DM 2.93 was very close to what we would like the central rate to be. It avoided the artificiality of inserting the announcement into a Party conference speech and allowed proper media follow up to be organised. It was agreed that 5 October was preferable.

There was an inconclusive discussion on the best time of day to make the announcement.

Summing up the meeting, the Prime Minister asked the Chancellor and officials to do further work on the modalities of an announcement the next day. This should cover:

(i) the text of the announcement

(ii) the timing of the announcement

(iii) the arrangements for convening the Monetary Committee

(iv) the media arrangements

(v) people to be contacted.

The meeting ended at 1700 and reconvened at 1915. Sir Peter Middleton reported on the results of the work done. It was recommended that an announcement should be made by the Chancellor at 1600, after the official close of European foreign exchange markets (and with it the intervention obligation of Central Banks). This would indicate that monetary conditions justified a cut of 1 per cent in interest rates and that to maintain a tight monetary policy the UK would be joining the ERM - the proposed central rate being close to DM 2.95 with 6 per cent margins.

The statement would be released to the tapes, and a press notice issued. A form of words for the No.10 Press Office would be prepared, plus a statement for the Prime Minister to use to camera in Downing Street at around 1715. The Chancellor would undertake a series of press interviews.

Mr. Wicks reported that he had sounded out Signor Sarcinelli, the Chairman of the Monetary Committee. The latter envisaged that UK entry would be welcomed, and he was ready to convene a meeting of the committee at short notice. Mr. Wicks suggested it would be better to try to secure this on Friday evening even though it meant warning people of an impending move earlier in the day (only the Chairman would be told in advance of the interest rate cut).

Mr. George said he proposed to talk to selected Central Bank Governors in the morning.

Concluding the discussion, the Prime Minister said it was agreed that sterling should now enter the ERM, and that this should be done in conjunction with a 1 per cent cut in interest rates. The arrangements suggested above were endorsed. The Treasury should refine the text of the announcement; prepare drafts of the statement for her and the No.10 Press Office, prepare the necessary Q & A material; and draw up a list of all those to be contacted and the times to do so.

I am copying this letter to Mr. George (Bank of England).

Yours sincerely
Andrew

ANDREW TURNBULL

John Gieve, Esq.,
HM Treasury.

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MEETING RECORD
SUBJECT CC MASTER

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

3 October 1990

Dear John,

EXCHANGE RATE MECHANISM

Following the discussion on the Public Expenditure Survey, the Chancellor stayed on to discuss the current economic situation and future policy. The Prime Minister asked him for his view on inflation and interest rates, and their implications for entry into the ERM.

The Chancellor said he now expected that the September RPI, which would be announced on the final day of the Conservative Party Conference, would show an annual inflation rate higher than August. He mentioned a figure of 10.9 per cent. Although he hoped this would be the peak, he could not be sure that it was. Much would depend on oil prices. Despite the course of the RPI, he was convinced conditions in the economy had changed in the last two months. The monetary squeeze was clearly biting hard and even if measured inflation continued to rise for a while, the conditions for achieving low inflation were now present. On interest rates, therefore, he believed a reduction could be justified in the next few weeks.

The Chancellor identified three courses of action.

(i) Interest rates could be reduced independently of ERM entry. He strongly advised against this as it could cause the pound to fall. Low interest rates and a weaker pound would give entirely the wrong signals.

(ii) Entry into the ERM and a cut in interest rates could be announced simultaneously. The advantage was that the market was given the full picture of the Government's intentions at one go. The disadvantage was that the entry could be misinterpreted as opportunistic, a move solely to gain lower interest rates.

(iii) Entry could be announced but action on interest rates delayed for a few days. This would allow the immediate reactions to be gauged before committing oneself to lowering interest rates.

b

The Chancellor indicated his preference for (iii). The Prime Minister agreed that an early cut in interest rates was justified, that it should be linked to ERM entry rather than free-standing, but she felt (ii) was better. The disadvantage identified could be overcome if, in presenting the move, it was explained that the reduction in interest rates was fully justified in terms of domestic monetary conditions.

On timing, the view in the Bank and Treasury was that the sooner entry was announced the better. They had reached this verdict without knowledge of how matters might develop in the Gulf but it was felt that it would be better for sterling to be in, should hostilities occur. If entry were delayed beyond October, the imminence of hostilities would cause postponement.

The Chancellor therefore recommended that the announcement should be made by the Prime Minister on 12 October in the course of the Conference Speech.

Before deciding finally on a 12 October announcement, the Prime Minister wanted to satisfy herself on the mechanisms. It would involve an announcement several hours just before the London market closed and several hours before US markets closed. The Chancellor agreed to prepare a paper setting out the forms of the words which the Prime Minister might use, the logistics of summoning the necessary Community meetings, and how these could be coordinated with the Prime Minister's speech. This would be discussed at the meeting arranged with the Chancellor on Thursday afternoon. As much of the discussion would be on modalities, Sir Peter Middleton, Mr. Wicks and Mr. George should also join the meeting. (You subsequently informed me that the Governor would still be in the country and would wish to attend.)

The discussion also touched on EMU. The Chancellor reported on his conversation with Beregovoy in Washington on which he had made it clear that there was no prospect of the UK adopting a single currency other than through the market process it had indicated. The French were mistaken if they believed the UK would jump on to the EMU bus at the last minute. The Prime Minister agreed there was no prospect of the UK Parliament legislating for a single currency. The announcement of entry into the ERM should make this clear.

Yours sincerely

Andrew

ANDREW TURNBULL

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

ADSO - SECRET

chex.kf/jg1/31

COVERING CONFIDENTIAL

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

3 October 1990

Charles Powell Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Charles

CHANCELLOR'S MEETING WITH FRENCH MINISTER OF FINANCE

You may be interested to see the attached record of the Chancellor's meeting with M. Beregovoy in Washington. As you know, the latter emphasised how important it was that the Prime Minister should meet the President to discuss EMU.

I should add that in the discussion before lunch, M Beregovoy implied that he would himself welcome an opportunity to meet the Prime Minister. The Chancellor did not respond to this hint and we have not heard any more about it yet.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

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CONFIDENTIAL

NOTE OF A DISCUSSION OVER LUNCH
AT HM AMBASSADOR'S RESIDENCE WASHINGTON ON 24 SEPTEMBER 1990

Present:

Chancellor of the Exchequer
Mr Wicks

M. Beregovoy, French Minister of Finance
M. Samuel-Lajeunesse
M. Authman

.....

The whole of the discussion concerned EMU. The conversation was carried out through an interpreter.

2. The Chancellor said he had found the discussion in ECOFIN in September most interesting. The German position, in particular, was open to different interpretations and might not become clear until after their elections. He would be interested to hear the Minister's views on the timescale for moves to EMU, on whether dates or conditions should be set for the move from Stage 1 to Stage 2 and on how the preparations for the IGC should proceed.

3. M Beregovoy agreed that the German position was not wholly clear. While Kohl and Genscher favoured EMU, Poehl and Waigel were concerned not to proceed too quickly (although it was not quite clear whether Poehl's remarks were intended to slow down the whole process fundamentally or to pave the way for a more rapid union of an inner core). However there was a clear agreement among most Community countries on the final goal: a single currency controlled by a European Central Bank which would be independent but democratically accountable. The question was how to get there. One issue concerned the starting date and nature of Stage 2. The French hoped that a treaty would be ratified by the

beginning of 1993 and would like Stage 2 to start then but might be willing to delay the start for a year. He had discussed with the Dutch their proposals on the transition. He thought they might offer a way forward although he had made clear that the independence of national central banks should not be a precondition of making the move to union but a part of that move. The French Government had not reached final positions on a number of questions. For example Stage 2 might have to be longer than the Commission had proposed and perhaps there could be a requirement for a unanimous decision to move to Stage 3. There might also need to be provision for longer transitional periods for certain countries. The form of the Treaty was also not yet clear. The French were keen for all 12 to participate. But the central question remained how far the UK could go and wished to go.

4. The Chancellor said that there was a minority in both the major parties in Parliament against any development of the Community. There was also a much more widespread opposition to giving up the control of finance that was the basis of Parliament's power. In addition to this concern over sovereignty there was a concern that a move towards economic union which preceded economic convergence would be profoundly damaging and disruptive. At present, even if the Government wished to accept the Commission's approach to EMU, it would not be able to carry it through Parliament. That was the background to our proposals on the hard ecu. These were not just tactical proposals but a genuine attempt to find a way towards economic and monetary union around which all 12 could unite. Moreover, they had the advantage of providing a practical way beyond Stage 1 and a way which would help to bring about the convergence that our partners were eager to see. In answer to a question, the Chancellor said

that we were committed to joining the ERM not least because of the lesson we had learnt from French experience over the last 5 years. We would join as soon as it was sensible to do so.

5. M Beregovoy said it would certainly help in the negotiations if the UK had joined the ERM. But the central question was whether we wanted to move to a closer political union in Europe. Certainly within France EMU was seen as part of and a condition of closer political union. If the UK could not accept the final goal of a single currency there might at some point be a breach with the majority of the Community. That was certainly not what he wanted. It would be more difficult to build a monetary union without the UK. Turning to the IGC, he said that one issue was whether the October European Council should give it a mandate or should simply leave it to do its best within the agreed time scale.

6. The Chancellor said that there was a risk of the emergence of an inner core if the pressure continued for a rapid move towards EMU. That would be disastrous. M Beregovoy agreed that it would be very difficult and undesirable so it was important to clarify common ground. He said it was very important therefore for the Prime Minister to talk directly to the President.

7. The discussion then turned to our hard ecu proposal. M Beregovoy said it was not clear a thirteenth currency would help. Under a competitive system one currency might dominate the others. It was not plain that it would bring about convergence. The Chancellor explained that the system would work as a powerful discipline on governments to converge on low inflation. M Beregovoy asked whether an independent EMF might not give rise to the same problems of sovereignty as the Delors prescription. The Chancellor said that the exact constitution of the EMF was for

discussion but there was a major difference between our evolutionary approach, in which people and markets would decide on the use of the ecu, and the prescriptive approach in the Delors report under which a single currency would be imposed by government fiat. He pointed out that it was not at all clear how the ESCB could be both independent and politically accountable.

8. M Beregovoy agreed that there was a real issue and that was why there should be separate arrangements for external policy, arrangements for the ECSB to report to democratic institutions, and the ECSB's members should be appointed by politicians. He was still not sure how the hard ecu proposals would work but he did not wish simply to set them aside. They needed to be examined at the IGC.

9. The Chancellor said that the UK would play a full part in the IGC negotiations. It was important that there should not be prior decisions upon dates. A large number of difficult political issues were bound to arise in the detailed discussions and it was important to proceed at a sustainable pace.

10. M Beregovoy said that the French could be flexible about dates providing there was agreement on the "architecture". There were those who were looking for EMU through institutional change, the traditional approach of the French and Italians, and those looking for a more pragmatic path. The risk of the UK's approach was that it might not lead to European union at all. If the majority supported the European Commission proposal that would either lead to a breach with the UK or, possibly, to the UK joining the majority at the end of the negotiations.

11. The Chancellor said that while we had come round in the end on other issues, that would not be true on EMU. If the other

States pressed ahead with the Delors prescription we would not join them; indeed such pressure would strengthen the hands of opponents of the Community within Parliament. Of course, the others could proceed without us but that would have a big cost for the Community, destroying the balance between France, Germany and the United Kingdom.

12. M Beregovoy emphasised that he did not want to see a breach with the UK. In his view it would absurd to proceed with monetary union without Italy and the UK. The UK played a key role in the WEU and in political cooperation in Europe; it was essential that they should also play a role in the monetary union. But there remained some doubts on whether the UK was committed to "building Europe". If that was clear it should be possible to come together pragmatically. He referred again to the fears of those who wished to tie Germany down for fear that it would become too strong and too oriented to the East. He did not take that view himself.

13. The Chancellor said that the UK certainly did wish to build up the Community. The process of convergence and greater unity was bound to continue. As for Germany he shared the Minister's view that its links with the West were indissoluble. But one way of ensuring that it did not begin to look East was to give the Eastern Europeans themselves the prospect of joining the Community in due course. That prize would be at risk if an inner core proceeded to closer union.

14. M Beregovoy said that President Mitterrand had this in mind when he spoke of a Confederation of Europe but he also wanted a strong federation. In practice Czechoslovakia and Hungary would not be ready to join the Community for many years and attempts to tie their entry to further strengthening of the Community could

look like a delaying tactics. He repeated that it was very important for the Prime Minister to meet the President and talk through these issues.

[We tried]

JC

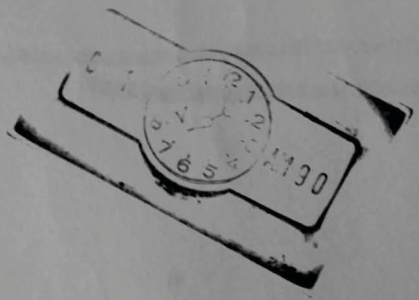
JOHN GIEVE

3 October 1990

Distribution

Financial Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Scholar
Mr R I G Allen
Mr Gray
Mrs M E Brown
Mr O'Donnell
Mr Macpherson
Mrs Chaplin

PS/Foreign Secretary



E. R.

ADSO - SECRET

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PRIME MINISTER

MEETING WITH THE CHANCELLOR ET AL

You are meeting the Chancellor again tomorrow to discuss the options for entering the ERM and reducing interest rates over next weekend, 12-14 October.

Those attending the meeting will be as follows:

The Chancellor
Sir Peter Middleton
Sir Terry Burns when was he added?
Nigel Wicks
Eddie George

Because the limited number of officials involved are having to think through carefully all the modalities, it will not be possible to get a Treasury paper until tomorrow morning. It should then be possible for you to consider it over lunch.

Though the precise form is not yet finalised, my understanding is that the paper will comprise the following:

(i) An exploration of the options. There are two broad approaches - joining the ERM and cutting interest rates at the same time; and joining the ERM and cutting interest rates a little while later. In practice, Treasury have discovered that these two broad options fairly quickly dissolve into a larger number of sub-options.

(ii) The mechanisms and modalities of these options. This will identify the necessary steps; who would take them; when they would be announced; when they would be taken; and the risks of inadvertent leakage.

E. R.

(iii) A draft section for your Party Conference speech. (It is not clear whether this will be ready in time for tomorrow.)

(iv) Presentation of ERM entry and reduction in interest rates. This would include references to UK policy on EMU. It would also deal with the response to anticipated criticisms.

Mr. Turnbull and I are of course available to discuss the Treasury paper with you before the ~~3pm~~ 3.30p.m. meeting.

BHP

BARRY H. POTTER

3 October 1990

A:\economic\barry (pmm)

Charles

I have agreed with Amanda Ponsonby that I will ring next Tuesday when you get back from N.Y. & see if I can be fitted in. I do hope it will be possible before the Party Conference takes over in the PM's mind.

Michael

HAMBROS

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 071-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

26 September 1990

Charles Powell Esq
10 Downing Street
London
SW1

Dear Charles,

EMU

May I trouble you with more advice on the Delors plan for economic and monetary union? I feel obliged to write because my conversations with those concerned in Brussels and elsewhere have convinced me that there is a risk that we shall be manoeuvred into a very weak position. This would happen if, as now seems only too probable, the Central Bank produce a Pöhl-type draft statute for a Central Bank in Stage 3 to which all the others will put their name and there will be nothing else on the table. Since it would be unacceptable to many of them to plan to ratify Treaty amendments for Stage 3 and then to do nothing for many years, this outcome would play into the hands of those who want a short Stage 2 and EMU to start with 5 or 6 members.

2. From what one or two of my French friends have let drop, I strongly suspect that an important French motive for backing this solution is to have a clear run for four or five years with the Banque de France as a principal operating arm of the ESCB and the Bank of England outside the system. This would greatly improve the competitive position of Paris (and Frankfurt) viz-a-viz London. It is therefore urgently necessary for us to table counter proposals including Treaty amendments and a draft EMF Statute to provide the institutional framework for our Stage 2.

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3. Everyone I have spoken to on the Continent is firmly of the view that there could be no agreement with the UK unless we accept the aim of a single currency in Stage 3. Leon Brittan was clear about this in a talk he gave in London last week. Those who see merit in our proposals do so because they regard them as the best way of getting from Stage 2 to Stage 3 without shocks to the economy. I have stressed to Tietmeyer and others that one of the advantages of our proposals would be that the EC would not move to Stage 3 unless the markets had accepted the hard ecu and unless the European Monetary Fund was managing it successfully in the interests of price stability. The responses I got encourage me to believe that, if the Prime Minister were to accept the recommendations in my letter of 6 September, the negotiation would start to move our way.

4. The private sector members of my European Committee, who are quite a powerful set of City practitioners, unanimously approved a paper at the Committee's meeting on 12 September recommending to the Government that it should accept in the Treaty the aim of a single currency one day and should now table proposals for the institutional and Treaty implementation of Stage 2.

5. The Prime Minister may feel that it is too early to make any move. But this is one of those situations which arise in the EC from time to time when an early move enables one to gain a lot more ground than the same move made later on when the negotiation has passed on.

Yours ever

Michael

Sir Michael Butler

SECRET AND STRICTLY PERSONAL

11

MR TURNBULL

ERM

I have been through your minute and the Chancellor's statement with the Prime Minister. She is pretty indignant, both with the Governor's reaction and what she regards as a 'panic' statement by the Chancellor. There is talk of being back to 'Lawson days'. But the storm has subsided and I think that I have dissuaded her from any immediate activity such as tearing a strip off the Chancellor and the Governor. But there are some points which she will very likely pursue with the Chancellor when they next meet:

- she resents the introduction of new statements such as "at the earliest sensible date" and "relative inflation" when she herself has stuck loyally to agreed formulations;

- she thinks the formulation "... not seeking delay, just awaiting the right circumstances .." is very weak;

- she has commented that the passage on oil is pure nonsense. In so far as it has any meaning, it relates to balance of payments not inflation;

- she is convinced that whatever he may now say, Poehl was referring to ERM and not to EMU.

The only point on which she is insistent that we must follow up is to write to David English about the flagrant misreporting of her press conference by the Daily Mail. She thinks they should publish an apology. Perhaps Bernard should pursue this.

CHARLES POWELL
22 September 1990

CDP

SECRET AND STRICTLY PERSONAL

SECRET

MR. POWELL

ERM

As I explained on the 'phone, the markets have been extremely turbulent and a degree of stability has been achieved only through intervention of $500 million involving action in Frankfurt and New York, as well as London. The markets have chosen to interpret the Prime Minister's remarks in Berne yesterday as meaning that the prospect of ERM entry has been put off for some considerable time.

The Governor 'phoned in a state of some anxiety, principally to let off steam about what he thought were ill-chosen words. He was pressing for a statement on the lines that the Chancellor was "optimistic" about UK entry and that the Prime Minister shared this view.

I believe the causation is the other way round. Market sentiment has changed and it will seize upon words which can be adduced in evidence. Nevertheless, the Chancellor thinks he need say something in Washington to reassure the markets. I attach a copy of the statement which he has released around 1630 hours London time.

I suggest that if the No. 10 press office are questioned about it, they should make clear:

(i) that policy has not changed and that the Madrid conditions have not been reformulated;

(ii) that the Chancellor and the Prime Minister are at one;

(iii) that Pohl's remarks related to EMU and as such were consistent with UK views, and not to ERM.

I suggest we refuse to be drawn on the reference to the different impact of oil prices which seems to be pure obfuscation.

AT

ANDREW TURNBULL

21 September 1990

c:\pps\erm (slh)

SECRET

Both the Prime Minister and I have made clear that it is our policy to enter the ERM at the earliest sensible date. We are not seeking delay, just awaiting the right circumstances, as the Madrid conditions made clear.

We have, therefore, to consider relative inflation. And what really matters is what happens from now on. The oil price rise is affecting both our inflation rate and that of our European partners. Indeed in some ways we are better placed than others to handle oil price rises.

The remarks attributed to Herr Poehl the other day concerned the dangers of a premature move towards EMU. These are dangers I have been emphasising for months. His remarks did not relate to our entering the ERM - as he subsequently made crystal clear.

I am sure that entry is the right policy and we will not delay when the opportunity occurs. I am confident that our entry will be welcomed by our European partners. I expect no difficulty with this - our colleagues are keen for us to join.

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IMF/IBRD WASHINGTON FOR PS/CHANCELLOR

EMU: FINANCIAL SECRETARY'S VISIT TO PARIS

SUMMARY

1. THE FINANCIAL SECRETARY DISCUSSED EMU WITH A GROUP OF INFLUENTIAL FRENCH POLITICAL AND FINANCIAL FIGURES AND OPINION FORMERS OVER LUNCH ON 20 SEPTEMBER. THE DISCUSSION, WHICH COVERED BOTH THE POLITICAL AND TECHNICAL ISSUES INVOLVED, WAS LIVELY AND PROFOUND. IT CONFIRMS THAT THERE IS STILL A DEBATE TO BE HAD IN FRANCE IN WHICH OUR VIEWS NEED TO BE ENERGETICALLY PROMOTED, PARTICULARLY THROUGH VISITS BY UK MINISTERS, BEFORE THE IGC'S.

DETAIL

2. MR MAUDE EXPLAINED OUR EVOLUTIONARY APPROACH AND THE MECHANISMS WHICH WE THOUGHT NECESSARY TO PROMOTE ECONOMIC CONVERGENCE. DISCUSSION FOCUSSED ON THE OVERALL VALUE AND VIABILITY OF EMU ITSELF (AND IN PARTICULAR OF A SINGLE CURRENCY) AND ON WHETHER OUR PROPOSALS WERE TECHNICALLY SOUND. THERE WAS LITTLE INCLINATION TO ACCUSE THE UK OF SEEKING TO DELAY REACHING THE FINAL OBJECTIVE WITH ITS PROPOSALS.

3. AMONG THE MAIN POINTS RAISED BY THE FRENCH WERE:

A) LITTLE ENTHUSIASM FOR RAPID MOVEMENT TO EMU. MOST FELT THAT IT WAS TECHNICALLY IMPRACTICABLE TO MOVE QUICKLY, ALTHOUGH SOME ARGUED THAT IF A FIRM POLITICAL DECISION WAS TAKEN NOW, THE TECHNICAL PROBLEMS WOULD FALL AWAY;

B) ONE OR TWO SUPPORTED THE PRINCIPLE OF A COMMON (REPEAT COMMON) CURRENCY, ALTHOUGH OTHERS ARGUED THAT THIS WOULD BE A COMPLICATION ON THE ROUTE TO STAGE 3. ONE INTERLOCUTOR EVEN SUGGESTED THAT THE BRITISH 'HARD ECU' MIGHT NOT BE HARD ENOUGH. SINCE ALL EUROPEAN CURRENCIES WERE ALLEGEDLY WEAK, THERE WAS A DANGER THAT A

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PARALLEL (NO A BASKET) ECU WOULD SIMPLY BE LINKED TO SUCH WEAKNESS. A 'SUPER HARD ECU', WHICH WAS STRONGER THAN THE STRONGEST CURRENCY, MIGHT BE BETTER, ALTHOUGH THIS MIGHT REQUIRE SUPPORT IN THE FORM OF A HIGHER INTEREST RATE:

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E) SCEPTICISM THAT A EUROPEAN CENTRAL BANK (OR EMF) COULD OR SHOULD BE INSULATED ENTIRELY FROM POLITICAL PRESSURES. MR MAUDE NOTED THE INCONSISTENCY IN THE FRENCH OFFICIAL POSITION HERE - IN CALLING FOR AN INDEPENDENT CENTRAL BANK BUT EXPECTING TO HAVE SOME CONTROL OVER IT: THERE WAS UNANIMOUS AGREEMENT WITH THIS POINT.

COMMENT

4. THE DISCUSSION SHOWS HOW, IN SPITE OF THE FRENCH GOVERNMENT'S POLITICAL COMMITMENT TO PRESSING AHEAD AS QUICKLY AS POSSIBLE, THERE IS A BODY OF EXPERT AND INFLUENTIAL OPINION HERE THAT HARBOURS DOUBTS ABOUT BOTH THE ULTIMATE OBJECTIVE AND THE BEST WAY OF ACHIEVING IT. THERE IS A DEBATE TO BE HAD IN PARIS, PARTICULARLY AS THE FRENCH BEGIN TO RECOGNISE THAT MANY OF THEIR PARTNERS, PARTICULARLY THE GERMANS, MAY BE HAVING SECOND THOUGHTS ABOUT THE PACE OF REFORM. THERE ARE, AS THERE ALWAYS HAVE BEEN, ELEMENTS OF INFORMED FRENCH OPINION READY TO LOOK AT THE DETAILS OF OUR PRAGMATIC PROPOSALS AND TO TAKE THEM SERIOUSLY. MOREOVER THERE IS NOW LITTLE INCLINATION TO QUESTION OUR MOTIVES. I AM GRATEFUL TO THE FINANCIAL SECRETARY FOR HIS VISIT. IT WAS A WELL-TIMED LAUNCH OF A SERIES OF VISITS TO PARIS BY BRITISH MINISTERS TO DISCUSS EUROPEAN MATTERS DURING THE RUN-UP TO THE IGC'S IN DECEMBER.

FERGUSSON

YYYY

SECRET

Prime Minister

To note: not marvellous. 24/9.

MR. POWELL

This is a pain in the arse. We are back to Lawson days ms.

ERM

As I explained on the 'phone, the markets have been extremely turbulent and a degree of stability has been achieved only through intervention of $500 million involving action in Frankfurt and New York, as well as London. The markets have chosen to interpret the Prime Minister's remarks in Berne yesterday as meaning that the prospect of ERM entry has been put off for some considerable time.

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(i) that policy has not changed and that the Madrid conditions have not been reformulated; ~~as the Prime Minister said~~ The P.M made that clear

(ii) that the Chancellor and the Prime Minister are at one;

(iii) that Pohl's remarks related to EMU and as such were consistent with UK views, and not to ERM.

I suggest we refuse to be drawn on the reference to the different impact of oil prices which seems to be pure obfuscation.

That is a new statement.

Both the Prime Minister and I have made clear that it is our policy to enter the ERM at the earliest sensible date. We are not seeking delay just awaiting the right circumstances, as the Madrid conditions made clear. Sounds like Paris — very weak

We have, therefore, to consider relative inflation. And what really matters is what happens from now on. The oil price rise is affecting both our inflation rate and that of our European partners. Indeed in some ways we are better placed than others to handle oil price rises. — This is not correct. We have to buy in much oil at the market price and sell our lighter oil at the world price. This is dpp. new words - previous words have been 'own inflation' is nearer the European average. not inflation.

The remarks attributed to Herr Poehl the other day concerned the dangers of a premature move towards EMU. These are dangers I have been emphasising for months. His remarks did not relate to our entering the ERM - as he subsequently made crystal clear.

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FERGUSSON

YYYY

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

21 September 1990

Andrew Turnbull Esq
Principle Private Secretary
to the Prime Minister
10 Downing Street
LONDON
SW1

Dear Andrew,

ERM

... I attach, for the record, the agreed text of the Chancellor's statement, which has now been issued.

I am copying this letter to Paul Tucker.

Yours ever Tarkowski

T TARKOWSKI
Private Secretary

Both the Prime Minister and I have made clear that it is our policy to enter the ERM at the earliest sensible date. We are not seeking delay, just awaiting the right circumstances - as the Madrid conditions made clear.

We have, therefore, to consider relative inflation rates. And what really matters is what happens from now on. The rise in oil prices is affecting both our inflation rate and that of our European partners. Indeed in some ways we are better placed than others to handle oil price rises.

The remarks attributed to Herr Poehl the other day concerned the dangers of a premature move towards EMU. These are dangers I have been emphasising for months. His remarks did not relate to our entering the ERM - as he subsequently made crystal clear. I am sure that entry is the right policy and we will not delay when the opportunity occurs. I am confident that our entry will be welcomed by our European partners. I expect no difficulty with this - our colleagues are keen for us to join.

place, whether the Madrid conditions have been met or are being met or indeed will be changed?

PRIME MINISTER:

No, the Madrid conditions will not be changed, the Madrid conditions, as you know, do include the condition of getting our inflation nearer to the European average. So in fact I do not think it is really any change upon the Madrid conditions, it is just that Carl Otto-Poehl said it that is the news. I do not think you will find it is any change from the Madrid conditions.

QUESTION (Swiss Radio International):

Could you remind us why a few weeks ago you were unhappy about the ICRC?

PRIME MINISTER:

Because it seemed to be acting very slowly and we have got used to acting and making decisions very quickly. In fact they have not been able to get into Iraq which I think is a tragedy and I think it reflects very badly on Iraq and of course we understand that they are not prepared to receive either Sadruidin Aga Khan (phon) from the United Nations. I think we should make it very clear that that is a thorough reflection upon Iraq in both cases.

QUESTION (Today):

You were referring to money earlier on drug trafficking, you also referred to terrorism, have you got any assurances that the Swiss will do more to track down for example IRA or other terrorist money in Switzerland?

and we shall play our part, and Switzerland is making some contribution I think with regard to the sanctions matter where they are biting particularly heavily on some other countries, and I am sure she is prominent in helping the refugee problem as well.

QUESTION:

Will your talks with the Swiss be concerned with the question of narcotics and the seizure of assets by people in Great Britain and in Switzerland who have been convicted of narcotic crimes?

PRIME MINISTER:

We are very anxious to get maximum cooperation about anything to do with terrorism, any criminal activities of a serious nature, including in particular narcotics and tracing the monies which are gained from peddling in drugs. I have not in fact raised that with them this morning, I will hope to do so with them later.

QUESTION (Trevor Kavanagh, Sun):

Did you discuss the position of possible Iraqi agents or subversives who may be operating from Switzerland?

PRIME MINISTER:

No.

QUESTION (Paul Reynolds, BBC Radio):

Herr Poehl, the Bundesbank President, yesterday suggested that Britain is some way from controlling inflation and therefore it might not be such a good idea to join the ERM soon, can you help us at all in saying when and how Britain's membership will take

Time for ERM not right, admits Maggie

MRS THATCHER last night placed a new question mark over Britain's ability to enter the Exchange Rate Mechanism before the end of the year.

Just 24 hours after Bundesbank boss Karl-Otto Pohl suggested the time for UK membership was not yet right, the Prime Minister also indicated that high inflation remains a major stumbling block.

During a visit to the Swiss capital Berne, she admitted inflation would have to fall by several percentage points before the pound can be linked to other major currencies within the European Monetary System.

'The Madrid conditions won't be changed and they include getting inflation near to the European average,' Mrs Thatcher said.

The ERM delay, John Major's opposition to a cut in interest rates and speculation surrounding Polly Peck shares, combined to wipe £10billion off share values yesterday.

The FTSE Index covering the top 100 shares fell 48.9 points to 2016.9 — the steepest drop since a 64.4 point plunge four days after Iraq invaded Kuwait.

● In New York the Dow Jones industrial average fell 39.11 points last night to close at 2,518.32. Volume of shares traded totalled 145.10million.

City — Pages 41 and 42

Bush set to visit U.S. front line in the Gulf

Mail Foreign Service

PRESIDENT Bush is planning a morale-boosting visit to American troops in Saudi Arabia.

The White House confirmed yesterday that the trip was very much on the cards, but said that for obvious reasons no date could be given.

However, a New York newsapper reported that it was tentatively scheduled for the American Thanksgiving holiday in late November.

The idea was to give encouragement to the thousands of servicemen and women involved in Operation Desert Shield, as the expedition is known.

The President might also take the opportunity to travel to Turkey and Egypt, both front-line states in the confrontation with Iraq.

Command

Meanwhile, in Washington British Defence Secretary Tom King spent a day with his U.S. counterpart Dick Cheney

POLICE RAID THEN SHARES HIT TYCOON

Nadir loses £165m

Continued from Page One

electrical appliances and the Japanese electronics firm Sansui.

The 47-year-old Turkish-Cypriot, who is neither a director nor trustee of South Audley Management, went voluntarily to the Serious Fraud Office after the raid, the first major operation since lawyer Barbara Mills, a prosecution QC in the Guinness trial, took over as director a fortnight ago.

It is understood that investigators have asked him about share dealings in Polly Peck. Particular attention is likely to be directed to trading around his recent abortive attempt to bid for Polly Peck himself and take it private.

Since that unhappy episode, Polly Peck

Audley Management and a variety of offshore companies.

Attention focussed on 27-year-old stockbroker and businessman Jason Davies, who was briefly a director of South Audley Management, and shared offices.

Last week Nadir forcefully rebutted any links between Polly Peck and Davies. He said that neither he — nor, he believed — any of his family had ever placed orders with Davies to trade in Polly Peck shares.

Passionate

Nadir has repeatedly emphasised that neither he nor Polly Peck has been involved in dealings in the company's shares, other than those which were properly disclosed. Yesterday he said: 'I

Charles

Continued from Page One

the chateau of a family friend.

As he stood wrapped in a white towelling robe in his bedroom, he squinted out across a valley while waiting for a physiotherapy session.

The Palace, meanwhile, insisted that the sunshine cure in Provence had done him 'the power of good.' He has responded to treatment and the weather.

When he leaves today, he will not be flying back to either Highgrove or Kensington Palace, but to Balmoral for his annual autumn pilgrimage on the Scottish moors.

Some benefits of his convalescence were seen yesterday when Charles removed his shirt to sunbathe, showing he no longer needed a sling. And his confident stride up a hillside later bore no trace of the limp that has bedevilled him since surgeons took bone from his hip to graft onto his smashed arm.

Since arriving here on Sunday, he has scarcely left the chateau's grounds.

Although the unexpected encounter with photographers doubtless contributed to his expression at the start of the day, he had still looked a man burdened.

He threw back the white shutters of his bedroom to a crescendo of camera shutters. Over breakfast, things looked brighter when he learned that one French photographer had 'met' the guard dog.

The cameramen settled into an almond grove just 350 yards away, police glowered from the grounds, and a Scotland Yard man directed the erection of a makeshift screen of sunlounges and a net around the villa's swimming pool.

Fatal jab

Continued from Page One

Economic Policies and Convergence

The projections for the EC as a group conceal substantial differences in the prospective performance of individual member countries. Whether these differences, particularly as regards inflation, are fully compatible with the degree of economic convergence required to complete stage one of EMU is an open question. Recent experience would suggest that broad stability in exchange markets can be maintained despite substantial differences in economic performance. 54/ However, the continuing large current account imbalances within the EC (substantial deficits in Greece, Spain, and the United Kingdom and large surpluses in the Federal Republic of Germany and the Netherlands) presumably could give rise at some point to pressures on exchange rates. To a large extent, these imbalances can be seen as a natural by-product of Europe's economic integration, and to that extent they need not--and indeed have not--led to exchange rate instability. But these imbalances also reflect divergent macroeconomic policies and performance. Moreover, the risk of exchange market pressures may have increased with the removal of restrictions on capital movements in Belgium, France, Italy, and Luxembourg in recent months, although it must be recognized that, so far, this has not given rise to instability. 55/

The objective of medium-term exchange rate stability among the currencies of all 12 of the EC countries could be advanced considerably if a greater degree of nominal convergence could be achieved early in stage one of EMU. Convergence could be facilitated most directly by tighter financial policies in several EC countries, including in particular Greece, Italy, Portugal, and Spain. Increasingly, national monetary policy--which is already overburdened in many countries--is expected to lose its autonomy as integration proceeds and fiscal policy may have to play a greater role in correcting underlying macroeconomic imbalances. 56/ What may be required is not a return to fiscal fine-tuning, but rather a steady and determined reduction of government dissaving in the countries where fiscal deficits remain substantially above the EC average, including in particular Greece, Italy, and Portugal.

In the United Kingdom, a reduction in inflation to the levels prevailing in the ERM countries would be facilitated by a decline in inflation expectations. While the entry of the United Kingdom into the ERM

54/ The parities of the EMS currencies participating in the ERM have not been realigned since January 1987, aside from the recent downward adjustment of the lira when it was brought into the narrow band.

55/ For Ireland and Spain the deadline for removing capital controls is the end of 1992; the deadline for Greece and Portugal is in principle the same.

56/ While a degree of monetary autonomy and exchange rate flexibility will, in principle, remain in the first two stages of the transition toward EMU, it is intended that policies will increasingly be geared toward multilateral objectives through enhanced policy coordination.

will ultimately enhance the credibility of monetary policy. As it has in some other countries--the entry of sterling into the mechanism while inflation differentials remain large would involve serious transitional difficulties. In particular, once the immediate risk of exchange rate depreciation is lessened, the size and openness of the United Kingdom's capital markets could encourage potentially large capital inflows which would exert downward pressure on domestic interest rates, and thus undercut the disinflationary stance of policy. The dangers involved in such premature easing of monetary conditions became apparent when interest rates fell in 1987-88 as the authorities resisted upward pressure on sterling and responded to the expected impact of the fall in stock markets, while underestimating the strength of domestic demand, and there was a subsequent resurgence in inflation. In the present situation, a substantial reduction of the inflation differential would appear to be a prerequisite to the entry of the United Kingdom into the ERM.

The recent experience of Italy and Spain also illustrates the potential conflicts that can arise between the internal and external objectives of monetary policy when capital controls are liberalized. In both of these relatively high-inflation countries pressures have mounted to lower domestic interest rates in order to arrest the upward movement of the exchange rate, even though such a shift in the stance of monetary policy would be undesirable from the perspective of these countries' inflation objectives.

Economic performance over the medium term in the other ERM countries (Belgium, Denmark, France, the Federal Republic of Germany, Ireland, Luxembourg, and the Netherlands) is not expected to threaten the convergence objective of EMU. However, as monetary integration proceeds and interest rates converge further, relative fiscal positions will become more important in the market's assessment of a country's policy stance and exchange rate. 57/ At the same time, the room for maneuver of national budgetary policies is likely to narrow. From this perspective, it would appear prudent for those countries with relatively large public sector deficits and/or high levels of public debt (Belgium, Ireland, and the Netherlands) to intensify their efforts toward fiscal consolidation.

Another important, and perhaps more immediate, objective of EC economic policies is to ensure a noninflationary adjustment to German unification. The potential effects of unification on German and EC-wide economic conditions have been discussed above. What must be emphasized in the present context is that the ERM and the other formal links to be established in stage one of EMU--in particular, enhanced policy coordination--may help to achieve this objective. Within the EMS, there is now a core group of countries, in addition to the Federal Republic of Germany, that have made significant progress toward price stability. These countries are well placed to play a valuable role in anchoring the system, particularly in view

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57/ The interaction between the fiscal stance and the market's valuation of public debt is discussed below in the section on transition issues.

Economic Policies and Convergence

The projections for the [illegible] in the prospective performance [illegible] these differences partially [illegible] with the degree of economic convergence [illegible] EMU is an open question. [illegible] stability in exchange markets [illegible] differences in [illegible] current account [illegible] Spain, [illegible] Germany and the [illegible] pressures [illegible] seen as a way [illegible] extent the [illegible] But these [illegible] performance [illegible] increased with the [illegible] France, Italy [illegible] recognised that [illegible]

The [illegible] current [illegible] greater [illegible] of EMU [illegible] policies in [illegible] Portugal [illegible] already [illegible] inconsistencies [illegible] corrective [illegible] is not a [illegible] reduced [illegible] remain [illegible] Italy and Portugal.

In the United Kingdom, a reduction in inflation to the levels prevailing in the ERM countries would be facilitated by a decline in inflation expectations. While the entry of the United Kingdom into the ERM

54/ The [illegible] been realigned [illegible] of the lira [illegible]

55/ For Ireland [illegible] the end of 1992 [illegible] same.

56/ While a degree [illegible] will, in principle, remain [illegible] EMU, it is intended that [illegible] multilateral objective

will ultimately enhance the credibility of monetary policy as it has in some other countries--the entry of sterling into the mechanism while inflation differentials remain large would involve serious transitional difficulties. In particular, once the immediate risk of exchange rate depreciation is lessened, the size and openness of the United Kingdom capital markets could encourage potentially large capital inflows that would exert downward pressure on domestic interest rates, and thus undermine the disinflationary stance of policy. The dangers involved in such a premature easing of monetary conditions became apparent when interest rates fell in 1987-88 as the authorities resisted upward pressure on sterling, responded to the expected impact of the fall in stock markets, which underestimating the strength of domestic demand, and there was a subsequent resurgence in inflation. In the present situation, a substantial reduction of the inflation differential would appear to be a prerequisite to the entry of the United Kingdom into the ERM.

The re... conflicts that ... monetary policy ... relative ... interest ... even though ... undesirable from the ...

Economic perfor... (Belgium, Germany, ... Luxembourg, and the ... objective of EMU. ... rates converge further ... in the market's ass... rate. 57/ At the same ... policies is likely to ... prudent for ... and/or high levels of ... intensify their efforts ...

Another important ... policies is to ... The potential effects ... conditions have ... present context is ... in stage one of EMU in ... to achieve this objective ... countries, in addition ... significant progress ... placed to play a valuable ...

57/ The interaction between ... of public debt is discussed ...

FROM: N I MACPHERSON (EC1)
DATE: 19 SEPTEMBER 1990

x4443

MISS SIMPSON

cc: PS/Chancellor
PS/FST
Sir P Middleton
Mr Wicks
Mr H P Evans
Mr Odling-Smee
Mr Gray
Mr R I G Allen
Mrs M E Brown
Mr J Grice
Mr McIntyre

POEHL'S PRESS CONFERENCE : 19 SEPTEMBER

Karl Otto Poehl has today been quoted as saying that "the result [of the Informal Ecofin] was to reject the [British] idea. But unfortunately this was never publicised." See Reuters report attached.

2. This claim is clearly untrue. I suggest the following line to take:

> No. Considerable interest in UK proposals; for example, Spain has incorporated hard ecu in their plans for EMU. UK plan remains very much on the table.

3. I will circulate a copy of the Bundesbank paper, which Poehl was launching, tomorrow.

Nick Macpherson

N I MACPHERSON

A Mr Evans Mrs Brown Mr McPherson. JS Pcs.

HIGH INFLATION COUNTRIES MAY HAVE EMU PROBLEMS XSUO
FRANKFURT, SEPT 19, REUTER - COUNTRIES WITH HIGH INFLATION LEVELS MIGHT FIND IT HARD TO BECOME FULL MEMBERS OF A EUROPEAN MONETARY UNION, BUNDESBANK PRESIDENT KARL OTTO POEHL SAID.
POEHL DECLINED TO SAY WHICH COUNTRIES HE WAS REFERRING TO. BUT SPEAKING AT A NEWS CONFERENCE HE SAID, "WITHOUT MENTIONING NAMES, CAN A COUNTRY WITH AN INFLATION RATE THREE TIMES THAT OF GERMANY PEG ITS CURRENCY TO THE MARK?"
POEHL ALSO SAID BRITISH PROPOSALS FOR A "HARD ECU" AS A PARALLEL TO OTHER EMS CURRENCIES HAD BEEN REJECTED BY ALMOST ALL EUROPEAN COUNTRIES AND STOOD LITTLE CHANCE OF SUCCESS.

19-SEP-1245. MON892 BB1903035 MONM

P

CONTINUED ON - XSUP

REUTER MONITOR 0622

HIGH INFLATION COUNTRIES MAY HAVE EMU PROBLEMS -PART 2 XSUP
"THE IDEA THAT WE SUPPORT THE BRITISH POSITION IS WRONG," POEHL SAID. "THE CONCEPT OF A PARALLEL CURRENCY HAS BEEN REJECTED BY US AND BY ALMOST ALL OTHER COUNTRIES."
POEHL SAID THE BRITISH PROPOSAL HAD BEEN EXAMINED AT A MEETING OF EUROPEAN FINANCE MINISTERS AND CENTRAL BANK CHIEFS IN ROME. "THE RESULT WAS TO REJECT THE IDEA. BUT UNFORTUNATELY THIS WAS NEVER PUBLICISED," HE SAID.
POEHL SAID THE BUNDESBANK WAS HAPPY WITH ONLY ONE ELEMENT OF THE BRITISH PLAN, THE PROPOSAL TO DO AWAY WITH FREQUENT REVISIONS IN THE WEIGHTING OF INDIVIDUAL CURRENCIES WITHIN THE EUROPEAN CURRENCY UNIT.

19-SEP-1251. MON902 BB1903035 MONM

CONTINUED FROM - XSUO

P

CONTINUED ON - XSVR

REUTER MONITOR 0622

HIGH INFLATION COUNTRIES MAY HAVE EMU PROBLEMS -PART 3 XSVR
THIS MEANT THE WEIGHTING OF WEAKENING CURRENCIES IN THE EUROPEAN MONETARY SYSTEM WOULD BECOME SMALLER, AND THE ECU ITSELF WOULD BECOME A HARDER CURRENCY BASKET, HE SAID.
THE IMPACT OF SUCH A MOVE WOULD BE SYMBOLIC RATHER THAN ANYTHING ELSE, HE SAID.

19-SEP-1253. MON910 BB1903035 MONM

CONTINUED FROM - XSUP

P

ENDS

REUTER MONITOR 0622

Mr Patterson 10/2

EXCHEQUER 19/9
CO. 19 SEP 1990
FROM Mrs Brown
COPIES TO FST, Sir P. Middleton, Sir T. Burns, Mr Wicks, Mr M.P. Evans, Mr Odling-Smee, Mr Scholar, Mr R.L.G. Allen, Mr Gray, Mr A.C.S. Allan, Mr Mountfield, Mr MacPherson, Mrs Chaplin

DEUTSCHE BUNDESBANK
Presse und Information

Frankfurt, im September 1990

Statement by the Deutsche Bundesbank on the establishment of an Economic and Monetary Union in Europe

I. The heads of state and government of the EC member states have decided to establish a European Economic and Monetary Union (EMU) in a multi-stage process. Stage one of EMU started in the middle of this year, and the further stages are to be laid down and the necessary contractual basis is to be created at the intergovernmental conference which is due to meet in December.

The Bundesbank considers it to be its duty to draw attention to the consequences associated with this process, and to point out which conditions must be met if monetary stability is to be assured in future, too.

II. The establishment of a Monetary Union signifies the irrevocable fixing of exchange rates between the currencies concerned (with the possibility of their subsequently giving way to a single currency), under conditions of complete, and durably guaranteed, freedom of capital movements. At the same time, this implies the necessity of relinquishing autonomous national domestic and external monetary policies, and of transferring the responsibility for such policies to Community institutions. In this way the participating economies will be inextricably linked to each other, come what may, in the monetary field. The implications of this - especially for the value of money - will depend crucially on economic and financial policy and on the behaviour of management and labour in all member states. They will have to satisfy in full the requirements of an Economic and Monetary Union. In the final analysis, a Monetary Union is thus an irrevocable sworn confraternity - "all for one and one for all" - which, if it is to prove

durable, requires, judging from past experience, even closer links in the form of a comprehensive political union.

III. Economic and economic policy trends in the European Communities are still marked by great differences between the member states. It is true that among some member states - and owing in part to the European Monetary System (EMS) - substantial progress has been made since the beginning of the eighties towards greater convergence in the field of anti-inflation policy, with the Bundesbank having made a major contribution through its policy stance, consistently geared as it is to the stability of the Deutsche Mark. Throughout the EC, however, deep-seated divergences still remain, and in part are actually widening again - divergences which are reflected in particular in the movements of costs and prices, the huge deficits in the national budgets of individual countries, and massive external disequilibria. These divergences are especially pronounced in the case of the United Kingdom, Portugal and Greece (which are not as yet participating in the EMS exchange rate mechanism), and they are likewise unmistakable in the case of Italy and Spain. In the majority of instances, the reasons for this are to be sought not so much in temporary factors as in the considerable differences in institutional structures, economic fundamentals and the attitudes of management and labour.

IV. Given this economic and economic policy situation in the Community, an early irrevocable fixing of exchange rates and the transfer of monetary policy powers to Community institutions would involve considerable risks to monetary stability, especially for the Federal Republic of Germany. Furthermore, widespread additional calls for compensatory public financial adjustment would be very likely, especially from the countries of Southern Europe, since, in a Monetary Union, these countries would be faced with the unavoidable

consequences of inadequate labour mobility and the continued existence of income and productivity differentials. Although the present situation in a number of member states cannot be compared to the conditions in the GDR, developments there do illustrate the consequences of a Monetary Union under conditions of markedly differing productivity levels.

Particularly at a time when the German economy is being confronted with substantial transitional problems as a result of the intra-German unification process, and when developments in eastern Europe are still unclear in many respects, there is much to be said for preserving such room for manoeuvre and for adjustment as still exists in the field of domestic and external monetary policy and budgetary policy until such time as the economic situation in Germany as a whole and in the European Communities can be regarded as sufficiently consolidated. By then, at all events, the risks inevitably associated with the transition to an Economic and Monetary Union in the EC will be more readily appraisable and presumably also easier to handle. In the meantime, it will be possible to press on resolutely with enhanced efforts to achieve greater convergence in the field of anti-inflation policy throughout the Community, which efforts were initiated upon the commencement of stage one.

V. In the concrete design of the further stages of EMU, and in determining the institutional structure for the final stage, the Bundesbank regards it as essential that due account should be taken of anti-inflation policy requirements. In particular, it must be ensured that the same stability record can in future be achieved at Community level as has hitherto been registered in the Federal Republic of Germany.

In the view of the Bundesbank, therefore, the contractual safeguarding of the following points is indispensable to the design of the <u>final stage</u>:

1. The basis of the Monetary Union must be an economic union comprising a common economic area without internal borders, which must also be as open as possible to third countries, as well as an adequate degree of lasting convergence of anti-inflation policy between the member states. An essential feature of the Single Market - besides the free movement of persons (including work permits), goods, services and capital - must be an efficient, market-orientated competitive system (including control of allowances) at Community level.

As far as the Single Market programme is concerned, at present there are still some pronounced deficiencies as regards both decison-making and implementation and, unless these deficiencies are overcome, the elimination of border controls, which is envisaged for 1992, will b in jeopardy. This applies particularly to the harmonisation of indirect taxes, which is regarded as e essential precondition for lifting the border controls

Another indispensable element of an economic union is adequate commitment on the part of all member states t gearing their financial policies to a lasting anti- inflationary stance. In the long run monetary stabili can be achieved and maintained only if, in particular government financial policy in all member states is likewise orientated towards fighting inflation. Sinc financial policy decisions in EMU will largely remai the hands of the member states, contractual arrangem (including binding rules and sanctions) to ensure effective budgetary discipline in all member states have to be adopted at Community level.

2. In the final stage of the Monetary Union, monetary will have to be formulated uniformly and bindingly Community level. This can only be done by a Commun

monetary authority in the form of a European Central Bank System (ECBS), which will have to satisfy the following requirements:

(a) The ECBS must be able and obligated to give priority in its decisions to pursuing the objective of monetary stability.

(b) The ECBS must be endowed with durably guaranteed independence in institutional, functional and personal terms. Its members, in the performance of their duties, may not be subject to any instructions or commitments given by other entities, and may not be restricted in their freedom to decide by overly far-reaching reporting requirements either. The principle of equal voting rights for all members is acceptable only if independence of this kind is assured vis-à-vis national influences as well.

(c) The necessary uniformity of monetary policy-making requires that what have hitherto been national central banks should largely become integral parts of the ECBS, and thus should no longer be able to pursue policies of their own. This is possible only if the national central banks have previously been given the same degree of independence within their respective member states as the ECBS enjoys at Community level and if the monetary policy instruments have been d harmonised.

(d) To guarantee the uniformity of monetary policy on one hand and to take due account of the federative structure of the Community on the other, the ECBS should be given a management structure comprising governing bodies: a Council and an Executive Boar

The Council should be composed of the Governors of the national central banks and the members of the Executive Board. A sufficiently long term of office (without any possibility of dismissal) and an effectively independent status must be guaranteed for all members of the Council.

The Executive Board should be made up of five to seven members, who are appointed by the European Council by virtue of their experience and ability.

The duties should be divided up between the Council and the Executive Board in such a way that the Council is responsible for setting monetary policy targets and the Executive Board for the necessary decisions of detail and their implementation.

(e) The ECBS must be endowed with all the instruments necessary for conducting monetary policy. Administrative controls that distort market mechanisms should not be permissible.

(f) The internal monetary policy of the ECBS must not be hampered by decisions taken in the field of external monetary policy. Hence the ECBS must be given sole responsibility for exchange market intervention, too. In all other decisions affecting external monetary policy - and especially in the event of exchange-rate-policy decisions - the ECBS must be involved in good time and on a basis of co-responsibility.

(g) The ECBS must not be subject to any obligations to extend credit to public authorities in the Community or in member states.

3. Because of the far-reaching political implications, the by-laws of the ECBS and the rules on budgetary discipline should be specified in the Treaty, which is subject to ratification by national parliaments and may be amended only with their approval.

VI. In the Bundesbank's view, the economic and institutional conditions for the commencement of the final stage of the Monetary Union and thus for the establishment of the ECBS - which conditions must be met in all member states - can be fulfilled only in the course of a lengthy transitional process. During this process, no institutional changes which result in any curtailment of the freedom of action of national monetary policy may be made.

At the end of the transitional period, the following prerequisites for the commencement of the final stage must be satisfied in the Bundesbank's opinion:

1. The convergence of anti-inflation policy among all the member states participating in the Monetary Union must have progressed so far that

   - inflation has been very largely eliminated in all the countries, and price differences have been virtually stamped out,

   - the budget deficits in all participating countries have been reduced to a level which is tolerable over the longer term and unproblematic in terms of anti-inflation policy, and

   - the durability of the convergence achieved is reflected in the markets' verdict, too, i.e. in a virtual harmonisation of capital market rates.

2. All the member states taking part in the Monetary Union must previously have participated, without any special arrangements, in the exchange rate mechanism of the EMS for a sufficiently long period, and must have finally dismantled all restrictions on capital movements.

3. Particularly with respect to their commitment to fight inflation and their independence, the by-laws of the national central banks must be harmonised to such an extent that these banks can become an integral part of the ECBS. Such harmonisation also includes an adequate adjustment of their monetary policy instruments.

4. The contractual arrangements (including binding rules and sanctions) for ensuring effective budgetary discipline in all member states must be adopted at Community level.

5. The Single Market programme must have been realised in full, including the dismantling of fiscal border controls.

VII. In order to pave the way, as required, for the transition to the final stage, the following should be provided for in the Bundesbank's view:

1. The efforts already initiated to promote the coordination of monetary policy among the member states, with a view to combating inflation, should be continued and stepped up. At the same time, the monetary policy instruments should be harmonised increasingly. The Committee of EC Central Bank Governors could be transformed into a Council of Governors in due course.

2. In all member states, the by-laws of the central banks should safeguard those banks' independence of

instructions from political entities, and of the influence of such entities, at an early date.

3. The fiscal policy divergences must be overcome as soon as possible by means of a marked reduction in the budget deficits of a number of member states. The EC Commission and the Ecofin Council should step up their efforts to ensure the observance of adequate budgetary discipline in all member states.

4. The convergence of anti-inflation policy within the Community could also be fostered by a hardening of the ECU through it being contractually stipulated that the ECU cannot be devalued against any Community currency. Such a hardening of the ECU calls neither for the development of a parallel currency nor for the creation of a new institution.

A particularly important point in the Bundesbank's eyes is that the transition to another stage (no matter whether this is a transitional stage or the final stage) should be made solely dependent on the fulfilment of previously defined economic and economic-policy conditions, rather than on specific timetables. Hence the transition to another stage must not be linked to deadlines fixed in advance.

VIII. In the Bundesbank's opinion, the points listed above are indispensable, and not optional, requirements. The Bundesbank considers it necessary for the German delegation to advocate these points vigorously at the intergovernmental conference. The viability of the envisaged strategy for the Economic and Monetary Union must not be endangered in the above-mentioned key respects by the acceptance of compromises during the negotiations. Otherwise, in view of the substantial risks involved, the favourable expectations entertained of such a Union might well be disappointed.

FILE NOTE

I rang Sir Michael Butler to explain how difficult it would be to find a time for this meeting. I have left it that he would contact us on Tuesday 2 October to see if any time has come free in the diary.

AP

MRS AMANDA PONSONBY

13 September 1990

chex.kf/tt1/81

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

12 September 1990

Charles Powell Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

CONFIDENTIAL

Dear Charles

I sent you a further Treasury paper on the hard ecu on 10 August. The paper did not break any new ground, but spelt out our proposals in more detail.

This is simply to let you know that, following last weekend's informal ECOFIN, the Chancellor has decided to make the paper available, in a low key way, to the Parliamentary Select Committees and other interested parties.

I am sending copies of this letter to Richard Gozney (Foreign Office), Martin Stanley (DTI), Paul Tucker (Bank of England) and Sonia Phippard (Cabinet Office).

Yours ever Tarkowski

T TARKOWSKI
Private Secretary

SECRET AND PERSONAL

9a-d ①

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You are meeting the Chancellor tomorrow morning at 1100 for the regular bilateral discussion.

Items for discussion include:

(i) release of key economic data this week;

(ii) report back from the ECOFIN discussion;

(iii) possibly ERM entry dates.

(i) Release of key economic data

As my separate note in the Box records, the revised figures on invisibles will be published tomorrow. While the invisible surplus estimates have fluctuated, the sharp downward revision will be unexpected. It suggests overall deterioration over the last six months on the balance of payments current account.

The release of the RPI figure on Friday will be even more difficult. City expectations are for a year on year RPI increase of around 10.2 to 10.3 per cent: the actual figure of 10.6 per cent - which is all on the underlying inflation rate - will be received as further bad news.

As you know sterling has recently been rather weak. With no move on entry into the ERM this weekend, there must be a risk of further downward pressure by the end of the week.

The Chancellor's statements on the radio last weekend were helpful. You may wish to discuss what further action is desirable in terms of aligning expectations more closely with reality over the next few days.

SECRET AND PERSONAL

(ii) ECOFIN

The Chancellor will report back on the ECOFIN discussions. (paper at Flag A). You have already seen the telegrams. The UK press interpretation is of a clear victory for the Chancellor's proposals. So too, and more remarkably, is that of much of the European press.

However the Chancellor is likely to give a less "up-beat" account. There seems to have been less a conversion to the Chancellor's proposals than a growing resistance to the Delors scheme. And, even then, the focus is on delay in the transition to stage 2 with other member states continuing to favour a single currency as the ultimate objective. However, there is more interest in the 'hard ecu' idea.

Very broadly, three groups of countries have emerged:

(i) the French, Belgians and Italians want to proceed with Delors more or less on schedule;

(ii) the Germans, Dutch and Irish are moving against the basic Delors scheme. Poehl seems to be the decisive factor here, following his speech in Munich.

(iii) the southern group - Spanish, Greeks and Portuguese - have become aware of the costs for their economy of a single currency without massive regional transfers: they too oppose EMU before convergence of their economies with the north. And they are supportive of the hard ecu - as a mechanism for achieving stage 3.

In short, as you suggested earlier, there has been a realisation by the rich countries that a rapid move to a single currency would impose great costs (regional transfers); and by the poorer that, without prior convergence of the economies, the strains could be intolerable.

You will want to ask the Chancellor where he thinks we go from here

- how can we exploit the divisions which have opened up and get the others to lower their sights?;

- are there any further steps which could be taken to advance the UK proposal?

(iii) Possible ERM entry dates

The Chancellor's other paper (Flag B) is intended to fulfil the remit from last week's discussion that he should look for alternative later dates for entry beyond 5 October.

The Chancellor's line is not to fix upon any particular date. He wants to weigh up movements on the key economic indicators, including month to month RPI inflation, before putting forward a specific alternative. None of the five dates up to 16 November is impossible: it is more difficult beyond that because of electricity privatisation and then Christmas.

He will press for 5 October, all the more strongly now that sterling is coming under pressure. Treasury interpretation of the recent drift in sterling is that the Chancellor's statement last Friday deflated expectations of early ERM entry; and that sterling has been falling accordingly (resisted with some intervention).

There have been no fundamental changes since your earlier meeting. Recent data on retail sales and weekly M0 confirms the slow-down in the economy. Gulf uncertainty remains.

But, the position on the "basic" Madrid condition, if interpreted to mean a fall in the UK underlying inflation rate, is less clear. The Chancellor (para 4) notes there could be no clear fall until the November figure is published in mid December. So implicitly he is not worried about meeting the condition before entry into the ERM. However, a small fall in the published RPI year on year increase could take place before

that - enabling earlier entry consistent with the commonsense interpretation of the Madrid condition.

Brian Griffiths' minute (attached at Flag C) makes the point that expectation of entry has now shifted till later in the year. If the recent fall in sterling represents a one-off adjustment to the later entry date, then there is no reason to fear a further slide on ERM grounds. But other data - BoP and RPI - could cause a further weakening.

BHP

(BARRY H. POTTER)
11 September 1990
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COPY NO. 1 OF 9 COPIES.

REF JG/37

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

PRIME MINISTER

POSSIBLE DATES FOR ERM MEMBERSHIP

When we met last week I promised to reflect further on the possible dates for ERM entry from the beginning of October until the end of this calendar year.

2. Subject to events, I think it will be right to come to you with a firm proposition to join the exchange rate mechanism during this period. Public opinion, particularly that in industry, is prepared for the move and will welcome it. The markets are expecting it. Our decision to put it off for the time being has already contributed to a weak exchange rate, which carries a double risk - it raises inflation directly and puts off the day when we can reduce interest rates. And industrial opinion is fickle. As you know, my own strong view is that we must join well ahead of the Inter Government Conference in December. If we do not, both the economics and the politics may go badly wrong.

... 3. The attached notes summarise key factors in relation to each of the weekends during this period. You may like to discuss the implications.

4. The latest indications for measured inflation are not encouraging. The figure for August, September and October - published in the following months - may all be broadly similar. The present prospect is that it will not be until the November figure published in December that we see a clear fall.

5. I have considered the possible dates before then. In summary the main conclusions I draw from the attached note are as follows:

(i) none of the five dates through from 19 October to 16 November is impossible. But by the time we get to 19 October Parliament will have reassembled and we will have missed the Party Conference and the Mansion House speech, two of our best platforms for explaining and restating our economic policy;

(ii) any date after 16 November until the end of the calendar year looks difficult, initially because of electricity privatisation, followed by the potential clash with the European Council/IGCs and the run up to Christmas;

(iii) if we wait until the period from mid-October to mid-November the Middle East position may have clarified. But depending on the course of events that could have made it harder as well as easier to contemplate entry.

6. You may wish to discuss this.

[J.M.]

11 September 1990

SECRET: ADSO

COPY NO: OF

5 October

A further month's money figures would be available, covering M0 in September and broader money in August (published 20 September). But the September RPI would not be published until a week later; internally we would have just received the advance indication.

No major mechanical difficulties are foreseen. Neither House would be sitting at the time of announcement, but the Lords would be returning the following Monday (ie a week before the Commons). That would mean the first Parliamentary statement would probably have to be in the Lords by Lord Hesketh.

This would be the last date available before the Conservative Party Conference. It would coincide with the leader of the Labour Party's speech at his Party Conference, although first news that we had decided to join would be unlikely to emerge until considerably later in the day.

12 October

This would be the same day as publication of the September RPI.

The Commons would return the following Monday enabling the first Parliamentary statement to be made there rather than in the Lords. It is however the same day as the Prime Minister's speech to the Conservative Party Conference.

19 October

The September broad money figures would just have been published on 18 October, although M0 for October would still be unclear. Internally we would know the September trade figures, although they would not be published until the following week.

This would be the day after the Chancellor's annual Mansion House speech, traditionally one of the main monetary policy statements of the year. There would be some - not impossible - awkwardness in making that speech the day before entry.

The annual informal meeting of the Monetary Committee will be taking place in Siena on Friday 19 October. The normal arrangement is for members to assemble on the Thursday evening. That would mean the Committee was already in place to consider a UK proposal to join the mechanism, although delicate handling would be required to ensure that news did not leak out early in the day.

26 October

The September trade figures would have been published earlier in the week.

Entry on this weekend would clash with the Special European Council which will consider EMU.

2 November

The monthly October M0 figures would become available internally on the Thursday afternoon, and the market is usually able to make an accurate estimate of the figures on the Friday from the published weekly information. But it would still be some days before internal estimates of the October RPI were available.

This date would come before the earlier of the two dates currently envisaged for the Autumn Statement (8 and 15 November). If Parliament was prorogued on the earlier of the two main possible dates (1 November) there would be no Parliament sitting on this day or the following Monday.

9 November

The internal advance indication of the October RPI should become available on Wednesday 7 November, prior to publication on 16 November.

This would fall one day after the earlier of the two possible dates for the Autumn Statement. And if Parliament was prorogued on the later of the two main possibilities (8 November) there would be no Parliament sitting this day or the following Monday.

16 November

The October RPI would be published on this day. But the internal indication of the October trade figures would not be known until 19 November.

If the Autumn Statement was on the later of the two possible dates (15 November) this date would imply ERM entry the day after.

23 November, 30 November and 6 December

The main economic information published during this period would be the October monthly broad money figures (20 November), the October trade figures (22 November), and the October M0 figures (29 November).

A major development during this period would be Impact Day for the regional electricity companies on 21 November, with no dealings until 11 December. That means that these three weekends would fall into the limbo period. A major policy statement such as ERM membership might best be avoided during this period.

The German elections are scheduled for 2 December.

13 December

This would coincide with the December European Council and the start of the IGCs.

20 December and 27 December

These dates would be extremely close to Christmas. There could be substantial logistical difficulties in ensuring the availability of representatives of other Member States.

chex.ps/tt/48

CONFIDENTIAL

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

PRIME MINISTER

I thought you would like a progress report on EMU developments, following the informal ECOFIN in Rome at the weekend.

2. Since launching our proposals for a hard ecu and a European Monetary Fund on 20 June, I have initiated a large scale lobbying campaign both at home and abroad. I elaborated on our plans to the Welsh CBI on 6 July, and gave evidence to the Treasury and Civil Service Committee and House of Lords sub-committee before the recess. During the course of the summer, I have met the Finance Ministers (and in some cases, the Central Bank Governor as well) of Germany, Spain, Italy, Holland, Ireland and Portugal, as well as the Presidents of the Commission and the Bundesbank. There have also been numerous contacts with our European partners at junior ministerial and official level.

3. The UK plan was first discussed at ECOFIN on 23 July, when it was remitted to the Monetary Committee for further examination. European monetary union, including the Monetary Committee's report on the UK plan, was the main item on the agenda at the informal ECOFIN on 7-8 September.

4. The discussion at ECOFIN was altogether more pragmatic than on previous occasions. The prospect of the forthcoming IGC seemed to be concentrating finance ministers' minds, and there was a marked drawing back from the ambitious timetable proposed by the Commission: this involved starting Stage 2 in January 1993, and moving rapidly to full monetary union thereafter. The majority opposed any pre-set date for Stage 2, and recognised the need for much greater convergence of economic performance throughout the Community before moving from Stage 1. They stressed (as I did) the importance of measuring convergence against objective

criteria: specifically, they had in mind greater convergence of inflation, the creation of more flexible economies and particularly labour markets and, of course, the progressive removal of very large fiscal deficits.

5. Most agreed with me that all member states should move forward together. The Single Market provided a good example in this respect; all 12 member states had put enormous efforts into completing it and all 12 stood to benefit from it. The aim of economic and monetary union should be to build on that programme and to carry the benefits of it further; that meant that all the twelve had to move forward together.

6. All the finance ministers wanted our ideas to be studied further, and some saw a definite role for the hard ecu in a transition phase. However, there was no movement amongst the 11 on the fundamental long term objective of establishing a single currency and an independent Central Bank.

7. It may be helpful if I give a first hand account of how the countries lined up. Opening the discussion on the transition to Stage 2, Beregovoy (France) strongly supported the Commission's approach, including a start date of January 1993. He gained little support. Only Belgium and Italy seemed prepared to sign up to such a date, and Beregovoy later back-tracked somewhat, moving his date back by a year and placing a strong emphasis on the need for everyone to have joined the ERM before Stage 2 began. I am planning to see Beregovoy for a bilateral later this month.

8. Waigel (Germany) - clearly to the surprise of Delors and Beregovoy - said firmly that there should be no decision on dates for the transition until clear conditions for convergence had been met. Although Poehl concentrated mainly on his Committee's recommendations on the statutes of the Central Bank, he clearly shared Waigel's views. A number of the smaller countries came in behind the Germans; clearly, they are beginning to have second thoughts about a precipitate rush to EMU. Kok (Netherlands)

opposed pre-set deadlines, as did the ministers from Luxembourg, Greece, Portugal and Ireland.

9. Solchaga (Spain) - to whom I had spoken earlier in the week - very usefully combined doubts on timing with a desire to use our hard ecu ideas. He proposed January 1994 as the start date for Stage 2. He did not envisage a move to Stage 3 this century. In Stage 2 - which he saw as a transitional phase to full EMU - he envisaged an institution, like our EMF, running a hard ecu alongside national currencies. However, he stressed that the EMF would eventually evolve into an independent Central Bank and that the passage to Stage 3 had to be a certainty for all members. The Portuguese supported this role for the hard ecu. The Greeks also welcomed further examination of the UK and Spanish ideas. Other countries were more ambivalent. Poehl told me outside the meeting that the Germans were interested in 'hardening' the ecu preparatory to a single currency, but still opposed creating an EMF.

10. The conclusions I drew from the meeting were generally encouraging. The UK now appears to be in a majority in wanting to slow the pace of transition to Stage 2; the Commission are clearly going to have to return to the drawing board when it comes to the conditions for movement to future stages. However, all the other member states remain very firmly in favour of what they see as the ultimate objective of a single currency.

11. We have had a generally good press both here and on the continent. But the more perceptive commentators have realised that there is still a substantial divide between the UK position and others' in Europe; they have noted that the other eleven are still in agreement with Delors on substance though not, of course, on timing. While it is vital that we continue to put our position across in the press but we must avoid giving the impression that we believe that we have now got the upper hand. The unfortunate truth is that we have not.

12. As regards the way forward, I propose to intensify our campaign to influence others' views. The UK plans, and some of the reservations we have expressed, clearly strike a chord in many Community countries, and I will take every opportunity to propound and explain them further. At the same time, if we are to exploit this more receptive mood, we will need to reiterate the message that the hard ecu could in the very long term develop into a single currency, if people and governments so choose.

13. Next, the handling of Community institutions between now and the opening of the inter-governmental conference on 13 December. Clearly, EMU will be on the agenda for the meeting of the European Council on 27-28 October. But we must continue to insist that preparatory work for the IGC is primarily handled by Finance Ministers in ECOFIN.

14. I will be using that forum to press for substantive work on the definition and measures of economic convergence. My overall objective is of course to promote the UK's proposals and to keep them on the table for the inter-governmental conference, and I am encouraged we will succeed in that.

15. I am copying this minute to Douglas Hurd, Peter Lilley and Robin Butler.

[J.M.]

11 September 1990

7 cc/back-up

SECRET AND PERSONAL

PRIME MINISTER

11 September 1990

MEETING WITH THE CHANCELLOR: ERM

Tomorrow you have a meeting with the Chancellor. Should the issue of the ERM come up the enclosed comments by press and analysts may be useful.

I was particularly struck by the article in The Times on Monday by Graham Searjeant as well as by the weekend press and the comments by Greenwells. They argued:

that it was positively a good thing not to join the ERM now;

that while they firmly expect us to join probably before the end of this year, they accept delay because the Madrid Conditions are still not met.

All of this supports the line you took in the meeting last week.

I was also struck by press comment on the strengths of the recession which could hit us post-ERM.

Since the meeting last week I have looked briefly at the Spanish experience. The main point which emerges is that the management of entry to the ERM is very much easier if there is policy convergence between the leading countries. For us this means that if UK inflation were clearly coming down, UK interest rates could move closer to German levels (which would hopefully might have moved up) on entry. We would as a result face less speculative capital flows, and therefore less turbulence in interest rates and exchange rates.

The case for waiting remains strong and the commentators response is very encouraging. In no way is press comment suggesting that delay is "negative".

BRIAN GRIFFITHS

SECRET AND PERSONAL

Comparable

Poised to play the ace

ECONOMICS: GAVYN DAVIES

CAN something be postponed if it has never been arranged in the first place? Probably not. So why did Mr Major's radio interview on Friday, designed to persuade people that his master plan for ERM entry was still in place, positively reek of procrastination? Because, whatever the Chancellor may claim, government policy is now drifting.

In the spring, the economy was thought to be growing too fast, with inflation the real threat. The Chancellor had wantonly missed the opportunity of doing anything about this in the Budget. With his hands tied on interest rates, the only way to tighten policy was to move sterling up.

The best way of doing this was to foster the belief that ERM entry, at quite a high central rate against the deutschemark, was imminent. Once inside the ERM, a high exchange rate would be preserved by the confidence effects generated, and interest rates could be safely reduced in time for an election in June or October 1991.

Initially, the strategy worked like a dream. Sterling started to rise against all other currencies a long while before the Gulf crisis came along to push oil prices higher. But as soon as the economic consequences of the Iraqi invasion began to clarify, Treasury officials became resigned to moving the ERM decision from the front to the back burner.

For one thing, ministers became (rightly) too obsessed with the wider problems of the Gulf to have any time left over to undertake a huge new economic initiative in a separate field. For another, the pound started to misbehave. It become very much more volatile, raising doubts whether it should be tied into a fixed rate system like the ERM during an oil crisis. It also stayed strong against the European currencies, while moving far too high against the generally weak US dollar.

One thing is certain. If sterling stays anywhere near present levels against the dollar, British companies exposed to American competition are going to be decimated in the markets in the next year. Few observers have noticed that sterling is now at an *all-time high* against the US currency after adjusting for inflation differentials between the two countries. The Chancellor admitted he was concerned about this on Friday; even if sterling is at about the right level against the deutschemark, should it really join the ERM while it is trading at so ludicrously high a level against the dollar (and, incidentally, against the yen as well)? Would this not just exacerbate the recessionary tendencies that are now bubbling away? Perhaps it might be best to wait a while for things to clarify.

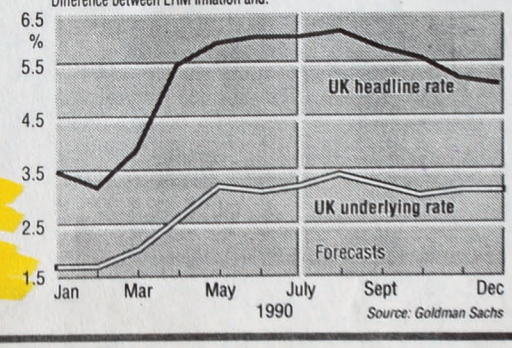
That, I suspect, is as far as the Chancellor has got. Although his Treasury officials are no doubt still keen on intensifying the economic squeeze, he is wondering whether the ERM might now impose too high an exchange rate on the economy to be compatible with victory in the next election. Many still view John Major as a rather grey technocrat. In fact, his every move in the last year shows him to be a politician to his fingertips, a far more political Chancellor than either Lawson or Howe. And his political instincts tell him that an easing in policy, possibly with a somewhat lower exchange rate, may soon be needed. My guts tell me that all talk of ERM entry at rates of DM3 or above will soon evaporate.

That does not mean that the ERM has no role from here in the election formula. The fundamental truth remains that, without the ERM, it could be very difficult to get interest rates down enough next year to stand a chance in a general election. Furthermore, the Chancellor is somewhat hoist with the success of his own earlier petard. The markets have an ERM premium still in them, and will not forgive an indefinite delay on this question. Sometime in the next few months, they will turn thoroughly nasty if the Chancellor continues to dither.

The graph shows that Mr Major's inflation condition for ERM membership will start to look a whole lot more credible by about mid-November. The Inter Governmental Conference on European Monetary Union is still due to start in mid-December. These two dates constitute a good window for entry. Any delay beyond that threatens a market debacle. So entry still seems imminent, if at a lower rate than was earlier in the frame.

■ *The author is Chief UK Economist at Goldman Sachs.*

Convergence starts in a couple of months



On rec

HARDLY a day goes by without a leadi British company confronting the harsh reality of the Government's high intere rate policy. Last week the chairman of construction group Wimpey, Sir Cliffo Chetwood, echoed the views of many when he described the recession in his industry as "the worst I have seen in a lifetime".

Empty blo

By Matthew Crabbe

THE BUILDING boom of the Eighties promises some lasting monuments to the Thatcher years. But even as the tower of the Canary Wharf project in docklands soars to become Europe's tallest building, the City of London is threatened with collapse in its commercial property market.

Supply heavily outweighs demand. A frenzy of office building since Big Bang in 1986 has produced an office vacancy rate in the City that will probably reach 20 per cent by the end of 1990, according to Chris

calf for backers

uccess due to conservatism as boom ended

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investors are

which promised him about a fifth of the Smithfield's exit value.

ERM membership hinges on German rates

ECONOMIC AGENDA

by TONY BARON

LAST week again witnessed rampant City hysteria about the timing of sterling's entry into the European Exchange Rate Mechanism. A number of commentators convinced themselves the Government would use this weekend's Rome meeting of Community finance ministers to announce ERM entry. This brought with it hopes of a base rate fall and the Bank of England was forced to act in the money markets to stop rates falling. On Friday, Chancellor John Major squashed the hysteria,

Last Sunday I said hopes of imminent ERM entry were likely to be disappointed. It was never likely Major would take sterling in and risk a premature base rate cut before inflation had peaked. Major said one Madrid condition for sterling's entry, the need for inflation to fall closer to that of the rest of the Community, was still outstanding.

This does not mean the headline figure as measured by the Retail Price Index has to fall to the EC average. Instead, the Treasury is looking at the underlying inflation rate excluding mortgages and the poll tax. This is because European inflation measures do not include those items.

Looked at this way inflation is still above that in almost all EC countries. At 7 per cent British underlying inflation is higher than the 4·4 per cent average and more than double the rate in West Germany and France. In the months ahead the inflation differential between Britain and other Community countries is likely to moderate as the economy slows down but also because inflation is tending to rise on the Continent.

One of the dangers alluded to by Major was that interest rates overseas, particularly in Germany, could rise soon. The political consequences of the Tories reversing a premature base rate cut are clear. Indeed, German interest rates may rise soon. Latest German retail sales figures showed a 14 per cent rise in July compared with a year earlier. After monetary union between East and West the pent-up demand for western goods is finding its way into West German consumer figures.

This, coupled with rising oil prices, is lifting German inflation. In consequence the Bundesbank will bear down on inflation by raising interest rates. Furthermore, German rates are likely to be lifted by Chancellor Kohl's decision to finance German unification through debt. With pan-German elections due in December Kohl has made a Bush-type promise not to raise taxes.

It seems likely Major would prefer to go into the ERM after any rise in German interest rates. Once sterling is in inevitably there will be downward pressure on UK interest rates towards the German level. UK residents would be able to substitute cheap German loans for their expensive UK debt at little exchange rate risk. This would be true both for companies refinancing their borrowings and for individuals swapping UK mortgages for cheaper German ones.

The ability to borrow abroad with little currency risk after ERM entry would make credit controls inoperative. This would be true both of specific controls and of informal controls in the form of moral persuasion.

The act of converting these overseas borrowings by UK residents into sterling would put upward pressure on the pound and force the authorities to reduce interest rates. If the Government did not allow rates to fall sterling would tend to rise through the top of its ERM range. This would be true no matter what level was chosen for sterling's entry. No-one would believe the monetary authorities of the ERM countries would fail to defend sterling on the down side at least for the first year after entry so the perceived down-side risk for sterling against the Deutschemark would be limited to sterling's lower intervention within the ERM.

The need to get inflation down before sterling's exchange rate with the Deutschemark and other European currencies is fixed is demonstrated by the fate of the East German economy following monetary union.

The huge differences in productivity between East and West German companies has left much of East German industry uncompetitive and unemployment is rising. Once sterling is fixed against the Deutschemark the opportunity for a sterling devaluation to maintain the competitiveness of British industry will be removed. Thus if costs and prices continue to rise more rapidly than those in the rest of the Community British companies will lose market share. As this happens unemployment will rise — the extent of the rise reflecting the degree to which costs move out of line with those in Europe.

ERM membership, therefore, should not be seen as a soft option. Indeed Britain, like France, is likely to experience much pain in adjusting to a lower inflation rate environment. The adjustment process would be eased if wage settlements were based on a company's ability to pay while maintaining its competitive position.

Superficially, last week's call by the TUC conference for talks between Government, industry and unions to decide what the economy could afford to pay might seem attractive. But the danger is that as in the past talks would give rise to a high target based on current inflation. The sad experience of the 1980s has been that employers have only controlled wages by cutting numbers rather than moderating settlements.

Major needs to push inflation down and there is no substitute for proper domestic monetary control. There is no reason why the Bank of England cannot perform as good a job as the Bundesbank. But this would mean giving the Bank independence. Only if monetary policy were determined by an independent Bank would it be possible to hold talks between Government, industry and unions that did not run the risk of lifting inflation.

Mountleigh looks a bargain

MARKETS IN FOCUS

"GULF fatigue" hit world markets last week and the City's focus returned to the knotty

how high interest rates and strong pound are hitting corpo rate earnings. Housebuilde

t DRX

the company. These s, he says, "represent the e most promising avenue financial restoration and re success for your pany".
X, which lost $2·9 million ear and which has a work- apital deficit of $1·6 mil- granted an option to Rand s, part of Glamis, for a venture worth potentially million on its Randsburg properties in California.
's DRX director George ey: "This is a further ipt by Clarke to use an rd conspiracy theory to k his own corporate lers."

s sights otation

Randall: optimistic

lafascan, a machine to ire the fat/lean ratio of which sells for about 0 and can enable produc- d retailers to cut waste ting the desired balance before packaging. The Glafascan stands for ge's Lean And Fat Ana- , and it was invented by e George Clarfelt.
dall performed the feat ating colouring group wo months after the 1987 But he is reluctant to oma until he considers mate is right.

kes gold

10 grammes for Driefon- The discovery is ed to yield 50 tonnes. ' ill recently the priority hikari has been on min- lica. Gold has been to be present in the ore ne time but to the puz- t of analysts Sumitomo

Major move still on cards t

THIS paper has never subscribed to the theory that Britain would enter the Exchange Rate Mechanism on September 8, so it did not cause any surprise to see John Major quashing ERM frenzy or the Bank of England holding the base rate at 15 per cent. The reasons are clear: inflation must come down for ERM entry and monetary conditions must improve for a base rate cut. Major has said this many times and has again shown *sang froid* by refusing to be bounced by fair weather friends of Tory economics.

That said, the Gulf, the oil price rise and the pound's petrocurrency surge have combined to complicate policy, as Tony Baron shows on page 26. Before the Gulf, Major could happily play an elegant game of talking up the pound to take the steam out of the feared post-entry surge as sterling becomes a high-yielding British Deutschemark — and improve the inflation outlook next year. Now he has to cope with far greater uncertainty.

But, inflation should still peak with the figures for August and the trend should be down later this year with the pound's strength reducing the impact of rising dollar denominated oil prices. Some things political are even starting to move Major's way with Spain throwing its weight behind the hard ECU and Germany backing away from a Delors style monetary union. This strengthens his hand in Cabinet. So subject to Madrid conditions being met, ERM entry can still come this year and Major can time it to maximum political effect. My favourite would still be an announcement to coincide with the party conferences.

Major should not delay too long as he risks a fall in the pound that could undo the recent anti-inflationary gains. And once in the ERM, interest rates can start to fall, alleviating the real problems now facing industry. One only has to glance at recent results to see that well-run well financed big companies are feeling the squeeze. For the first time in years corporate UK may make less money this year than last. The problems should focus Treasury minds more on working out how to achieve tight money at lower interest rates without credit controls. I side with Sir Martin Jacomb of Barclays who wants greater incentives for saving.

If people save more and borrow less, the cost of money and consumption fall. It is that simple. Major with Tessa became a convert to incentives and fresh initiatives on share ownership and saving must be in the next Budget.

Meantime, where does the economic cocktail leave a market that looks cheap on fundamentals, with a low p/e and the highest yield outside Australasia? A real Gulf war may produce a panic which could cut prices 10 per cent within days but any panic could be a buying opportunity. It will bring out predators. Already the market is throwing up shares like Thorn EMI, yielding 6·7 per cent at 598p. Thanks to problems with disposals, with defence, lighting and Rumbelows on the block but without buyers, Thorn is unloved, yet chairman Colin Southgate has built music and rental businesses which are worth far more than its market value. If investors fail to spot this, Thorn could be ripe for a predator.

CITY COMMENT by **JOHN JAY**

Major: balancing act

Ronson's mistake

THE tabloids cannot get enough of Guinness. The reporters camp outside Ford open prison and each day we read more about prison life for Messrs Saunders, Ronson and Parnes. It all gives new meaning to the phrase "inside information".

In the City, all conversation turns to Guinness. Were the sentences too lax? Did the defendants do well in court? How did Gerald Ronson get a year and Ernest Saunders five? If the money had been stolen from a bank would the robbers have spent more time in prison?

Ronson intrigues me, not least because of the mail we have been receiving, a strange mixture of sympathy for a successful and generous businessman and some of the most ugly anti-semitic junk I have ever read. A fortnight ago, the *Mail on Sunday* suggested it was not in Ronson's best interest to tell the truth to the DTI and Guinness and last week it apologised to Ronson and his advisers, noting the judge had commended him for the truthfulness of his evidence.

Ronson was a big player in the bid battles of the mid-1980s and saw nothing wrong in profiting from the market power his wealth gave him. In Guinness he negotiated an illegal up-front payment with the person he and anyone else would regard as

TODAY'S STOCKMARKETS

The Risks ar

Sunday Times

Agony of post-ERM depression

Economic Perspective

David Smith

WAITING for the government to take the pound into the European exchange-rate mechanism is like a child's longing for bonfire night. The anticipation is exciting but the event often turns out to be a damp squib. And some people might get hurt.

Since he returned from his summer holidays a fortnight ago, John Major has watched sterling's increasingly bumpy flightpath towards the ERM. The Gulf crisis has contributed but so too have some blatant examples of market nonsense about ERM entry.

The ERM factor, which has usually boosted the pound, also showed that it could work in the opposite direction a few days ago when strong rumours swept the markets that the Bank of England was intervening to push the pound *down* before entry into the ERM.

The chancellor, having had something of a free ride by tantalising the markets with ERM-entry hopes, knows that he has to take the rough with the smooth.

Even so, and after a relentless stream of propaganda from both the Treasury and the Bank of England on their desire for a strong pound, the idea that the authorities would be seeking a deliberate depreciation of sterling was not one he was expecting.

What has also started to emerge is a condition that could be described as post-ERM depression. Even those who have long advocated full sterling membership of the system are viewing Britain's adjustment prospects with concern.

Economists at the Confederation of British Industry, in their report last week, UK Inflation Performance, were clear that a stable pound must be part of the environment in which industry operates.

Sterling stability, however, also means that competitiveness has to be achieved without outside help.

Industry's prices, and the most important determinant of them, unit-wage costs, need to be growing in line with our European competitors.

The CBI sees the need for 3% inflation by the mid-1990s and warns that, on present trends, absolute pay levels in Britain will overtake those in Germany by 1995, without a commensurate catch-up in productivity.

With average earnings growing at 10%, gloom about Britain's labour market, and its ability to adjust to the disciplines of the ERM, is widespread.

The CBI sees pay bargaining in Britain (although also to a lesser extent in France and Germany) as occcupying an uncomfortable middle ground.

In some countries, for example Japan and Switzerland, pay negotiations are decentralised and the outcome is generally good. In others, for example Austria, a highly centralised system also delivers low settlements.

Britain's framework, with elements of both centralised and decentralised pay bargaining, appears to be the worst of both worlds.

A thoughtful paper from union leaders John Edmonds and Alan Tuffin, Bargaining for Prosperity in the 1990s, discussed at last week's Trades Union Congress, also addresses itself to pay in the context of ERM membership.

Membership, it says: "Will heighten the need to stay cost-competitive with our leading European partners, with unavoidable consequences for bargaining and pay levels . . . Badly handled, entry into the ERM could mean stable prices but many lost jobs."

The paper, treading carefully through the minefield of TUC, Labour party and government sensibilities, proposes increased centralisation in pay negotiations.

Although this would involve nothing as crude as a pay norm, the idea is of tripartite discussions between the government, the TUC and the CBI to set the agenda for individual negotiations.

Governments that have accepted interference in the currency markets by joining the ERM may have to be prepared to accept greater interference in the labour market. Under the Tories it is, of course, a non-starter. Under a future Labour government, it could well feature.

That does not, however, solve the present problem. With double-figure average pay rises in prospect this autumn more than two years after the Treasury embarked on its tightening of monetary policy, one could be forgiven for thinking that Britain's labour market is a law unto itself. ERM entry, on this view, will fail to break the inflationary psychology that forms the basis of pay negotiations, as happened with monetary targets in the early 1980s.

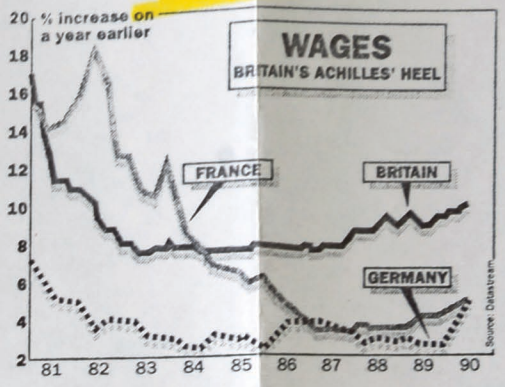
The result is that, assuming sterling's level within the ERM is held, the process of grinding pay increases in Britain down to, say, 3% will be a painful one.

The old rule of thumb from the Treasury model, that every 1% off wages requires a 100,000 increase in unemployment, could in such circumstances underestimate the pain.

Most pay negotiators would claim, however, that they respond to the temperature of the inflationary climate, rather than creating it.

In this, although they may not care to admit it, they are at one with monetarists, in saying that the cause of inflation is lax monetary policy and high pay settlements are merely an effect.

The optimistic interpretation of the consequences of ERM entry is that it will reinforce anti-inflationary policy and change the inflationary psychology in Britain. The French example of the success of the *franc fort* policy has been over-used but it shows



that realistic expectations of low inflation can be more important than labour-market reforms in changing the behaviour of pay negotiators.

Indeed, worries about politicians abusing ERM entry, by using it as an excuse to cut interest rates prematurely, may have been overstated. Far more likely is that full membership of the system will present a useful scapegoat when tough policies have to be continued during periods when it is politically inconvenient to do so.

Achieving low pay settlements in Britain will be far from easy. In the mid-1980s, when unemployment approached 3.5m, the annual rise in average earnings never fell below 7.5%.

High pay settlements have survived two recessions and four major reforms of trades-union law.

Many sectors of the economy, notably those producing goods and services which are not internationally traded, will be only indirectly affected by ERM membership and pay levels will be slower to respond than in export and import-competing industries. This could mean, paradoxically, that one of the temporary effects of entry will be to provide an incentive for workers to move into those sectors that are not making a much-needed contribution to reducing Britain's trade gap.

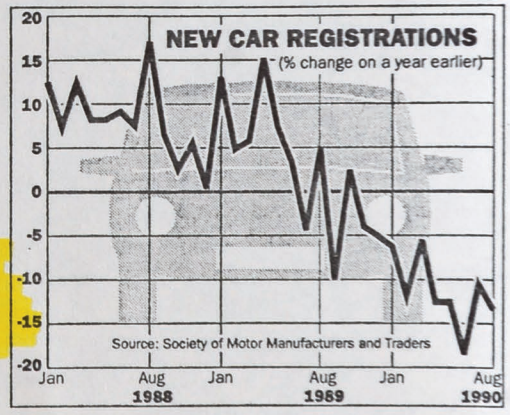
Pay, of course, is only one area in which Britain's competitive position is at risk. An Institute for Public Policy Research report, Learning by Right, to be published tomorrow, highlights the lamentable training gap between Britain and the rest of Europe.

Only 38% of the workforce in Britain has skilled vocational training, compared with 56% in Spain, 67% in West Germany and 80% in France. And this at a time when the Department of Employment is under pressure from the Treasury to cut its training budget.

None of this means that full membership of the system is a bad thing, merely that it requires complementary action elsewhere in the economy. Initially, the effect will be to create additional pain in the economy and the chorus of "I told you so" from long-standing opponents of the system will be deafening.

Ultimately, entry will force competitiveness on the economy in a way that policy outside the system has failed to achieve. Meanwhile, pass the pills for post-ERM depression.

Indicator of the week



NEW car registrations in August, the first month of the new H prefix, totalled 432,867, a drop of 13.45% on a year ago, providing further evidence of the weakness of the economy.

The Confederation of British Industry, in its latest survey of the distributive trades, pointed to particular weakness affecting the motor trade. In every month this year, new-car sales have been well below their 1989 level. For the first eight months of 1990, registrations were 1,544,626, a fall of 11.61% on the corresponding period of 1989.

Imported cars accounted for 59.56% of registrations last month, slightly down on the 60.18% share of August 1989. In the January-August period, however, importers increased their share to 57.35%, from 56.91% in the corresponding period last year.

Among the top manufacturers, Ford's market share has dropped to 25.02% this year, from 27.03% in January-August 1989. Vauxhall rose from 14.83% to 15.74%, and Rover from 13.62% to 13.98% but Peugeot-Talbot slipped from 6.06% to 5.85%. Nissan, despite its successful UK manufacturing presence, suffered a drop in market share from 6.17% to 5.75%.

The weakness of vehicle registrations is not confined to cars. August commercial-vehicle registrations were 25.9% down on last year. The last time there was a similar sharp drop was during the 1980-1 recession.

The week ahead

Date	Event	Expectation	Previous
Mon 10	UK retail sales (Aug)	–0.2%	1.0%
	UK input prices (Aug)	1.6%	0.6%
	UK output prices (Aug)	0.4%	0.3%
Thu 13	UK unemployment (Aug)	+15,000	+10,900
Fri 14	UK manufacturing output (Jul)	0%	–0.5%
	UK retail prices (Aug)	0.7%	0.1%
	US producer prices (Aug)	1.2%	–0.1%
	US industrial output (Aug)	–0.1%	0%

Source: IDEA

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Sunday Times

Agony of post-ERM depression

Economic Perspective

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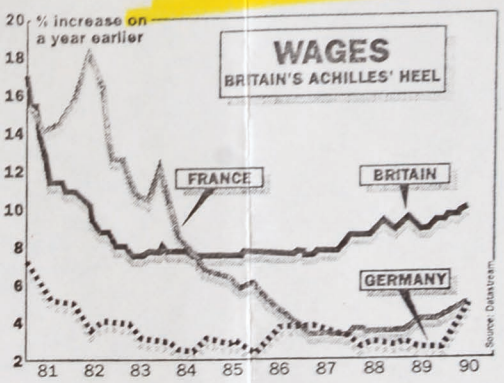

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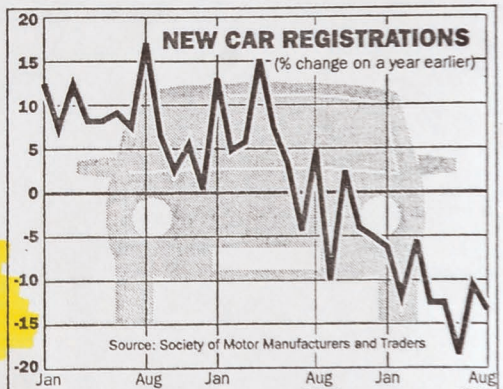

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Sunday Times

Agony of post-ERM depression

Economic Perspective

David Smith

WAITING for the government to take the pound into the European exchange-rate mechanism is like a child's longing for bonfire night. The anticipation is exciting but the event often turns out to be a damp squib. And some people might get hurt.

Since he returned from his summer holidays a fortnight ago, John Major has watched sterling's increasingly bumpy flightpath towards the ERM. The Gulf crisis has contributed but so too have some blatant examples of market nonsense about ERM entry.

The ERM factor, which has usually boosted the pound, also showed that it could work in the opposite direction a few days ago when strong rumours swept the markets that the Bank of England was intervening to push the pound *down* before entry into the ERM.

The chancellor, having had something of a free ride by tantalising the markets with ERM-entry hopes, knows that he has to take the rough with the smooth.

Even so, and after a relentless stream of propaganda from both the Treasury and the Bank of England on their desire for a strong pound, the idea that the authorities would be seeking a deliberate depreciation of sterling was not one he was expecting.

What has also started to emerge is a condition that could be described as post-ERM depression. Even those who have long advocated full sterling membership of the system are viewing Britain's adjustment prospects with concern.

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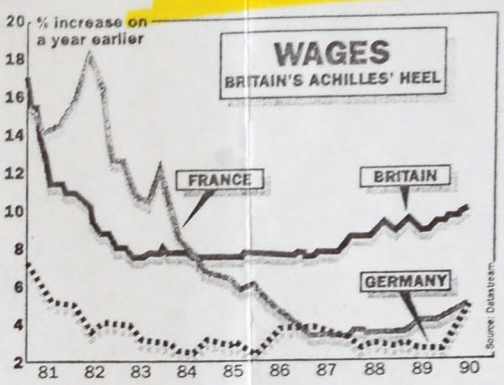

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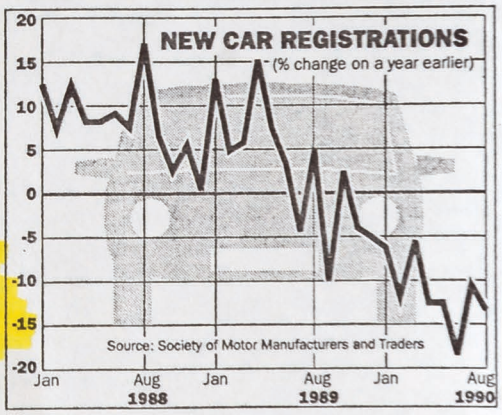

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The Message from Sterling's Recovery

– Robert Thomas & Ray Richardson

In his radio interview last Friday Mr Major confirmed that sterling's entry into the ERM still lies some way off in the future. This article looks at sterling's recovery over the last four months and concludes that, as was suggested in an article in the issue of the Greenwell Gilt Weekly of 18th June, it is likely that sterling has already taken most of the benefits of entry into the ERM. The article then considers the implications for sterling in the coming months and whether the market could begin to lose confidence if entry were delayed too long.

Mr Major's Interview

Mr Major began his interview by stating clearly that sterling would not enter the ERM last week-end. Sterling immediately fell over 2 pfennigs, but partially recovered when he reaffirmed that he "believed without any doubt whatsoever that it is the right policy for sterling to enter the ERM". But his remarks suggest that entry is still some weeks, if not months, away. Inflation remains the Madrid Condition which still has to be met, although he refused to state categorically that inflation has to be falling before entry. But his doubts about the trend in inflation and the strength of the real economy surfaced more than once.

Our interpretation of the interview is that sterling will enter the ERM, but probably not for a month at least. November becomes the most likely time for entry. His remarks, however, are consistent with entry being delayed until next year, and it is significant that, at one point, he said that he will recommend entry as soon as he thinks "it is **safe** to go in".

Cuts in interest rates will depend on how the economy develops. Mr Major is still concerned about the strength of retail sales as well as inflation. He emphasised that interest rate reductions will not be necessarily tied to ERM entry, and could start before entry. But both Mr Major's comments and last Thursday's action by the Bank of England suggest that the first reduction will wait until other countries have decided whether or not to tighten policy in response to higher oil prices.

Sterling's Recovery

Since mid-May sterling has rallied strongly, as the three charts show. Even after its slight softness of the last few days it is up by nearly 9% on its trade weighted index, 13% against the US dollar and by 8% against the deutschemark. In order to understand how sterling will now react we must first consider what has caused it to strengthen over recent months. There are a number of candidates to consider.

Chart I
Deutschemark per Sterling

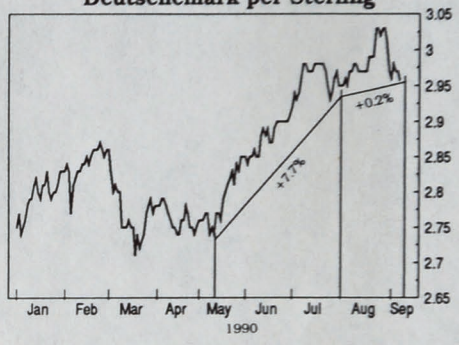

Chart II
US Dollar per Sterling

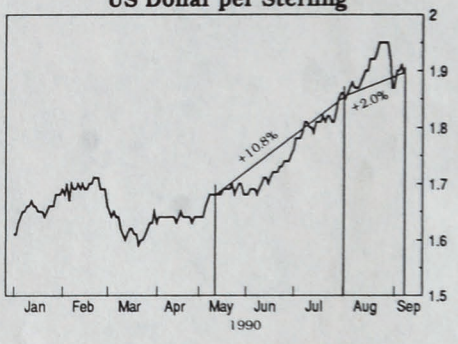

Chart III
Sterling Trade Weighted Index

High Interest Rates
Sterling interest rates have been well above those in other major economies. But short term interest rate differentials have not widened significantly in the last four months.

There are signs that investors have been favouring the high yielding currencies, but sterling has been significantly stronger than other higher yielding currencies. For example, since early June, it has risen 10% against the Australian dollar.

It appears that interest rate (or bond yield) differentials, therefore, do **not** on their own explain sterling's strength.

Bank of England Intervention
In every month since April the UK's underlying foreign exchange reserves have risen, in total by $716m. Even though this has been boosted by funds flowing in to meet the call on the Water issues, if the Government had been pushing sterling up by intervention there would have been a fall, not a rise, in the UK's foreign exchange reserves. It seems, therefore, that sterling's stength cannot have been associated with intervention by the authorities.

Politics and Economic Data
In the first few months of the year the Conservatives were in a real mess. Not only were they way behind Labour in the opinion polls, but talk of replacing Mrs Thatcher as Prime Minister resurfaced. This may well have been a contributory factor to sterling's weakness.

The Conservatives' better than expected performance in the local elections on 3rd May effectively ended talk about the demise of Mrs Thatcher, and the Conservatives began to whittle down Labour's lead in the polls. The improving political standing of the Government raised hopes that it has a sporting chance of winning the next General Election, which after all does not have to be until 1992.

Moreover, signs of a much weaker economy began to appear more frequently in the second quarter. The first monthly rise in unemployment since 1986 was published in May and there was a much lower current account deficit announced in late June.

The improving political and economic climate may well have contributed something to the strength of sterling. However, it must also be said that this effect may well have been associated with prospective ERM entry, in that an improving economic climate has enhanced the chance of entry.

The Impact of the Gulf Crisis
What about sterling's position as a petro-currency? In the month following Iraq's invasion of Kuwait on 2nd August, sterling's strength has been underlined, especially against the US dollar and the deutschemark. But the Gulf Crisis has **not** contributed much to the overall rise in sterling. Its index rose 8% between mid-May and end-July, but less than 1% since then.

Attraction of Other currencies
The trend in sterling cannot be considered in isolation. Its recovery coincides with growing concern about the cost of German unification, with the deutschemark being weak in the ERM until late August. Similarly, the weaker US economy focussed attention on the poor outlook for the US dollar, and easing by the Fed on 13th July highlighted the policy dilemma there.

After falling from a peak of Dm3.28 at the start of 1989 sterling was beginning to be oversold. This contributed to its attractions. When there are few particularly attractive currencies, the high yields offered by a currency which has already fallen a long way can be a draw.

The Impact of ERM Entry
Nevertheless, none of the above provides a sufficient explanation on its own for the turn round in sterling, which closely coincided with a stream of statements by the Prime Minister and the Chancellor that were interpreted as a shift in policy towards the ERM. Mrs Thatcher was believed to have dropped her veto on entry. This was signalled in her speech on 12th May to the Scottish Conservative Party Conference when she made a comparison between the 6.5% underlying inflation in the UK and the comparable European level of 5%, and drew the conclusion that UK inflation was not far above the European average. The belief then grew that sterling would most probably be in the ERM by the end of the year.

When sterling's entry into the ERM was just a very uncertain prospect, there was no obvious downside limit to the fall in sterling. At the other extreme, once sterling is in the ERM there will be a high degree of confidence that it will remain within its

bands, at least until after the next General Election. As the probability of sterling's entry rose, from a low level, through 50% to its current level of, perhaps, 90%, the currency risk from investing in sterling deposits to gain the extra income of some 0.5% a month fell sharply. After all, if sterling is around the central rate of its ERM band it can only fall a maximum of 6%, and in practice slightly less.

Sterling's Recent Fall

One recent event may give a further insight into sterling's possible behaviour. Why was sterling so weak on Friday 31st August, when there were rumours of ERM entry? Was it profit taking, especially as there were rumours of a central rate of Dm2.95 rather than Dm3.00? Or was it fears that interest rates would be cut on entry or soon after? We will never be sure of the actual reasons, but the event highlights the risks to sterling, if the market suddenly decided sterling was not about to enter the ERM.

But what has become clearer after Mr Major's interview last Friday and the Bank of England's action on Thursday is that interest rate cuts will be decided separately to ERM entry. They will not necessarily immediately follow entry or, indeed, even have to await sterling's entry into the ERM.

Implications for the Future

The main factor behind sterling's recovery since April has been the rising prospect of its entry into the ERM. The better trends in the economy and in trade, the lack of really attractive alternative currencies and sterling's overall position have doubtless helped, but they do not seem to be the prime reason. What will happen now that entry appears to have been delayed?

The fact remains that the Government had up to last Friday done nothing to prevent the build-up of a considerable bubble of market expectation that ERM entry was imminent. This raises three questions: What really is the Government's position on entry? Have their intentions changed? How will markets react to delay?

The manner in which this whole episode is being handled suggests to us that the Government does not have a completely settled policy. This may just reflect the fact that Mrs Thatcher, deep down, does not want sterling to join at all. It is not hard to see her arguing that, given the Gulf crisis, entry was not opportune at this time. Underlying this might be an expectation of military conflict in the Gulf. Objectively, this is by no means a clear cut reason for delaying entry. Indeed, sterling might well benefit from the protection of membership, if war were to break out.

The other possibility is that Mr Major himself is still unsure about the terms of entry. In his interview last Friday he made it clear that he does intend to have sterling in the ERM. But inflation has been raised by the Gulf crisis, and probably by the drought, so that even if he had hoped to enter this month he may now feel that he has to delay until he is more confident that the inflation peak has been reached. Also, the real economy has kept going for longer than he probably expected. He will certianly not want to be forced by the foreign exchange market to cut interest rates soon after entry, if he does not think a cut is justified by domestic economic conditions.

All this suggests that entry is most likely a month or more away, with the Gulf Crisis being the rogue factor which could delay entry into next year. Markets have probably given insufficient weight to this and the strength it could give to any delaying tactics which Mrs Thatcher might wish to use.

But how will the market react to continued delay? As long as it still believes that the delay can be justified, sterling should not come under severe pressure. The greatest danger would come if markets began to believe that the delay was turning into an excuse for not joining at all, or that the central rate would be a good deal below Dm3.00. The need to contain inflation is likely to rule out the choice of a rate close to sterling's low of earlier this year. But a rate slightly below Dm3.00 would probably provide more room to reduce interest rates than a rate of Dm3.00 or higher. As the choice of central rate is likely to follow the pattern of other currencies, such as the peseta, and be close to the market rate at the time of entry, the Government may try to manipulate the market or choose the date for entry when sterling is close to the desired level.

As long as entry occurs before the inter-governmental conference on 13th December, which despite recent events is still very much our central view, sterling should not have any difficulty remaining relatively close to its current level. The prospect of a further lasting surge through the recent high of Dm3.04, however, does not look very likely.

At long last, the time is still not right

ECONOMIC VIEW

GRAHAM SEARJEANT

John Major is, fortunately, a lot calmer than the foreign-exchange markets were last week. The September Euro-gathering had been booked as a desirable moment for the chancellor to pop sterling into the European exchange-rate mechanism ever since the prime minister made it clear that entry would come sooner rather than later. As a curtain-raiser to the party conferences, this would have been politically perfect.

Mr Major was wise to leave the rabbit in the hat. After a decade of arguing, with shrinking credibility, that the time was not right, Britain had changed its mind just as the time really stopped being right.

Economic reformers must obey one rule above all others. They must always distinguish between the benefits of a different system and the likely effects in a free economy of making the change.

The difference was well demonstrated when Labour introduced its corporation tax, now long forgotten, in 1965. The new system, intended to boost industrial investment, imposed a higher tax on dividends and a lower tax on retained profits, giving companies an incentive to plough more back. But the process of change produced the opposite effect. Companies maintained their dividends at higher cost, so retained profits fell sharply.

Fixing sterling against the currencies of nations that account for half our trade should produce the inestimable benefit of stability. A stable currency should cut the risks of companies that export or compete with imports, helping them save money and plan ahead. By cutting the risk of holding sterling, it should allow interest rates to be lower. Once wage bargainers get the hang of it, a stable currency tied to the strongest in the system should dissolve inflationary expectations and be an anchor for stable prices, allowing faster growth.

By contrast, moving into the ERM at the wrong time, at the wrong rate or in the wrong way can damage and destabilise the economy for years ahead. That would have happened had the chancellor succumbed to temptation at the weekend, and will happen if he accedes to political or market pressures for entry in the coming weeks.

The crucial error would be to use entry as a short-term anti-inflationary measure. This idea seems to have crept into official thinking since early summer. High interest rates did not seem to be working, notably on rising pay settlements. Sterling was soft and the impact of any further rise in mortgage interest on prices would make things worse.

As an international report on Britain suggested, the monetarist strategy so effective in the early Eighties had fallen apart. Swift entry into the ERM, previously rejected as impractical until inflation had come down to continental levels, might itself do the trick, ruling out devaluation and making policy credible again.

This seemed attractive with sterling just below DM2.80. That was about average for the decade, allowing for the higher price rises in Britain than in West Germany. Respected analysts at City firms such as Goldman Sachs and BZW thought it a sensible level to fix the pound for the long term. The authorities, however, skilfully talked the pound up in the markets by offering a tasty dish of security with high returns: ERM entry with 15 per cent base rates.

The final step was to see a high fixed exchange rate plus sustained high interest rates as the ultimate weapon with which to slash inflation.

These logical steps had led to nonsense, which has been compounded by the unpredictable resurgence of sterling as a petrocurrency. Lower interest rates should be a prime benefit of being in the ERM, but the Treasury and the Bank want high interest rates in the short term. Sterling would therefore have to be fixed at so high a rate that the risk of an exchange loss from holding it would remain, so that interest rates could be kept up.

Almost by definition, this has to be an economically unrealistic rate now, since Britain has been running a trade deficit of about 4 per cent of output with sterling at lower levels. If it takes three years to bring inflation down permanently to the average rate of other ERM members, industry might well be a further 8 per cent less competitive and could not realistically recoup that loss.

On this plan, the government would soon be forced into a dire choice. It must accept a long, deep slump, costing the permanent loss of many factories sensitive to relative European exchange rates, such as chemicals, building materials, engineering components, capital goods and textiles. Or, horror of horrors, sterling would suffer humiliating devaluations within the ERM, just as the franc did, for different reasons, in 1983.

The better way is to fit into the long-term logic of a stable currency. Entry must wait until inflation is decisively down, ideally until the short-term inflation gap can be covered by the currency's widest permitted range of movement within the ERM. This will allow interest rates to be cut to a level suitable to keep the pound at a realistic rate. Mr Major could then fix sterling at a central rate equivalent of about DM2.80. The time will not be right before mid-December, when talks on monetary union start, and probably not until next spring.

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YOUR TELNO 497 TO ROME: INFORMAL ECOFIN

SUMMARY

1. FRG PRESS HIGHLIGHTS DIFFERENCES OVER TIMING OF STAGE TWO. EDITORIAL COMMENT NOTES THAT POSITIONS HAVE SHIFTED AND SUPPORTS A CAUTIOUS APPROACH.

DETAIL

2. THE INFORMAL ECOFIN RECEIVED WIDE COVERAGE IN THE GERMAN PRESS ON 10/11 SEPTEMBER. PROMINENT FACTUAL REPORTS EMPHASISED THAT THE MAJORITY OF FINANCE MINISTERS OPPOSED DELORS' PROPOSAL THAT THE SECOND STAGE OF EMU SHOULD BEGIN ON 1 JANUARY 1993. WAIGEL WAS QUOTED AS SAYING THAT IT MADE NO SENSE TO PUT THE TIMETABLE UNDER PRESSURE. POEHL WAS REPORTED TO HAVE SAID THAT THE CONTENT OF THE SECOND STAGE MUST BE CLEAR BEFORE FIXING ITS STARTING DATE. WHILE HE WAS NOT AGAINST A NEWLY-DEFINED AND HARDER ECU, A 13TH CURRENCY AND A NEW INSTITUTION TO ISSUE IT MADE NO SENSE AND WAS A DETOUR WHICH HE DID NOT RECOMMEND. SOME PAPERS SPECULATED ON THE POSSIBILITY OF ANOTHER INFORMAL ECOFIN BEFORE THE IGC.

3. THOSE PAPERS WHICH COMMENTED GENERALLY SUPPORTED THE MORE CAUTIOUS PACE NOW ADVOCATED BY THE FINANCE MINISTRY AND THE BUNDESBANK, CITING THE NEED TO ENSURE STABILITY. GREATER ECONOMIC CONVERGENCE AND CONTROL OF BUDGET DEFICITS WERE NEEDED BEFORE PROGRESSING TOWARDS THE SECOND STAGE. COMMENTATORS RECOGNISED THAT THERE HAD BEEN A SHIFT IN POSITIONS. NOTING THAT THE UK NO LONGER REGARDED TREATY AMENDMENT AS UNTHINKABLE, THE LIMITED CIRCULATION BOERSEN ZEITUNG (SPECIALIST STOCK EXCHANGE DAILY) SAID THAT A REDEFINITION OF THE ECU WAS WORTH CONSIDERING AS PART OF THE EMU PROCESS. DIE WELT (CONSERVATIVE) POINTED OUT THAT THE BUNDESBANK HAD SHIFTED ITS POSITION TOWARDS THE UK PROPOSALS FOR COMPETING CURRENCIES BECAUSE IT WANTED TO MAINTAIN A STRONG MONETARY POLICY, BUT THAT IT WOULD NEVER ACCEPT SUBSTITUTION OF THE DEUTSCHMARK BY THE HARD ECU. THE FRANKFURTER RUNDSCHAU (WELL-INFORMED, LEFT OF CENTRE) SAID THAT THE UK PROPOSALS WERE AIMED AT DEFERRING EMU UNTIL

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FRAME ECONOMIC

INFORMAL ECOFIN, ROME 8 SEPTEMBER: ITALIAN PRESS COMMENT

SUMMARY

1. ITALIAN PRESS SEE THE OUTCOME OF THE INFORMAL ECOFIN AS A SUBSTANTIAL SETBACK FOR THOSE SUPPORTING RAPID IMPLEMENTATION OF THE DELORS PLAN.

DETAIL

2. ALL ITALIAN NEWSPAPERS CARRY FULL REPORTS ON THE 8 SEPTEMBER ECOFIN MEETING. MOST CONCLUDE THAT THE MEETING WAS A SUBSTANTIAL SETBACK FOR THE THREE MEMBER STATES FAVOURING RAPID PROGRESS TOWARDS EMU WITH PHASE II BEGINNING ON 1 JANUARY 1993. SOME ARGUE THAT THE FUTURE OF THE DELORS PLAN IS NOW IN DOUBT. HEADLINES INCLUDE 'IN ROME, THE TWELVE RISK A BREAK ON MONETARY UNION' INSOLE/24 ORE (MILAN-BASED ECONOMIC/FINANCIAL DAILY, READERSHIP 1.1 MILLION), 'MONETARY UNION ON ICE' IN MESSAGGERO (ROME BASED, LEFT OF CENTRE DAILY, READERSHIP 1.5 MILLION), 'A BRAKE ON MONETARY UNION' IN CORRIERE DELLA SERA (MILAN-BASED CENTRIST DAILY, READERSHIP 3 MILLION) AND 'IN ROME THE TWELVE SPLIT ON EMU' IN ITALIA OGGI (MILAN-BASED ECONOMIC/FINANCIAL DAILY, READERSHIP 250,000).

3. DETAILED REPORTING FOCUSES ON THE DISAGREEMENT OVER THE TIMING OF A MOVE TO STAGE II. THE GIST IS THAT THREE COUNTRIES, FRANCE, ITALY AND BELGIUM, TOGETHER WITH DELORS, ARGUED THAT PHASE II SHOULD BEGIN ON 1 JANUARY 1993. BUT A LARGER GROUP, LED BY THE UK AND FRG AND INCLUDING THE NETHERLANDS, LUXEMBOURG, GREECE AND PORTUGAL, ARGUED THAT A SATISFACTORY DEGREE OF ECONOMIC CONVERGENCE MUST COME FIRST. THE ITALIAN PRESS CONCLUDE THAT, THOUGH NO CONSENSUS WAS REACHED, THOSE ARGUING FOR CONVERGENCE WERE DOMINANT AND THE DELORS PLAN AS A WHOLE IS NOW IN DOUBT. DELORS IS QUOTED IN IL SORE/24 ORE AS SAYING THAT 'THE MORNING SESSION OF THE MEETING THREATENED TO THROW AWAY TWO AND A HALF YEARS OF WORK - BUT THE DISCUSSION CAME BACK ON COURSE IN THE AFTERNOON'. ACCORDING TO

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MESSAGGERO, NOT ONLY DID THE MEETING FAIL TO AGREE A DATE FOR PHASE II: 'THE RISK NOW IS THAT THE OPPOSITION OF CERTAIN COUNTRIES, WITH THE UK AT THEIR HEAD, WILL PREVAIL AND MONETARY INTEGRATION WILL BE DILUTED AND PUSHED FAR INTO THE FUTURE'. CORRIERE DELLA SERA AGREES: 'EVEN IF EMU HAS BEEN SAVED FROM THE MENACE OF THE GULF CRISIS, FROM THE ATTACKS OF THE BRITISH AND FROM GERMAN RESISTANCE, IT HAS BEEN GRAVELY WEAKENED BY THE ROME MEETING'. OTHER NEWSPAPERS NOTE THAT SO GREAT WAS THE OPPOSITION TO THE FIXING OF A DATE FOR PHASE II THAT EVEN A SPANISH PROPOSAL THAT THIS BE DELAYED UNTIL 1994 FOUND NO SUPPORT.

4. ITALIAN PRESS OPINION IS DIVIDED ON THE RECEPTION GIVEN TO THE BRITISH HARD ECU PROPOSAL. CORRIERE DELLA SERA SAYS THAT 'THE UK APPEARS ISOLATED AND THE PROPOSALS ARE NOT CONSIDERED SUCH AS TO PUT IN SERIOUS PERIL THE INTEGRATION PROCESS: THE REAL OBSTACLE IS GERMAN OPPOSITION TO PHASE II BEFORE CONVERGENCE'. OTHER NEWSPAPERS TAKE A MORE POSITIVE LINE. POEHL IS QUOTED IN SEVERAL ARTICLES AS SAYING THAT HE FAVOURS MAKING THE ECU HARDER THAN THE STRONGEST NATIONAL CURRENCY, AS A PRECURSOR TO A SINGLE CURRENCY, BUT THAT HE OPPOSES THE CONCEPT OF A PARALLEL CURRENCY MANAGED BE A NEW EC INSTITUTION . LA STAMPA (TURIN-BASED, CENTRIST, OWNED BY FIAT, READERSHIP 1.75 MILLION) REPORTS THAT THE BRITISH PLAN IS SUPPORTED BY SEVERAL COUNTRIES AS A TRANSITION BETWEEN PHASES I AND III OF EMU. ITALIAN OGGI SUGGESTS THAT THE CHANCELLOR WILL HAVE RETURNED HOME HAPPY WITH HIS SCHEME 'STILL ON THE TABLE AND BOUND TO BE RE-EXAMINED'. MOST NEWSPAPERS ALSO REPORT THE SPANISH COMPROMISE PROPOSALS, WITH IL SOLE/24 ORE PRINTING THEM IN FULL ON ITS FRONT PAGE. ACCORDING TO IL MESSAGGERO, THE SPANISH ARE SUPPORTING THE MAIN ELEMENTS OF THE BRITISH PLAN BECAUSE IT ALLOWS A TRANSITION PERIOD OF SEVERAL YEARS. 'THIS WILL GIVE THEIR ECONOMY TIME TO CATCH UP WITH OTHERS SO THAT THEY CAN PLAY A FULL PART IN EMU: WHEREAS IN THE IMMEDIATE FUTURE THEY WOULD HAVE NO CHANCE'.

5. ITALIA OGGI, ALSO CARRIES A VERBATIM EXTRACT FROM THE CHANCELLOR'S PRESS CONFERENCE, IN WHICH IT COMMENDS HIM FOR HIS 'CALMNESS AND LACK OF ARROGANCE' DESPITE THE SUCCESSFUL OUTCOME OF THE MEETING FROM THE BRITISH VIEWPOINT. A COPY OF THIS, AND A SELECTION OF OTHER ARTICLES, IS BEING FAXED TO O'DENNELL, TREASURY PRESS SECRETARY.

6. FCO PLEASE ADVANCE TO PS/CHANCELLOR, O'DONNELL PRESS OFFICE TREASURY AND HITCHENS, ECD(I)

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Prime Minister

Nigel Wicks' account of the informal ECOFIN meeting.

CDP 10/9

INFORMAL ECOFIN

SUMMARY

1. The Chancellor of the Exchequer and the Governor represented the UK at Saturday's Informal ECOFIN in Rome at which EMU and help for the front line states affected by sanctions were discussed. On EMU, the eleven Member States maintained their intention to amend the treaty to establish a single currency and an independent Central Bank, but disagreement about the pace of transition and other issues emerged. Presidency to report to October's Informal European Council. Another informal ECOFIN possible. A general welcome that the UK had put forward proposals which remain on the table for further examination. Solchaga incorporates UK ideas in his proposals for Stage 2. Commission proposals on help for front line states affected by sanctions to be examined in

Brussels

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Brussels colon no decisions. Sensible conclusions about the economic policy response to the oil price rise.

EMU

2. Setting the meeting's agenda Carli said consensus was emerging on colon a common monetary policy semi colon a single currency semi colon price stability as the main economic policy objective semi colon an independent Central Bank with democratic legitimacy semi colon and no monetary financing of deficits or budgetary bail outs. The outstanding issues included colon binding budgetary rules and their enforcement, including sanctions semi colon cohesion semi colon the transition to full EMU including the decision whether the move to Stage 2 should be taken by reference to a date or to the achievement of economic criteria semi colon the possibilities for a single speed movement to EMU by all Member States semi colon the role of the British ideas for the ecu semi colon and the role of Treasury and Finance Ministers in the two IGCs.

3. In introductory statements the Chairman of the Central Bank Governors' Committee (Poehl) gave a long report of the work of his Committee semi colon Delors said that the Commission had tried in their latest report to keep to the middle road, especially on budgetary issues semi colon Christophersen emphasised that events in the Gulf were no reason to slow up progress to EMU semi colon the Chairman of the Monetary Committee (Sarcinelli) reported on his Committee's discussion of the British proposals as in FCO Tel No 238 semi colon and the Chairman of the Economic Policy Committee (Molitor) summarised his Committee's report.

MANAGEMENT

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MANAGEMENT OF THE TRANSITION

4. Beregovoy (France) argued in his first intervention for the transition to Stage 2 on 1 January 1993 after completion of the work on the Single Market and membership of all countries of the ERM. But when it became clear that this date had little support, he later moved his date forward by a year with an even stronger emphasis on universal ERM membership for movement. He asked whether the statutes of national Central Banks would have to be modified in Stage 2 to make them independent, which might cause problems. Expressing opposition to variable geometry, he called for every effort to associate all Member States with the move to EMU. Waigel (FRG) thought that dates for the transition should not be decided until clear conditions for convergence had been met. He suggested that at the beginning of Stage 2 the Committee of Governors should be given legal personality in the form of a Council of Central Bank Governors. Only in Stage 3 would the ESCB be established and binding budgetary rules invoked. In this way the issue of two speeds could be avoided for some time, though he volunteered in response to Beregovoy's question that Central Bank constitutions should be approximated in Stage 2 as did Pedersen (Denmark). Kok (Netherlands) agreed. Kok was unconvinced that setting a date for the transition of the move from Stage 1 to Stage 2 would bring EMU nearer. The criteria for convergence described by the Monetary Committee needed to be met. He called for an analysis of convergence. Rubbi (Italy) thought that convergence conditions should focus on trends towards acceptable levels, not precise figures. Transitional provisions were necessary because of the need to be realistic about whether all Member States could move to EMU at the same time. Stage 2 should be shorter than Stage 1. Solchaga

(Spain)

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(Spain) favoured a precise date for the start of Stage 2, namely 1 January 1994, after one year's experience of the Single Market, the removal of all exchange controls, membership of all currencies of the ERM (though not necessarily the narrow band), independence for all Central Banks and a sufficient degree of economic convergence. In addition, a new Community institution should be established at the beginning of Stage 2 independent of national governments and as part of the move to an ESCB. It should issue a genuine currency as proposed by the UK, put pressures on national monetary policies, serve as a forum for coordination, and study the complex procedures necessary for Stage 3. During Stage 2, which should not be exceptionally short, possibly 5-6 years, the ERM bands should narrow to 1 per cent and realignments should become exceptionally rare. The passage to Stage 3 needed to be a certainty for all members though special transitional arrangements should be available for those not able to go immediately to Stage 3.

5. Pedersen (Denmark) thought the arrangements for EMU should permit the association of non-EC European countries. Reynolds (Ireland), emphasising the importance of parallelism, wondered whether speeding up the move to EMU might not exacerbate problems. Juncker (Luxembourg), recalling the Werner experience, thought the setting of deadlines could be counterproductive. Christodoulou (Greece) opposed a rapid transition to EMU, the timing of which should be decided in the light of objective criteria. Beleza (Portugal) supported Solchaga's approach, except that he argued for the moves between stages to be based on economic criteria. Maystadt (Belgium) gave strong support to the Commission's approach to the transition.

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DEMOCRATIC ACCOUNTABILITY

6. Beregovoy, supported by Maystadt, emphasised that further thought should be given to the relationships between European Parliament, the Commission and the Council and for parallel progress between EMU and political union, a point echoed by Christodoulou.

EXTERNAL MONETARY POLICY

7. Beregovoy appeared more ready to accept that an ESCB should be responsible for operation of external monetary policy within a framework or regime established by the political authorities. Waigel and Kok were certainly of this view, as were most other Ministers.

BUDGETARY RULES

8. Waigel emphasised the need for firm budgetary rules, including powers to suspend payments from the Community Budget for Member States with excessive budget deficits. Kok wanted more discussion of prescriptive rules. Just enough sovereignty should be transferred on budgetary policy to prevent the undermining of monetary policy. Rubbi thought that budgetary rules should not be detrimental to national sovereignty, nor restrictive of national budgetary action to deal with quote asymmetric unquote disturbances. There should be a gradation of disciplinary pressure, going beyond peer pressure. Pedersen favoured the latest Commission proposals on budgetary issues and believed it unwise to seek to infringe national sovereignty. He commented too that while he expected a solid majority in Denmark for EMU and an ESCB, his Government would not seek a Parliamentary mandate until the

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details were clearer - and in these matters quote the devil lies in the details unquote.

9. Juncker saw quote tiers unquote of responsibility for budgetary policy, including the use of it as an indicator of the golden rule (deficits not to exceed government investment). Christodoulou wanted to avoid rigid rules. Reynolds preferred the Monetary Committee's (tougher) approach to budgetary rules to the Commission's.

COHESION

10. Waigel saw no reason for further Treaty or budgetary provisions for cohesion. He disagreed with the Commission's latest proposal for a special financial assistance facility. Any action should wait until the results of the doubling of the structural funds were available. Kok though that the Commission's proposal conflicted with the no bail out rule. Rubbi argued that lack of harmonisation of fiscal regimes made it harder to achieve cohesion. Maystadt and Beleza agreed and the latter thought tax harmonisation could be made subject to majority vote. He liked the Commission's latest proposals for cohesion and called for an early increase in the Community's resources. Christodoulou favoured the Commission's new facility and argued that cohesion policy was about more than the size of the structural funds.

THE UK'S IDEAS

11. Beregovoy thought that everything should be considered in helping Member States move forward, including the Chancellor's ideas. Waigel was glad that the Monetary Committee would consider further the Chancellor's ideas for a

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hard ecu which could be an important contribution to the move to EMU. (As Poehl pointed out outside the meeting, the Germans' interest is in the hardening of the ecu preparatory to a single currency, not the European Monetary Fund.) Kok, after welcoming the British moves, thought the strong ecu proposals needed serious attention. Rubbi observed delphically that interesting ideas were about on the composite ecu which might not be incompatible with the British ideas. Solchaga saw an important role for the British ideas in his proposals for Stage 2. Reynolds welcomed the degree of movement evident in the UK position but did not see the ideas as an alternative to the Delors approach. Christodoulou welcomed further examination of the UK and Spanish ideas. Beleza thought the UK proposals were constructive, of particular relevance to the transition and should remain on the table.

THE ROLE OF ECOFIN

12. Waigel agreed with the Monetary Committee that the role of ECOFIN should be strengthened and that Finance Ministers should have the fullest role in the IGC. Kok feared preparations for the IGC would not be completed by the Council's October meeting, the last time EMU appeared on their agenda before the IGC despite its appearing on the FAC's November and December agendas. Finance Ministers should remain in charge of the political aspects of EMU. Rubbi and other Ministers assumed that the EMU IGC would be led by Finance Ministers.

13. The Chancellor, speaking towards the end of the morning's discussion, noted that the debate had been realistic and pragmatic. The UK had consistently focused on how the

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Community might move forward after Stage 1. We accepted the need to amend the present Treaty and make institutional changes. Our evolutionary approach could lead to a single currency and monetary policy if peoples and governments so chose, though we were not part of the consensus described by the Chairman in his introductory remarks. The two key issues in his view were now to achieve economic convergency and how to promote price stability. The first issue was relevant to the Council's debate after the timing of the Community's move from Stage 1 and the number of Member States that should make that move. All agreed that greater convergence was a prerequisite for monetary union and that parallelism was a fundamental principle of the move to EMU, though suggestions that the second stage would begin on 1 January 1993 appeared to move away from that principle. Work was needed on the extent to which Community economies were now convergent and how convergent they had to be before EMU could be introduced in a desirable form without enormous tensions and costs.

14. He was grateful for colleagues' consideration of the UK's ideas and had listened with interest to Solchaga's proposals. Clearly more work needed to be done in the Monetary Committee. The UK proposals were directly relevant to his second key issue of the promotion of price stability. In his concluding remarks, the Chancellor emphasised that the objective should be for all Member States to move forward together, not creating, perhaps permanently, different tiers of members.

15. After lunch Delors called on ECOFIN to report to the European Council. Some issues were becoming clearer, for example on exchange rate policy, institutional structure and budgetary restraints. But further definition was needed on

cohesion,

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cohesion, the role of the ecu, and management of the transition where his impression was that matters were moving backwards.

16. After Carli had tried in vain to stimulate discussion of Delors' comments, in a mixture of summing up and personal opinion he attempted to list the issues which should be reported to the European Council and then decided in the IGC colon the conduct of external monetary policy where there was emerging agreement semi colon budgetary policy semi colon the institutional structure where no profound divergences had emerged semi colon the time to modify Central Bank statutes where Delors' suggestion for action when there was certainty of the move to Stage 3 looked a way forward semi colon the two approaches identified for the management of the transition where he preferred the calendar approach, though the majority of Ministers preferred the objective criteria route semi colon and the role of the ecu.

17. Kok then unsuccessfully tried to stimulate more debate on the criteria for moving from Stage 1 which he suggested could combine the timetable and objective criteria approaches. In response to Kok's question, Carli confirmed that ECOFIN would remain in the lead and there could be a further informal ECOFIN before the IGC began, though Waigel thought that the German elections would rule out his attendance.

CONSEQUENCES OF THE SITUATION IN THE GULF

18. Despite Commission pressure during the discussion over lunch, no decisions were reached on their proposals for help for the front line states. There was agreement that the Commission proposals should be rapidly examined in Brussels

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with a report to Coreper later this week, including estimates of the countries' needs and the consequences of a Community contribution for the Community budget. Many Finance Ministers expressed concern about the prospective impact of growing overseas claims on Community and national budgets.

19. There was general agreement about the economic policy response to the oil price rise colon no accommodation of the oil price rise through a relaxation of monetary policies semi colon maintenance of budgetary stringency semi colon advice to wage bargainers not to try to recoup oil price rise through higher wages semi colon and the reflection of crude oil price rises in product prices. Solchaga's suggestion for promulgation of this advice in a communique was not adopted.

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FRENCH PRESS REACTION TO ECOFIN
SUMMARY
1. EXTENSIVE FACTUAL REPORTING AND ANALYSIS. CERTAIN SOURNESS AT WHAT IS SEEN AS GROWING SUPPORT FOR THE CAUTIOUS BRITISH APPROACH AGAINST THOSE (INCLUDING FRANCE) SEEKING TO PRESS ON QUICKLY TOWARDS EMU.

DETAIL
2. NO EDITORIAL COMMENT YET. BUT MOST ANALYSTS AGREE ON THE FOLLOWING POINTS:

A) THE DELORS PLAN FOR EARLY MOVEMENT TO STAGES II AND III HAS SUFFERED A REVERSE. WHAT WAS ACCEPTED BY ALL EXCEPT THE UK THREE MONTHS AGO IS NOW RE-OPENED TO QUESTION:

B) FRANCE, ITALY, BELGIUM AND THE COMMISSION ARE DISAPPOINTED BY THIS. WIDE REPORTING OF DELORS' COMMENT THAT: ''AT ONE POINT IN THE DISCUSSION WE RETREATED TWO AND A HALF YEARS'':

C) EXPERIENCE OF GEMU AND THE REPERCUSSION OF THE GULF CRISIS ARE CONSIDERED AS THE CATALYSTS FOR GERMAN SUPPORT FOR BRITISH CAUTION:

D) SPANISH PROPOSAL SEEN AS A IMPORTANT TILTING OF THE SCALES, REPRESENTING THE LESS DEVELOPED SOUTHERN ECONOMIES' FEARS OF THE EFFECTS OF HASTY, FORCE-FED CONVERGENCE.

3. ALTHOUGH IT IS JUDGED THAT ELEVEN OUT OF THE TWELVE REMAIN COMMITTED TO EVENTUAL EMU, THERE IS A GENERAL SENSE THAT A SIGNIFICANT GAP HAS OPENED BETWEEN TWO CAMPS WHICH MAY PROVE DIFFICULT TO BRIDGE BY THE DECEMBER IGC. THOSE ADVOCATING A SLOW APPROACH (OF WHICH THE UK IS CAST AS THE RINGLEADER) ARE DESCRIBED IN LA TRIBUNE DE L'EXPANSION AS RUNNING THE RISK OF SETTING SUCH HIGH CRITERIA FOR CONVERGENCE THAT EMU WILL BE PUT OFF UNTIL THE GREEK CALENDS.

4. FINALLY, LE FIGARO ASSESSES THAT IN SPITE OF ITS ROLE IN

DELAYING THINGS, THE UK IS EDGING TOWARDS ACCEPTANCE OF EMU AS AN ULTIMATE AIM: ''IT IS MORE OR LESS ACQUIS THAT THE BRITISH HAVE DECIDED TO BOARD THE EMU TRAIN EVEN IF, IN SO DOING, THEY HAVE SLOWED DOWN THE COMMUNITY ENGINE''.

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PRIME MINISTER

MESSAGE FROM CHARLES POWELL

You may have seen press reports about yesterday's ECOFIN, suggesting that our plan for a hard ecu was accepted. This is an exaggeration. I have spoken to Nigel Wicks who was there. He says it went well, and there was indeed considerable interest in our ideas and a reluctance to accept Delors wish for a commitment to start Stage 2 on 1 January 1993. We are very much still in the game, but well short of having converted the EC to our way of thinking.

The joint press conference between President Bush and Mr. Gorbachev is about to start. I will let you have a report.

C. D. POWELL
9 September 1990

10 DOWNING STREET

AP to rep

Amanda

Can you please find 1½ hr. ear the end of the month

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HAMBROS BANK LIMITED

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6 September 1990

Prime Minister

This comes back yet again to the insistence that you accept the aim of achieving a single currency one day.

Are you prepared to see him again?

CDO 6/9

Charles Powell
10 Downing Street
London
SW1

Dear Charles,

EMU

We agreed on the telephone the day before yesterday that I would prepare a short paper for you to show to the Prime Minister, explaining why I think that the negotiating position requires a tactical move on our part before the end of the month. It is enclosed.

2. I should stress at present the enclosed paper represents only my own views. Naturally, since it is written for the Prime Minister's eyes, I will not show it to my City European Committee. But the matter is on the agenda of the Committee on 12 September and I will let you know if there are any new developments there. So far the Committee has given me strong and unanimous support and I expect that they will approve the general approach in the paper on proposed institutional arrangements for Stage 2.

3. I should be most grateful if the Prime Minister could agree to see me before the end of September.

Yours ever

Michael

Sir Michael Butler

MDB/JSD

There is no point in doing so but I will if he wishes me to

EMU

The present negotiating position and future tactics

1. The negotiating phase has now opened. Our Stage 2 proposals are alive and gaining a little ground in Brussels. But they could only secure an important degree of support if our negotiators were in a position to explain their value as transitional arrangements on the way to an eventual Stage 3. It is clear that the Italian Presidency and several member governments are reluctant to bring our proposals into the centre of the negotiations unless:-

(a) we accept that the aim of a single currency in Stage 3 can be in the Treaty;

(b) we spell out how our proposed European Monetary Fund would fit into the institutional and Treaty framework.

2. Meanwhile the Commission, with support from the French and some other member states, are moving ahead with drafts designed to create an insititutional framework for Stage 3, with a fully independent "Eurofed" to manage a single currency, and are talking about a short Stage 2 beginning on 1 January 1993. The obvious disadvantages of any sudden great leap from a situation with 12 (or even 6) monetary authorities, policies and instruments, and currencies to one of each will raise doubts about this option, but the Stage 3 institutional proposals themselves are increasingly attaining sacred cow status.

3. The best outcome which I believe the Prime Minister can hope to achieve at the end of the negotiation (and even this will be very difficult indeed) will be:-

(a) to get something very like our evolutionary approach accepted as Stage 2 in a three stage process;

(b) to prevent the Treaty or the Statute of the EMF from spelling out the details or timing of Stage 3, but to accept in the Treaty the aim of achieving a single currency one day;

(c) to create the institutional and Treaty framework for Stage 2 (along the general lines of the attached paper) which would provide that any move to Stage 3 and consequential amendments to the EMF would be subject to unanimous agreement of all member states.

4. To achieve such an outcome would be a major negotiating triumph. We should have not only to promote our own proposals successfully and to kill the idea of a short Stage 2, but also:-

(a) to get the negotiations to focus on the institutional arrangements for Stage 2;

(b) at the end of the day to knock out the now rather solidly entrenched institutional proposals for Stage 3;

(c) to resist pressure to set a time-table for the passage to Stage 3.

5. The Prime Minister cannot achieve all this herself in the two or three European Councils likely to be held before the final crunch. Probably she will be the only person able to achieve 4(b) and (c) above. But in order to give her a reasonable hand to play, officials and the Chancellor need to get the Presidency to include in the draft going to the IGC (if only in square brackets) language giving effect to 4(a). Otherwise I cannot see how we can get through to the outcome in para 3.

6. I conclude that the Prime Minister needs not later than the end of this month when the ECOFIN Council of 8 October will be being prepared (the last before the European Council of 27 October) to authorise her negotiators:-

(a) to put forward proposals along the lines of the attached paper, less para 2(b);

(b) to say that if other member Governments are ready to accept proposals on these lines for Stage 2, she would be willing to consider including the aim of achieving a single currency one day in the Treaty.

If the Prime Minister gave such instructions, I think that her negotiators would stand a reasonable chance of getting the draft negotiating documents into a shape which would permit her to fight a successful battle at her level over the following months.

Annex A

EMU

Proposed institutional arrangements for Stage 2

1. The objective would be to create a system for Stage 2 under which only those things which need to be decided centrally are put under the control of the European Monetary Fund (EMF).

2. (a) The Treaty would create a European System of Central Banks (ESCB) consisting of the twelve national Central Banks and a European Monetary Fund owned and run by the Central Banks, to be operational from day one of Stage 2.

(b) It would also lay down the aim of permanently fixed parities or more probably a single currency in Stage 3.

(c) The aim of price stability would be in the Treaty and in the Statute of the EMF.

(d) The Statute of the EMF would be annexed to the Treaty which would provide that it could be changed by unanimous agreement as necessary.

(e) The Treaty would provide that National authorities (Central Banks, Governments or Parliaments) would not seek to influence EMF policy contrary to its Statute.

3. The Statute of the EMF would also provide that in Stage 2 the ESCB shall co-ordinate national monetary policies and the EMF shall control ecu monetary policy. It would create the hard ecu and provide that it should be managed so as to be always as strong as the strongest currency. It would contain the two golden rules - no monetary financing of budget deficits and no money creation to replace national currency converted into ecus. It would provide for convertibility of national currencies into and out of ecus and for the EMF to be a lender of last resort in ecus. It would lay down that the exchange risk on national

currencies converted into ecus would rest with the National Central Banks and that the EMF should have the right to require any member state judged to be breaking the golden rules or running too lax a monetary policy to reconvert into ecus some or all of the balances of its national currency held by the EMF. These provisions would all help to ensure that no Government could take advantage of the system to run a lax monetary policy.

4. On this basis, arrangements for Stage 3 would no doubt require amendments to the EMF Statute but not necessarily to the Treaty. It would be wise at this stage only to create the ESCB as required for Stage 2. No-one can fully foresee at present what will be required for Stage 3.

5. The Chairman of the EMF Council would report to the European Parliament and to Ecofin annually in writing and be available to them in person to answer questions when required.

6. National Central Bank Governors could retain their existing relationships with national Parliaments and Governments and could report to national Parliaments if so desired (provided always that 2 (e) above was respected). In this way the ESCB and the EMF would be protected from political pressure to take action contrary to the EMF's Statute but would remain accountable to national Parliaments as well as to ECOFIN and the European Parliament.

MDB/

6 September 1990.

chex.kf/tt1/77

CONFIDENTIAL

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

6 September 1990

Charles Powell Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Charles,

ECOFIN: UK RESERVE ON MONETARY COMMITTEE REPORT

We understand from Sarcinelli, the Chairman of Monetary Committee, that Carli, the Italian Finance Minister may, as Chairman, ask the Chancellor at the informal ECOFIN next weekend whether he is prepared to lift the UK's general reserve on the Monetary Committee report on EMU. The various reserves which the UK entered in the report are attached.

We are considering what scope there is for persuading Carli not to make this request. However, if he does, the Chancellor proposes to take the following line:

> "The UK still maintains its reserve on the report's references to a single currency, single monetary policy and ESCB; and on the references to legally-enforceable rules on budget deficits. However, as we have consistently stressed, we are ready to play a full part in the Inter-governmental Conference, including discussion of Treaty amendments along the lines we have proposed."

I am copying this letter to Stephen Wall and Paul Tucker.

Yours ever,
Tarkowski

T TARKOWSKI
Private Secretary

chex.kf/tt1/76

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

6 September 1990

Barry Potter Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDON
SW1

Dear Barry,

ERM: QUESTION AND ANSWER BRIEFING

... I attach for information the briefing on the ERM which we are currently using.

T TARKOWSKI
Private Secretary

35/1 mg1.a/dw.11.5.9

Date for Sterling's entry into ERM ?

UK not committed to any particular date, but will be during so-called stage 1 of Delors which has already begun.

Why not join ERM now ?

Very clear conditions for UK entry. A very good deal of progress has been made on a number of the Madrid conditions for membership of ERM but all have not yet been met.

What are conditions for joining ERM ?

Set out clearly after Madrid Summit. Government committed to join ERM when level of UK inflation is significantly lower, there is capital liberalisation in the community and real progress has been made towards completion of single market, freedom of financial services and strengthened competition policy.

What progress towards meeting conditions has been made ?

[Note Headline inflation Madrid (June '89) 8.3% cf 9.8% July; Underlying inflation (ex Mips/cc) Madrid 5.8% cf 7.0% July]

Countries required to abolish exchange controls by 1 July 1990 under 1988 Capital Liberalisation Directive have now done so. Also progress on competition policy and on liberalisation of financial services.

Sterling should join ERM as part of anti-inflationary battle ?

Government committed to achieving significantly lower inflation. ERM entry will not substitute for firm Monetary policies but complement them.

Exchange rate on entry ?

Aim is to join in a way that supports policy to reduce inflation. Entry rate will be determined by that objective.

Will Gulf situation affect entry (uncertainty, oil price inflation etc?)

Uncertainty caused by Gulf crisis will have to be taken into account. But so far the economic distrubance has been fairly limited. Rise in oil prices, if sustained, will increase inflation throughtout EC for a while. But effect on UK smaller as import prices moderated by rise in sterling.

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ECONOMIC AND MONETARY UNION : SPEECH BY POEHL

SUMMARY

1. IN A MAJOR SPEECH POEHL EXPRESSES DOUBTS ABOUT MOVING AHEAD WITH EMU TOO QUICKLY AND SAYS THAT HE SYMPATHISES WITH THE BRITISH CONCEPT OF COMPETING CURRENCIES.

DETAIL

2. ADDRESSING THE MONT PELERIN SOCIETY OVER LUNCH IN MUNICH ON 3 SEPTEMBER, BUNDESBANK PRESIDENT POEHL SPOKE AT LENGTH ABOUT EC ECONOMIC AND MONETARY UNION (TEXT BY FAX TO ARTHUR ECD(I), HMT AND UKREP BRUSSELS).

3. POEHL WONDERED WHETHER A EUROPEAN CURRENCY AND A EUROPEAN CENTRAL BANK WERE REALLY QUITE AS INDISPENSABLE AS SOME MADE OUT. IT WOULD BE BETTER TO GAIN EXPERIENCE WITH STAGE I OF EMU BEFORE MORE FAR-REACHING STEPS WERE CONTEMPLATED. THIS WAS TRUER THAN EVER IN VIEW OF THE CHANGES IN PROSPECT RESULTING FROM GERMAN UNIFICATION. HE THEREFORE STILL HAD SOME SYMPATHY WITH THE BRITISH CONCEPT OF A COMPETITION OF CURRENCIES, 'OR PERHAPS IT WOULD BE BETTER TO SAY A COMPETITION OF POLICIES, AT LEAST FOR THE TIME BEING'. THE SINGLE MARKET NEEDED CONVERGING POLICIES MORE THAN A SINGLE CURRENCY. THE FRG SHOULD NOT SACRIFICE THE DM ON THE EUROPEAN ALTER WITHOUT KNOWING WHAT IT WOULD GET IN RETURN.

4. THE SPEECH CONTINUED ON FAMILIAR LINES. THE DECISION WHETHER TO MOVE AHEAD WITH EMU WAS A POLITICAL ONE ON WHICH HE DID NOT WISH TO GIVE AN OPINION. HE DOUBTED WHETHER ALL OR ANY GOVERNMENTS WOULD REALLY BE WILLING TO RELINQUISH MONETARY SOVEREIGNTY. CENTRAL BANK GOVERNORS WERE ALL AGREED HOWEVER, THAT MONETARY STABILITY COULD BEST BE GUARANTEED BY A SYSTEM WHICH WAS INDEPENDENT OF POLITICAL INTERFERENCE. A SYSTEM WHICH CO-ORDINATED MONETARY POLICY BUT LEFT THE RIGHT TO DECIDE ON THE PRICE AND QUANTITY OF MONEY TO NATIONAL GOVERNMENTS WOULD BE HALF-BAKED.

5. POEHL APOLOGISED FOR NOT GOING INTO FURTHER DETAIL, FOR EXAMPLE ON THE BRITISH PROPOSAL FOR A HARD ECU, BUT SAID THAT HE HAD

EXPRESSED HIMSELF EXHAUSTIVELY ON OTHER OCCASIONS. A FOOTNOTE IN THE PRINTED VERSION OF THE SPEECH REFERS BACK TO PREVIOUS ARTICLES AND SPEECHES, MOSTLY PUBLISHED BEFORE THE HARD ECU PROPOSAL WAS LAUNCHED, BUT INCLUDING HIS 2 JULY SPEECH IN LONDON WHICH REJECTED IT.

6. IN CONCLUSION, POEHL SAID THAT AS LONG AS THE PRESENT DIVERGENCE EXISTED BETWEEN EUROPEAN ECONOMIES, IT WAS HARD TO CONCEIVE HOW THE EXCHANGE RATE COULD BE GIVEN UP AS AN INSTRUMENT OF ADJUSTMENT. THE ADJUSTMENT PRESSURE WOULD FALL ENTIRELY ON OTHER AGGREGATES, PARTICULARLY ON EMPLOYMENT, AND EVER INCREASING PUBLIC TRANSFER PAYMENTS WOULD BECOME INESCAPABLE. GEMU PROVIDED A SPECTACULAR LESSON IN THIS RESPECT. THE DM ANCHOR SHOULD NOT BE ABANDONED BEFORE SOMETHING EQUIVALENT COULD TAKE ITS PLACE.

COMMENT

7. THIS SPEECH REVERTS TO DOUBTS THAT POEHL EXPRESSED AT AN EARLIER STAGE AT THE EMU DEBATE AND WHICH WERE SUBSEQUENTLY OVERLAID BY A TENDENCY TO EMPHASISE THE OPPORTUNITY WHICH A SMALL GROUP OF GOVERNMENTS MIGHT WANT TO TAKE TO FORM A SMALL EMU. THIS IS NOWHERE EVEN HINTED AT THIS TIME AS A POSSIBLE WAY ROUND THE PROBLEM OF ECONOMIC DIVERGENCE BETWEEN THE TWELVE, RATHER SUGGESTING THAT POEHL MAY THINK THAT THE TIME IS NOT RIGHT FOR THE FRG TO BE ENCOURAGING THE IDEA THAT STAGE III WILL COME SOON OR EASILY. AND HE HANGS ON TO THE INDISPENSABILITY OF A SINGLE MONETARY AUTHORITY.

8. POEHL'S ANALYTICAL POINT ABOUT GEMU IS FAIR ENOUGH, BUT ONE IS STILL LEFT WITH THE FAINT FEELING THAT HE IS DISTANCING HIMSELF EVER SO SLIGHTLY FROM THE TERMS ON WHICH IT WAS BROUGHT ABOUT. IF HE IS SAYING 'WE MADE A MISTAKE THEN', THE IMPLIED MESSAGE TO POLITICAL LEADERS IN RESPECT OF EMU IS NOT TO IGNORE HIM A SECOND TIME.

9. FCO PLEASE PASS TO LORD PRESIDENT OF THE COUNCIL.

MALLABY

YYYY

(2)

PRIME MINISTER

EMU: KARL-OTTO POEHL

I attach some comments on EMU said to have been made by Karl-Otto Poehl at a conference in Munich. They were noted down by Patrick Robertson of the Bruges Group. Some of them are of interest.

(C. D. POWELL)
4 September 1990

071-628 0343.

(1)

- Fax to: Anne Segall [redacted] The DAILY TELEGRAPH
- From: Patrick Robertson, The Bruges Group.
- Location: Sheraton Hotel - Munich, W. Germany.

KARL OTTO PÖHL, PRESIDENT OF THE BUNDESBANK

Monetary union is not indispensable.

At a hastily arranged address to the international gathering of the Mont Pelerin Society, the President of the German Bundesbank issued a veiled criticism of the French Government, stating that:

"European Monetary Union is not as indispensable as it is believed to be in some quarters."

After an address by Mrs Thatcher's former economic adviser, Sir Alan Walters, Dr Pohl lent his support to the British Chancellor's "hard" ecu scheme:

"I have some sympathy for the British concept of competing currencies... John Major is right to point out that a joint monetary policy is not as efficient as it is made out to be."

Dr. Pohl said that "the alleged savings in transaction costs in a monetary union are not in the least convincing."

The President of the Bundesbank pointed out that the decision to implement EMU was political, not economic:

"If the German Government is prepared to negotiate on the transfer of monetary policy powers, this can only be considered in terms of the long-term objective of political union ... The proposal for monetary union came from the Minister of Foreign Affairs, (Herr Genscher) not the Minister of Economics."

He doubted that monetary union was feasible:

"I continue to have substantial doubts as to whether any (emphasis Pohl's) government is likely to give up monetary sovereignty to Community institutions ... It will certainly take some time if we arrive at a common currency for Europe — if at all"

3.

Echoing the fears of Mrs Thatcher's former ~~Trade~~ Secretary of State for Trade and Industry, Nicholas Ridley, Dr Pöhl said that he agreed with the view ~~that~~ recently expressed by M. Edouard Balladour, the former French minister, that "...achieving monetary union means the elimination of all central banks — except one." (the Bundesbank). ~~That view was recently expressed by EDOUARD BALLADOUR, former French minister.~~

Dr Pöhl doubted that the exchange rate as a policy mechanism could be given up:

"As long as divergences between EC countries exist ~~as~~ today, it is hard to conceive how the exchange rate can be given up as an adjustment mechanism."

Referring to the recent all-German Monetary Union, Dr Pöhl said that "it" provides a spectacular example in this respect — we have to pay the price for that either in terms of unemployment or in expenditure of public funds to prevent the worst."

(9)

~~Defending the~~ In a robust defence of the Bundesbank's monetary policy, which came under fire from Sir Alan Walters, Dr Pohl made it clear that ~~"Any step towards the~~ Communitisation of monetary policy means a loss of manoeuvre for the Bundesbank. Nobody is willing to dispense with his currency"

Dr Pohl's ~~comments~~ comments ~~etc~~ to the Gathering of 500 European liberals firmly opposed to EMU were widely interpreted as a warning shot to over-ambitious plans for wider political union. According to M. Henri Lepage, ~~President of~~ a prominent French liberal ~~the Paris based Institut Euro~~ "The Germans do not want monetary union. This is good: we can now set about integrating Eastern Europe into the Community."

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- From: Patrick Robertson, The Bruges Group.
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KARL OTTO PÖHL, PRESIDENT OF THE BUNDESBANK — Monetary union is not indispensable.

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Treasury Chambers, Parliament Street, SW1P 3AG
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10 August 1990

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

Rather a good paper.

CDS
10/8

Dear Charles.

FURTHER UK PAPER ON THE HARD ECU

At the July meeting of the ECOFIN Council it was agreed that the UK proposals for a hard ecu should be examined at a meeting of the Monetary Committee on 4 September. The outcome of that meeting would then be reported to the informal ECOFIN Council on 7-8 September. It was also agreed that the UK should prepare a more detailed paper for the Monetary Committee on the proposals, spelling out the material in the Chancellor's speech to the German Industry Forum on 20 June. In conversation with Delors the Chancellor said he would consider whether that paper could be made available a week or so in advance of the Commission meeting on 21 August.

Treasury officials, in consultation with Bank of England and other departments, have now prepared the attached paper, which the Chancellor thought that the Prime Minister might wish to see. It is being sent to the Monetary Committee, with personal copies also being made available to the Delors, Brittan and Christophersen Cabinets.

The paper is not being made publicly available at this stage, although the Chancellor will be considering after the Monetary Committee and informal ECOFIN Council discussions whether a similar document should be made available to the Parliamentary Select Committees and other UK audiences. But once the paper is available in Community circles, the possibility of it being made public cannot be ruled out. If this does happen the Chancellor sees no difficulty about confirming the existence of the paper and

making clear that it spells out in greater detail the proposals he launched in his 20 June speech.

I am sending copies of this letter to Richard Gozney (Foreign Office), Martin Stanley (DTI), Paul Tucker (Bank of England) and Sonia Phippard (Cabinet Office).

T TARKOWSKI
Private Secretary

UK PROPOSALS FOR A EUROPEAN MONETARY FUND AND A HARD ECU

Background

In his speech to the German Industry Forum on 20 June 1990 the Chancellor of the Exchequer outlined his further proposals for the development of economic and monetary union beyond Stage 1. These included some key new features, in particular:

- the creation of a common currency, the hard ecu, with firm anti-inflationary properties;

- and a new Community institution to manage both the currency and other monetary activities.

2. The purpose of this paper is to provide further details of the proposals so as to assist the Monetary Committee in their examination of the Chancellor's ideas. The paper deliberately does not provide a precise blueprint. Indeed views would be welcomed on the various options available for carrying forward beyond Stage 1 the framework described below.

3. The paper focuses on the key role of the new central monetary institution, namely the management of the hard ecu as a common currency in the Community. But it would also be possible for the institution, which might be called the European Monetary Fund (EMF), to assume responsibility for a number of existing Community functions. These could include the management of the ERM, the coordination of exchange rate intervention against the currencies of non-Community countries, the management of medium term balance of payments lending, and the provision of a secretariat for the coordination work of Community central bank Governors. These possibilities, which would have to be consistent with the monetary role of the institution, are not explored in this paper, but would merit further consideration.

4. The rest of this paper discusses the hard ecu proposal under the following main headings:

- The key requirements (paragraphs 5-6)
- The Chancellor's approach in outline (paragraphs 7-11)
- The relationship between the basket ecu and hard ecu (paragraphs 12-13)
- The development of the hard ecu (paragraphs 14-26)
- Counter-inflationary discipline: operation of the EMF (paragraphs 27-38)
- Realignments and the EMF's balance sheet (paragraphs 39-43)
- Conclusion (paragraphs 44-45)

The key requirements

5. Any approach for moving onwards from Stage 1 to the further development of EMU should reflect a number of basic principles. These are:

- The process should be evolutionary, because in that way any costs and shocks to member states' economies are likely to be reduced.
- It should ensure, to the maximum degree possible, anti-inflationary pressure and movement toward stable prices and exchange rates, in order to reinforce economic convergence.

- It should work with the grain of the market and individual choice. In this way economic efficiency will be maximised and political acceptability increased.

- It should maintain the clarity of responsibility between Community and National institutions, while respecting the principle of subsidiarity.

- It should provide a framework within which all member states can proceed together along the path of financial and economic integration towards the Community's agreed objective of economic and monetary union.

6. The Chancellor's proposals incorporate all these features.

The Chancellor's approach in outline

7. The main role of the EMF would be the management of the hard ecu. This would serve as a common currency in the Community, and at the same time strengthen the pressures towards anti-inflationary convergence throughout the Community. The present basket ecu offers no guarantee of that anti-inflationary outcome; its performance is linked to the average inflationary performance of the existing national currencies from which it is formed. The need is for a common currency which meets the standard of the best, not of the average.

8. The hard ecu would meet that requirement. It would no longer be defined as a basket of other European currencies. It would be a new currency in its own right, operating alongside the existing Community currencies - all of which, following Stage 1, it is assumed would be fully participating in the ERM on equal terms.

9. The hard ecu's key feature would be that at realignments it could never be devalued against any national Community currency (though, like other ERM currencies, it would be free to move within its band). It would provide a means for putting the ecu at the centre of the system, managed by a new Community institution, immediately after Stage 1 rather than at a later point in the progressive realisation of EMU.

10. The hard ecu represents a fundamentally different approach from the parallel currency proposal rejected by the Delors Committee. That approach, as the Committee pointed out, would have weakened anti-inflationary pressures in the Community. The hard ecu, on the contrary, has been designed specifically to strengthen the pressures for anti-inflationary convergence in the Community.

11. This would be achieved by reinforcing the central provision that the hard ecu could not be devalued against other Community currencies with provisions for:

- the EMF to issue hard ecu deposits in the Community only in return for national currencies.

- a requirement for national central banks to repurchase excess quantities of their national currencies held by the EMF.

- the EMF to operate interest rate policy in a way which affected monetary conditions throughout the Community.

- a possible requirement that each national monetary authority should guarantee the value in hard ecus of the EMF's holdings of their currencies.

The relationship between the basket ecu and the hard ecu

12. In recent years there has been substantial and encouraging growth in the use of the basket ecu. A continuing role for the basket ecu is not inconsistent with the introduction and progressive development of the hard ecu. But the normal pattern might be for outstanding arrangements in basket ecu simply to run to maturity, and then be steadily replaced by hard ecu alternatives. Over time, individuals, businesses and market operators are likely to be increasingly attracted to the hard ecu, given its stronger anti-inflationary properties and greater suitability as a common currency in the post-Stage 1 development of EMU. Therefore, from its inception the hard ecu would probably be the main vehicle for new ecu contracts. (In due course the new common currency might simply be termed the "ecu", although in order to distinguish it from the present basket currency this paper uses the term "hard ecu").

13. Meantime, of course, existing basket ecu contracts would continue to be serviced. And it would be open to market operators to continue to use the basket ecu, for example as a hedging instrument. As use of the hard ecu grew, instruments and options for converting assets and obligations from basket into hard ecus could be developed by the market.

The development of the hard ecu

14. The hard ecu would from the outset be a currency operating within the ERM, subject to the normal margins of fluctuation. Its initial definition, enshrined in the statutes of the EMF (if not in the Treaty itself), would prescribe a central rate against each member currency which could only be changed as part of a realignment within the ERM. It would be subject to the constraint that the hard ecu could never be devalued at realignments against any other Community currency. Thus the hard ecu could be realigned upwards with whichever happened to be the strongest Community currencies, or revalued over time against all other Community currencies.

15. The hard ecu would be issued and managed by the EMF. The Fund would set interest rates at which it was prepared to receive hard ecu deposits. Those rates would be set at levels which ensured the hard ecu was held within its ERM margins. In this way the EMF would receive funds in national currencies from the general public - probably for the most part channelled through commercial banks - and these national currencies would provide its initial asset base. In return it would issue obligations denominated in hard ecu which would comprise the main part of its liabilities. The Fund would be able to accept and convert national currencies on demand at the market rate, with an obligation to purchase national currencies at the lower margin against the hard ecu central rate and to supply national currencies at the upper margin.

16. The EMF's hard ecu liabilities would take various forms. The Fund could offer interest bearing liabilities with a range of maturities and notice periods, including in marketable certificate of deposit form. The Fund could issue hard ecu currency notes as soon as demand for transactions in hard ecu developed. As commercial demand grew, a central clearing and settlement system would be developed for banks participating in hard ecu denominated business, which would be matched by the start of demand for non-interest bearing operational hard ecu deposits at the Fund.

17. The speed at which private and commercial demand for the hard ecu developed would depend on the forces of supply and demand. Thus the speed of its development is inevitably uncertain - just as it has been for the basket ecu. But some likely factors can be identified; and are described in the paragraphs that follow.

Hard Ecus in the Financial Markets

18. In the initial stages of development the main source of growth for the hard ecu would be as an instrument in financial markets. It would offer attractions both as an asset and a liability.

19. As an asset its appeal would develop strongly once its anti-inflationary features became clear in financial markets. Both savers and lenders would find a strong common currency that was not a national currency a highly attractive medium, and they would also have the benefit of a full currency guarantee within the Community.

20. But the fact that it was attractive to lenders would not mean it was lacking in appeal to borrowers. Those personal sector borrowers whose income or assets were still largely denominated in national currency might be initially reluctant to expose themselves to currency risk by borrowing in hard ecu. But, for as long as there was a significant risk of member state currencies being devalued against the hard ecu, interest rates on hard ecu, relative to the Community average, would tend to be low. For sophisticated corporate borrowers and financial market operators this would provide a marked incentive to demand the new common currency.

21. To some degree the attraction of hard ecu to borrowers is the obverse of the attraction to lenders. But the reduction in uncertainty and greater stability provided by the development of hard ecu instruments would provide a substantial net increase in the currency's overall attraction as a financial mechanism. And financial institutions would be an important catalyst for the development of lending and borrowing transactions. They would be keen to increase the use of - and their market share in - what they would perceive as the key European currency of the future.

Transactions in Hard Ecus

22. For transactions purposes growth in the use of hard ecu is likely to come initially from businesses engaged in intra-Community trade, which will form a growing proportion of the member states' total trade as the benefits of the single market are secured. Community businesses would derive substantial convenience benefits and cost savings from the use of a common

currency which was free from risk of devaluation. Once a central clearing and settlement system was in place, firms would find attractions in holding hard ecu balances, and in urging both suppliers and customers to settle accounts in this form.

23. The benefits of using the hard ecu would also be apparent to private individuals travelling - either on holiday or business - from one member state to another. With growing travel between Community countries an increasing proportion of the population might also consider using the hard ecu for domestic transactions - particularly as it became clear that it was the most secure currency.

24. The attitude of Governments to the use of hard ecu for transactions in which they are involved - for example payments for contracts and of the salaries of employees, together with receipts of tax payments - would influence the potential demand for the new currency. Governments might wish to consider removing impediments to the use of hard ecu for these purposes. But as in other areas of demand it would be right to let the speed of development reflect market demand rather than for Governments to insist on the use of hard ecu before people were ready for it.

Legal Tender

25. Legal tender is a concept which applies throughout the Community and is recognised in Community law. Once demand for the hard ecu for transaction purposes had developed action could be taken in member states to make the currency legal tender. It would be a step which could be taken to help the process of monetary integration with relatively little difficulty. But the significance of this action should not be overstated. Indeed, the concept itself is often misunderstood.

26. First, since legal tender is relevant only to transactions to be settled in notes and coin, it has no practical impact on the vast bulk of commercial transactions settled in other ways. Second, it is relevant only when the means of settlement has not been agreed in advance (in which case the debtor can settle in

legal tender in the knowledge that that will constitute full and fair settlement of his debt). In the vast majority of cases, both parties to the transaction will have agreed the means of settlement in advance and legal tender rules will have no application. So, overall, the absence of legal tender status is not usually an obstacle to the use of a particular currency for transactions. What matters is the acceptability to both parties.

Counter-Inflationary Discipline: Operation of the EMF

27. The precise way in which the Fund would operate in managing the hard ecu would evolve over time. But it would be of the essence that its operations could only subtract from inflationary pressure and never add to it. This would reflect the key features summarised in paragraph 11 above.

The EMF would only issue hard ecu deposits in return for national currencies within the Community

28. The EMF by its nature would act as the "central bank" for the hard ecu and its deposit liabilities would comprise the hard ecu monetary base. It is clearly important in avoiding inflation that increases in the EMF's liabilities should not have the direct effect of adding to the aggregate Community money supply. The safeguard that it would issue its deposit liabilities only in exchange for Community currencies would prevent that undesirable outcome. On the one hand, it would preclude the EMF from financing its own expenditure by creating money. But, more importantly, it would prevent sales of non-Community currencies to the EMF, dollars or yen for example, from expanding the Community's money supply via an increased issue of hard ecus, unmatched by a reduction in Community national currencies.

The hard ecu would never be devalued against any other Community currency

29. The EMF's ability to issue hard ecu deposits only in return for Community national currencies is a necessary safeguard. But it is not of itself sufficient to produce the appropriate monetary discipline. As the hard ecu developed, as with other currencies, it would be most unlikely that it would consist solely of its central bank's liabilities. A large part of the hard ecu money supply, perhaps the predominant part, would consist of liabilities of the commercial banks. In a fully liberalised financial system, such as some members of the Community already enjoy, and which will characterise all of the Community by the end of Stage 1, it will be possible to control wider monetary growth only by means of influencing its price. In practice that means keeping interest rates - the price of money and credit - sufficiently high to maintain a tight counter-inflationary policy.

30. It is in this context that the no devaluation requirement would be vital. Because it could never devalue the hard ecu against any other Community currency the EMF would be constrained to follow as least at tight a monetary policy as that of the firmest national monetary policy in the Community. Should the EMF begin to pursue a policy less firm than would be consistent with this stringent standard, it would find the hard ecu under pressure in the financial markets and in increasing danger of devaluation. The EMF would then have no choice but to defend the hard ecu by raising its interest rates and thus tightening its monetary policy.

The repayment requirement provisions

31. By setting its interest rates to maintain the hard ecu as the strongest currency in the Community, the EMF would be setting a stiff standard that other national monetary authorities would be under pressure to emulate. They would have either to pursue policies themselves which would be equally tough on inflation or

to face the prospect of having to devalue within the ERM to which they would all belong. But to prevent the discipline being undermined, it is necessary to close a potential loophole stemming from the EMF itself.

32. If a national monetary authority persisted in pursuing a loose policy, there would be a tendency for people to move out of that currency into, amongst other currencies, the hard ecu. People would sell the weak currency to the EMF in return for hard ecu deposits. But if the EMF was prepared to go on absorbing the weak currency without limit, there would be no pressure on the national monetary authority concerned to correct its lax policy stance. It could persist with its loose stance safe in the knowledge that the EMF would continue to hold its excess monetary creation as the Fund's own assets - in effect, providing unlimited support. Apart from the attenuation of monetary discipline, these operations would place the financial viability of the EMF in question. It would have increasing exposure from its growing holding of weak currency assets compared with increasing volumes of strong hard ecu liabilities.

33. The repayment requirements envisaged in the scheme would be mandatory on all participating monetary authorities. On demand from the EMF, an individual member state would have to repurchase its own national currency from the Fund in exchange for hard ecu or some other strong Community currency which the Fund might nominate. The detailed workings of the repayment requirements need to be discussed further. But in order to maintain counter-inflationary discipline, as well as to protect the EMF's financial standing, there would need to be, at the centre of the arrangements, pre-set limits on the amounts of individual national currencies the EMF could hold. These might be prescribed either in absolute terms or in relation to the proportion of total EMF assets in any one currency. Once reached, such limits would automatically trigger the repurchase requirement. They would need to be tightly drawn.

34. It would also, however, probably be desirable, as the system developed, to allow for some graduation of response without detracting from the rigour of the system. One possibility would be to have, within the pre-set limits, "grey zones" for each currency - where the proportion for a particularly national currency had built up to a certain level but not yet reached the pre-set limit. Within this range, the EMF board might have the discretion but not the obligation to insist on repayment. It might also be empowered to instigate monitoring or surveillance. But the national monetary authority would know that if it failed to take the necessary corrective action, the repurchase requirement would shortly be operated against it automatically.

35. Tight application of the repurchase requirement would establish beyond doubt the counter inflationary credentials of the EMF by demonstrating that it would not allow excessive money creation by an individual central bank to be validated at Community level. An increasingly strong discipline would be exercised by the repurchase obligation as the hard ecu became more widely used. (This discipline could be given added force by imposing a guarantee obligation on each national monetary authority - see paragraphs 42-43.)

Interest rate management

36. Whilst it would be necessary from the outset for the EMF to set interest rates at the levels needed to keep the hard ecu strong, the means that it employed to set interest rates could well evolve over time. In the initial stages of its operation, whilst the hard ecu circulation was building up, the EMF would be likely to rely on its own deposit rates as its main means of influencing interest rates. But as an increasing range of institutions come to deal in hard ecus, and the hard ecu financial structure itself developed, the EMF would be able to employ the techniques which established national central banks use to set rates.

37. In particular, it would be able to conduct open market operations in hard ecu paper to generate cash shortages in the hard ecu money market. It would then be able to relieve those shortages on its own chosen terms, thus influencing hard ecu interest rates, the hard ecu's exchange rate against other currencies and affecting monetary conditions throughout the Community.

Institutional arrangements

38. The organisation necessary to ensure this gradual exercise of the EMF's wider role would need to be considered in formulating the precise constitution, initial financing and accountability arrangements. This paper does not seek to address these issues, for which there would be a range of options. But a key feature of the EMF's constitution would have to be that all its actions were governed by the fundamental objective of price stability in the Community.

Realignments and the EMF's balance sheet

39. The precise composition of the EMF's balance sheet cannot be forecast with any certainty, because the development of the hard ecu would largely depend on market demand. But its general outline is clear. Initially, the Fund would probably have relatively few non-interest bearing liabilities; these would develop as demand for the hard ecu for transactions purposes built up. The currency mix of its asset base is also uncertain, although rigorous rules would be likely to apply at the outset. But it is clear that, in the early stages, the bulk of the EMF's liabilities would be in hard ecu and most of its assets in other currencies.

40. This currency mismatch could have important consequences for the EMF's balance sheet if there were realignments within the ERM. Although the hard ecu would from the beginning have a helpful influence on the convergence of inflation rates within the Community, realignments remain a possibility.

41. Because the hard ecu would be at least as strong as any other currency when parities changed, realignment would expose the EMF to exchange losses. It is impossible to say whether such capital losses would exceed the EMF's regular net earnings arising from having higher interest rates on its national currency assets than on hard ecu liabilities. But in fact, over the period since the inception of the EMS, the total return to the weaker currencies has tended to exceed that on stronger ones - perhaps to compensate for their perceived poorer stability in value. If that pattern continued the EMF might well be able to operate at a profit over time. But of course the possibility of losses in some periods cannot be ruled out.

42. These potential losses would need to be covered in some way. One approach would be to place on each national monetary authority an obligation to guarantee the value in hard ecu terms of the EMF's holding of their currencies. In that case if there was a realignment each country would face an obligation to reimburse the EMF to cover the extent to which their rate was devalued against the hard ecu.

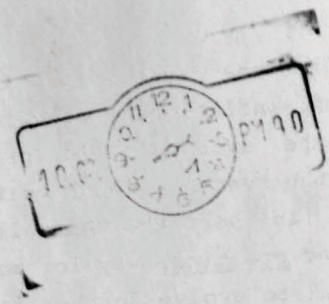
43. Apart from safeguarding the EMF against the risk of losses such an arrangement could also provide an extra discipline on individual member states who were pursuing relatively lax monetary policies. This too would add to the stimulus for convergence under the new system.

Conclusion

44. This paper has indicated possible ways in which the hard ecu and EMF could develop. It is an evolutionary system and the pace of development would largely be driven by individual choice and the operation of market forces. That is perceived as a crucial strength in the system.

45. Moreover the system provides a powerful mechanism for promoting anti-inflationary convergence in the Community. At the same time the system could provide a currency - the strongest currency in the system - which most Community citizens could come to prefer. In short the Chancellor's approach provides a highly attractive and practical way for moving onwards from Stage 1, with the potential to evolve further into a single currency if peoples and governments so chose.

HM Treasury
8.8.90



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9 August 1990

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

It doesn't seem that helpful to me — but para. 40-42 are not bad. The CBI

Dear Charles

... In case you have not seen it, I attach a copy of the latest CBI paper on economic and monetary union, "European Monetary Union - The Next Steps", which John Banham and Sir Brian Corby sent to the Chancellor.

The Chancellor feels that the Prime Minister might like to see this paper: it is extremely helpful in its support of our hard ecu proposals.

still see our Lord e'en as a step to a single currency.

Leonard Tarkowski

T TARKOWSKI

CBD

This is singularly unhelpful and wrong in its analysis.

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TO THE COUNCIL FOR THE MEETING ON 25 JULY 1990

EUROPEAN MONETARY UNION: THE NEXT STEPS

1 The CBI's policy on European economic and monetary union (EMU) was set out in its report "European Monetary Union: a Business Perspective, published in November 1989. The report set out the CBI's support for a single European currency as the culmination of an evolutionary process towards monetary union within the European Community. (The policy recommendations of the report are set out in Appendix A).

2 Since the publication of this report (subsequently referred to as "the CBI EMU report") the European Community agreed at its December summit to consider the possibility of moving beyond stage one of EMU, which commenced on 1 July 1990, at an intergovernmental conference later this year. The UK Government has put forward its own proposals to be considered at this conference, set out in a speech by the Chancellor to the German Industry Forum on 20 June 1990. Meanwhile, the UK has not joined the Exchange Rate Mechanism (ERM) of the European Monetary System, mainly because of the adverse trend in our inflation rate.

3 To consider the CBI's response to these developments, the CBI Economic and Financial Policy Committee (EFPC) reconvened its European Monetary Working Group. The membership of the Group is set out in Appendix B. This memorandum sets out the report of this Group amended in the light of the comments of EFPC, for the approval of Council as the CBI's input to the forthcoming intergovernmental conference on EMU.

4 The memorandum is divided into two sections. The first sets out the main reasons why UK businesses seek further progress towards monetary union - which would lead to the establishment of a single European currency. The second section sets out of the evolutionary approach by which we should move in this direction. This involves:

a immediate UK entry to the ERM within the wider (+/- 6%) fluctuation bands;

b movement to the narrow (+/-2.25%) fluctuation bands once UK inflation is clearly on a downward trend;

c implementation of the UK Government's plan to establish a common European currency (the "hard ECU" controlled by a European Monetary Fund as stage two of the process of monetary union; and

d permanently fixed exchange rates and the introduction of a single European currency.

5 It is not possible, at this stage, to set out a clear timetable for these developments. As the CBI EMU report made clear, progress towards a single currency will depend on the convergence of inflation rates, the implementation of the 1992 programme, and the political commitment to the goal of monetary union. However, the establishment of a single currency does not require fiscal policy to be exercised at Community level, as the Delors report suggested. As a result, even within a full monetary union, national Governments will retain considerable control over domestic economic policy.

THE IMPORTANCE OF A SINGLE CURRENCY TO BUSINESS

6 British business believes that the main reason for moving towards European monetary union is the benefits which would flow from the establishment of a single European currency. While there is much to be gained during the process to EMU - not least from full membership of the ERM, closer economic policy cooperation and, the establishment of a common European currency - only when a single European currency is established, will businesses reap the full benefit from EMU.

7 There are four main reasons why businesses in the UK believe a single European currency would be advantageous.

i A single currency would act as a psychological spur to trading within Europe, so enhancing the benefits which would flow from the single market.

ii A single European currency should help the UK to achieve and sustain a lower inflation rate, and hence achieve interest rates in line with our EC competitors.

iii A single currency would remove the uncertainty attached to transactions within Europe.

iv A single currency would reduce the transactions costs of dealing in a number of different European currencies.

These benefits are discussed in detail below.

Incentives to trade

8 Perhaps the most powerful argument for a single currency, is the incentive that this provides for trade to take place. The 1992 programme aims to establish a Single Market where the barriers to trade between locations in different

countries are no greater than those within a single EC country. The benefits which would flow from these were estimated in the Ceccini report to amount to between 5% to 7% of Community GDP.

9 But as long as different currencies exist in different markets, there will always be a hidden barrier to trade. For the UK, this could be particularly damaging. Within the Single Market, the UK will be competing from a position on the periphery of Europe with a number of disadvantages, including an inadequate infrastructure. The English Channel and the North Sea provide barriers which do not exist for other countries (excluding Eire). For UK businesses to exploit the full advantages of the Single Market, therefore, will require the other barriers to trade to be reduced to a minimum.

10 Recent surveys have confirmed the considerable benefits which are expected to flow from a single European currency in this respect. The CBI/Price Waterhouse survey showed that 39% of UK exporters felt a single European currency replacing existing European currencies would provide a significant additional incentive to trade within Europe. Twenty-two per cent rated the incentive to be "very significant". A majority of respondents (55%) indicated less costly export activity as a significant benefit with 29% rating the benefit "very significant".

11 A recent Ernst and Young survey confirms these findings. The survey, of private use of the ECU, asked companies to assess the differences in impact of two scenarios: (1) the ECU as a thirteenth currency; and (2) the ECU as a single European currency. It gave rise to the following results.

a Over 50% of companies felt that a European currency would have a positive effect on their export, sourcing, marketing and distribution strategies.

b There were no perceived negative aspects on any part of corporate strategy, with the likely impact deemed to be either positive or non-existent.

c There was a definite preference for scenario two (that is, a single European currency as opposed to a thirteenth currency) as shown by the higher number of companies which feel there would be a very positive impact.

12 There would, of course, be greater competition from overseas competitors to match the benefits that UK companies expected to achieve from a single currency. However, this competition should be seen as beneficial rather than disadvantageous. It would allow the reallocation of resources within Europe and help to achieve the benefits which the Ceccini report indicated could be achieved from breaking down barriers to trade.

Low inflation

13 The second major benefit which UK companies would gain from a single European currency would be a greater degree of commitment to a low rate of inflation. Inflation in the UK has been a persistent problem in the post-war period; and though it has been much lower in the 1980s than in preceding decades, our performance has still not matched our main European competitors.

14 The reasons for this poor inflation performance are complex. (They are discussed in detail in Council paper C 51 90). Nevertheless, comparisons with other European countries show that two key elements affecting the issue are:

a insufficient commitment of the monetary authorities to securing and achieving stable prices, which needs to be the credible and over-riding objective of policy; and

b the ability to depreciate the currency, which has provided the UK with a mechanism for reinforcing and accommodating inflation. This, in turn, has weakened the implementation of policies to reduce inflation and contributed to an "inflationary psychology".

15 A single European currency, managed with the objective of achieving stable prices, should provide UK businesses with stronger counter-inflationary anchor than they have enjoyed hitherto. This would provide a much more stable background against which UK companies can plan and invest.

16 This, of course, also poses a potential threat to UK businesses. If we attempt to move to a single currency before the UK has achieved an inflation rate in line with our major European competitors (ie under 3%), we would be subject to a cumulative loss of competitiveness. This fact gives added urgency - from a business perspective - to the drive to reduce inflation. It also suggests that the decision to move to a single currency will need to be conditional on a much greater degree of convergence in inflation performance than already exists. Achieving this degree of convergence should be an important element in the evolutionary approach to European monetary union that is adopted.

Currency instability

17 A third benefit to business from a single European currency is the elimination of currency instability, which acts as an impediment both to trade and business investment. It is true that currency movements can act as a means of economic adjustment. But fluctuations also take place which prove to be transitory and provide only conflicting signals to business. The objective should therefore be to remove, in so far as it is possible, the risks to business posed by such fluctuations.

18 The Exchange Rate Mechanism of the EMS has been a great success in this respect. The system has now functioned for well over three years without a general realignment. When the UK becomes a member, business will benefit greatly from the greater climate of stability it provides. Indeed, a recent survey, conducted by the CBI for Price Waterhouse, indicated that the impact of this greater stability would be to increase UK manufacturing exports by an average 6% per annum over the longer-term.

19 However, if the Exchange Rate Mechanism is seen as the final resting point of monetary union, business will still be exposed to currency instability from two sources.

a The fluctuation within the existing exchange rate bands, which could amount to a margin of 4.5% - even within the narrow bands.

b The possibility of a realignment.

20 These factors could still act as an impediment to trade and investment flows within the European Community, despite the degree of stability provided by the ERM. The instability they create, however, will be reduced if it is clear that the EC countries are working toward a more stable regime - a single currency. Moreover, once this single currency is achieved, the uncertainty attached to currency movements will be eliminated.

21 The CBI/Price Waterhouse survey of exporters (referred to above) suggests that the current cost of hedging exports to other European Community countries averaged 1.15% of the value of transactions, or about £300m. This would be a direct cost saving to business from the elimination of currency instability within EC countries.

Transactions costs

22 Finally, a single currency would not only result in the elimination of currency instability. It would eliminate the need for currency transactions within the EC altogether. Research by the European Commission shows that typical transactions costs paid by commercial firms and persons to banks range from the trivial (0.1% for very large transactions where privileged customers secure inter-bank rates) to 12% for small international bank transfers (100 ECU). A recent survey also found that cross-country bank transfers in the Community took an average of 5 days. The minimum charge for clearing a 150 ECU Eurocheque internationally is 2.7% of the amount involved, but the total effective cost often amounts to twice as much, rising to 7% in some cases. The cost of exchanging bank notes between major and minor currencies is an extremely high 25%.

23 Overall, the Commission estimates that explicit foreign exchange costs may amount to at least 15 bn ECU on intra-EC transactions or about 5% of the net revenues of the banking sector in the Community. This is approximately 0.3% of the EC GDP. However, once the internal costs to companies of foreign exchange transactions are added in, the cost could well exceed 1.0% of GDP, or some £4.5 bn a year in the UK.

24 There would, of course, be a transitional cost of moving towards a single currency, akin to the costs of decimalisation in the UK in the early 1970s. This means that when the decision is taken to move to a single currency, sufficient time should be allowed for the necessary adjustments to be made. However, this change would represent a one-off cost and, in the long run, will be greatly offset by eliminating the continuing and pointless transactions costs of changing twelve national currencies into each other with conversion factors of up to six places of decimals.

AN EVOLUTIONARY APPROACH TO EMU

25 A single European currency would, therefore, quite clearly provide considerable benefits for business. It is crucial for the future competitiveness and growth of UK businesses, however, that we are in a position to realise these benefits at the same time as our EC partners. A major threat to UK business would be posed by a two-speed Europe with the UK in the outer tier, not fully integrated with the other main countries of the Community. This means identifying a path to EMU in which the UK can participate. It also requires the UK to show its commitment to participating in stage one of EMU, which has already been agreed, and in the stages to come.

26 The CBI's November 1989 EMU report set out a smooth evolutionary transition to a single European currency, based on four main principles:

a There should be a staged approach to the move towards EMU within the Community. The first stage, which is already underway, should include all members joining the ERM under the narrow bands, followed by a transition to fixed exchange rates and then a single currency.

b The success of each stage should be ensured before moving on to the next. In particular, greater convergence of inflation performance will be needed before exchange rates can be permanently fixed.

c Measures should be taken to enhance the use of the ECU so that it can gradually assume the role of a single currency. This may require some shift in the composition of the ECU currency from its current position as a basket currency to a currency that is managed independently by the European Central Bank during the transition to full EMU.

d The move to fixed exchange rates should be followed as quickly as possible by the adoption of a single European currency. This is needed not only to reinforce the commitment to fixed rates, but so that business can enjoy the full benefits of monetary union.

27 These principles remain valid in the light of recent developments. The remainder of this memorandum applies these principles to the issues facing the UK Government and its EC partners in the run up to the intergovernmental conference.

Stage one and the Exchange Rate Mechanism

28 A major plank of the CBI's policy on European economic and monetary union has always been that the essential first step should be UK membership of the ERM. The CBI's EMU report sets out the basis on which the CBI believed this should take place:

> "Entry should not be delayed to await the abolition of the exchange controls, the completion of the Single Market nor the establishment of an appropriate exchange rate.
>
> "To reap the full benefits of stability within the system, the UK should enter sterling into the ERM with a plus or minus (+/-) 2.25% fluctuation band and seek to avoid frequent realignments.
>
> "High UK inflation and interest rates relative to the ERM countries, however, could prompt an early realignment and create instability within the system. This could, therefore, act as an obstacle to entry in the short-term, though in the long-term the ERM has acted to reinforce low inflation. As soon as UK inflation is clearly on a downward trend, there are no further reasons for delaying entry. This should be the case by early 1990, if not before."

29 Since the report was agreed, however, although some economic indicators suggest that inflationary pressures may have begun to moderate, both the underlying rate and the headline rate of inflation have remained stubborn in the face of slower demand.

30 As a result, UK inflation has been a 'tougher nut to crack' than was previously thought and the headline rate will probably not establish a clear downward trend until well into the second half of the year. The underlying rate - excluding mortgage interest and the Community charge - may take somewhat longer to respond. Under present CBI policy, this would mean that sterling's entry into the ERM could be delayed until after the intergovernmental conference towards the end of this year.

31 Such a delay would seriously weaken the UK position and the intergovernmental conference. It would undoubtedly increase the perception that the UK Government is not committed to a greater degree of monetary intergration and run the risk of a two speed Europe, which would be a great disadvantage to UK businesses. Moreover, it would delay still further the process of adoption within the UK to the disciplines of the European Monetary System and the potential benefits to business.

32 However, to enter the system within the narrow bands immediately, without some improvement in inflation performance runs a serious risk of destabilising the mechanism, building up pressure for an early realignment or a sharp change in domestic economic policy. This would not be to the advantage of UK business. As a result, the CBI believes that as an intermediate step, the UK should immediately enter the ERM within the wider fluctuation band (+/-6%) and move to the narrow band (+/-2.25%) band as soon as UK inflation is clearly on a downward trend.

33 The advantages of this strategy are that it would:

- be fully consistent with the existing CBI stance of calling for sterling entry into the narrow fluctuation band "as soon as UK inflation was on a confirmed downward trend";

- enable the eventual transition to narrow bands to be smoother than it might otherwise be, given that sterling would be allowed a settling-in period within the wider bands; and

- allow the UK Government to indicate to the rest of the EC that it intends to play its full part in discussions on EMU.

34 It is important to recognise, however, that the benefits to business from ERM membership within the wider bands are very limited. It will only be when a narrower fluctuation band can be achieved that the full benefits can be felt. A move to the narrow bands should be made as soon as a greater degree of inflation convergence emerges.

Stage two and the "hard ECU"

35 It is clear from the preceding discussion that it will take some time to move to a single currency and full monetary union, particularly as the UK has yet to take the first step of entering the ERM. But at the same time, it is important for UK business that progress is being made towards the ultimate goal of a single currency for Europe. As a result, the most important issue for the intergovernmental conference to address later this year will be the establishment of a second stage in the evolutionary path to full monetary union.

36 Unfortunately, the Delors report is not very forthcoming in setting out how this would be achieved. Paragraph 57 of the report states the problem identified by the Delors Committee concerning stage two of the path to EMU:

> "The fundamental difficulty inherent in this transition would lie in the organisation of a gradual transfer of decision-making power from national authorities to a Community institution. At this juncture, the Committee does not consider it possible to propose a detailed blueprint for accomplishing this transition, as this would depend on the effectiveness of the policy coordination achieved during the first stage, on the provisions of the Treaty and on decisions to be taken by the new institutions."

37 Since the publication of the Report, there has been considerable discussion of this issue. Three "blueprints" have emerged.

a A long stage one, followed by a rapid move to a single currency, managed by a single central Bank, once sufficient convergence had been achieved.

b A two-speed Europe, with some ERM countries moving more quickly toward, using a common currency, while others (perhaps Denmark, Eire, Italy and Spain), wait until greater convergence had been achieved, before attaching themselves to the process.

c The "hard-ECU" plan set out by John Major, the Chancellor of the Exchequer, on 20 June 1990. This involves the reformation of the ECU as a new "hard" currency, managed by a European Monetary Fund (EMF), which would become the linchpin of the existing ERM. Other currencies would be unable to revalue against the ECU and the EMF would adjust ECU interest rates with the objective of maintaining stable prices. The ECU would thus become the 'hardest' currency in the system. The "hard ECU" would be a common European currency operating alongside other currencies, but could eventually become a single European currency, replacing existing currencies.

38 Of these approaches, the third is the most attractive for British business. There are three particular problems with the first option, a long stage one:

- It does not provide a genuine evolutionary approach. While the ERM continues as at present, it will still be strongly dependent on the anti-inflationary axis of the Bundesbank. When the jump is made to full monetary union, a new European monetary institution will be needed, yet it will be difficult - if not impossible - for such an institution to take on the mantle of the Bundesbank. Experience in running monetary policy - and the resulting anti-inflationary credibility - can only be built up over a period of time.

- There is little role for developing the ECU - as a currency in which contracts can be written and payments made - before a single currency is achieved. While the ECU remains a basket currency, as at present, its attractions will be distinctly limited and it will remain, as at present, mainly a hedging instrument for financial markets.

- There may be insufficient pressure for inflation convergence within the EC, especially if realignments continued to be permitted within the ERM.

39 The second approach, a two-speed Europe, is totally unacceptable to British business as a means of moving to EMU. For too long, the UK has suffered a competitive disadvantage through our non-membership of the ERM. To find ourselves in a similar position again, in the outside tier of a two-speed move to monetary union, at a time when Europe is coming much closer economically through the Single Market, would compound this error.

40 By contrast, the Chancellor's "hard ECU" plan has many advantages, and meets many of the CBI's requirements for an evolutionary approach, set out in paragraph 26 of this paper.

- The proposals set out a realistic basis for developing the widespread use of the ECU as an additional common European currency. The CBI believes that the ultimate transition to a single currency would be smoother if the use of the ECU were encouraged in the process;

- As a result, although the plan does not guarantee that a single currency will emerge, it provides a useful intermediate step, beyond ERM membership, in an evolutionary process to EMU; and

- The UK Government's proposals recognise the importance of following a path to EMU that is conducive to achieving low inflation and inflation convergence between member countries. In particular, the proposals for the new currency, the "hard ECU", are aimed at avoiding inflationary pressures, by preventing its value against existing EC currencies from being reduced, and placing additional obligations on EC members to pursue policies to maintain the values of currencies.

41 It may appear surprising that a thirteenth currency is needed in order to produce a single currency. Nevertheless, the preliminary indications from the CBI's European Monetary Union Working Group are that a "hard-ECU" would provide an attractive currency for pricing, invoicing, internal company accounting and money transfers within the EC. There is therefore a very good chance that this plan, coupled with the pressure for inflation convergence, would in fact move the EC relatively quickly to a position where a single currency could become a reality.

42 The advantages of the "hard ECU" plan over a long stage one were summarised by the Governor of the Bank of England in a recent speech at the European Parliament on (11 July 1990). He said:

> "So what, in summary, would the EMF and the Hard ECU bring to the process of European Community monetary integration that could not be achieved simply by relying on a long Stage one to take us to Stage three? In my view four things:
>
> a first and foremost, it would add an extra counter-inflationary discipline to monetary policy decisions in individual member states;
>
> b building on the hoped-for achievements of Stage one, it would significantly strengthen the forces leading to convergence of economic conditions in the Community;
>
> c it would pave the way for a move away from the current position where the ERM anchor is a single country's currency, and would bring an element of collective decision-making to the ERM;
>
> d it would provide a common currency that could be used throughout the Community, enabling consumers and producers to get used to using a real, new currency.
>
> "As I have said, the hard ECU could in time develop into a dominant common currency, creating conditions where a move to a single currency was feasible. But that would not be preordained; it would be a consequence of market developments and political reaction.
>
> "Establishing a European Monetary Fund to issue the Hard ECU would therefore be an evolutionary, market-based approach to greater monetary integration in the Community. It would be a desirable step beyond stage 1. It would reinforce the anti-inflationary characteristics of the ERM. It would avoid putting the ultimate goal of Monetary Union in jeopardy by pushing for it too soon. And it would also be a way forward beyond Stage 1 for all members of the Community."

43 The Government's proposals for the next stage of EMU, therefore, provide a feasible and welcome plan for moving beyond stage one of the Delors path to EMU. Nevertheless, the ultimate objective for British - and European business, as voiced by UNICE - from EMU is to establish a single currency, across Europe. The CBI, therefore, hopes that the Government's proposals will help in the process of achieving a single currency in the years ahead.

Stage three and a single European currency

44 The culmination of the evolutionary process of EMU will, eventually be a single European currency with a European central bank and a single monetary policy. The CBI's views on these issues were set out in some detail in the CBI's EMU report and these remain valid.

45 However, it should be recognised that a single European monetary policy does not imply loss of national control over economic policy. Though there will need to be increasing cooperation between EC members in formulating fiscal as well as monetary policies, the CBI would stick by its view that Governments should retain the freedom to implement fiscal policy in line with national objectives. Indeed countries will probably need greater flexibility in fiscal policy to reconcile the monetary policy objectives of the Community with national economic policies: that is, the principle of "subsidiary" should be preserved in fiscal policy.

* * *

46 The Delors Committee report has fulfilled an important role by stimulating the debate on EMU. As the above discussion makes clear, British business has much to gain from progress in this area, and considers the immediate priority to be sterling's entry into the ERM - a move which the UK Government is now committed to taking.

47 The CBI also supports the plan for the next stage of European Monetary Union, set out in the Chancellor of the Exchequer's recent speech and at the EC Summit in Dublin. This indicates quite clearly that the UK Government recognises the importance of contributing to the process to EMU in a positive and constructive way. The CBI hopes that the UK will now be able to build on this and play its full part in achieving EMU during the 1990s.

Centre Point
July 1990

APPENDIX A

RECOMMENDATIONS OF THE CBI'S EUROPEAN MONETARY UNION REPORT PUBLISHED IN NOVEMBER 1989

Exchange rate mechanism

1 Entry into the Exchange Rate Mechanism would be of great benefit to business. Entry should not be delayed to await the abolition of exchange controls, the completion of the Single Market nor the establishment of an appropriate exchange rate.

2 To reap the full benefits of stability within the system, the UK should enter sterling into the ERM with a plus or minus (+/-) 2.25% fluctuation band and seek to avoid frequent realignments.

3 High UK inflation and interest rates relative to the ERM countries, however, could prompt an early realignment and create instability within the system. This could, therefore, act as an obstacle to entry in the short-term, though in the long-term the ERM has acted to reinforce law inflation. As soon as UK inflation is clearly on a downward trend, there are no further reasons for delaying entry. This should be the case by early 1990, if not before.

Economic and monetary union

4 The move towards a common currency within the EC as an extension of exchange rate stability would be beneficial to business, as long as the monetary authorities remain committed to low inflation. This should be pursued as a longer term objective. In fact, the move to irrevocably fixed exchange rates as proposed by the Delors Report actually consists of two separate steps: the move to fixed, but adjustable rates, followed by the commitment to a single European currency and the transfer of control over monetary policy to a European System of Central Banks.

5 The use of a commonly accepted European currency, such as the ECU, would carry with it great advantages to business over and above a regime of fixed exchange rates. Its use would eliminate not only the variability of currencies but, also, transactions costs - though its creation would involve some significant layout costs akin to those involved, for example, with the previous move to decimalisation in the UK.

6 The successful transition to a common currency will, however, depend upon the success of intermediate stages. It must, therefore be seen as the culmination of an evolutionary process which builds on the success of the current European Monetary System. Indeed, before any further steps are taken towards monetary union, beyond those already agreed to as

part of stage one of the Delors Committee (all EC members to join ERM and greater cooperation in macro-economic policy and on Central Bank decision-taking) and the full liberalisation of capital movements in major ERM countries, a number of factors should be in place.

- The UK should join the Exchange Rate Mechanism. A well functioning EMS in which the UK fully participates is essential before moving on to further stages.

- EC countries must enjoy much greater stability of exchange rates and greater convergence of inflation rates and greater convergence of inflation rates than at present. This means all EC currencies remaining within the discipline of the ERM (2.25% bands) over a period of time.

- The opening up of national markets implied by the 1992 programme and the liberalisation of capital movements must be much further advanced.

7 The Group does not accept that binding rules on fiscal policy re implied by the move to monetary union. The group supports the Single Market programme and the need for a strong European competition policy and grater policy coordination, but does not support the other objectives of 'economic union' as set out by the Delors repot: common policies aimed at structural change and regional development and binding rules of budgetary policies. Greater macro-economic coordination will inevitably follow from the commitment to reduce exchange rate fluctuations and national Governments should retain the freedom to implement fiscal policy in line with national objectives.

8 A greater degree of monetary integration will inevitably have an impact on the way in which member countries use Fiscal policy - and indeed other instruments of economic policy - as it already does in the existing ERM countries. But countries should be allowed themselves to determine whatever fiscal targets are implied by the need to reconcile the monetary policy objectives of the monetary union with domestic economic growth and employment objectives.

APPENDIX B

MEMBERS OF THE CBI ECONOMIC MONETARY UNION WORKING GROUP

David Lees (Chairman)	Chairman, GKN plc
Gottfried Bruder	General Manager, Commerzbank AG
Constant Busch	Managing Director, Philips Electronics (UK)
Richard Desmond	Group Treasurer, BAT Industries plc (representing Brian Garraway, Deputy Chairman)
Richard Freeman	Chief Economist, ICI plc
Christopher Johnson	Chief Economic Adviser, Lloyds Bank plc
Terence Libby	Managing Director, Morrisflex Ltd
David Pennock	Managing Director, Astell Hearson
Paul Richards	Director, Samuel Montagu & Co Ltd
David Simon	Managing Director, British Petroleum plc

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

26 July 1990

Dear Stephen,

ECONOMIC AND MONETARY UNION

The Prime Minister said to the Foreign Secretary this afternoon that we must make a major effort first to prevent the Italians from trying to railroad the Community into premature decisions on EMU: and second, to expose the practical problems which a single currency would cause for other member states. We should mount a really substantial campaign on these points. The Prime Minister added that, in the event that the Italian Presidency pressed ahead with tabling specific Treaty amendments at the opening of the IGC in December, we should be ready with alternative drafts of our own.

I am sending a copy of this letter to John Gieve (Treasury).

Yours sincerely,

CHARLES POWELL

J S Wall Esq
Foreign and Commonwealth Office

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(2)

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23 July 1990

Prime Minister

You will not find this palatable, but also to read the first enclosure

CDS 23/7

PERSONAL

Charles Powell Esq
No 10 Downing Street
London SW1

Dear Charles,

EMU

Thank you for your letter of 19 July.

2. I enclose a record of my discussions with Sarcinelli and Padoa-Schioppa. I am afraid that they confirm my fears that we shall get into an 11:1 position by October if we continue to present our proposals as an alternative to the Delors plan as a whole rather than as a preferable route to full EMU.

3. The Prime Minister has accepted the aim of EMU on several occasions, for example at Madrid. Full EMU has always meant permanently fixed parities or, more recently, a single currency. It was the particular version of full EMU in the Delors proposals to which the House of Commons objected. If the Prime Minister is to escape from all the serious consequences, at home as well as in the EC, of an 11:1 situation in October and isolation in the IGC, there is no alternative to shading her line a little and accepting that the EC will aim to achieve permanently fixed parities or a single currency one day. That need not prevent her from arguing that we do not have to decide the modalities of Stage 3 now.

4. If Pöhl did not reveal his hand to the Prime Minister, that was naughty of him. But it was quite clear from what he said at a lunch at the German Embassy after seeing her and from the line he has taken since that para 4 of my letter of July 17 corectly represents his position.

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5. Please tell the Prime Minister that I would not press this issue so hard if I were not convinced of its importance for her. I hope she may be wiling to have another discussion on the subject with me.

Yours ever

Michael

Sir Michael Butler

MDB/JSD

EMU

Visit to Sarcinelli (Italian Treasury)
and Pado-Schioppa (Bank of Italy)

Each was accompanied by an assistant. We had two hours intensive discussion. A note on the technical points is attached.

2. Their understanding of Pöhl's aims was the same as mine; either to maintain the status quo or to agree a Treaty amendment setting up a European Central Bank System (ECBS) this autumn, to which all member states would belong but which would start operating with those able to tie their currencies inevocably to the Deutschmark (analogy of EMS/ERM). As expected, they do not like this idea and are examining our proposals with increasing interest as they understand them better. They think that there must be a real Stage 2 which would prepare the EC for the move to Stage 3. But they are reluctant to make any move in our direction unless we make it clear that we regard the hard ecu proposals as transitional because:-

(a) the ECBS proposal for Stage 3 is advancing well, with only a general reserve by the UK;

(b) they are worried about losing the agreement of Pöhl to Stage 3 if they move our way (though they accepted that our proposals are not open to the objections to a parallel currency which he has raised in the past).

3. They stressed that EMU had always included either permanently fixed parities or a single currency (with opinion moving fast towards the latter recently). They asked whether the Prime Minister preferred permanently fixed parities. I said that I thought she saw objections to both, though not necessarily the same objections.

4. I urged them to put forward proposals for Stage 2 very soon. (My unspoken thought was that we would then be more in the thick of the negotiation and could aim to water down the Stage 3 proposals). They said that Stage 2 would be discussed in ECOFIN and the Central Bank Governor's deputies but it was important to them to hang on to the Stage 3 ground gained so far. I said that they would risk a British veto if they let the ECBS band-wagon roll too far in its present form.

5. Sarcinelli said that the Italian Finance Minister was determined to complete the work of the Ecofin Council by mid October so that the draft treaty and statutes of the Eurofed, or whatever it would be called, could be finalised in the light of the consensus reached, so that the intergovernmental conference could settle any remaining issues rapidly in December. I expressed concern that this left time very short for working out a real Stage 2 with the proper institutional arrangements.

ANNEX

EMU
Visit to Sarcinelli (Italian Treasury)
and Pado-Schioppa (Bank of Italy)

The following are the technical points which were raised in discussion:-

a) With reference to our proposal that the exchange risk on balances in national currencies held by the EMF rest on the national authorities, Sarcinelli said that Finance Ministries had always opposed such an exchange guarantee.

b) Sarcinelli and Pado-Schioppa were concerned that the hard ecu would not necessarily generate sufficient demand to give it critical mass. Sarcinelli seemed to think that we would be relying on the prospect of devaluation in the high inflation countries to generate demand. To the first point I replied that conversations with a number of banks and companies had convinced me that once there was no risk of devaluation of the ecu and therefore no need to cover against risk exchange, and once there was convertibility for banks, companies and private individuals, with a lender of last resort in the EMF, companies engaged in intra-Community trade would quite quickly move to holding ecu balances and asking their suppliers to accept ecus in payment and invoicing their clients in ecus. Obviously, those companies able to net off ecu payments and receipts in this way would move more quickly than those the majority of whose expenses were in one country. To the second point I replied that obviously where inflation remained high there would be a bigger incentive to move into ecus but our proposals were designed to provide a strong disincentive to devaluation.

c) Pado-Schioppa advocated an early statement that the hard ecu would definitely become the single currency at some not too distant date. I said that it would cause difficulties to go this far. But if the aim of a single currency one day was in the treaty and if the hard ecu was created at the beginning of Stage 2 as a common currency alongside the national currency, everbody would draw the conclusion that they would need to operate in ecus one day. This would be an additional incentive to start using it. It would not be sensible to try to fix the duration of Stage 2.

d) They were both concerned to establish whether there would be a real job for the EMF to do in Stage 2, having possibly been concentrating too much on the Currency Board alternative proposal. I explained that Stage 2 would begin with national currencies fixing their central rates against the ecu and retaining the two and a quarter per cent band. The EMF would need to manage ecu interest rates in such a way that strong currencies would not remain permanently in the top part of their band and revaluations against the ecu were impossible. This might involve quite a lot of activity in open market operations, especially in the first year or two while things were settling down. The EMF would also be engaged in intervention on the foreign exchanges, both to restrain EC currencies from breaking out of their bands and to carry out exchange rate policy towards the dollar and the yen. There would be plenty to do for the EMF, though they might sensibly use the national central banks as their operating arms.

e) This led to a discussion of who would control national monetary policy. I explained that national monetary policy would in the

last resort be the responsibility of national authorities in Stage 2. But I pointed out that there would be strong disincentives to a lax monetary policy. Monetary financing of budget deficits and money creation to replace national currency converted into ecus would be forbidden. If either of these golden rules were broken or if in the opinion of the EMF a member state was running an unduly lax monetary policy, the EMF would have the right to require the member state concerned to reconvert some or all of its balances in national currency with the EMF back into ecus. Moreover, the exchange risk would in the last resort remain on national authorities. All this would require still closer coordination of national monetary policies than in Stage 1 and would give the EMF an important role.

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FINAL PART OF 2

ECOFIN COUNCIL: 23 JULY

ECONOMIC AND MONETARY UNION (EMU)

13. DELORS (COMMISSION) EXPRESSED SUPPORT FOR THE PRESIDENCY'S WORK PROGRAMME. IT WAS NOT NECESSARY TO REACH AGREEMENT ON ALL POINTS BEFORE THE START OF THE IGC. HE EXPRESSED INTEREST IN THE UK'S IDEAS AS AN APPROACH TO THE TRANSITIONAL PHASE BUT DOUBTED WHETHER THEY WOULD LEAD TO THE FINAL OBJECTIVE SPONTANTANEOUSLY. THE COMMISSION WOULD ADOPT ITS POSITION ON 21 AUGUST. HE NOTED THE LINK BETWEEN THE EMU AND EPU IGCS, ALTHOUGH HE PREFERRED TO DESCRIBE THE LATTER AS THE POLITICAL AND INSTITUTIONAL REINFORCEMENT OF THE COMMUNITY. HE AGREED WITH SCHLECHT ON THE NEED TO STUDY WIDER ECONOMIC POLICIES AND HE PERSONALLY SUPPORTED THE GERMAN POSITION ON BUDGETARY RULES. ON COHESION THE POORER REGIONS COULD BENEFIT FROM EMU BECAUSE OF THEIR LOWER PRODUCTION COSTS. THE STRUCTURAL FUNDS HAD BEEN DOUBLED IN 1988 AND THE EFFECTIVENESS OF THIS POLICY COULD NOT BE ASSESSED UNTIL THE REVIEW EXPECTED AT THE END OF 1991. HE HAD EXPRESSED THE VIEW THAT IN THE FINAL STAGE OF EMU THE EC BUDGET MIGHT RISE FROM 2.5 PERCENT OF TOTAL PUBLIC EXPENDITURE TO 5 PERCENT. HE AGREED WITH BEREGOVOY ON THE NEED FOR FISCAL APPROXIMATION. THE COMMUNITY SHOULD AVOID BEING PERFECTIONIST IN SETTING CONDITIONS FOR FURTHER PROGRESS ON EMU: OTHERWISE NO FURTHER PROGRESS WOULD BE MADE.

14. CARLI CONCLUDED THAT ECOFIN MUST RESPECT THE CALENDER SET BY THE DUBLIN EUROPEAN COUNCIL. IN HIS VIEW THERE WWAS SUFFICIENT CONSENSUS TO PROPOSE AN AGENDA FOR THE IGC. DECISIONS WOULD BE TAKEN AT THE IGC. THE MONETARY COMMITTEE WOULD HAVE A SPEICAL MEETING ON TUESDAY 4 SEPTEMBER TO DISCUSS THE POINTS RAISED AT THIS MEETING AND IN PARTICULAR THE UK IDEAS BUT WITHOUT RE-OPENING DISCUSSION ON ALL

THE POINTS IN THEIR EXISTING REPORT. THE ECONOMIC POLICY COMMITTEE SHOULD BE INVITED TO MEET ON THE SAME TIMESCALE. BOTH REPORTS WOULD BE CONSIDERED BY THE INFORMAL ECOFIN ON 8 SEPTEMBER.

15. AFTER THE LUNCH THE PRESIDENT OF THE COMMISISON SPOKE PRIVATELY TO THE CHANCELLOR. DELORS ASKED THAT THE UK SHOULD NOW CIRCULATE A FULL PAPER (IN ADDITION TO THE SHORT PAPER DISTRIBUTED IN COREPER AND TO THE TECHNICAL PAPER IN THE COMMITTEE OF CENTRAL BANK GOVERNORS) ON ITS ''HARD ECU'' AND EMF IDEAS. THE COMMISSION WOULD LIKE TO TAKE PROPER ACCOUNT OF THESE IDEAS IN THE COMPREHENSIVE PAPER ON EMU WHICH IT WOULD BE CIRCULATING ON 21 AUGUST. TO DO SO THE PAPER NEEDED TO BE ROUND A WEEK OR SO BEFORE THAT. DELORS SAID HE HOPED ANY SUCH PAPER WOULD UNDERLINE, AS THE CHANCELLOR HAD IN ECOFIN, THE MAIN DIFFERENCES BETWEEN THE UK PROPOSALS AND THE EARLIER COMMON CURRENCY PROPOSALS WHICH WERE CONSIDERED AND REJECTED BY THE DELORS COMMITTEE. THE CHANCELLOR SAID WE WOULD CERTAINLY BE CIRCUALTING SUCH A PAPER: WE WOULD AIM TO GET IT ROUND IN GOOD TIME AS DELORS SUGGESTED: AND WE WOULD EMPHASISE THE DIFFERENCE BETWEEN THIS AND EARLIER COMMON CURENCY PROPOSALS.

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PART 1 OF 2

ECOFIN COUNCIL : 23 JULY

ECONOMIC AND MONETARY UNION (EMU)

SUMMARY

1. AFTER LONG TABLE ROUND ON MONETARY COMMITTEE REPORT PRESIDENCY CONCLUDE THAT THERE IS BROAD CONSENSUS FOR ITS TIMETABLE FOR FURTHER WORK ON EMU. CHANCELLOR INTRODUCED UK IDEAS FOR DEVELOPMENTS BEYOND STAGE 1. SPECIAL MEETING OF MONETARY COMMITTEE ON 4 SEPTEMBER WILL CONSIDER THEM IN ADVANCE OF INFORMAL ECOFIN ON 8 SEPTEMBER. AT GERMAN REQUEST ECONOMIC POLICY COMMITTEE TO CONSIDER ECONOMIC ASPECTS. COMMISSION TO AGREE ON ITS POSITION ON 21 AUGUST. PRESIDENCY AIM TO REACH CONSENSUS IN ECOFIN ON IGC AGENDA BY OCTOBER WITH A VIEW TO CIRCULATING GUIDELINES FOR AMENDING THE IGC BEFORE ITS START DATE IN DECEMBER.

DETAIL

2. CARLI (PRESIDENCY) SET OUT THE PRESIDENCY'S PREFERRED TIMETABLE FOR FURTHER DISCUSSIONS OF EMU. THE PRESIDENCY INTENDED TO VISIT CAPITALS IN THE LAST 10 DAYS OF AUGUST WITH A VIEW TO ACHIEVING A BROAD CONSENSUS AT THE INFORMAL ECOFIN COUNCIL IN SEPTEMBER. THERE WOULD BE A MEETING WITH THE EUROPEAN PARLIAMENT ON THE SAME DAY AS THE 8 OCTOBER COUNCIL IN LUXEMBOURG. THE PRESIDENCY INTENDED TO CIRCULATE A PAPER ON GUIDELINES FOR AMENDING THE TREATY BEFORE THE START OF THE IGC. IN THE MEANTIME THE GOVERNORS COMMITTEE WAS PREPARING DRAFT STATUTES FOR THE EUROPEAN CENTRAL BANK SYSTEM (ECBS) FOR DISCUSSION IN OCTOBER. CARLI SUGGESTED THAT THE UK PROPOSALS COULD BE DISCUSSED AT THE INFORMAL ECOFIN ON 8 SEPTEMBER.

3. SARCINELLI (CHAIRMAN OF THE MONETARY COMMITTEE) INTRODUCED THE MONETARY COMMITTEE REPORT. HE NOTED THAT THERE WAS A BROAD DEGREE OF

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CONSENSUS ON MOST ISSUES BUT THE REPORT WAS SUBJECT TO A GENERAL RESERVE BY THE UK MEMBERS AND THE COMMITTEE HAD NOT YET BEEN ABLE TO EXAMINE THE UK PROPOSALS IN DETAIL. SUBJECT TO THE UK RESERVE THERE WAS BROAD AGREEMENT ON THE FOLLOWING POINTS:

(I) IT WAS IN THE POWER OF THE COMMUNITY TO ACHIEVE EMU BASED ON PRICE STABILITY AND A SINGLE CURRENCY.

(II) THIS REQUIRED A TRANSFER OF SOVEREIGNTY OVER MONETARY POLICY AND ACCEPTANCE OF CONSTRAINTS ON ECONOMIC POLICY.

(III) THERE SHOULD BE BIN[redacted]NG COMMITMENTS TO BUDGET DISCIPLINE AND CLOSER COORDINATION OF ECONOMIC POLICIES. SOME MEMBERS WANTED MACRO-ECONOMIC STABILISERS AT THE COMMUNITY LEVEL TO HELP COPE WITH EXTERNAL SHOCKS.

(IV) THE COMMUNITY WOULD NEED TO AVOID EMU WORKING AGAINST THE INTERESTS OF THE PERIPHERAL REGIONS. i.e. money

(V) DOMESTIC MONETARY POLICY SHOULD BE DETERMINED BY AN INDEPENDENT INSTITUTION COMMITTED TO PRICE STABILITY BUT EXECUTED BY NATIONAL CENTRAL BANKS.

(VI) A HIGH DEGREE OF ECONOMIC CONVERGENCE SHOULD ENABLE THE ESTABLISHMENT OF A SINGLE CURRENCY.

(VII) EXTERNAL MONETARY POLICY SHOULD BE DETERMINED BY THE POLITICAL AUTHORITY BUT THE MODALITIES NEEDED FURTHER DISCUSSION.

(VIII) PASSAGE TO FULL EMU REQUIRED A TRANSITIONAL STAGE BUT IF CONVERGENCE WAS ACHIEVED, STAGE 2 COULD BE RELATIVELY SHORT. MINISTERS WOULD NEED TO DECIDE WHETHER THE ECSB SHOULD HAVE RESPONSIBILITY FOR INTERVENTION IN STAGE 2.

(IX) THE ROLE OF THE ECOFIN COUNCIL WOULD NEED TO BE ENHANCED WITH IMPLICATIONS FOR THE COMPETENCE OF THE MONETARY COMMITTEE.

4. SARCINELLI SUMMARISED THE MONETARY COMMITTEE'S REPLIES TO DELORS' 6 KEY QUESTIONS AS FOLLOWS:

(I) THE COMMUNITY DID NEED A SINGLE MONETARY POLICY. NO Co-operation

(II) THE COMMITMENT TO BUDGETARY DISCIPLINE AND COORDINATION OF ECONOMIC POLICIES WERE THE KEY ELEMENTS OF ECONOMIC UNION.

Co-operation

(III) EMU WOULD BRING BENEFITS AS WELL AS DISADVANTAGES TO THE PERIPHERAL REGIONS. THE CASE FOR A FURTHER INCREASE IN STRUCTURAL FUNDS WAS UNPROVEN.

(IV) THE COUNCIL WOULD NEED TO DECIDE ON THE APPROPRIATE RELATIONS WITH THE EUROPEAN PARLIAMENT AND NATIONAL PARLIAMENTS TO ACHIEVE POLITICAL AND DEMOCRATIC LEGITIMACY FOR [redacted]EIR ECSB.

(V) A TRANSITIONAL STAGE WOULD BE NECESSARY.

(VI) IN THE FINAL STAGE THE ECU WOULD BECOME THE SINGLE CURRENCY.

5. THE FOLLOWING WILL REMAIN POINTS RAISED IN THE SUCCEEDING TABLE ROUND. REYNOLDS (IRELAND) CALLED FOR AN AGREED DEFINITION ON MONETARY FINANCING AND FURTHER STUDY OF THE PROBLEMS OF COHESION. IT SHOULD NOT SIMPLY BE ASSUMED THAT THE STRUCTURAL FUNDS AND COHESION WERE THE SAME THING. BEREGOVOY (FRANCE) SUGGESTED THAT THE KEY QUESTION WAS WHEN STAGE 2 SHOULD BEGIN AND UNDER WHAT CONDITIONS. IN HIS VIEW THE TARGET DATE SHOULD BE 1 JANUARY 1993 (TO COINCIDE WITH THE SINGLE MARKET). BY THAT STAGE ALL CURRENCIES SHOULD BE WITHIN THE NARROW BANDS OF THE ERM, ALTHOUGH TRANSITIONAL ARRANGEMENTS COULD BE ENVISAGED FOR THOSE WHO WERE NOT. THE ECSB SHOULD BE INDEPENDENT BUT EXTERNAL MONETARY POLICY SHOULD BE DETERMINED BY THE POLITICAL AUTHORITY NOT THE ECSB. BEREGOVOY ALSO CONSIDERED THAT IT WOULD BE DIFFICULT TO ACHIEVE EMU WITHOUT SOME FURTHER FISCAL HARMONISATION, PARTICULARLY OF CAPITAL TAXES.

6. SOLCHAGA (SPAIN) SUGGESTED A REVIEW OF COMMON POLICIES TO AVOID DISCRIMINATION AGAINST THE PERIPHERY. THIS SHOULD INCLUDE A REVIEW OF THE RELATIVE BURDENS IMPOSED BY THE COMMUNITY BUDGET. ANY ECSB PROFITS COULD BE TREATED AS NEW RESOURCES. MACRO-ECONOMIC STABILISERS MIGHT BE NECESSARY. THE GENERAL COORDINATION OF BUDGET POLICIES MIGHT IN THE FUTURE NEED TO BE EXPANSIONARY. HE AGREED WITH BEREGOVOY THAT FISCAL COMPETITION COULD BE DETRIMENTAL TO ECONOMIC CONVERGENCE. HE FAVOURED DEFINING THE ECU AS THE FUTURE SINGLE CURRENCY WITHOUT CHANGING ITS MAKE-UP. OBJECTIVE CRITERIA WILL BE NEEDED TO MOVE FROM STAGE 1 TO STAGE 2 BUT COUNTRIES UNWILLING TO MAKE THE TRANSITION SHOULD NOT BE ALLOWED TO PREVENT THE MAJORITY FROM MAKING PROGRESS. IT WOULD BE HELPFUL TO SET TARGET DATES FOR THE ACHIEVEMENT OF STAGE 2.

7. PALAEOKRASSAS (GREECE) REJECTED THE CONCEPT OF A TWO SPEED EUROPE. IT WAS NECESSARY TO TAKE ACCOUNT OF INFRASTRUCTURE AND

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ECONOMIC DEVELOPMENT AS WELL AS BUDGET DISCIPLINE AND COORDINATION OF MONETARY POLICY. BUDGETARY RULES NEEDED TO BE FLEXIBLE. HE WAS SCEPTICAL ABOUT SANCTIONS. THERE WOULD NEED TO BE A NEW COMMITMENT TO ENHANCING STRUCTURAL POLICIES TO COUNTERACT THE DISADVANTAGES OF EMU FOR THE PERIPHERY. THE TRANSITION FROM STAGE 1 TO STAGE 2 SHOULD BE GRADUAL.

8. WAIGEL (GERMANY) ADVOCATED CRITERIA FOR IDENTIFYING EXCESSIVE DEFICITS. HE COMMENDED THE PROVISION IN THE GERMAN CONSTITUTION THAT THE BUDGET DEFICIT SHOULD NOT EXCEED TOTAL INVESTMENT. THERE NEEDED TO BE A SINGLE MONETARY POLICY DETERMINED BY CENTRALISED (NOT REGIONALISED) CENTRAL BANK SYSTEM. MONETARY POLICY INSTRUMENTS SHOULD BE HARMONISED. THE LENGTH OF STAGE 2 SHOULD BE DETERMINED BY PROGRESS TOWARDS CONVERGENCE: ARTIFICIAL DEADLINES SHOULD NOT BE SET. HE SUGGESTED THAT THE ECONOMIC POLICY COMMITTEE SHOULD LOOK FURTHER INTO THE ECONOMIC ASPECTS OF EMU. FINANCE MINISTERS SHOULD BE INVOLVED IN THE EMU IGC. SCHLECHT (STATE SECRETARY GERMAN ECONOMIC MINISTRY) ADDED SOME FURTHER COMMENTS ON THE NEED FOR CONVERGENCE OF ECONOMIC POLICIES INCLUDING ON WAGES AND SALARIES, COMPETITIVENESS AND THE EFFICIENCY STRUCTURAL SPENDING.

9. PETERSEN (DENMARK) SAID THAT OTHER ECONOMIC POLICY OBJECTIVES (IE GROWTH AND EMPLOYMENT) SHOULD BE GIVEN EQUAL STATUS WITH PRICE STABILITY. ON BUDGET DISCIPLINE HE COULD NOT ACCEPT COMMUNITY DECISIONS WHICH OVERRODE NATIONAL DECISIONS ON THE LEVEL OF BUDGETS. FINANCE MINISTERS SHOULD LEAD IN THE EMU IGC. MAYSTADT (BELGIUM) AGREED WITH BEREGOVOY ON THE TIMING OF STAGE 2 AND THE DESIRABILITY OF FISCAL HARMONISATION. THE ECSB'S DEMOCRATIC LEGITIMACY COULD BE ACHIEVED BY MAKING APPOINTMENTS TO ITS DIRECTORATE SUBJECT TO APPROVAL BY THE EUROPEAN PARLIAMENT.

10. THE CHANCELLOR OF THE EXCHEQUER NOTED THAT FURTHER WORK WAS NECESSARY IN A NUMBER OF AREAS INCLUDING BUDGET DISCIPLINE SANCTIONS, THE CRITERIA FOR DECIDING THE OVERALL EC BUDGET STANCE AND ITS CONSISTENCY WITH NATIONAL BUDGETS AND THE CRITERIA FOR ANY CENTRALISATION OF RESERVES. HE SUGGESTED THAT THE UK IDEAS FOR DEVELOPMENTS BEYOND STAGE 1 SHOULD BE CONSIDERED BY THE MONETARY COMMITTEE. THEY WERE INTENDED TO BE A POSITIVE CONTRIBUTION TO THE DEBATE WHICH OFFERED A WAY OF MAKING REAL PROGRESS TOWARDS MONETARY INTEGRATION BEYOND STAGE 1 WHILST AVOIDING A PREMATURE BIG BANG TRANSITION TOWARDS MONETARY UNION. THEY WOULD ENABLE THE COMMUNITY TO MOVE FORWARD TOGETHER AND PROVIDE TIME FOR PROCESS OF CONVERGENCE TO GATHER PACE. THE HARD ECU COULD PROVIDE AN ATTRACTIVE COMMON CURRENCY AND HAD BEEN DESIGNED IN A WAY WHICH WOULD STRENGTHEN NOT

WEAKEN ANTI-INFLATIONARY FORCES IN THE COMMUNITY. ALL THESE ISSUES DESERVED FURTHER CONSIDERATION BEFORE THE START OF THE IGC IN DECEMBER.

11. BELEZA (PORTUGAL) SAID THAT MANAGEMENT OF THE PROCESS TOWARDS ECONOMIC SOCIAL COHESION WOULD BE DIFFICULT. THE EFFECTS ON CAPITAL IMPORTING COUNTRIES WOULD BE DIFFERENT FROM THOSE ON CAPITAL EXPORTING COUNTRIES. HE ALSO LOOKED FOR PROGRESS ON FISCAL HARMONISATION. NIEMAN (NETHERLANDS) AGREED WITH WAIGEL ON THE IMPORTANCE OF BUDGET DISCIPLINE. ECONOMIC CONVERGENCE SHOULD BE SUBSTANTIALLY IMPROVED IN STAGE 1 TO ALLOW FOR A SHORT, TECHNICAL STAGE 2. HE SUPPORTED THE UK'S REQUEST FOR A THOROUGH EXAMINATION OF ITS IDEAS. ECOFIN MINISTERS SHOULD TAKE THE LEAD IN THE EMU IGC.

12. JUNKER (LUXEMBOURG) AGREED THAT FURTHER STUDY WAS NEEDED ON OBJECTIVE CRITERIA FOR BUDGET DEFICITS. THE GERMAN EXPERIENCE MIGHT BE HELPFUL. HE REFERRED TO PROSPECTIVE REFORMS OF THE LUXEMBOURG TAX SYSTEM BUT WAS RESERVED ON CALLS FOR FISCAL HARMONISATION. SOCIAL POLICIES COULD ALSO EFFECT MEMBER STATES' COMPETITIVENESS. RUBBI (ITALY) AGREED THAT FINANCE MINISTERS SHOULD TAKE THE LEAD IN THE EMU IGC. THERE WOULD NEED TO BE PARALLEL PROGRESS ON EMU AND THE POLITICAL UNION IGC. THE EUROPEAN PARLIAMENT WOULD ALSO WISH TO EXPRESS ITS VIEWS. HE SUPPORTED THE NEED FOR FURTHER FISCAL HARMONISATION.

HANNAY

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ADDITIONAL 1

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

PERSONAL

19 July 1990

Thank you for your letter of 17 July and its enclosure. Your prediction as to the likely reactions to paragraph 2(b) were absolutely correct. It is incompatible with the majority view of the House of Commons.

Incidentally, Poehl did not take the line in paragraph 4 of your letter when he came here.

C. D. POWELL

Sir Michael Butler, G.C.M.G.

(2)

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 071-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

17th July 1990

Charles Powell Esq
No 10 Downing Street
London SW1

Dear Charles,

As I told you on the telephone, I have been invited to talk to Sarcinelli (Italian Treasury) and Padoa Schioppa (Bank of Italy) on Friday before the Ecofin Council next Monday. They wish, in particular, to discuss the way in which our Stage 2 proposals could be given institutional effect.

2. I have therefore prepared the attached short paper. I know that the Government has not yet taken a position on this question and I shall make it abundantly clear that the paper does not have its approval. It merely illustrates the way in which our proposals for a hard ecu managed by an EMF could be put into effect by agreement in the IGC. On the other hand my aim has of course been to devise arrangements which would in the last resort be acceptable to the Government.

3. I know that para 2(b) may cause difficulties for the Prime Minister. But as I told her in April, I am sure that we cannot get agreement without going at least that far. To rally to our side the Italians, Spaniards and others who do not like the Pöhl approach, we need to accept that the aim of EMU is to move one day to permanently fixed parities or more probably a single currency. As you will see, the attraction of my proposal is that it only lays down the Charter of the EMF for Stage 2 and leaves for unanimous decision later the possibility of amendment for any move to Stage 3.

4. The Pöhl approach is doubly unattractive. He made it clear to me that he expected the IGC to create his European Central Bank in full charge of EC monetary policy in Stage 3 and lay down that national central banks shall become wholly independent of national governments and Parliaments. Stage 2 would then disappear and Stage 3 would begin with those countries able and willing to form a D-mark zone. He uses the analogy of the EMS of which we were founder-members while staying out of the ERM. To allow this to happen would be disastrous for the

City. The Central Banks of participating countries, mainly of course the Bundesbank and the Bank of France, would act as the operating arms of what he calls the European Central Bank System (ECBS), not European System of Central Banks (ESCB) which I have taken from Delors and used in my paper in a rather different sense. So the Bank of England would be cut out and open market operations on ecu interest rates and exchange intervention to maintain the ecu parity would take place in Frankfurt, Paris and Amsterdam. In my view, there would be a massive movement of business out of the London market, both as a direct result of these arrangements and as a consequence of international banks and other companies becoming convinced that London could not remain the principal financial centre in the European time zone outside EMU.

5. I do not believe that the Chancellor and the Governor of the Bank of England will be able to persuade their colleagues to rally to our plan unless they can soon explain what our alternative proposals are for the institutional arrangements. So I hope the Prime Minister may agree to set work on this in hand. As I said when I saw her I think that it is vital to have a properly coordinated campaign, so that all concerned know what they have to do and speak with one voice. I remain at the Prime Minister's disposal if she would like to use me in any way for this purpose.

6. I have sent copies of the enclosed paper to officials but am not copying this letter elsewhere.

7. I should much welcome an opportunity for another discussion with the Prime Minister before the summer holidays.

Yours ever

Michael

Sir Michael Butler

MDB/JSD

EMU

Proposed institutional arrangements for Stage 2

1. The objective would be to create a system for Stage 2 under which only those things which need to be decided centrally are put under the control of the European Monetary Fund (EMF).

2. (a) The Treaty would create a European System of Central Banks (ESCB) consisting of the twelve national Central Banks and a European Monetary Fund owned and run by the Central Banks, to be operational from day one of Stage 2.

(b) It would also lay down the aim of permanently fixed parities or more probably a single currency in Stage 3.

(c) The aim of price stability would be in the Treaty and in the Charter of the EMF.

(d) The Charter of the EMF would be annexed to the Treaty which would provide that it could be changed by unanimous agreement as necessary.

(e) The Treaty would provide that National authorities (Central Banks, Governments or Parliaments) would not seek to influence EMF policy contrary to its Charter.

3. In addition to the aim of price stability, the Charter of the EMF would provide that in Stage 2 the ESCB shall co-ordinate national monetary policies and the EMF shall control ecu monetary policy. It would create the hard ecu and provide that it should be managed so as to be always as strong as the strongest currency. It would contain the two

/golden

golden rules - no monetary financing of budget deficits and no money creation to replace national currency converted into ecus. It would provide for convertibility of national currencies into and out of ecus and for the EMF to be a lender of last resort in ecus. It would lay down that the exchange risk on national currencies converted into ecus would rest with the National Central Banks and would provide for the sanctions in my statement to the Schmidt/Giscard Committee.

4. The Chairman of the EMF Council would report to the European Parliament and to Ecofin annually in writing and be available to them in person to answer questions when required.

5. Arrangements for Stage 3 would no doubt require amendments to the EMF Charter but not necessarily to the Treaty. It would be wise at this stage only to create the ESCB as required for Stage 2. No-one can fully foresee at present what will be required for Stage 3.

6. National Central Bank Governors could retain their existing relationships with national Parliaments and Governments and could report to national Parliaments if so desired (provided always that 2 (e) above was respected).

MDB/MML
2nd July, 1990

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PM 00

FILE

MRM

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

16 July 1990

Dear Herr Pohl.

Thank you very much for your letter of 5 July. I too thoroughly enjoyed our talk and thought it a very useful exchange of views. It was extremely helpful to hear at first hand about the economic developments in Germany from someone who is very much at the centre of these great events. Like you, I would be very happy to continue our discussion at a suitable future occasion. — Let me know when you are likely to be in London again. Kind regards

Yours sincerely

Margaret Thatcher

—

Herr Karl Otto Pöhl

D

chex.jp/tt1/18

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

13 July 1990

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

Dear Geoffrey,

SCRUTINY DEBATE ON ECONOMIC AND MONETARY UNION

The House of Commons Select Committee on European Legislation recommended on 2 May that there should be a debate on Economic and Monetary Union following their scrutiny of a Commission report on this subject.

The House has since had the opportunity to discuss EMU twice, once in the European Community White Paper debate on 11 June and secondly in the debate following Brian Sedgemore's private members' motion on 15 June. Accordingly I have not felt it necessary to propose a further debate before the Recess. I recognise, however, that the House will wish to have another full debate in the autumn, in good time before the opening of the Inter-Governmental Conference on EMU in December. I will write again closer to the time with the proposed wording of a motion.

I am copying this letter to the Prime Minister, Members of L Committee and OD(E) and to Sir Robin Butler.

Yours Ever,
John

JOHN MAJOR

CONFIDENTIAL
FM PARIS
TO IMMEDIATE FCO
TELNO 788
OF 061209Z JUL
AND TO IMMEDIATE TREASURY, BANK OF ENGLAND
INFO ROUTINE UKREP BRUSSELS, OTHER EC POSTS.

(FRAME ECONOMIC)

CHANCELLOR'S EMU PROPOSALS : VIEWS OF THE GOVERNOR OF THE BANK OF FRANCE

SUMMARY

1. LAROSIERE WELCOMES THE SPIRIT OF THE CHANCELLOR'S PROPOSALS, BUT REGRETS THAT THEY WERE NOT TABLED A YEAR AGO. PRELIMINARY DOUBTS ON A NUMBER OF POINTS, BUT FURTHER EXAMINATION BY EXPERTS NECESSARY. PROVIDED POLITICAL PROBLEMS CAN BE MANAGED LAROSIERE FAVOURS SWIFT PROGRESS TO STAGE III TO CONSOLIDATE THE GOOD ANTI-INFLATIONARY PROGRESS ALREADY MADE THROUGH ERM MEMBERSHIP. HE DOES NOT RULE OUT AN INNER GROUP OF COUNTRIES MOVING AHEAD FIRST, WITH OTHERS JOINING LATER. BUT ALL SHOULD FROM THE BEGINNING, HAVE A ROLE IN THE CENTRAL BANKING INSTITUTION. COMMENT IN MIFT.

DETAIL

2. I CALLED ON LAROSIERE, GOVERNOR OF THE BANK OF FRANCE, ON 5 JULY TO SEEK HIS REACTION TO THE CHANCELLOR'S PROPOSALS FOR EMU BEYOND STAGE I. I STRESSED THAT THESE PROPOSALS WERE A SERIOUS AND CONSTRUCTIVE CONTRIBUTION TO THE DEBATE ON EMU UP TO AND THROUGH THE IGC, AND GAVE LAROSIERE AN ADVANCE COPY OF THE ARTICLE BY THE CHANCELLOR THAT APPEARS IN TODAY'S LES ECHOS.

3. LAROSIERE SAID HE WELCOMED THE SPIRIT BEHIND THE CHANCELLOR'S PROPOSALS. IT WAS IMPORTANT THAT THE UNITED KINGDOM SHOULD BE AT THE HEART OF THE EMU DEBATE. HE HAD REFLECTED CAREFULLY ON THE PROPOSALS, THOUGH THEY WOULD REQUIRE FURTHER STUDY BY EXPERTS. HE HAD NOT YET, HOWEVER, DISCUSSED THEM IN DETAIL WITH BEREGOVOY, SO HIS COMMENTS SHOULD BE REGARDED AS PERSONAL, AND NOT NECESSARILY REPRESENTATIVE OF THE FRENCH GOVERNMENT'S VIEWS.

4. HIS FIRST COMMENT WAS THAT THE PROPOSALS ARRIVED A LITTLE LATE. THEY WOULD HAVE HAD MORE IMPACT HAD THEY BEEN PUT FORWARD AT THE START OF THE DELORS COMMITTEE'S DISCUSSIONS. THE DELORS COMMITTEE HAD STARTED WORK WITH AN OPEN MIND ABOUT THE MEANS OF ACHIEVING AND

THE DEFINITION OF MONETARY UNION, BUT A STRONG CONSENSUS HAD FORMED IN FAVOUR OF THE APPROACH SET OUT IN ITS REPORT : I E EMU CONSISTING OF IRREVOCABLY FIXED PARITIES LEADING TO A SINGLE CURRENCY, WITH THE NECESSARY COROLLARY OF A COMMON MONETARY POLICY RUN BY AN INDEPENDENT CENTRAL BANK. THE CHANCELLOR'S IDEAS DID NOT FIT WELL INTO THIS APPROACH. THE IDEA OF A PARALLEL CURRENCY HAD BEEN EXAMINED AND SET ASIDE BY THE DELORS COMMITTEE. SO HAD HIS OWN PERSONAL IDEA - SIMILAR IN CONCEPT TO THE CHANCELLOR'S IDEAS - OF AN INTERIM INSTITUTION CARRYING OUT CERTAIN SPECIFIED TASKS WHICH MIGHT PACE THE WAY FOR EMU. HE DOUBTED WHETHER OTHER MEMBER STATES, SUCH AS THE GERMANS AND THE BENELUX, WOULD WANT TO GO OVER THIS GROUND AGAIN.

5. LAROSIERE REPEATED THAT THE TECHNICAL ASPECTS OF THE PROPOSALS WOULD NEED TO BE STUDIED BY EXPERTS. BUT IT WAS NOT CLEAR THAT THE PROPOSALS WOULD LEAD NECESSARILY TO A SINGLE CURRENCY, WHICH WAS WHAT BUSINESSMEN WANTED. INDEED, IT WAS NOT CLEAR THAT THEY WERE INTENDED TO. THE CREATION OF A NEW CURRENCY, WITH ASSETS AND LIABILITIES, WOULD INSTEAD COMPLICATE AND DELAY THE MOVE TOWARDS A SINGLE CURRENCY.

6. THERE WERE MORE DETAILED TECHNICAL OBJECTIONS TOO:

I. IT WAS NOT CLEAR THAT THE PROPOSALS WOULD LEAD TO ECONOMIC CONVERGENCE

II. COMPULSORY DEVALUATION COULD LEAD TO A TRANSFER OF THE EXCHANGE RISK FROM FINANCIAL INSTITUTIONS TO CENTRAL BANKS

III. THE PROPOSED ARRANGEMENTS COULD LEAD TO A SWITCH FROM STRONG CURRENCIES WITH LOW INTEREST RATES TO THE HIGHER-INTEREST BEARING ECU, WITH CONSEQUENCES FOR DOMESTIC MONETARY POLICY

IV. IT WAS NOT CLEAR THAT THE INFLATIONARY LOOP HAD REALLY BEEN CLOSED.

7. I SAID THAT LAROSIERE HAD NOT TOUCHED ON THE VERY DIFFICULT QUESTION OF LOSS OF SOVEREIGNTY INHERENT IN THE DELORS APPROACH, NOR OF THE PROBLEMS OF THE DEMOCRATIC ACCOUNTABILITY OF A CENTRAL BANK. THE TIMESCALE WAS CRUCIAL TOO: WHATEVER ONE SAW AS THE FINAL GOAL, COULD ONE REALLY ENVISAGE WITHIN THE NEXT SAY, 5-10 YEARS, THE DEGREE OF ECONOMIC CONVERGENCE NEEDED TO SUSTAIN EMU, WITHOUT EXCESSIVE BUDGETARY TRANSFERS FROM RICHER TO POORER STATES? AN EVOLUTIONARY APPROACH GENUINELY SEEMED BETTER TO US. FURTHERMORE,

WITH THE DM ZONE STRENGTHENING, BUT WITH THE DM ITSELF SUBJECT TO UNCERTAIN PRESSURES FROM EMU, WAS NOT A HARD ECU A BETTER ROUTE FORWARD?

8. LAROSIERE REPLIED THAT FOR FRANCE THE DEBATE ON LOSS OF SOVEREIGNTY WAS EFFECTIVELY OVER, THOUGH THE POSITIVE SIDE OF THIS WAS, OF COURSE THAT ERM MEMBERSHIP HAD REDUCED INFLATIONARY PRESSURES TO THE STAGE WHERE FRENCH INFLATION WAS ALREADY VIRTUALLY ON A PAR WITH GERMANY'S AND WOULD CERTAINLY BE BY THE END OF THE YEAR. THE ERM WAS BECOMING A EUROPEAN RATHER THAN A DM ZONE. LAROSIERE ADDED THAT IN ANY CASE A CENTRAL BANK ON THE DELORS MODEL WITH ONE MAN ONE VOTE ON THE BOARD, WOULD INCREASE RATHER THAN REDUCE FRENCH CONTROL OVER MONETARY POLICY.

9. LAROSIERE SAID THAT A HARD ECU WOULD NONETHELESS HAVE ATTRACTIONS FOR SOME. HE HAD NOT DISCUSSED THE IDEAS IN DETAIL WITH BEREGOVOY, BUT BELIEVED HIM STILL TO BE WEDDED TO THE DELORS ROUTE, THOUGH RIGHTLY CONCERNED AT THE MAGNITUDE OF ADJUSTMENT IN STAGE II. LAROSIERE WAS AT PAINS TO AVOID ANY SUGGESTION THAT THERE WERE DISAGREEMENTS AT MINISTERIAL LEVEL. SOME IN THE TRESOR, HOWEVER, WERE MORE SCEPTICAL ABOUT STAGE III. HE HIMSELF BELIEVED THAT GIVEN THAT PROGRESS ALREADY MADE, AND PROVIDED THE POLITICAL DIFFICULTIES WERE UNDERSTOOD AND MANAGED, GERMANY, FRANCE AND BENELUX WERE ALMOST IN A POSITION NOW TO MOVE TO STAGE III. HE RECOGNISED THAT OTHERS MIGHT NOT BE, BUT COULD ENVISAGE AN INNER GROUP AGREEING TO MOVE AHEAD SEPARATELY PROVIDED THAT:

I. PROVISION WERE MADE FOR OTHERS TO JOIN WHEN THEY WANTED

II. ALL MEMBER STATES JOINED AND TOOK PART IN THE NEW CENTRAL INSTITUTION, THOUGH WITH THE INNER AND THE OUTER GROUPS NO DOUBT PLAYING DIFFERENT ROLES.

10. FINALLY, LAROSIERE REPEATED HIS APPRECIATION OF THE CHANCELLOR'S IDEAS AS A SERIOUS CONTRIBUTION TO THE DEBATE. HIS REMARKS WERE PRELIMINARY, AND SHOULD NOT BE SEE AS NEGATIVE. BRITAIN MUST PLAY A FULL PART IN THE DEBATE AHEAD.

11. SEE MIFT FOR COMMENT.

12. FCO PLEASE ADVANCE PS/SOS, PS/MR MAUDE, KERR, ARTHUR(FCO) PS/CHANCELLOR, WICKS, SCHOLAR, ODLING-SMEE, EVANS(TSY), PS/GOVERNOR, CROCKETT, ARROWSMITH(B/E).

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Prime Minister
If you compare X, Y, Z you will see that M. Delors was not so seriously misreported.

File

A.T.

NOTE FOR THE RECORD AT 9/7

File
on EMU

SPEECH BY DELORS AT THE EUROPEAN PARLIAMENT SOCIALIST GROUP CONFERENCE ON CENTRAL AND EASTERN EUROPEAN ECONOMIES, 6 JULY 1990

1. President Delors gave a speech today (6 July) to wind up a two-day Conference organised by the EP Socialist Group on the economies of Central and Eastern European countries.

2. Delors firstly considered it essential for structural adjustment to take place concurrently with economic action in these countries. EC cooperation should be geared to this end and not be confined simply to giving aid. Institutional decentralisation in central/Eastern Europe was needed, and this went hand in hand with the introduction of a market economy. But organising such markets, and introducing a spirit of competition - when alien to one's ideology - was not easy. Secondly, labour markets needed to be organised. Here, many Western countries - notably Sweden and Germany could offer good advice based on their own experience. Thirdly, public and private property would have to be redistributed - not forgetting that living standards depended on some property and services being provided free of charge (or almost so), eg telecommunications, transport links, education and health care. The basic message was that market economies should be created without recourse simply to adopting legislation. Appropriate people (such as the farmers in Poland) had to be identified in the countries concerned to carry out this marketisation process. Fourthly, Central and Eastern countries faced problems of debt and the environment, both of which would need to tackled. Turning to trade links, Delors foresaw a continuing role for COMECON - at least in the medium term. The existing Western and Eastern systems could not be brought together over night, so the West needed to allow time for COMECON to adjust, open up and catch up.

3. Delors continued by speculating on a new international economic order. He outlined the following parameters:

i) TRADE: The easiest to deal with. Western European countries should open up their economies to Central and Eastern Europe and development multilateral trade in order to integrate both sets of economies. Inevitably, sacrifices would be needed on the part of the West.

E.E.C.?!

/ii) ...

ii) **FINANCE:** A centralistic approach was unacceptable. Europe should not forget about the debt problems in other parts of the world. Money was available, but was not equitably distributed; so capital flows needed to be looked at.

iii) **CURRENCIES:** A combination of weak currencies and high interest rates had made life difficult - particularly for Eastern Europe in getting loans.

Henceforth, there was a case for a new model of economic growth to replace the "ultraliberalistic" approach still advocated by the US and the UK. That approach was now losing ground to one of a "mixed" economy in which 11 Member States now believed.

4. In conclusion, Delors favoured a long period of engagement before further EC enlargement to embrace the countries of Central and Eastern Europe. Patience was needed. Meanwhile, the EC should continue to develop cooperation with these countries. The G24 approach was the right one and could be stepped up. The EC was developing cooperation with EFTA and had proposed a new type of agreement with Eastern Europe. Cooperation could also be broadened under the CSCE umbrella to include such areas as transport, telecommunications and energy.

A F N GOODWORTH

6 July 1990

cc: D Halligan Esq, HMT
M Arthur Esq, ECD(I), FCO
L Parker Esq, Cabinet Office
C Gray Esq, EED, FCO

Mr de Fonblanque
Mr Pakenham
Mr Bonney
Mr Baird
Ms Glynn

Office of the United Kingdom Permanent Representative
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Telephone (02) 230 62 05
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S Gass Esq
Secretary of State's Party
Houston Summit
by fax - 713 7580025

Your reference

Our reference

Date 9 July 1990

Fax from Secretary of State's Party Houston

Dear Simon

INDEPENDENT REPORT OF DELORS' SPEECH, 8 JULY

1. As requested by the Resident Clerk I enclose a copy of the (front page) article by David Usborne in Saturday's Independent.

2. As you will see from reading the article, the headline is misleading. It is not Delors who warns against unfettered capitalism but J K Galbraith. Delors apparently spoke off-the-cuff and no text is yet available. But there is a short summary produced by his spokesman which I also enclose. I have underlined the sections in the summary which are reflected in the article.

3. We will continue to pursue and let you have a text or fuller report as soon as possible.

Yours ever,

J Grant

cc : N Westcott Esq, ECD(I), FCO
(by fax)

Bruxelles, le 6 juillet 1990.

NOTE BIO (90) 206 AUX BUREAUX NATIONAUX
cc. aux Membres du Service du Porte-Parole

Intervention du président devant la conférence sur les économies de l'Europe centrale et de l'Est, organisée par le Groupe socialiste du PE et l'Union des P.S. de la Communauté européenne (Bruxelles, 06/07/90)

Après avoir rappelé les tâches qui ont été confiées à la Commission, et sa grande humilité intellectuelle, le président Delors a souligné que notre effort était placé sous le signe de la coopération, et non de l'assistance. "Nous apprendrons autant de ces pays que nous leur apporterons".

Il a développé trois thèmes :
1) la problématique de la réforme économique,
2) le lien entre cette problématique et l'ordre économique international,
3) la dimension politique.

1) Face à l'extraordinaire diversité des situations, il s'agit :

- de faire le lien entre l'action conjoncturelle et l'action structurelle : un simple ajustement à court terme peut être très coûteux sur le plan social et même économique ; c'est pourquoi la Commission s'efforce de mettre l'accent sur les réformes de structure.

- à la fois d'inclure l'esprit de marché et de réussir la décentralisation institutionnelle. L'esprit de marché est avant tout un esprit de compétition et l'organisation des marchés n'est pas facile : d'où la nécessité de trouver les endroits où cet esprit existe déjà potentiellement, comme dans l'agriculture, et de faciliter l'organisation d'un marché de travail, fondé sur la notion d'"employability", au risque d'un accroissement du chômage ; "c'est là que les pays de l'Est ont le plus à attendre de nous". La question des coûts sociaux supportables est également fondamentale, sous son angle psychologique (ne pas engendrer des agents passifs ou opposants à la réforme).

- de prendre en compte la dialectique entre bien privés et collectifs : "les pays de l'Est ne devront pas jeter l'enfant avec l'eau du bain".

Comment déclencher un engrenage vertueux ? Car le temps presse, et deux contraintes fortes pèsent sur ces pays :

- l'endettement : il y a risque que son poids excessif annule les effets positifs des autres mesures.

- l'environnement.

L'insertion dans l'économie mondiale doit être facilitée, mais les réseaux d'échanges ne pourront être modifiés du jour au lendemain, sachant que ces échanges sont largement fondés sur des produits de la seconde révolution industrielle.

2) La question du nouvel ordre économique international va être regardée sous l'angle

- du commerce
- des finances : "jamais, il n'y a eu autant d'argent dans le monde, or, il est introuvable pour certains ; c'est un obstacle fondamental à un ordre économique équitable"
- de la monnaie : la surenchère constante des taux d'intérêts aggrave actuellement la situation des PVD.

(Y) Si le monde occidental a connu depuis les années 70 une vague d'ultralibéralisme, ce dernier perd de sa force. Le nouveau modèle de développement devra être plus respectueux de la solidarité, de la qualité de vie des hommes et de la nature. "Les pays de l'Est, ayant mis l'accent sur les biens collectifs, pourront beaucoup apporter de ce point de vue".

Il s'agit enfin de ne pas confondre économie de marché et capitalisme : 11 pays sur 12 de la Communauté appliquent l'économie mixte.

3) La discussion des mois qui viennent sera dominée par le concept de sécurité, et par la primauté des droits de l'homme. A partir de là, le choix existe entre le rêve et la réalité. Actuellement, l'extension de la Communauté serait un rêve : voir la longue adaptation de pays comme la Grèce, l'Espagne et le Portugal ; de plus, "l'entrée dans la Communauté n'est pas un remède miracle".

En attendant, la place est ouverte à des coopérations multiples : opération PHARE, qui vient d'être étendue, perspectives de développement (accords d'association, EUREKA, secteurs des infrastructures de transports, des télécommunications, de l'énergie, etc.).

Il n'y a aucun intérêt à affaiblir la Communauté, pour établir un cadre institutionnel prématuré. "L'architecture de la grande Europe sera un jeu de patience ; je vous conseille de longues fiançailles, la Communauté n'en sera que plus unie, solidaire et généreuse".

B.D.

Amitiés,
Bruno Dethomas

THE INDEPENDENT

Delors warns against unfettered capitalism

From David Usborne in Brussels

JACQUES DELORS, the President of the European Commission, yesterday declared the "ultra-liberal" economic experiments of the United States and Britain dead and urged East Europe to beware the lure of full-blooded capitalism.

Mr Delors told a socialist conference on economic reform in Eastern Europe at the European Parliament that the world had to embark on an "intellectual revolution" to overcome international indebtedness and to query the doctrine of economic growth for its own sake.

He meanwhile advised the new East European democracies "not to confuse market economies with capitalism" and to look to West Germany, among the EC member states, as the best model for the development of mixed economies where liberalism was blended with some state intervention.

Mr Delors' advice was echoed by Professor J K Galbraith, of Harvard, who scorned the US for giving little aid while prescribing a shock transition to unrestrained capitalism, in spite of the social pain it would cause. It showed, he said, a "casual commitment to human deprivation – to unemployment, inflation and disastrously reduced living standards . . . Only a few years of suffering and all will be well. This – I choose my words carefully – is insanity."

Nor did the prescription match reality in the West, Professor Galbraith suggested. "In Britain Mrs Thatcher, and until lately in the US Mr Reagan and his acolytes, have pictured themselves as arch-exponents of unfettered capitalism. In fact they owe their eminence to early generations of socially minded leaders who made their citizens economically and socially comfortable."

Mr Delors said the relative bad health of the US and UK economies showed "ultra-liberalism" had failed. The experiment "was on the way out, because it did not produce the results expected of it", he said, citing the budget deficit crisis in the US. "We have to work for a new equitable world economic order," he declared.

An immediate aim must be to alleviate dramatically the debt burden of Eastern Europe. The current distribution of money in the world, Mr Delors argued, represented a "fantastic obstacle to the resolution of the world's imbalances".

He warned the East European states not to dream of early entry into the European Community but to focus on developing relations with it through association agreements. "You must distinguish between the dream and the reality. The dream is that the Community of 12 will, in the next two years, grow to become one of 24," he said.

■ More than 120,000 East German industrial workers staged wildcat strikes yesterday in a surge of labour unrest over fears of unemployment in a new market economy, union officials said. Reuter reports.

(2)

Nr Arthur EED (1)

Do we have a fuller report or the full text? — Secretary of State has asked from Houston.

9/vii

— See attached correspondence. UKRep has been pursuing this since it was drawn to attention last night by the Resident Clerk.

9/vii

7 July 1990

(36)

KARL OTTO PÖHL
PRÄSIDENT DER DEUTSCHEN BUNDESBANK

6000 FRANKFURT 50
WILHELM-EPSTEIN-STRASSE 14
TELEFON 069/1581

July 5, 1990

P10

The Rt. Hon.
Margaret Thatcher, MP
Her Majesty's Primeminister and
First Lord of the Treasury
10, Downing Street

London SW1 A2AA

Dear Primeminister,

I am writing to say how much I appreciated our exchange of views, particularly on European monetary matters. I truly understand your point of view with regard to giving up sovereignty rights in the area of monetary policy in favour of a common European monetary institution, and I am sure that your Government is not the only one which will take this view at the end of the day. I would ask you, however, also to understand my position after the decision of the European Council to start negotiations on an amendment to the EEC Treaty. I thought it was necessary to make very clear the conditions on which from the German point of view the decision-making process could be transferred to a supra-national institution. That does not mean that I expect that to happen very soon but I think it is good to know the end of the road before one sets out on a journey.

I was surprised and a little upset by the fact that my visit to London attracted so much attention. This was certainly not my intention, and I feel sorry that this may have caused any inconvenience to you. Nevertheless I would be very happy if we could continue our conversation on some other occasion.

With best regards
Yours
Karl Otto Pöhl

(2)

10 DOWNING STREET

Prime Minister

To note particularly Hew Pocklington's comments about the date of ERM entry on the last page.

CDP

4/7

SECRET - ASDO

FILE ECL

SUBJECT CC MASTER 6(A-B)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 July 1990

Dear John,

UK ENTRY INTO THE EXCHANGE RATE MECHANISM

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

I should be grateful if you could ensure that this letter is seen only by those with a strict need-to-know.

The Chancellor said that it was essential to join the ERM before the Party Conference. The exchange rate was high and still appreciating. It was essential to maintain a high rate. The latest forecast from the Treasury Ministers showed the continuing resilience of the economy and the need to sustain high interest rates to rein back growth in money GDP. The forecast also indicated that retail price inflation would remain high until September; but there might be a drop in the year on year RPI that month which would be published in October. If the UK were to stick rigidly to the Madrid conditions before joining the ERM, the Government might have to wait until next year. That was not practical: the UK had to join while the exchange rate could be sustained at around the present level; and the Chancellor was concerned that, while exchange markets were always unpredictable, it might be difficult to sustain the high rate beyond the Party Conference.

He continued to believe that entry in July was attractive, it gave a number of political advantages; the exchange rate was about right; and it would give an early signal to wage negotiators that wage settlements must be brought down.

The following points were made in discussion:

(i) It might be very awkward to join in July. The inflation rate would still be rising and would go higher in subsequent months. It might look like a panic measure which would prejudice keeping the exchange rate up within the wide bands.

(ii) If entry were timed in the early autumn, two possible dates were September 14 and October 5. On the latter date, it might be possible to make an announcement after the Labour Party Conference had closed; that

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would be just before the beginning of the Conservative Party Conference, and at a time when Ministers knew the RPI figure for September (which was expected to show the first fall in the year on year rate). It would be too late to enter the ERM in the weeks leading up to the IGC. That would look like political weakness.

(iii) It would be important to use the Exchange Rate Mechanism to put downward pressure on wage settlements. But that in turn had to imply the exchange rate could not fall very far. That argued for careful positioning of the bands around the exchange rate when the UK joined the ERM: they might be set to give more room for appreciation than depreciation. There was also an argument for having narrower bands than those previously envisaged: one possibility would be to enter on bands of 4 per cent.

(iv) It was also necessary to avoid too high an exchange rate emerging: an excessively high level could damage the balance of payments and put unduly intense pressure on the business sector.

(v) Entry into the ERM would bring forward the date at which interest rates could safely be reduced and thus mortgage rates. On the other hand the longer that entry was delayed, the closer the reduction in interest rates would be to the point when it would have been justified in any case.

(vi) When the UK joined the ERM, it would also be appropriate to announce that the present RPIAC would be wound up and the Government would consider how a replacement index of retail prices might be constructed in line with European practice. It would be necessary for the Treasury to consider in advance how index-linked gilts, pensions, benefits etc. would be handled if the RPI were to be revised.

Summing up the discussion the Prime Minister agreed with the Chancellor that they should reconsider possible dates for UK entry into the ERM at the end of August. Two candidates were September 14 and October 5 - and the practicalities of each should be investigated further. In the meantime Treasury should also consider further the economics of going in with rather narrower bands at 4 per cent initially; other options included going in initially with the wider bands of 6 per cent and reducing them to narrower bands at some later stage. It would be appropriate to announce when the UK entered the ERM that the present RPIAC was being wound up and the Government was investigating the construction of a new retail prices index, more along the lines of European practices.

Yours ever,
Barry

(BARRY H. POTTER)

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

chex.jp/jg1/3

CONFIDENTIAL

(2)

Prime Minister

CBP 4/7

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

3 July 1990

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

Dear Charles

CHANCELLOR'S MEETING WITH THE PRESIDENT OF THE BUNDESBANK

The Chancellor had lunch today with Herr Poehl. Sir Peter Middleton, Sir T Burns, the Deputy Governor of the Bank of England, the German Ambassador, and Herr Poehl's Private Secretary were also present.

Germany monetary union

Poehl said that the first days had passed smoothly. He thought the concerns that had been expressed about the inflationary consequences of union had been much exaggerated. There were already inflationary pressures within the Federal Republic which was operating near to full capacity and the Bundesbank were not complacent about those but he doubted whether monetary union with the East would add much to the pressures. He main concern was that after a few months the inability of the GDR's industry to compete would lead to a dramatic rise in unemployment and redundancies which could in turn give rise to social unrest. There was a high probability that the Federal Government would respond to that in a pre-election period by subsidising jobs and increasing Government borrowing. That in turn could put further upward pressure on interest rates. He feared that some members of the Government thought of borrowing as a soft option; the Bundesbank was trying to disabuse them of that. But on balance he was optimistic about the outcome of monetary union.

EMU

The Chancellor said that he was puzzled by the lack of attention given elsewhere in the Community to the practical question of how

to move beyond Stage 1 and the obsession with the details of Stage 3. There seemed a widespread assumption that a rapid move to full monetary union was possible yet in reality that would be disastrous for several Community countries. The consequent pressures for a massive increase in regional aid could hardly be attractive to the more prosperous member states. Herr Poehl agreed. He said he had always been opposed to trying to proceed rapidly towards union. The pressure had come, above all, from France which wished both to bind Germany more closely to the Community and to reduce the dominance of the Bundesbank in monetary policy. No one believed that Greece or Portugal (or probably Spain or Italy) would be ready for full union in the near future but there was a powerful commitment to produce a new treaty quickly and it would be very damaging if the IGC failed.

The Chancellor said that the IGC could not be a success if one or more members refused to sign the treaty and for the foreseeable future he could not see Parliament ratifying a treaty which committed the UK to Delors Stage 3. Herr Poehl said that he doubted whether the British Parliament would be alone in that. The Danes for examples were likely to resist such a treaty and the French National Assembly might also throw it out. He referred to recent comments by Chirac, Balladur and Giscard and noted that Beregovoy had been non-committal on EMU. He would not be surprised if the outcome were an agreement which allowed some countries to advance faster than others. Another possibility, if the IGC broke down or the new treaty was not ratified, would be a Franco-German agreement (in which Benelux would almost certainly participate) to set up their own joint central bank which other Community members could join when and if they wished to. This had been the model for a number of Community developments including the EMS and the Schengen agreement. A third possibility would be a search for a face-saving alternative like, perhaps, the hard ecu proposals.

The Chancellor said that these ideas had not been put forward as a diversionary tactic but as serious proposals which would allow the Community to move beyond Stage 1 in an evolutionary manner. Herr Poehl said that the proposals needed to be examined more closely in the Monetary Committee and in the Central Bank Governors' Committee. However, the UK should not expect that all work on the leading option would be abandoned or set aside. He recalled that proposals somewhat like the UK's had come up in debates in the 1970s and the Bundesbank had always strongly opposed the creation of parallel currencies and was not likely to change its view. It had taken many years, for example, to reconcile his Council to the present ecu. The Ambassador said that it was very important to emphasise that the hard ecu could develop into a single currency and the EMS into a ESCB.

Herr Poehl asked what would happen to the existing ecu under the proposals. The Deputy Governor said that there was no difference in principle between this and dealing with the periodic revisions

of the existing basket. The old ecu would have to be used for existing contracts and the hard ecu would be used for new ones. He did not think this was an insoluble problem. Referring to Poehl's comments about the indivisibility of monetary policy, he said that he thought a confusion of responsibilities was more likely to arise under the Bundesbank's approach than under the Chancellor's alternative scheme. Herr Poehl was encouraging the Central Bank Governors' Committee to assess the economic position of each country and advise on the appropriate stance of policy. The UK proposals left a clear division of responsibility with the EMF being responsible for managing the ecu while the national authorities remained entirely responsible for national monetary policies, although the existence of the ecu would affect the environment within which they worked. He added that the EMF could be obliged under its statute to operate the ecu with a view to exercising counter-inflationary pressure within the Community. Herr Poehl said that he was keen to find some method by which national monetary policies could be made more consistent. The Central Bank Governors' Committee would have no executive authority over national policies but would simply offer advice to national authorities. The Deputy Governor said that if this advice were made public - as had been suggested - it could become a real factor in markets and would confuse responsibility for policy.

Herr Poehl said that he had not claimed that the hard ecu proposals would be inflationary but they would make things much more complicated and would not avoid any of the problems of accountability that had been identified in the Delors proposals. They would not bring the economic advantages of lower transactions costs (although he did not place too much weight on that) and there was no certainty that the hard ecu would be any more popular than the existing ecu.

Sir T Burns said that one advantage of the EMF proposals were that they provided a flexible route beyond Stage 1 in which all 12 could participate and which could start early. The Deputy Governor pointed out that the creation of the hard ecu also built in new pressure on European economies to converge on low inflation. Progress along the Delors route by contrast was dependent entirely on political will among governments and the influence of the Central Bank Governors' Committee. Herr Poehl acknowledged these advantages but asked about the risk of turbulence in the markets if expectations of a realignment built up. Sir T Burns said that the repurchase arrangements would bring matters to a head very quickly and would impose a considerable penalty on devaluation. Herr Poehl accepted that that was one charm of the hard ecu proposals. By contrast, under the Delors route a profligate Government would be constrained only by loss of competitiveness and high unemployment. He acknowledged that in practice that would lead to pressure for high regional subsidies.

Concluding this part of the discussion, the Chancellor said that the hard ecu proposals were not a flight of fancy and he intended to press them in ECOFIN and in the other Community forums. He expected them to be fully discussed. Herr Poehl said that the proposals were well developed and he did not want to dismiss them. Certainly the UK should promote them but, equally, they must expect others to promote their own ideas. He could imagine a point during the IGC when the British ideas might attract some support so he did not think now was the time to say "the last word".

ERM

The Chancellor said that he had not always been an enthusiast for joining the ERM but was now convinced that it would be in the UK's interests. We were committed to joining as soon as conditions were right. Herr Poehl said that he had long been in favour of UK membership. Conditions two or three years ago would have been easier for entry and there could be advantage in seeing inflation peak before entry. Care was needed on the rate as well; too high a rate had disadvantaged Belgium when the ERM was first established. He did not think that GEMU would be a factor in the decision. It had not led to turbulence in the markets, although there could be some reaction in the autumn if there were disturbances following redundancies and closures. The Chancellor said that it seemed likely that UK inflation would rise a little further and reach a peak in August (whose index would be published in September). The Deputy Governor noted that sterling had risen strongly in recent weeks and days in anticipation of early entry.

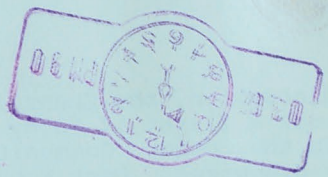
The Chancellor asked Herr Poehl when he would join were it his decision. Herr Poehl said that a number of his colleagues in the Bundesbank would be concerned at early entry because of the risks of strain within the system but his own opinion was that we should join in September or early October. Waiting too long would risk disappointing market expectations and that could be disastrous for sterling. He added, however, that it was entirely a decision for the British Government although he hoped that we would talk to the Bundesbank once our minds were made up.

I am sending copies of this letter to Paul Tucker at the Bank of England and to Stephen Wall (FCO).

Yours

John

JOHN GIEVE
Principal Private Secretary



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CCPC.

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

3 July 1990

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

Dear Charles,

ECONOMIC AND MONETARY UNION: THE WAY AHEAD

... The Chancellor has agreed to do a signed article, pushing our hard ecu proposals, for syndication in the European press. I attach the latest draft. As the article needs to be signed off this evening, I am afraid any comments would need to reach us by 5.00 pm this afternoon.

I am copying this letter to Stephen Wall (FCO) and Paul Tucker (BoE).

Yours sincerely,

Moira Wallace

MOIRA WALLACE
Private Secretary

chex.jp/mw/9

DRAFT OF 3 JULY 1990

ECONOMIC AND MONETARY UNION: THE WAY AHEAD

There is no more important issue facing the European Community than the path we choose towards economic and monetary union. We are all committed to this goal. That is no longer news. What is new is that we are getting close to the point of decision on what economic and monetary union actually means, and what steps we need to take to progress towards it. We cannot afford to get this wrong. For to do so could wreck the cohesion of the Community, and be fatal to its future development

2. Stage 1 of economic and monetary union began on 1 July. It will involve the construction of a single community financial area with a single market in financial services and wholly free movement of capital. Britain is a wholehearted supporter of all the elements of Stage 1, and has been in the van of implementing agreed legislation. We hope that the nations in the rear will match their oratory about European ideals with practical action, and soon. Also during Stage 1 all member states will become full participants in the exchange rate mechanism of the European Monetary System. For its part, the UK will join the ERM as ~~soon~~ Soon as it is appropriate to do so.

I have suggested striking to a historical formulation.

3. But what happens after Stage 1? On the economic side excellent progress has already been made and there is now considerable agreement that future arrangements should allow freedom of action for member states in taking decisions about appropriate levels of public expenditure, taxation and budget deficits, while outlawing monetary financing. We should encourage the process by which Finance Ministers and Central Bank Governors discuss the problems they face in managing their economies - and look for co-ordinated solutions where possible. The Community can only gain from such an approach.

4. But there is, as yet, no consensus on post-Stage 1 developments on the monetary side. Until now the debate has been dominated by the Delors Report, with its proposals for a final stage of economic and monetary union involving automatic transition by administrative fiat to a single currency, a single monetary policy, and a European central bank. Britain's reservations about these proposals are well-known. They are based on firm convictions about what is right for the future of the Community, and what is in the best interests of member states.

5. Our clear view is that without improved economic "convergence", monetary union simply would not work - indeed it <u>could</u> not work. A premature attempt to impose it would be unsustainable, and would lead not to unity, but to disunity.

6. At present there are still significant disparities in economic performance between member states. Until that has been corrected, and economic performance converges, a rapid jump to a single currency and a single monetary policy would put an intolerable strain on the Community. The cost for the less strong nations would be high, and would be expressed in lost output, lost jobs and a loss of asset values. This would undoubtedly lead to pressure for large budget transfers from the richer nations; but even if these were forthcoming, they themselves would merely delay adjustment, as well as risking new tensions between contributor and recipient nations.

7. Surely this is not the kind of Europe anyone wants. Rather, we want an open Europe: open to trade and investment; and in due course open too to new members from Europe, East and West. We believe passionately that we should develop a form of EMU that is consistent with that vision. That is important for EFTA countries, and will in due course be important for the newly emergent democracies of Eastern Europe. That argues powerfully for a gradualist and evolutionary approach and against any attempt to move to a rigid and closed structure.

8. These are the reasons why Britain has come forward with new ideas going beyond Stage 1. These ideas satisfy six key criteria:

- they are gradual and evolutionary, following naturally from Stage 1, avoiding a "big bang" approach;

- they work with the grain of the market;

- they would strengthen price stability;

- they allow proper accountability and avoid an unnecessary centralisation of economic and monetary decision-making in the Community;

- they make greater economic convergence in the Community a pre-condition of further progress towards economic and monetary union;

- and they avoid talk of two-tier or multi-speed Europes, dividing north and south. I want to see the Community more united, not fragmented. That is the right way forward.

9. The new British proposals concentrate on offering the whole Community a way forward <u>now.</u> We propose two steps. First, we should transform the ecu from a unit of account into a real currency by issuing ecu bank notes for general circulation. For this we propose the establishment of a new institution - a "European Monetary Fund". The EMF would also be responsible for a range of other important activities -

managing the Exchange Rate Mechanism, co-ordinating the intervention of central banks against non-EC currencies such as the yen and dollar, and helping to manage medium-term balance of payments lending.

10. We think that ecu notes will be attractive to business travellers and tourists from the start. But we would go further, and suggest the creation of a "hard ecu". This would be a new international currency in its own right, no longer a basket of the 12 national currencies; it would co-exist beside the existing currencies of the 12 member states. A central feature of our proposals is that the new ecu would never be devalued - it would always be at least as strong as any other community currency. This would mean that the hard ecu would not run the inflationary risks of previous parallel currency proposals. We have set out safeguards to ensure that the European Monetary Fund did not accommodate lax national monetary policies. We see the hard ecu promoting lower inflation and greater exchange rate stability.

11. In time, the ecu would become more widely used - a genuine common currency for Europe. In the very long term, if peoples and Governments so choose, it could develop into a single currency. That is a decision we cannot and should not take now. But Britain proposes this approach in the clear knowledge that it could happen.

12. I look forward to discussing these ideas with my Community colleagues in the preparations for, and during, the Inter-Governmental conference on economic and monetary union due to begin in December. I want the Community to maintain the momentum established by Stage 1. We will not achieve that by going for a leap in the dark which could all too easily prove disruptive and self-defeating. I believe our ideas avoid many of the potential dangers of the present Stage 3 proposals, and offer a more practical and sustainable way forward for the whole Community.

[wordcount = 1092]

PRIME MINISTER

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BILATERAL WITH THE CHANCELLOR: JOINING THE EXCHANGE RATE MECHANISM

You are meeting the Chancellor tomorrow for a further bilateral discussion on when the UK should join the Exchange Rate Mechanism.

The Chancellor has submitted a further note and the latest Treasury forecast. Page 25 of the forecast is an important backdrop to the discussion: the table shows

(i) the RPI year on year increase is not expected to fall until September (ie. announced in October);

(ii) neither is the underlying inflation rate (column 3) expected to fall before September;

(iii) in July, when the June RPI figure is published, the year on year RPI rate will be rising at or close to 10 per cent.

The Chancellor continues to press for entry to the ERM in July - though not so vigorously as before. There is a distinct hint that he may settle for entry before the Party Conference. Accordingly October 5, the last day of the Labour Party Conference, is the earliest possible date - when the September RPI figure will at least be known to the Government though not yet published.

Chancellor's Paper

The Chancellor's minute takes a slightly different, and rather more persuasive, line than previously. The new information is the Treasury's latest economic forecast. It shows the continued resilience of the economy through the rest of this year and well into next year.

Since the last forecast at Budget time, the Treasury have revised upwards their figures for the growth in domestic demand

for next year; increased the forecasts of money GDP for this year and next; and substantially raised the projections of RPI inflation. Indeed, on the basis of existing policies, there would be very little fall off in the underlying inflation rate until well into next year.

The Chancellor rightly draws the conclusion that the policy stance need to be tightened. A tighter stance means continuing with high interest rates for longer and keeping the exchange rates up. Yet achieving some cut in interest rates is clearly important for wider political reasons; and the latest projections show no cut in interest rates - and therefore mortgage rates - until 1991 Q4 on present policies.

Accordingly, the Chancellor argues that policy considerations now argue for early entry into the ERM. It is necessary to keep the exchange rate high in order to put downward pressure on pay settlements and achieve a more rapid turnaround in inflation. Entry would also allow more weight to be laid on a high exchange rate and less reliance on interest rates - thus permitting an earlier reduction in mortgage rates.

The minute accepts that entry into the ERM next month or early in the autumn would mean the Madrid conditions had not been met. He continues to contend this need not matter - although the arguments in paragraph 8 remain unconvincing.

Assessment

The forecast is an important new consideration. Prospects are rather worse than before - even the PSDR threatens to disappear this year or next. The need to tighten policy even further is clear.

The desirability of entry for political, though not necessarily economic, reasons to avoid over reliance on interest rates, is a vital consideration. Joining the ERM would tighten policy through sustaining the exchange rate and putting downward pressure on wages. It would enable an earlier reduction in mortgage rates.

But none of this is a convincing reason for entry as early as next month. If the UK joined the ERM in July it would be against a backdrop of rising inflation at or near 10 per cent. There is no evidence of any weakness in the exchange rate at the moment - quite the reverse. There is no expectation in the City of entry next month - it is widely assumed the UK will join in the autumn. So there is no reason to consider that the policy stance would be weakened if the UK did not join the ERM until say October - though exchange rates are of course never predictable.

There is a more persuasive case for joining in early October. The Government could just have met the Madrid conditions if the forecast RPI turns out to be correct in September. Rather more persuasive is the policy case for tightening the monetary stance and making it clear to wage negotiators, at the start of the wage round, that they will not be bailed out by exchange rate depreciation. (The Chancellor conveniently ignores that there is quite some scope for depreciation within the wider bands.)

Entry in October would also allow the Government to declare a tougher policy stance against inflation. That could be made clear at occasions like the Party Conference, the Autumn Statement and the Mansion House speech. What were obstacles in the Chancellor's previous paper become opportunities.

Conclusion

The forecast shows the need to tighten monetary policy. An interest rate rise is politically very difficult. Joining the ERM to sustain the present high exchange rate is, in the circumstances, a politically better means of achieving that tightening.

That is not a case for joining in July, however. But you may consider that there is a more persuasive case for considering joining in October. The Chancellor has, however, still not shown that the dangers of backlash next year could be avoided.

BHP

BARRY H. POTTER 3 July 1990 c:\wpdocs\economic\erm (slh)

B 2 (A-b)

SECRET - ADSO

PRIME MINISTER 3 July 1990

ERM

You would take a substantial, if not enormous, risk in accepting the Chancellor's advice by surprising the markets and entering the ERM in July. The latest monthly profile for inflation is quite shocking- with figures for the next three months being all over 10%. If we were to join the ERM now and then the published rate of inflation was seen to rise in July and August the markets would be bound to question our real motives for joining. It would look as if we had something to hide and that the inflation outlook was far worse than we have so far published. It could well provoke a sharp fall in the pound.

You are known to stick to your word. As a result the Madrid conditions really matter. It is important, therefore, that we do not go in until inflation has peaked, and has started to come down. This means that the very earliest entry date should be on the publication of the September RPI figure, which would be in October. Even on this occasion, however, inflation would still be 10%, which would be far from ideal.

The Chancellor, however, does have a point about the exchange rate. What we need to avoid is a run-up to the Party Conference, or - a Party Conference week during which there would be speculation about sterling and possibly a sharp fall. So far the Chancellor has been extremely successful in talking the rate up by being so bullish about entry into the ERM. You might suggest to him that you see no possibility of the rate falling providing he stresses that the first of the Madrid conditions must be met, namely that we will enter when we have succeeded in controlling inflation.

My own personal view is that when the rate of inflation is seen to have peaked it will be quite hard for us not to enter the ERM - and indeed we could well get bounced into doing so by the markets. As a result the ideal timing might be the first publication of an RPI

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figure following the peak. Although this is something of a gamble, it would nevertheless make sense to most private sector forecasters who are predicting a substantial fall in inflation in the coming 12 months.

Brian Griffiths

BRIAN GRIFFITHS

chex.jp/8

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SECRET - ADSO

1 of 6
JG/24
cc B/G.

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

((A-D)

PRIME MINISTER

I have been reflecting further on our conversation. You asked ... about the price prospect. I enclose the Treasury's July forecast. It is prepared for internal purposes, especially for public expenditure and is not published. You will find the price forecast in Chapter 6 and the forecast monthly profile in Table 6:3.

2. Against this background, can I turn again to the options I advanced on the timing of our entry into the ERM? It goes without saying that I agree that we should not join the ERM in order to gain from a possible short term honeymoon period. That would be very silly and counter-productive. It is the fundamentals that concern me, as I know they do you.

3. The fundamentals are of two sorts. First the prospect. Second our policy stance.

4. Given the prospect set out in the forecast, we shall need to maintain and preferably reinforce the stance of monetary policy. This may require high interest rates for some time. And we must try to keep the exchange rate at present levels or higher. If it drops we shall certainly need high interest rates for longer.

5. Of course, there are risks in joining ERM early - as there will be whenever we join. I know you are particularly worried by the view of a number of economists that our interest rate differential with the DM could lead to substantial capital inflows

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and force a premature reduction in interest rates. But I think two developments have greatly reduced that risk.

(a) The present strength of the exchange rate is in anticipation of our early entry into the ERM. So much of the expected pressure may already have occurred.

(b) We are proposing to join with wider margins so the rate could rise considerably further - possibly above 3 DM - without a threat to our interest rates.

In any event, as a last resort we have the ability to revalue. We are after all new members and this would not be a disaster.

6. The positive advantage to be gained from early entry is that it would give new impetus - which the forecast suggest it needs - to counter inflation policy. We would face the next pay round with a stance which would be perceived as both clearer and firmer. We should seize the political and economic initiative which we could maintain throughout the summer and autumn. There would be less risk that the exchange rate would fall back through disappointed expectations and the private sector would realise that there could be no bail out through exchange rate depreciation. By reducing expectations of inflation in this way, it would help to get inflation itself turning down decisively.

7. The risks of waiting are that the exchange rate may indeed fall back and that we should face a difficult winter in which we should find ourselves on the defensive both on the economy and on Europe as we approach the IGC. As I indicated when we spoke, I am very apprehensive of such a market reaction if we delay too long. If it happened it would be a grim prospect for us.

8. I know you are concerned about joining when inflation is still rising and when it will be asserted that the Madrid

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conditions are not yet met. I am also concerned about this. But we must be realistic about what we can achieve. Though inflation should peak in the summer, it may not come down much for many months. We cannot wait too long without losing all the political advantages of entry. I believe we can answer questions on the Madrid conditions by pointing out:

(a) our entry is on wide margins; This does not give the certainty on leverage which the market assumes

(b) inflation will peak in the summer and we are confident of the direction it is going;

(c) the other conditions have pretty well been met.

9. Of course the Opposition will try to play up the change of line but I have no doubt that the overall reaction will be positive and our entry and its implications will be the dominant interest. I am sure that early entry will not be seen as a defensive move; indeed that will be much more likely if we enter late in the year after sterling has fallen (and when our inflation rate will still be little better than it is now).

10. The greater danger if we delay entry is that the pound will fall and further worsen the prospect for inflation. I cannot say that if we wait into the winter, that is bound to happen. But I do believe the odds are unacceptable. It would continue to rise and thus give us a higher value on entry.

11. I remain convinced, therefore, that it would be a mistake to put off entry towards the end of the year. Before the Party Conference looks the best and safest economic prospect to me. It would also offer the greatest political dividend and enable us to use the major speeches of the autumn to spell out the implications of membership - particularly for pay. And, on balance, I still favour a surprise move in July and believe we can carry this off. We could capitalise on the widespread belief that inflation will

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peak in the summer. Indeed, we should reinforce this belief. And we should present it as a positive move to strengthen domestic policy that is also in keeping with our European commitments.

12. I am sorry to persist where I know you are cautious and I understand the reasons for your concerns. But I am sure the advantage lies in grasping this nettle speedily.

[J.M.]
2 July 1990

PART 7 ends:-

BP to Greve 27-6-90

PART 8 begins:-

Aunt to PM 27-90