

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 11 MAY

I have agreed the following agenda items with the Chancellor's Office.

Tokyo Stock Exchange

I gather the Chancellor wants to take stock with you on the position reached. He may express some irritation about what he sees as the haphazard line of press briefing on the subject.

The Markets

The usual stock-taking. Following yesterday's strengthening of sterling, the markets have been very quiet today. I attach the evening report. I have no indication that the Chancellor would want to make any further interest rate reduction if the upward pressure on the pound continued. But if discussion gets on to this topic you might like to emphasise your concern that monetary conditions should not be eased at present; this week's figures on consumer credit and producer prices point to the continuing threat of upward pressure on inflation.

Meeting of ECOFIN

The Chancellor is going to an informal ECOFIN at Lubeck next weekend. I have suggested that he should report to you on the items for discussion and the line he plans to take - in particular on the so-called European Monetary Construction issue.

I attach two reporting telegrams on the 3 May Monetary Committee discussion on this. One is tempted to think that more is going on here than meets the eye, particularly by the curious way in which the telegrams report that the Monetary Committee Chairman (Sir Geoffrey Littler) "will be representing the Committee's views to ECOFIN".

One important factor in all this is the paper by Balladur, which you saw some weeks ago, about his plans for some sort of European Central Bank. The Treasury insist they are anxious to avoid this grand scheme getting anywhere, and that they will want to focus at the ECOFIN discussion on much more detailed points. But you will want to listen carefully to what the Chancellor has to say. Points to watch are:

- (i) To ensure he resolutely opposes any remit to a group of "wise men" on the Central Bank idea.
- (ii) Will any of this be on the European Council agenda for Hanover? Although you would probably welcome its absence, you will also want to ensure that ECOFIN is not in the meantime cooking up something unwelcome for the future.
- (iii) What are the detailed points and improvements that the Chancellor wants to focus on? All I have established is that they relate to greater liberalisation of capital movements and greater use of the ecu in commercial transactions, which at first sight seem relatively harmless. But is there anything else?

Tax Approximation

I understand the Chancellor is concerned that the provisions of the European Single Act may leave the UK vulnerable to ^{Commission} commercial pressures on tax approximation. He is considering getting the lawyers to look into this. You will want to ask him to explain his worries.

Recg.

PAUL GRAY

10 May 1988

*Pls
to see you.*

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OUR TELNO 171 TO UKREP: 3 MAY MONETARY COMMITTEE

1. YOU SHOULD KNOW THAT THE 3 MAY MONETARY COMMITTEE DISCUSSION OF EUROPEAN MONETARY 'CONSTRUCTION' WENT WELL. THE COMMITTEE IDENTIFIED A NUMBER OF TECHNICAL IMPROVEMENTS TO THE WORKING OF THE EMS AND ARRANGEMENTS FOR EC MONETARY COOPERATION THAT WOULD BE WORTH FURTHER EXAMINATION IN FUTURE. AS TO THE CONCEPT OF A EUROPEAN CENTRAL BANK, THERE WAS NO SUPPORT FOR THE IDEA OF A STUDY BY 'WISE MEN', AND GENERAL AGREEMENT THAT ANY FURTHER EXAMINATION WOULD BEST BE CARRIED OUT IN ECOFIN, IN THE MONETARY COMMITTEE AND IN THE COMMITTEE OF CENTRAL BANK GOVERNORS.
2. AS NOTED IN TUR, THE MONETARY COMMITTEE CHAIRMAN WILL BE PRESENTING THE COMMITTEE'S VIEWS TO ECOFIN.

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MEETING OF EC MONETARY COMMITTEE: 3 MAY
SUMMARY

COMMITTEE MET WITH LITTLER IN CHAIR. UK REPRESENTED BY PERETZ, LEONIS, ARROWSMITH. MAIN ITEMS ON AGENDA WERE A DISCUSSION OF THE VARIOUS PROPOSALS FOR STRENGTHENING THE EUROPEAN MONETARY SYSTEM: AND AN EXAMINATION OF THE ECONOMIC AND MONETARY SYSTEM IN ITALY.

TOUR D'HORIZON: RECENT MARKET DEVELOPMENTS

2. MAIN TOPICS WERE SATISFACTION THAT ELECTIONS IN FRANCE AND DENMARK HAD NOT DISTURBED THE ERM: AND SOME CONCERN AT SUGGESTIONS THAT GERMAN INTEREST RATES MIGHT RISE. RIEKE (BUNDESBANK) SAID THERE WERE NO INDICATIONS OF ANY RISE IN GERMAN SHORT-TERM RATES TO COME: THE RATE OF GROWTH OF M3 HAD SLOWED IN MARCH. LONG-TERM RATES HAD RISEN A LITTLE, REFLECTING US RATES MORE CLOSELY NOW THAT EXCHANGE RATE EXPECTATIONS WERE MORE STABLE. IN REPLY TO A SUGGESTION FROM TRICHET (FRANCE), TEITMEYER (FRG) SAID THAT THE DIFFERENCE BETWEEN LONG-TERM GERMAN AND JAPANESE RATES SHOULD BE ATTRIBUTED TO JAPANESE RATES BEING HELD ARTIFICIALLY LOW RATHER THAN TO GERMAN RATES BEING ARTIFICIALLY HIGH.

3. PERETZ GAVE AN ACCOUNT OF RECENT DEVELOPMENTS IN THE UK, NOTING THE COMMISSION'S SUGGESTION THAT STERLING MIGHT HAVE ACTED AS A LIGHTENING CONDUCTOR PROTECTING THE ERM FROM MARKET PRESSURES. THE INTERESTING FEATURE OF UK LONG-TERM INTEREST RATES WAS THAT THEY HAD FALLEN ONLY MODESTLY, DESPITE THE SHARP FALL IN THE GOVERNMENT'S BORROWING REQUIREMENT.

PROPOSALS FOR THE MONETARY CONSTRUCTION OF EUROPE

4. THERE WAS AN EXTENSIVE DISCUSSION UNDER THIS HEADING, CARRIED OUT AGAINST THE BACKGROUND OF PAPERS CIRCULATED BY BALLADUR (WITH A RECENT MORE DETAILED SUPPLEMENT CIRCULATED TO THE MONETARY COMMITTEE BY TRICHET), AMATO, STOLTENBERG, GENSCHER, AND (MOST RECENTLY) POOS. IT WAS AGREED THAT LITTLER WOULD REPORT THE

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DISCUSSION AND VIEWS EXPRESSED, ORALLY, TO ECOFIN.
(THE SUBJECT IS LIKELY TO BE DISCUSSED AT THE INFORMAL
ECOFIN ON 13-15 MAY).

ECONOMIC AND MONETARY SITUATION IN ITALY

5. DISCUSSION WAS BASED ON A SUBSTANTIAL PAPER PRODUCED
BY THE COMMISSION. SUMMING UP THE CHAIRMAN SAID HE
WAS STRUCK BY THE EXTENT TO WHICH THE COMMISSION'S
ANALYSIS, WHICH POINTED IN PARTICULAR TO THE NEED
TO TACKLE THE ITALIAN BUDGET DEFICIT, WAS SHARED
BY ALL MEMBERS OF THE COMMITTEE, INCLUDING THE ITALIAN
MEMBERS.

COMMUNITY STATEMENT ON THE ECU SUGGESTED BY THE COMMISSION
IN THE CONTEXT OF CO-OPERATION WITH ARAB STATES IN
THE GULF

6. ALTHOUGH MOST MEMBERS EITHER EXPRESSED NO VIEW
OR EXPRESSED THEMSELVES CONTENT WITH THE REVISED TEXT
SUGGESTED BY THE COMMISSION, GLESKE (BUNDESBANK) AND
SZASZ (NETHERLANDS) EXPRESSED RESERVATIONS ABOUT THE
COMMUNITY APPEARING TO RECOMMEND USE OF THE ECU: AND
TRICHET ASKED WHETHER IT WAS RIGHT IN CURRENT CIRCUMSTANCES
TO SUGGEST THE ECU AS A RESERVE ASSET TO COUNTRIES
WHOSE RESERVES WOULD BE LARGELY HELD IN DOLLARS.

FUTURE MEETINGS

7. NEXT MEETING IS ON 9 JUNE, AT WHICH THERE WILL
BE A REVIEW OF THE SPANISH SITUATION, AND A DISCUSSION
BASED ON A COMMISSION PAPER ON RECENT ECONOMIC AND
MONETARY INDICATORS.

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