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PRIME MINISTER

DELORS COMMITTEE: ECONOMIC AND MONETARY UNION

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

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

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

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

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

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

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

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

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

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

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

C.D.P

(C. D. POWELL)
13 December 1988

c/Blup.

PRIME MINISTER 13 December 1988

DELORS COMMITTEE

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

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

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

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

(a) Benefits of Monetary Union

The Delors Committee looks like perpetuating a fundamental fallacy of the Werner Report - namely that an EEC monetary union will bring substantial net economic benefits to consumers even after barriers to trade, capital and labour mobility have been removed.

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

(b) Implications of an Economic Union

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

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

The Governor should insist this is spelt out.

(c) Developing Alternatives

In developing alternatives, as much as possible should be made of the need for:

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

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

[or per contra the non-fanatics!]

BG

BRIAN GRIFFITHS

PRIME MINISTER

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

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

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

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

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

That's well and [illegible] [illegible]

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

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

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

Points should be such that they don't antagonise Pöhl.

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

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

N.L.W.

N. L. WICKS

13 DECEMBER 1988

MRMABB

CONFIDENTIAL

MR GRAY

DELORS COMMITTEE : PRIME MINISTER'S MEETING ON 14 DECEMBER

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

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

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

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

R G LAVELLE

12 December 1988

DELORS COMMITTEE : ANNOTATED AGENDA

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i)

PRIME MINISTER

ECONOMIC AND MONETARY UNION

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

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

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

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

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

C D.P.

C. D. POWELL
9 December 1988

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DELORS COMMITTEE: A PROGRESS REPORT

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

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

The Mandate

3 The Hanover European Council:

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

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

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

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

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

The definition of economic and monetary union

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

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

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

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

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

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

(iv) unified capital market policies;

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

(vi) shared responsibility for regional and structural policies;

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

In describing this final objective, the Werner Report argued that economic and monetary union "... will make it possible to realise an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium ...".

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

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

(ii) reliance on fine-tuning;

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

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

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

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

(i) an acceptable timeframe for EMU;

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

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

Some members of the Committee would even argue that the existing degree of economic union in the Community has already caught up with the level of monetary union and that there would be no harm if monetary union were to run ahead of economic union in the next stage. Others are almost certainly more attracted to the political gains they see in a symbolic monetary union and are inclined to under-estimate the extent to which such a move would be a leap rather than a step. Delors himself has identified four distinctive possible attitudes (a tentative identification of supporters in brackets):

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

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

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

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

No

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

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

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

Institutional

(i) A Central Bank

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

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

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

(ii) The Larosiere proposal

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

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

(iii) Treaty Amendment

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

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

A parallel currency or a common currency?

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

What sort of report?

dotty!

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

!!

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

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

The first draft report

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

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

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

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

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

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

(iii) the paper offers far too much detail in areas which have not been justified by the arguments. The detail, if any, will have to flow from an analysis of what is necessary to bring about economic and monetary union, rather than prescribing the number of monthly board meetings of a putative Federal European Monetary Institution;

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

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

BANK OF ENGLAND
8 December 1988

ANNEX

SUMMARY OF PAPERS ON A EUROPEAN CENTRAL BANK

DELORS' PAPER (CSEMU/4/88)

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

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

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

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

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

TWO CONTROVERSIAL ISSUES

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

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

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

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

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

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

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

(iii) monetary stability must be paramount (page 2); Not Xchange rates?

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

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

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

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

Principles of monetary union (pages 12 to 14)

[Also set out in Delors' paper] (is this Xchange rate or in real terms?

(i) mandate of ECBS must be to maintain monetary stability; but has also to support general economic policy; You can't have both as a priority

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

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

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

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

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

(vii) the ECBS should undertake banking supervision.

Models of monetary integration

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

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

You still have to keep one national currency i.e. we will have the ECU like the !! IMF?!

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

- (i) co-ordination intervention policy (within the Community and vis-a-vis third currencies);
- (ii) at a later stage it could "assume the entire responsibility for influencing exchange rates";
- (iii) and, ultimately, responsibility for determining central rates could be transferred from national governments to the EMA/EC Governors.

Transitional problems (pages 35-44)

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

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

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

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

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

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

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

1 What decisions need to be taken jointly?

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

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

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

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

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

2 Decentralisation of operations

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

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

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

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

3 Composition of governing bodies (pages 10 to 11)

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

4 Autonomy and accountability (pages 11 to 14)

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

(i) by regular reporting to ECOFIN;

(ii) by monitoring by the Monetary Committee;

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

(iv) by regular reporting to the European Parliament.

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

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

Timetable for change (pages 14 to 15)

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

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

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

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

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

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

(i) Intervention

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

(ii) Monetary surveillance

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

(iii) Structure

The structure of an ERF could be:

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

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

(c) Forex Committee, and

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

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

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

Proposed action programme

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

European Central Bank

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

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

Interim steps

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

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FRAME ECONOMIC
CORRECTED VERSION
LIBERALISATION OF CAPITAL MOVEMENTS : TAXATION OF SAVINGS

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

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

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BANK OF ENGLAND
LONDON EC2R 8AH

cc NLW
CDP

9 December 1988

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

CDP
9/12.

Dear Paul

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

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

Yours ever

John

J R E Footman
Private Secretary
to the Governor

2628M

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DELORS COMMITTEE: A PROGRESS REPORT

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

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

The Mandate

3 The Hanover European Council:

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

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

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

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

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

The definition of economic and monetary union

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

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

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

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

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

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

(iv) unified capital market policies;

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

(vi) shared responsibility for regional and structural policies;

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

In describing this final objective, the Werner Report argued that economic and monetary union "... will make it possible to realise an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium ...".

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

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

(ii) reliance on fine-tuning;

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

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

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

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

(i) an acceptable timeframe for EMU;

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

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

Some members of the Committee would even argue that the existing degree of economic union in the Community has already caught up with the level of monetary union and that there would be no harm if monetary union were to run ahead of economic union in the next stage. Others are almost certainly more attracted to the political gains they see in a symbolic monetary union and are inclined to under-estimate the extent to which such a move would be a leap rather than a step. Delors himself has identified four distinctive possible attitudes (a tentative identification of supporters in brackets):

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

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

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

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

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

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

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

Institutional

(i) A Central Bank

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

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

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

(ii) The Larosiere proposal

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

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

(iii) Treaty Amendment

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

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

A parallel currency or a common currency?

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

What sort of report?

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

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

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

The first draft report

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

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

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

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

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

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

(iii) the paper offers far too much detail in areas which have not been justified by the arguments. The detail, if any, will have to flow from an analysis of what is necessary to bring about economic and monetary union, rather than prescribing the number of monthly board meetings of a putative Federal European Monetary Institution;

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

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

BANK OF ENGLAND
8 December 1988

ANNEX

SUMMARY OF PAPERS ON A EUROPEAN CENTRAL BANK

DELORS' PAPER (CSEMU/4/88)

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

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

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

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

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

TWO CONTROVERSIAL ISSUES

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

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

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

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

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

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

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

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

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

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

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

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

Principles of monetary union (pages 12 to 14)

[Also set out in Delors' paper]

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

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

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

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

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

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

(vii) the ECBS should undertake banking supervision.

Models of monetary integration

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

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

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

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

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

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

Transitional problems (pages 35-44)

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

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

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

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

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

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

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

1 What decisions need to be taken jointly?

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

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

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

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

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

2 Decentralisation of operations

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

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

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

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

3 Composition of governing bodies (pages 10 to 11)

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

4 Autonomy and accountability (pages 11 to 14)

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

(i) by regular reporting to ECOFIN;

(ii) by monitoring by the Monetary Committee;

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

(iv) by regular reporting to the European Parliament.

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

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

Timetable for change (pages 14 to 15)

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

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

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

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

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

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

(i) Intervention

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

(ii) Monetary surveillance

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

(iii) Structure

The structure of an ERF could be:

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

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

(c) Forex Committee, and

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

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

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

Proposed action programme

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

European Central Bank

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

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

Interim steps

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

Prime Minister

You may like to look at this interesting speech by the Governor of the Bank of England.

CDP 25/xi

(4)

THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM

... I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train - principally but not exclusively in the Committee formed under President Delors - about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on "concrete stages" is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market - "1992" for short - and the exchange rate mechanism of the EMS.

- one, that 1992 will destroy exchange rate stability by removing one of the major defences of the ERM - namely exchange controls; and
- the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much greater degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate - and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants - Germany and the Netherlands - had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; whilst in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years - a period which has encompassed considerable external turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term·flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be coordinated. A fair degree of coordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case - there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that coordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgment, is "no". The purpose of the internal market programme is to remove barriers and distortions to trade - in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price - that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies - something that is not always the case at the moment in the Community with, for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency - provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer term decisions - including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur within countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; between member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences - often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even promote currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union, as a premature obsession with that process that is likely to be an impediment to the internal market.

The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the economic challenges that will have to be faced. It is also worth spelling out what monetary union - a single currency - would involve in political terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy; and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur between countries, in the same way as today they exist within countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes - means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the commitment of governments and electorates to the long term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal - topical though it may be to investigate the details of a European currency or a European central bank - but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

The decision is a difficult one. I would not deny that the existing participants have on the whole been happy with their choice; but it has to be said that many small, open economies started from a position of enjoying little effective policy freedom, or saw benefits in the discipline of alignment with the counter-inflationary deutschemark. This latter factor was perhaps particularly important in the early years of the ERM's life, when inflation was high. Now that inflation is less of a problem, one can see emerging, in the debate about the symmetry or otherwise of adjustment under the mechanism, some of the concerns that have influenced the United Kingdom over the years.

I have to say that it is still not obvious that the conditions are yet right for United Kingdom participation in the ERM. As you well know, our domestic monetary policy is at present responding to the excessive growth of domestic demand during the course of this year, and to the inflationary pressures that accompanied it. The main objective of policy is to exert steady downward pressure on inflation. Interest rates play an important part in this process and we while we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation.

From the viewpoint of the ERM itself I think it still also true to say that the involvement of sterling in the mechanism at this stage would introduce a new element of complexity into its operation.

What then are the practical steps open to us? I suggest that we should concentrate first on promoting the real economic integration of the Community. The success of the single market programme will be important, of course, but even after 1992 we must expect to see further steps towards integration, and the markets will need time to take full advantage of the opportunities created. In many if not all member states there are instances of structural imperfections and rigidities which make markets work less than perfectly and which can hinder adjustment to changing circumstances; this tends to be true of labour markets in particular. If the Community is to work smoothly as a single market, such structural problems will need to be dealt with.

Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy coordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

There are a number of further practical steps that could be considered. For example, there might be greater use of EMS currencies in intervention within the Community. The ECU might have a useful role to play here, as markets in it develop; the impact of a country's intervention in ECUs upon relative exchange rates in the rest of the EMS will be muted by the wide spread of currencies in the ECU basket. But such issues can be controversial, and it cannot be denied that, even now, there are differences between ERM participants on the appropriate course of monetary and exchange rate policies. These are genuinely held differences which will not easily be resolved. One should perhaps not be too surprised that it is proving difficult to agree the precise terms of a common policy in regard to the ERM; and it underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an "exogenous shock" for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major pre-occupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and has been continued at summit meetings and meetings of Finance Ministers and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

Tonight is not the occasion to speculate where the Plaza-Louvre process of policy co-ordination and exchange rate management is leading. Some siren voices regard it as wholly misconceived. Others hanker after a return to a Bretton Woods type system, and are encouraged by the successes of the ERM to hope that this is no longer so fanciful an idea as it may have seemed only a few years ago. Still others believe we are heading for a tripolar currency system based on a US dollar zone, a Japanese Yen zone and the EMS.

What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short-term

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.

CONFIDENTIAL

FILE KK

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 November 1988

14/12

EUROPEAN COMMUNITY: DELORS COMMITTEE

As you know, the Prime Minister is holding a meeting in December to consider progress in the Delors Committee on economic and monetary union in Europe. It might be helpful if the Treasury were to prepare a short paper for the meeting, either as a brief for the Prime Minister or to be available to all the participants in the meeting. I should be grateful if you could put this in hand.

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

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PG

RA – ERS file

Prime Minister 2

You will wish to see.
Generally very helpful.

PRCG
17/11

Agreed

FOR RELEASE ON
DELIVERY AT 5.00 PM GMT

Speech given by

THE RT HON ROBIN LEIGH-PEMBERTON
GOVERNOR OF THE BANK OF ENGLAND

at the 1988 Forex Conference
of the Forex Club, Luxembourg
on Tuesday 15 November 1988

THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM

... I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train - principally but not exclusively in the Committee formed under President Delors - about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on "concrete stages" is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market - "1992" for short - and the exchange rate mechanism of the EMS.

- o one, that 1992 will destroy exchange rate stability by removing one of the major defences of the ERM - namely exchange controls; and
- o the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much greater degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate - and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants - Germany and the Netherlands - had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; whilst in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years - a period which has encompassed considerable external turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be coordinated. A fair degree of coordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case - there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that coordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgment, is "no". The purpose of the internal market programme is to remove barriers and distortions to trade - in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price - that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies - something that is not always the case at the moment in the Community with, for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency - provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer term decisions - including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur <u>within</u> countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; between member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences - often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even promote currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union, as a premature obsession with that process that is likely to be an impediment to the internal market.

The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the economic challenges that will have to be faced. It is also worth spelling out what monetary union - a single currency - would involve in political terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy; and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur between countries, in the same way as today they exist within countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes - means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the commitment of governments and electorates to the long term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal - topical though it may be to investigate the details of a European currency or a European central bank - but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

The decision is a difficult one. I would not deny that the existing participants have on the whole been happy with their choice; but it has to be said that many small, open economies started from a position of enjoying little effective policy freedom, or saw benefits in the discipline of alignment with the counter-inflationary deutschemark. This latter factor was perhaps particularly important in the early years of the ERM's life, when inflation was high. Now that inflation is less of a problem, one can see emerging, in the debate about the symmetry or otherwise of adjustment under the mechanism, some of the concerns that have influenced the United Kingdom over the years.

I have to say that it is still not obvious that the conditions are yet right for United Kingdom participation in the ERM. As you well know, our domestic monetary policy is at present responding to the excessive growth of domestic demand during the course of this year, and to the inflationary pressures that accompanied it. The main objective of policy is to exert steady downward pressure on inflation. Interest rates play an important part in this process and we while we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation.

From the viewpoint of the ERM itself I think it still also true to say that the involvement of sterling in the mechanism at this stage would introduce a new element of complexity into its operation.

What then are the practical steps open to us? I suggest that we should concentrate first on promoting the real economic integration of the Community. The success of the single market programme will be important, of course, but even after 1992 we must expect to see further steps towards integration, and the markets will need time to take full advantage of the opportunities created. In many if not all member states there are instances of structural imperfections and rigidities which make markets work less than perfectly and which can hinder adjustment to changing circumstances; this tends to be true of labour markets in particular. If the Community is to work smoothly as a single market, such structural problems will need to be dealt with.

Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy coordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

There are a number of further practical steps that could be considered. For example, there might be greater use of EMS currencies in intervention within the Community. The ECU might have a useful role to play here, as markets in it develop; the impact of a country's intervention in ECUs upon relative exchange rates in the rest of the EMS will be muted by the wide spread of currencies in the ECU basket. But such issues can be controversial, and it cannot be denied that, even now, there are differences between ERM participants on the appropriate course of monetary and exchange rate policies. These are genuinely held differences which will not easily be resolved. One should perhaps not be too surprised that it is proving difficult to agree the precise terms of a common policy in regard to the ERM; and it underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an "exogenous shock" for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major pre-occupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and has been continued at summit meetings and meetings of Finance Ministers and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

Tonight is not the occasion to speculate where the Plaza-Louvre process of policy co-ordination and exchange rate management is leading. Some siren voices regard it as wholly misconceived. Others hanker after a return to a Bretton Woods type system, and are encouraged by the successes of the ERM to hope that this is no longer so fanciful an idea as it may have seemed only a few years ago. Still others believe we are heading for a tripolar currency system based on a US dollar zone, a Japanese Yen zone and the EMS.

What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short-term

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.