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25 April 1989

C D Powell Esq
PS/Prime Minister
10 Downing Street
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Dear Charles,

MEETINGS WITH PRIME MINISTER LUBBERS, CHANCELLOR KOHL AND PRESIDENT DE MITA: THE DELORS REPORT

The Prime Minister's meetings with Messrs Lubbers, De Mita and Kohl provide an important opportunity to begin moving the follow-up to the Delors Report in the direction that meets our interests. The Chancellor has therefore asked that I should write setting out the line he suggests the Prime Minister might take at these three meetings.

We have, of course, already made our general response to the Delors Report very clear: that it brings out starkly the fundamental nature of economic and monetary union, with the transfer of national sovereignty which it would involve, and that there is no question of the UK agreeing to further Treaty amendment. The Chancellor believes that for these three meetings, we should concentrate on the following more immediate and practical points:

- There are many useful practical measures which the Community can, and should, take to further economic and monetary co-operation among member states.

- The task of the European Council should be to concentrate attention on these measures and agree a procedure for pursuing them - almost certainly in ECOFIN and, where appropriate, in conjunction with the Committee of Central Bank Governors.

- In fact, many of the practical measures to which the UK would willingly agree are included in Stage 1 of the Delors Report. These cover financial aspects of the completion of the single market, including of course capital movement liberalisation; and improving economic and monetary cooperation for example by replicating in the Community the arrangements for discussions between G7 finance ministers and central bank governors. We would also favour other measures such as the promotion of greater use of the private ecu and increased holdings of Community currencies in national foreign exchange reserves. (This last item would be unwelcome to the Germans).

We shall need to develop our line further in the run-up to the European Council, for example on exactly how we should react if other Governments press for an IGC to discuss Treaty amendment. But the Chancellor believes it is worth putting our wares on the table now, and trying to steer the discussion in the direction we want. Besides making the points above, the Prime Minister might say:

- The European Council should remit the work on practical measures to ECOFIN and central bank Governors, as appropriate, with instructions to bring as many as possible of them into effect as early as practicable. The ECOFIN should report progress to the Paris Council.

- None of these measures should require amendment of the Treaty. Suggestions for Treaty amendment are a diversion from the main task now before the Community - the completion of the single market, on which a lot of work is still needed (for example, further transport liberalisation, public procurement, and a range of measures in the area of financial services). So proposals for amending the Treaty should be set on one side. They are irrelevant to the practical work which the Community should now be concentrating upon.

- The Report itself makes clear that early institutional change is not required, so this is not something on which time should be spent at the European Council in Madrid. In any event, Parliament and public opinion in the UK would not accept further Treaty amendment, particularly when the Treaty has so recently been amended by the Single European Act.

The Chancellor believes that we stand a better chance of securing agreement to our strategy, and to heading off those who argue for early Treaty amendment, if we concentrate the Community's attention on these practical steps on which early action can take place. For that reason he thinks that it would be a tactical mistake to concentrate too much on the principle of EMU, on which the UK's views are already clear and well known, and to which all Member States feel they have signed up in the preamble to the Single European Act. So, if the Prime Minister is asked during her meetings about our attitude to EMU, the Chancellor suggests she should use the line agreed for the press briefing: namely that EMU implies nothing less than European Government and political union. This is simply not on the agenda now, nor for the foreseeable future. In the meantime the priorities must be to concentrate on making a success of the Single Market, coupled with the practical steps for improved monetary and economic co-operation outlined above.

If the Prime Minister is asked about the sentence in paragraph 39 " ... the decision to enter upon the first stage should be a decision to embark on the entire process", the Chancellor thinks that she should say that it is quite impossible for any British Government to accept such a commitment. There is no possibility of a British Parliament passing a single comprehensive Treaty of the sort described in the Report.

Annex A of this letter describes the stance taken so far by the Dutch, Italian and German Governments on the Delors Report. The Chancellor sees no reason for the Prime Minister to differentiate the presentation of our line in her discussions with the three Heads of Government. But she might emphasise to:

<u>Lubbers</u>: the similarity of the UK and Dutch positions on practical next steps; the substantial nature of those steps; and the crisis in which the Community will find itself if Treaty amendment is pressed;

<u>Kohl</u>: that the time to transfer control of economic and monetary affairs from a national to a Community level is not on the agenda and will not realistically be so for the foreseeable future;

<u>De Mita</u>: the need for further work, as soon as possible, to provide a sound basis for economic and monetary development in the Community.

I am sending a copy of this letter to Stephen Wall in the FCO and to Trevor Woolley in the Cabinet Office.

Yours
Alex

A C S ALLAN
Principal Private
Secretary

ANNEX A

BACKGROUND

DELORS COMMITTEE REPORT: OTHERS' VIEWS

Netherlands

1. The Dutch Government have yet to take a formal position on the report. The State Secretary for Foreign Affairs, Van Voorst Tot Voorst, said on 18 April that the proposal for a European System of Central Banks was worth considering, and observed that the Dutch position on the ESCB was likely to be in line with that of the German Government. The Finance Minister, Ruding, described the report as constructive. Duisenberg, Governor of the Netherlands Bank, said on 18 April that all member states should agree now to the final goal of economic and monetary union; but that it would be a long time before there was a single currency and a single central bank. The Dutch Cabinet is likely to have its first full consideration of the report on 28 April.

2. Senior officials have told us privately that whilst the Dutch Government may be prepared to endorse the concept of an independent central bank as a final stage in the process of EMU, Dutch attitudes towards next steps are close to our own. In particular, the Dutch may be reluctant to see follow-up referred to an Inter-Governmental Conference (IGC), and may be receptive to UK proposals for a series of practical intermediate steps. They recognise, however, the problems inherent in the fact that whilst Treaty amendment requires unanimity, only 7 member states are required to call an IGC.

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Federal Republic of Germany

3. Chancellor Kohl, beset by domestic difficulties, has yet to declare his hand on the report. His position will be influenced by both Genscher (EMU enthusiast) and Pöhl (cautious welcome to report). The independence of central banks, and the possibility of increased structural funds, are central to German concerns; and Kohl will be very cautious about making commitments that could be seen as damaging to German interests. At the same time, he will be reluctant to rebuff French aspirations for substantive progress during their Presidency, and may see political benefits of his own in movement on the EMU dossier. Whilst Genscher and Dumas are reported to have called at the Franco-German summit on 19-20 April for early joint examination of Treaty amendment, officials have suggested that no work is yet under way, and that real German willingness to transfer control of economic and monetary affairs from a national to a Community level is an extremely long way off.

4. There is little evidence of liaison between the Government in Bonn and the Bundesbank in Frankfurt on follow-up to the report; or indeed of any Bundesbank strategy, beyond seeking to ensure the freedom from political influence of any European monetary institution. While Bundesbank officials see progress towards EMU as a long-term but inevitable process, they argue that Treaty amendment should not be considered until after the completion of the first of the three stages in the report. They also have reservations about the possibility of a European Reserve Fund, and about references to the structural funds, which they see as a potentially costly distraction.

Italy

5. The Italians favour rapid movement towards Economic and Monetary Union and have no objections of principle to Treaty change. In a press statement, De Mita has said that the report:

> "will allow the Heads of State and Government of the twelve to show clearly their political will to pursue monetary and economic union.... The report confirms that economic and monetary union is necessary to realise the full potential of European integration. It is not only desirable but above all feasible.... The basis has now been laid for the next European Council at Madrid to agree to begin immediately the first phase and to set out the procedures for calling a conference charged with drawing up a new Treaty to provide for the institutions in the economic and monetary field".

6. The Italian Treasury and Bank of Italy have not commented publicly but have welcomed privately the report's emphasis on fiscal rectitude and the control of public deficits. The Minister for EC Affairs, La Pergola, noted in a discussion with the Ambassador on 18 April that the report set the basis for "those countries which wished to do so" to proceed with the necessary steps leading to the establishment of EMU.

(2)

Prime Minister

You may like to be aware of this.

CDP
27/4

SIR MARTIN JACOMB

CHAIRMAN OF BARCLAYS de ZOETE WEDD

SPEECH TO THE

DAVID HUME INSTITUTE

EDINBURGH

MONETARY UNION AND A EUROPEAN CURRENCY

A TARGET OR A TRAP?

24th April 1989

When I chose the title for this talk, I thought I was choosing a non-topical, rather out of the way subject which we could reflect on as a purely academic exercise. Since then, however, the Delors Committee of Central Bankers has come out with its report. The quest for monetary union has been cast into the middle of the arena. This raises issues of absolutely fundamental importance to us all.

Thus what I am going to say will sound more like an urgent plea, than a purely philosophical assessment of whether monetary union is a good idea.

First, a couple of remarks on the Community itself. These will tell you something about my approach to the question how the European community is developing and should develop; and if you think they are nonsense, this will help you to judge the validity of the rest of what I say.

The concept of a nation state, national frontiers and nationality itself, is viewed quite differently in the countries which were overrun and defeated in World War II. In our case however, our national frontiers were not overrun and nothing occurred to invalidate the basic concept of our nation state and our nationality. Thus while we cling to the validity of the nation state, on the Continent many people feel instinctively that the whole idea has become outdated and belongs, as far as Western Europe is concerned, to an era which is past.

This difference does not mean that we feel differently about the importance of Community Members converging into a political unity. And certainly businessmen feel that economic union in the sense of trading goods and services across frontiers quite freely is becoming a reality already. The point is, however, that it does have a crucial bearing on our views about how this unity is to be achieved, and about time scales.

Secondly, and again because we were not defeated, we had no discernible need to make a huge collective effort to rebuild our economy after the war was over. We thus put up with, perhaps even opted for, until a decade ago, a long dose of socialised economic policy, by which I mean non-market economic policy. All our post war governments until 1979 were somewhat interventionist and basically pro-consumer and only spasmodically pro-business. Even now there is ambivalence about how pro-business government policy should be. You can see this clearly with the haphazard approach to monopoly decisions.

Throughout the whole post war period there has never been a clear understanding, for example, of the obvious point that if you want industries to succeed internationally, they must be allowed to have flourishing and profitable domestic bases.

There has never been a consistent grasp of the need to avoid creating excessively over-competitive conditions domestically, thus weakening business so that it lacks the strength to develop in overseas markets. To the Japanese this is obvious. This blindness has always struck me as strange especially since our own market is so open to foreign competition.

The other Member countries, mainly because of the need to rebuild their economies after the War, have had throughout this period either more consistent adherence to the market economy or more intelligent pro-business dirigisme from after Government or both. This has led to more consistent and superior economic performance in many cases, but it has also led, and this is the point that I want to emphasize, to a different view of the merits of Government intervention, and dirigisme.

There are many other differences of course. But at this stage I simply wanted to point out what I think has led to the different approach to the question how the community should develop. This was what Mrs. Thatcher's Bruges speech was about.

That speech, incidentally was very largely her own personal work and therefore can be taken to represent her true views. It shows quite clearly that she is a totally committed European; she declared: "Our destiny is in Europe and part of the community; Britain does not dream of an alternative to the community; of some cosy isolated existence on its fringes."

Again she said: "the community is the practical means by which Europe can ensure the future prosperity and security of its people in a world where there are many other powerful nations and groups."

So the idea that the Government is not committed to the community is rubbish.

But she feels very strongly about how Europe should develop. Do you remember the five principles?

The first was the need to maintain Europe's defence which is obvious.

Secondly, she feels strongly that difficult problems should be handled in a practical rather than a theoretical way. The common agricultural policy is an example of her idea of how not to handle problems.

Thirdly, she made a plea against protectionism. Again you have to agree with that.

It is the other two principles which I particularly want to mention tonight; because they have a direct bearing on the question of monetary union. The first of these was this: Community policies must encourage free enterprise and economic liberty. They must avoid as much central planning and economic dirigisme as possible. This is the spirit which lies behind deregulation and, indeed, privatisation, and it is the lesson of the success of the 80s.

Do you remember her words "We have not successfully rolled back the frontiers of the state in Britain only to see them reimposed at a European level"?

Her final principle was the one which caused the furore. It is that unity should be based on active co-operation between sovereign states, with the accent on the word 'sovereign'. The point obviously has a very direct bearing on the idea of monetary union which involves a major sacrifice of sovereignty.

The idea of economic and monetary union has always been at the core of the community since the Treaty was originally signed; but Mrs Thatcher has said "not in my lifetime".

This brings me to the Report of the Delors Committee of Europe's Central Bank Governors. It is incidentally a very worth while and well put together document. It is quite thick, but only literally. It explains how monetary union can be achieved.

Do not be confused by the various stages by which it suggests progress can be made. Those are technical matters, though the analysis shows clearly how it can be done. What it is talking about is full monetary union. Whether this is a single currency, or several currencies freely convertible and with irrevocably fixed exchange rates makes no difference. The staging is only designed to make progress more politically acceptable and to use the agencies and institutions of member countries to carry out policy decisions made at the centre.

What are the merits of the idea? Let me just get one thing out of the way first. We are not talking about the ECU. ECU might be a good name for a European currency, for it appears in so many languages, including our own. It comes from the Latin word for shield, and thus escutcheon. The word ECU was sold by Giscard d'Estaing to Mr Callaghan as an acronym for "European currency unit". But unknown to Mr Callaghan the ECU was in olden times a five franc coin, on which a shield appeared.

Escudos is the same word, and so obviously is the old Roman escudo, the escudo being 5 lire at the time of unification in Italy.

But the ECU we have today is not a currency. It is simply a unit of account and on present showing it is not likely to develop into anything like a parallel currency of its own accord.

Everyone knows that actual monetary union and a single currency is some time away, but I think it is very important to understand the issues and see what the choices really are, because, quite frankly, I think the signs are that we are getting ourselves into a serious jam. In fact I think the outright dismissal of the idea as not desirable or not practical, and its rejection without argument will indeed be very damaging. I will try and explain why.

Everybody likes the idea of a single currency in the sense that it would remove the uncertainties and expense of having to deal across the foreign exchanges. To have a single currency would undoubtedly be good for competition, trade and for industrial investment. But you cannot seriously contemplate such a change without ensuring that goods, labour, services and capital are able to flow without restriction throughout the community. Price rigidities would have to be removed. That is indeed what is contemplated by the Single European Act and it is supposed to be completed at the end of 1992. But ensuring the removal of all these rigidities would still be nowhere near enough for a single currency. You need, in addition, a single monetary policy.

You could not contemplate a single currency with different interest rates and different monetary policy stances in different Member countries. This applies whether you are talking about a genuine single currency or a number of different currencies with irrevocably fixed exchange rates and convertibility.

This means in turn that if you are to have a single monetary policy as an absolute necessity, you also need a similar basic economic policy throughout the whole single currency area, and also a broadly similar fiscal policy.

You do not have to have tax rates exactly the same throughout a single currency area, indeed some competition in keeping taxes down is desirable, but there must be harmony.

For significant disharmony of tax rates has an immediate effect on the allocation of resources.

Do you remember when taxes went too high in New York City? Everyone moved out to New Jersey and Connecticut. The tax base collapsed and the City went bankrupt.

So, at this stage, you can already see that very big sacrifices of national sovereignty are essential. A Member country's government would no longer have the primary power over its economic fiscal or monetary policy. That might or might not be thought a good idea in theory. Some might argue, do argue in fact, that opting irrevocably for monetary union would force economic policy throughout the community to become permanently locked into non-interventionist market economy principles which would stop governments making an interventionist mess of things. Certainly it would lead to harmonisation of prices. You can indeed debate which is cause and which effect, as it were.

Others argue persuasively that a single currency under the control of a European Central Bank (it is called in the Delors Committee Report, the European System of Central Banks) independent of political pressure and dedicated to price stability, i.e. no inflation, is indeed attractive as a concept. I heartily agree with this myself. But it is pretty obvious that other member countries besides ourselves are not yet ready to hand over economic and monetary policy to a central European authority.

Indeed as yet there is no political authority over the central bureaucracy; so the idea is inconsistent with democratic principles, for the moment. Even apart from this there is a major hurdle in the way and it is this which represents the greatest danger to our country.

Distribution of economic resources within a single currency area is affected by two factors: one, market forces and the other political intervention. Market forces magnetise resources to the centre; political action is needed to counter balance this. Within any single currency area that you can think of, there are enormous and continuous flows of resources from rich to poor regions as a result of political action. This takes place not just by the flow of regional aid but by transfer payments under social security systems, educational and infra-structure expenditure, and so forth. In fact, you can guarantee that whereas tax revenues moving to the Government depend on production, Government expenditure depends on population. Were it not for these continuous transfers, market forces would always tend to make rich regions richer, and poor regions relatively poorer until some gigantic political or natural event occurs to interrupt this.

Rich economic regions attract the resources from poor regions. In fact, the Delors Committee Report recognises this where it says "Historical experience suggests that in the absence of counter-vailing policies, the overall impact (of monetary union) on peripheral regions could be negative. Transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially if they were at the periphery of the Community, to the highly developed areas at its centre." This is the force which, when uncontrolled leads, for example, to labour migrating to shanty towns round big industrial centres.

It is this point above everything else on which attention should now be focused. Because if you move to monetary union, with no effective political mechanism to counteract this magnetism of the centre, the result could be disasterous at any rate for the less successful regions of the community, including ourselves.

It is crucial that there should be already in place a democratically controlled political power at the centre. And this presupposes a sufficent transfer of sovereignty to a central European Government, so that it can handle the decisions needed to effect these transfers of resources. Only then can you actually contemplate with equanimity full monetary union. And with the best will in the world we, and I don't mean just the United Kingdom, are miles away from agreement on such a massive transfer of power; as I have said we don't even have democratic control in Brussels yet, even over such power as has already been transferred. The Delors Committee's suggestion of doubling the commission's structural funds, is merely a gesture. This is no where near adequate. We are talking about transfers of a different order, requiring continuous and unified political power, not periodic bargaining by separate sovereign governments.

If you go to monetary union before you have such a single government at the centre, with enough tax gathering power to effect the massive transfers of resources required, plus the unified political will to put such transfers into effect, it would lock in, probably irrevocably, the gulf between rich and poor regions. The poor regions would have lost the ability to correct imbalances by exchange rate adjustments irrevocably. They would have lost the ability to make themselves more competitive through devaluation.

There are examples, even within Europe, of what can happen. We do not read much about this in our history books because in our day historians did not understand much if anything about economics. But the events in Europe in the 19th Century, are clear and the lessons are perfectly plain.

In Germany the Zollverein, i.e. customs union, came into being after the Napoleonic wars. It started in 1818, and was complete by about 1833. Economic convergence was occurring. Nevertheless it took 50 years from the end of the Napoleonic era to achieve political union, and then, even though currency unification was a cherished aim, it took several further years of effort to achieve this. There is no clearer example of the fact that a full and successful monetary union presupposes first economic convergence, and then the centralisation of financial and economic policy, upon which you then have what is in substance full political unification. A single currency comes at the end.

Although the desire for unification may have been as strong in Italy and the genius of Cavour truly amazing; (he had his tunnel to France too, incidentally; tunnel vision in fact. His was the Mont Cenis tunnel under the Alps; started in 1857; rather omenously it was not opened to traffic, however, until ten years after his death). But there was one highly important difference: the state of economic advancement and economic convergence within each of the two regions. Railways are a good measure of what the state of affairs was. In 1850 Italy had 400 kilometres of working railways, Germany as a whole had 6,000 kilometres. In Italy standards of living varied enormously. And the contrast between North and South was of vastly different ways of life. As to currencies, there were hundreds of them. Tuscany alone had twenty four.

The Risorgimento was a military political and institutional unification. Economic unity was imposed, there was no convergence of economic performance. There was no convergence of economic performance. Inevitably the net result was the magnetization of resources from poor to rich regions, which has crystallised permanently the impoverishment of Southern Italy.

It would indeed be a tragedy if in the desire to keep up the momentum towards unification of Europe on all fronts, the Community fell into this trap and it would be a particular tragedy for this country.

It is a particularly vital point for us.

You see, we ought to recognise that this question looks quite different to anyone in Germany, Belgium, Holland, France or Nothern Italy. It is important to note that Italy too is in this camp because it is the prosperity of Northern Italy that now governs the Italian Government's Community policy. In that group of countries there is economic convergence, and the attractions of monetary union are great. Their economies would be the beneficiaries.

Thus there are two views about this and certainly two views about the appropriate speed of advance. But the important point is that it is no longer possible to occupy a simple blocking position. For what we have, explicit in the Delors Report, is the clear threat of a two speed Europe. If we continue to object to the whole concept, we shall provoke just that.

Our membership of the EMS is to be the test. So far, much to the annoyance of our continental partners, we have refused to join the Exchange Rate mechanism. The time is not yet ripe, it is said. This is a perfectly understandable view. The point is that Mrs Thatcher wants to see greater convergence of economic performance first. She wants us first to be much nearer the performance of Germany in particular. This means controlling inflation and her belief is that you can only do this by monetary policy. This means interest rates; and if you want to retain the power to put up interest rates you must be ready to see the Exchange Rate rise. You must not lock yourself to a particular exchange rate, sacrificing thereby your sovereignty over monetary policy.

All very logical; although many say that if we did take the plunge and join, our inflation rate would converge with theirs thereafter. This is a complex economic argument about cause and effect; but whatever its merits it is not government policy.

But now our partners interpret our failure to join the ERM as a withholding of an irrevocable commitment to the European idea.

It is clearly stated, in the Delors Report, that membership of the Exchange Rate mechanism of the EMS will be treated as a test of how committed Member countries are, and that those who do not go to full membership by July next year will have less influence. This is the two speed Europe looming up over the horizon.

It is quite a feasible option for the countries I have mentioned at the centre of the community and possibly even Spain as well, to adopt the Delors Report and decide on a firm timetable for its implementation.

Thus, in my view we no longer have the luxury of saying simply "not in my lifetime; I am not even going to discuss the idea". If that is the Government's attitude, the response will indeed be the two speed Europe and we shall be left behind on the platform as the train pulls out. We shall retain the right to have our own monetary policy, and the right to devalue our currency, but we shall have none of the advantages of being part of a powerful single currency area at the centre of the community, and we shall cease to have significant political influence on its development.

It is thus no good relying on the fact that the Delors Committee Report is a document about how and not about when, or even whether. That is much too dangerous a choice. On the other hand, it is certainly true that we cannot contemplate committing ourselves to monetary union or even negotiating the timetable for it, without greater convergence of our economic performance with that of the countries at the centre. We need to retain the flexibility needed to improve our performance.

You will, I recognise, find people with a different view; like this week's Economist newspaper which argues, on the basis of Ronald McKinnon's work, that for decades pre-1914 when the gold standard ruled, European currencies were locked together without political unity, without tax harmonisation, and without harm resulting. In fact this argument really amounts to little more than saying prices of tradeable goods and services always tend to find their own level internationally and capital flows according to supply and demand. In fact, there were during that period great inbalances in the price of labour, with periods of severe unemployment and much misery, and great political upheaval resulted. Not much of an example of how to do things in my view.

So what ought we to do? The answer must lie in being altogether more cooperative. We should welcome the idea of monetary union as a goal; not just reject it as impracticable. We should point out logically the dangers of imposing it too soon. We should put new energy into discussing with our partners how to achieve economic convergence, and make the single European Market really work, and of course, continue, as an urgent necessity the task of correcting our own economic performance which, in my view, cannot be done without increasing markedly the personal discretionary savings rate. In the U.K. right now, this is probably nil. In Italy it is well over twenty per cent. This lies at the root of our problems. But that is another story. Hence, the answer is: monetary union is both a target and a trap.

- E N D S -