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PRIME MINISTER 10 May 1989

WHEN "THE TIME WILL BE RIPE"

1. One of the difficulties in dealing with the EMS issue is that we always appear to be negative, declining a "seat on the bus" etc. This note attempts to set out a positive response, which will, nevertheless, preserve our position.

2. I suggest we say the time is ripe when:

(a) all constituent countries have abolished all foreign exchange controls and the legal machinery through which they are imposed. (Note that this condition could be specified as one year without controls. We should ensure that any conditions are satisfied before we enter the ERM. Promises of future reforms are not sufficient.)

(b) all domestic banking systems and financial and capital markets are deregulated and open to competitive entry from EEC countries. In particular, cartel arrangements would be regarded as a form of non-competitive behaviour, and

(c) any institution, corporation, partnership or individual would be free to enter any banking or financial business, subject only to minimum prudential conditions. (We need to be very specific about such conditionality.)

3. This would put the ball squarely into our opponents' court. What would they do with it? There are two alternatives:

(a) They could say that the conditions are tantamount to rejection of ERM since the other EEC countries could not conceivably liberate their financial and capital markets to the extent of the UK. Then we could reply b

that EEC ministers had reiterated their view that open, unregulated and competitive financial systems had been the aim; now the reality was that the other countries were backing off their commitments. We have kept the faith: they have not.

(b) They could accept and carry through the conditionality. Europe's financial systems would then be like ours - free and competitive. Then we would be in honour bound to join.

4. I conjecture that response 3(a) is much more likely than 3(b). For all the talk of deregulation and competition, I cannot see, for example, Italian banks allowing British banks to enter their lucrative and highly restricted mortgage business. The cartelised financial markets of other Common Market countries are part and parcel of their corporatist systems. It is unlikely that, protestations to the contrary, they will be dismantled.

5. But supposing they are so changed into the epitome of competitive and open markets. Then we would have to join the ERM. But surely we would then want to belong fully to this vast liberal market. A free competitive financial system would destroy the corporatism of France, Italy and Germany and set such a dynamic supply-side revolution in train that all countries would gain enormously. (Of course those groups protected by the barriers of corporatism would suffer, at least initially.)

6. None of the arguments against joining the ERM are discredited. They remain as strong as ever. The cost of joining the ERM seem to me to be worth paying if we have open and uncartelised financial markets for us to exploit in the community.

7. But such a cost is likely to be very small since it is most unlikely that the ERM as we know it could remain in a milieu of open and competitive financial markets. There would have

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to be more room for movements of exchange rates. As the late 1960s showed, the pseudo-fixed exchange rates of Bretton Woods could not be maintained in the face of the, by today's standards, very modest capital movements that fairly free markets then generated.

8. Whether the response is 3(a) or 3(b), I think that this "time is ripe" conditionality should enable us to reverse the negative image and show that we are on the side of the liberal angels. This approach is consistent with various statements of the Government's position. It is also a natural development from your Bruges speech. I suggest that it is worth some consideration.

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ALAN WALTERS

FIXED EXCHANGE RATES AND COMMON MARKETS - THE CASE OF THE UNITED STATES AND CANADA

1. One Market

* Canadian - US trade flows are larger than any other pair of countries in the world.

* Both capital and labour are free to move unhindered across the border.

* There are no non-tariff barriers and the remaining tariffs are to be abolished under the Free Trade agreement.

2. Exchange Rates and Monetary "Union"

If there were ever a case for an exchange rate fix or monetary union, then it would clearly imply that Canada (a) fix the Canadian dollar against the US dollar, and (b) arrange that Canada's dollar be exchanged for US dollars and for Canada to become an integral part of the US Federation.

3. The History

Canada did, in fact, experiment with two periods when she fixed the Canadian dollar to the US dollar. On each occasion, the Government decided that the costs of pegging were far too large to offset any conceivable benefits. The Canadian dollar has floated with virtually no intervention for fourteen years.

During this period, Canadian dollars have circulated modestly in the border areas of the United States, and US dollars are widely accepted throughout Canada as an alternative medium of exchange.

4. Present Policies

In the wake of the free trade agreement, there is simply no body of Canadian opinion, either academic, political or commercial, in favour of a new bout of fixed exchange rates or a monetary union. The past lessons are not forgotten. And Canada has retained her monetary identity and sovereignty.

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