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PRIME MINISTER

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EC ISSUES, AND MADRID

1. It is now clear that the Spanish have ambitions to make progress on several very contentious issues at Madrid. The main items on the agenda are EMU and the Social Charter, and the Spanish are seeking substantive progress, rather than just an exchange of views before action in the French Presidency. They are also trying to get agreement to an initiative on international debt.

2. Our basic line on these issues is clear. But we need to think carefully about our tactics for Madrid: if we are seen to be unremittingly hostile to any progress in the Community we may set the scene for a dangerous confrontation during the French Presidency. This note analyses the risk of this, and what might be done at Madrid to head it off.

Background

3. Last year's budgetary reform package has bedded down satisfactorily, and the Commission's proposed 1990 budget is some £2½ billion below the agreed ceiling. The 1992 programme is still going our way, with the Commission apparently ready to operate a more active competition policy against state aids, to draw back from the extreme Cockfield position on tax approximation, to drop the proposed withholding tax on savings income, and, under the influence of Bangemann, Brittan and Andriessen, to follow a liberal line on external trade issues and against "Fortress Europe". On most of the issues where ours is a minority view, eg our determination to maintain adequate frontier checks, our reasons are understood and command some support.

4. We shall be more isolated on the "social dimension" of 1992, where the Commission line is inspired by Delors and the Greek Socialist Commissioner, Mme Papandreou, and rings bells in both Madrid and Paris. We shall have to fight hard to ensure that the liberal thrust of the single market programme is not undercut by new socialist regulation.

5. This makes our tactics on EMU all the more important. Though the step by step approach to Economic and Monetary Union, which is set out in the Delors Report, and the nature of the eventual monetary institutions which it purports to prescribe, are closer to Bundesbank thinking than to traditional French views, there is no doubt that the French will make follow-up to the Report the centre-piece of their Presidency. There is equally no doubt that they will wish to record a significant advance: Mitterrand will wish to outdo the Giscard/Schmidt achievement of setting up the EMS.

6. The French will also argue, as will the wiser heads in Bonn, that visible forward Community movement is necessary to avoid Western Europe becoming mesmerised by the Gorbachev phenomenon: the view is widely held that if the bicycle goes too slow the FRG may fall off. In addition, the French have an interest in involving us in closer co-operation on economic and monetary issues, on which they see us as an ally against the Germans. There is also a general - and understandable - concern that Europe should, by getting its act together, reduce the risk of bipolar US/Japanese relationships dominating international economic debate (and a concern that the European voice in that debate should not become exclusively German).

7. It does not of course follow that most of our partners will be ready to sign up now to the Delors Report's blueprint for Economic and Monetary Union (stage 3), or for the interim test-bed arrangements loosely sketched out as stage 2. The Report stresses that EMU would require not

Regional variants
 will EMS imply convergence policies toward high cost countries

only full capital liberalisation, labour mobility, wage and price flexibility, and unfettered intra-EC cross-frontier trade, but also genuine free competition, and convergent inflation, growth rates, and fiscal policies. Few could in practice quickly swallow all that.

8. The Report also claims - but with less justification - that a greatly increased official flow of resource transfers from richer to poorer member states would be essential. We shall not be alone in querying that proposition. It also claims that central control over fiscal deficits are an essential element in monetary union; this is a false analysis - but its inclusion no doubt reflects Delors' desire to arrogate as much power as possible to the centre. Similarly, there are real problems about the democratic accountability of the proposed arrangements, which will worry many others too.

9. The need for much greater discussion of such issues was brought out at the informal ECOFIN meeting at S'Agaro on 19-21 May. The general view then was that while work on launching the measures set out in Stage 1 of the Report should go ahead as a matter of urgency, work on stages 2 and 3 should have a lower priority. And it was accepted that the question of convening an inter-governmental conference (IGC) to consider Treaty change should be considered in due course, in the light of this further work.

10. The indications are that the Spanish Presidency will want to build on this approach at Madrid. In particular, they are proposing that Stage 1 should start on 1 July 1990, but without any commitment to the timing of a move to Stage 2, nor on precisely what measures would be included in Stages 2 or 3, nor even - and this is particularly welcome - that a decision to embark on Stage 1 should be a decision to embark on the entire process. They are proposing that the European Council should review progress in mid-1993, and by

implication that no decision on an IGC would be taken before then. The main difficulty for us - which we discuss below - is that they propose that there should be a reference, albeit of a non-legally binding kind, to all EC currencies being brought within the exchange rate mechanism by 1 July 1992.

11. The Spanish objective is to pull off the trick of getting the whole follow-up procedure to Delors agreed at Madrid and not left over to the French Presidency. This is an astute tactic, which will not be altogether to the French liking, but very difficult for them to oppose too directly. But, conversely, it will be very easy for the French to argue, if there were a confrontational debate at Madrid, that clearly everyone needed more time to think about the matter and it could all be taken up again at Paris. That would greatly increase the chances of the French then pressing for a decision to convene an early IGC (or, conceivably, setting up a conference of 11 member states to prepare a separate Treaty without us).

12. It is of course too soon to say with any certainty that other member states would in the end play along with such French tactics. But a large majority believe that while further monetary cooperation and economic convergence is not necessary to the Single Market, 1992 Europe would work better if they were secured. The political arguments - para 6 above - go in the same direction. Kohl would be unlikely to hold out against pressure from Mitterrand, and Poehl would mount no counter-pressure against the principle of Treaty amendment. The Spanish and Italians would probably support Mitterrand with some enthusiasm; the position of pragmatic gradualists like the Dutch and Danes, believers in the EMS model, and concerned that we should join the ERM, would probably depend on whether they believed that we were ready for some pragmatic advance, including on ERM.

13. It is our joint assessment that if the UK line at Madrid were seen as wholly dismissive of any progress on this issue, and rejected the Presidency compromise outright, then the risk of the French at Paris seeking, and securing, the votes necessary for an IGC, would be high.

14. All one can say with certainty now is that:

- (a) all other member states would prefer to proceed on the basis of the Twelve acting together, accepting that the convoy will move at the speed of the slowest;
- (b) if we seem unwilling to move at all, most and perhaps all the others would not be prepared to wait for us;
- (c) the French, if convinced that the UK would block the alternative of real practical progress, would probably go for an IGC decision later this year, and the grand gesture of new Treaty provisions with or without the UK;
- (d) a UK veto would not necessarily work: if the other Eleven agreed on a text, which we found unacceptable, there would be a risk of their choosing to consecrate it in a new Treaty, separate from the Treaty of Rome. If this happens, our status in the Community would then be rather different, and semi-detached.

Consequences of an IGC leading to a Treaty of Eleven

15. Would this matter? Our joint assessment is that the evolution of a two-tier Europe would matter, both politically and economically.

16. The domestic political impact would undoubtedly be negative. Though we could point to deeper rifts below the surface of their EC policies, Labour are now in a position to exploit the friction inside the Conservative Party which would be inevitable. Our supporters in business would be

uneasy, and the impact of our 1992 Awareness campaign blunted. In the City, concern about its position vis-a-vis Frankfurt and Paris would grow.

17. Abroad, our negotiating position in other key current Community debates (paras 3 and 4 above) would be weakened. We do best at Brussels when (as on frontiers or tax, or indeed CAP and budget reform) we build alliances. But to isolate ourselves on the issue which is now seen as No 1 would scare off allies or potential allies on the rest of the Community agenda.

18. Isolation in the monetary debate would be far more damaging than the isolation on "the social dimension" which may be inevitable. The "social dimension" is a straight liberal/dirigiste, Right/Left issue, and our attitude, though unpopular with some, will be seen as consistent with our domestic policies, and validated by 3 successive elections here. We can argue with conviction that we believe new social regulation would be damaging to the Community, but we cannot say the same about greater monetary convergence. So outright UK opposition to monetary development would be seen as a UK v Community issue: our attitude would be assumed to reflect a new insularity: and this would in turn be assumed to determine our policies on other current EC issues, and so would reduce the chances of agreement to such policies. On all issues where majority voting applies, the number of which has been greatly enlarged by the Single Act, the others would be more inclined to vote us down rather than seek to accommodate us.

19. Vis-a-vis the external world, the consequence of third countries (eg the US, Japan) detecting a reduction in our influence on the Community's policies and development would probably be reduced reliance on us as a principal interlocuteur. In particular we could expect to have less influence on the Bush Administration if we were seen to have less influence within the Community.

20. Economically, the damage would primarily be to confidence, and could start relatively quickly. If perceived as formally and indefinitely outside a currency area of increasing exchange rate stability, and more generally moving out of the Community mainstream, the UK would become relatively less attractive for new investment. It is true that we would remain within the single market, and that is important. But doubts, eg in Japan, about whether we would indefinitely remain within the Community trading block, or would be able to retain our present influence on its trade policies, could be expected to lead the Japanese and others to reckon the course of prudence was to direct their European manufacturing investment to continental sites rather than to the UK; and the flow of new inward investment geared to 1992 would tend to dry up. Non UK Banks and other financial institutions could similarly have a greater incentive to develop their continental bases rather than their London operations. Some domestic investment could similarly transfer to the EC mainland.

21. It follows that:

- (a) since complete isolation on the monetary issue this year could have adverse short term consequences and could cause the UK serious long term damage; and
- (b) since the damage could extend well beyond monetary issues;
- (c) at and after Madrid we should, while dismissing the two plainly unacceptable elements of the short term prescription in the Delors Report (paras 39 and 66), aim to convince our EC partners that we are genuinely interested in greater economic and monetary cooperation, and willing to make progress.

UK Line at Madrid

22. We have been considering how this can best be done, first at Madrid.

23. Partly it will be a matter of tone of voice. As already mentioned we would do well not to condemn every aspect of the Delors Report, though we should certainly point to some of the defects in its prescription for an eventual EMU - eg the professed requirement for massive resource transfers through the EC Budget, the unwarranted assertion of the need for central control of fiscal policy, and the question of non-accountability (para 8 above). But we also need to make clear that we are ready to move some way in the direction of closer monetary cooperation as set out in Stage 1 of the Delors Report. We would point to the full agenda of practical work to be done now. In some respects we could indeed go a little further, and propose some measures not included in Delors' Stage 1 (though it would be necessary to ensure that the French idea of establishing a European Reserve Fund remained on the sidelines). We would argue that one must walk before trying to run, and that more analysis and debate is needed to clarify what Stage 3 might entail, and especially its political implications, which are barely touched on in the Report.

24. There are two important tactical traps to avoid.

25. First, we would be in a minority of one if we sought to argue at Madrid that EMU as a long-term aim, last reaffirmed at Hanover, should now be dropped. Instead we should make plain, when rejecting - as we must - the Delors Report's assertion (para 39) that the "decision to enter upon the first stage should be a decision to embark on the entire process", that we do so because it is wholly unnecessary, needlessly divisive, and hopelessly premature. Nor would it be acceptable to the House of Commons. The political debate

on the form of the arrangements which full monetary union implies has yet to start; and we don't sign blank cheques. On the basis, it should be possible, at Madrid, to have the para 39 "in for a penny ..." argument discounted, as the Spanish appear ready to accept.

26. Secondly, we should not appear to rule out Treaty amendment ever. We need to play this long. In the Single European Act we secured confirmation that "insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236" (ie Treaty amendment, requiring unanimity) "shall be applicable". Our line at Madrid should be that there could be no question of the UK Parliament agreeing now to ratify Treaty amendments transferring powers to new institutions at an unknown, but distant, future date. Westminster does not sign undated cheques. The institutional question is, as S'Agaro recognised, one to be addressed in due course, in the light of further work on Delors's Stages 2 and 3.

27. The real difficulty however is that the ERM issue will inevitably arise at Madrid, for the Delors Report suggests that all Community countries should become full ERM members by the end (undated) of stage 1, and the Spanish have announced that they hope to join by the stage 1 start-date (1 July 1990). As we mentioned earlier (para 10), they are likely to seek Conclusions language setting a target date, probably of 1 July 1992, for the other ERM non-members (ourselves, the Greeks and the Portuguese).

28. We can of course accept the ERM reference in the Delors Report: it is entirely consistent with our formula about joining when the time is ^{right} ripe. But - although you repudiated this pretty explicitly at the 22 May Manifesto launch - many in the Community believe that our formula disguises a determination that the time will never be ripe. If what we say in Madrid, eg about the idea of setting a

target-date, appears to slam the door on UK entry and so reinforces that belief, they would see agreement to a step-by-step approach in which nothing more happens until stage 1 (including UK ERM membership) is complete as in fact ensuring that nothing beyond Stage 1 ever happens. Even the Dutch would not settle for that.

29. So if we prescribe a step-by-step approach, following the S'Agaro priorities, we are bound to be asked whether we can foresee circumstances in which we would be prepared to step into the ERM. Our answer will determine whether we can in the rest of the year build support for concentrating on S'Agaro priority one - ie Stage 1 measures, and so ensure that the French do indeed leave the IGC issue to be addressed "in due course". If what we say fails to carry credibility - and simply repeating the "when the time is ripe" formula would certainly fail, given that the ERM is already ten years old - the odds must be that, even if we deal satisfactorily with the problem of Conclusions language at Madrid, we shall face later in the year the crisis envisaged at para 14(c) above.

30. Our judgement is that, if what we say holds out the prospect of movement on ERM in the foreseeable future, the French would probably prefer to build their Presidency package round that prospect, rather than the divisive pursuit, via an IGC, of Treaty change which would, at least, for a time, be only symbolic. To succeed where Giscard failed, completing the composition of the ERM, would be politically attractive to Mitterrand. Conversely, there have been hints from Paris that, "the question of institutional change, if necessary in a small group, would force itself onto the agenda" in the absence of any sign of UK movement on ERM. Moreover, while one cannot be wholly certain that a clear indication of a likely UK move on ERM would dissuade the French from exploring the IGC route as well, it seems certain to dissuade most other member-states from encouraging such explorations.

31. How precise would that indication have to be? As mentioned above, we doubt very much that it would be enough simply to restate the line that we will join when the time is ripe, without going on to suggest by when we think the time will be ripe, or in what circumstances. The indications are that the Spanish Presidency will propose language in the form of a non-legally binding reference to all currencies joining by 1 July 1992 (perhaps in the form "it is important that..."). We do not propose that we should accept that as it stands. But we believe we could accept that sort of approach, which would not present us with any difficulties in the financial markets, providing certain conditions were attached. These would include a condition that all the major member states had completely abolished all exchange controls well before that date - as is provided for in the Capital Liberalisation Directive. And, perhaps, an understanding that the pound would enter with wider margins, as the Spaniards have themselves stipulated for the peseta. We would also of course want to ensure that our inflation rate was [on the way] down again; but that is a matter for us, and something we are determined to achieve anyway.

32. Setting a non-legally binding timetable for joining the ERM - say by 31 December rather than 1 July 1992 - would represent a change in policy. But setting a date over three years in the future, and with certain conditions attached, is conceding very little. And seeing off the - potentially very damaging - debate over EMU for an even longer time would be a major prize.

33. We see no risk that taking such a line would be interpreted as any weakening of our objection to EMU. Indeed, if we succeed in securing Madrid acceptance of the S'Agaro priorities we would be seen to have defeated the Delors' "in for a penny ..." approach. And ERM would not be a slippery slope towards EMU, for ERM arrangements are inter-governmental, not supranational.



34. In short, we believe that the Madrid discussion will be difficult, and may settle the course of the French Presidency. There is a way through the minefield, provided we avoid outright rejection of the Delors Report, and convince the others that our call - first things first - for concentration on Stage 1 is made in good faith, not just as a tactical manoeuvre. But it is our joint view that we would maximise, and perhaps precipitate, the IGC risks (paras 14 and 21 above) if at Madrid we said less than is suggested at para 31 above. C

35. Could we discuss this with you?

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