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From the Private Secretary

20 June 1989

MADRID EUROPEAN COUNCIL: ECONOMIC AND MONETARY UNION

The Prime Minister had a talk this evening with the Foreign Secretary and the Chancellor of the Exchequer on the handling of debate on the Delors Report at the Madrid European Council. The discussion took place on the basis of the joint minute from the Foreign Secretary and the Chancellor dated 14 June.

This letter contains sensitive information about our negotiating position and should be given only a very limited circulation.

It was agreed that our objective at Madrid should be to avoid any commitment to Stages 2 and 3 of EMU as set out in the Delors Report or to an Intergovernmental Conference to consider Treaty amendment. The Prime Minister's talks with Sr. Gonzalez on 19 June had indicated that the Spanish Presidency were prepared to work for an outcome at Madrid similar to that of the informal meeting of ECOFIN, namely a commitment to implement Stage 1 of Delors within an agreed time frame, while remitting Stages 2 and 3 for further study by experts. This would be a satisfactory outcome. But others would wish to go further. The question was whether we could clinch the sort of conclusions apparently envisaged by the Spanish Presidency by giving a clearer indication of when the UK would join the Exchange Rate Mechanism of the EMS.

It was recognised that this was a matter of fine tactical judgement. The view in the joint minute was that a clear indication at Madrid of our intention to join the ERM by the end of 1992 provided other Member States had implemented in full their obligations under the Capital Liberalisation Directive would be sufficient to secure agreement on the outcome envisaged by the Presidency, and shunt away any decisions on Stages 2 and 3 of the Delors Report into the future. It was already our policy to join the ERM at the right time, so no major concession was involved, only a further step towards defining when the time would be right. Without this, our commitment to Stage 1 would not appear

credible and there would be a serious risk that the other Member States would go direct to an Intergovernmental Conference and a stronger commitment to the whole process of EMU as envisaged in the Delors Report, leaving the United Kingdom isolated. Such an outcome would be perceived as a defeat for the United Kingdom and our influence would be diminished. The other Member States would acquire the habit of working together without us, and would take decisions among themselves which would in effect be imposed on us. We would cease to be a favoured destination for inward investment. The forthcoming Council in Madrid offered a unique opportunity to settle the issue on terms acceptable to us. It was most unlikely that an equally satisfactory outcome would be available at the Paris European Council in December.

Subsequent discussion focussed on two main aspects of this proposition. The first was the question of tactical judgement. Would a more forthcoming statement on membership of the ERM in practice secure a significant respite from an IGC and a clear understanding that the Community would not move towards steps Stages 2 and 3 of the Delors Report? Or would those Member States who were enthusiastic to make faster progress simply return to the matter at the Paris European Council in December or soon thereafter? Experience of the Community suggested that the latter was more likely, in which case any concession by us at Madrid would have been made for no worthwhile return. But the tactics could only be decided finally at the Madrid Council itself, in the light of the views expressed there.

The second aspect was exactly how our position on membership of the ERM should be modified. There was no question of joining now, as the Chancellor had made clear in his evidence to the TCSC. Setting a date by which we would join would be a virtually irrevocable commitment which would constrain the Government's economic and monetary policy as the date for membership drew closer. Moreover the Government had only recently restated its position on membership of the ERM in traditional terms in the Conservative Manifesto for the European elections. To adopt a stronger commitment so soon after the poor election results would be perceived as a sign of weakness (although equally it would be welcomed in some quarters). An alternative way of proceeding would be to give a clearer indication of the conditions which would have to be fulfilled before sterling could join the ERM, so that we did not go in until there was a level playing field for financial and monetary issues in Europe. These conditions would include significant progress with reducing inflation in the United Kingdom, abolition of exchange controls in the main EC countries and completion of the Single Market in particular in financial services. These steps would have to be in effect long enough for us to be able to judge that they were being genuinely implemented by all member states. Whether the ERM would survive in these conditions was an open question. Against this, it was argued that a statement which failed to set a date would not carry sufficient credibility with other member states to secure our goal of substantial deferralment of an IGC and Stages 2 and 3 of Delors. Moreover, it would be a

mistake to introduce extraneous conditions going beyond the Capital Liberalisation Directive since they would be seen as simply a delaying tactic. They were valid concerns but should be pursued separately.

The Prime Minister said that she would reflect further on the way in which this issue should be handled at Madrid. She remained sceptical whether a concession by us on membership of the ERM would really achieve our agreed aim of blocking an IGC and Stages 2 and 3 of Delors. But this could only be judged on the spot at Madrid. In any event she remained very wary of to setting a date for sterling's membership of the ERM because of the extent to which this would constrain the Government in future.

I am copying this letter to Alex Allan (H M Treasury) and Sir Robin Butler.

C. D. POWELL

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