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PRIME MINISTER

~~Put in box~~ ~~Next Wednesday evening~~

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ERM AND EMU

You asked Mr. Ridley to prepare a paper on ERM and EMU. He has now done so and I attach it. It is a useful summary but does not - to my mind - have any new insights. I am not quite clear what use you have in mind for it. Perhaps you would like to discuss it with Mr. Ridley at your next bilateral.

- Yes, we must allow sufficient time.

CDP

(C. D. POWELL)
1 December 1989
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CONFIDENTIAL AND PERSONAL

ERM & EMU

1 This paper describes the various proposals being suggested by the European Commission in the field of European economic policy, and how they would work. It attempts to assess their consequences from a United Kingdom point of view. It concludes by suggesting the policy which would be in the best interests of the United Kingdom.

The necessary definitions are:

EMS - The European Monetary System. This consists of Credit mechanisms together with the ERM.

ERM - The Exchange Rate Mechanism : a scheme which attempts to link the currencies of the member states to give more stable rates of exchange between them. [Currencies may move upward or downwards within "bands", and realignments are allowed when they become necessary].

EMU - Economic and Monetary Union between the 12 member states of the Community - leading to a common currency.

2 The Single Market is to be achieved by 1992. It consists of a Free Trade Area among the 12, but one where the rules are laid down by Directives - so that central control is achieved of standards, regulatory practices, non-tariff barriers to trade, subsidies, and many other matters. This is to ensure fair conditions for competition and for the free movement of labour, capital, goods, and services. It is accepted by all member states as highly desirable to achieve the Single Market in the interests of greater economic opportunities.

The Exchange Rate Mechanism of the European Monetary System

3 The EC established the present European Monetary System (EMS) in 1979. It included the Exchange Rate Mechanism in order to achieve greater convergence of economic policies through greater exchange rate stability. This consists of a set of fixed but adjustable bilateral rates with permission for minor fluctuations within fixed bands around those central rates.

? 4 The system includes credit mechanisms to help central banks intervene voluntarily to keep market rates within the limits. Central rates may, however, be adjusted from time to time, but only by mutual agreement amongst all participants. It is assumed that its existence will bring pressure to bear upon the participants to order their economic policies, particularly their monetary policies, so that they avoid re-alignments. We are formally members of the EMS but sterling is not in the ERM.

5 The advantages which the ERM seeks to achieve are those of a fixed exchange rate system - where there is reduced exchange rate uncertainty. It also seeks to achieve a firmer discipline upon Governments to pursue policies likely to produce low inflation. The need to adjust exchange rates from time to time to allow for changing economic circumstances is recognised by allowing periodic realignments when necessary.

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Economic and Monetary Union

6 The focus of debate within the EC has become the Report of the Delors Committee of April 1989. This suggested a three stage process leading to Economic and Monetary Union.

Delors Stage 1

7 Delors Stage 1 involves:

(i) full implementation of Single Market, including single financial area;

(ii) strengthened competition policy including action against economic aids;

(iii) closer co-ordination of economic and monetary policies by member states;

(iv) inclusion of all the Community currencies in the Exchange Rate Mechanism under the same rules;

(v) The reform and doubling of the structural funds.

Delors Stages Two and Three

8 These two stages involve a move to irrevocably locked exchange rates and the eventual replacement of national currencies by a single Community currency. National budgetary policies and Community structural policies would become subject to binding central rules. The European Central Bank, acting independently, would determine monetary policy, exchange rate policy with non-EC countries, and the management of official reserves. The European Central Bank would be controlled by a Committee of the Central Bank Governers of the Member States. There is also a suggestion that supervision (by some unspecified process) by those with political responsibility in the Community, might be exercised on the European Central Bank.

How the ERM has worked

9 The actual performance of the ERM was poor to start with, but it has been better over recent years. There have had to be eleven currency realignments within the ERM over the 10 years from 1979-1988 but most were in the early years and there have been no realignments since January 1987. Since 1979 the franc has depreciated by 47% against the mark and the

This needs revising.

lira by 64%. So the system has not - over the long term - overridden the market. Nor has it remotely produced stability of exchange rates. Sterling has actually fallen less against the DM than either of these two currencies by 25%. Only the Dutch guilder has maintained approximate parity with the mark over the period. Despite the scale of these movements, over ten years there has lately been a reduction in the day to day volatility of exchange rates between ERM currencies. Nor has the reduced volatility of exchange rates been accompanied by more volatile interest rates.

10 There are a number of reasons for the relatively smooth operation of the ERM. First because the DM is a widely traded international currency, it is affected by movements in the dollar much more than other ERM currencies. When the dollar is weak funds move into DM, making the DM strong, and vice versa. The strength of the dollar between 1981 and 1985 therefore made it easier to keep the DM in line with other currencies within the system.

11 Second, the 1980's has been a period of relative calm in the world economy. The precursor to the ERM the currency "snake" of the 1970's, fell apart partly because of its inability to withstand the differential pressures on exchange rates of extreme turbulence in the foreign exchange markets as a result of the first oil crisis, as well as and divergent economic policies. There were on several occasions exchange rate adjustments beyond those allowed. The less than wholehearted commitment of member countries to stable economic policies and to the goal of monetary union which was the stated object of the 1970 Werner report meant that by 1976 the 'snake' had degenerated into a system involving only Germany and the Benelux countries.

12 In the early years of the EMS several members had extensive controls over the movement of capital. These controls allowed countries to delay but not to avoid adjustments in exchange rates or in domestic economic policies by limiting the ability of capital to move in response to

changes in economic performance and policies. Recently, there has been a marked reduction in exchange controls in the major countries. The main exchange controls in both France and Italy are now on holdings of foreign bank accounts by domestic residents. In both countries the really powerful constraints - those preventing companies from moving money abroad, or from advancing or delaying trade payments, or from borrowing their currency to sell it - have recently largely gone. A major impact of relaxing controls has been to stimulate capital inflows as investors realise that they can withdraw their funds if necessary.

13 There is a remarkably close relationship between relative changes in Exchange Rates within the EMR and relative changes in Unit Labour Costs. Unit Labour Costs are a combination of inflation and productivity. Over the ten year period the Franc has been devalued by 47%, and its ULCs have gone up by 45% more than Germany's. For the Lira the figures are 64% and 71% respectively. For the pound sterling, not a member of the ERM, the figures are 25% and 23% respectively.

14 There appear to be other reasons apart from ULCs why the pound's value changes relative to those of the ERM currencies, as it did particularly around 1981 when sterling was very strong. Sterling is an internationally traded currency, and has not been protected by exchange controls for 9 out of the 10 years. It is also a "petrocurrency" in that about 5% of its GDP was represented by oil production over the period. The waxing and waning of prospects for oil prices and production clearly affected its value, as well as changes in UK Unit Labour Costs.

15 The ERM system is potentially incompatible with a world of high capital mobility. Whenever the need for adjustment becomes apparent fixed but adjustable exchange rates provide market operators with a one way bet. If, say, markets come to expect the franc to be devalued, selling francs yields substantial gains if the franc is devalued but virtually no loss if it is not. The result is likely to be large sales of

francs, perhaps forcing a devaluation, with extreme movements in interest rates to try and defend the currency. These pressures caused the breakdown of the Bretton Woods exchange rate system in the late 1960's early 1970's as capital flows were liberalised and economic policies became more divergent creating pressures for exchange rate changes. In fact the ERM has been so organised that the permitted margins of fluctuation before and after realignments have overlapped, so speculators have not necessarily been given a one way bet. In realignment it has been possible for the exchange rate to rise even though the realignment has been downwards. Clearly this might not apply were world markets to enter a period of great turbulence, and the relative movements of exchange rates become greater as a result.

16 The reason for the apparent success of the ERM in recent years has been the convergence in ULCs between members and in particular the convergence emergence in rates of inflation that were previously so disparate. This has reduced the need for realignments and enabled the mechanism to survive the liberalisation of capital movements which naturally exacerbate speculative pressures. In the early years there was a wide divergence between ULC performance in Germany, France and Italy. In the last three years the growth of unit labour costs in Italy has been similar to Germany and the French performance has been slightly better than the German. Both French and Italian monetary policies have been adjusted in the light of developments in the ERM. The French authorities, in particular have placed great emphasis in recent years on keeping the franc/mark rate unchanged. They have been prepared to keep interest rates 3-4 points above the Germans for this purpose. This has been necessary because the markets still clearly believe French inflation is likely to be higher than German. But it is not the ERM which has produced the stability; it is the determination shown by the Authorities to pursue economic policies likely to result in exchange rate stability.

17 Despite the greater convergence of inflation rates between members of the ERM, strains are re-emerging within the system. The German trade surplus with other members of the ERM continues to increase. A period of renewed dollar weakness would put upward pressure on the DM. The German authorities have indicated a desire for a DM revaluation to help reduce trade imbalances and reduce the German inflation rate. Other ERM members are unwilling to see their currencies devalued against the DM but a realignment cannot be ruled out in the early part of next year. Strains and parity adjustments are by no means a thing of the past.

18 So the conclusion must be that the ERM has worked for its member countries in recent years because there have been no dramatic economic upheavals to put irresistible and differential pressure on currencies within the system and because the countries concerned have committed themselves to sensible domestic economic policies which have kept their currencies within the rate bands. Membership of the system itself may have given the markets greater confidence in the commitment of these countries to continue sensible policies, but the system has not 'beaten' the market and the success is more a result of sensible domestic economic policies. It is thus neither a cause of good economic management, nor a cure for mismanagement. A World economic crisis or the pursuance of an inflationary economic policy by a member state would leave the ERM looking rather less successful.

EMU - Delors Stages II and III

19 Moving to irrevocably fixed exchange rates, as proposed in Stages II and III, would remove the possibility of exchange rate realignments. It inevitably means that there has to be a common currency, managed centrally. The consequences of this are that no country can adjust its parity upwards or downwards if it suffers from high or low productivity growth in relation to its neighbours. The strain has to be taken by a change in relative wages or by Regional

grants from the richer to the poorer countries, or a mixture of both. Delors recognises this by suggesting much larger flows of regional grants than at present. Others would argue that the strain should in fact be taken by wage rates alone. What happens when one country suffers high wage claims which it cannot resist is not wholly clear, but one result is likely to be increased unemployment. A common currency might suggest a common labour market, but such a market is not likely to develop except in the very long term.

20 Whether movement to a common currency would improve upon the financial discipline of the current ERM is doubtful. The anti-inflationary stance of the EMS arises largely from the perception of the need for other countries to follow monetary policies not too different from those of Germany. What would happen in a full monetary union would depend upon whether the monetary policy of the European system of central banks was as restrictive as that currently followed by the Bundesbank. It might well be and could indeed be given a remit to operate this way.

21 Even more fundamental, the UK like other Member States would lose certain national policy instruments. We should not be able to have an independent monetary policy, with the serious loss of political and economic sovereignty this implies. Unaccountable institutions would assume considerable control.

22 Delors also envisages rules on fiscal policy involving restrictions on the size and financing of budget deficits and some degree of co-ordination of fiscal policies between countries. Other member states could be penalised by higher interest rates if they had no control over the scale of a member's borrowing. Excessive borrowing by one member could therefore lead to instability and might shake the union apart. In Delor's scheme binding rules are necessary to prevent such monetary indiscipline. The risk, however, is that they could not be relied on because of difficulties of enforcement ('Brussels fines Government for refusing to close hospitals',

perhaps).

23 The salient feature of all these arrangements is that control over monetary policy, fiscal policy, and interest rates moves to the centre. Delors envisages that the centre would need to control the size of budget deficits. A key element in the freedom of Member States to choose how to finance their budgets will be removed. In enforcing any such rules, Brussels could well be percieved as intervening and dictating the level of spending on specific programmes. Though Delors does not propose to control tax rates, pressures towards the closer federation to which Delors aspires but has not described in detail and pressures towards economic convergence may well lead to Community interference in this area too. This would mean that spending programmes for the unemployed including social security benefit levels, and the provision of roads, hospitals, schools etc. would in effect no longer be the responsibility of the elected representatives of a Member State or its Government. Such a transfer of sovereignty is unthinkable for the United Kingdom to accept. It ends the ability of the UK Parliament to order its own affairs, and to be accountable to the people for its decisions. It would be in effect a fully fledged Federal system.

24 There is an element of the population who may be prepared to join a Federal Europe, to give up the degree of sovereignty envisaged in these proposals. But the Authority to whom these powers are to be given is woefully inadequate. Monetary policy is to be discharged by a Committee of Central Bankers, and major parts of fiscal policy, it seems, by the European Commission. Neither of these bodies is to be elected. There is thus no political accountability proposed at all for the exercise of perhaps the most important functions of Government exist in the economic field.

25 This is not the place to discuss whether a Federal Europe should have a Parliamentary Democracy or a Presidential System, or some other constitution. But some system of

democratic political responsibility is essential if powers of this importance were ever to be exercised at the centre. Since no such system is proposed, even a committed Federalist has to reject Stages II and III. For the UK at least, these proposals must remain unacceptable.

An Evolutionary Approach

26 These difficulties lead the British Government to promote the idea of an evolutionary approach to developments in the Community beyond Delors Stage 1. Delors Stage 1 is essentially about the freeing of markets and the levelling of competition. Stages 2 and 3 are about central control, without any of the necessary political accountability. Encouraging the wider use of whatever currency or currencies offers the least risk of inflation provides a different approach which does not rule out exchange rate adjustment or bring with it unaccountable central control.

27 EMU as proposed by Delors is not and never will be acceptable for Britain for reasons of sovereignty and accountability. The concept of monetary union is not one which offers great advantages in principle and, given the political and structural difficulties, is not likely to happen for a long time to come. Britain has proposed an alternative way forward - competing currencies. This enables each nation to keep control of its fiscal and monetary policy, the essentials of economic sovereignty and political accountability. It leads to something like monetary union - certainly lower transaction costs than now, lower inflation and the greatest degree of exchange rate stability that is practical among sovereign nations.

28 Subjecting Delors' plan for EMU to this degree of scrutiny will doubtless draw accusations of "foot dragging" from the Centralists in Europe. Britain will be accused of a lack of enthusiasm for European integration. But it is not a lack of enthusiasm for European integration which this

analysis produces; it is a total lack of confidence in the method of achievement proposed by Delors.

29 The British Government has always wanted to see Europe progress so that it can exploit the potential economic strength of a single market of 320m people. It has always wanted to see the political unity for Europe to speak with one voice in world affairs. It has always wanted ties to be established which end forever the possibility of conflict in Western Europe. But the Government believes that the wide diversity of the history and culture of the European States can also be preserved by a Europe of cooperating Member States, pooling sovereignty only to the extent necessary to achieve the goals above.

30 The Community will have to rethink Stages II and III. If Britain cannot accept them, then together we must work for an alternative plan. We have been constructive in this respect, by putting forward our plan for free competing currencies. There may be other ways forward. Let us jointly explore them. What is certain is that Britain must remain in the Community, but also the Community's future must be acceptable to Britain.

31 So finally we come back to the question of joining the ERM. The economic arguments are analysed earlier in this paper. The advantages and disadvantages are fairly evenly balanced. It is no substitute for good economic management, nor does it provide exchange rate stability by itself. But it could have a helpful effect in reassuring markets and in providing discipline to achieve good economic management. The case is not proven either way on economic grounds.

32 Nevertheless we have stated our intention of joining the ERM when certain conditions are met. These are, first, that Britain's rate of inflation and trade deficit should be greatly improved. Second, that there is full freedom of capital movements within the Community; that is that the Single Market is complete. Third, that all exchange controls

in the major Member States are abolished. These conditions will take some time yet to be met.

33 Recently, joining the ERM has been seen as a political gesture; a signal that Britain is prepared to travel along the Delors road; a token of our good European intentions. "Good Europeans" though we are, we are not prepared to travel down the path set out in the Delors Report - so we should not hasten to join the ERM for the purpose of giving such a signal.

34 If we are not to follow the Delors path to EMU, where then will the Community go? Surely that question should be answered before we give political signals in any direction? Britain has made clear that we will join the ERM if and when certain conditions are met - that remains the position. We believe that Europe should concentrate on making sure these conditions are met, and at the same time allow the debate to range wide and free as to what should follow Stage I.

35 There are new factors which have to be taken into account. The dramatic changes in Eastern Europe; the difficult question of possible German re-unification, the need for forms of association between the emerging democracies of the East and the Community. Austria, Turkey and Malta are already seeking membership. Perhaps others will do likewise.

36 Thus there are questions of huge importance to be settled about the future of both East and Western Europe. Britain should play its full part in the debates that are to come. We should help chart out the future course of European integration. We must find an alternative to the ~~present~~ Delors version of Economic and Monetary Union. Joining the ERM is a relatively minor question, which must depend on the situation where our conditions for entry have been met.

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