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Prime Minister!

Charles P. will
provide a brief before
next weeks discussion
with the Chancellor &
Mr Hicks.

BHP

12/9

PRIME MINISTER

ECONOMIC AND MONETARY UNION

At ECOFIN, I was very startled at the attitude of our European partners. It was clear that all of them were determined to agree a Treaty for full EMU. More worryingly, these were the Finance Ministers and the Central Bank Governors (including the Chairman of their Committee, Pohl) - who have generally been more reserved on this issue than Heads of Government or Foreign Ministers.

2. The precise terms of any Treaty are still hazy. But their presumption is that it would include provisions for some budgetary coordination, a central monetary institution operating a common monetary policy and, eventually, a single currency. At present such a Treaty would only be an expression of intent and when (or whether) it would ever be implemented is uncertain. Nonetheless we need to confront the issue now in order to decide our approach to their plans.



3. As you know the Interdepartmental Group (comprising officials from the Treasury, FCO, Cabinet Office, Bank of England and Brian Griffiths) have prepared a report covering strategy and tactics for the IGC and I attach this.

4. I have considered this Report carefully. In doing so, I have taken it as axiomatic that the Commons will not be prepared to be committed to binding EMU as defined by Delors. Nor would we wish it to be. We are attracted even less by the other strand of thinking that is appearing in the Community, on political union and further powers for the European Parliament. However, I also believe that it is very much in our interests to preserve a Community of 12 and to maximise our influence in it. This means we must carefully prepare our position in advance of the IGC and negotiate very hard to achieve it. Whatever position we take will be controversial in both Party and country and we will need to keep the electoral timetable in mind as it proceeds.

The Evolutionary Approach in the UK Paper

5. So far our approach has been to point out the objections of principle and practice to the Delors route. We have maintained that, while we are committed to EMU, the best way of achieving that goal is through the evolutionary approach set out in the UK paper. But that approach has not so far shaken the determination of the other Member States, let alone the main players, the FRG and France, to press ahead with the drafting of a Treaty. Nor is it likely to do so for the following reasons.

- (i) Our paper was predicated on the assumption that there would be no Treaty change. But the establishment of, and the preparations for an IGC assume the opposite. Our paper is seen to have been overtaken by the decision to hold an IGC



- (ii) Furthermore, the debate in the Community is proceeding on a fairly conceptual level. Our European partners are talking in terms of what would be required in a Treaty, not in terms of the practical and operational implications of moving to EMU which were the subject of our paper.
- (iii) Our paper has also failed to command support as a credible alternative to the Delors definition of full monetary union. There seem to be three reasons for this. Firstly, we have been thought unwilling to accept the ultimate goal of EMU; secondly, the evolutionary approach is perceived as giving politically unacceptable primacy to the Bundesbank; and thirdly, our partners do not accept that the EMS could, even under our evolutionary process, evolve into one of fixed rates without some institutional underpinning. That is what they wish to see.

6. The uncomfortable truth is that, even if we were to intensify the presentation of the case in our evolutionary paper, this would not deflect other Member States from their determination to agree a Treaty.

7. There is, of course, no need for us to come to final decisions about our attitude to Treaty amendment before the IGC completes its work, which may be in the summer of 1991 or perhaps later. But we must have a strategy for the IGC and we must settle our negotiating tactics if we are to maximise the prospects of securing the best outcome.

Five Possible Strategies for an IGC

8. Against this background I see five broad strategies which could guide us in an IGC and its preparation.



9. First, we could make clear that we believe it premature to consider the drafting of a Treaty and that we would not be willing to put one forward for approval to the UK Parliament.

10. This would be, I suppose, just about reconcilable with our political commitments to EMU but it would make our participation and influence in the IGC and the preparatory discussions little more than nominal.

11. My judgement is that if we took this course, the momentum now behind EMU would lead the other eleven Member States to establish a separate Treaty on EMU. Such a Treaty of Eleven is, I am advised, legally feasible. Its consequences for the UK are not certain but would be likely over time to shift the balance of decision making from the Twelve to Eleven. More damagingly, it would be seen both at home and abroad as a move by the UK to distance itself from the European Community. Moreover, the breach within the Community would happen in the near future - perhaps as early as next year and before the next Election.

12. Such perceptions would be unhelpful for the exchange rate and for investor confidence generally, for example for the flow of Japanese inward investment. A Treaty of Eleven would give increased and unwelcome weight to German influence in the Community. You are better placed than I to judge the consequences for our relationship with the United States Government.

13. In party political terms, some of our colleagues in Parliament would welcome a move to distance ourselves from these developments in the Community. But others would regard this as the creation of "a two-tier Europe" and perhaps a step towards our eventual departure from the Community. It would be a hugely divisive Party issue for us and we may need the Whips' advice on the balance of Party opinion.



14. The Interdepartmental Group's report identifies in paragraph 1.9 four other possible options for an IGC. The first two are:

- (i) A new Treaty confined only to some interim "Stage 2" arrangements, merely hinting at further developments beyond that on the route towards EMU, and leaving detailed specification of "Stage 3" institutions for a further Treaty.
- (ii) A Treaty mainly concerned with interim institutional arrangements, but also defining EMU more specifically as a target; but again leaving detailed specification for "Stage 3" institutions for a further Treaty.

Both these options, which would require subsequent further Treaty change to provide for the final stage, present a sensible and pragmatic approach. But it is evident that other Member States want to go beyond them. Neither of these options would remotely secure the support of other Member States.

15. Another option - (iv) in the Interdepartmental Report - envisages:

- (iv) A comprehensive Treaty, which gives a full definition of EMU and the institutions necessary for its final stage and which specifies stiff conditions that would have to be met before all Member States moved together to full EMU.

Even if this is acceptable to other Member States - and it may not be if it gives one country, however small, a block on the move to the final stage - I am clear that neither we, the Government, nor our Parliamentary colleagues would accept such a firm commitment



for this country to move to EMU and to accept its associated mechanisms, such as membership of the central monetary institution and a single currency. Such an outcome is not acceptable.

16. This leaves the third option identified in the Interdepartmental Report.

- (iii) A Treaty which gives a full definition of EMU and the institutions necessary for its final stage (together with any transitional stage, if agreed) but then allows an "opting in" mechanism for Member States. This would allow them to join in the new Stage 3 arrangements at their own pace.

In more detail, such a Treaty might look as follows:

- For economic union, acceptance of binding budgetary surveillance procedures on the lines you have already agreed, but no unreasonable fetters - such as an enforceable limit on national Parliaments' powers to set budget deficits. We could not possibly accept that, either through stipulations in the amending Treaty regarding the level of "acceptable" budget deficits or through any other mechanism such as a Council decree in specific cases, or through the intervention of the Court of Justice.
- For monetary union, a stipulation in the Treaty that before its provisions involving a common monetary policy operated through a central monetary institution and any single currency took effect in any Member State, that Member State should have to "opt in" to the arrangements. Such decisions would have to be endorsed by national Parliaments. (We would need to consider the precise form of such endorsement.) This outcome would



probably require us to accept that Treaty change would embody the definition of EMU as a single monetary policy, a single Community monetary authority committed to price stability and irrevocably fixed currencies. As the officials' paper points out this would lead probably to a single currency too. [We did in fact accept a definition on these lines in 1973.]

If this option was adopted, it would provide the Community with its Treaty. It would maximise our negotiating position during the IGC. And it would leave us outside any currency union until or unless a future House of Commons decided to enter. (This is, of course, not remotely likely for as far ahead as I can see.)

Evaluation of the Five Strategies

17. All this is most uncomfortable, particularly against a background where some of our partners are talking in vague terms about political union (which is utterly unacceptable) and greater powers for the European Parliament (which we should oppose).

18. Maintaining our present stance and pushing the evolutionary approach in the UK paper will not succeed in distracting other Member States from a Treaty. At the extreme we could opt for a two-tier Community or even leave it. But the impact on our economy and on our wider political relations if that were to come about, or even if it were thought to be likely, would be enormous.

19. The 'opting in' Treaty seems to be the least undesirable option and the one I recommend we should work for as the outcome to the IGC. It would provide us with an opportunity for maintaining our influence in the Community while enabling the UK to decide later whether or not to move to the later stages of EMU. This seems to me to offer the maximum protection for our position consistent with our remaining an active partner in the Community.



20. In due course this "opting in" variant could lead to a two-speed Europe if other countries go ahead with monetary union and we do not. We may wish to make that choice but it is very much in our political and economic interest to delay the point at which it may occur and in the meanwhile to remain full members of the Community with influence over its development. The alternative is to have the immediate and certain breach of a new Treaty of 11, which would reduce our influence in Europe and more widely, and also bring considerable economic risks.

21. If we adopt the approach I recommend we will be in a better position to influence the negotiations before and during an IGC. I am sure we should aim to prolong these negotiations and delay as far as possible the implementation of any Treaty.

22. There are a number of points over which disagreement is likely to arise between Member States, for example political control over a central bank (where most Member States are arguing for Bundesbank type arrangements) and the call for additional resources for those countries who find it most difficult to adapt to a single currency. We will need to consider where to position ourselves on these issues to gain maximum tactical advantage.

Stage 2

23. More positively I think it will be in our interests to build up the so-called Stage 2 which, following the Informal ECOFIN, is to be the subject of discussion in the relevant Community Committees. Some, like the Germans, Dutch and Luxembourgers are arguing that the Community should proceed from Stage 1 to the full EMU of Stage 3 with either a short or indeed a non-existent Stage 2. The French Finance Minister is talking, in somewhat elliptical terms, of a substantial Stage 2.



24. A long Stage 2, after what I hope is a long Stage 1, would further put off the moment that Member States had to take decisions on entering the Stage 3 arrangements. But a Stage 2 would, I believe, only be worth running if it was seen to have real substance.

25. One possibility, based on a new institution called a European Monetary Fund, is described in the paper recently sent to you by Sir Michael Butler.

Have read no.

26. A preferable approach however, is set out in paragraphs 2.34-2.42 of the Interdepartmental Group's report. It also proposes a new institution called a European Monetary Fund, though one with different functions. The first attraction of this body is that it could take over existing functions performed by the Commission and others (itself a good idea which might be welcomed by France and by the Party). These include ERM management, promoting the ECU, managing certain Community financing facilities and providing an enhanced secretariat for the Community's monetary authority. It would also effectively run a currency board to issue ECU bank notes for general circulation which would exist together with national currencies; and it could have responsibility for coordinating intervention against third currencies.

who?

Very similar to Butler's proposal

27. Acceptance of such institutional development in Stage 2 would not, I am certain, be sufficient by itself to persuade the rest of the Community against pursuing a Treaty for full EMU. (Indeed, if we were to float such ideas, without accepting that the Treaty would include arrangements for Stage 3, our intervention would be regarded as wrecking and would be counter-productive). But I think it would be worth running as a complement to the "opting in" approach I have recommended on full monetary union. It could have attractions for the French and other countries. At the least it would provide a further complicated subject for consideration, and would demonstrate that we were playing a full part in discussions.



If it gained support, it could postpone the point at which other countries moved to full union and, in the meanwhile, could diminish the Commission's authority in this field.

28. I would like to float the idea at technical level in the Community first before putting it forward as a formal UK initiative.

29. The Interdepartmental report raises many other important questions, but at this stage we need to focus on the central issues. I am sure you will wish to discuss them when we return after Easter.

John H.

[J.M.]

9 April 1990