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CHANCELLOR'S BREAKFAST WITH PRESIDENT DELORS

The Chancellor met M. Delors over breakfast at the Ritz Carlton Hotel, Houston yesterday. M. Delors was accompanied by M. Lamy and Mr Dixon. Mr Wicks and Mr H P Evans were also present.

Introduction

The Chancellor said he was delighted to have this opportunity of seeing M. Delors. He hoped to give him dinner in London before too long. M. Delors said he would be delighted if that could be arranged. He went on to spell out the considerable agenda before the Commission: the completion of a single market, management of German union, Stage 1 of EMU, the Uruguay round, relations with EFTA, a new relationship with Eastern Europe, an analysis of the Soviet Union etc.

The Chancellor agreed that there was a huge amount to do for example in completing the single market and Stage 1 of EMU. Some other issues might have to be dealt with in slower time. M. Delors agreed and said that without a successful Stage 1 there would never be a Stage 2 or 3 of EMU.

EMU

The Chancellor said that we had made our concerns about the Stage 3 proposals clear. The government's objections were shared by both the main parties in Parliament and were well known. But apart from these constitutional points, a rapid move to a single monetary policy and currency would produce great economic difficulties. The economies whose performance was less good would find their lack of

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competitiveness reflected in high unemployment and falling asset values. This would create enormous pressure for huge regional transfers within the Community which would reduce the prospect of those economies improving their performance. It was against that background that he had put forward his proposals for moving beyond Stage 1. These involved the creation of a parallel currency which, unlike the ideas considered by the Delors Committee, would be anti-inflationary. The currency could develop into a common currency and, if governments and peoples so wished, in due course into a single currency. The proposals offered a way forward for the whole Community. He was strongly opposed to the idea of creating an inner core which would move ahead of the rest. His proposals were not fully worked up, but he hoped they would provide a useful basis for discussions in the Monetary Committee, Central Bank Governors' Committee, ECOFIN and the IGC.

M. Delors said that he had welcomed the Chancellor's proposals when they were first produced and hoped they would be the basis for a full debate on the transition from Stage 1. He did this both because it was his function to promote consensus within the Community and because he wished to be helpful in a UK context. He had been surprised, therefore, by the Chancellor's speech in Wales on Friday and by the article in the European press. Both had appeared to reject completely the ideas put forward in the Delors report. This made it difficult for him and could lead back to a confrontation between the UK and the other 11 members. Returning to the substance of the proposals, he said that the problem of regional poverty and under-development already existed and needed to be addressed whether or not EMU proceeded. He did not think that monetary union would aggravate the problem. Secondly, while any approach had to work with the market, there was no example in history of markets creating a new currency. That needed a political decision.

The Chancellor said that there had been no difference of intention or substance between his initial presentation and his speech in Wales. They were both intended to open up the debate and to point to the economic difficulties of trying to move from Stage 1 to Stage 3 before European economies had converged fully. He agreed that there was no precedent but he was convinced that the hard ECU proposals were sound and could be made to work. They represented a major development in the UK's thinking: a new institution and a common currency for Europe.

M. Delors said that he too was not in favour of "a big bang" approach to Stage 3. The first step was for ECOFIN to discuss monetary policy more openly and explicitly. He noted that in 1986 he had occasioned surprise and some consternation by announcing the goal of capital liberalisation. That was now on the way to completion although different countries had required different transitional periods. This approach might be appropriate also for Stages 2 and 3. Turning to the Chancellor's proposals, he said he had been considering setting up a new study of a parallel currency

taking account, for example, of the ideas put forward earlier by Ciampi and De Larosiere. (His staff later confirmed that no such study is currently under way, though one might be commissioned later). His personal view was that it was important to "diffuse the ECU" ie to make greater use of it. He agreed that it had to be transformed from a basket of currencies into a real currency in its own right. For example, he would like to see the central banks in Europe using only ECU for their transactions within the ERM. Unless the ECU was built up, he feared that the DM would become the predominant currency in East and West Europe within 5 years. He added that he had doubts whether a majority of Germans would favour EMU when it came to the point not least because DM was a symbol of "the new Germany". He would like to use the Chancellor's proposals as the basis for a full debate of the role of the ECU. This would not be possible if the UK government criticised comprehensively the alternative approach.

The Chancellor said that his speech had responded to criticisms of his hard ECU proposals by pointing out that the alternative approach raised great difficulties. He noted that the Belgian reaction to his proposals had been particularly unhelpful. It was important to proceed at a sustainable pace. M. Delors said it was important also to preserve the momentum of the Community. Turning to economic union he said that Germany and Holland wanted strict budgetary rules and he had accepted that in the Delors committee in order to preserve unanimity. However, in practice this would be impossible and budgetary policy together with decisions on defence, health, social security, etc should remain with individual nations.

Concluding this part of the discussion, the Chancellor said that he was very pleased to have had such a useful discussion. In commenting to the press he would say that it had been a constructive and friendly meeting, that his proposals were intended as a serious contribution to discussion and that both M. Delors and he had confirmed that they would be studied further in the various appropriate committees. M. Delors said that he too would maintain his positive line on the proposals and, within the Commission would certainly consider further the hard ECU and the implications of enhancing the role of the ECU.

ERM

In a brief discussion, M. Delors noted that ERM membership could have a psychological effect on industry and unions and thus help in the task of reducing inflation. He commented that it had played an important part in the disinflationary process in France in 1982/83.

Agriculture

The Chancellor said that there was general agreement in the G7 on the objective of reducing subsidies to agriculture over a period but there was a disagreement on the mechanism. The US wanted specific targets for different types of subsidy while the EC wished to focus on a measure of aggregate support. One way forward might

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be to persuade the US to accept an aggregate measure but to acknowledge that this would have an impact on specific types of subsidy.

M. Delors said that he objected to the pressure from the US and the unreasonable and unfair comments they made. Clearly there needed to be a move towards greater reliance on markets and a reduction in total support to agriculture. The EC had done much in the last 6 years and he did not resist, in the long term, making a radical change to the CAP. However, there were particular difficulties in many countries at the moment and he did not accept that the market could be left entirely to itself in agriculture given the great variations in production from year to year. He had suggested to President Bush that a group of "wise men" should be appointed to examine the problem but Bush had refused. If the US seriously wanted a deal, he was sure one could be found but the EC should not succumb to bullying.

The Chancellor said that it was most important that the Summit should give a political push to the Uruguay round and should not fail to reach agreement on agriculture.

Soviet Union

M. Delors said that the European Council at Dublin had reached agreement on the need to support perestroika but had postponed any firm commitment to assistance until after an analysis of the Soviet economy had been carried out. The Commission's remit was clear. His own view was that any general credits given now would disappear without trace and that know-how was likely to be the first priority. The Commission intended to collect information in the next few weeks and then consult the IMF, OECD, IBRD, the US, and perhaps Japan, before putting a short paper to the October meetings of ECOFIN and Foreign Affairs Ministers. He said that he did not fully understand the nature of the present economic crisis in the Soviet Union nor, as far as he could see, did the Soviet Government.

I am sending copies of this to Charles Powell in the PM's Office, to Martin Stanley in DTI and to Paul Tucker at the Bank.

V. G.

JG.

JOHN GIEVE