CDG

PRIME MINISTER

cc Mr Powell

At 12.45 on Monday you are seeing Sir Christopher Prout, who has requested a meeting to update you on the current activities of the EDG and to discuss issues at the forthcoming European Council. I attach an agenda which he has sent me.

I also attach a copy of a letter which Christopher has sent to the Chancellor reporting the Group's views on ERM and EMU. These are predictable and depressing. A small delegation from the Group have since had a meeting with the Chancellor and Christopher will wish to report on this.

JW

JOHN WHITTINGDALE

20th April, 1990

The Chairman
The European Democratic Group

European Parliament Office
2 Queen Anne's Gate
SW1H 9AA

Tel. 01-222 1720

John Whittingdale Esq.,
Political Secretary,
Prime Minister's Office,
10, Downing Street,
London. SW1A 2AA

20th April 1990

Dear Mr. Whittingdale,

Further to our conversation, I have listed below the main points I would like to raise in the course of my meeting with the Prime Minister next Monday, if that is agreeable to her:

1. Relations with national Party Members of the European People's Party: especially the Italian Christian Democrats (my letter before the Prime Minister's meeting with Andreotti and his article in the magazine Europeo) and the Dutch Christian Democrats.

2. Campaigning in Eastern Europe: completed for East Germany and Hungary and plans for Czechoslovakia, Romania and Bulgaria.

3. Meeting with the Chancellor on April 19th concerning Economic and Monetary Union (see my attached letter to the Chancellor).

4. The Intergovernmental Conference: timing; one or two conferences; the pre-conference conference; influencing the Italian Presidency.

5. German Unification (see my letter to the Prime Minister before her meeting with Chancellor Kohl).

6. Political Union and all that.

7. State of the Group.

pp Sally Lawrey

Christopher Prout

(Dictated by Sir Christopher and signed in his absence)

The Chairman
The European Democratic Group

European Parliament Office
2 Queen Anne's Gate
SW1H 9AA

Tel. 01-222 1720

Private and Confidential

17th April 1990

Dear Chancellor,

I have sketched out below, very roughly, our current views in the Group on the ERM and on EMU. They are not, I hasten to add, set in stone! I have written them down simply to get our discussions rolling. If they can be said to contain a message, it is that the ERM and EMU are increasingly seen as part of a single process in the minds of the markets as well as the other Member States; and that ignoring that fact could undermine any strategy to defeat inflation in Britain which is perceived as regarding the ERM as an end in itself.

JOINING THE ERM

1. To win the forthcoming general election depends, more than anything else, upon getting mortgage rates down substantially by the latter part of next year. How far down is a matter of judgment. At the last two general elections, mortgage rates were at 10%. Current public perceptions of the Party suggest that we must do better than this if we are to face the electorate again with confidence.

2. To reduce mortgage rates to, say 9%, over the next 18 months is, to put it mildly, a tall order. Nevertheless, like many others, we believe this could be achieved by joining the ERM this year; we are convinced that only within the ERM is such a drastic monetary easing, without an unacceptable weakening of sterling, possible. The Government's anti-inflationary credibility in the markets has been severely undermined and cannot, in our view, be restored in time for the next election by purely domestic measures.

3. Our case for ERM entry is an essential part of our proposed strategy designed to get us successfully past polling day. Entry will be perceived by the foreign exchange markets, initially at any rate, as a sufficient indication of our determination to face up to the damage that is being done to our economy by the re-emergence of inflationary pressures. As to timing, we think the earlier the better. It is particularly important that management enter the next round of wage negotiations in the certain knowledge that a depreciating currency can no longer rescue them from the effect of awards well above the levels granted by their competitors in Member States with low inflation rates. We should do everything we can, as early as possible, to persuade management to resist collaborating in an old-fashioned 1970's wage price spiral. If we are not in by the Autumn then we should be in at the very latest by the opening of the IGC.

4. I should emphasize that we do not claim that membership of the ERM will, of itself, achieve any lasting improvement in the inflationary propensity of the UK economy. Nor do we believe that, following the full liberalisation of EC capital movements, the ERM will be capable of surviving, long-term, in its existing form. However, we see it as a necessary step in a longer term strategy.

5. Entry would have the additional advantage of depriving the Labour Party of what is presently its principal platform for ensuring the electoral respectability of its economic policy. If its front-bench can no longer answer questions as to how labour will tackle inflation by saying that it would join the ERM, we could more easily reveal their supposed economic policy alternatives for the sham they are.

6. You may be concerned that the process of GEMU will so disrupt the D.M. rate as to make the ERM incapable of satisfying our domestic policy objectives. However, our contacts in Bonn and Frankfurt persuade us that GEMU should not significantly alter the international value of the D.M. Indeed, looked at in the context of the process of economic development in East Germany, we believe that GEMU will enhance the short-term stability of the ERM. This is because the principal structural imbalance in the system is the persistent West German trade surplus. With unification leading to approximately 1% per annum additional German growth over the next four years, and the accompanying demand for capital inflows leading to real interest rates some 1 - 1.1/2 per cent above the January 1979 /January 1989 mean, thereby depressing domestic demand in the rest of the Community, the German trade surplus will fall really quite rapidly. This ought not to lead to a weakening of the D.M. But it should prevent higher real German yields leading to D.M. strength. In short, a stable sterling D.M. rate seems the best bet.

7. Nor do we think, incidentally, that higher German yields will prevent us from reducing our own interest rates. We are confident that the rise in yields will be contained within the above-mentioned rates and that the effect of this will be counter-balanced by the improvement in our own balance of payments performance.

ECONOMIC AND MONETARY UNION.

8. As the Prime Minister has consistently and correctly argued, the ERM is not a long-term answer to the EC's monetary problems. Systems like Bretton Woods and the ERM don't work, quite simply, because most national monetary policies are not designed solely on the basis of keeping the exchange rate of their currencies at an agreed level. Temporary expedients, such as officially arranged capital flows, foreign exchange controls or restrictions on international trade - both now prohibited by the EC - can help but only be delaying the inevitable. The ERM has worked as well as it has only because Germany has been willing to play exactly the same role that the United States used to play in the Bretton Woods system, pursuing a non-inflationary domestic policy and tolerating capital movement and foreign exchange controls by other Member States. Our most recent contacts with Bonn and Frankfurt suggest that Germany in the 1990s, just as the United States in the 1970s, may no longer be either willing or able to manage the system as it has done in the past for everyone's benefit - given the combined effect of new single market rules and of German unification. This probably explains what we have detected as a genuine (as distinct from a diplomatic) and growing enthusiasm in Bonn and Frankfurt for EMU - though on Mr. Pohl's and not Mr. Delors' terms! It seems clear that Germany now sees a system supporting irrevocably fixed exchange rates or a common currency as the most effective means of spreading across the whole EC economy the costs of reconstructing both the existing territory of East Germany and the other economies of Eastern Central Europe. They recognise that the demands on their capital market alone to fulfil this function will be too great - and the evidence for this conclusion is already emerging.

9. Given the generally accepted weaknesses inherent in any exchange rate system like the ERM, H.M.G's often repeated scepticism about it and Germany's increasing lack of confidence that it will be able to continue to play the anchor role in it, we believe that the Treasury Paper needs recasting. In its present form, the paper is regarded as an argument for the perpetuation of a system, the ERM, about which H.M.G. and, it seems, Germany now have publicly declared serious doubts. These doubts will also be shared by the markets. If we are not prepared, therefore, to convey the impression that we are

determined to get on top of inflation by seeking a European solution which builds on and goes beyond the ERM, then our strategy for entering the mechanism soon, as evidence of our determination to conquer inflation, may be undermined to such an extent that the market will sell sterling again as soon as our refusal to look beyond the ERM in the IGC negotiations becomes clear.

10. It will also be extremely damaging politically if we are seen by domestic political opinion to be on the sidelines during the IGC. The run-up to the general election is likely to coincide with the concluding phases of the IGC. Analysts of opinion polls differ on the extent to which European issues matter in elections or, indeed, as to whether the British public is fundamentally pro or anti- European. It is, however, a fact, that the Labour Party, in the European elections last June, persuaded the media that the government's eleven to one position on a number of issues, far from evidence of our standing up for Britain's interests in the European Community, left Britain isolated and hopelessly out of touch. Moreover, as in the European elections, this situation is likely to aggravate the European debate within the Party at the worst moment, giving the widespread impression that we are hopelessly divided.

11. Moreover, assuming that we are going to remain a member of the EC and that we do not wish to travel in the slow lane of a two-speed Europe, it must be in the national interest for Britain to play an active part in shaping the future monetary arrangements for the EC. We will only be able to play such a part if we are regarded by our partners as serious negotiators. If we are taken seriously then we will have ample opportunity to influence the tone and the length of these negotiations in such a way as to suit our electoral timetable

12. In the light of these considerations, we would like, respectfully, to suggest a way forward. To us the essential characteristic of both the Delors Report and H.M.G's paper is that they both concentrate on the <u>means</u> of achieving EMU rather than on the desired character of the <u>end</u>. We believe that we ought to adopt precisely the opposite approach - that we ought to begin the negotiations by insisting on a precise definition of the end. If we succeed in making this the point of initial focus, it will become clear, immediately, that a significant diversity of views exists between several Member States as to the type of monetary union they wish to see. The kind of system envisaged, in circumstances where the option to revalue or devalue their currency is no longer available to a government, is unlikely to look the same to the Portuguese as it is to the Germans! Moreover, concentrating on the final shape of the regime will make it much easier to counter any unwelcome intermediate institutional moves which could accommodate such divergences of view by leaving them unresolved. Our views, of

course, would be based upon two fundamental principles: the sole basis for determining the object of EMU would be to establish throughout the EC the principal of sound money; and the sole basis for determining the means by which this principle was put into operation would be the principle of subsidiarity.

13. As far as defining ends are concerned, the credibility and effectiveness of this strategy would be substantially enhanced if we were prepared to go beyond the statement made in paragraph 37 of the Treasury Paper and commit ourselves, clearly, to the ultimate goal of irrevocably fixed exchange rates. The expression actually used in the Paper says that "as realignments become increasingly rare and exchange rates fluctuate in narrower bands, the system could evolve into one of fixed exchange rates. But that cannot and should not be decided now." This view of ours is taken for a number of reasons. First, because it will add considerable weight to the credibility of our negotiating position. In any case, since irrevocably fixed exchange rates are generally regarded as the irreducible minimum requirement for an economic and monetary union, our already well documented commitment to economic and monetary union will, sooner or later, be undermined by an unwillingness to commit ourselves to irrevocably fixed exchange rates. Second, because it will help reinforce in the minds of the foreign exchange dealers our determination to squeeze inflation out of the British economy once and for all. Indeed, without such a commitment, retaining the confidence of the markets after entering the ERM, as we have previously argued, may prove short-lived. Third, there are a number of longer-term factors which also indicate that this is the line we should take which can be summed up by saying that, in external affairs, the Community needs to achieve the same collective bargaining power in international monetary matters that it already enjoys in trade; and in internal affairs, the best hope that the Community has of being economically and politically stable is to establish the principle of sound money in all its component Member State economies.

14. As far as means are concerned, the doctrine of subsidiarity would, in our view, make unnecessary the transfer of any national fiscal powers to the EC both with respect to the overall dimensions of budgetary surpluses and deficits and with regard to enhanced budgetary transfers through the regional and social funds. Nor is there, we would argue, any case for transferring any economic and monetary policy making powers from the Member States to the Commission; though clearly improved co-ordination through ECOFIN will have to be arranged. It is true that a system of irrevocably fixed exchange rates could be achieved, as the Treasury Paper and a significant body of financial opinion in Frankfurt argue, if the Central Banks of the Member States do no more than conduct their monetary policy so that their national currency does not become subject to downward pressure as against

other national currencies. However, we do not believe that such behaviour will be forthcoming from many national central banks unless they are subject to international rules obliging them to place sound money and a stable currency at the top of their agenda. We believe that this state of affairs ought to be acknowledged as a fact and that we ought to be prepared to talk about the nature and the content of these rules and the way in which the existing Committee of Central Bankers, now under Mr. Pohl's Chairmanship, can be adapted to operate them effectively.

15. We also believe that this approach would make it easier to deal with EMU domestically. By emphasizing the fundamental importance of price stability, and condemning both centralized fiscal controls and redistributive structural funds, we will not only expose the real reasons for Labour's flirtation with European integration but also underline how little changed is their general approach to economic management.

16. Although our influence in the European Parliament on these matters, even within the centre-right coalition, is extremely limited, we are in close touch, both directly and through our Christian Democrat and other allies, with developments in their respective capitals, on these issues, and would greatly value the opportunity to establish a mechanism for regular communication with Treasury Ministers to let you know our views and discuss any way in which you think we might be of help to you.

With best wishes,

Yours ever,

Christopher

Christopher Prout
(Signed on Sir Christopher's behalf
in his absence)

The Rt. Hon. John Major MP,
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