BUTLER PAPER

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CONFIDENTIAL

12th March, 1990,

Charles Powell, Esq, CBE,
c/o 10, Downing Street,
London S.W.1.

Dear Mr. Powell,

Stage 2 of EMU

I attach a draft of a covering paper which I propose to table in the European Committee, to go with the longer paper which I sent you last week. I should be most grateful to receive any comments by Wednesday morning, 14th March.

Yours sincerely,

p.p. Sir Michael Butler

Written by Sir Michael Butler and
typed in his absence.

MDB/MML

Enc.

DRAFT

Stage 2 of Economic and Monetary Union

1. The Treasury paper of 2nd November, 1989, though it contained interesting ideas, failed to get the U.K. back into the centre of the EMU debate because:-

(a) it was regarded not as a contribution but as an alternative to E.C. action to realize EMU in accordance with the Madrid conclusions;

(b) it appeared not to accept the generally agreed definition of full EMU, namely that there should at least be irrevocably fixed exchange rates (or a single currency);

2. At the other end of the spectrum, the Delors report said very little about how to move forward after Stage 1; and the Commission is still concentrating on the requirements of Stage 3. This is unwise since an attempt to make a great leap forward after Stage 1 would almost certainly land the E.C. flat on its face.

3. Provided that the British Government is prepared to subscribe to the generally agreed final Stage 3 aim of moving in the long run to irrevocably fixed exchange rates (or a single currency), a well-thought-out proposal for Stage 2 would fill a real gap and get the U.K. back into the centre of the discussion. The attached paper, approved by the BIEC's European Committee on 27th March, contains such a proposal. It is consistent with the British Government's evolutionary approach. Its main features are:-

(a) co-ordination of macroeconomic and fiscal policy remains as at present with ECOFIN;

(b) in replacement of the present EMCF and Central Bank Governor's committee, a new European Monetary Fund (EMF) is created to co-ordinate monetary and exchange rate policies; it is to be run by the Central Bank Governors and owned by the Central Banks of the Member States:

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(c) action is taken to strengthen the ecu by cutting it loose from the basket of currencies and to make it as strong as the strongest E.C. currency, i.e. it would no longer be possible to revalue a national currency against the ecu though it would remain possible to devalue; the ecu would become convertible into national currencies (and vice versa) and be managed by the EMF which would act as lender of last resort;

(d) money creation would be strictly controlled since Central Banks would be under an obligation not to create national currency to replace that exchanged for ecus;

(e) the two principles in the Treasury's 2nd November paper would be adopted i.e. no bail-outs of Member Governments with irresponsible fiscal or monetary policies and no monetary financing of budget deficits; the EMF would report persistent offenders to ECOFIN and, if corrective action were not taken, would be empowered to suspend convertibility with ecus of the currency concerned;

(f) the ecu would thus become a thirteenth currency, at least as strong as the D-mark; the preferences of users would determine whether it gradually came to pre-dominate in cross-border transactions and thus a candidate to become the E.C.'s main (or even one day single) currency.

4. A system of weighted majority voting would have to be negotiated for the EMF, thus involving some extra sharing of sovereignty, but the EMF's charter would lay down in inescapable terms its duty to manage the

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ecu on the lines set out above. The constitutional relationship between governments and central banks would remain a matter for national governments and parliaments. Accountability to the British Parliament for the Governor's actions in the EMF could thus be maintained if Parliament so decided.

5. British Ministers could concede that the final Stage 3 aim should be incorporated in the new Treaty amendments to be agreed in the I.G.C. but could agree that it would be desirable to experience the working of the EMF in Stage 2 before deciding what further changes, either in the powers of the EMF or in the institutional arrangements, might (or might not) be required for Stage 3. Thus it would be for later decision whether a further I.G.C. would be needed to complete the move to Stage 3.

6. The Bundesbank has always been reluctant to promote the present ecu because it is by definition less strong than the D-mark. The new ecu would by definition be at least as strong and could in the medium-term be stronger. In the early years of Stage 2, when ecus would still be a relatively small part of the total money of the E.C., there should be no difficulty in maintaining the necessary interest rate differential to ensure that it remains as strong as required. The markets will then come to assume that its strength will be maintained, as laid down in the Charter of EMF, and the interest rate differential with the strongest currency should normally be very small. The Bundesbank might find it difficult to argue convincingly against the proposal, particularly now that the strength of the D-mark over the next two or three years may be rather harder to maintain.

7. If Member Governments are serious about wanting to move on from Stage 1 to a final Stage 3 (when all Member Governments are prepared irrevocably to renounce any further devaluation of their currency), a

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proposal on these lines for Stage 2 should commend itself to them. It minimises the risks of unforeseen shocks to the system and provides a route towards full EMU which could prove practical if the markets come to accept the new ecu and if all Governments adopt responsible fiscal and monetary policies. It would indeed provide a serious deterrent to irresponsible policies in any Member State, including the U.K.

MDB/MML
12th March, 1990.

Written by Sir Michael Butler and typed in his absence.