Sir M. Butler

9/4

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

Ackd 29 March 1990

I enclose a copy of a letter which the Prime Minister has received from Sir Michael Butler.

I should be grateful if you would let me have an early draft reply for the Prime Minister's signature.

I am copying this letter and enclosure to Richard Gozney (Foreign and Commonwealth Office) and Sonia Phippard (Cabinet Office).

(CHARLES POWELL)

Tancred Tarkowski, Esq.,
H.M. Treasury.

R28/3

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28th March, 1990

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
Prime Minister,
10, Downing Street,
London, S.W.1.

Dear Prime Minister,

Second Stage of E.M.U.

1. I enclose a substantial paper prepared over the past few months by Paul Richards of Samuel Montagu after informal consultation with a number of key experts, together with a covering paper by myself as Chairman of the European Committee of the B.I.E.C. Both were approved at its meeting yesterday as a contribution to the debate and for the consideration of H.M.G.

2. I know how busy you are, but I hope that you may be able to find time to give these ideas early consideration. If the Government feels able to make them their own, the sooner they are put forward, the better the chances of British representatives securing a powerful position in the E.C. negotiations. At present Delors seems to be making a lot of the running. If you yourself were ready to put forward ideas on these lines, either in a speech or a letter to your E.C. colleagues, the hand of British negotiators would in my view be further strengthened.

3. The existence of this private sector initiative is now known by quite a wide circle. But we propose to take no action to publicise it while you are considering it. If its existence is leaked, we shall have to respond, but will try to do so in as helpful a way as possible.

4. I would be most grateful if you could find time to discuss this initiative with me before long.

5. I am copying this letter and its enclosures to the Chancellor and the Foreign Secretary.

Yours ever
Michael Butler.

Sir Michael Butler

MDB/MML

Copy: The Rt. Hon. Mr. John Major, M.P.,
The Rt. Hon. Mr. Douglas Hurd, M.P.

28 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

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THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

SUMMARY

1. There appear to be three main ways in which the UK can approach the Inter-Governmental Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might lead to a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives of competition, subsidiarity and price stability.

It is the third approach that is considered in this paper.

2. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in the paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

3. In the alternative Stage 2 proposed in the paper, the European System of Central Banks would consist of the national central banks of member countries and a European Monetary Fund. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. Alongside national central banks, a European Monetary Fund would be established, which would be owned jointly by national central banks, and would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS.

4. In Stage 2, Community monetary policy would operate on the European Standard: that is, the equivalent of the Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would either be fixed (though not irrevocably fixed) at the outset in terms of the ECU, or they would float initially within very narrow margins and be fixed later. They would be convertible into (and out of) ECUs on demand.

5. The current definition of the ECU, which is based on 'the average' in the Community, would need to be changed. For the ECU to become a standard of 'the best' in the Community, its value would need to be as strong in terms of dollars as the strongest national Community currency. The European Monetary Fund would set ECU interest rates and conduct exchange intervention in ECUs against dollars to protect the external value of the ECU.

6. In Stage 2, the ECU would be issued by the European Monetary Fund as a dual currency in substitution for the national currencies of member countries on demand. Unlike the Delors plan, consumers in the Community would have freedom to choose whether, and if so when and to what extent, they wished to exchange their national currencies for ECUs. Exchange rates between member countries would not need to be fixed irrevocably first.

7. National authorities would cooperate within the European Monetary Fund in Stage 2 in exercising monetary control in national currency, and would act collectively through the European Monetary Fund in exercising control in ECUs. There is a question about whether the European Monetary Fund would need the power to implement monetary sanctions against 'profligate' national authorities.

8. The Community institution established in Stage 2 would take the form of a European Monetary Fund rather than a Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. New members (e.g. from EFTA and eventually from Eastern Europe) could be admitted to the European Monetary Fund with less difficulty than to a Central Bank. The UK would be able to put a strong case for locating the chief ECU operating arm of the European Monetary Fund at the Bank of England in London.

9. Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3.

10. A revision in the Treaty along the lines proposed in the paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) the principle of subsidiarity would be preserved;

(ii) the prospects for price stability would be enhanced; and

(iii) competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added.

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THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

INTRODUCTION

1. The purpose of this paper is to identify a route to monetary union that is consistent both with the UK's objectives and with a revision in the Treaty. The paper is set out in six sections, as follows:

(i) The first section considers different approaches to the Inter-Governmental Conference called to revise the Treaty, and distinguishes between 'beyond Stage 1' and Stage 2.

(ii) The second section outlines an alternative to the Stage 2 that is described in the Delors Report. The alternative Stage 2 is based on the establishment of a European Monetary Fund owned jointly by national central banks. The outline is then considered in more detail in the rest of the paper.

(iii) The third section examines the way in which the Community would operate during Stage 2 on a European Standard based on the ECU, which would need to be redefined first, and would then be issued as a dual currency in substitution for the national currencies of member countries on demand, with monetary control being exercised at national level and at Community level.

(iv) The fourth section explains the operations of the European Monetary Fund in ECUs, distinguishing between the note issue, open market operations, and exchange intervention in Community currencies and in dollars.

(v) The fifth section puts the case for an institution that takes the form of a European Monetary Fund in Stage 2 rather than a European Central Bank, for expanding its membership in future, and for locating its chief operating arm in London.

(vi) The final section concerns the timing for the introduction of Stage 2, its duration, and the revision in the Treaty that would be necessary to bring Stage 2 into effect.

THE INTER-GOVERNMENTAL CONFERENCE

2. The European Council agreed in Strasbourg on 8/9 December 1989 to call an Inter-Governmental Conference before the end of 1990 to revise the Treaty, despite UK opposition. In the absence of a viable alternative, the revision in the Treaty is likely to be based on the route to EMU described in Stages 2 and 3 of the Delors Report. The Treasury has put forward a UK alternative in a paper published in November 1989 on 'An evolutionary approach to EMU'. The Bank of England has recently elaborated on the UK alternative in a series of speeches by the Governor and the Deputy Governor. Both the Treasury and the Bank of England have emphasised the UK's commitment to complete Stage 1 (i.e. including sterling participation in the ERM), and suggested what should happen 'beyond Stage 1'.

Beyond Stage 1

3. The Treasury paper sets out (in paragraph 26) three fundamental principles for successful economic and monetary integration. They are: (i) to increase the influence of markets and competition; (ii) to respect the principle of subsidiarity; and (iii) to strengthen the forces tending to bring about stable prices. As the Treasury and the Bank of England have shown, these objectives can be achieved without the need for a new institution at Community level with decision-making power. National authorities can compete, within the framework of the single market and the EMS, with the objective of achieving price stability, while retaining responsibility for making decisions about monetary policy at national level. There is room for debate about whether price stability is more likely to be achieved if, in addition to a government commitment to achieve price stability and popular support, the central bank has statutory responsibility for achieving price stability too. But even if this is more likely, the decision to give the central bank statutory responsibility can be made at national level, and the central bank can remain democratically accountable at national level for carrying out the responsibility with which it has been entrusted. Consequently, in the UK's view, there is no need for an Inter-Governmental Conference or for a revision in the Treaty.

4. It is of course possible that developments in Eastern Europe in general, and the prospect of monetary union in Germany in particular, will help to persuade other Community member countries of the merits of the UK's position. But it seems likely that other member countries will still conclude that a revision in the Treaty is necessary, on the grounds: (i) that, whatever the case may be in the UK, other member countries would be very unlikely all to succeed in achieving price stability through decisions taken independently at national level; (ii) that, even if all members of the Community did succeed in achieving price stability eventually, the result would not conform with the definition of monetary union endorsed by all the participants on the Delors Committee: that is, a common monetary policy agreed at Community level with a common Community currency, or at least irrevocably fixed exchange rates; and (iii) that it is not possible to achieve monetary union on the Delors definition without a revision in the Treaty.

5. While the Treasury alternative meets the UK's objectives, it does not require a revision in the Treaty. By calling an Inter-Governmental Conference to revise the Treaty, the other member countries have indicated that the Treasury alternative does not in their view go far enough towards EMU. The question for them is not whether there should be a revision in the Treaty, but what form it should take. Stage 2 should in their view be the next stage to monetary union rather than 'beyond Stage 1'.

Stage 2

6. Given the UK's decision to participate in the Inter-Governmental Conference, there appear to be three main ways in which the UK can approach the Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might well be counter-productive. The other member countries might proceed to a new Treaty without the UK. The result would be portrayed as a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start. The other member countries can be expected to favour a revision in the Treaty of some sort. Otherwise, there would have been no point in calling an Inter-Governmental Conference in the first place.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives, and which would also carry sufficient support from other member countries that the UK's proposals would be agreed by the Community as a whole in the interests of securing unanimity among its members.

7. It is the third approach that is considered in this paper. The paper attempts to identify an alternative route to monetary union (i.e. from Stage 1 to Stage 3) to the route described in Stage 2 of the Delors Report. In doing so, the paper aims to build on the original Treasury alternative and adapt it to the new circumstances created by the Council's decision, while remaining consistent with the UK's objectives. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in this paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

8. As a result of considering the question of a Community institution with decision-making power, the paper also proposes a way of resolving the fundamental difficulty identified in paragraph 57 of the Delors Report. This lies in the organisation of a gradual transfer of decision-making power from national authorities, which have power to take all the decisions at the beginning of Stage 2, to a Community institution, which has power to take all the decisions at the beginning of Stage 3. The proposal in the Delors Report on economic union, involving the control of budget deficits and an increase in structural and regional transfers at Community level, is not discussed in detail in the paper, on the grounds that the Delors Committee's arguments on these two points have effectively been addressed already in paragraphs 29-31 of the Treasury paper.

OUTLINE OF AN ALTERNATIVE STAGE 2

9. Following the revision in the Treaty, the European System of Central Banks (ESCB) would consist in Stage 2 of the national central banks of member countries and a European Monetary Fund. The ESCB would have a monopoly of money creation in the Community, taking national central banks and the European Monetary Fund together. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. They would continue to compete within the framework of the single market and the EMS, through monetary operations denominated in their respective national currencies, with the objective of achieving price stability. But they would also cooperate to ensure sufficient convergence in their respective monetary policies that: first, exchange rates could either be fixed (though not irrevocably fixed) at the outset, or float initially within very narrow margins and be fixed later; and second, that interest rate differentials between their currencies could be reduced to the minimum.

10. Alongside national central banks, a European Monetary Fund (EMF) would be established. The EMF would be owned jointly by national central banks, which would subscribe its capital, and through which they would cooperate. The EMF would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS, including the ERM, the EMCF, the Committee of Central Bank Governors, the sub-committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent secretariat.

In parallel to the EMF's coordinating role in monetary policy, ECOFIN would coordinate fiscal and macroeconomic policy in the Community, as at present.

11. In Stage 2, individual and business consumers in the Community would have the choice of transacting their business in national currencies or in ECUs. In other words, in addition to competing national monetary policies, there would be competition between national currencies and the ECU. If and when the ECU eventually emerged as the single European currency, the principle of subsidiarity would no longer apply, in the same way as it would not apply under the Treasury proposal for competing national monetary policies, if a national currency (e.g. the Deutsche mark) were to emerge as the single European currency. The main difference would be that, on the European Standard, the UK would have a say in the policy of the EMF. However, a more likely scenario on the European Standard would be that sterling would continue to be used in national transactions for some time, while ECUs were increasingly used in transactions between the UK and the rest of the Community, thereby reducing exchange rate uncertainty and (with the help of improvements in technology) reducing transactions costs.

12. The decision about when and to what extent to move towards monetary union would therefore be determined by the market preference of individual and business consumers in the Community for ECUs in substitution for national currency. That is an important difference between the route to monetary union set out in this paper and the route set out in the Delors Report. In the Delors Report, power to take decisions would be transferred from national level to Community level by administrative fiat before the issue of the ECU as a common currency, whereas under the scheme proposed in this paper, power to take decisions would only be transferred from national level to Community level to the extent of the demand for the ECU as a common currency among individual and business consumers in the Community.

THE EUROPEAN STANDARD

13. In Stage 2, Community monetary policy would operate on a European Standard: that is, the equivalent of a Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would either be fixed (though not irrevocably fixed) at the outset in terms of the ECU, or float initially within very narrow margins and be fixed later. They would be convertible into (and out of) ECUs on demand. The current definition of the ECU would be revised, so as to make the ECU a standard of 'the best' in the Community rather than 'the average'. Once redefined, the ECU would be issued as a dual currency in substitution for the national currencies of member countries on demand. National central banks would each retain separate responsibility for monetary policies denominated in their respective national currencies, and they would collectively take responsibility for the issue of ECUs. In both cases they would cooperate through the Committee of Central Bank Governors in their capacity as the Council of the EMF.

Redefinition of the ECU

14. As currently defined, the ECU does not represent a standard of 'the best' in the Community. It represents 'the average'. The current definition is based on a basket representing fixed weights of Community currencies, whose proportions are revised every five years, and at which point the currencies of new members of the Community are generally included. In the last revision, which took effect on 21 September 1989, the weight of the Deutsche mark in the ECU was reduced: (i) to offset its relative strength against other Community currencies over the previous five years; and (ii) to accommodate two new 'weak' currencies: i.e. the peseta and the escudo.

15. It is inconsistent to promote the use of the ECU, when it is based on 'the average', while following a monetary policy in the Community which is intended to represent 'the best'. If the ECU was to act as a standard of 'the best' in the Community rather than 'the average', the definition would need to be changed:

(i) One option would be to fix the existing currency composition of the ECU for all time, as proposed in the Treasury paper (paragraph 22). In those circumstances, the value of the ECU would strengthen over a period compared with its value if the currency basket were to be revised in the normal way every five years. But the ECU would still represent a variant of 'the average' rather than 'the best'.

(ii) A second option would be to reduce the number of currencies in the ECU basket to (say) the Deutsche mark, the French franc and sterling. An equivalent change has been made in the definition of the SDR (from sixteen currencies to five). But there might be political implications arising from the exclusion of some member countries from the composition of the ECU. And even if the number of currencies were significantly reduced, the ECU would still not represent 'the best' in the Community.

(iii) A third option would be to link the ECU to the Deutsche mark. A link to the Deutsche mark - a sort of European or 'E' mark - would have the advantage of simplicity, and would recognise the fact that the Deutsche mark is currently the most important single currency in the Community. But it might not be an acceptable solution for those member countries whose interest in monetary union is closely linked to the desire for a greater say in Community monetary policy than they currently enjoy in practice within the ERM. In addition, the link with the Deutsche mark would only represent 'the best' so long as the Deutsche mark continued to be the strongest currency within the Community. The onset of German monetary union suggests that this may not always be the case.

(iv) A fourth option would be to link the ECU to gold or some other non-currency indicator. A link to gold would avoid the need to create a new Community institution. But it would carry implications for the international monetary system beyond the Community. Some countries would be opposed to remonetising gold on principle, and in practice it would be difficult to agree on the price at which to fix the link between the ECU and gold. A link to any other non-currency indicator would be untested and would be likely to carry unacceptable risks.

(v) The final option would be for the ECU to be managed independently of national member currencies by Community central bank governors through the EMF, with the objective of setting a standard of 'the best' rather than 'the average'. The central parities of national currencies would be fixed (though not irrevocably fixed) in terms of the ECU, either with no margins or with very narrow margins. But the value of the ECU would no longer be determined by any particular mix of national currencies.

16. For the ECU to become a standard of 'the best' in the Community, its value would need to be as strong in terms of third currencies (e.g. the dollar) as the strongest national Community currency. This would mean that the central parities of Community member countries' national currencies could never be revalued in terms of the ECU, though they could be devalued. If a member country revalued the central parity of its national currency against other member countries' national currencies, the ECU would be revalued with it. So agreement would be needed prior to realignments in the central parities of member countries, as it is now. Unlike now, agreement would be needed with the EMF.

17. The (redefined) ECU would be 'the best' in the sense that its exchange rate would always be the strongest within the Community, with two qualifications. First, so long as member countries' exchange rates continued to fluctuate within very narrow margins of their central parities against the ECU, then the ECU could depreciate as well as appreciate against member countries' national currencies, though only within the narrow margins. Once exchange rates between member countries' national currencies were fixed, the ECU could never depreciate in terms of the currency of any member country. Second, the overall return on ECUs in comparison with the overall return on the national currencies of member countries would depend on interest differentials between them as well as exchange changes. So the overall return on ECUs over a period would not necessarily be higher than the return on member countries' national currencies, any more than the return on Deutsche marks at present is necessarily higher than the return on lire expressed in Deutsche marks.

18. If the ECU was going to be redefined from a basket of currencies representing 'the average' in the Community to an independently managed currency based on 'the best' in the Community, then it would be easier to implement the change in definition if exchange rates between member currencies were fixed (though not irrevocably fixed) first. The change in definition would also be easier to implement if a realignment in parities was not considered by the market to be in prospect in the short term. But there is no reason in principle why the change in definition could not be introduced, even if exchange rates were still floating within very narrow margins at the point of change.

19. There would have to be continuity between the external value of the new definition of the ECU and the old definition at the point of change. This would be necessary to reassure practitioners in the ECU market with contracts written in ECUs that were due to mature after the change in definition. There has been continuity at the point of change in the case of previous revisions in the definition of the ECU. The difference on this occasion would be that, after the change in definition, the ECU exchange rate and ECU interest rates

would not be determined by a new mix of component currencies. ECU interest rates would be set instead by Community central bank governors through the EMF, and the external value of the ECU exchange rate would be enforced by changes in interest rates and exchange intervention in ECUs against third currencies (e.g. the dollar). In setting ECU rates, the Council of the EMF would be guided by the objective of achieving price stability over a period of time. Making the ECU a standard of 'the best' in the Community would help to achieve this.

20. An additional option would be to redenominate the ECU when it was redefined by making one new (heavy) ECU equal to 10, 100 or 1000 old ECUs. Contracts written in old ECUs that matured after redenomination would be paid off in the appropriate number of new ECUs. Redenomination would help consumers to distinguish between the ECU and their national currencies, and enable a dual relationship to develop in each country between the ECU and national currency roughly equivalent to the relationship between pounds and pence. The use of a heavy ECU could also act as a psychological 'anchor' at Community level against inflation.

The ECU as a dual currency on the European Standard

21. Once the ECU had been redefined, it would be issued by the EMF in Stage 2 as a dual currency in substitution for the national currencies of member countries on demand. This would enable national currencies to be converted into ECUs on the European Standard, in the same way as national currencies could be converted into gold on the Gold Standard. The process of substitution would be similar to the process of substitution outlined in the Delors Report. The differences relate to the circumstances in which substitution could take place, and who would decide.

22. In the Delors plan, the ECU would be issued by the ESCB as a dual currency in substitution for national currencies once exchange rates were irrevocably fixed. The term 'dual currency' is used here - rather than 'parallel currency' - in the sense in which it is used by the Bundesbank in the collection of papers submitted to the Delors Committee (page 141). Under the alternative scheme presented in this paper, the ECU would be issued as a dual currency in the same way as proposed in the Delors plan, but there would be three differences from the Delors plan in the circumstances in which the substitution of ECUs for the national currencies of member countries would take place. First, exchange rates would not have to be fixed irrevocably. In fact, they might not even be fixed at all: they might still be floating within very narrow margins in the ERM, and there would be an objective of fixing them after a period of time. Second, the substitution of the ECU for national currencies would not take place on the basis of a bureaucratic decision at Community level. It would take place on the basis of market choices by individual and business consumers. Third, the decision would not be irreversible, as it would be in the Delors plan. Consumers could change their preference and convert back into national currency if they wished to do so.

23. There are two criticisms of the issue of the ECU as a parallel currency in the Delors Report (paragraph 47). One is that the issue of ECUs as a parallel currency would be inflationary. This would, of course, be true if ECUs were issued as a parallel currency in addition to national currencies rather than in place of them. But under the proposal set out in this paper, the issue of ECUs by the EMF would not be inflationary, as ECUs would only be issued in substitution for national currency. Second, the issue of ECUs would be accompanied by national monetary policies which would bear down on inflation. Third, ECUs already exist in the private market as a parallel currency. The creation of the EMF to control monetary policy for the ECU could ultimately become an additional means of bearing down on inflation by providing a mechanism for controlling the supply of ECUs, in exactly the same way as national central banks control the supply of national currencies.

24. The second criticism of the issue of the ECU as a parallel currency in the Delors Report is that the issue of a thirteenth currency would complicate the task of coordinating national monetary policies. This would not be the case under the alternative scheme set out in this paper. First, the relationship between the EMF's responsibility for the ECU and member central banks' responsibility for national currencies would be similar to the relationship between the Commission's responsibility for some categories of public expenditure and national governments' responsibility for others. Second, whatever configuration of ECUs and national currencies emerged, it would be quite clear at any particular point in time who had responsibility for taking monetary decisions in every case. Third, the task of coordinating national monetary policies would be easier for member countries to accept if it did not also involve transferring control of them irrevocably from national level to Community level first. As a result, the arrangements proposed in this paper should be less difficult to implement than the route to monetary union proposed in the Delors Report. The Guigou Committee has indicated the wide range of questions that would need to be settled in preparation for or by an Inter-Governmental Conference, if the Delors plan were to be implemented.

25. A separate criticism of a fixed exchange rate regime short of a single currency is that it is vulnerable to speculative attacks. This would of course apply to Stage 2 of the Delors Report as well as to the alternative Stage 2 presented in this paper. In the event of speculative attacks, national authorities on the European Standard would retain the option to change short term interest rates denominated in national currency, or in the last resort to devalue their exchange parity in terms of the ECU. But assuming that they decided not to do so, the response to a speculative attack from within the Community would be for national central banks to intervene in ECUs in unlimited amounts against their national currencies (or vice versa). There would be no need for sterilisation, as there would be no net monetary effect within the Community. If the speculative attack came from outside the Community, the EMF would intervene against the dollar (or the yen) in ECUs, and/or national central banks would intervene in national currency, and the net monetary effects of the intervention on the Community would be sterilised, where appropriate.

Monetary control on the European Standard

26. Monetary control within the Community during Stage 2 would be exercised at national level and Community level. National authorities would cooperate within the EMF in exercising control in national currency, and would act collectively through the EMF in exercising control in ECUs. The instruments for the exercise of monetary control in ECUs would be similar to the instruments for monetary control in national currency: the ability to influence ECU interest rates through open market operations in ECUs; and the ability to influence the ECU exchange rate by intervention in the exchange market. The EMF's operations in government securities would be confined to monetary management.

27. The monetary aggregates over which control would be exercised would include national currency, other Community currencies and ECUs, because it would no longer be appropriate to assume that residents of a particular member country would hold liquid assets denominated only in national currency. Notes and coin would be measured at national level, if ECU notes were not issued. If ECU notes were issued, then notes and coin would be measured at Community level by aggregating the sum of notes and coin in issue in national currencies and ECUs. Wider definitions of liquid assets would be measured at national level (and aggregated at Community level) by adding residents' holdings of liquid assets denominated in national currency, the national currencies of other Community countries and ECUs. These definitions would be identical to

the definitions that would be needed under the Treasury proposal for competing national monetary policies, with the exception of the inclusion of the ECU (in substitution for national currency). The problems of exercising monetary control within the Community would be no more difficult than they are at present, given the complete freedom of capital movements within the Community.

28. There is a question about whether the EMF would need the power in Stage 2 to exercise monetary sanctions against 'profligate' national authorities, and if so what the sanctions would be. In one sense, sanctions by the EMF would not be necessary. A member country which followed an inflationary policy would run the risk, either: (i) that residents would sell national currency for ECUs, with the effect that the national authorities concerned would lose control of national monetary policy to the EMF; or (ii) that interest rates would have to be raised to prevent this from happening, with the effect that national monetary conditions would be tightened; or (iii) that the member country was forced to devalue its exchange rate against the ECU to maintain the competitiveness of the local economy in the EC single market.

29. However, if it was generally agreed that sanctions were necessary in Stage 2 to reinforce efforts at Community level to secure price stability, some indicators of whether sanctions were required would be more useful than others. It might not be practicable to set similar monetary targets for all member countries, for the reasons set out in the Governor's speech of 16 January. Control over the size of member countries' budget deficits would not be effective, for the reasons set out in the Treasury paper (paragraph 29). Instead, the objective might be to prevent the monetary financing of budget deficits rather than controlling their overall level, and to agree that the Community would not bail out governments which run excessive budget deficits, as suggested in the Treasury paper (paragraph 24). National authorities would not in those circumstances be able to create more national currency to replace national currency that had been exchanged for ECUs.

30. One way in which the EMF might enforce sanctions would be by suspending (or threatening to suspend) the convertibility of the national currency of the member country concerned into ECUs. The procedure might work as follows. If a member country was in breach of its obligations, the EMF would bring it to the attention of ECOFIN. A decision would be taken by ECOFIN to invite the member country concerned to take corrective action. If corrective action was not taken within a given timescale, the EMF would have the power to suspend the convertibility of the member country's national currency into ECUs.

OPERATIONS OF THE EUROPEAN MONETARY FUND

31. The operations of the EMF in ECUs can be divided into three main categories:

(i) the issue of ECU notes and coin;

(ii) open market operations in ECUs; and

(iii) exchange intervention between ECUs and national Community currencies, and between ECUs and third currencies (e.g. dollars).

In each case, the objective would be that any exchange risk arising from the EMF's operations in ECUs would be borne by each member country in relation to the extent to which its currency was converted into ECUs, rather than by all member countries in proportion to their central banks' shareholdings in the EMF.

ECU notes and coin

32. It is not essential to the scheme that the EMF should issue ECU notes (and coin) on demand. It could be argued that the ECU would mainly be used for large-scale business transactions within the Community, and that notes would not be necessary, at least until later in Stage 2. If the EMF did not issue bank notes on demand, the European Standard would correspond to the Gold Bullion Standard, under which sterling was convertible into gold bullion on demand, but not into gold coins. However, as the ECU increased in importance, it is likely that there would be demand for ECU bank notes, from individuals and for small-scale business transactions, and there is no reason why this demand could not be met by the EMF in a way that was consistent with the principle of substitution. Legal restrictions on the issue of notes, which vary from country to country within the Community, would need to be removed first. There might also be advantages in making the ECU legal tender alongside the national currency in each member country, subject to a unanimous vote by ECOFIN first.

33. Payment for ECU notes would either be made in ECUs or in national currency (e.g. sterling). If payment was made in sterling, the proceeds could be handled in two main ways. One way would be for the issue of ECU notes to be backed by the sterling notes withdrawn from circulation in exchange for them. This would enable the exchange risk arising from the transactions and the profits from seignorage to be kept at national level. The other way would be to invest the proceeds in sterling gilt-edged. The effect would be to reduce the liabilities of the Issue Department of the Bank of England and increase the liabilities of the EMF, and to reduce the Bank of England's holdings of sterling gilt-edged and to increase the holdings of the EMF.

Exchange of £ notes for ECU notes

Bank of England

Liabilities	ECUm	Assets	ECUm
£ notes in issue	-100	£ gilt-edged	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU notes in issue	+100	£ gilt-edged	+100

34. The issue by the EMF of ECU bank notes and the investment of the proceeds in assets denominated in national currency would give rise to an exchange risk. This would be borne by the central bank whose currency had been substituted for ECUs, as happens at present in the case of purchases of foreign exchange by member countries from the IMF. The exchange cover could be provided by means of an exchange guarantee, or by denominating government securities purchased by the EMF in ECUs. If so, it would have the effect of giving an added incentive to member countries not to devalue their exchange rates. The profits earned by the EMF from seignorage (and from its other operations) would be distributable to shareholders.

Open market operations

35. In Stage 2, the EMF would act as lender of last resort to the ECU banking system. Left to itself, the market would set a level for ECU interest rates based on its assessment of the ECU's revised definition as equal to the central parity of the strongest currency in the Community rather than a weighted basket. While it might take time for the market to adjust to the revised definition, the ECU as redefined should be attractive both to investors as a strong currency and to borrowers as a result of low ECU interest rates. The EMF would be able to determine the level of ECU interest rates by open market operations in ECUs with the objective of reinforcing the Community's policy of bearing down on inflation. By determining ECU interest rates, the EMF would not initially determine Community monetary policy, because each national authority would make its own decision about interest rates in national currencies. But interest rates on ECUs would influence national monetary policy, because of the threat that, if national monetary policy was not sufficiently tight, residents could switch their liquid assets denominated in national currency ECUs. The degree of control by the EMF over national monetary policy would increase, once a critical mass of ECUs were in circulation in substitution for national currency.

Exchange intervention

36. Exchange intervention in Stage 2 can be divided into two categories:

(i) exchange intervention between members of the ESCB in Community currencies; and

(ii) exchange intervention between the currencies of members of the ESCB and the currencies of third countries (e.g. dollars).

37. Within the EMS, the parity grid consisting of bilateral exchange intervention points would be replaced by intervention margins for each currency in terms of the ECU. At sterling's lower intervention margin, the Bank of England would be obliged to buy the sterling offered by the market in exchange for ECUs. The Bank of England would finance the purchase of sterling by borrowing ECUs from the EMF. The ECU loan by the EMF would be financed by borrowing from the Bank of England the sterling offered by the market. The residual claims of the Bank of England and the EMF on each other would cancel out. At sterling's upper intervention margin, the mechanism would work the other way round. In either case, there would be no net monetary effect. The creation of ECUs by the EMF would be offset by the withdrawal of an equivalent amount of sterling by the Bank of England (or vice versa). An increase in the market's holdings of liquid assets denominated in ECUs would be offset by a reduction in the market's holdings of liquid assets denominated in sterling (or vice versa). The mechanism would be symmetrical, simultaneous and unlimited as to amount.

(i) Purchases of £ from the market
at £'s lower intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
ECU liability to EMF	+100	£ claim on EMF	+100
Repayment of ECU liability	-100	Use of £ claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
£ liability to Bank	+100	ECU claim on Bank	+100
Repayment of £ liability	-100	Use of ECU claim	-100

(ii) Sales of £ to the market
at £'s upper intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
£ liability to EMF	+100	ECU claim on EMF	+100
Repayment of £ liability	-100	Use of ECU claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU liability to Bank	+100	£ claim on Bank	+100
Repayment of ECU liability	-100	Use of £ claim	-100

38. Outside the EMS, national central banks would continue to intervene in their national currencies against third currencies (e.g. dollars), as at present. But the EMF would become responsible for intervention between the ECU and third currencies (e.g. dollars). If the EMF purchased dollars against ECUs, it would pay for the ECUs that it sold in exchange by issuing ECU securities. Conversely, if the EMF sold dollars against ECUs, it would use the proceeds to redeem ECU securities. As in the case of the EEA, the monetary effects of the EMF's exchange operations in dollars would depend on whether the ECU securities issued (or redeemed) by the EMF were purchased (or sold) by the banking system or by the non-bank private or overseas sectors. If the securities were purchased (or sold) by the non-bank private or overseas sectors, the monetary effect on the Community of the EMF's dollar operations would be sterilised.

39. A separate question that needs to be addressed is who would be responsible for issuing the ECU securities. While in principle the securities could be issued at Community level, in practice the rules of subsidiarity could apply. In that case, the EMF would pay for its net purchases of foreign exchange by increasing its net liabilities in ECUs to national authorities (pro rata). National authorities would then have the task of deciding whether, and if so how, to sterilise the monetary effects, within any guidelines agreed at a Community level. These would need to take account of the Bundesbank's policy of not sterilising the monetary effects of exchange intervention. To the extent that the monetary effects of exchange intervention were to be sterilised, this could be achieved by issuing securities to the non-bank private sector in local currency or in ECUs. The net sale of securities at national level would not be additional, because exchange intervention by the EMF in ECUs would substitute for exchange intervention that would otherwise have taken place in the national currency of member countries at national level.

(i) EMF purchases of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Sale of ECU securities to central banks	+100	Purchase of $ claims	+100

National central banks

Liabilities	ECUm	Assets	ECUm
Increase in money supply	+100	Purchase of ECU securities from EMF	+100
Reduction in money supply	-100	Sale of ECU securities to non-banks	-100

(ii) EMF sales of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Purchase of ECU securities from central banks	-100	Sale of $ claims	-100

National central banks

Liabilities	ECUm	Assets	ECUm
Reduction in money supply	-100	Sale of ECU securities to EMF	-100
Increase in money supply	+100	Purchase of ECU securities from non-banks	+100

40. In order to enable it to intervene in third currencies, the EMF would take over the assets and liabilities managed by the EMCF. The assets taken over would consist of dollars (and gold), representing 20% of the dollar (and gold) reserves of member countries. The liabilities would consist of the claims of national authorities in ECUs on the EMF, representing the counterpart to the EMF's holdings of dollars (and gold). There would be no monetary effects from the transfer. One option would be for the EMF to take over direct ownership of the proportion of dollar (and gold) reserves allocated to it. Alternatively, national authorities might decide to retain direct ownership of all their dollar (and gold) reserves. In that case, the EMF would manage as agent the initial proportion (say 20% of the total) allocated to it, in the same way as the Bank of England acts as manager of the EEA on behalf of the Treasury. The statutes of the EMF might need to provide for the circumstances in which a greater proportion of national authorities' foreign reserves would be put at the disposal of the EMF, subject to a unanimous vote by ECOFIN first. But in practice, an additional transfer of reserves should not be necessary for the foreseeable future, because the EMF would be able to use interest differentials to defend the external value of the ECU, as well as being able to use its foreign reserves in exchange intervention.

ORGANISATION OF THE EUROPEAN MONETARY FUND

41. The new institution established in Stage 2 would take the form of a European Monetary Fund rather than a European Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. (An EMF of a slightly different kind was envisaged as the next stage to monetary union in 1978, when it was originally agreed that the EMS should be established.) The EMF would have some similarities with the IMF in terms of its institutional form, though its role would differ: the primary role of the EMF would be to set a European monetary standard, not to act as a regional IMF providing short term balance of payments support. The EMF would be complementary to the EIB, in broadly the same way as the IMF is complementary to the World Bank.

Need for a Community institution

42. The question arises why an EMF would be needed in Stage 2 to take responsibility for the development of the ECU as a common currency, and why this could not be left to the private market. Of course, the private market can already substitute ECUs for national currency on demand. But there are drawbacks:

(i) The ECU cannot compete on a level playing field with the national currencies of Community countries while it is manufactured in the market rather than being issued with official backing as legal tender, as national currencies are.

(ii) To the extent that the circulation of the ECU does increase in substitution for national currency under the existing ECU definition, this is not necessarily desirable because the current definition represents 'the average' in the Community rather than 'the best'.

(iii) Although a link between the ECU and gold or the Deutsche mark would eliminate the need for a new institution, in the case of gold because no institution would be needed and in the case of the Deutsche mark because the Bundesbank would take overall responsibility at Community level, neither link would necessarily represent 'the best' in the Community, and both would have other disadvantages.

(iv) It would not be feasible to make the ECU a standard of 'the best' in the Community in Stage 2 while linking it permanently with any single Community currency or group of currencies. Consequently, the ECU would need to be independently managed at Community level.

(v) Although the implementation of ECU operations could be delegated to national central banks, a central institution would still be needed with powers to formulate a single monetary policy for the ECU, in the same way as a single monetary policy is formulated for each national currency at the moment.

43. So when Stage 2 began, following the revision in the Treaty, the EMF would be established as a Community institution with decision-making power over the ECU. Whether the EMF that was established would represent a new institution would be more problematic. In one sense, it would not be new, because it would take over the functions of the EMCF. In another sense, the institution would be a new one, because a revision in the Treaty would be required before it could be established.

The constitution of the European Monetary Fund

44. The EMF would be owned by national central banks rather than their governments. The constitutional arrangements relating to the statutory responsibility and accountability of national central banks currently vary from country to country. Insofar as monetary operations denominated in national currency are concerned, the existing constitutional arrangements would not change in Stage 2 in any way unless a particular country wished to change them (e.g. by giving the central bank statutory responsibility to achieve price stability while remaining democratically accountable at national level), in which case it would continue to be free to do so. Insofar as monetary operations denominated in ECUs are concerned, decisions would be taken at Community level through the EMF rather than at national level.

45. The constitution of the EMF would need to be discussed at the Inter-Governmental Conference. It might take the following form:

(i) The capital of the EMF would either be subscribed by national central banks in the same proportions as the EIB, or some other measure of economic and currency significance, such as the respective weights in the definition of the ECU basket at the time of the last revision.

EIB weighted voting and ECU basket weights

	EIB	ECU
Belgium	5	6
Denmark	3	2
Germany	10	23
Greece	5	1
Spain	8	4
France	10	14
Ireland	3	1
Italy	10	8
Luxembourg	2	...
Netherlands	5	7
Portugal	5	1
United Kingdom	10	10
	76	76

(ii) The Council of the EMF would consist of the governors of the national central banks of member countries and EMF Board members. The appointment of national governors to the Council of the EMF would run concurrently with their appointments at national level, and the relationship between national governors and their respective governments would reflect the constitutional arrangements in place in each case. EMF Board members would be appointed by ECOFIN. Their appointments would run for a fixed and long period of time (e.g. eight years). They could not be removed in normal circumstances.

(iii) Voting procedures would need to be discussed at the Inter-Governmental Conference. Decisions by the EMF might in some cases require unanimity, and in other cases might be made on the basis of qualified majority voting.

(iv) The Council of the EMF would have as its prime objective the achievement of price stability within the Community. Subject to this overriding objective, it would have an obligation to support the general economic policy set at Community level by the competent bodies.

(v) The Council of the EMF would be democratically accountable for achieving these objectives in four principal ways. First, the EMF would be established following a revision in the Treaty approved by national parliaments. Second, appointments to the Council of the EMF would be made by national governments and by ECOFIN. Third, the President of the EMF Council would be required to report on the EMF's policy from time to time to ECOFIN and the European Parliament. Fourth, although the EMF Council could not be dismissed en bloc, either by ECOFIN or by the European Parliament, the influence of the EMF would effectively be determined by the extent to which citizens within the Community chose to use ECUs in preference to their national currencies.

(vi) The Chairman of ECOFIN and the President of the Commission might be invited to participate in the proceedings of the EMF Council without a vote, and the President of the EMF Council might be invited to attend meetings of ECOFIN on a similar basis.

Expansion in membership

46. New members could be admitted to the EMF, which would be based on cooperation among its members, with less difficulty than to a European Central Bank, which would be based on central control. One option would be to confine membership to Community member countries. Another option would be to widen it, either at the outset or at a later stage, in anticipation of the expansion of Community membership (e.g. to include member countries from EFTA, and eventually from Eastern Europe). It is worth noting that membership of the BIS does not at present coincide precisely with membership of the Community, and includes Switzerland and Sweden.

Location and infrastructure

47. The policy arm of the EMF would be based, either at the BIS in Basle, or in a Community capital. The operations of the EMF would be carried out by the national central banks of member countries on the EMF's behalf, and by the ECU operating arm of the EMF. National central banks would continue to have responsibility for monetary policy denominated in their respective national currencies, including exchange intervention between national currencies and third currencies (e.g. dollars), and would undertake the exchange of national currencies into ECUs on demand on behalf of the EMF. The ECU operating arm of the EMF would be responsible for implementing decisions taken by the EMF relating to open market operations in ECUs and exchange intervention between ECUs and third currencies (e.g. dollars).

48. The UK would be able to put a strong case for locating the chief ECU operating arm of the EMF at the Bank of England in London. First, London is Europe's most important financial centre, as the survey in the November 1989 issue of the Bank of England Quarterly Bulletin shows. Second, the Bank of England has taken the initiative in promoting the use of the ECU (e.g. through the regular issue of ECU Treasury bills). Third, London would be in the best position to put in place the financial infrastructure necessary to support, at minimum cost, the full range of financial transactions in ECUs: payment and clearing arrangements, and settlement arrangements for banking and securities operations. To the extent that ECU systems are currently based elsewhere, the UK could take the initiative in coordinating them.

49. It is sometimes argued that there is no particular importance to be attached to the decision about whether the chief operating arm is located in London. The argument runs that London has developed as an international financial centre by carrying out financial transactions more cost-effectively than they are carried out in the host country of the currency concerned. One of the reasons for this is that London has advantages over competing financial centres in terms of language, skills and critical mass. But another reason is that London has been subject to a lighter level of regulation and control than most potential alternative centres.

50. This advantage is likely to be removed by the advent of the single financial market within the Community. In these circumstances, if the chief operating arm was based in another financial centre (e.g. Frankfurt, Paris or Luxembourg), the principal money, government debt and foreign exchange markets within the Community would be likely over a period of time to develop there, along with the clearing and settlement systems needed to support them. It would be advantageous for large financial institutions within the Community to build up a significant presence in the market where the chief operating arm was based, and the same considerations would apply to US and Japanese financial institutions requiring a European base. Of course, London would remain a financial centre, but its pre-eminent position in Europe would in due course be lost, and its relative position would over a period be likely to decline.

THE TIMING AND DURATION OF STAGE 2

51. One difference between the scheme set out in this paper and the scheme set out in the Delors Report is that Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3, which is the way in which Stage 2 is described in the Delors Report. As Stage 2 would become a significant step, it could take longer to prepare than it would take to prepare Stage 2 on the Delors model. The main questions that would need to be resolved first would be how stable exchange rates between members would need to be, how convergent their monetary policies would need to be, and how nearly price stability would need to be achieved in each member country, before the EMF began to issue ECUs in substitution for national currency. A measure of when the conditions would be right to begin Stage 2 would be when member countries were ready for the EMF to begin issuing ECUs as a dual currency on the European Standard. Until that point, cooperation between central banks within the Community could continue and intensify through existing informal arrangements during and 'beyond' Stage 1. But there would be no need for a new Community institution as such, or a revision in the Treaty.

52. Once Stage 2 had been introduced, progress towards Stage 3 would be determined by the time that it would take for the ECU to gain acceptance as a popular currency, and by the success of the EMF in fostering the ECU's acceptance within the Community. Unlike the Gold Standard, where the supply of gold was limited, it would be feasible on the European Standard to evolve from the use of the ECU as a standard to its use as the single Community currency, once a critical mass of ECUs was achieved. In this respect, the scheme goes further than the Delors Report, by proposing a way of resolving the problem identified in paragraph 57 of the Delors Report. Power would transfer from national level to Community level, but only to the extent that individual and business consumers within the Community decided to use ECUs rather than national currency.

53. An Inter-Governmental Conference would be needed under the proposal set out in this paper to prepare the way for a revision in the Treaty, but the path to monetary union that the Conference would consider would be different from the path set out in the Delors Report. The issues that would need to be considered in preparing the Conference, or by the Committee of Central Bank Governors outside it, would include: (i) membership of the EMF; (ii) its statutes; and (iii) the redefinition of the ECU. The revision in the Treaty resulting from the Conference would be roughly equivalent to Stage 2 of the Delors Report, though provision could be made in the Treaty for the circumstances and conditions in which the Community would move to Stage 3. One condition might be that the ECU should become the single (rather than a dual) currency when it represented more than a specified proportion (e.g. 80%) of liquid assets in each member country. But account would also need to be taken of the option available to holders of liquid assets denominated in ECUs to convert them back into national currency if they wished to do so.

54. It now looks as though the revision in the Treaty relating to monetary union in the Community will be preceded by monetary union in Germany. The question will no doubt arise whether German monetary union should be used as a model for the Community as a whole. German monetary union is similar to monetary union in the Community in the sense that monetary union is likely to precede political union. But the differences outweigh the similarities. The main differences are, first, that German monetary union represents the union of a single divided nation. The Community by contrast, is a group of sovereign nation states which has never been unified. Second, the Ostmark is not a convertible currency, leaving a potential overhang of unspent savings in East Germany. This is not the case in the Community, where all member currencies are fully convertible. Third, one of the main reasons why German monetary union is being proposed now is that the East German economy is near a state of collapse.

Not yet

CONCLUSION

55. In the event that a decision was taken at the Inter-Governmental Conference to revise the Treaty, a revision in the Treaty along the lines proposed in this paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) The principle of subsidiarity would be preserved. National central banks would remain directly accountable at national level under the constitutional arrangements in place in each country, and the EMF would act as a forum for the coordination of national monetary policies by means of cooperation rather than control.

(ii) The prospects for price stability would be enhanced. The European Standard would be based on 'the best' in the Community rather than 'the average'.

(iii) Competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added, with the market determining progress towards the common currency. In addition:

(iv) The EMF would be open-ended, so as to be able to accommodate new members (e.g. from EFTA and eventually from Eastern Europe) without disrupting the system.

(v) There would be a strong case for basing the ECU operating arm of the EMF in London.

56. Stage 2 would become a significant set of monetary arrangements in its own right, and not simply a process of transition to Stage 3. Once Stage 2 was introduced, individual and business consumers within the Community would decide when and to what extent to move towards monetary union. This would resolve the fundamental difficulty identified in the Delors Report relating to the circumstances in which decisions about monetary policy should be transferred from national level to Community level.

OPR
28 March 1990

Paper by the Chairman considered at the European Committee of the B.I.E.C. on 27th March, 1990

Stage 2 of Economic and Monetary Union

1. The attached paper, approved by the BIEC's European Committee on 27th March as a contribution to the discussion and for consideration by H.M.G. contains a proposal for Stage 2 of EMU.

2. 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. On the other hand, while the Treasury paper of 2nd November, 1989 contained interesting ideas for Stage 2, it has not had much impact on the debate because:-

(a) 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);

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

3. The BIEC's European Committee believes that a well-thought-out proposal for Stage 2 would make a valuable contribution, fill a real gap and - 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) - get the U.K. back into the centre of the discussion.

4. The proposal made here 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)

(b) in replacement of the present EMCF and Central Bank Governors' 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: the E.R.M. continues to operate, under the aegis of the EMF, (sterling having been included in Stage 1 in accordance with the Madrid conclusions) either with the present bands or possibly with fixed, but not irrevocably fixed, exchange rates;

(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;

(d) national currencies would be convertible into ecus (and vice versa) through the EMF, which would manage the ecu as a European standard with the objective of achieving price stability, and would act as lender of last resort in ecus;

(e) these arrangements should not lead to uncontrolled money creation since Central Banks would be under an obligation not to create national currency to replace that exchanged for ecus;

/(f)

(f) 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 into ecus of the currency concerned;

(g) the ecu would thus become a dual European currency alongside each national currency, and be 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 Council, thus involving some extra sharing of sovereignty, but the EMF's charter would lay down in inescapable terms its duty to manage the 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 argue 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.

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 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.