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Prime Minister

Some belated advice for your meeting with Sir Richard Butler tomorrow.

Paras. 8-11 of the accompanying note spell out objections to his version of a European Monetary Fund.

CDP 19/4

Treasury Chambers, Parliament Street, SW1P 3AG
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19 April 1990

Charles Powell Esq
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Prime Minister
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Dear Charles,

SIR MICHAEL BUTLER'S PAPER ON EMU

I understand that, following her letter of 11 April, Sir M Butler is coming to see the Prime Minister tomorrow about the paper by Mr Paul Richards which he sent her on 28 March, with the blessing of his BIEC (Europe) Committee.

As you know, the Treasury's view is that the approach set out in paragraphs 2.34-2.42 of Nigel Wicks' Interdepartmental Group's report is preferable to the Richards approach, though they have some similarities, and the Richards proposals are certainly worth considering further.

... I attach a critique of the Richards proposals, prepared by officials here, which points up some of the technical difficulties which would need to be addressed, which the Prime Minister may find interesting. It also argues that although many of the conclusions of the Richards paper are similar it goes further towards setting up a fully fledged central bank - albeit fettered - than the more neutral proposal for a Currency Board in the interdepartmental Report.

The paper goes on to suggest that the Germans might have some difficulty with an EMF along the lines proposed by the Richards paper. While it is true that the Germans will see difficulties with the proposal for a parallel currency, there are other aspects - eg the "strong ecu" - which they could find attractive.

Sir Michael Butler may well not want to get involved in discussion of the details. It is more likely that he will want to discuss the politics of the situation, and the need to be seen to take a constructive part in Community discussions. We suggest the Prime Minister takes the following line in discussion :

(i) Thank Sir Michael Butler and Mr Richards for their constructive and imaginative contribution to the debate. This is well worth considering further, and it will be interesting to see what our Community partners make of it.

(ii) Explain our reasons for believing that the approach must be an evolutionary one.

(iii) Acknowledge that more thought will be needed on the practical meaning of an evolutionary approach beyond Stage one, and what institutional developments might be compatible with it.

(iv) Recognise that the Richards approach has some attractions compared with the Delors proposals, though clearly there are technical difficulties which would need to be addressed.

(v) Point out that the Germans may not be attracted to some aspects of the idea.

(vi) Encourage Sir Michael and his group to continue to think about these issues.

Tancred Tarkowski

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Private Secretary

The next stage in an evolutionary approach to Monetary Union

The main author of this paper is Mr Paul Richards of Samuel Montagu. It has been adopted by Sir Michael Butler's BIEC (Europe) Committee. We understand that there has been some confusion in Brussels about its status. At his recent presentation on EMU to the Central Bank Governors' Committee, Delors referred to it as a "second" British paper, with some interesting ideas.

Summary of the Main Points

2. The paper is based on the assumption that the UK aim should be for a revision to the Treaty allowing Stage 2 to commence but one consistent with the UK objectives of competition, subsidiarity and price stability. Going as far as that, the paper argues, implies setting up a Community institution with decision-taking powers of some kind. So the question is what institutional structure would best achieve the UK objectives. Its answer is along the following lines:

(a) the Stage 2 European System of Central Banks would consist of existing national central banks and a new European Monetary Fund (EMF). The former would administer existing national currencies straightforwardly;

(b) the EMF would take responsibility for a completely redefined ecu, which would become an entirely separate "dual" European currency. It would also take over the administration of the EMS and would provide a permanent secretariat to service the ERM, the European Monetary Co-operation Fund, the Committee of Central Bank Governors and its various sub-committees, and so on;

(c) although the EMF would be the monetary authority for a quite separate currency, its actions would be fettered. In particular: (i) it could only issue its ecu money in exchange for European national currencies at the going exchange rate so that there would be no addition to total European money to cause extra inflationary pressure; (ii) the EMF would be bound to ensure that its ecu was at least as strong as any other European national currency. In practice, that would mean it could revalue against other Community currencies but that it could never be devalued against any other European currency. In this sense, the newly-defined ecu would set "the standard for the best" rather than being a measure of the average European currency, as at present. Richards hopes this would meet the usual German objection to parallel currencies;

(d) the EMF would have to conduct the normal range of central banking functions to implement what was required of it: setting interest rates, conducting open-market operations, engaging in intervention;

(e) there would be no compulsion to use the ecu. Individuals and companies would be free to choose national currencies or the ecu as they saw fit. The element of currency competition in the original UK paper would therefore be maintained;

(f) it would be for separate decision whether to proceed to Stage 3 later on. But in the light of experience of Stage 2, Community members might decide not to progress to this later Stage at all.

Appraisal

3. The paper represents a well thought out and coherent set of proposals. At the least, they provide a further illustration of our point that there are a number of possible approaches to monetary union and that Delors is not the only way open. There are some similarities with the proposals for Stage 2 in the recent

report of the Interdepartmental Group, but also a crucial difference.

4. Like the Richards paper, the Interdepartmental Group Report argues that there may be a case for supporting interim institutional developments in Stage 2. It illustrates the possible functioning of a new institution with the working title of a European Monetary Fund (confusingly, as it happens, the same title that Richards calls his new institution). The functions of the Interdepartmental Group Report EMF would be :

i) to run a range of administrative functions currently performed by the Commission and others - managing the ERM amongst them;

ii) to co-ordinate intervention against third currencies (without pooling of Reserves);

iii) creating and running a Currency Board to issue ecu bank notes for general circulation.

5. Neither of these first two functions are greatly in tension with Richards' proposals. The Interdepartmental Group Report EMF would have a slightly wider range of administrative functions than Richards suggests. In particular, it would manage and monitor Community financing decisions, including recommending conditions for Community loans to member states (a function largely carried out by the Commission at present). Moreover, Richards' EMF would be restricted to conducting intervention in the newly-defined ecu rather than co-ordination national intervention against third currencies. But extending the role of the EMF in both of these directions would not change fundamentally the nature of Richards' proposal.

6. The key difference is in the monetary policy competence of the two versions of the EMF. Both proposals take as given that a full-blown parallel currency - a new ecu managed by an independent ecu central bank - is probably undesirable and certainly unacceptable to most Community members. The Interdepartmental

Group Report proposal limits the new institution only to currency board activities for just this reason. It could issue ecu notes but only ones fully backed by EMF holdings of the composite national currencies which make up the ecu. That would allow an ecu note circulation to come into being but in a way guaranteed to be monetarily neutral.

7. The Richards proposal would not incorporate this direct monetary neutrality. His EMF would have freedom to manage its currency, subject to the requirement that its currency had to be at least as strong as the strongest Community currency.

8. In this respect, it is therefore misleading to suggest that the Richards proposals represent an evolutionary approach to monetary union. In one step, the foreign exchange markets would be presented with an entirely new currency embodying the unique property of never depreciating (at least against other European currencies): only appreciating. Although Richards may be right to see only gradual movement away from national currencies to the new currency for transactions purposes, speculative movements in funds would be most unlikely to be gradual. There would probably be enormous swings into and out of the national currencies as investors weighed up the interest rate differentials together with the new currency's guaranteed non-depreciation. One-way bets in currency markets generally do not produce stable trading conditions and the new currency would have this feature built-in.

9. These doubts relate to a further set of uncertainties as to how precisely the Richards EMF would control its currency. He supposes that it would use the usual central bank techniques of setting short term interest rates, conducting open market operations in longer term debt and intervening against other currencies. There are potential difficulties in all these areas:

(a) to start with at least, there would be few assets denominated in the newly-defined ecu currency with which the EMF could conduct open market operations. There are some ecu-denominated assets on the existing definition but this would be irrelevant for Richards' purpose;

(b) the intervention that the EMF would have to carry out could be enormous, if the speculative flows turned out to be on the scale suggested in the previous paragraph. The EMF would be entirely mismatched by currency. Its liabilities would be the can-only-appreciate ecus, whilst its assets would be the depreciating currencies people had bought the ecus with in the first place. Interest rate differentials would compensate to some extent, but the potential losses (or gains) to which the EMF shareholders - the national central banks - would be subject would be large;

(c) the EMF could find that its interest weapon had to be used primarily to control short term capital flows into or out of its currency. That might prevent it from using rates to control longer term expansion of the ecu money supply to the growth rates needed to ensure the ecu remained appropriately strong. The EMF would need to make the same judgements in setting interest rates as any other monetary authorities. Like other monetary authorities, it would no doubt make mistakes from time to time.

10. It is, of course, possible that in practice the scheme might work. The problem is that it is such a leap in the dark that we just do not know. With such a degree of uncertainty on such a critical matter as monetary policy, it does not seem very likely that the Richards scheme would overcome German opposition towards parallel currencies, nor perhaps desirable that it should.

11. Indeed, German worries would probably be particularly pronounced on at least two scores:

(a) generally, the scheme would involve a substantial surrender of monetary sovereignty - much greater than the more limited proposal for an ecu Currency Board, made in the Interdepartmental Group's Report.

(b) more specifically, at least in the short term, the most likely outcome would be the newly defined ecu becoming a pseudo-deutschemark. It would be the deutschemark which was the strongest currency against which the new ecu would be fixed. It is most unlikely that the Germans would tolerate a currency looking to all intents and purposes just like the mark but outside the Bundesbank's control.

Summary

12. The Richards paper contains a coherent proposal for progress to monetary union which differs from Delors'. Some of the functions which Richards proposed European Monetary Fund would carry out - administrative functions, in particular - cause few difficulties. It addresses the question of giving more institutional content to Stage 2 of EMU, and reaches somewhat similar conclusions to those in the Interdepartmental Group Report, with one key difference. The Interdepartmental Group Report proposes creation of ecu Currency Board arrangements for issuing ecu bank notes in a neutral way that should have no impact on the operation of domestic monetary policy. The Richards Report on the other hand involves the creation of a fully-fledged, albeit fettered, European central bank with the ecu as a fully independent separate currency. It is in this area that the Richards proposals are most likely to run into heavy opposition, particularly from the Germans; and, indeed, where their wisdom is most open to question.