

Sir M. BUTLER
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From the Private Secretary

23 April 1990

EMU

I enclose a copy of a letter to the Prime Minister from Sir Michael Butler following up their meeting on 20 April. I should be grateful for advice on the points he makes and a draft reply.

I am copying this letter and enclosure to Stephen Wall (Foreign and Commonwealth Office).

C. D. POWELL

John Gieve, Esq.
HM Treasury

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2

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23rd April, 1990

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

Prime Minister

Michael Butler, Junior

Thoughts.

CD 23/4.

Dear Prime Minister,

E.M.U.

I have been thinking about our conversation on Friday all the weekend and I would be most grateful if you would consider a few thoughts arising out of it. The handling of this issue over the next few months is going to have major consequences for the future of the City, our influence in Europe in the 1990s and the outcome of the next election. I am convinced that you will be able to work out a line that you can sell in Parliament and which will enable you to get your way in the European Council. But I am afraid you are not there yet.

2. Economic and monetary union can cover quite a wide range of structures, ranging from federations like Switzerland (where the cantons nevertheless still have quite a lot of autonomy) to something much less centralized. Your E.C. colleagues, with their tendency to call things by grander names than they warrant, will be happy to call a structure with minimal centralization "EMU". You have already largely won the battle over control of fiscal and macro-economic policy. But you cannot hope to sell them a definition of monetary union which does not include as its aim either permanently fixed parities or a single currency. To all of them this is what EMU has always meant. Permanently fixed parities does not necessarily imply centralization of economic decision-taking. Parities were fixed under the gold and gold exchange standards.

3. The advocates of a single currency see two advantages in it over permanently fixed exchange rates. First, there is always a risk that such rates would not stay fixed. Second, there would be big savings on transaction costs. But I fully understand why you have political difficulties with the single currency idea. I see no reason why you should not continue to say that the British people will wish to retain the pound sterling. But I do not believe that, in the present state of opinion on the Continent, you will be able to get your way and gain acceptance for an evolutionary Stage 2 without agreeing that in the last stage of EMU there will either be permanently fixed parities or a

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single currency. It ought to be possible to get it agreed that:-

- (a) no move beyond Stage 2 can take place without a positive vote by national Parliaments as well as unanimity in the European Council; and
- (b) the earliest time when a choice would need to be made between permanently fixed parities and a single currency will be at the end of Stage 2 (the hard ecu could continue alongside national currencies after the parities had been permanently fixed).

4. An evolutionary Stage 2 will probably last a long time. The Greeks, Italians, Spaniards, Portuguese and Irish will be unwilling to renounce the possibility of devaluation without agreement by the net contributors to massive resource transfers. The French and Germans will be as determined as we are to resist massive resource transfers. It will also probably take quite a few years of co-operation in the E.M.F. before monetary co-ordination really works well. But you will be suspected of delaying tactics if you stress how far away permanently fixed parities will be. Much the best line will be that the length of Stage 2 will depend partly on how well it works and partly on when all member States are ready permanently to renounce the possibility of devaluation.

5. You retain doubts about resisting speculative attacks in Stage 2 with fixed, but not permanently fixed, parities - still more about permanently fixed parities. You are right to question this. But please consider carefully the twin ideas in the paper I sent you of hard, freely convertible ecus and the self-cancelling creation of them (i.e. each ecu created in exchange for national currency means that much less national currency). This will improve the chances of resisting speculative attacks. (I am working on a short paper on this point with one or two examples which I hope to send to you later this week).

6. The hard ecu has the other advantages I mentioned:-

- (a) its use would be counter-inflationary which the existing ecu would not;
- (b) it would therefore meet the Bundesbank's objections to using the ecu rather than the D. Mark as the E.C.'s fledgeling currency;
- (c) it would be a genuinely new and important proposal and therefore avoid accusations that, in proposing a European Monetary Fund, we are simply returning to an earlier French idea which they now consider out of date.

7. To sum up, I wonder whether you could not take the line in Parliament that:-

- (a) you accept that the "progressive realization of EMU" (Bremen and Madrid conclusions) has a lot of steam behind it and have no doubt that Britain will have much to contribute to the discussion about how to achieve it;
- (b) you have throughout made it clear that Britain is determined to ensure that progress towards EMU does not centralize control over fiscal and macro-economic policy and you will continue to insist on this;
- (c) the final stage of EMU will involve permanently fixed parities one day, but of course not before all member States have agreed to renounce devaluation for ever;
- (d) in any case any great leap forward from Stage 1 to Stage 3 would risk failure and bringing EMU into disrepute and could cause serious shocks to the system; the British Government have therefore devised an original and coherent plan for Stage 2 as a contribution to the debate (describe hard ecu proposal, etc.) and in order to remove the risk of a premature move to Stage 3;
- (e) if this plan is accepted, it will be for the markets to decide how much use to make of the ecu but you confidently predict a long life for the pound.

8. I do hope you find these thoughts helpful. I know that they will raise other questions in your mind, but my letter would be far too long if I tried to answer them in advance. Naturally I am at your service if you want me to try to do so.

*James
Michael*

Sir Michael Butler

MDB/MML