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PRIME MINISTER

ECONOMIC AND MONETARY UNION

attached
I was interested to see the papers attached to Charles Powell's letter of 6 June.

His note of your meeting with John Major on 31 May records that John is determined 'not to commit the UK to a Single currency or a European System of Central Banks'. I strongly share that view. I am therefore concerned to see that the Treasury paper of 16 May says that, if we are outvoted at the IGC, we should virtually agree to do just that. I do not understand why our agreed views on the undesirability of EMU, strongly endorsed by Parliament, do not make it imperative for us stick with a refusal to join in any of these arrangements.

I quite see the desirability of finding wider and more liberal suggestions to pull our EC partners away from their overriding interest in EMU. I attach a paper on trade issues which officials from my Department and the FCO have prepared in response to the first remit in Charles Powell's minute. It makes the point, with which I agree, that we are already fully engaged with our North Atlantic trade partners in the Uruguay Round, so that anything more specifically in a North Atlantic context would have follow it, not come now. In any event, although we must always keep our eyes on the wider sphere, and encourage others in that direction, changes in trade relations are complementary to those in the monetary sphere, not alternatives or diversions from them.

I similarly look forward to seeing what the Treasury has to say on the linking of major world currencies to an objective reference standard. I am afraid that I also have my doubts

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about the capacity of any such proposals to divert attention from EMU for other than a very short while.

There may, of course, be more fruitful ideas for a diversion, but surely we should tackle our position with the EC head on? I prefer and recommend an alternative approach as follows.

The Community is bound to become larger, and one group of countries may opt into EMU, while another group will not. But neither group should be seen as inferior to the other. What is important, as I told the Bruges group last week, is that membership of the EC should become the basic foundation of a European club. Membership of that club should carry the obligation to engage in political co-operation, to operate the single market fully and firmly, and to accept the necessary obligation of enforcement. I said and repeat that tight economic and monetary union would make a wider Europe more difficult to achieve.

We should remember that one group of non Community countries (EFTA) has actually grown faster than the Community during the 1980's - by an average of 2.6% pa as opposed to 2.1% pa for the EC. We need to get these countries into the Community, but the Community should not insist that they join EMU in the development of which they will have no say.

We should continue to distinguish clearly between the Single European market and the EMU, for commentators often confuse the two. For the purposes of trade, access to markets and opportunities for investment it is the Single Market which matters, particularly for the Japanese and Americans. There is a tendency for them to think the UK will be disadvantaged for purposes of trade and industry investment if we do not join EMU, whereas the truth is that it is the Single Market which is essential for these purposes.





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We should therefore promote the idea of allowing various regional groupings or even currency agreements to emerge. Those who wished could form joint central banks to manage their currencies. But there should be no compulsion for others to join if their national instincts or economic circumstances made such a course unattractive. In our case, of course, the inability to let market movement of our exchange rate help us adjust to changing circumstances would be an enormous disadvantage and sacrifice.

Groupings in a wider Europe seems a far better approach than one in which, because we are likely to be outnumbered at the IGC, we run the risk of allowing ourselves to be manouvered into EMU by accepting the logic of a positive Stage II to the point that we should be also obliged to accept Stage III. The long-term price for short term harmony would be immeasurably greater than the short term political benefits to be derived from a day or two's respite from criticism in the Guardian - a newspaper which few read and most distrust.

To be alone in the 12 is not the end of the world, nor would we be alone if other candidates were allowed to join the EC. There is no need for any such arrangement to be seen as the "second tier of a two-tier Europe". Instead there is a political benefit in standing up for our own interests. The ERM may be a relatively harmless, although incorrect step. But there is a feeling in the country that, although we protest, we are being dragged inexorably first into the ERM, secondly into the negotiations on Stage II, thirdly into EMU itself. The British people do not want this. The important thing is to relate to the electorate by making it clear that we will have nothing to do with full EMU, and to evolve our strategy from there.

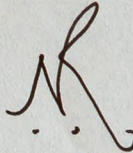
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I am sending copies of this letter to the Foreign Secretary
and to the Chancellor of the Exchequer.

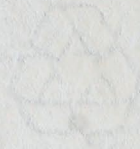


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14 June 1990

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CONSERVATION



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Recycled Paper

EMU : TRADE AND GLOBAL INTERDEPENDENCE

Our Trade Objective

1 Greater transatlantic interdependence, through more open markets, would strengthen economic efficiency and political cohesion (eg helping to ensure a continuing US commitment to European defence). It would also contribute to the global aim of trade liberalisation, and, critically, should strengthen the multilateral trading system. However, the issue of closer economic links with the US cannot be separated from the Community's involvement with the wider world economy. The established forum for this is the GATT.

2 Our major current objective in trade is to ensure the success of the Uruguay Round negotiations. These involve over 100 countries representing more than 85% of world trade. They are due to be completed in December and constitute the most ambitious multilateral trade negotiation since the formation of GATT. More follow-up work will be entailed, particularly in the "new areas" such as services and intellectual property, where framework agreements will need filling out, as well as a possible remit from the December meeting to develop the exiguous organisation that is GATT into a stronger body. So there should be a substantial continuing workload facing GATT and its members from next January.

3 If the Round is successful, important new multilateral agreements and disciplines will be set up which should ease trade tensions between the EC and the US and give a big boost to these links. Any initiative should therefore be located in the context of the outcome of the Round, build on its positive elements and be consistent with GATT. This could cover further multilateral efforts and/or elements of a North American/EC Single Market approach. If the Round were to fail, we should need anyway to look at alternative ways of developing EC/US trade relations.

A Europe/North Atlantic Free Trade Area (NAFTA)

4 Because of the overriding importance of completing the Uruguay Round, this is not the time to float a proposal for a NAFTA, since if it made any headway the attention of trade negotiations would be distracted from the Round at the crucial time. However, a NAFTA would be unlikely to be negotiable. The US would not be interested if agriculture were not included. But including agriculture would, in effect, mean the dismantling of the CAP and thus be

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unacceptable to the EC (and to EFTA countries, who are themselves protectionist in agriculture). In fact, classical tariffs and quotas are not the principal barrier facing EC exports to North America. Product standards, government procurement, including defence, the free movement of services, particularly financial, and so on, would have to be considered. These issues would raise major institutional and constitutional questions relating to decision making procedures, public accountability and enforcement. The EC/EFTA dossier shows how acute the problems can be.

5 A NAFTA would be badly received by Japan, Australia/New Zealand and the major NIEs like Korea and Singapore. They could not all be brought within a big FTA, and special arrangements for them would in any case evoke a hostile reaction from European and North American industry. Japan might be interested in FTA membership but would want agriculture excluded: Australia and New Zealand would insist on its inclusion. Yet to leave these countries out would appear to them a major and damaging step away from the multilateralism that the EC and US so frequently advocate: one result might be to stimulate closer Pacific co-operation and accentuate the drift towards regional trading blocs.

6 Thus our efforts should be within the context of GATT and strengthening the multilateral trading system. We need before too long to be considering further approaches to carry forward the process of liberalisation, particularly if the Uruguay Round looks like going badly.

Alternative Approaches

(i) **Continuing GATT Business**

7 Even a successful Uruguay Round will not be the end of the story. Just as the EC needed a special push to complete the Single Market, so the GATT has been extending the scope and complexity of its negotiating rounds. The Uruguay Round has been a major step in that direction. There is other major potential work for GATT - eg in restrictive business practices which can affect trade significantly but which have hardly been looked at internationally. It would serve us best if further work needed on the "new areas" fell to GATT. The Uruguay Round has also shown the need for a more fundamental look at some of GATT's existing rules, notably anti-dumping.

8 A major GATT exercise on these lines would require careful consideration, not least its timing. Initial work could not begin until after the end of the Uruguay Round. The Round's failure would mean prospects in GATT would be poor, at least in the short term. A successful Round would, however, provide a good springboard.

(ii) Sectoral Arrangements

9 The GATT already has a number of codes to which only some of its contracting parties have adhered (but almost all of the developed countries). These codes usually prescribe in detail how rather general GATT provisions such as for anti-dumping are to be applied or lay down particular arrangements as for the aircraft sector. It remains to be seen to what extent developing countries will adhere to Uruguay Round texts on the new areas in particular. If there were insufficient support for further major GATT negotiations (or indeed the Uruguay Round failed) that could lead to the negotiation of a number of specific arrangements to which would adhere those countries wishing to do so.

10 The GATT framework would be the natural home for agreements of this kind. However, they could be negotiated outside the GATT either directly between interested parties or within some other convenient organisation like the OECD: neither of these courses would prevent any agreements from being sponsored subsequently in GATT to secure wider adherence.

11 There is much scope for subsequent further liberalisation between the Community and other developed countries, in particular the US. This could, for example, cover:

(i) Financial Services

The EC is creating a Single Market in financial services, including banking and insurance. It will be open to non-EC firms established in EC. US arrangements are much less liberal. The aim might be EC/North Atlantic agreement to a "single passport" approach to financial services, ie licence to operate under one domestic authority would mean automatic access throughout the EC/US area. Subject to accommodating major differences in EC and others' prudential arrangements, this could apply to banking, investment services, unit trusts, and insurance.

(ii) Aviation

Liberalisation of transatlantic services with onward access to respective internal markets would benefit consumers and competitive airlines. There are no competence problems. But we would not wish

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to erode the UK advantages of Bermuda 2, or detract from progress on internal EC liberalisation.

(iii) Standards

GATT will not produce major new agreements. EC and US are already co-operating on Standard setting in Internal Market context. The next step is full mutual involvement in each other's standards making, eg CEN and CENELEC, although some of the bodies are industry based, outside government. Our ultimate objective should be to establish the principle of mutual recognition (Cassis de Dijon) throughout the North Atlantic Area, covering all manufactured goods (and processed foods). Depending on GATT outcome, phyto-sanitary standards might be included.

(iv) Public Sector Procurement

This is a sensitive area where agreed GATT conclusions are essential. But there will be scope for bilateral agreement to apply mutually-agreed rules throughout the area, particularly to utilities - telecommunications, energy, transport and water. Government procurement of services could also be included.

(v) Intellectual Property, Trade related Investment Measures and Subsidies

These are under consideration in GATT. Whatever the outcome there will be scope for wider action, eg a strengthened understanding on subsidies. It would be important to ensure a level playing field for aids and competition policy aspects.

(vi) Updating of the OECD codes on capital movements and invisibles, and the national treatment instrument

An important aim would be for the US and other federal systems to go beyond "best endeavours" for application of agreed measures to the lower tiers.

Eastern European Aspects

12 The importance of the EC's relations with Eastern



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Europe make it necessary to take account of their needs. Their economies are not strong enough for them to play a full part in initiatives of the kind described above. They need help. Any initiatives in the trade field should reinforce the UK's open liberal approach to the Community and its external relations. It is therefore desirable that we build on current links with the emerging democracies, and set our proposals in the context of one Europe, whole, free and prosperous. The Single Market, EC/EFTA and EC/Eastern Europe develop this theme, and the UK has led.

13 The negotiation of individually tailored association agreements, with the aim of free trade as a major step on the road to eventual EC membership, should build on the more limited trade and economic co-operation agreements with the Central and Eastern European countries. To speed up this process the UK could propose that -

the Community consider adopting projections for import growth from these countries, as well as targets for the removal of all trade barriers. This would help increase pressure on protectionist elements;

the East Europeans be encouraged to set down for themselves, and make public, phased and targetted programmes for removing their own impediments to inward investment flows;

the negotiation, perhaps with OECD support, of a pan European charter for enterprise co-operation. This could set out rules on joint ventures, double taxation, investment protection, etc., to create a better framework for trade and investment.

Institutions

14 Following the Baker December initiative and the UK January response, the machinery of EC/US consultative partnership has been strengthened. It now includes more frequent meetings and consultation at all levels between the Commission and the US Administration; regular 6 monthly meetings between the US Secretary of State and Community Foreign Ministers, and between the US Administration and the Commission; and six monthly meetings between the US President and the EC Presidency. The importance of these new arrangements should be highlighted. They permit the trade relationship to be monitored and the scope for further liberalisation.

15 Similar formal tripartite (EC/US/Japan) arrangements would be well worth considering, both across the board and



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for specific areas of activity. The role of GATT will be much extended as a result of the Uruguay Round. Putting the organisation on a more formal legal basis would increase its authority, and secure more rigorous observance of GATT rules. But this should not be allowed to divert attention from the Uruguay Round.

DTI
FCO
13 June 1990