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PRIME MINISTER

ECONOMIC AND MONETARY UNION: OBJECTIVE REFERENCE STANDARD:
NORTH ATLANTIC FREE TRADE AREA

I attach a contribution from the Trade and Industry Secretary on Economic and Monetary Union, and on ideas for a wider transatlantic free trade area.

I also attach a Treasury note on an objective reference standard, as an alternative to EMU.

Both are relevant to the meeting with the Chancellor, Foreign Secretary and Trade and Industry Secretary which we hope to squeeze in on Tuesday morning. But the main purpose of that meeting will be to decide whether and when to launch our proposals for Stage II of EMU (the 'Butler' proposals).

Ridley Paper

Mr. Ridley's ideas on EMU can be summarised as follows:

- the UK would not be much disadvantaged from the point of view of trade and investment if we remain outside EMU. It's the Single Market which really matters.
- anyway, we should work on the assumption that the Community will be enlarged after 1992: we should be able to contemplate with equanimity a 'variable geometry' structure, with different groupings within the Community for different purposes.
- meanwhile we should make a virtue out of necessity and seek political benefits from standing out against EMU and fighting for our independence.

On the trade side, Mr. Ridley's view is that our first priority has to be to complete the Uruguay Round and we should not float any other proposals for fear of distracting attention from that over-riding objective. Once that is achieved, we should focus on sectoral arrangements to bring about further liberalisation,

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e.g. of financial services, aviation and public sector procurement. He does not see any future for a North Atlantic Tree Trade Area as such, more because it is not negotiable than because it is not desirable.

The Treasury paper is dismissive of an objective reference standard. It would involve the loss of national monetary discretion: interest rates would move automatically and might overshoot in a big way: price stability could not be guaranteed: and anyway there is no realistic chance that by launching a proposal of this sort, we could head off EMU - the others are too committed to it, and would see our proposal as a wrecking tactic. Anyway, you can have a single European currency and an objective standard.

Then this must be against ERM!
On these arguments we could not join the ERM.

The Chancellor's conclusion is that this is not a way out of the fix we are in on EMU. The only satisfactory course is that recommended in his earlier paper: i.e. agreeing to the objective of EMU but with an opting-in mechanism.

You will want to read the papers and form your own judgement. But the following points strike me:

(i) Mr. Ridley may well be right that a free trade agreement with US and Canada may not be the best way to develop freer trade;

(ii) the Chancellor may well be right that there is no prospect at present of interesting anyone in an objective standard and particularly in Alan's extreme form of ECOM which removes all discretion from monetary policy; and that in any case it is more likely to be seen as the development of EMU than an alternative to it. But

(iii) that does not have to lead you unavoidably back to the Chancellor's negotiating stance on EMU. On this, Mr. Ridley is surely correct: before all this happens, we shall have joined the ERM and our isolation will be less apparent: and anyway we shall be in a very different sort of Europe. That may mean parting company with the Eleven if they insist on taking

decisions now, which will only be implemented under conditions which they cannot now foresee. It will probably all look very different. We should not allow this to be a defeat but as a stand for a wide, variable geometry Europe.

We will put up briefing for your Tuesday meeting after the weekend. Realistically, I don't think you are going to get very far with radical ideas before the European Council in ten days time. You need to develop them in shorter time as part of the wider 'Bruges' vision of Europe's future, rather than as something operational in the short term. What we really need is one or two good articles and publications to flesh out the ideas. The IEA and the CPS might be able to do something: you could also talk to Jimmy Goldsmith. Your speech in Aspen would be an occasion to develop the thinking.

C.D.P.

CHARLES POWELL

15 June 1990

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PRIME MINISTER

AN OBJECTIVE STANDARD AND EMU

I have been reflecting on the idea which we discussed at our meeting on 31 May of the linking of currencies to some objective reference standard, for instance a commodity index which would work automatically, with the possibility of extending such a system to the dollar and the yen.

... I attach a short note on the proposal and a more detailed analysis by our economists. It shows that, while it has some attractions, it seems a very mixed blessing.

In particular, such a system would involve the loss of national monetary discretion. There would be no need for a central institution in the purer forms of these rule based systems. But, equally, national governments would retain no control over their interest rates which would rise automatically to whatever rate was needed to bring inflation down. Interest rates could rise very sharply and to high levels if there were shocks to the system. The effect on interest rates would be immediate so long as there was inflation in the system whereas the effect of interest rates on inflation would remain subject to long and uncertain lags. There would thus be a prospect of interest rates overshooting in a big way. To abate these effects would require an arrangement for overriding the rules which would undermine the whole purpose of the scheme.

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In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs in operating them. A commodity indexed reserve asset system might avoid the latter but it exists at present only in theory and to establish such a system would require an immense amount of work. There is no certainty that an operational scheme could be devised or, if it could, that governments would find it acceptable and the public find it credible.

Turning to tactics, I very much doubt whether launching such a proposal would succeed in leading the Community's current EMU endeavour off in a different direction for a number of reasons.

To the extent that the approach has merits there is no reason why we or others should not adopt it now. Yet no major country (nor any minor one so far as I know) has shown interest in such an initiative as a practical proposition. That is not to say that they could not be persuaded to look at it. But even getting them to address the issue could take quite some time, almost certainly beyond the beginning of the IGC.

Secondly, there is no inconsistency between a single European currency and an objective reference standard. Indeed, there would be those who would argue that the most certain route towards linking the major currencies to an objective reference standard would be through the creation of a single European currency managed by a European central bank which was required to minimise inflation. This would create a tripolar currency world of the dollar, yen and ecu which could then be linked through an objective reference standard. That is certainly not the route forward that we would have in mind.

More important, the attachment in other EC Members - for political and economic reasons - to the ultimate goal of EMU as now

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conceived is very strong. An initiative for a commodity index would be seen either as irrelevant to that or, more probably, as a deliberate wrecking tactic.

All this leads me back to the difficult conclusions described in my minute of 24 May. Short of circumstances that are difficult to conceive, eleven Member States are intent on agreeing Treaty amendments for a single monetary policy and monetary authority. To let a Treaty of Eleven be signed would, I think, have grave economic and political consequences for our country as well as causing difficulties with many of our supporters at a crucially sensitive electoral time. Yet to sign a Treaty committing the UK to a single monetary policy and all that went with it is impossible. So I continue to believe that the course I proposed in my minute of 24 May is the least bad way forward.

We agreed on 31 May that we could make public our detailed ideas for Stage 2 at a suitable time. The Bank are proposing to put them forward for discussion in the Central Bank Governors' Committee and I am working on a speech which I will send you shortly.

I am sending a copy of this minute to the Secretary of State for Foreign and Commonwealth Affairs and to the Secretary of State for Trade and Industry.

[J. M.]
14 June 1990

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EMU: OBJECTIVE REFERENCE STANDARDS

The attached paper discusses possible objective reference standards to which European currencies and perhaps the dollar and the yen could be linked so as to provide an alternative monetary system to Delors Stage 3. The main features of such systems and their advantages and disadvantages are summarised below. The discussion is at a simplified level: the details are potentially very complicated and, given the lack of experience of such systems, would take a lot of work to develop.

What are objective reference standards?

2. The paper considers three broad possibilities: the gold standard, the commodity standard and a standard based on an index-linked reserve asset (ILRA). In each case the basic idea is that currency is issued to the extent of the value of assets in the hands of the monetary authority.

~ ECOM

3. In such systems the value of money moves in the long term inversely with the availability of the asset which backs the currency. More gold (or commodities, or ILRAs) will devalue money, that is raise prices. Thus the general price level will depend on the amount of the reserve asset in existence. Although history suggests that the supply of gold and commodities can be sufficiently stable over long periods of time to produce a reasonable degree of price stability, there is no guarantee of this. Moreover, prices could fluctuate in the shorter term in response to fluctuations in the gold or commodity markets. ILRAs can be created by governments, but the real value of the reserve asset is constant by definition.

How do objective reference standards work?

4. Price stability is not instantaneous. The mechanism by which it comes about in the long term is the same in most respects as with conventional monetary policy. In both cases a price rise,

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for example because of an increase in the oil price, means that the real amount of money in circulation is reduced, and interest rates rise as people seek to obtain money to maintain their transactions. Higher interest rates reduce activity in the economy and eventually bring prices back into line.

5. Objective reference standards produce a more automatic response of interest rates than conventional monetary policy as people seek to exchange money for the reserve asset. Thus the initial rise in interest rates under an objective reference standard could be immediate and sharper, leading to a more severe recession. There might be overshooting of interest rates initially. Because monetary authorities in a conventional system have discretion over the speed and scale of any interest rate response, they are likely to choose a more gradualist route than would be automatically imposed by a system based on an objective reference standard. This point is closely related to that which arises in the monetary base control debate: the more automatic nature of this system of monetary control is similarly likely to lead to faster and sharper interest rate changes than conventional monetary control.

6. Discretionary behaviour by the monetary authorities could be grafted onto an otherwise automatic objective reference standard system. But some of the benefits would thereby be lost: the chances of achieving price stability in the long term would be weakened, and inflationary expectations in the private sector consequently less favourable. Moreover, if discretion is to be allowed anyway, there seems little point in introducing novel and untried objective reference standards only in order to override their mechanisms in practice. In practice, there would sometimes be very strong pressures on governments to override them.

Economic advantages and disadvantages

7. The essential choice between an objective reference standard and conventional monetary policy is therefore one between on the one hand the greater counter inflation certainty which,

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subject to deviations caused by fluctuations in the supply of gold and commodities, they offer, and on the other hand the loss of the ability to react in a discretionary way to shocks, so that the monetary authorities just have to accept whatever movements in interest rates and the real economy the system throws up. Some might see this loss as an advantage because it removes governments' ability to pursue policies which could be inflationary. The debate about automaticity versus discretion in monetary policy is not a new one. Despite the short lived flirtation with monetary rules in the 1970s and 1980s by some monetary authorities, all major countries including the UK have clearly chosen discretion. It would be a major shift of direction to opt now for automaticity.

8. As between the three alternative versions of objective reference standards, the gold and commodity standards suffer from:

- their inability to guarantee price stability in the long term;
- their exposure in the short term to fluctuations in the supply and demand of gold and commodities;
- the costs of storing gold or commodities to act as backing to the currency.

On the other hand, an ILRA system has never been tried. An enormous amount of further analysis would be necessary before we could be sure that we could design an operational system which was both efficient and non-inflationary. And it would need to establish credibility before it could be expected to work well.

Objective reference standards in EMU and wider contexts

9. There are three main ways in which an objective reference standard could be introduced:

- (a) the UK (or another country) could introduce it unilaterally;

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- (b) it could be introduced by a new institution as a parallel currency alongside all existing currencies;
- (c) a new Community institution could introduce it as a new single Community currency to replace the existing 12.

10. The UK's evolutionary approach to EMU suggests that we should be arguing for going through all three stages in turn, or perhaps starting in the second stage with a view to moving onto the third stage. If we argued for starting in the second stage, we would be exposed to the challenge that, if we think objective reference standards are so good, why do we not introduce them in the UK first. Although there is a response to this (we are content with monetary policy as conducted by national monetary authorities now but Community systems need a new approach), it may not convince others. Another disadvantage of starting in the second stage is that there would be a serious risk that the new parallel currency based on an objective reference standard would never achieve critical mass and so not act as an effective competing currency.

11. Thus there are difficulties about moving gradually towards a European or wider system (ie embracing the dollar and the yen) based on an objective reference standard. On the other hand the UK would not find it easy, in view of our known scepticism about EMU, to argue credibly for moving straight to a new single currency. This third stage would involve a complete loss of monetary sovereignty, albeit to market forces operating through a set of rules rather than to a new institution.

12. More importantly, our Community partners have no interest at all in systems of this type. With one or two rare exceptions, Community governments and central banks have consistently and clearly favoured discretionary monetary policy over automaticity. They are also likely to be extremely wary of systems which are completely untried in modern circumstances. And they are anyway strongly committed to a conventional approach to monetary policy as embodied in the Delors proposals.

Conclusions

13. An objective reference standard could produce more counter inflation certainty than conventional monetary policies at either national or Community level. But it would be largely automatic and so would impose movements in interest rates and the real economy which governments and monetary authorities would have to accept. As with monetary base control, these movements could be sharp. In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs associated with operating them. An index-linked reserve asset system would be entirely new and would require time to establish the details and, more importantly, credibility. Without much more study we cannot be at all certain that it would work.

14. Other Community countries are unlikely to have any interest in this approach. They would have doubts about its desirability in principle, and would not be prepared to invest time and effort in working out operational arrangements given their commitment to conventional monetary policies within a Delors Stage 3 framework. Any UK initiative along these lines could well be regarded as a wrecking tactic and could damage our negotiating position in the IGC.

CONFIDENTIAL**EMU: OBJECTIVE REFERENCE STANDARDS**Introduction

1. The purpose of this paper is to consider possible schemes of monetary reform which involve the use of some objective reference standard, for example gold, to which the value of money would be linked. The main types of objective reference standard that might be considered are:

- gold;
- basket of commodities;
- index-linked reserve asset (ILRA);

2. Clearly there are a number of possible variants for each of these, both in terms of the standard itself and the way in which the schemes might work. What they have in common is that the unit of account is defined in terms of something - the objective reference standard - other than the medium of exchange itself.

3. There are two main reasons for seriously considering such schemes. Firstly, they may provide a better way of achieving price stability and preserving the value of money. Secondly, and for present purposes more importantly, they may provide a viable alternative to Delors stages 2 and 3 without the need either for a new monetary policy institution at Community level or for a single currency. A simple European standard could be envisaged in which all 12 currencies would be defined in relation to the chosen commodity. More complex schemes could also be accommodated within this framework. For example one of the schemes examined below involves setting up a new currency based on an index-linked reserve asset alongside national currencies.

4. This paper discusses alternative models as though they apply to the EC alone. But all could be extended to the dollar and yen without significant difficulties of principle. Indeed, if a scheme were working well with a high degree of credibility then it is possible that non-EC countries would wish to join. It therefore has an obvious advantage over Delors stage 3 where

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participation in the currency scheme also implies full institutional integration.

5. The paper starts with a consideration of traditional gold and commodity standards, primarily to show the principles of how such schemes work. It then considers more modern versions based on index-linked reserve assets (ILRA) which in principle overcome some of the shortcomings of traditional commodity standards. A final section compares possible schemes with the single currency and European Central Bank of Delors stage 3.

Gold Standard

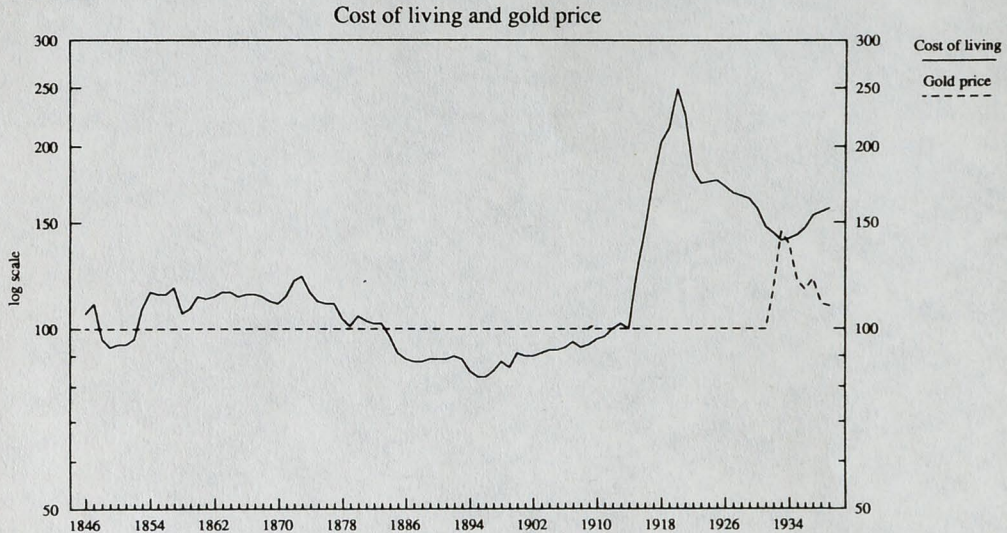
6. There is a range of possible gold and commodity standards. Common to all is the fixing of the unit of account, e.g. a pound sterling, in terms of a fixed volume of gold or of a basket of commodities. Under the international gold standard system which operated between 1870 and 1914 Britain and most other countries operated a fully convertible system, with gold itself playing a vital role. Private individuals generally had the unrestricted right to buy gold from and sell it to the central bank, and to export and import gold. Thus there was full convertibility of sterling, and free movement of capital between countries. Each country fixed, de facto, the value of its own currency against gold. As a consequence exchange rates between currencies were fixed.

7. Under a pure gold standard there is a link between the aggregate supply of gold and the global inflation. With constant velocities of circulation, an expansion of gold supply leads to a fall in the price of gold relative to all other commodities, and hence a fall in the value of money. In other words the general price level rises. At the individual country level any tendency for prices to rise faster than elsewhere would lead to an outflow of gold as individuals found that a given quantity of gold bought more goods elsewhere. This in turn would reduce the money supply in the more inflationary country, and this process would continue until prices had been brought back into line.

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8. Whether the pre 1914 gold standard actually worked in this way is still debated. In practice central banks exercised some discretion and changed interest rates so as to influence flows of gold. Credit conditions therefore changed both because of the automatic gold flow mechanism and also as a result of discretionary policy. But there is no doubt that price stability was quite good, as chart 1 illustrates.

CHART 1

9. Under the gold exchange standard system used during World War 1, and, in the UK, from 1925 to 1931, it was no longer possible to convert currency for gold, although its value remained fixed in terms of a quantity of gold. Also, reserves of dollars or other foreign currencies were held alongside gold, enabling countries to avoid the feed-through from changes in their reserves onto the domestic money supply. Similarly, gold inflows could be sterilized by open market operations. Thus much greater reliance was placed on discretionary action. The failure of both surplus and deficit countries to take appropriate action is sometimes cited as a reason for the breakdown of the system.

10. This brief description brings out some of the pros and cons of gold standard systems. In principle, in its pure form, it offers a system which could be fairly automatic in operation and give a high degree of price stability. In practice, a pure gold

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standard would almost certainly be unworkable, either for a single country or group of countries, in present day conditions:

- The tightness of monetary conditions, and hence prices generally, would depend on the supply of gold. Producing countries such as South Africa and the USSR would have undue influence. The price of gold has fluctuated much more in recent years than it did pre-1914.
- There would be significant transactions costs, as gold was stored by and moved between central banks.
- Under difficult conditions, for example the oil price shocks of the 1970s, governments would find it hard to resist calls to override the system, either by changing exchange rate parities or interest rates.

11. It would therefore make little sense nowadays to revert to a purely gold based standard on an EC wide basis. Changes in the supply of gold, either newly-mined or from non-EC countries' existing stocks, would affect the value of the nominal anchor and hence prices in Europe in a way which bore no relationship to underlying fundamentals.

A modern day commodity standard

12. In the light of evidence that the real price of groups of commodities have been less volatile than those of gold or any single commodity, a better standard might be one based on a bundle of commodities. The goods chosen would need to be transportable and storable since it would be an important feature of the system that money could be redeemed for the commodity bundle, by governments and central banks if not individuals. Thus metals such as copper, and wheat and oil might be included, but not manufactured goods. For reasons of price stability the composition of the commodity bundle should ideally be such that the individual prices varied together as little as possible, and no single commodity had a dominant weight. It might in practice

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be difficult to make this choice, there has been a tendency for most commodity prices to move together quite closely.

13. The advantages and disadvantages of a commodity standard compared with present day monetary systems are very similar to those of gold. However, compared with a gold standard it might give better price stability since supply factors might have less influence on monetary conditions than under gold. But there would be a price to pay for this advantage. Transactions and storage costs would be much higher. This would be especially so if perishable or bulky commodities, such as wheat or oil, were included. This is probably the main reason why in practice the idea of a commodity standard has found little favour. To our knowledge it has never been tried in modern times.

Index-Linked Reserve Asset (ILRA) system

14. An important shortcoming of traditional commodity standards is the requirement for money to be redeemed for the commodities which back the currency. As we have seen this would impose heavy transactions and storage costs. And it means that not all goods and services can be included in the commodity basket, so that the value of money will fluctuate. Some recent authors have proposed systems in which currency is defined in terms of some broadly based commodity basket, so that its value simply varies inversely with the price level. But there would be no redemption of currency for these goods. Such a system, it is argued, would have all the attractive features of a commodity system - especially stable prices and automaticity - without the disadvantages - high transactions and storage costs and sensitivity to choice and weights of the goods in commodity basket.

15. At the centre of this system would be a reserve asset (ILRA), issued by the central bank. Its market value would be index-linked to the price of a broadly based commodity basket while its par value would be fixed, as with a conventional Treasury Bill, in terms of currency. The index-linking ensures that the real value of the ILRA is constant. The currency itself, call it new pounds, would, analogously with the gold system, be

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backed by ILRAs: it would always be possible to redeem currency for ILRAs of equal par value at the central bank. Although currency may be redeemed for ILRAs it is an important feature of the system that the latter cannot be used for transactions purposes, so they are not money. The final element of the system is the commodity basket whose price is used to index the market value of the ILRA. This should be as widely defined as possible, so a generalized basket of goods and services consumed in the economy might be chosen.

16. The central bank would be responsible for redeeming ILRAs for currency, and issuing notes and coins. So as to prevent too ready redemption it might do so at slightly below par, or do so only in very large multiples, thus effectively confining the redemption process mainly to commercial banks and other financial institutions rather than private individuals. It would not, for reasons explained below, be responsible for interest rate policy.

17. Under this system equilibrium would hold when 'new pounds' and the ILRA were equal in value, i.e. the ILRA was trading at par. To see how the system might work we can consider the case of a rise in the general price level of, say, 10 per cent, caused, say, by a rise in world oil prices. The market price of the ILRA also rises by 10 per cent, by virtue of its being index-linked. An opportunity for profitable arbitrage has now opened up. By redeeming one new pound at the central bank for one ILRA whose value has risen to 1.1 new pounds and then selling the ILRA, holders of cash can make a risk free capital gain of 0.1 new pounds. The opportunity for this arbitrage continues as long as the market value of the ILRA remains above the nominal value of the new pound. This will be so as long as prices in general remain above their initial, pre-disturbance, level. But it will not be in the arbitrageurs' interests to exploit this to the maximum possible extent, as explained later.

18. In practical terms, as already suggested, most of the arbitrage would probably be done by commercial banks. It is this fact which would cause interest rates in general to rise as cash is redeemed. This causes a change in the asset composition of

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their portfolios, which are now less liquid because ILRAs have been substituted for cash. In order to rebuild their liquidity the commercial banks raise interest rates to attract more deposits, some of which will be in the form of cash. This rise in interest rates also reduces bank lending to the private sector. The commercial banks would therefore raise their interest rates to the point where the non-bank private sector had reduced its cash holdings by the same amount as the banks had redeemed at the central bank.

19. Interest rates would rise to the level at which the extra cost to the banks of attracting more cash from the non-bank private sector was exactly equal to the risk-free capital gain obtained from redeeming cash at the central bank. The rise in interest rates is therefore directly related to the size of the initial price increase. In practice interest rates would rise very quickly to their new level following any price rise.

20. In this light, the monetary policy transmission mechanism might in practice not be fundamentally different from that in place today. Higher interest rates would reduce expenditures, and holdings and hence inflationary pressures. The greater automaticity of the ILRA system might lead to favourable effects on expectations by enhancing the anti-inflation credibility of monetary policy. This in turn might reduce the lags between interest rates and inflation, and hence the real costs of disinflation.

21. There could be a danger that behaviour of the economy might be unstable under this system. Experience shows that the lags between interest rates, expenditure and prices are long, and that they differ among the various areas of the economy. This might mean, in the example above, that the rise in interest rates was so large that at some later date the deflationary impact would cause prices to undershoot their equilibrium level. This would initiate a rise in the money supply, as the original arbitrage process was reversed. Such instability would undoubtedly encourage the authorities to modify the system, perhaps by seeking a way to

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restore to the central bank some of its influence over interest rates.

22. The system has close parallels with that of monetary base control. Under the ILRA system the demand for new pounds would be closely limited by arbitrage through changes in interest rates. Under monetary base control the central bank varies interest rates in order to keep the growth of the monetary base in line with the target. In both cases interest rate changes would from time to time be much sharper than under conventional monetary policies. But an ILRA system has a number of essentially untried features, and it would therefore be a more risky innovation than monetary base control. Because in principle the system is automatic and depends on the behaviour of financial markets unfettered by the action of a central bank, adjustment might be more rapid and unstable than under monetary base control, where the rule for the monetary base is at the discretion of the central bank.

The ILRA system as an alternative to Delors 3

23. A number of alternative ways of introducing an ILRA system at an EC level can be envisaged.

(i) A single country could undertake a currency reform introducing an ILRA based system in place of its own currency. This would then become a competing currency, which might gradually displace other currencies with inferior price performance.

(ii) The ILRA system might be introduced as a parallel currency to be used as an alternative to national currencies anywhere in the EC. In this case there would need to be some central body to fulfil the role that the central bank would play in a domestic ILRA system. (This seems to be the idea favoured by Professor Walters.)

(iii) A single EC currency could be based on an ILRA using a Community wide commodity basket. A central EC institution would be required as in (ii).

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Each of these would have significantly different properties, and pros and cons compared with Delors stage 3. In order to keep discussion manageable we discuss (ii) and (iii), with (ii) perhaps as a first step towards (iii) brought about by competition.

ILRA as a parallel currency

24. Probably the easiest way to establish this would be for national central banks to provide assets, which would be converted into ILRAs, in exchange for shares in the ILRA issuing authority. At the same time the new ILRA currency would be issued, redeemable for ILRAs and treated as legal tender throughout the Community. In this respect the ILRA currency would be another competing currency within Europe.

25. The ILRA currency would gain acceptability within the EC as and when it showed itself better able to hold its value than other currencies. Acceptability could not be guaranteed, and much would depend on whether the ILRA itself was a useful addition to private sector portfolios. There are existing financial assets with near certain real value, for example indexed gilts, and it might therefore be difficult for the ILRA to establish a niche.

26. Initially at least, it would seem unlikely that the market for ILRAs would be sufficiently large that the interest rate on them would have an influence on interest rates in general. So the macroeconomic effect of a 'competing currency' ILRA might be small, especially if its value proved to be volatile and its acceptability for international transactions limited. It is therefore unlikely that policy credibility, inflation expectations or price stability would be favourably influenced. The decisions of national central banks would still be the main influence on monetary policies. The main merit compared with Delors stage 3 of this form of ILRA would be the avoidance of the loss of sovereignty to the ESCB.

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27. In principle, under the parallel currency model, the ILRA might gradually displace other currencies. This is perhaps far fetched, and a single currency ILRA system is more likely to come about as the result of agreement between EC governments. Its virtues and drawbacks compared with Delors stage 3 would in many ways be similar to those of a modern day gold standard as described in paragraphs 6-11 above.

28. Arguments for the ILRA based system might include:

(i) greater price stability, essentially because of the link between the ILRA and the price level. This might be even greater than under a commodity standard, where there is always the possibility of a change in the price of the commodity bundle;

(ii) helpful effects on inflation expectations. This advantage would be stronger if the greater automaticity of the system led to greater credibility of policy. There would be diminished scope for political interference compared with the ESCB, provided of course that countries agreed that the ILRA issuing authority should stick to the rules, even under difficult conditions;

(iii) little or no loss of monetary sovereignty to the ESCB - the ILRA issuing authority would be confined to the task of redemption of currency and issuance. Of course, the loss of freedom of manoeuvre of monetary policy for individual countries is similar to that under Delors 3, but the loss could be to a set of rules rather than to the ESCB.

29. Arguments against an ILRA based version of Delors 3 might include:

(i) much tougher anti-inflation adjustment, with greater volatility of interest rates and/or monetary base, and hence greater instability of the real economy;

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(ii) the automaticity of the ILRA would present a strong temptation to national governments, either individually or at the Community level, to override the system. Even if they did this only infrequently at times of major difficulties it would tend to undermine any possible credibility advantage;

(iii) much greater uncertainty as to how the system would work in practice. Without much more study, we cannot even be sure that it could be set up to produce guaranteed price stability in the long term. It has no close parallel in modern times. Its closest parallel, monetary base control, was adopted by the US between 1979 and 1981. The experiment was short lived mainly because of the greater volatility of interest rates that resulted. This suggests that countries are reluctant to pursue rigid rule based systems;

(iv) it would be difficult to devise and agree on a Community wide price index. Consumption patterns vary considerably between countries. It is difficult to know what implications this might have for the stability of the system.

30. Although an ILRA system might be the front runner amongst objective reference standards there are a number of powerful arguments against it as a serious alternative to Delors stage 3. It avoids the loss of monetary sovereignty inherent in the ESCB, although in terms of freedom of manoeuvre for the UK the gain might be small. It might also lead to greater price stability. But there would be no certainty in this. Governments have shown a willingness to interfere and mitigate the effects of very high or volatile interest rates. But the main argument against the system is that its macroeconomic consequences, for example for inflation and the stability of the economy, are very uncertain.

IF2 Division
HM Treasury

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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.

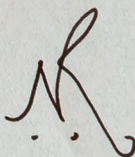
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I am sending copies of this letter to the Foreign Secretary
and to the Chancellor of the Exchequer.



N R

14 June 1990

DEPARTMENT OF TRADE AND INDUSTRY

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

of course not!

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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

Euro Poi: Euro 147

