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From the Private Secretary

20 June 1990

Chancellor's Speech on EMU

I have shown the latest draft of the Chancellor's speech tonight on "EMU Beyond Stage One: the UK Approach" to the Prime Minister. She is well content with it. Her only comment relates to the fifth sentence of paragraph 26 ("The ECU could become in time ... a single European currency"). She thinks there are too many thoughts compressed into a single sentence, with the risk that the Press will make a headline of "Chancellor Proposes Single European Currency". I think the Prime Minister's concern would be met if you will consider the following redraft, developing the thought rather more fully:

"In time the ECU would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be".

I hope you will feel able to accept this point.

C. D. POWELL

John Gieve, Esq.,
H.M. Treasury.

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19 June 1990

CDP 20/6

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
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Dear Charles

EMU

Following the Prime Minister's meeting this morning, the ... Chancellor has worked up the attached draft of a speech spelling out our new ideas on what should follow Stage 1 of EMU. Provided the Prime Minister is content with this, he plans to deliver the speech tomorrow evening. Since we need to set up the occasion and brief both the press and posts abroad during the course of the day, I would welcome a very early response.

I am sending copies of this to Stephen Wall (FCO), Martin Stanley (DTI), and Paul Tucker (Bank of England).

Yours

JG.

JOHN GIEVE
Principal Private Secretary

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EMBARGOED UNTIL 9.00 pm - WEDNESDAY, 20 JUNE

CHANCELLOR'S SPEECH TO GERMAN INDUSTRY FORUM: 20 JUNE 1990

ECONOMIC AND MONETARY UNION: BEYOND STAGE 1

Tonight, I want to deal with one of the most important issues on the current political agenda: the future of economic and monetary union in Europe. It is a hugely controversial subject, but I know of no other that is of such importance to the future direction and influence of the Community.

2. The Delors Report on EMU, with its 3 stage model, is at the centre of that debate but it does not present a universally acceptable prescription for the future and certainly cannot be the final word. But although we have substantial objections to the Delors prescription, that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage 1.

3. Of course Stage 1 is vitally important. It starts in ten days' time, and will entail the construction of a Single Financial Area in the Community, with a single market in all financial services, and wholly free movement of capital. That is a massive task - by any yardstick - which will mean an enormous amount of hard work for many people. But it is a task to which we in the UK are wholly committed. And our commitment is not merely expressed in words, but also - and more importantly - in deeds. A Commission report at the end of March found that the UK and Germany lead the rest of the Community in this respect, the UK having enacted all but 9 of the single market measures due for implementation by then, and Germany all but 11. Some other member states have as many as 30 or even 50 measures outstanding. I need hardly make the obvious point that we need faster progress than that.

4. Stage 1 also involves the completion of the exchange rate mechanism. The UK is firmly committed to taking

sterling into the exchange rate mechanism of the EMS. This we shall do, as I have made plain on innumerable occasions, when our well-known conditions are met. I restate that commitment yet again.

5. But the starting point for my remarks tonight is a world where Stage 1 is in place. For the debate about what comes then is moving rapidly forward. In a few months' time the economic and monetary inter-governmental conference will begin. That is a perilously short time when the Community is so far from reaching agreement on the practical steps needed to develop the Community's institutions. We need to debate these matters fully and constructively and reach conclusions that take all of Europe's nations forward together. Tonight I would like to indicate some fresh developments in our thinking.

6. Our approach builds on the paper I published last November that set out principles which should guide the future development of economic and monetary integration in the Community. We believe that any change:

- should be gradual and evolutionary;

- should work with the grain of markets;

- should respect the principle of subsidiarity - namely that functions should not be carried out at Community level when they can satisfactorily be carried out at national level;

- and we believe that any change should strengthen the forces making for stable prices.

7. We do not believe the ideas currently being worked on meet these criteria and we continue to have fundamental reservations about them. The core of our concern is that a

Central Community Bank - a Eurofed - would not be accountable to elected Governments even though the electorate would look to these Governments to ensure their economic wellbeing. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. Moreover we do not believe that the single monetary policy and the single monetary authority that are envisaged would deliver the economic performance and inflation performance that the Community will need in the future.

8. These are significant disadvantages that cannot lightly be brushed aside. But this does not mean that some form of EMU is not desirable - it clearly is - or that there are not other - better - ways of achieving convergence and low inflation, throughout Europe. And this could well involve institutional and currency development. That is the theme of the ideas I shall be putting forward tonight.

9. In particular they address the very practical question of where the Community should be looking to go once Stage 1 has been completed. It is generally recognised that this is one of the weaker points in the current debate. But it is a no less crucial question for that. For this reason, I have to say I view with concern recent suggestions from some quarters that the Community could do without Stage 2 altogether. I do not think that is practical.

10. It may well be that this latest outbreak of Big-Bangism has been triggered by events in Germany, where a very rapid transition to monetary union is envisaged. We all, of course, welcome the momentous changes in Germany. But we must beware of drawing false parallels with events on the broader European canvas. What is happening in German monetary union is that a large and healthy economy, and a strong currency, is absorbing the declining economy and weak currency of the GDR. It is - to all intents and purposes - a

takeover, willed by both sides, and with economic consequences primarily affecting Germany. EMU is a much bigger, and wholly different, proposition.

11. One of our main concerns about the idea of an EMU "big bang" is that it presumes a far greater degree of convergence of economic performance than is yet available, or in prospect. I might add that it is far from self-evident to me that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences in inflation between the economies of the Community probably require that for our inflation performances to converge, our interest rates must diverge - as indeed they do at present. That does not suggest a swift move to a single European monetary authority; indeed it argues strongly against it.

12. All those who are most anxious to set in place successful movement towards economic and monetary union should hold fast to this: without greatly increased convergence, monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening.

13. What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, East and West. We welcomed to Community membership some of the newly democratic countries in Southern Europe. Now several of the countries in Eastern and central Europe see very clearly the benefits of membership of the Community. In due course we should welcome this prospect, when their political and economic systems are ready. We should develop a form of EMU

that permits them to join us and does not put up barriers against it.

14. To my mind that argues even more powerfully for a gradualist and evolutionary approach, and against any attempt to move to a rigid and closed structure. It suggests that we should look for arrangements that promote convergence - and particularly convergence on low inflation - while retaining flexibility and choice.

15. We believe that we can now see a way forward which does precisely this. We believe that whatever the outcome of the debates about the longer-term, in the short and medium-term there are steps the Community could - and should - be taking which are valuable and useful in their own right and which would take the process of economic and monetary convergence further.

16. The issue need not be so divisive. The key is to build on Stage 1 further steps to promote convergence of economic performance, low inflation and stable exchange rates. And to do so by building up our infant common currency - the ecu.

17. A first practical step towards this might be to encourage the use of the existing ecu by issuing ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The Fund, acting as a currency board, would provide ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the Fund could only issue ecu notes that were fully backed by its own holdings of the various currencies which make up the ecu. So there would be no new money creation, and no threat to inflation. Interest rates on ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the ecu's constituent

currencies and so the Fund would play no role in setting interest rates.

18. Ecu bank notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of largescale markets in ecu deposits.

19. But these are modest steps, and I think we could and should go further. In my view, the best approach is the creation of a new "hard ecu". Under this approach the ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right - a new and international currency - which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their Chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

20. Under our approach, the European Monetary Fund which I have suggested would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue ecu deposits or notes in exchange for national currencies. It would set interest rates on hard ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard ecu market developed and commercial banks built up hard ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

21. A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose - indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the Fund's own money creation - through the issue of hard ecu liabilities and the influence it exerted on money creation by national central banks - was not inflationary.

22. It will be noted that both these ideas for developing the ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the central Bank Governors Committee and the existing European Monetary Cooperation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

23. It might also take on the essential task of coordinating member states' intervention against external currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This coordination would not involve member states giving up part of their foreign

currency reserves. Instead, intervention would be coordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

24. All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution - an EMF - to carry them out.

25. There is much discussion about the final stages of EMU. And more than one version of it. In these discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening - for promoting greater economic and monetary integration beyond Stage 1 - must be fully considered. They offer a way forward around which all Europe should be able to unite.

26. They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally from stage 1 and have the potential to evolve further. In time the ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be. In addition the development of a hard ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they represent a practical and sustainable way forward for Europe.