



See by
our
LWS

10 DOWNING STREET
LONDON SW1A 2AA

20/6

From the Private Secretary

Prime Minister

EMU

This is the text of the
speech which the Chancellor
will give tonight, launching
our proposals on EMU. It
reflects comments which I have
made on an earlier version.
I think it is fine: it
suggests moving to the hard
écu via the Treasury's

original proposal. It makes
clear that we cannot accept
Delors stage 3. It makes no
reference to opting-in. The
only point you will want
to reflect on is that - in
the very long term and by
national choice - the hard EU
could itself become a single
currency. That seems logical if
unhindered.

The Charter needs clearance
by mid-morning. Content?

C.D.I. 20/6

10.00 pm
Tuesday

EMU BEYOND STAGE 1: THE UK APPROACH

[Revised speaking note]

I am very pleased to be here this evening and grateful to you for accepting a switch of speaker at the last minute. I offer my commiserations to those who were present at the German Chamber of Commerce Lunch last Tuesday, and who are therefore faced with the same speaker twice in one week. But I hope there will be at least some consolation in hearing the next instalment of the story, for it is the ideas I began to spell out on that occasion which I wish to take further.

2. Tonight, I want to deal with 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. 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.

3. But that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage I.

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✓ 4. Of course Stage I 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 on the ground. 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. [Record of single market implementation.]

✓ 5. Stage I also involves the completion of the exchange rate mechanism. The UK is just as 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 tonight.

6. But the starting point for my remarks tonight is a world where Stage I is in place. For the debate about what comes then is moving rapidly forward. In a few months' time an inter-governmental conference will begin to consider how best to take forward the process of economic and monetary integration in the Community. 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

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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.

7. 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;

✓ and should strengthen the forces making for stable prices.

✓ 8. We do not believe the Delors report meets these criteria and we continue to have fundamental reservations about the approach it sets out. The core of our concern is that we do not believe that a single monetary policy and a single monetary authority will deliver the economic performance and inflation performance that the Community will need in the future. Moreover, a Central Community Bank - a Eurofed - would not be accountable to elected Governments even though

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✓ the electorate would look to these Governments to ensure their economic wellbeing. These are significant disadvantages that cannot lightly be brushed aside. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. 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, Europe-wide. And this could well involve institutional and currency development. That is the theme of my proposals tonight.

[good formulation - not Stage II] ✓
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 was one of the weaker points in the Delors report. 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. [It would be like moving from infancy to adulthood with no intermediate stage.]

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

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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. 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 that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences that exist at present between the economies of the Community probably require that for our performances to converge, our monetary policies 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, economic and monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both

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economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening. It would be tragic indeed if the desire to intensify European unity were to turn against itself.

✓
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 have already seen how membership of the Community has strengthened the democracies and economies of existing member states. Several of the newly democratising 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.

[Mr. Liddell's point]

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.

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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 integration further. The issue need not be so divisive.

16. The key is to build on Stage I further steps to promote convergence, low inflation and stable exchange rates. And to do so by building up our existing 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 would be done in such a way as to avoid increasing the Community's total supply of money. We should insist that the board 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

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average of interest rates on the ecu's constituent currencies and so the currency board would play no role in setting interest rates.

18. Ecu banks 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 I think we could and should go further than that limited step. 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 as a 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 Committee under their Chairman, Sir Michael Butler. My own ideas are rather different, but I readily acknowledge the debt they owe to his.

20. Under my approach, the European Monetary Fund would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. It would set interest rates on hard ecu. Initially, it would do this by setting rates on

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the 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 hard ecu bank for hard currencies. This repurchase obligation would ensure that the combined effect of the bank'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

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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 manage it.

23. It might also take on the essential task of coordinating intervention against third 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.

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If we leave this all in a single sentence
the head-line will be "Chancellor proposes
single currency". It must be taken in longer
time. Suggest it is divided into at least 2
sentences.

"In time the ecu would be more widely used:
it could become a common currency for Europe.
In the very long term, ~~provided~~ if people and governments
so chose 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 or circumstances
of the new Europe will be."

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

25. ^{There is much} ~~discussion is bound to continue of~~ ^{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.

The ecu could become in time much more widely used: a common currency for Europe - and in the very long term - if people and governments so choose - a single European currency. 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

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represent a practical and sustainable way forward for
all Europe.

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Received
0630
20/6/90