

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

The Chancellor wishes to discuss the date of entry into the ERM at tomorrow's bilateral.

I attach his minute to you covering a background Treasury paper. The papers are disappointing: they are not an objective appraisal of different entry dates.

Treasury Case

The Chancellor's minute identifies three "windows" for entry:

- next month (20 July)
- September/October
- After the 1991 Budget.

The Chancellor considers that the UK should join the ERM either in July or September/October. His line of argument is driven by two considerations.

a. The exchange markets have clearly anticipated early UK entry into the ERM. The strong Effective Exchange Rate is helping to tighten the monetary stance; the rate is at the right level for entry now into the ERM; but that rate is not sustainable for more than a few months - unless the UK joins the ERM.

b. Whatever domestic upsets may arise e.g. adverse inflation figures, wage settlements, balance of payments etc, and whatever the external shocks e.g. disruption to the ERM following GEMU, they can be accommodated providing the UK joins within the wider

bands.

Assessment

Several aspects of this reasoning seem distinctly unsatisfactory.

First, are these "windows" genuinely the only possibilities? It is not clear for example that November and December are ruled out by the existence of the Autumn Statement in November and the Inter-Governmental Conference in December. Nor is the Treasury line that the high exchange rate could not be sustained convincing. The pound has, in effect, been talked up in recent weeks: it should not be difficult to heighten expectations of imminent entry in the months after September/October, if the exchange rate were to come under downward pressure.

Clearly, if entry is delayed too long, markets might come to doubt the UK's intentions; and it might then not be possible to sustain the exchange rate, if the fundamentals on inflation, balance of payments etc were adverse. But the timing and size of any such confidence effect is much less clear than implied in the paper. And the economic fundamentals are expected to begin improving from early autumn.

Judicious statements about intention to join the ERM should allow the choice of a wide range of dates between November and February 1991.

Secondly the Treasury case for joining in July looks to be little more than opportunism on the back of the (inspired) rise in the exchange rate. There are three good reasons for not going in next month which also need to be taken into account.

- a. One of the Madrid Conditions was that the Government wanted to get inflation down before the UK joined the ERM. In July, the latest RPI figures will be for June: it is quite likely that the RPI rate will be higher than this month's 9.7 per cent annual increase; and the underlying rate is still rising. Quite simply the Madrid Conditions would not have been

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met.

The corollary is the strong argument for delay at least until September or October. The nominal RPI year on year rate should have turned down and the underlying rate should be steadying. With a new wage round getting underway then it is important to stiffen the resolve of employers to resist high wage settlements - though it can be argued that the mere expectation of entry might be sufficient to do that.

b. The Government might well be criticised for political opportunism - taking the UK into the ERM when the exchange rate was high, despite adverse economic fundamentals. And you may consider that there are political reasons for delaying any announcement beyond the end of the present session.

c. The paper argues that the impact of GEMU has been discounted in advance by the exchange markets. The recent weakness of the DM would suggest <sup>that</sup> sentiment is right. But it is by no means clear that all the adjustment of the Deutschmark, following GEMU, within the ERM is complete. Nor, as the Chancellor's paper implies, can we be sure that any such adjustment would be complete within three weeks of entry to GEMU.

Thirdly, the background paper correctly identifies the danger of "backlash" some months after entry - with the UK coming under pressure to raise interest rates etc. After a honeymoon period, UK entry to the ERM will imply rising unemployment and difficulties for the business sector as price expectations are painfully brought down. You will wish to avoid this adjustment at a politically sensitive time.

But the Treasury paper offers no views on how long this honeymoon period might be; it does not therefore work out whether any backlash might be timed in July or October 1991. In short, it does not explore the political dimension.

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CONCLUSION

You may wish to ask the Chancellor to probe some of the above factors more thoroughly. (I attach an earlier brief which provides a longer list of relevant considerations than in the Treasury note.) In the meantime, you may judge that the Chancellor should be discouraged from considering entry to the ERM as early as next month. (I might add that no newspaper article and no-one of the City is expecting entry before the early autumn).

BHP

BARRY H. POTTER

26 June 1990

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UNCLASSIFIED**EMU**Pohl says UK proposals would not solve problem of achieving economic and monetary union in Europe

UK proposals widely welcomed as positive contribution to debate on EMU.

President of the Bundesbank said British proposals should be discussed in relevant EC committees. My Rt Hon Friend the Chancellor of the Exchequer, and the Governor of the Bank of England who has been fully involved in preparing UK's proposals, will look forward to explaining our ideas further;

Herr Pohl expressed strong reservations about the Commission's latest prescription for EMU. He said the latest Commission proposals were "unrealistic and will not work". Government entirely agrees with that. Our evolutionary approach the right way forward.

PM has agreed to intergovernmental conference, starting December?

House will want to hear Prime Minister's own report on outcome of Dublin European Council. Understand reached agreement to start IGCs on EMU and on institutional reform in mid-December. Government has always made clear it will take full part in IGCs: we do not believe in an empty chair policy.

Two-speed EMU?

Do not believe many in Community would want two-speed EMU. Whole point of IGC is to discuss way forward as 12. Hope we will reach common agreement.

ERM: Pohl said time not yet right but may be soon

UK will join ERM when Madrid conditions met.

Single currency one day?

Simply cannot say now. Chancellor said in speech:

"In time the ecu would be more widely used: it would become a common currency for Europe. And in the very long term - if people 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".

Pohl says UK proposals raise same problems as Delors prescription: how ensure independence of central bank?

Key difference between our proposals and Delors prescription: European Monetary Fund managing hard ecu would not have discretion to follow inflationary policies. Would be bound by its obligation

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to keep its currency at least as strong as the strongest national currency.

UK proposal too complicated: responsibility for monetary policy divided between EMF and national central banks?

No. National monetary authorities would remain fully responsible for their own currencies. Hard ecu would be further currency, managed by EMF, by its nature setting a stiff standard for competition between national monetary policies. Entirely beneficial.

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**UNCLASSIFIED****BACKGROUND**

1. In an interview with The Times today (attached), Herr Pohl, President of the Bundesbank, said that
  - a parallel currency has more disadvantages than advantages;
  - it would not solve the real problem, which is also posed by the Delors proposals: how to achieve a genuinely independent central bank? In sharp contrast to the UK, Pohl considers that the Commission's latest ideas do not go far enough in creating an independent Eurofed.
  - however, the UK proposals should be discussed in the relevant EC Committees;
  - a two-speed EMU is possible: all EC countries might sign an EMU Treaty, but they could enter the arrangements at different speeds in the same way as the EMS had been set up.
2. The Chancellor's speech on EMU has been widely reported in Europe. Most reactions are:
  - welcome for UK's positive approach in putting forward these proposals:
  - some scepticism about the idea of building up the hard ecu as a parallel or common currency, rather than the Delors prescription for moving (via a transitional stage) straight to locked exchange rates and a single currency managed by a single Community central bank.

HM Treasury  
26 June 1990

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# Pohl rejects Major's plan for hard ecu

By ROBIN OAKLEY AND MICHAEL BINYON IN DUBLIN

## THE TIMES Thatcher edges towards monetary union

THE president of the West German Bundesbank, Karl Otto Pohl, yesterday rejected British proposals to introduce a hard European currency unit as the continent's common money.

Plans put forward last week by John Major, the Chancellor of the Exchequer, for an ecu to run alongside national currencies were greeted with widespread interest at the European Council in Dublin yesterday, according to Douglas Hurd, the foreign secretary, and British officials.

In an exchange with Mrs Thatcher, President Mitterrand of France gave some encouragement to the plan as marking a British advance towards a single European currency. But West German officials were totally dismissive, saying it was irrelevant to the real debate and had not even been discussed by Bonn.

Charles Haughey, the Irish prime minister and host to the summit, said: "Everyone accepted that the British proposals were a clear indication of a positive and constructive approach by the British government to the whole question of EMU (European monetary union) and a commitment to the EMU goal — though not necessarily along the lines outlined in the Delors report."

West German scepticism of the Major plan, cited by officials in Brussels as soon as it was announced, was one of the main reasons why most European Commission sources suggested it would not be

adopted. Their feelings were clearly reflected in an interview with *The Times* yesterday by Herr Pohl. He said that a parallel currency had more disadvantages than advantages and "would not solve any real problem".

The Major plan called for management of the ecu by a European monetary fund, but Herr Pohl said the creation of a central bank which left national and central banks in charge of monetary policy was impractical. He declared: "The non-divisibility of responsibility is the decisive argument."

While Mrs Thatcher was arguing in Dublin for the need to write into the EC constitution the doctrine of subsidiarity — that community institutions did not do things which national authorities could do for themselves — Herr Pohl said: "In monetary policy the principle of subsidiarity does not apply."

He was insistent that the problems of European currencies could not be solved by the creation of an additional currency, the essence of Mr Major's plan.

Mr Haughey described the summit discussion as "very good, positive and philosophical". The decision to hold an inter-governmental conference on EMU and on political union had been taken unanimously, with Mrs Thatcher agreeing that enough preparatory work had been done.

She told her EC partners she did not envisage a single currency within 20 years. But Mr Haughey said this was just a figure of speech and Britain's position was well known.

Other summit participants accepted that she is edging towards ultimate acceptance of monetary union, including plans for a central bank and single currency. Noting how she has continued her conciliatory tone towards European institutions and closer integration, they saw this confirming a change in her confrontational approach first apparent at the Strasbourg summit last December.

At one stage during yesterday's discussion, the Prime Minister and President Mitterrand indulged in one of their jocular sparring sessions, a feature of these meetings. He said of the hard-ecu plan that

the policy was good as long as it did not stop the EC from going further. "Maybe that's her aim." She replied: "I don't have arrière-pensées. I can't hide my intentions." He countered: "You don't have a record for your arrière-pensées."

The decisions to hold two inter-governmental conferences starting in Rome on December 14 came before a private discussion over dinner of possible Community aid to the Soviet Union — one of the few divisive issues of this summit.

Mr Haughey said beforehand that all the Twelve had a deep concern that President Gorbachev should overcome his economic and political problems and a real interest in seeing that perestroika was not derailed. He added: "To that extent the community must look at any possible way in which we could be supportive." But so far it had received no analysis of the real extent of the Soviet problems.

The summit broke for dinner shortly before the end of the World Cup football match between Ireland and Romania which virtually shut down Dublin for the afternoon. Mr Haughey, who had promised to go and watch the Republic in Rome if they went on to the next round, broke off a briefing to watch the final decisive penalties. But finding the tension too much he turned away from the screen, erupting seconds later in a whoop of joy along with everyone else in Dublin Castle.

He then danced an Irish victory jig in the courtyard before driving off to talk about South Africa, the Soviet Union and the vexed but still unsettled question of where to site the various European agencies looking for a home.

● The Bank of England, which did much of the technical work on the "hard ecu" proposal, was understood to be disappointed by Herr Pohl's remarks (Colin Narbrough writes). Robin Leigh-Pemberton, the Governor, will seek to explain details of the proposal to his fellow central bankers at a meeting in Basle on July 10.

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THE TIMES

# Flexibility // by Thatcher on the EC's path to union

From MICHAEL BINYON IN DUBLIN

EUROPEAN Community leaders yesterday formally launched two conferences on political and monetary union, a move described by the French as setting Europe on the road to a federal destination.

The 12 leaders agreed on the first morning of their summit to call an inter-governmental conference on political union on December 14 in Rome, immediately after the next European Council summit. A similar parallel conference on economic and monetary union will open at the same time, with both aiming to conclude by the end of 1992.

Margaret Thatcher, bowing to the inevitable, put a brave face on the decisions, raising no objections and promising vigorous British participation.

Douglas Hurd, the foreign secretary, said the session had been "good humoured". Britain still did not think the timing ideal because "we have enough on our plate", but he said the proposals for political union were really about practical ways to improve the workings of the community. "A lot of the rhetoric has been flushed out," he said.

Mrs Thatcher praised the report he and fellow foreign ministers presented, which outlined the questions to be answered on political union. She said it respected the separate identities and institutions of member states, reaffirmed that the Council of Ministers would remain the decision-making body, and underlined the principle of subsidiarity — leaving to national governments everything that did not need to be decided at community level.

This principle, she argued, should be written into any changes in the Treaty of

Rome. Until now there had been much lip-service paid to subsidiarity. But on such questions as social policy it was not respected. It was ridiculous that decisions on part-time work and night work should be taken in Brussels. She insisted that the Twelve were still sovereign nations and would yield sovereignty only on the basis of joint decisions.

On economic and monetary union, she showed equal flexibility. She again praised John Major's plans for a hard ecu and a European monetary fund, which Mr Hurd said provoked more interest than he expected. Britain was an enthusiastic supporter of the first stage of the Delors plan for EMU, which comes into force on July 1. And, dropping the hard line she showed a year ago at the Madrid summit, she agreed there had been "full and adequate preparation", although she wanted to see further work by finance ministers.

Britain was at pains to show its partners that it did not rule out an eventual common currency. Mrs Thatcher insisted that the widely differing economies of the Twelve demanded flexibility, and a single currency ran the risk of breaking down, like the Bretton Woods fixed exchange rate system did in the early 1970s. And, in a teasing variation on her assertion that this would not come in her lifetime, British sources suggested it would not be possible before 10 or 20 years.

EC leaders decided yesterday to use their foreign ministers' report on political union as the agenda for the inter-governmental conference. There was little detailed discussion yesterday of the ideas that will be broached in December. Mrs Thatcher did not put forward her call for an EC ombudsman or British proposals for strengthening the role of the European Court of Justice.

The report on political union identifies four issues as the main themes for debate: the further transfer of competence to the community, the need to ensure more democratic accountability, including a strengthening of the European parliament and greater involvement of national parliaments; increased efficiency of EC institutions, including more majority voting in council meetings and better enforcement of decisions; and the working out of a common foreign and security policy, with a proper definition of the European Commission's role.

For the first time, an outsider was invited to attend the summit. Lothar de Maizière, the East German prime minister, was invited to lunch with the 12 leaders.

THE TIMES

BRITISH proposals for a hard European currency unit (ecu) as Europe's common currency will not achieve monetary union, Bundesbank president Karl Otto Pöhl claims.

The proposal was made last week by John Major, the Chancellor of the Exchequer, and endorsed by Margaret Thatcher and Robin Leigh-Pemberton, Governor of the Bank of England. It envisaged the establishment of the ecu as a 13th European currency.

In an interview with *The Times*, Herr Pöhl said the proposals would not solve the problem of achieving monetary union for Europe. "A parallel currency has more disadvantages than advantages and would not solve the real problem. The real problem is if you create a genuine ecu — not just a basket ecu — is that you get the same problems which you would have with a single European bank and currency; that is, questions like the bank's independence that would need to be decided. But I would like to add that we will discuss the British proposals in the relevant committees." In his proposal, outlined last week, the Mr Major proposed the establishment of a European Monetary Fund (EMF) to act as a currency board and supply member states with "hard ecus" in exchange for their national currency.

The EMF's responsibility would be to manage the hard ecu and ensure it stayed within its margins in the exchange-rate mechanism. In case of a realignment within the ERM, the hard ecus would not be devalued. The Chancellor said this proposal, unlike other previously floated ideas of parallel currencies, had the advantage of being evolutionary and anti-inflationary.

Herr Pöhl rejects this idea as impractical: "Once you create a central bank which does not have the instruments and the opportunity to conduct efficient monetary policies, national and central banks will still be in charge. It is the non-divisibility of responsibility for monetary policy which is the decisive argument.

"In monetary policy, the

# A hard ecu poses same problems<sup>23</sup> says Pöhl



Karl Otto Pöhl: more disadvantages than advantages

principle of subsidiarity does not apply. I believe this represents a widespread mistake in the current debate. The responsibility for monetary politics cannot be divided.

"There is also a lack of clarity in the most recent proposals by the EC Commission. There, an impression is being created that the European central bank would formulate only the general principles, while it would be up to national central banks to implement them. This concept is unrealistic and will not work."

He also said the establishment of the hard ecu would ignore the rationale of EMU; to reduce the power of the Deutschmark. "A process of

competition of currencies would lead to one currency — and no prizes for guessing which one that is — which would dominate a system. That's the whole philosophy behind this argument. You can't solve the problem by creating an additional currency to the 12 we have already."

Herr Pöhl also stressed that a parallel currency, in hard and soft forms, had been rejected in the Delors Report, which set out the three stages towards monetary union. Herr Pöhl stressed the report had been signed by all EC central bank governors, including Mr Leigh-Pemberton.

Herr Pöhl's comments indicate that the Chancellor's proposals may not prove to

end the deadlock between Britain and the rest of Europe in the debate on European Monetary Union, as was hoped last week. The West German government and the Bundesbank favour a single European currency only on the condition that a European central bank would enjoy independence in the day-to-day conduct of its monetary policy.

Herr Pöhl said: "If we are to have a European monetary regime, then it has to be as good as, for example, the Bundesbank's. And a European central bank can only achieve price stability if it is independent in its monetary policies of the EC institutions and governments."

Mrs Thatcher again rejected last week the concept of a single European currency on the grounds of national sovereignty.

Herr Pöhl repeated comments made last week that in the event of a delay towards an agreement on monetary union, some nations could progress more rapidly than others. "It is conceivable that the treaty will be ratified by all members, but also that some who are unable or do not want to participate straight away, are invited to take part at a later stage. This is not new in Europe. The EMS, too, was founded in this manner.

"As far as monetary union is concerned, it is evident there are some countries which do not want that or cannot do that. The Delors Report also mentions this explicitly under paragraph 44."

He also said the "time is not yet ripe" for Britain to join the exchange-rate mechanism, but said the situation could change soon. "The success [of reducing inflation] is a result not of membership of the exchange rate mechanism, the success is a result of changes in policies. But Britain already conducts such a [anti-inflationary] policy. I am optimistic that the rate of inflation will be reduced to a degree, which will enable Britain to enter the system without creating tensions for the system itself."

Wolfgang Münchau  
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