



②
Prime Minister

CGP
4/7

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

3 July 1990

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Charles

CHANCELLOR'S MEETING WITH THE PRESIDENT OF THE BUNDESBANK

The Chancellor had lunch today with Herr Poehl. Sir Peter Middleton, Sir T Burns, the Deputy Governor of the Bank of England, the German Ambassador, and Herr Poehl's Private Secretary were also present.

Germany monetary union

Poehl said that the first days had passed smoothly. He thought the concerns that had been expressed about the inflationary consequences of union had been much exaggerated. There were already inflationary pressures within the Federal Republic which was operating near to full capacity and the Bundesbank were not complacent about those but he doubted whether monetary union with the East would add much to the pressures. He main concern was that after a few months the inability of the GDR's industry to compete would lead to a dramatic rise in unemployment and redundancies which could in turn give rise to social unrest. There was a high probability that the Federal Government would respond to that in a pre-election period by subsidising jobs and increasing Government borrowing. That in turn could put further upward pressure on interest rates. He feared that some members of the Government thought of borrowing as a soft option; the Bundesbank was trying to disabuse them of that. But on balance he was optimistic about the outcome of monetary union.

EMU

The Chancellor said that he was puzzled by the lack of attention given elsewhere in the Community to the practical question of how

CONFIDENTIAL



to move beyond Stage 1 and the obsession with the details of Stage 3. There seemed a widespread assumption that a rapid move to full monetary union was possible yet in reality that would be disastrous for several Community countries. The consequent pressures for a massive increase in regional aid could hardly be attractive to the more prosperous member states. Herr Poehl agreed. He said he had always been opposed to trying to proceed rapidly towards union. The pressure had come, above all, from France which wished both to bind Germany more closely to the Community and to reduce the dominance of the Bundesbank in monetary policy. No one believed that Greece or Portugal (or probably Spain or Italy) would be ready for full union in the near future but there was a powerful commitment to produce a new treaty quickly and it would be very damaging if the IGC failed.

The Chancellor said that the IGC could not be a success if one or more members refused to sign the treaty and for the foreseeable future he could not see Parliament ratifying a treaty which committed the UK to Delors Stage 3. Herr Poehl said that he doubted whether the British Parliament would be alone in that. The Danes for examples were likely to resist such a treaty and the French National Assembly might also throw it out. He referred to recent comments by Chirac, Balladur and Giscard and noted that Beregovoy had been non-committal on EMU. He would not be surprised if the outcome were an agreement which allowed some countries to advance faster than others. Another possibility, if the IGC broke down or the new treaty was not ratified, would be a Franco-German agreement (in which Benelux would almost certainly participate) to set up their own joint central bank which other Community members could join when and if they wished to. This had been the model for a number of Community developments including the EMS and the Schengen agreement. A third possibility would be a search for a face-saving alternative like, perhaps, the hard ecu proposals.

The Chancellor said that these ideas had not been put forward as a diversionary tactic but as serious proposals which would allow the Community to move beyond Stage 1 in an evolutionary manner. Herr Poehl said that the proposals needed to be examined more closely in the Monetary Committee and in the Central Bank Governors' Committee. However, the UK should not expect that all work on the leading option would be abandoned or set aside. He recalled that proposals somewhat like the UK's had come up in debates in the 1970s and the Bundesbank had always strongly opposed the creation of parallel currencies and was not likely to change its view. It had taken many years, for example, to reconcile his Council to the present ecu. The Ambassador said that it was very important to emphasise that the hard ecu could develop into a single currency and the EMS into a ESCB.

Herr Poehl asked what would happen to the existing ecu under the proposals. The Deputy Governor said that there was no difference in principle between this and dealing with the periodic revisions

CONFIDENTIAL



of the existing basket. The old ecu would have to be used for existing contracts and the hard ecu would be used for new ones. He did not think this was an insoluble problem. Referring to Poehl's comments about the indivisibility of monetary policy, he said that he thought a confusion of responsibilities was more likely to arise under the Bundesbank's approach than under the Chancellor's alternative scheme. Herr Poehl was encouraging the Central Bank Governors' Committee to assess the economic position of each country and advise on the appropriate stance of policy. The UK proposals left a clear division of responsibility with the EMF being responsible for managing the ecu while the national authorities remained entirely responsible for national monetary policies, although the existence of the ecu would affect the environment within which they worked. He added that the EMF could be obliged under its statute to operate the ecu with a view to exercising counter-inflationary pressure within the Community. Herr Poehl said that he was keen to find some method by which national monetary policies could be made more consistent. The Central Bank Governors' Committee would have no executive authority over national policies but would simply offer advice to national authorities. The Deputy Governor said that if this advice were made public - as had been suggested - it could become a real factor in markets and would confuse responsibility for policy.

Herr Poehl said that he had not claimed that the hard ecu proposals would be inflationary but they would make things much more complicated and would not avoid any of the problems of accountability that had been identified in the Delors proposals. They would not bring the economic advantages of lower transactions costs (although he did not place too much weight on that) and there was no certainty that the hard ecu would be any more popular than the existing ecu.

Sir T Burns said that one advantage of the EMF proposals were that they provided a flexible route beyond Stage 1 in which all 12 could participate and which could start early. The Deputy Governor pointed out that the creation of the hard ecu also built in new pressure on European economies to converge on low inflation. Progress along the Delors route by contrast was dependent entirely on political will among governments and the influence of the Central Bank Governors' Committee. Herr Poehl acknowledged these advantages but asked about the risk of turbulence in the markets if expectations of a realignment built up. Sir T Burns said that the repurchase arrangements would bring matters to a head very quickly and would impose a considerable penalty on devaluation. Herr Poehl accepted that that was one charm of the hard ecu proposals. By contrast, under the Delors route a profligate Government would be constrained only by loss of competitiveness and high unemployment. He acknowledged that in practice that would lead to pressure for high regional subsidies.

CONFIDENTIAL



Concluding this part of the discussion, the Chancellor said that the hard ecu proposals were not a flight of fancy and he intended to press them in ECOFIN and in the other Community forums. He expected them to be fully discussed. Herr Poehl said that the proposals were well developed and he did not want to dismiss them. Certainly the UK should promote them but, equally, they must expect others to promote their own ideas. He could imagine a point during the IGC when the British ideas might attract some support so he did not think now was the time to say "the last word".

ERM

The Chancellor said that he had not always been an enthusiast for joining the ERM but was now convinced that it would be in the UK's interests. We were committed to joining as soon as conditions were right. Herr Poehl said that he had long been in favour of UK membership. Conditions two or three years ago would have been easier for entry and there could be advantage in seeing inflation peak before entry. Care was needed on the rate as well; too high a rate had disadvantaged Belgium when the ERM was first established. He did not think that GEMU would be a factor in the decision. It had not led to turbulence in the markets, although there could be some reaction in the autumn if there were disturbances following redundancies and closures. The Chancellor said that it seemed likely that UK inflation would rise a little further and reach a peak in August (whose index would be published in September). The Deputy Governor noted that sterling had risen strongly in recent weeks and days in anticipation of early entry.

The Chancellor asked Herr Poehl when he would join were it his decision. Herr Poehl said that a number of his colleagues in the Bundesbank would be concerned at early entry because of the risks of strain within the system but his own opinion was that we should join in September or early October. Waiting too long would risk disappointing market expectations and that could be disastrous for sterling. He added, however, that it was entirely a decision for the British Government although he hoped that we would talk to the Bundesbank once our minds were made up.

I am sending copies of this letter to Paul Tucker at the Bank of England and to Stephen Wall (FCO).

*Kws
Ja*

JOHN GIEVE
Principal Private Secretary

