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3 July 1990

Spencer CD 3/7

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

Dear Charles,

ECONOMIC AND MONETARY UNION: THE WAY AHEAD

... The Chancellor has agreed to do a signed article, pushing our hard
ecu proposals, for syndication in the European press. I attach
the latest draft. As the article needs to be signed off this
evening, I am afraid any comments would need to reach us by
5.00 pm this afternoon.

I am copying this letter to Stephen Wall (FCO) and
Paul Tucker (BoE).

Yours sincerely,

Maira Wallace

MOIRA WALLACE
Private Secretary

DRAFT OF 3 JULY 1990

ECONOMIC AND MONETARY UNION: THE WAY AHEAD

There is no more important issue facing the European Community than the path we choose towards economic and monetary union. We are all committed to this goal. That is no longer news. What is new is that we are getting close to the point of decision on what economic and monetary union actually means, and what steps we need to take to progress towards it. We cannot afford to get this wrong. For to do so could wreck the cohesion of the Community, and be fatal to its future development

2. Stage 1 of economic and monetary union began on 1 July. It will involve the construction of a single community financial area with a single market in financial services and wholly free movement of capital. Britain is a wholehearted supporter of all the elements of Stage 1, and has been in the van of implementing agreed legislation. We hope that the nations in the rear will match their oratory about European ideals with practical action, and soon. Also during Stage 1 all member states will become full participants in the exchange rate mechanism of the European Monetary System. For its part, the UK will join the ERM as ^{soon} ~~soon~~ as it is appropriate to do so.

I have
suggested
sticking to a
habitual
formula.

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3. But what happens after Stage 1? On the economic side excellent progress has already been made and there is now considerable agreement that future arrangements should allow freedom of action for member states in taking decisions about appropriate levels of public expenditure, taxation and budget deficits, while outlawing monetary financing. We should encourage the process by which Finance Ministers and Central Bank Governors discuss the problems they face in managing their economies - and look for co-ordinated solutions where possible. The Community can only gain from such an approach.

4. But there is, as yet, no consensus on post-Stage 1 developments on the monetary side. Until now the debate has been dominated by the Delors Report, with its proposals for a final stage of economic and monetary union involving automatic transition by administrative fiat to a single currency, a single monetary policy, and a European central bank. Britain's reservations about these proposals are well-known. They are based on firm convictions about what is right for the future of the Community, and what is in the best interests of member states.

5. Our clear view is that without improved economic "convergence", monetary union simply would not work - indeed it could not work. A premature attempt to impose it would be unsustainable, and would lead not to unity, but to disunity.

6. At present there are still significant disparities in economic performance between member states. Until that has been corrected, and economic performance converges, a rapid jump to a single currency and a single monetary policy would put an intolerable strain on the Community. The cost for the less strong nations would be high, and would be expressed in lost output, lost jobs and a loss of asset values. This would undoubtedly lead to pressure for large budget transfers from the richer nations; but even if these were forthcoming, they themselves would merely delay adjustment, as well as risking new tensions between contributor and recipient nations.

7. Surely this is not the kind of Europe anyone wants. Rather, we want an open Europe: open to trade and investment; and in due course open too to new members from Europe, East and West. We believe passionately that we should develop a form of EMU that is consistent with that vision. That is important for EFTA countries, and will in due course be important for the newly emergent democracies of Eastern Europe. That argues powerfully for a gradualist and evolutionary approach and against any attempt to move to a rigid and closed structure.

8. These are the reasons why Britain has come forward with new ideas going beyond Stage 1. These ideas satisfy six key criteria:

- they are gradual and evolutionary, following naturally from Stage 1, avoiding a "big bang" approach;
- they work with the grain of the market;
- they would strengthen price stability;
- they allow proper accountability and avoid an unnecessary centralisation of economic and monetary decision-making in the Community;
- they make greater economic convergence in the Community a pre-condition of further progress towards economic and monetary union;
- and they avoid talk of two-tier or multi-speed Europes, dividing north and south. I want to see the Community more united, not fragmented. That is the right way forward.

9. The new British proposals concentrate on offering the whole Community a way forward now. We propose two steps. First, we should transform the ecu from a unit of account into a real currency by issuing ecu bank notes for general circulation. For this we propose the establishment of a new institution - a "European Monetary Fund". The EMF would also be responsible for a range of other important activities -

managing the Exchange Rate Mechanism, co-ordinating the intervention of central banks against non-EC currencies such as the yen and dollar, and helping to manage medium-term balance of payments lending.

10. We think that ecu notes will be attractive to business travellers and tourists from the start. But we would go further, and suggest the creation of a "hard ecu". This would be a new international currency in its own right, no longer a basket of the 12 national currencies; it would co-exist beside the existing currencies of the 12 member states. A central feature of our proposals is that the new ecu would never be devalued - it would always be at least as strong as any other community currency. This would mean that the hard ecu would not run the inflationary risks of previous parallel currency proposals. We have set out safeguards to ensure that the European Monetary Fund did not accommodate lax national monetary policies. We see the hard ecu promoting lower inflation and greater exchange rate stability.

11. In time, the ecu would become more widely used - a genuine common currency for Europe. In the very long term, if peoples and Governments so choose, it could develop into a single currency. That is a decision we cannot and should not take now. But Britain proposes this approach in the clear knowledge that it could happen.

12. I look forward to discussing these ideas with my Community colleagues in the preparations for, and during, the Inter-Governmental conference on economic and monetary union due to begin in December. I want the Community to maintain the momentum established by Stage 1. We will not achieve that by going for a leap in the dark which could all too easily prove disruptive and self-defeating. I believe our ideas avoid many of the potential dangers of the present Stage 3 proposals, and offer a more practical and sustainable way forward for the whole Community.

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