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PERSONAL

Charles Powell Esq  
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*mp*

Prime Minister

*You will not  
find this palatable,  
but also to  
read the firm*

*Dear Charles,*

EMU

Thank you for your letter of 19 July.

2. I enclose a record of my discussions with Sarcinelli and Padoa-Schioppa. I am afraid that they confirm my fears that we shall get into an 11:1 position by October if we continue to present our proposals as an alternative to the Delors plan as a whole rather than as a preferable route to full EMU.

*enclosure*

*C 100  
23/7*

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3. The Prime Minister has accepted the aim of EMU on several occasions, for example at Madrid. Full EMU has always meant permanently fixed parities or, more recently, a single currency. It was the particular version of full EMU in the Delors proposals to which the House of Commons objected. If the Prime Minister is to escape from all the serious consequences, at home as well as in the EC, of an 11:1 situation in October and isolation in the IGC, there is no alternative to shading her line a little and accepting that the EC will aim to achieve permanently fixed parities or a single currency one day. That need not prevent her from arguing that we do not have to decide the modalities of Stage 3 now.

4. If Pöhl did not reveal his hand to the Prime Minister, that was naughty of him. But it was quite clear from what he said at a lunch at the German Embassy after seeing her and from the line he has taken since that para 4 of my letter of July 17 correctly represents his position.

5. Please tell the Prime Minister that I would not press this issue so hard if I were not convinced of its importance for her. I hope she may be wiling to have another discussion on the subject with me.

*Yours ever  
Michael*

Sir Michael Butler

MDB/JSD

EMU

Visit to Sarcinelli (Italian Treasury)  
and Pado-Schioppa (Bank of Italy)

Each was accompanied by an assistant. We had two hours intensive discussion. A note on the technical points is attached.

2. Their understanding of Pöhl's aims was the same as mine; either to maintain the status quo or to agree a Treaty amendment setting up a European Central Bank System (ECBS) this autumn, to which all member states would belong but which would start operating with those able to tie their currencies inescapably to the Deutschmark (analogy of EMS/ERM). As expected, they do not like this idea and are examining our proposals with increasing interest as they understand them better. They think that there must be a real Stage 2 which would prepare the EC for the move to Stage 3. But they are reluctant to make any move in our direction unless we make it clear that we regard the hard ecu proposals as transitional because:-

(a) the ECBS proposal for Stage 3 is advancing well, with only a general reserve by the UK;

(b) they are worried about losing the agreement of Pöhl to Stage 3 if they move our way (though they accepted that our proposals are not open to the objections to a parallel currency which he has raised in the past).

3. They stressed that EMU had always included either permanently fixed parities or a single currency (with opinion moving fast towards the latter recently). They asked whether the Prime Minister preferred permanently fixed parities. I said that I thought she saw objections to both, though not necessarily the same objections.

4. I urged them to put forward proposals for Stage 2 very soon. (My unspoken thought was that we would then be more in the thick of the negotiation and could aim to water down the Stage 3 proposals). They said that Stage 2 would be discussed in ECOFIN and the Central Bank Governor's deputies but it was important to them to hang on to the Stage 3 ground gained so far. I said that they would risk a British veto if they let the ECBS band-wagon roll too far in its present form.

5. Sarcinelli said that the Italian Finance Minister was determined to complete the work of the Ecofin Council by mid October so that the draft treaty and statutes of the Eurofed, or whatever it would be called, could be finalised in the light of the consensus reached, so that the intergovernmental conference could settle any remaining issues rapidly in December. I expressed concern that this left time very short for working out a real Stage 2 with the proper institutional arrangements.

ANNEX

EMU

Visit to Sarcinelli (Italian Treasury)  
and Pado-Schioppa (Bank of Italy)

The following are the technical points which were raised in discussion:-

- a) With reference to our proposal that the exchange risk on balances in national currencies held by the EMF rest on the national authorities, Sarcinelli said that Finance Ministries had always opposed such an exchange guarantee.
- b) Sarcinelli and Pado-Schioppa were concerned that the hard ecu would not necessarily generate sufficient demand to give it critical mass. Sarcinelli seemed to think that we would be relying on the prospect of devaluation in the high inflation countries to generate demand. To the first point I replied that conversations with a number of banks and companies had convinced me that once there was no risk of devaluation of the ecu and therefore no need to cover against risk exchange, and once there was convertibility for banks, companies and private individuals, with a lender of last resort in the EMF, companies engaged in intra-Community trade would quite quickly move to holding ecu balances and asking their suppliers to accept ecus in payment and invoicing their clients in ecus. Obviously, those companies able to net off ecu payments and receipts in this way would move more quickly than those the majority of whose expenses were in one country. To the second point I replied that obviously where inflation remained high there would be a bigger incentive to move into ecus but our proposals were designed to provide a strong disincentive to devaluation.
- c) Pado-Schioppa advocated an early statement that the hard ecu would definitely become the single currency at some not too distant date. I said that it would cause difficulties to go this far. But if the aim of a single currency one day was in the treaty and if the hard ecu was created at the beginning of Stage 2 as a common currency alongside the national currency, everybody would draw the conclusion that they would need to operate in ecus one day. This would be an additional incentive to start using it. It would not be sensible to try to fix the duration of Stage 2.
- d) They were both concerned to establish whether there would be a real job for the EMF to do in Stage 2, having possibly been concentrating too much on the Currency Board alternative proposal. I explained that Stage 2 would begin with national currencies fixing their central rates against the ecu and retaining the two and a quarter per cent band. The EMF would need to manage ecu interest rates in such a way that strong currencies would not remain permanently in the top part of their band and revaluations against the ecu were impossible. This might involve quite a lot of activity in open market operations, especially in the first year or two while things were settling down. The EMF would also be engaged in intervention on the foreign exchanges, both to restrain EC currencies from breaking out of their bands and to carry out exchange rate policy towards the dollar and the yen. There would be plenty to do for the EMF, though they might sensibly use the national central banks as their operating arms.
- e) This led to a discussion of who would control national monetary policy. I explained that national monetary policy would in the

last resort be the responsibility of national authorities in Stage 2. But I pointed out that there would be strong disincentives to a lax monetary policy. Monetary financing of budget deficits and money creation to replace national currency converted into ecus would be forbidden. If either of these golden rules were broken or if in the opinion of the EMF a member state was running an unduly lax monetary policy, the EMF would have the right to require the member state concerned to reconvert some or all of its balances in national currency with the EMF back into ecus. Moreover, the exchange risk would in the last resort remain on national authorities. All this would require still closer coordination of national monetary policies than in Stage 1 and would give the EMF an important role.