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The Rt Hon Douglas Hurd CBE
Secretary of State for Foreign
and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
London SW1A 2AL

Dear Douglas,

EMU

Brooding on recent Parliamentary and press debates and strongly supporting your recent proposals to get ourselves a clear and agreed policy for the future, I have ventured to draft a contribution to such a paper. Here is my effort a toutes fins utiles.

Warmest best wishes.

Yours ever
Michael

Sir Michael Butler

MDB/JSD

cc:
The Rt Hon John Major
The Rt Hon Robin Leigh-Pemberton
Mr J Kerr

EMU, Federalism and Sovereignty

1. A great deal of confusion continues to exist in the press and in Parliament about the implications of the sort of EMU now under consideration by the other eleven member governments. It is most important to clear up as much of this confusion as possible before the IGC begins.

A Single Currency

2. Other member Governments will only accept our hard ecu proposals if they are clearly presented as being Stage 2 in a three-stage process, Stage 3 being permanently fixed parities leading to a single currency. What are the implications of a single currency?

3. There are a number of examples of independent countries using a single currency (or more than one currency with permanently fixed parities) apart from the pre-1914 gold standard, for example:-

- (a) the English pound and Irish punt were virtually indistinguishable between 1922 and 1979 (when the Irish cut loose the punt and joined the ERM). The Irish retained a separate budgetary and fiscal system and remained neutral in the 1939-45 war.
- (b) the CFA franc, with its value permanently linked to the French franc, has been used for more than 40 years by the French West African countries - who have very diverse foreign and other policies, though their inflation record has been relatively good.

- (c) Belgium and Luxembourg have had indistinguishable currencies for many years without Luxembourg being prevented from, for example, having completely different laws on banking secrecy.

I conclude therefore that it is untrue to say that a single currency implies a single government.

A Federal State

4. Most organisations to which two or more countries belong can be placed somewhere along a line stretching from 0 (totally independent states with no binding multinational commitments) to 100 (a federal state). One major distinguishing characteristic of all federal states is that the central authorities can tax the citizens in the states without the consent of the governments or parliaments of those states. There are no states in the modern world which are at zero on the line (even Switzerland has multinational commitments eg. in EFTA). The European Community clearly places its members further along the line than the UN, NATO, GATT or the IMF, though all these contain binding multinational commitments. The Treaty of Rome, subsequent legislation directly applicable in all member countries, and the Single European Act have carried the EC some way along the line (say, 30% of the way). EMU would carry us a few steps further. But no-one is at present proposing anything in the fiscal field remotely resembling the arrangements in a federal state. The "binding commitments" in the budgetary field in the Delors report fell far short of federal arrangements and they have been replaced, even for Stage 3, with the two ideas in the British Treasury paper of November 1989 namely:

- (a) no monetary financing of budget deficits;

- (b) no country which gets into trouble as a result of a lax fiscal policy to be bailed out by the EC.

Giving up the freedom to finance budget deficits by printing money should not cause problems for the British Parliament. A Federal State is not proposed for Stage 3..

5. It follows that the Finance Ministers of member states, rather than becoming redundant as some people have suggested, would continue to exercise their present fiscal responsibilities under the control of their national Parliaments. In addition, it seems probable that the eleven other member governments will wish to place responsibility for deciding the main lines of exchange rate policy towards the dollar, the yen, etc, on the Finance Ministers (ECOFIN) Council.

Independence of Central Banks

6. The other member Governments propose that the 12 Central Bank Governors and the central monetary institution should both be declared "independent", as a means of ensuring that the system is not subject to irresistible pressure for inflationary action from national Parliaments and Governments. There is much to be said on the merits of the case, in favour of independent central banks. But European Commissioners from some countries, though nominally independent, are prone to follow their national Government's line. Nominal independence is not therefore sufficient. The position of the 12 Central Bank Governors could therefore be more specifically protected by providing in the Treaty that the European Monetary Fund (EMF) proposed by the UK shall have a statutory responsibility to assure price stability and that all member Governments and Parliaments shall respect the (counter-inflationary) statute of the EMF and undertake not to seek to influence its decisions contrary to its statute (see attached paper on the implementation of the UK proposals in the Treaty and the EMF Statute).

Sovereignty

7. Sovereignty is defined in the OED as "possessing supreme power". The British Parliament is and would certainly remain "sovereign" in the sense that it is in a position to pass a vote that the UK shall leave the European Community. The complications would be horrific but neither the EC institutions nor other member states could, or would try to, impose continuing membership on us.

8. The British Parliament is also "sovereign" in that it can decide to ratify or not to ratify the EMU Treaty amendments which will be negotiated in the IGC if the Government puts them to it. Assuming that the Treaty provides for an evolutionary approach to EMU, with a Stage 2 on the lines of the Major proposals beginning on 1 January 1994 and a review three years later (Rome Communique of the Eleven) to consider when the passage to Stage 3 (permanently fixed parities leading to a single currency) shall take place "within a reasonable time", what freedom of action will the British Government and Parliament be giving up?

9. Joining the ERM, if serious about it as the Chancellor is, constricts to some extent the freedom of action of the Chancellor and the Bank of England to manage UK interest rates and the exchange rate. By ratifying a Treaty enshrining the UK Stage 2 proposals in a Treaty, Parliament would reinforce these constraints since the penalties for running a lax monetary policy or devaluing the pound would be considerably more severe.

10. It seems safe to assume that the EC will agree that a further unanimous decision by governments and Parliaments (not earlier than 1998) will be required to take the final decision to move to Stage 3. So the next British parliament but one may be

asked permanently to renounce devaluation and to accept a move to permanently fixed parities. The economic effects of permanently fixed parities are not very different from those of a single currency. But it might well be possible to secure agreement in the EC that there should be unanimous agreement by Parliaments and governments before a final move to a single currency.

11. So what we would see would be a decision by Parliaments in 1992 to accept rather more stringent constraints than the ERM in 1994. The move to Stage 3 would be unlikely to take place unless the 1997 review showed that Stage 2 was working well, ie:

- (a) convergence in economic performance had been achieved;
- (b) the new ecu had established itself as a widely used common currency;
- (c) the EMF and the 12 Central Banks had managed the ecu and coordinated national monetary policies successfully in the interests of price stability;
- (d) realignments had become very infrequent;
- (e) the ERM bands had been abolished.

If all these things happened, the decision by Parliament to move to Stage 3 (not earlier than 1998) would mean giving up the possibility of reverting to inflation and devaluations but would otherwise have been so well prepared that little practical change would take place.

21 November 1990