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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 November 1990

I attach a copy of a letter the Prime Minister has received from Sir Michael Butler of Hambros Bank Limited.

I should be grateful if you could provide advice and a draft reply for us to send to Sir Michael. It would be helpful if this could reach me by 6 December.

I am sending a copy of this letter to Richard Gozney (Foreign and Commonwealth Office).

C.D. POWELL

Miss Kate Gaseltine,
H.M. Treasury.

JT.

B28/11

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28 November 1990

The Rt Hon John Major MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

Congratulations on your election! You were very much the majority choice of the management at Hambros and we are delighted to have found ourselves in tune with the majority of the party in the House.

2. I write as Chairman of the City's European Committee which will, I know, wish to continue to try to be of help to the Government on EMU. You may remember that on 12 September it approved unanimously a recommendation to Mrs Thatcher on the institutional implementation of the UK proposals for Stage 2. For ease of reference I enclose a copy (Annex A) of the version of these proposals which I made public at the Hambros seminar on 11 October at which Francis Maude and Terry Burns kindly spoke.

3. I sought a meeting to discuss the subject with Mrs Thatcher in September. Though she agreed in principle, it was only after the Rome European Council that a date was finally agreed - last Friday!

4. I know how many urgent things you have to do, but few are more urgent than preparing the Government's position on this issue for the IGC. Events since 12 September seem to me to strengthen the case for the proposals at Annex A. In particular, several points in the Communique of the other eleven Heads of Government in Rome provide just the openings we need for tabling proposals on the lines recommended.

5. If I may, I should like to repeat a recommendation and an offer which I made to Mrs Thatcher when I saw her on 20 April. The recommendation was that the Government as a whole should get itself an agreed line not only on the details of a Stage 2 proposal but on the constitutional implications of what we may have to accept in order to get agreement in the EC. After all that has happened since then, this seems to be both more important and perhaps more complicated. I enclose at Annex B a contribution which I sent to Douglas Hurd just before Mrs Thatcher resigned.

6. The offer was to help, on a strictly informal and unpaid basis, to coordinate the campaign. Experience with the 1979-84 campaign on the reduction of the UK contribution to the EC budget demonstrated how vitally important it is, in order to win difficult EC battles, that Ministers, Whitehall officials, UK Rep, the Bank of England etc should all know at every stage what they have to do and say in the EC and in Parliament and public. With so much going on in the EC, you and your colleagues might find a helping hand useful.

7. I should be very grateful if you could find time to discuss these ideas, especially the paper at Annex A. It would be very welcome if you could do so before my European Committee's meeting on 4 December. But I expect that you will have other priorities, in which case perhaps you could fit me in before the IGC.

Yours ever

Michael Butler

Sir Michael Butler

cc:
The Foreign Secretary
The Chancellor of the Exchequer
The Rt Hon Robin Leigh-Pemberton,
Governor of the Bank of England

Annex A

ANNEX A

Summary of Statement by Sir Michael Butler, Chairman, European Committee of the British Invisible Exports Council

EMU: Proposed Institutional Arrangement for Stage 2

1. So far, discussion in both the Monetary Committee and the Central Bank Governors' Committee has focussed mainly on the arrangements for Stage 3 of EMU, including a draft statute for a Stage 3 central banking institution. There has been very little discussion of the institutional arrangements for Stage 2 and the Bundesbank says that there should be no new institutional arrangements until Stage 3. Since majority opinion now holds that Stages 1 and 2 should together be quite long, say 7-10 years, this would imply that the work of this December's IGC would only bear fruit towards the year 2000.

2. The British Government has proposed a practical plan for Stage 2, including a European Monetary Fund to manage a hard ecu. But they have not yet spelt out the nature of its statute or of the Treaty provisions which would create it. I should like to put forward recommendations to fill that gap. The objective would be to create a system for Stage 2 under which only those things which need to be decided centrally are put under the control of the European Monetary Fund (EMF).

3. A Treaty amendment would:

(a) create a European System of Central Banks (ESCB) consisting of the twelve national Central Banks and a European Monetary Fund (EMF) owned and run by the Central Banks, to be operational from day one of Stage 2; the Chairman of the EMF's Board of Management and three or four of his colleagues would sit with the 12 governors on the ESCB Council;

(b) lay down the aim of price stability for the whole EMU process and of permanently fixed parities leading to a single currency in Stage 3; and set out the necessary conditions for the passage to Stage 3 in terms of convergence of inflation rates, money supply growth and interest rates, use of monetary instruments and budgetary rectitude;

(c) attach at Annex the Statute of the EMF (see below) and provide that it could be amended by unanimous agreement between the Governments as necessary (no further <u>Treaty amendment</u> required in order to move to Stage 3);

(d) provide that all national authorities (Central Banks, Governments or Parliaments) shall respect the Statute of the EMF and would not seek to influence EMF policy contrary to its Statute.

4. The Statute of the EMF would reiterate the aim of price stability. It would provide that in Stage 2 the ESCB should co-ordinate national monetary policies and the EMF should control ecu monetary policy. It would create the hard ecu and provide that it should be managed so as to be always as strong as the strongest currency. Revaluation of national currencies against the ecu would be forbidden. Devaluation would be permitted (but discouraged). The Statute would contain two golden rules - no monetary financing of budget deficits and no money creation to replace national currency converted into ecus. It would provide for convertibility of national currencies into and out of ecus and for the EMF to be a lender of last resort in ecus. It would lay down that (a) the exchange risk on balances of national currencies deposited with the EMF in exchange for ecus would rest with the national Central Banks and (b) the EMF should have the right and the duty to require any member state judged to be breaking the golden rules or running too lax a monetary policy to reconvert into ecus some or all of the balances of its national currency held by the EMF.

5. These provisions would all help to ensure that no Government could take advantage of the system to run a lax monetary policy. They would thus provide a strong impetus towards convergence of high inflation countries' performance on that of the low inflation countries and at the same time a strong deterrent to devaluation.

6. Arrangements for Stage 3 would require amendments to the EMF Statute. These could be considered nearer the time. In 1990 it would be wise only to create the ESCB and EMF as required for Stage 2. No-one can fully foresee at present what will be practical and necessary in Stage 3.

7. The Chairman of the ESCB Council would report to the European Parliament and to Ecofin annually in writing and be available to them in person to answer questions when required.

8. Under 3(d) above, national Central Bank Governors would be protected from pressures for inflationary action by national governments or Parliaments. They would not therefore need, as proposed by the Delors Committee to be made "independent". In matters not covered by the Statute of the EMF they could retain their existing relationships with national Parliaments and Governments and could report to national Parliaments if so desired. In this way the ESCB and the EMF would be protected from political pressure to take action contrary to the EMF's Statute and would remain accountable to national Parliaments as well as to Ecofin and the European Parliament.

9. The Treaty would thus create:

(a) a real currency to which banks, companies and individuals would have time to accustom themselves without it being imposed on them;

(b) an institutional framework with a real job of work to do and whose efficacity in managing the ecu in the interests of price stability would be tested in the markets; and

(c) a European System of Central Banks whose operation would strongly promote convergence in the performance of the national economies and thus help to prepare the EC for a move to Stage 3 when the peoples and Governments so choose.

10. Stage 2 could begin relatively early, in 1993 or 1994. No date would be set for the passage to Stage 3. This would depend on progress with convergence in economic performance, the degree to which the hard ecu gained acceptability and the success of the ESCB and EMF in managing it in the interests of price stability. A major advantage would be that when the time comes to move to Stage 3 there would be a functioning European banking system in being in which everyone would have confidence.