

PERSONAL



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From the Private Secretary

10 December 1990

EMU

I enclose a copy of a personal letter to the Prime Minister from Sir Leon Brittan, proposing a modification to the hard ecu plan. The Prime Minister has not himself seen the letter yet. But I am sure he would welcome some very early comments on it, in particular before he sees Sir Michael Butler on Wednesday, and, in due course a draft reply.

C. D. POWELL

John Gieve, Esq.,
H.M. Treasury.

PERSONAL

THE RIGHT HONOURABLE
SIR LEON BRITTAN, QC
VICE-PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

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Already received by
J.K.
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2 Prime Minister,

PERSONAL

I thought it might be worth writing to you before the IGC on economic and monetary union starts, letting you have my own thoughts on what might be the best way forward. What I am suggesting amounts to a modification of your hard ECU plan which should not in my view cause difficulties in principle but which would greatly increase the chance of the plan receiving a favourable reception. What I have in mind in short is a Community commitment to "harden" the existing ECU further, rather than introduce a new hard ECU. The remainder of your plan, as I explain below, would remain as it has so far been presented.

A key objective for Stage Two of the EMU process must be greater convergence of Member States' inflation performance around the best and not simply the average inflation levels. The stress which you have laid on this aspect of convergence as a precondition for further moves towards monetary union is now widely shared and understood throughout the Community.

There is also increasing acceptance of the need to develop and strengthen the ECU during Stage Two. The challenge is to ensure that this occurs in a non-inflationary way.

In this context, the EMS exchange rate mechanism has demonstrated its worth by providing a framework within which inflation rates of member currencies have converged downwards towards greater price stability. In practice the Deutschmark and the Bundesbank's monetary policy have provided an effective anti-inflation anchor to the system.

Rt. Hon. John Major MP,
10 Downing Street,
London SW1

This has had the important consequence that over the last three years the absence of substantive currency realignments in the exchange rate mechanism has already effectively hardened the ECU. The decision to bring sterling within the mechanism extends those disciplines so that almost all of the ECU's value is now constrained within the low inflation EMS structure. Thus there would over this time have been no practical difference between the proposed new hard ECU and the existing ECU. Consequently a formal commitment by Member States at the start of the next stage of EMU that they will strengthen this low inflation discipline by avoiding future realignments would be a realistic possibility. At the same time it would provide the explicit recognition that the low inflation role of the ECU would continue and be further strengthened.

It would also have the important advantage that existing ECU contracts could continue undisturbed without the need for an additional form of ECU to be introduced, while still leading to the central objective of a stable low inflation currency. The ECU markets would then develop more effectively without discontinuity or confusion over the type of instrument being traded. At the same time the extent to which the ECU was used would be decided by the markets and not by governments.

The other elements of the UK proposal would remain fully valid. In particular the role of a European monetary fund or embryo central bank in conducting ECU market operations and ultimately taking on wider monetary responsibilities would be able to develop during Stage Two.

The hard ECU proposal amended in this way, with a formal commitment to develop the existing ECU in a hardened form through the avoidance of future realignments, also offers clear tactical advantages. It would build on Britain's commitment to the success of the existing EMS structure and the steady reduction of inflation in an evolutionary way. It would correspond to the widespread desire to encourage the development of the ECU as a more widely used currency. And it would achieve the central British objective of ensuring that the speed of development of Stage Two was determined in the market rather than being imposed on Member States.

I believe that this approach, together with an acceptance that in the right circumstances a single non-imposed European currency could indeed offer benefits to the European Community as a whole, would provide the United Kingdom with a constructive and genuinely market-oriented approach to the IGC - and one that would stand a good chance of receiving a constructive response from other Member States.

I am copying this letter to Norman Lamont and Douglas Hurd, and would of course be happy to discuss it with you, although I appreciate that there is now very little time before the IGC begins.

Lamont,
Hurd