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21 November 1991

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Private Secretary to the
Prime Minister
10 Downing Street
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File

with JSW2

Dear Stephen,

PRIME MINISTER'S MEETING WITH LUBBERS: EMU

Following the Chancellor's minute to the Prime Minister of earlier today, I have set out below the points the Chancellor thinks the Prime Minister should make at his meeting with Lubbers tomorrow. I also attach a revised 'issues' paper; the draft EMU Treaty has not been significantly changed over the last month and so the back-to-back Commentary I sent you then remains valid.

Background

The Dutch have so far been very helpful on 'no imposition' (or, as they term it, '<u>no coercion</u>'). They have stuck with a text of general applicability despite widespread opposition from other Member States, in particular Italy. Our objective now must be to stiffen Dutch resolve on this issue: emphasising the importance of a text of general applicability while expressing flexibility on the wording and procedure for opting for 'exemption status.'

The Prime Minister may wish to use the opportunity to raise a number of other UK concerns on EMU (set out in the Chancellor's minute of today): in particular, <u>budget deficits</u> where the Treaty must be absolutely clear that there are no legally binding obligations or sanctions in Stage 2 and where, in the Chancellor's view, the proposed trigger criteria are still far too restrictive; <u>monetary financing</u> where the UK is opposed to a prohibition in Stage 2; <u>the capital share of the ECB</u> where the Chancellor is seeking a political settlement to ensure the UK's capital share equals that of France and Italy; and independence where the UK is now prepared to accept a fully independent ECB in Stage 3 but is opposed to a requirement to 'start the process' of making the Bank of England independent in Stage 2.

Lubbers is likely to raise the issue of the seat of the EMI/ECB. This has not been discussed in the IGC as yet. But the Dutch are pressing for a decision on the EMI location (which will in turn have a strong bearing on the eventual choice for the seat of the ECB). The Dutch have made clear that they intend to press the case for Amsterdam and that this will be an issue for Maastricht. The Prime Minister may wish to press London's case; it is not necessary yet to reveal any fall-backs.

Line to take

The Prime Minister wish to draw on the following:

- Dutch Presidency should be congratulated on progress in EMU IGC. Much in current draft helpful to the UK. Welcome emphasis on convergence and principle that national monetary policy responsibility should remain in national hands in Stage 2.

- For UK, provision allowing us to decide at appropriate time whether or not to move to Stage 3 has always been indispensable. Very grateful for Dutch understanding on this. Welcome clause of general applicability on no coercion in draft Treaty.

- Important that we are not singled out and set apart from mainstream of EC development. Would make decision to move to Stage 3 more difficult. Realise some Member States have difficulty with this provision. If Presidency have ideas for improving text to make it more acceptable to others, would be happy to consider them. But to remove generally applicable clause would be seen as a very serious reverse to the UK and make it more difficult to sell Treaty to Parliament.

- Have a number of other key concerns on EMU:

    (i) Understand Dutch concerns on excessive deficits. As you know UK has serious reservations on legally binding rules and sanctions in Stage 3. But regard it as critically important they should not apply in Stage 2. Current text close to reflecting this view; but important that our officials should make the text legally water-tight. Also concerned that excessive deficit procedure is unnecessarily constraining: 3 per cent deficit to GDP ratio applied as a trigger on an annual basis will lead to far too many Commission investigations. Realise breaching the trigger does not mean a Member State will be found guilty by ECOFIN.

But procedure must be credible: to be so should only be triggered by genuine gross errors.

(ii) UK as opposed to monetary financing of deficits as any Member State. But an important principle agreed by the IGC is that monetary responsibility should remain in national hands in Stage 2. Follows that there should be no legal obligation to ban monetary financing until Stage 3.

(iii) Very opposed to capital key of ECB being decided mechanistically. Must be matter for political judgement. ECOFIN should have full discretion to determine key.

(iv) Recognise the importance you (and Germany) attach to national central banks being independent in Stage 3. This has been a difficult issue for the UK, but am willing to accept principle in context of satisfactory overall agreement. In particular must be no requirement to change the status of central banks in Stage 2 and must be adequate arrangements for *ex post* accountability.

- [If necessary] No need to decide on seat of ECB now. On seat of EMI, UK preference is for London. Not only most sophisticated financial centre in Europe but also the clear leader in the ecu markets. London:

  - carries most of ecu banking business of BIS area banks;
  - has 90 per cent of primary market activity in ecu eurobonds
  - half of 40 registered market makers in ecu bonds operate from London
  - has derivatives market in ecu products.

I am sorry it has taken some time to put this brief together. The Chancellor wanted to give careful consideration to main points we need to focus on as we move towards the end-game.

I am copying this letter to Christopher Prentice (Foreign and Commonwealth Office) and Sonia Phippard (Cabinet Office)

Yours,

Sheila

S M A JAMES
Private Secretary

EMU IGC: KEY ISSUES FOR THE UK

Set out below is a list of issues which cause the UK difficulty in the EMU IGC. The list is not exhaustive but focuses on the areas of priority for the UK. (An asterisk denotes potential sticking points, Chancellor to Prime Minister, 21 November).

Transition to Stage 3

1. *No imposition (Articles 109f and 109g)**

The UK position on this is clear: it cannot commit itself to moving to a single currency and single monetary policy without a separate decision by Government and Parliament at the appropriate time. The latest Dutch text is helpful on this point, permitting Member States to opt if they so wish for 'exemption status' after the European Council decision to move to Stage 3. Such status would exempt a Member State from Stage 3 obligations, and would be separate from 'derogations' available to those who wish to move to Stage 3 but are not yet ready. A number of Member States, including Germany, are concerned that this provision might lead to 'contagion': they would prefer either a UK-specific solution to 'no imposition' or to bring forward the timing at which Member States opt for 'exemption' status.

We are also keeping a close eye on the opening articles of the Treaty dealing with the Community's objectives. *Article 2* commits Member States to EMU undefined; *Article 3a* commits Member States to the activity of 'the irrevocable fixing of exchange rates leading to the introduction of a single currency' but only 'as provided for in this Treaty and in accordance..with the procedures set out therein'. Since the Treaty provides for an exemption clause, legal advice is that this Article does not commit the UK moving to a single currency or single monetary policy.

Holland: have been helpful so far. Have stuck to clause of general applicability despite widespread opposition.
Germany: would prefer a UK specific solution but have some sympathy for UK position and so may accept general text if appropriately drafted.

Italy: vigorously opposed to general text. Believe Protocol or declaration more appropriate.

2. *Convergence (Article 109f and Protocol)*

Together with Germany and the Netherlands, the UK has argued for rigorous convergence conditions for transition to Stage 3. The Dutch text is again helpful in this respect, providing for stringent conditions relating to inflation, interest rates, budget deficits and membership of the ERM.

Holland and Germany: support rigorous convergence conditions.
Italy: want weaker conditions.

Monetary policy

Content of Stage 2

3. *Monetary policy in national hands*

The UK has argued that national monetary policy responsibility should remain unambiguously in national hands in Stage 2. To this end, the UK regards it as very important that:

a) *Member States are not obliged to make (or begin to make) their national central banks independent unless and until they move to Stage 3.* Here, the Dutch texts are unhelpful, requiring Member States to 'start the process' before entry into Stage 2 with a view to making their national central banks fully independent before transition to Stage 3 (Article 109c.2).

   Holland and Germany: strongly support 'start the process';
   Italy: supports (more because reflects Rome I than out of any strong principle).

b) *Member States are not obliged to ban monetary financing in Stage 2*.* Apart from breaking the principle of national monetary policy responsibility in Stage 2, this would affect our ability to run an overdraft with the Bank of England (Ways and Means advances). The present

Dutch text would make it an obligation to prohibit monetary financing before entry into Stage 2 (Article 109c).

Holland, Germany and Italy: all support ban in Stage 2.

c) *the European Monetary Institute's role does not compromise national monetary policy responsibility.* Here, the Presidency text is helpful (109d). And a British-German-Dutch alliance should prevail over a French-Italian attempt to have the EMI's role extended.

Holland and Germany: strongly support;
Italy: reluctantly accepts; would like to extend EMI's tasks.

4. *Hardening the ecu (Article 109e).*

The current Dutch text provides for a frozen basket ecu (ie the currency composition of the ecu would be irrevocably fixed) from the start of Stage 2. We are continuing to press for a hard ecu (ie the ecu would not be devalued against any ERM currency). However, we have few allies. Germany and Spain would both appear to be able to live with the frozen basket.

Holland and Italy: support frozen basket
Germany: supports hard basket but can live with frozen basket.

Content of Stage 3

5. *Capital share (Statute Article 28)**

The UK's objective is for a capital share in the European Central Bank at least as great as that of France and Italy. The Dutch text is unsatisfactory, providing for an objective key based on GDP and population; the UK is pressing for a political solution - ECOFIN to determine the shares acting unanimously.

Holland: sympathetic to UK position. Want share of extra-EC exports as additional criterion, which could help UK.
Germany and Italy: happy with mechanistic approach.

6. *Notes and Coin (Articles 105.4 and 108.3)*

The draft Treaty gives the ECB the exclusive right to authorise the issue of Bank notes and to control the volume of coin; the Council acting by QM would be able to harmonise the denominations, weights and sizes of coins. Although the continued issuance of Scottish, Northern Irish and Gibraltar bank notes would be subject to the agreement of the ECB, the latter is likely to look favourably on regional variations (at least for Scotland and N.Ireland). The latest draft of the Treaty makes no reference to the ECB or Council having a role in relation to effigies ('the Queen's head' point) on notes and coin issued by national authorities. We are pressing for an explicit recognition of Member States' rights in this area.

Holland and Germany: likely to have some sympathy;
Italy: likely to take relaxed view.

Economic Policy

7. *Excessive Budget Deficits (Article 104b and Protocol)**

The UK remains opposed to legally binding limits and sanctions in relation to excessive budget deficits. However, we have few if any supporters in this area. As a fall-back (Wall to Heywood, 8 July), Ministers have agreed that such rules and sanctions should apply only to participants in Stage 3. The Dutch texts now reflect this position subject to one technical wrinkle being ironed out.

Holland, Germany and Italy: support rigorous regime.

Another issue is the excessive deficit procedure itself. The Dutch and Germans are pressing for very rigorous triggers: a debt to GDP ratio of 60 per cent and a deficit to GDP ratio of 3 per cent. They justify these on the grounds that breaching them would not imply guilt: the Council would have total discretion in deciding whether an excessive deficit existed. We have argued that this would lead to the procedure being triggered far too often and, while we support the debt to GDP ratio of 60 per cent, we are continuing to argue against the 3 per cent deficit to GDP trigger.

Holland and Germany: support rigorous triggers.
Italy: agree with UK that deficit trigger should be less constraining.

8. Special financial assistance (or a 'bail-out' fund) (Article 103a.2)

The Presidency text provides for special Community assistance for Member States in difficulties due to national disasters or exceptional occurrences in Stage 3. The UK remains opposed to such assistance on the grounds that it is inconsistent with the 'no bail out' rule. However, we have little support on this (the Germans and French now accepting the principle of special assistance provided the facility is narrowly drawn). The Chancellor has suggested that as a fall-back the UK should agree to special assistance provided it is only available in exceptional circumstances and agreed by the Council acting unanimously. The text now on the table is very close to this position. Our fall-back has yet to be deployed.

Holland: position close to UK's but have put forward text as basis for compromise;
Germany: believe special assistance inevitable but want narrow as possible scope.
Italy: supports Presidency text.

Miscellaneous

*9. Capital Movements (Articles 73a-73g)**

We are watching closely the Treaty articles on capital liberalisation since they may have implications for the UK's corporation tax imputation system and ability to maintain proper rules on supervision; they may also affect the UK's ability to impose sanctions (for political reasons) on countries outside the EC. We have made some progress in negotiations and a satisfactory outcome looks within reach.

Holland: corporation tax system different and so not very sympathetic but working towards compromise.
Germany: have worked closely with UK on tax issue.
Italy: no strong views.

10. Seat of EMI/ECB

Discussion of this issue is barely under way. The site of the ECB need not be settled now but the need to agree a site for the EMI is more pressing. The Dutch are likely to make a strong pitch for Amsterdam; Luxembourg will claim a dubious historical right to EC financial institutions; Germany is thought to have done a deal with France whereby the former gets the site in exchange for agreeing a wider role for the EMI. Although we will be arguing for London, our negotiating position is weak.

Holland: Amsterdam.
Germany: Frankfurt (or Bonn or Berlin)
Italy: Milan (but unlikely to push issue)