

PRIME MINISTER

MODELS OF ECONOMIC AND MONETARY UNION

Attached is a copy of the longer Treasury paper the Chancellor mentioned to you setting out alternative definitions of Economic and Monetary Union.

I felt that when you discussed this with the Chancellor you were to some extent at cross purposes. As is clear from paragraph 5, he is taking as his starting point the completion of Stage One where sterling has joined the ERM, though no date is indicated for this. At that point, sterling the exchange rate is fixed in the sense of not fluctuating from day to day but it is not irrevocably locked as periodically exchange rate changes can take place. Sterling is, therefore, still a separate currency and there is still scope for it to compete with other currencies.

You took the view that while joining the ERM did not fix the exchange rate for all time, the ERM limited the scope for competition and was therefore, to some extent, an alternative to a system of competing currencies.

The view taken by the paper - paragraph 52b - is that the ERM would blunt the required competition even if it did not eliminate it.

The paper also notes - paragraph 118 - that it will be difficult to persuade others to see this as representing monetary union. Nevertheless, it is worth trying.

My other main reaction was that the gold or commodity standard had the appearance of an idea being put forward for ideas' sake. The drawbacks seem considerable

i. The value of European currencies would depend to some extent on the objective value of gold or the basic

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commodity which in turn would depend on the state of the world economy and political factors such as the Middle East or South Africa. This seems to me to put economic management too much on to autopilot - see paragraph 80.

ii. It would be very difficult to decide at what level to set the EMS gold parities initially. The costs of setting them wrongly could be considerable. Adopting such a system involves a step change rather than developing continuously from the status quo.

iii. The gold standard would encourage countries to hold a larger proportion of gold in their reserves. This is inefficient as resources are expended in creating the gold and once acquired, the gold yields no return.

The paper offers on pages 36-37 useful corrections to the view that close central control of fiscal policies is required and that EMU will involve a major increase in regional transfers.

The paper indicates that you were right to ask the Chancellor to put forward only the competing currencies idea, and that tentatively. In the letter we have sent to him following your meeting, we have reminded him that a fully worked up paper will need to be submitted to the formal Ecofin and that you will want to go through this with a wider group of colleagues.

AT

ANDREW TURNBULL
9 September 1989

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