File

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EMU

I put your note on EMU to the Prime Minister last night, but she feels that she simply has not the time to concentrate on it at the moment with the Party Conference looming, and has said she wants to read it and discuss it on her return from CHOGM at the end of October.

I can see this gives you something of a problem in that there will be a considerable hiatus. You may decide to discuss it informally with people in the Treasury. But I think that you should be very careful not to imply at any point that it has the Prime Minister's support or endorsement.

CDP

3 October 1989

jd a:emu

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10 DOWNING STREET

With the compliments of

Alan Walters

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A STRATEGY AND TACTICS FOR EUROPEAN MONETARY UNION

PART I

A COMMODITY CURRENCY FOR EUROPE

1. THE OBJECTIVE

Delors envisaged one currency controlled by a new bureaucracy in a European System of Central Banks (ESCB). Each country would relinquish its monetary sovereignty to this as yet ill-defined supernational "co-ordinating" body.

We can counter this by claiming that we are in favour of one currency for Europe provided that we do not surrender our sovereignty to a supernational body (like the ESCB).

We would favour a currency (say a "monnet") firmly based on a non-politicised commodity standard. Then the ESCB would have no power over our money, interest rates or credit or, one may add, our budgets.

2. A commodity standard does not require any trade or stocks of physical commodities. The commodity standard could be devised to deliver a constant price level (i e zero inflation or deflation) with respect to a basket of commodities and services - such as the goods etc in the RPI, or some average of Euro-RPIs. In essence, the European Issue Bank (EIB) would issue currency in exchange for a reserve asset, in suitably high denominations, defined as the RPI basket. The reserve asset would always be sold or bought by EIB at par. If the EIB by accident overissued currency and this increased RPI prices and the market value of the reserve asset, then the private sector would find it profitable to buy reserve assets at par from EIB, thus

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reducing the money supply and correcting the overissue. Private arbitrage will ensure that the RPI cannot go up or down without being quickly corrected.

3. Such a commodity standard with its stable prices would have ostensible disadvantages. The main drawback is that one would not be able to finance budget deficits through currency issue. Secondly, in response to external shocks such as an increase in the oil price, one would be precluded from a response that includes inflation. Of course one may argue that these are arguments pro rather than contra. Thirdly, it may be said that such a system is new and has never before been implemented. In a strict sense, this is true, but in fact the system is closely analogous to a gold system or the dollar exchange system (Bretton Woods) except that we tie down the actual price level instead of the gold or dollar price level <u>and</u> it does not require stocks of gold or dollars to make it work.

4. The economic advantages are obvious. The political advantages are also quite large:

<u>First</u> you could be seen as the true European supporting a <u>non-policized</u> monetary system with one currency for Europe;

<u>Second</u> you are the statesman whose commitment against the scourge of inflation is not only complete but is manifest in enshrining it in the Constitution of Europe;

<u>Third</u> you would be seen to be saving Europe (particularly Germany, Denmark, Netherlands) from a new Eurocracy over which they fear they would have little control.

PART II

A STRATEGY - E M U AND DELORS

1. AN OUTLINE OF THE STRATEGY

Proximate Policy (i e Delors 2)

Our undertaking to consider joining the EMS, after liberalization is complete, should contain the proviso that the Bundesbank retains its hegomony of the EMS albeit temporarily until Stage 3. Thus there is to be no development of a central bank of Europe (ESCB) and no non-German representation on the Board of the Bundesbank (although consultations would take place at the behest of the Bundesbank).

Ultimate Objective (i e Delors 3)

We agree to the idea of ultimate monetary union and one currency for Europe.

We reject however, the development of a central bank (ESCB).

We believe that a Euromoney should be set constitutionally to deliver zero inflation or deflation by creating a European Issue Bank (EIB). To this end, we propose that the EIB operate a commodity standard.

2. ATTITUDES OF FRANCE AND GERMANY

At first sight the above strategy seems risky, even wild. But it is designed to divide and conquer, and yet be fail-safe.

Perhaps the most likely result is that it would founder at the Delors 2 stage. The Germans would be wholeheartedly

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behind our insistence on German hegemony in Stage 2. And since the French want to control the Bundesbank, they would be as adamantly opposed.

It is not conceivable that the Germans would yield on this point of sovereignty, especially if we gave them full support. Clearly the French could not succeed when Britain endorses wholeheartedly the German hegemony. This will at least delay and I hope kill any progress towards a Central Bank of Europe.

3. At the same time we could claim that the commodity standard in Stage 3 is consistent with long-held French views of the need for an "anchor". After all, it was in the 1960s that de Gaulle who called for an "immutable" gold standard. The idea of such an anchor has been raised periodically by the French. The commodity anchor would be a greatly improved version of a gold standard, without its waste, its idiosyncracies of varying technology and discoveries and its hostages to South Africa and the USSR. We could reasonably credit France with the basic idea.

4. FAIL-SAFE - A COMMODITY CURRENCY

What of the fail-safe? Suppose that our partners accepted our Stages 2 and 3, what would we be saddled with? I would argue that a fixed and immutable commodity peg has a lot of attractions. Its automaticity would de-politicise money and the standard of account. We would not need a Central Bank. Interest rates would be determined by the market, and the public sector would have to compete for credit (although it would still be possible for any sovereign Government to rig the market by taxes and regulations if it wished). The quantity of money - under an almost fixed general price level - would be automatically adjusted to the needs of trade and capital movements. There would be no persistent shortage or excess issue. Private arbitrage would do the trick. In practice anyone may issue their own currency to compete with the commodity convertible Eurocurrency. They would not get very far unless they also had commodity convertibility. This can be represented as consistent with the Chancellor's suggestion at the last ECOFIN. To summarise: for the objectives espoused by the Government, a Euro-commodity currency would be not far from ideal.

5. Suppose, however, that our Stage 3 is not accepted and we are stuck at our Stage 2 which <u>is</u> accepted. (I think this is virtually impossible for the reasons outlined but I may be wrong in my assessment, so it should be worked through.) It will be recalled that Delors 2 also calls for developing decreasing bands and virtually no realignments. There is no denying it would be a bad result,even with Bundesbank hegemony,compared with our existing situation outside the ERM. We could <u>avoid</u> this risk by, as it were, "doing a Delors". Thus Stage 2 would only be stipulated as only a short (one year?) way-station <u>on the understanding that Stage 3 is accepted</u>. Acceptance of Stage 3 is the critical issue.

<u>CONCLUSION</u>

6. The Prime Minister would emerge as a far-seeing leader of Europe absolutely committed to a sound Euro-currency with a practical strategy and definite policy for achieving it. No pie in the sky or cash down the drain. She will be the champion of those who are deeply suspicious of any ESCB super authority.

At the <u>minimum</u>, it will be likely to <u>buy us more time</u> as an attractive (to all but the French and Italians) alternative to the Leviathan Delors. It is very likely that Delors would emerge as a busted flush.

I believe that this strategy should be further explored as a development of that of the Treasury.

ALAN WALTERS