

PRIME MINISTER

*Return to me  
this evening  
Sunday  
ml*

ECONOMIC AND MONETARY UNION

The Chancellor wants to talk to you on Monday about the paper which he has prepared for ECOFIN on The Market Approach to Economic and Monetary Union. A copy of the paper is attached. It is intended as the "alternative approach" which you promised at the Madrid European Council. The Chancellor proposes to circulate the paper to ECOFIN.

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The paper dilates upon the very substantial changes which implementing Stage I of Delors will bring about in the European economy. The conclusion drawn is that it is very hard now to look beyond Stage I: key measures such as those to bring down barriers in the provision of financial services will not even start to come into effect until 1993. Experience with the Werner Plan shows that theoretical blue prints are little help. It makes more sense to think in terms of an evolutionary process, resulting from the operation of the market. But one or two possible measures can be identified:

- one is removal of all restrictions on the use of Community currencies, eg restrictions on the currency in which assets of long-term savings institutions are held. This would lead to greater competition between currencies which would increase the pressure on governments to keep down inflation;
- another is to reduce the costs of transactions between currencies. This could be done by promoting relatively cheap means of payment and improving technologies;
- another possibility, but not one which would be favoured by the Bundesbank, would be for Central Banks to remove all restrictions on official use of their currencies. This would lead, among other things, to increasing use of different EMS currencies for intervention.

The overall purpose would be to strengthen the process of convergence throughout the EC on price and exchange rate stability by use of market mechanisms rather than a central plan. In short, it is a market-based approach rather than the bureaucratic/institutional approach favoured by Delors.

There are a number of points which you will want to consider with the Chancellor:

- how convincing is it? Our paper is much less substantial than the Delors Report with all its detail. But this is in part the difference between leaving things to the market and trying to regulate everything from the centre. Nonetheless other governments are likely to find it a bit meagre;
- in practice, the Chancellor's proposals don't really go much beyond Delors Stage I. Would it not be more credible to present them as a super-Stage I, rather than as an alternative to Stages 2 and 3? That way we could rest on the argument that it is premature to start discussing Stages 2 and 3 until we can see what the results of Stage I are in practice. (The Governor inclines to this view.)

is it acceptable (to you) to have the Chancellor put forward a paper based on the promise of sterling's membership of the ERM and hints that the ERM might in due course be strengthened by narrowing its bands?

- our most important objective is to get the Germans on board. What prospect is there that the Chancellor's paper will achieve this? Shall we have to go beyond it, eg by reverting to the "soft monetary union" approach which Poehl sketched out in his own original paper for the Delors Committee? And should we exclude the proposal to remove restrictions on official use of currencies that the Bundesbank dislike?
- procedure. The Chancellor wants to circulate the paper in Europe in early November. What degree of Ministerial

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consultation is needed here first? Can it go to OD(E)? Or do you want to chair a meeting immediately after CHOGM, with the Chancellor, Foreign Secretary and Mr. Ridley?

I don't think you will want to give the Chancellor a clear green light at this meeting. There are points which still need some reflection, especially the tactics of it.

C.D.?

C. D. POWELL

13 October 1989

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