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Foreign and Commonwealth Office

London SW1A 2AH

8 June 1988

Dear Charles,

Prime Minister's Visit to Paris: 10 June

The Prime Minister will have about 2½ hours' discussion with President Mitterrand, including lunch, and one hour with M Rocard, when she visits Paris on 10 June. There is plenty of current business to discuss, eg before Toronto and Hanover, but President Mitterrand is likely to want also a broader discussion of the place of Britain and France in the European and international context over the next few years. We believe that he and M Rocard would agree on the desirability of laying the groundwork at this meeting for future Anglo-French initiatives (what the Elysée call "projets mobilisateurs").

France Internal

President Mitterrand's convincing victory (54-46%) over M Chirac has given him a clear mandate and fresh authority. Although the Socialist Party did less well than expected in the first round of the legislative elections, they are still expected to win an overall majority in the National Assembly in the second round. The voting percentages were:- Communists 11.35%; Socialists 37.5%; UDF/RPR 40.4%; Front National 9.7%. If the same pattern prevails in the decisive second round the Socialists will emerge as the largest single party; the Front National will be virtually eliminated. The message seems to be that President Mitterrand's victory was a personal one, and that the voters are seeking a moderate, centrist government, but the exceptionally low turn-out makes all interpretation subject to caution.

A Socialist victory would in some respects recall their success in 1981. It would certainly mean an end to cohabitation for the next 5 years. But the parallel also brings out the changes since the 1981 euphoria - a much more pragmatic Socialist Party, an incumbent President who claims he will preside and leave the detail to his Ministers, a deeply divided Right and an active debate over whether either individuals or a group from the centre-right can be detached to join M Rocard's government. All this gives the President a strong tactical position. What is less clear is how he intends to use it. There is little sign of any radical departure from the policies already being pursued.

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On the economy for example, M Rocard has already announced that he is prepared to see unemployment rise rather than increase the budget deficit and renew special employment schemes. The recent further, if minor, relaxation of capital controls also signals continued commitment to some at least of the previous administration's micro-economic objectives. The economic situation is not however particularly good. Growth is not expected to exceed 2% in 1988; unemployment is 10.5%; the external current account moved into deficit in 1987, and trade in manufactures was in deficit for the first time in 18 years. Inflation was however down to 2.5% in March this year. Statistics are attached.

Agenda

Although there is no agenda as such, Elysée officials have identified four main headings:-

- East/West Relations (following the Moscow Summit).
- The Hanover European Council meeting (in broad terms) and the main priorities for Europe in the period up to 1992, including monetary cooperation.
- The bilateral relationship (follow-up to the January Summit and priorities for the future).
- The Toronto Summit (International, Economic and Financial matters, Third World debt, Terrorism).

Although M Rocard will almost certainly not attend the Toronto and Hanover meetings, he will probably want to discuss, possibly in greater detail than President Mitterrand, some of the main international and EC subjects which will come up. This reflects the general division of tasks between President and Prime Minister.

East/West Relations

In many respects the French analysis of the changes in Soviet policy, particularly in foreign affairs, is very close to our own, if not even more cautious. They share our concern about the effect of Gorbachev and his smile on Western public opinion and our desire to bolster support for nuclear deterrence. Traditional French suspicions about a US-Soviet condominium fixing world affairs over Europe's head have also resurfaced, most notably over Afghanistan. Even so, there is much scope for us to work together to persuade other Western governments to make realistic assessments and to discourage moves to "help" Gorbachev.

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The Foreign Secretary recommends that in Paris the Prime Minister:-

- a) explain our support for Gorbachev's reform efforts and our readiness to acknowledge genuine change; but that is matched by our caution about how far withdrawal from Afghanistan will lead to the emergence of a genuinely independent government there, or to the peaceful solution of other regional conflicts (Soviet and Cuban military support on the ground for the regimes in Angola and Ethiopia has been unaffected so far) and by our concern that the Soviet military threat continues unchecked, not least in Europe.
- b) stress that despite the lack of major new agreements or breakthroughs, the Moscow Summit was a real success. It consolidated the recent improvement in US/Soviet relations and was a symbol of the steady, stable management of East/West relations which has long been our aim. The Prime Minister could give President Mitterrand her personal impression of the Summit on the basis of her talks with President Reagan last week. She could also take the opportunity to emphasise that the President was quite right to put the spotlight on human rights. This is a key issue and lies at the very heart of differences between East and West. To gloss over it would give the wrong impression to the Russians (who now accept that Western leaders have a right to comment on these questions).
- c) stress the need for Britain and France to concert closely on the challenges and opportunities of the present period. Specifically, the Foreign Secretary recommends that the Prime Minister seek to maximise the common ground on nuclear issues. President Mitterrand's attitude to France's theatre nuclear modernisation was at best ambivalent during the Presidential election campaign. By extension, French resistance to SNF negotiations cannot perhaps be taken for granted in future. The political danger of appearing to sanction progress towards the denuclearisation of Europe is, however, something that President Mitterrand should be alive to. The Prime Minister might remind him of the impact on German public opinion of his support, expressed in a speech in the Bundestag, for the INF decision of 1979; and express the hope that he will use his influence helpfully over SNF modernisation as well.
- d) underline the need for early Alliance agreement on proposals to put forward at the forthcoming conventional stability negotiations. The French have hitherto resisted what other Allies favour, namely an equal ceilings regime covering the entire Atlantic/Urals area. They have said

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that they can only accept equal ceilings in a much narrower zone of the WEU countries on the Western side and an equivalent zone on the Eastern side, or in a zone which excludes France entirely. These proposals have attracted no support because they make little military sense. The Prime Minister could make clear to both President Mitterrand and M Rocard that we should not enter into complex conventional arms control negotiations except on the basis of zonal arrangements reflecting sound security considerations; and that equal ceilings covering the entire area represent an effective and publicly defensible method for securing the asymmetrical reductions by the East which we seek.

A number of other subjects may come up in discussion:-

- on Soviet internal developments, the Prime Minister could draw attention to the struggle going on in the run-up to the Party Conference at the end of June. It involves attempts by both sides to fix the choice of delegates and (for the first time) some argument in public. In the end, the Conference is unlikely to produce large-scale personnel changes, but endorsement of Gorbachev's overall approach may make resistance to reform more difficult in the future. In the longer term, Gorbachev's ability to put more food and consumer goods in the shops may be a critical factor in his success or failure.

- on Eastern Europe, the French may be interested to hear the Prime Minister's impressions of Grosz in view of his elevation to the Party leadership. She might also mention that she hopes to use the prospect of her visit to Poland to put pressure on the Poles to pursue economic reform and political dialogue.

- on CSCE, we still hope the negotiation can be completed in July, but this depends on Eastern willingness to agree a balanced and substantial outcome. There remains much to negotiate, particularly on military security, human rights/human contacts and follow-up activities. Soviet hints to the Americans about a more forthcoming attitude in Vienna have not so far borne fruit, and the obstructive Romanian attitude to human rights looks increasingly like a major stumbling block. The issue of a Moscow Conference on human rights has receded into the background (it was not mentioned at the US-Soviet Summit) but is not yet dead. The Prime Minister might say that it would now be timely for the West to consider how to kill off the idea.

- on chemical weapons, the French support a global and effective ban but, like us, believe that complex issues remain to be resolved in the Geneva negotiations and that this will take time. They have been particularly irritated by FRG

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pressure for speedy progress. It would be useful to sound them out about their attitude to the German approach, while encouraging them to do what they can to maintain Western unity in public, in particular at a time when Soviet propaganda risks putting the West on the defensive. We informed the French about the exchange of visits between the chemical defence establishment at Porton Down and the Soviet CW facility at Shikhany. We shall brief them and other allies in detail on the Shikhany leg (30 June - 3 July). They have no intention of arranging a similar exchange between a French and Soviet establishment.

EC ISSUES

All the signs are that President Mitterrand will want the European Council to take a significant step further in the field of monetary construction. He will also want to mark the return to power of a Socialist government by giving fresh impetus to Community involvement in social issues. This fits with M Delors' priorities and those of the Greek Presidency.

There are obvious difficulties for us in this agenda but no reason to assume that we and the French must be at loggerheads. For a start, the French agree with us that the single market must be top of the EC agenda. They will also be very aware that progress may be slow under the next two (Greek and Spanish) Presidencies and that it will be for them to give real impetus to the single market campaign in their Presidency in the second half of 1989.

The Prime Minister may therefore wish to stress to President Mitterrand the importance we attach to the French Presidency and to outline the areas we see as priorities to end-1989. She may wish to suggest that we should work with the Germans to get Hanover to endorse these priorities for future work in the knowledge that this will help us to keep up the momentum between now and the French Presidency next year. The priorities are:

- financial services (further progress beyond the likely agreements on capital movements and non-life insurance) eg banking, securities and life insurance;
- mutual recognition of testing and certification procedures and further agreement covering product standards;
- further opening up of public purchasing in member states and measures to ensure compliance;
- further transport liberalisation (including shipping cabotage; further opening up of air transport services and road transport cabotage);
- opening up the market in telecommunications.

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For the immediate future, Chancellor Kohl's letter to EC Heads of Government outlines the areas in which the Presidency hope to see progress by Hanover, including;

- capital liberalisation
- mutual recognition of diplomas
- rights of residence
- road haulage market access
- public procurement
- intellectual property (trade marks and patents)
- food law

With the exception of rights of residence, these are all UK priorities. The letter also identifies some 31 individual measures which the Presidency hope to see agreed between now and Hanover. Few of these present any substantive problems for the UK. However, the French may try to insist that liberalisation of capital movements should be accompanied by a withholding tax on savings. The new French Government has made encouraging noises about agreeing to move swiftly to end the remaining French exchange controls. However, the French, who tax investment income relatively heavily, have also expressed disquiet about the increased scope for tax evasion which they believe will follow from abolition. Hence the French pressure for a harmonised withholding tax on savings. We have naturally opposed this (not least because it will simply drive business away from Europe altogether) and ECOFIN had earlier accepted that while, discussion should continue on this issue, agreement on it should not be regarded as a precondition for the adoption of the Directive. The heightened concern recently shown by the French on this issue may be linked to President Mitterrand's manifesto commitment to the introduction of a substantial wealth tax. If the French raise the issue, the Prime Minister may wish to point out that their view ignores the fact that third countries will still be able to offer beneficial rates. Investment would be driven out of Europe, taking business, jobs and taxable profits with it. EC Finance Ministers rightly agreed at ECOFIN on 14 May that there should be no question of making tax harmonisation a precondition for the liberalisation of capital movements.

Unlike us, the French do not see the creation of a Single Market as part of a necessary wider liberalisation, internal and external. They remain more protectionist, and keen to ensure that third countries do not have access to the liberalised internal market without providing reciprocal access in their home market. This is not an issue which need be raised with the French at this stage. But if the French raise it, the Prime Minister may wish to say that the Single Market is about dismantling barriers to trade, not about erecting new ones. What is true for the Community is true for

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the Community's relations with the outside world: putting barriers in the way of competition removes much of the pressure for innovation and efficiency. In the short term the consumer suffers through higher prices. In the long term even the workforce in the protected industries suffer.

Social Issues

President Mitterrand, and to a lesser extent M Rocard, may press the French Government view that the Community should be making progress on the "social area", ie harmonisation of legislation relating to wages, social security, working hours and working conditions. Such ideas have considerable support in the Commission. The proposals involve a "minimum threshold of social rights" for workers; a right to permanent training based on a system of credits over a lifetime; and changes in Community company law to promote worker participation in decision making.

In response to any approach, the Prime Minister may wish to make the following points:

- Europe's biggest social problem is unemployment. The Single Market will provide new opportunities for growth and job creation. There is scope for building on the 1986 Employment Resolution and implementing its provisions for greater labour market flexibility and training and retraining of the long-term unemployed.

- Rights and duties of employees should be decided by discussions between employers and employees. We must not create new burdens on businesses that destroy the benefits of the single market including the capacity of firms to generate new jobs.

- We have not neglected the social dimension in our national policy: we are spending more than ever before on training and retraining. But it is much easier to engage the interest and support of firms in training programmes for eg young school leavers if they themselves are operating in a climate of deregulation and therefore of opportunities for growth. The UK unemployment rate is falling faster than in any other EC country (and is lower than that of France: 8.9%/10/5%).

Monetary Cooperation

President Mitterrand favours the establishment of some kind of independent group of 'wise men' to look into monetary construction, including the possible establishment of a European Central Bank. Reports (from Paris) of his meeting with Chancellor Kohl on 3 June suggest that he may have made

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progress in overcoming Chancellor Kohl's scepticism about "wise men". It is likely that, without going into detail, he will want to explain to the Prime Minister how he sees greater monetary cooperation as essential to the development of the Community and urge that the UK join the ERM. French interest is motivated partly by a political desire to be seen to be giving a greater impetus to economic and monetary union; and partly a wish to see what they call greater symmetry in the present system: a less DM-centred zone and a greater Bundesbank willingness to support the weaker currencies. They favour sterling's membership of the ERM in part because they think that would make it less of a DM-centred system. Some of M. Mitterrand's advisers argue, however, that the task of developing the ERM further must now proceed without waiting any longer for the UK.

The ex-French Finance Minister, M Balladur, wrote to his EC Finance Minister colleagues in January with a paper on 'European Monetary Construction'. This proposed various steps including early liberalisation of capital movements, lessening the 'asymmetry' within the ERM, adopting a common stance towards non-Community currencies and, finally, the long-term development of a single currency area with a common central institution. French spokesmen have subsequently made it clear that they see the last step as a long-term one; and have stressed the need to concentrate on points of more immediate operational interest. The French appear to wish to proceed by building up a central role for the European Monetary Cooperation Fund. The new French Finance Minister, Bérégovoy, has indicated his support for the thrust of these proposals - though not for the idea of countries ceding sovereignty to a supra-national European Central Bank.

Since M Balladur put his paper to other Finance Minister, French officials have made a number of more detailed suggestions. These include intensified coordination of economic policies, greater 'symmetry' in intervention, the diversification of reserve assets (encouraging the growth of cross-holdings of currencies between central banks over the medium-term) and a timetable for phasing out the 'special arrangements' in relation to the EMS exchange rate mechanism (ie a timetable for sterling and other currencies to join and for the Italians to move to narrower margins).

Our priority has been to press for the removal of all remaining exchange controls in the Community. We hope that agreement can be reached on this at ECOFIN on 13 June. But there are other, more technical, issues where we believe some progress can be made. We, and others, support the French proposal for the removal of obstacles which deter Member States from holding other Community currencies in their reserves (The Germans seek to limit intervention by other

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central banks in DM, and refuse to hold anything other than dollars in their own reserves). We also support moves to encourage Member States to maintain greater holdings of private ecus in their official foreign currency reserves and to make greater use of the ecu as an intervention currency. The Chancellor has indicated, both at the informal ECOFIN last month, and publicly, that the UK does not believe it is worth pursuing the more "visionary" ideas of a European Central Bank and a Common currency.

When these issues come up the Prime Minister may wish to draw on the following points:

- Have been interested to hear of variety of French ideas relating to European economic and monetary union;

- First essential step is to agree quickly on full capital liberalisation, and a timetable for dismantling exchange controls in Europe. Should focus efforts initially on achieving that. Therefore warmly welcome new French Government's removal of remaining exchange controls on corporate sector. Hope this will quickly be followed by abolition of controls on individuals. Scrapping UK exchange controls in 1979 was wholly beneficial;

- There are also a number of other more technical ideas in the monetary area on which early progress could be made, including a greater use of the ecu and wider cross-holdings of community currencies in foreign exchange reserves;

- Any remit from Hanover should seek to give further impetus to work on these points - rather than to a wider study of more futuristic ideas, such as establishment of a European Central Bank, which in any event could not be a true Central Bank so long as nation states exist;

- Any further work on monetary co-operation should be taken forward by Finance Ministers themselves in ECOFIN, together with Monetary Committee and Central Bank Governor's Committee;

- [if asked] Government policy is that sterling will join the ERM when the time is right. Not sensible to try to set a timetable.

Bilateral Relations

East-West relations and Community issues will both be major areas for concertation with the French during Mitterrand's second term. We agreed in our earlier correspondence that defence was also a promising area for future Anglo-French initiatives. We recommend that the Prime Minister underline to President Mitterrand the importance

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which she attaches to taking forward practical defence cooperation between our two countries in the context of strengthening the collective defence of Europe. As mentioned in my earlier letter, the ideas in the Prime Minister's January letter to President Mitterrand were remitted for study to his military adviser, General Fleury. The Elysee have not offered a substantive reaction, and the new government have not yet had time to study the question. It would nevertheless be helpful if the President would agree that work should be taken forward after the elections.

On TASM, there will be feasibility studies over the next 6-9 months with a view to a final decision in 1989. The MOD are considering which options to include in these studies. If the subject is discussed, we recommend that the Prime Minister adopt a neutral line.

The Prime Minister might also wish briefly to touch on conventional defence equipment cooperation. The recent Anglo/French reciprocal procurement initiative is unique within the Alliance and points the way to a more open defence equipment market among all the Allies.

In his reply to the Prime Minister's message of congratulations, the President hinted that he might raise the WEU. If he does, the Prime Minister might say that our objectives during our WEU Presidency will be to develop practical measures for implementing the Platform agreed in The Hague last October; and to bring the enlargement negotiations with Spain and Portugal to a successful conclusion in parallel with a satisfactory definition of Spain's relationship with NATO. On the administrative side, we continue to believe that Brussels is the right site for the organisation to be co-located. We would be prepared to offer London as a second best, but could not agree to Paris. We do not think however that the organisation should waste too much time on this issue if agreement is not in prospect; and we shall not want it to get in the way of other higher priorities.

President Mitterrand may be in a position to confirm French agreement on dates for the major visit to France planned by the Prince and Princess of Wales (7-11 November). The proposed highlight is TRH's attendance at the ceremony on 11 November at the Arc de Triomphe to celebrate the 70th Anniversary of the Armistice. However, announcement of this and the visit's date would be best delayed until nearer the time.

Work on youth exchanges is being taken forward. We are concentrating on doubling the number of government funded youth exchanges within two years, on vocational training exchanges and on a colloquium on educational exchanges.

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We would not expect President Mitterrand or Prime Minister Rocard to raise the Channel Tunnel in other than general terms. However should the familiar French case for the high speed rail link from London to Dover be pressed, the Prime Minister could respond that BR are still studying this possibility and are expected to produce their findings later this month.

Toronto Economic Summit

The new Foreign Minister, M Dumas, has said that agriculture and debt will be French priorities for Toronto. Briefing on debt will follow separately. Agriculture will be a key issue at the Mid Term Meeting (MTM) in Montreal in December. The Prime Minister may wish to say that the Americans must stop denigrating the February Brussels CAP reforms, relax their insistence on zero support by the year 2000, and negotiate sensibly; but that the Community cannot just rest on its February laurels. The main objective at Toronto will be to get a serious negotiation on agriculture going in GATT, without trying to spell out what might or might not be achieved at the MTM.

On the closely linked subject of trade, the Prime Minister could say that UK and French objectives are similar in many areas of the GATT Round. We attach great importance to more effective dispute settlement procedures and closer observance of existing GATT rules. The Toronto Summit can again give new impetus to the negotiations. If the French insist on a narrow interpretation of "globality" the Prime Minister could say that to progress on all issues at the pace of the slowest is a sure recipe for failure. We should make progress at Montreal where we can.

President Mitterrand may refer to his proposal for a discussion (during the informal session on the second day of the Summit) of the impact of fast changing technologies on the labour market and education system. This would fit well with the wider field of demographic change that the Americans may plan to raise. These are issues of growing importance to all European (and Japanese) economies.

On the political agenda at Toronto, apart from East-West relations, we have been seeking discussion of terrorism and the Middle East. Both issues, as well as South Africa, are worth raising with President Mitterrand if time permits.

On terrorism, the French continue to show hesitancy over including any language in the political statement at the summit. It would be useful if the Prime Minister could impress on them the importance we attach to covering terrorism

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in the statement (on the lines of draft already prepared). We recommend that she also take this opportunity to thank both President Mitterrand and M Rocard for allowing us access to recently released French hostages, and to express concern at the deal which M Chirac is alleged to have struck with Iran. Could the President assure her that no convicted terrorists will be released as part of the deal?

On Iran/Iraq, the Prime Minister could:-

- reiterate our support for the UNSG's proposal for proximity talks on the implementation of UNSCR 598;
- assure the French of our continuing support for an arms embargo against the Iranians if they remain intransigent;
- underline the valuable role played by western navies in the Gulf, and urge the French to maintain their contingent. (There has been speculation that they might be considering reducing their force.)

The Prime Minister could also restate our concern at the proliferation of ballistic missiles in the region. The Missile Technology Control Regime, designed to control the sale of longer range nuclear capable missiles from Summit 7 countries, owes much to Anglo-French cooperation. We wish to see it extended to include the proliferation of other types of missiles, including those with a CW capability, and to cover other European suppliers, the Russians and Chinese.

On Arab/Israel, in advance of her planned meeting with King Hussein on 15 June, the Prime Minister might compare notes with the French on recent developments in the peace process - the US/Soviet talks in Moscow, the latest shuttle by Mr Shultz (3-8 June), and the Arab Summit in Algiers (7-8 June). Prospects for early progress on the US initiative are poor: Shamir remains obdurately opposed to a land-for-peace deal, and to an international conference; and the Algiers Summit is likely to result in an increasingly tough Arab position. However, we recommend that the Prime Minister stress the importance of keeping faith with US efforts, and maintaining pressure on the Arabs not to adopt more radical policies. These are the best tactics for helping Peres in the run-up to the Israeli elections. The Prime Minister might also test whether there is any French appetite for specific higher profile activity by the Twelve: we doubt that this would be effective (particularly under a Greek Presidency) and suspect that any European move would risk undermining US efforts.

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Recent contacts with the French indicate that the end of "cohabitation" may lead to a change in French attitudes to South Africa. They have drawn up a list of possible additional sanctions, including a limited range of economic measures to be applied if South African behaviour was such as to require (in their view) additional Western pressure. They are toying with the idea of a ban on imports of South African fruit and vegetables. The French are well aware of our views. But the Prime Minister may wish to remind President Mitterrand of the familiar slippery slope. Concessions to sanctions pressure in one area - which may be relatively painless for the imposing country - invariably lead to pressure for concessions in other less welcome areas. A ban on fruit and vegetable imports would not just hit Afrikaner farmers. It would increase black rural poverty and accelerate the drift to the towns, without beneficial effect on South African policies.

I am copying this letter to Ian Andrews (MOD), Alex Allan (Treasury) and Trevor Woolley (Cabinet Office).

Yours ever,
L Parker

(L Parker)
Private Secretary

C D Powell Esq
10 Downing Street

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FRANCE: BASIC STATISTICS

		France	UK
Population	1985	55.2	56.6
	1986(P)	55.4	56.8
Labour Force	1986	24.0	27.8
Unemployed (% OECD standardised rate)	1987	10.8	10.3
	Mar 1988	10.5	8.9
GDP (\$bn)	1986	724.2	548.2
	1987(P)	870.3	658.9
GDP per head (\$)	1986	13,070	9,650
Annual Growth Rate of real GDP (%)	1986	2.1	2.3
	1987	2.1	4.4
Annual Growth Rate of Industrial Production (%)	1986	1.0	1.9
	1987	2.0	3.6
Inflation (%)	1986	2.5	3.4
	1987	3.3	4.2
	Feb 1988	2.4	3.3
Changes in Relative Labour Unit Costs (% change)	1986	3.0	-6.6
	9 mths 1987	-1.7	-4.7
Balance of Payments on Current Account (\$ bn)	1986	3.7	-1.4
	1987	-3.9	-2.8
Trade Balance (fob-cif, \$bn)	1986	-4.6	-19.2
	1987	-10.0	-23.2
Volume Growth (%): Exports	1986	-.2	3.7
	1987	1.3	6.1
Imports	1986	7.1	6.4
	1987	6.3	8.3
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Bilateral Trade	1985	1986	1987
UK Exports to France (fm)	7,771	6,210	7,782
UK Imports from France	6,635	7,349	8,382
Trade Balance	1,136	-1,139	-600

Economic Advisers
31/05/1988

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7 June 1988

L Parker Esq
PS/Secretary of State
FCO
King Charles Street
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Bar Lyn

PRIME MINISTER'S MEETING WITH PRESIDENT MITTERRAND: 10 JUNE

I attach a brief on European monetary integration. This has been approved by the Chancellor. We agreed to hold up the brief on the Chancellor's sub-Saharan debt initiative until we have seen the French proposals.

I am copying this letter to Charles Powell (No.10).

Yours ever

A handwritten signature in dark ink, appearing to read 'J M G Taylor'.

J M G TAYLOR

EUROPEAN MONETARY INTEGRATION

President Mitterand seems likely to raise this subject. Reports (from Paris) of his meeting with Chancellor Kohl on 3 June suggest he favours the establishment of some kind of independent group of "wise men" to look at the long-term monetary development of Europe, including ideas for a common currency and European Central Bank. He is also likely to urge the UK to join the ERM.

Line to Take

The Prime Minister might like to draw on the following points:

- (i) Have been interested to hear of variety of French ideas relating to European economic and monetary union.
- (ii) First essential step is to agree quickly on full capital liberalisation, and a timetable for dismantling exchange controls in Europe. Should focus efforts initially on achieving that. Therefore warmly welcome new French Government's removal of remaining exchange controls on corporate sector. Hope this will quickly be followed by abolition of controls on individuals. Scrapping UK exchange controls in 1979 was wholly beneficial.
- (iii) [If tax difficulties raised] Concerned to hear France may be seeking to make progress on fiscal issues a precondition of agreement to draft capital liberalisation Directive in Brussels. Understand ECOFIN had earlier agreed no preconditions should be attached to adoption of Directive. Clearly right. Ending UK exchange controls caused us no serious tax problems.
- (iv) There are also a number of other more technical ideas in the monetary area on which early progress could be made, including a greater use of the ecu and wider cross-holdings of community currencies in foreign exchange reserves.

(v) Any remit from Hanover should seek to give further impetus to work on these points. Do not believe it is sensible to devote time and resources to wider study of more futuristic ideas, such as establishment of a European Central Bank, which in any event could not be a true Central Bank so long as nation states exist.

(vi) [If pressed to agree a study] No point at all in a study by "wise men". Any further work on monetary co-operation should be taken forward by Finance Ministers themselves in ECOFIN, together with Monetary Committee and Central Bank Governor's Committee.

(vii) [If asked] Government policy is that sterling will join the ERM when the time is right. Not sensible to try to set a timetable.

BACKGROUND**French views on European Monetary Integration**

The French are motivated partly by a political desire to be seen to be giving a greater impetus to economic and monetary union; and partly a wish to see what they call greater symmetry in the present system: a less DM-centred zone; and a greater Bundesbank willingness to support the weaker currencies. They favour sterling's membership of the ERM in part because they think that would make it less of a DM-centred system. Some of M.Mitterand's advisers argue however that the task of developing the ERM further must now proceed without waiting any longer for the UK.

The ex-French Finance Minister, Balladur, wrote to his EC Finance Minister colleagues in January with a paper on "European Monetary Construction". This proposed various steps including early liberalisation of capital movements, lessening the "asymmetry" within the ERM, adopting a common stance towards non-Community currencies and, finally, the long-term development of a single currency area with a common central institution. French spokesmen have subsequently made it clear that they see the last step as a long-term one; and have stressed the need to concentrate on points of more immediate operational interest. The French appear to wish to proceed by building up a central role for the European Monetary Co-operation Fund. The new French Finance Minister, Bérégovoy, has indicated his support for the thrust of these proposals - though not with the idea of countries ceding sovereignty to a supra-national European Central Bank.

Since M. Balladur put his paper to other Finance Ministers, French officials have made a number of more detailed suggestions. These include intensified co-ordination of economic policies, greater "symmetry" in intervention, the diversification of reserve assets (encouraging the growth of cross-holdings of currencies between central banks over the medium-term) and a timetable for phasing out the "special arrangements" in relation to the EMS exchange rate mechanism (ie a timetable for sterling and other currencies to join and for the Italians to move to narrower margins).

UK response

Our priority has been to press for the removal of all remaining exchange controls in the Community. We hope that agreement can be reached on this at ECOFIN on 13 June. But there are other, more technical, issues where we believe some progress can be made. We, and others, support the French proposal for the removal of obstacles which deter Member States from holding other Community currencies in their reserves. (The Germans seek to limit intervention by other central banks in DM, and refuse to hold anything other than dollars in their own reserves.) We also support moves to encourage Member States to maintain greater holdings of private ecus in their official foreign currency reserves and to make greater use of the ecu as an intervention currency.

The Chancellor has indicated, both at the informal ECOFIN last month, and publicly, that the UK does not believe it is worth pursuing the more "visionary" ideas of a European Central Bank and a Common currency - especially when even those advancing them are not sure what they mean.

Capital liberalisation

The new French Government has made encouraging noises about agreeing to move swiftly to end the remaining French exchange controls. Indeed the informal ECOFIN was moved from 6 June to 13 June specifically so that French agreement to a new Community directive on this would fall after the French assembly election.

However, the French have also expressed disquiet about the increased scope for tax evasion which they believe will follow from abolition. If this subject comes up it might be useful for the Prime Minister to repeat our belief from our own experience with abolishing exchange controls, that the French fears are groundless. The French have been pressing within the Community for a harmonised withholding tax on savings. We have naturally opposed this (not least because it will simply drive business away from Europe altogether) and ECOFIN had earlier accepted that while discussion should continue on this issue agreement on it should not be

regarded as a precondition for the adoption of the Directive. However, the latest signs are that the French may be seeking to impose just such a condition. The heightened concern recently shown by the French on this issue may be linked to President Mitterand's manifesto commitment to the introduction of a substantial wealth tax.



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