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10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

22 February 1989

Dear Alex,

PRIME MINISTER'S LUNCH AT THE BUNDESBANK
IN FRANKFURT ON 20 FEBRUARY

The Prime Minister lunched with Herr Poehl at the Bundesbank in Frankfurt on 20 February. Also present were Dr. Herrhausen of the Deutsche Bank, Dr. Seipp of the Commerz Bank, Herr Gleske of the Bundesbank and the two Ambassadors. It was a cheerful indeed boisterous occasion with - I am bound to record - a certain, jovial air of belle alliance against Finance Ministers and all their works. I do not think that the participants were left in any doubt of the Prime Minister's views on the main issues of the day. They seemed to share most of them.

It was not the sort of occasion to take a record. The following is based on my recollection.

Herr Poehl got off to an excellent start by reading the opening passage of a speech he had delivered that morning in Kiel praising the Prime Minister's views - in the Bruges speech - on the dangers of bureaucracy, regulation and centralisation in Europe. This led to a discussion of the motives of some of those who were arguing for full economic and monetary union in Europe. The Prime Minister took the view that EMU was simply the handmaiden of their determination to have a fully fledged federal Europe. The most ardent supporters of EMU were those who wanted to run Europe on socialist and dirigiste lines, which could not be reconciled with the free market approach in which both Britain and Germany believed.

There was then a brief discussion on international debt. The Prime Minister inveighed against attempts to transfer the burden from the commercial banks to the taxpayer. Herr Poehl was cautiously approving of proposals being developed by the US Administration. As I understood it, these were related to or modelled on the J.P. Morgan proposals for Mexico.

Discussion then moved on to the Delors Committee. The Prime Minister said that the tasks of the Committee were to describe what full EMU would involve in agnostic terms, and to spell out starkly the implications in terms of loss of national sovereignty over economic and monetary policies. An enormous transfer of power away from national governments and parliaments would be involved. If the scale of this were clearly explained in the report, most European Governments would think twice before setting out down this route.

Herr Poehl and his colleagues began by arguing that in reality the European Community was not so far from EMU now, with stable exchange rates achieved through the ERM over the past couple of years. The Prime Minister argued the folly of trying to fix exchange rates and the damage done by the Plaza and Louvre Accords and by other attempts to defend particular rates. Arguably this had set us back by two years in the fight against inflation in the United Kingdom. Moreover fixing exchange rates in Europe would remove an important means of adjustment and lead to demands from the poorer countries for further massive transfers of resources through the regional and structural funds. Convergence of economic policies should come first. Exchange rates were the result.

Herr Poehl and his colleagues then edged away from this line of argument, protesting that they did not believe in fixed exchange rates. But equally they wanted a process of closer economic and monetary cooperation in Europe, based upon convergence of policies. They did not think that a single European market could be achieved without progress on monetary cooperation. They regretted that Britain, with its liberal policies, was not exerting more influence in this field. The Prime Minister said that neither tax approximation nor EMU were essential to a single market. The obstacles were quite different: the refusal of some governments to play by the rules in Europe, for instance on public procurement: and the continuing heavy subsidies not least in Germany. The bankers offered no defence on this last point.

The Prime Minister went on to attack the Commission's proposals for an EC-wide withholding tax. It was not necessary to liberalisation of capital movements and would only drive capital out of Europe altogether. The United Kingdom would not accept it. Herr Poehl and his colleagues said that the introduction of such a tax in Germany had been little short of disastrous, leading to a major outflow of capital. They would not like to see it repeated at the European level.

Discussion then returned to the Delors Committee, and was characterised by some steady back-pedalling by Herr Poehl who was harried more than supported by his banking colleagues. Poehl said that he was confident that the Committee's report would be as stark and agnostic as the Prime Minister hoped. He did not think that there would be support for a European Central Bank or a euro-currency.

They were simply not realistic goals, although the report would not say that. He did not expect to have problems with the text, or to find it necessary to subscribe to a minority report. The Prime Minister said darkly that some reports of Herr Poehl's views suggested that he had shifted somewhat from the excellent exposition of the case against a European Central Bank in his article of 28 May 1988 in the FAZ. Herr Poehl conceded that his views might have changed in some respects but not in any major way. The Prime Minister said that it would be a great mistake to argue that EMU would never happen so there was no need to worry too much about it. There were many in the Community who were dedicated to EMU as an aspect of full political union and they had to be resisted. She did not see how Herr Poehl could possibly go along with any proposals which threatened the independence of the Bundesbank and its ability to protect the value of the Deutschmark. Surely such loss of independence and substitution of political control was the inevitable concomitant of proposals for a European Central Bank? Herr Poehl conceded the risk of this, but seemed to argue that no government, when faced with the real implications of EMU, would actually want to go to Treaty amendment.

Herr Poehl raised, rather tentatively, the issue of British membership of the ERM. The Prime Minister argued that sterling was in a different position to other European currencies except the DM, because of its international role and the volume of daily trade in it. She also argued that our political stability would give sterling an artificially high rate. Sterling's participation would certainly make the ERM far more difficult to manage. The bankers returned to the argument that they wanted Britain in the ERM, to make Europe's monetary co-operation more liberal and open.

The Prime Minister also spoke in forceful terms of the scale of Britain's net contribution to the EC budget and cost over the exchanges of keeping our forces in Germany. I have to say that this was received rather blandly.

I think this covers most of the main points. It was a very good humoured discussion throughout, with a lot of teasing about the likely reactions of the German Government to the views expressed.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), to John Footman (Bank of England) and to Roger Lavelle (Cabinet Office).

Yours sincerely,

Charles Powell

CHARLES POWELL

Alex Allan Esq
Treasury