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1. COP - to see
2. Prime Minister
You will wish to note these exchanges, particularly pages 2-3 on EMS etc.
PRCG 23/3

Dear Richard

CHANCELLOR'S MEETING WITH FRENCH FINANCE MINISTER

M. Pierre Beregovoy, the French Finance Minister, had lunch with the Chancellor today. The lunch was followed by a further discussion. Beregovoy was supported by various French officials, and the French Ambassador. The Economic Secretary, Mr Wicks, Mr Lankester, Mr R I G Allen, and Mr Tyrie (all Treasury) were also present.

Recent economic developments

The Chancellor explained why it had been necessary to tighten monetary policy in the UK. We already enjoyed a tight fiscal policy - there was a substantial budget surplus - and monetary policy was in current circumstances a more effective tool of economic management than fiscal policy: it was quicker acting, and acted on consumer spending rather than investment. Beregovoy said that he had been successful in bringing down the French rate of inflation. There were upward pressures on wages, particularly in the public sector. These would need to be resisted. Generally, however, investment remained buoyant; the budget deficit was declining; and the monetary aggregates were reasonable.

The Chancellor said that the strong growth in the world economy over the last three years had been followed by a resurgence in inflation. Commodity prices, especially metals, were up. It was inevitable in these circumstances that interest rates had to be increased.

European monetary matters

Beregovoy asked the Chancellor whether the UK would join the exchange rate mechanism of the EMS this year. The Chancellor said we would join when the time was right. Beregovoy said that the decision whether or not to join the ERM had been as controversial in France as it now was in the UK. But, taking stock of France's ten years' membership, the decision to join had been most beneficial, eg in terms of imposing monetary discipline. That process now needed to be taken forward. He noted that the Delors Group would soon be making its report. The Chancellor said that membership of the ERM was not necessary for monetary discipline. More generally, there was scope for greater co-operation within the existing framework. There was, for example, greater scope for using the ecu. There should also be wider cross-holdings of each other's currencies. But there was no possibility of the UK agreeing to anything which might arise from the Delors Group which would require Treaty amendment. Even if the Government were prepared to agree to any such proposal, there was no possibility of the House doing so. (The Chancellor emphasised this point again later.) Greater co-operation should be achieved within the limits of the existing Treaty.

Beregovoy said that he did not know what conclusions the Delors Group would reach. There might be proposals for Treaty amendment, or perhaps a more limited monetary agreement. He agreed that there should be wider cross-holdings amongst central banks. But, he suggested, it might be helpful to delegate the responsibilities of intervention to some autonomous central body.

Continuing, Beregovoy said that the value of the ecu was determined by the value of its component currencies. Eight of these had accepted the discipline of the ERM; two had not. There should be the same constraints and disciplines on all the currencies in the ecu basket. It was contradictory to argue for the development of the ecu while maintaining the independence of some of its component currencies. The Chancellor noted that it was desirable to maintain the stability of sterling whether or not it formed part of the ERM. And, to be blunt, sterling was more important to the ecu than vice versa. If sterling were left outside the ecu, that would be to the ecu's detriment. It was true that having sterling in the ecu did give rise to a very slightly greater volatility between eg the ecu and the deutschmark. But it gave greater stability to the ecu vis a vis the dollar.

Beregovoy said that he did not see how closer economic policies could be developed without closer monetary cooperation. This was a political problem. The ecu reweighting would necessarily give rise to debate over sterling's inclusion. The Chancellor said that, for the ecu, it was important that currencies retained weightings appropriate to their importance.

Beregovoy said that he would get down to brass tacks. If Member States could not advance together, a two speed Europe must be a possibility. The Chancellor said that such a development was clearly undesirable. But comparisons between Member States should not be limited to ERM membership. An alternative comparison might be made between those countries which enjoyed full capital liberalisation, and those which did not. We needed to confront the practical issues. For example, some of the peripheral countries would no doubt argue that they should be compensated for their loss of exchange rate flexibility through resource transfers. This was a false analogy. But they would nonetheless argue it. It was premature to ignore these practical issues, and instead to focus on the more general, idealistic, proposals.

Beregovoy said that France had taken a number of steps since 1984 to bring its economic management into line with other major European countries. Price controls had been eliminated; exchange controls had been largely removed. In return, France was asking for the other participants in the EMS to play by the same rules. The Chancellor noted that these things had been in France's own interests. The French economy had grown stronger as a result of these changes - a fact which he welcomed.

Withholding tax

The Chancellor said that there seemed to be a misunderstanding over the UK's position in relation to the Commission's proposals for withholding tax. In particular, he detected a feeling that we objected to withholding taxes on philosophical or ideological grounds. In fact, we already had a quasi-withholding tax in the form of CRT. He had himself extended CRT to the banks. But he had been very conscious that, unless exemptions were made, business would be driven offshore. For that reason, CRT had been designed to catch only small accounts. The Commission's proposals, on the other hand, would simply drive business outside the Community altogether. This would be the result even if there were numerous exemptions, because of the apparent invasion of privacy perceived by potential offshore investors. It was for this reason that we opposed the tax.

Beregovoy said this was a practical issue, but with a high political content. It was necessary that the same principles should apply to all EC residents, and non-residents. The French wanted to avoid tax evasion, and imbalances between Community countries. The Commission's proposals seemed reasonable: income from capital was already taxed in all major countries. There was a link - which he admitted was not juridical - between capital flows and tax harmonisation. How could capital flows be liberalised in the Community without common principles of taxation?

The Chancellor said that we had abolished exchange controls in 1979, without any corresponding tax changes - and had suffered no detectable increase in tax evasion nor any loss of yield. It was quite correct that there was no juridical linkage between capital liberalisation and withholding taxes: capital liberalisation had been agreed without pre-conditions. We welcomed closer co-operation between fiscs. But the Commission's proposals would simply drive business offshore. The German experience had been very illuminating here.

Beregovoy said it was essential to make plain to the public that Member States shared common principles for the taxation of savings. The Chancellor said he understood the political pressures. But it was not obvious why taxes on income from savings should be the same in the various Member States, when there were great differences in the taxation of earnings. We were not proposing to exempt from tax the income from capital. Indeed, it was compulsory that such income should be declared in the UK. The point at issue was simply how that tax should be levied. We were satisfied that our own procedures allowed us to control evasion. He would be happy to arrange a meeting between fiscs to explain this in more detail, if Beregovoy would find it helpful. Beregovoy said he would like to send a delegation to discuss this with the Revenue experts. But there was a real political problem here for him. In effect, if a withholding tax were not agreed, the French parliament would argue that only wage-earners would be forced to pay any tax.

Indirect tax approximation

Beregovoy said that the UK and France were much closer on this topic. We agreed to disagree with the Commission's proposals. The Chancellor agreed. Everyone thought that the Commission's excise duties proposals were non-starters, and that the clearing house mechanism for VAT was a monstrosity. We also had particular concerns about our zero rates. These must be retained; any apparently time-limited derogation would not be enough. He did not think that the zero rates were, in any case, a real economic distortion. Beregovoy said he thought there was room for agreement here. Each country should be able to set its own VAT levels. Member States would need to be practical and take account of each other's rates. But there should not be forced harmonisation. The Chancellor agreed.

Debt

Beregovoy said there were now three proposals on the table for dealing with the problem of middle income debt: the Japanese, the French, and the recent US proposals. The Chancellor said that there would be no UK proposal, so we could afford to be dispassionate. We would be guided by three principles - the need to reach a market based solution; to avoid any further shift of the burden from the private to the public sectors; and to ensure no further contribution from taxpayers. Beregovoy made a pitch for Government and public sector guarantees. The Chancellor said he was suspicious of these; they let the commercial banks off the hook, and transferred risk. There was no longer a systemic threat to the banking system. Trichet (head of French Treasury) said that creditors should perhaps devise something which forced the banks to take the responsibility for reducing their outstanding loans, or their interest rates. The Chancellor agreed. Beregovoy said that we should nonetheless seek to alleviate the debtors' problems by enabling fresh flows of capital to be provided. The Chancellor said that we should be alert to these fresh flows simply turning into flight capital: Beregovoy said this was a very good point.

Beregovoy said that he hoped that there would be a fruitful discussion in Washington, which could then give rise to a "step forward" at the Paris summit.

Comment

I think I should record that although the talking was tough, the atmosphere was friendly throughout. Beregovoy himself remarked, at the end of the discussion, that he always enjoyed his discussions with the Chancellor because although the talk was frank, the "divergences" were "cordiales"!

I am copying this letter to Charles Powell (No.10), John Footman (Bank), and Trevor Woolley (Cabinet Office).

Yours ever

Jonathan Taylor

J M G TAYLOR
Private Secretary