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From the Private Secretary

22 November 1989

Dear John.

**EUROPEAN COUNCIL: STRASBOURG:
ECONOMIC AND MONETARY UNION**

I enclose a paper on discussion of EMU at the European Council in Strasbourg which has been sent in by Sir Michael Butler. It would be helpful to have any comments which you and the Foreign and Commonwealth Office would like to offer. Sir Michael has asked for a meeting with the Prime Minister and I shall be consulting her about this.

I am copying this letter and enclosure to Stephen Wall (Foreign and Commonwealth Office) and David Hadley (Cabinet Office).

C. D. Powell
(C. D. POWELL)

John Gieve, Esq.,
HM Treasury.

DRAFT

Discussion of EMU at the Strasbourg European
Council in December

Paper by the Chairman of the European Committee

see, Prime Minister
Michael Baker
has sent this
in.
CDD
24 xi

It looks as though the December European Council may again have a difficult discussion on EMU. The French Presidency and the Commission seem intent on forcing a decision on the holding of an intergovernmental conference (IGC) on EMU during the Italian Presidency in the second half of 1990.. Though this seems premature (given that Stage 1 will only begin next July) and probably undesirable, experience in Milan in June 1985 showed that it is not easy to block a procedural decision of this kind if the majority of Member States are in favour.

Though the Germans may want to delay the IGC until after their elections in December 1990, there seems little doubt that there will be the necessary majority in favour of holding it early in Stage 1.

2. The European Committee has consistently taken the view that it would be contrary to the interests of the City for the U.K. to be isolated in discussions of EMU and that the British Government and the Bank of England ought to be seen to be at the centre of the discussion and playing a constructive role. We should, therefore, consider whether (as before Madrid in June) there is any advice on this subject which we could usefully offer to the Prime Minister before Strasbourg. The situation will no doubt have evolved considerably before 8th/9th December. But the broad outline of the likely situation is already discernible.

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The position already reached

3. The Prime Minister has agreed:-

- (a) on the aim of progressive realization of EMU;
- (b) to implement Stage 1 of the Delors plan including (once certain conditions are fulfilled) the entry of sterling into the exchange rate mechanism.

These matters should not, therefore be at issue in Strasbourg.

4. The British Government published on 2nd November a paper on an evolutionary approach (circulated separately). Whether or not the other member Governments regard some or all of these ideas as constructive, they are unlikely to regard them as a sufficient alternative to Stages 2 and 3 of the Delors Plan. They will note that the paper only speaks of "a system of more or less fixed exchange rates", whereas almost everyone in the Community, ever since the early 1970s has regarded permanently locked exchange rates as the essential aim of EMU and most of them regard a single currency as a more durable and advantageous option. Many of them argue that the "progressive realization of EMU" will only be possible if the IGC agrees on what should be done after Stage 1, lays down appropriate stages and provides the institutional framework which is capable of managing these stages. The French Government are determined to seek agreement on a list of practical questions, going beyond the rather fuzzy picture of Stage 2 painted in the Delors report, as a basis for the work of IGC.

5. The British Government will presumably wish to maintain the line that progress towards EMU should be evolutionary and that

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institutional changes should only be made as and when the situation makes such changes necessary. If other Member Governments do not, however, regard the November 2nd British paper as an adequate starting point two questions will arise:-

- (a) what other options could the British Government put forward as possible lines of advance after Stage 1 without abandoning their evolutionary approach;
- (b) can discussion of the substance best be carried on by resisting the procedural decision to hold the IGC or by acquiescence in it as the forum for that discussion, but with acceptable terms of reference

Whether or not the British Government can get support for an evolutionary approach will depend on whether other Heads of Government think that the Prime Minister is approaching the problem in a constructive spirit.

Possible Developments after Stage 1

6. One possible line of progress towards EMU which is played down by the Delors report (at the behest, no doubt, of the Bundesbank, though it would be popular with others such as the Italians and Belgians) and which is only touched on in three lines in paragraph 22 of the November 2nd paper is the development of the ECU. In the real world there have been a number of significant developments such as the issue of ECU Treasury bills by the Bank of England, the use of the ECU for intervention on the foreign exchanges, the ECU contract on LIFFE, and a

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gradual increase in its use by companies for internal pricing, external invoicing, denomination of bond issues or equity capital and so on. Evolutionary progress seems likely to continue in this direction. The British Government might suggest (without necessarily recommending any of them) that options to be considered for Stage 2 could include:-

- (a) removal of all impediments to the use of the private ECU by companies or individuals (this is under study in the Association for the Monetary Union of Europe) and, possibly, encouragement to companies to use it to finance and pay for intra-Community trade;
- (b) possible ways of moving towards eliminating the distinction between the official and the private ecu;
- (c) ^{each of} agreement by the twelve central banks to act as lenders of last resort in ecus (and how to ensure that any creation of ecus is controlled);
- (d) } further down the road, a decision to freeze the composition of the ECU (though what about potential new members of the E.C.);
- (e) an alternative to (d) would be to cease to define the ECU as a basket and to allow it to continue as a currency in its own right;
- (f) a decision as to whether the ECU should at some stage officially be regarded as one of the "competing currencies" in accordance with the Mr. Lawson's ideas.

7. Another possible line of advance would be the further development of the co-ordination of monetary and exchange rate policy after Stage 1. A subsequent British paper could raise some of the questions about which all members of the ERM would need to satisfy themselves before they could safely abandon the option of realignments from time to time, even if they could in future take place rarely and on a small scale. It could, for example, discuss the pros and cons of a further narrowing of bands as a step in that direction. It might cast some doubt on the practicality of moving, at the end of Stage 2, from 12 currencies to one without passing through a stage with a parallel currency. As regards monetary policy and the supply of money in the E.C. as a whole, it is difficult for an outsider to offer suggestions, given the lack of public knowledge of the work of the Monetary Committee and Central Bank Governors. It is clear that the money supply in the E.C. as a whole will be a matter of major concern to all Member States in a Community without exchange controls. The Treasury or the Bank of England could no doubt sketch out how they expect monetary co-ordination to be working at the end of Stage 1 and put forward some options for controlling the money supply in the E.C. (both practical and, possibly, at present impractical) which could be considered for Stage 2. These need not necessarily involve further institutional changes.

8. The same considerations apply to macro-economic co-ordination. A Treasury paper could examine the likely position at the end of Stage 1 and options for Stage 2, at the same time casting doubt on the need for central decision-taking on fiscal policy, especially the details of either the revenue or expenditure sides of the account. Community consultation on fiscal policy, mainly the fiscal balance or borrowing requirements of Member States, already takes place. As the November 2nd paper makes clear, it will be important to influence those Governments and Parliaments who are responsible for massive and unsustainable budget deficits in the direction of good management. From our present satisfactory position, we can argue with vigour the need to make this

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fiscal consultation effective in preventing excessive deficits which damage the economic stability of the Community. Two constructive ideas to this effect are put forward in paragraph 24 of the November 2nd paper, though pages 29 and 30 are more negative.

9. The purpose of putting forward substantive ideas about what might be done after Stage 1 would be to focus the minds of our partners on practical issues rather than institutional blue-prints for the future. This would reinforce us in arguing that the Community should first decide what it wants to do in Stage 2 and then consider whether this requires either:-

(a) additional powers for existing institutions;

or (b) new institutional developments.

The lesson of the European Monetary Co-operation Fund devised as a result of the Paris Summit of October 1972 is instructive. The Institution was set up in Luxembourg as an embryo central bank after much argument (Mr. Heath wanted it in Brussels for this reason) and has done virtually nothing since. Creating institutions does not necessarily lead to substantial progress.

10. The logical way to consider substantive ideas for Stage 2 is to put the existing (Stage 1) institutions to work. This would constitute the agreed necessary preparation for an IGC. Ministers will presumably wish to argue this procedural case.

11. It seems likely, however, that the majority of other member Governments will be persuaded by the Presidency and the Commission that the crucial test of success or failure at Strasbourg will be a decision on the IGC. To concede this would not be without cost to our tactical position since the nature of IGC discussions is marginally biased

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towards the drafting of Treaty amendments rather than the discussion of substance. But if the majority are determined to go ahead with an IGC it would be better to concentrate on securing acceptable terms of reference for an IGC than to fight against it right up to an adverse vote against us. It would be essential to include consideration of the evolutionary approach but, if such an approach is to be acceptable to other Member States, it will be essential to build on the November 2nd paper along the lines of paragraphs 6 - 9 above.

Conclusions

12.

- (a) discussions on EMU at Strasbourg will be difficult and careful tactical preparation will be important; for example, the F.C.O. could mount a major campaign on the theme "substance first, institutions second";
- (b) our interest is to put forward as many substantive ideas for consideration for Stage 2 as possible, even if at the same time we argue that some of them will not be practical for a considerable number of years;
- (c) the ideal place to discuss such ideas would be the Stage 1 institutions;
- (d) but if it does not prove practical to persuade a majority of member Governments to accept conclusion (c), it will be desirable to concentrate discussion at Strasbourg on getting acceptable terms of reference for the IGC which ensure that it considers the option of deciding first what substantive progress might be possible after Stage 1 and relating institutional developments to whatever may be agreed on substance.

MDB/MML

3rd November, 1989