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Prime Minister
CDP 29/6.

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

29 June 1990

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles,

VISIT OF HERR POEHL, PRESIDENT OF THE BUNDESBANK

... I attach a brief, as requested, for the Prime Minister's meeting with Herr Poehl on Monday, 2 July.

The Prime Minister will be aware that Herr Poehl is in London to give the IEA lecture on Monday, 2 July and that it has been rumoured that he will address the subject of EMU and, in particular, that he will criticise proposals for a parallel currency.

The Chancellor considers that it would be very helpful if the Prime Minister could personally impress upon Herr Poehl that the ideas which we have advanced for developments beyond Stage 1 are seriously meant, that we think they are technically sound and that we hope that he will consider them carefully.

She might also mention the fact that Bank of England officials have been discussing our ideas with their counterparts at the Bundesbank and that the Governor will be presenting them to the meeting of EC Central Bank Governors on 10 July.

I am copying this letter, with the brief, to Stephen Wall (FCO), Sonia Phippard (Cabinet Office), Paul Tucker and Clive Briault (Bank of England).

Tancred Tarkowski

T TARKOWSKI
Private Secretary

VISIT OF HERR POEHL

Issues for discussion

You may like to ask Herr Poehl some of the following questions:

ERM and EMU

1. What implications will sterling's entry have for the operation of the ERM?

2. What, precisely, does economic convergence mean in terms of indicators and over what period? Should it be substantially complete in Stage 1 (ie as a result of full membership of the ERM by all 12 countries) or will there still be a major job to do beyond Stage 1?

3. Should we work towards a free-market oriented Community? If so, should not the market be permitted to choose a parallel common currency?

4. What are the pros and cons of two-speed progress towards monetary union (an "inner core")?

5. Our hard ecu proposals provide stringent safeguards against inflationary risks. What are Poehl's worries about the non-devaluing ecu and the mandatory repurchase obligation mechanism?

6. Could we be sure that an "independent" Eurofed would give top priority to fighting inflation? Or wouldn't it in fact be subject to political manipulation?

7. Can there be a single currency and single central bank without a much higher degree of political union than now exists.

German economy and GEMU

1. What will the effect of GEMU be on interest rates and exchange rates?

2. The Deutschemark has fluctuated little so far in 1990. Can this relative stability continue?

3. FRG economy already operating at close to capacity. Will an increase in interest rates be necessary to control inflationary pressures arising from additional consumers' expenditure, government expenditure and private investment?

4. Just how weak is GDR industry? How severe will short-term burden on FRG fiscal policy be?

ERM AND EMU

1. Poehl has spoken - on and off the record - a number of times recently on these subjects.

ERM

2. Poehl has said on the record repeatedly that he hopes sterling will join the ERM. With sterling in the ERM, its members would be a bigger counterweight to the dollar in international negotiations; and it would be good for London as a financial centre. Joining the ERM would give us more say in EMU negotiations. On 8 June he said that "the moment is not very good" right now for sterling to join the ERM, citing relatively high UK inflation and the UK current account deficit. He said the Government's "preparedness" for joining the ERM is a "positive" sign, and that "it won't be a very long time" before sterling can join. He considered the absence of the UK "more than just a blemish."

(i) Development of the system

3. Poehl in his lecture to the Frankfurt Society for Trade, Industry and Science on 30 May argued that the DM was the "stabilising anchor of the European Monetary System". The Bundesbank and Federal Government had a responsibility to see that it stayed that way, in particular to those countries with currencies pegged to the DM. Poehl mentioned the Netherlands, Austria and now Belgium. The east Europeans wanted the DM to play this role too.

EMU

(i) Stage 1

4. Poehl said in his Frankfurt lecture on 30 May that EMU was in fact further advanced than most people thought. Integration of

the markets, including now capital markets, was far advanced. The EMS was highly developed. Currencies within the ERM had been in a stable relationship to each other since 1987.

(ii) Institutions

5. He went on to say that he believed that the EMS would develop in the direction of fixed exchange rates. He foresaw the greatest difficulty in the area of institutions. He doubted if any government (he singled out France) would be willing to give up its sovereign rights to a supranational institution. His fear was that for political reasons the inter-governmental negotiations on EMU would lead to some sort of squalid compromise. He thought that parallel currencies would not work. If people believed in parallel currencies they should favour a European Central Bank (which the Bundesbank would like to be sited in Frankfurt).

6. Poehl emphasised privately to the Anglo-German Economic Committee on 11 May the difficulties that a number of countries would face in signing a Treaty which set up the kind of European central bank that he (Poehl) wanted, and in applying the necessary budgetary discipline. He thought the UK had appreciated earlier than some others the extent of loss of sovereignty involved.

(iii) "Inner core"

7. Poehl went on to discuss the likelihood of a core group of Member States, with sufficiently convergent economies and policies, setting up a single monetary policy and central bank. France, Benelux and possibly Denmark could be Germany's partners in this. He did not want to see contractual arrangements for some member states to be in and some out; but different speeds would be appropriate. (He has indicated separately that the development of an inner core would be less than ideal because it would bring about a two-speed Europe, leaving some Member States affected by the operations of the market outside the decision-making process.) Spain and Italy, which would have particular difficulty in signing

up to no monetary financing, would not be able to join for some time.

8. Speaking after ECOFIN, 11 June, Poehl said: "What I could envisage is a smaller number of countries would start with a European Central Banking System, and others who have not reached the same degree of convergence are invited later." We understand that this answer was in response to a question from journalists, that Poehl later regretted his answer and that he had written to his Central Bank colleagues to say so. The idea of an inner core will be divisive and would be widely resented by the southern states: Carli's tetchy response to Poehl's press conference after the June ECOFIN was an indication. Nevertheless, Poehl may be launching an initiative for an inner core EMU at his IEA lecture on 2 July. In addition, he has been invited to give evidence to the House of Lords Select Committee on EMU, and he may wish to do this during his 2-3 July visit.

(iv) Hard ecu

9. In an interview with 'The Times', published on 26 June (attached), Poehl said:

- a parallel currency has more disadvantages than advantages;

- it would not solve the real problem, which is also posed by the Delors proposals: how to achieve a genuinely independent central bank?

- however, the UK proposals should be discussed in the relevant EC Committees;

- a two-speed EMU is possible: all EC countries might sign an EMU Treaty, but they could enter the arrangements at different speeds.

10. A front-page headline read "Poehl rejects Major's plan for hard ecu."

... 11. Telegrams 781 and 795 (attached) from Bonn give Poehl's latest thinking on EMU (the latter telegram also covers GEMU).

(v) Central Bank Governors' Committee

12. Poehl is Chairman of the Central Bank Governors' Committee which has a strengthened mandate in Stage 1. Poehl has said that Committee's enlarged secretariat provides a "strong nucleus for a European central bank system."

GERMAN ECONOMY AND GERMAN ECONOMIC AND MONETARY UNION

Summary

1. Currency union (GMU), to take place on 1 July. FRG Government wants all-German elections on 2 or 9 December, to be followed by immediate unification. State Treaty on all aspects of economic monetary and social union signed by GDR and FRG Ministers on 18 May, and ratified by Bonn and GDR parliaments on 21 June. Unity Fund will tap capital markets to meet the cost of unification. FRG economy growing strongly: GDR economy in need of extensive restructuring.

Detail

Currency Union

2. Details of GMU set out in State Treaty. The main elements are:

- The Bundesbank gets full freedom to operate in the GDR.

- Wages and pensions to be converted on the basis of a one for one conversion of Ostmarks for Deutschemarks.

- Savings balances up to an average of 4,000 Ostmarks converted on a one for one basis.

- Other stocks, including corporate debt to the former GDR state banks to be converted at 2 for 1.

FRG Economy and Monetary Policy

3. Growth in the Federal Republic continues at a rapid rate: GNP grew by 4 per cent in 1989, led by investment and net exports, and by 4.4 per cent in the year to 1990Q1. GEMU will increase the growth of domestic demand in the FRG economy: GDR residents will purchase FRG consumer goods, and firms will order capital goods to locate in the GDR. The OECD expects domestic demand growth in the

FRG to be 4.1 per cent in 1990 (up from 2.8 per cent in 1989), and GNP to grow by 3.9 per cent.

4. The current account surplus, 4.6 per cent of GNP in 1989, puts the FRG economy in a strong position. Even so, there is some concern at the possible inflationary consequences of additional demand: capacity utilisation is at high levels and the labour market tight, and the weak GDR economy will not be able to meet very much of the additional demand GEMU will create. Consumer price inflation in the FRG was 2.3 per cent in May, and is likely to be under 3 per cent for year as a whole.

5. 3-month interbank rate on 18 June was 8.3 per cent. While short-term rates have been little changed since November 1989, long-term bond yields have risen from 7.2 per cent in December to 8.9 per cent on 18 June on concerns over inflation and increased expected demand for capital. The money supply target for 1990 is M3 growth of 4-6 per cent. The annualised rate of growth in the period to April was 4.0 per cent, although the Bundesbank's new measure of extended M3, including stocks of DM held overseas is growing at 6.4 per cent. On balance, the Bundesbank is probably content with its present monetary stance. The DM appreciated in the second half of 1989 but has been relatively stable so far in 1990: slightly weak within the ERM but remaining firm against the Dollar.

Restructuring in GDR

6. Much of GDR industry will be uncompetitive: at a 1:1 conversion rate wages are about a third of those in the FRG, and productivity also about a third. The large Kombinate are to be broken up and privatised: some parts may have to be closed. Estimates in circulation that 30 per cent of GDR industry will not be viable and 40 per cent will only be viable with significant restructuring. GDR companies face severe liquidity constraints, and a period of adjustment before profitable investments can take place in the GDR may be necessary. Pressures towards equalisation of wages will worsen competitiveness. Figures of up to

1½-2 million unemployed, within a workforce of 8-9 million, have been mentioned.

7. The Treaty provides for the GDR to adopt GATT principles, while fulfilling existing CMEA trade commitments. Trust fund set up to assist restructuring, and credit given to it by FRG to be repaid from asset sales. Also temporary investment grants (8 or 12 per cent) and tax reliefs to aid restructuring. Subsidies for housing, transport to be maintained in short-term. Prices will be freed, and agricultural producer prices will be set conformably with the CAP.

Unity Fund and Fiscal Policy

8. The Treaty states that the GDR is to have a maximum budget deficit of DM33bn in 1990H2 and DM53bn in 1991. Bonn government announced (May 16) plans to raise total of DM115bn over 4½ years via German Unity Fund to be managed and guaranteed by FRG. DM20bn will be raised in 1990H2 and DM35bn in 1991, and these funds will be used to finance GDR budget deficit. Implications for FRG budget remain unclear. Latest forecast for 1990 is a deficit of DM35bn. FRG spokesmen stress that pressure on budget only a short-term problem so no rise in taxes is necessary, but admit combined fiscal deficit may rise to 3½ per cent of combined GDP in 1991, perhaps implying a Federal deficit of DM50-60bn. However, this should be set against background of a generally good budget position, FRG growth of close to 4 per cent forecast for 1990, and net public sector debt only 20 per cent of FRG GNP.

Currency Union and Monetary Policy

9. The period immediately after currency union will present real challenge to Bundesbank: size of GDR consumers' additional spending and extent to which GDR savings balances will enter into targetted M3 aggregate are unknown. Bundesbank will review experience at end-1990. Until then, will probably rely less on monetary aggregates than hitherto. The key indicators will be those of inflationary pressure. Bundesbank has made clear its continued anti-inflationary commitment, and a rise in official

interest rates will be the likely response to any sharp rise in inflation.

10. Pohl is now playing down his earlier disagreements with Chancellor Kohl e.g. over the timing of GEMU and over the appropriate exchange rate. He has expressed concern over the large sums of FRG support that may be needed to support the weak GDR public finances, and has warned that fiscal "irresponsibility" would lead to higher interest rates.

IF2 Division
25 June 1990

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MY TELNO 731: BUNDESBANK PRESIDENT'S CALL ON THE PRIME MINISTER, 2 JULY.

SUMMARY
1. POEHL'S REPUTATION IS RIDING ON THE SUCCESS OF GEMU. HE PROFESSES TO BE OPTIMISTIC. ON EMU IT WILL NOT BE POSSILE TO GAIN HIS SUPPORT FOR OUR VIEWS, BUT HE DOES WANT TO CONTINUE THE DIALOGUE.

DETAIL
2. POEHL WILL BE CALLING ON THE PRIME MINISTER LESS THAN 48 HOURS AFTER THE GDR BEGINS TO INTRODUCE THE DM. HIS MOOD, AS EXPRESSED MOST RECENTLY TO THE PARLIAMENTARY SELECT COMMITTEE ON TREASURY AND CIVIL SERVICE AFFAIRS, IS ONE OF SLIGHTLY FORCED OPTIMISM. HAVING DELIBERATELY MINIMISD HIS DIFFERENCES WITH THE FEDERAL GOVERNMENT OVER THE TERMS OF GEMU (WHICH WERE REAL ENOUGH AT THE TIME), HE IS NOW SADDLED WITH THE RESULT, AND HIS REPUTATION, WHICH CURRENTLY REMAINS HIGH, IS RIDING ON GEMU'S SUCCESS. HE CLAIMS THAT MONETARY UNION ON THE AGREED TERMS WILL NOT INCREASE LIQUIDITY AND THAT THE EAST GERMANS ARE TOO UNCERTAIN ABOUT THE FUTURE TO GO ON A SPENDING SPREE. HE BELIEVES THAT THE FINANCIAL MARKETS HAVE ALREADY DISCOUNTED ANY SHORT-TERM EFFECT OF THE CURRENCY EXCHANGE ON INTEREST RATES. HE ADMITS TO BEING MORE WORRIED ABOUT WHETHER IN THE LONGER TERM WAGE LEVELS IN THE GDR CAN BE KEPT DOWN UNTIL PRODUCTIVITY RISES, WHICH IN PART DEPENDS ON THE SPEED OF INVESTMENT. HE ALSO THINKS THAT THE GDR GOVERNMENT WILL BE TEMPTED TO PROFLIGACY IN THE RUN UP TO THE ELECTIONS, AND THAT HE AND WAIGEL WILL HAVE A BATTLE TO KEEP THE LID ON. HE BELIEVES THAT TOTAL PUBLIC SECTOR BORROWING, WHICH HE SAYS WILL RISE TO DM 100 BILLION NEXT YEAR, IS STILL UNDER CONTROL (ABOUT 3 PER CENT OF GDP) BUT SUSPECTS THAT THERE ARE UNRECOGNISED COSTS IN THE PIPELINE. WHETHER OR NOT THERE IS MORE BORROWING, HE BELIEVES THAT IN THE END THE FRG WILL HAVE TO INCREASE TAXES.

3. POEHL'S POSITION ON EMU REMAINS COMPLEX AND NOT ENTIRELY ABOVE

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MALLABY

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Mr Williams

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MY TELNO 775: ECONOMIC AND MONETARY UNION

SUMMARY

1. POEHL, THOUGH SCEPTICAL ABOUT THE BRITISH PROPOSALS, DOES NOT REJECT THEM OUT OF HAND.

DETAIL

2. WHEN THE PARLIAMENTARY SELECT COMMITTEE ON TREASURY AND CIVIL SERVICE AFFAIRS CALLED ON HERR POEHL AT THE BUNDESBANK IN FRANKFURT ON 26 JUNE, HE SPOKE ON FAIRLY FAMILIAR LINES ABOUT EMU. HE SAID THAT HE DID NOT WANT TO COMMENT IN DETAIL ON THE BRITISH PROPOSAL BECAUSE HE HAD PROMISED THE GOVERNOR OF THE BANK OF ENGLAND THAT HE WOULD NOT DO SO BEFORE THE CENTRAL BANK GOVERNORS HAD HAD A CHANCE TO DISCUSS IT AMONG THEMSELVES IN BASLE. HE RECALLED NEVERTHELESS THAT IN THE DELORS REPORT ALL CENTRAL BANK GOVERNORS HAD REJECTED PARALLEL CURRENCIES, BECAUSE THEY WOULD ADD TO, RATHER THAN SOLVE THE PROBLEM OF CURRENCY MANAGEMENT HE AND HIS DUTCH COLLEAGUE HAD CONTRIBUTED ANNEXES TO THE DELORS REPORT WHICH WENT INTO THE SUBJECT IN MORE DETAIL. HE HAD TO ADMIT THAT THE BRITISH PROPOSAL INTRODUCED A NEW ELEMENT IN THE SHAPE OF THE 'HARD' ECU. HE ADDED THAT IN PRACTICE HE THOUGHT THE EMF WOULD ENCOUNTER THE SAME CURRENCY MANAGEMENT PROBLEMS AS A FULL BLOWN EUROPEAN CENTRAL BANK HE THOUGHT THAT THE BRITISH PROPOSAL HAD COME A LITTLE LATE IN THE GAME, THOUGH HE DID NOT WANT TO FORECAST THE RESULT.

3. THE REST OF THE DISCUSSION WAS VINTAGE POEHL. HE DID NOT WANT TO GIVE UP THE DM OR THE BUNDESBANK, BUT IF THE EUROPEAN HEADS OF STATE AND GOVERNMENTS WANTED EMU, WHO WAS HE TO ARGUE ? IT WAS NOT YET CLEAR WHETHER GOVERNMENTS WERE REALLY PREPARED TO GIVE UP THEIR SOVEREIGNTY, BUT IF THEY WERE THE CENTRAL BANK GOVERNORS WERE READY TO ADVISE ON THE TECHNICAL ASPECTS. IF EMU WENT AHEAD IT MUST BE ON THE BASIS OF AN INDEPENDENT EUROPEAN CENTRAL BANK RESPONSIBLE FOR MAINTAINING PRICE STABILITY. THE CATHOLIC CHURCH HAD INVENTED THE CONCEPT OF SUBSIDIARITY (SIC), WHICH MIGHT BE ALL RIGHT FOR OTHER

THE TIMES 26.6.90

Hard ecu, harder problems says Pöhl

BRITISH proposals for a hard European currency unit (ecu) as Europe's common currency will not achieve monetary union, Bundesbank president Karl Otto Pöhl claims.

The proposal was made last week by John Major, the Chancellor of the Exchequer, and endorsed by Margaret Thatcher and Robin Leigh-Pemberton, Governor of the Bank of England. It envisaged the establishment of the ecu as a 13th European currency.

In an interview with *The Times*, Herr Pöhl said the proposals would not solve the problem of achieving monetary union for Europe. "A parallel currency has more disadvantages than advantages and would not solve the real problem. The real problem if you create a genuine ecu – not just a basket ecu – is that you get the same problems which you would have with a single European bank and currency; that is, questions like the bank's independence that would need to be decided. But I would like to add that we will discuss the British proposals in the relevant committees."

In his proposal, outlined last week, Mr Major proposed the establishment of a European Monetary Fund (EMF) to act as a currency board and supply member states with "hard ecus" in exchange for their national currency.

The EMF's responsibility would be to manage the hard ecu and ensure it stayed within its margins in the exchange-rate mechanism. In case of a realignment within the ERM, the hard ecus would not be devalued. The Chancellor said this proposal, unlike other previously floated ideas of parallel currencies, had the advantage of being evolutionary and anti-inflationary.

Herr Pöhl rejects this ideas as impractical: "Once you create a central bank which does not have the instruments and the opportunity to conduct efficient monetary policies, national and central banks will still be in charge. It is the non-divisibility of responsibility for monetary policy which is the decisive argument.

Karl Otto Pöhl: more disadvantages than advantages

"In monetary policy, the principle of subsidiarity does not apply. I believe this represents a widespread mistake in the current debate. The responsibility for monetary politics cannot be divided.

"There is also a lack of clarity in the most recent proposals by the EC Commission. There, an impression is being created that the European central bank would formulate only the general principles, while it would be up to national central banks to implement them. This concept is unrealistic and will not work."

He also said the establishment of the hard ecu would ignore the rationale of EMU; to reduce the power of the Deutschmark. "A process of competition of currencies would lead to one currency – and no prizes for guessing which one that is – which would dominate a system. That's the whole philosophy behind this argument. You can't solve the problem by creating an additional currency to the 12 we have already."

Herr Pöhl also stressed that a parallel currency, in hard and soft forms, had been rejected in the Delors Report, which set out the three stages towards monetary union. Herr Pöhl stressed the report had been signed by all EC central bank governors, including Mr Leigh-Pemberton.

Herr Pöhl's comments indicate that the Chancellor's proposals may not prove to end the deadlock between Britain and the rest of Europe in the debate on European Montary Union, as was hoped last week. The West German government and the Bundesbank favour a single European currency only on the condition that a European central bank would enjoy independence in the day-to-day conduct of its monetary policy.

Herr Pöhl said: "If we are to have a European monetary régime, then it has to be as good as, for example, the Bundesbank's. And a European central bank can only achieve price stability if it is independent in its monetary policies of the EC institutions and governments."

Mrs Thatcher again rejected last week the concept of a single European currency on the grounds of national sovereignty.

Herr Pöhl repeated comments made last week that in the event of a delay towards an agreement on monetary union, some nations could progress more rapidly than others: "It is conceivable that the treaty will be ratified by all members, but also that some who are unable or do not want to participate straight away, are invited to take part at a later stage. This is not new in Europe. The EMS, too, was founded in this manner.

"As far as monetary union is concerned, it is evident there are some countries which do not want that or cannot do that. The Delors Report also mentions this explicitly under paragraph 44."

He also said the "time is not yet ripe" for Britain to join the exchange-rate mechanism, but said the situation could change soon. "The success [of reducing inflation] is a result not of membership of the exchange rate mechanism, the success is a result of changes in policies. But Britain already conducts such a [anti-inflationary] policy. I am optimistic that the rate of inflation will be reduced to a degree, which will enable Britain to enter the system without creating tensions for the system itself."

Wolfgang Münchau
Frankfurt

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