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From the Private Secretary

2 July 1990

Dear John,

PRIME MINISTER'S MEETING WITH THE PRESIDENT OF THE BUNDESBANK

The Prime Minister had a talk this morning with the President of the Federal German Bundesbank. Herr Poehl was accompanied by his Private Secretary.

GEMU

The Prime Minister commented that the first day of GEMU appeared to have passed off well. Herr Poehl said it was already clear that the operation was a success in technical terms. He was not worried that the East Germans would splash out and spend too much: the average conversion so far was only DM400 per person. The real problem for the GDR was a longer term one of lack of competitiveness. The Prime Minister said that the East Germans had a great advantage, compared with other East Europeans, of being able to plug straight into a successful market economy. She thought that, within about seven years or so, they would have one of the most technologically advanced industrial economies in Europe because everything would have to be renewed. Herr Poehl said that he would not make any precise forecasts. But it was important to make a success of introducing a market economy in East Germany, because the experiment would be watched elsewhere in Eastern Europe. He expected Berlin to become a huge metropolitan area, with an inflow of people from the East and capital from the West. Berlin's development would be spectacular but much of the rest of the GDR would lag behind.

British Economy

The Prime Minister said that Britain's economy had been growing much more strongly than we had realised, and it was taking a long time to slow it down. Herr Poehl interjected that it was much longer than he had expected. The Prime Minister continued that the single most important task was to get down inflation. She envied Germany's record on this. They had not needed to link their currency to anyone else's: their history had given them the necessary will and discipline.

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EMU

The Prime Minister said that Britain would join the ERM. Linking ourselves to the DM should help to keep down inflation, provided that the DM itself remained strong. Herr Poehl said that would depend on how things went. He was worried about the consequences of the great increase in public borrowing. The Prime Minister said that there was a respectable argument for not going beyond the ERM. She doubted that twelve Central Bank Governors would be as resilient as the Bundesbank in making downward pressure on inflation the first priority. Several of them would want to monetary policy to stimulate growth, convergence, expansion and reduction of unemployment. Anyway, the House of Commons has made clear that they were not prepared to hand over control over economic and monetary policy. Herr Poehl said that several other countries in the EC would not in reality be ready to give up sovereignty in these areas: they were just pretending. He would not himself have any problem with simply staying with the ERM. The pressure for EMU came above all from France, which found it unacceptable to have monetary policy dominated by the DM and the Bundesbank. Genscher had supported the French for political reasons and subsequent developments had moved very fast. His private forecast was that France, Germany and the Benelux countries would get together in a Schengen-type agreement, but the southern member states would not be able to join. A high degree of convergence between economies was the first condition for EMU and there was no prospect of that happening in Europe for a long time.

Herr Poehl recalled that he had not himself proposed a European Central Bank. He had only said that <u>if</u> one was set up, then it would have to meet certain criteria. He shared the Prime Minister's concern that it would prove too "soft". He resented the way in which politicians pushed through these proposals. The decision to set up a Franco-German Finance Council, with an obligation to consult on monetary policy, had been taken without his even being consulted, and he had had to insist vigorously on preserving the independence of the Bundesbank. But it was a fact that the political will to make progress on EMU was very strong. As he had said earlier, the most likely outcome was that a few countries would decide to go ahead, while others would follow more slowly.

The Prime Minister referred to our alternative proposals for a hard ecu and a European Monetary Fund. They showed there was another way forward other than a single currency. Herr Poehl said that he would study the proposals carefully. He did not think that they were a solution, but that was not necessarily his last word. He did not like the idea of a parallel currency, and thought that the EMF would have many of the problems of an ECB. But tactically our proposal was a very good one, although it was a pity it had not been put forward earlier. The discussion had already moved on.

Objective Standard

The Prime Minister made a brief reference to the idea of establishing an "objective standard" for currencies, such as a commodity index, which might also extend to the dollar and the yen. Herr Poehl said that you could fix, or nearly fix, currencies on a regional basis as in Europe, but it would be unrealistic to attempt it more widely. Unlike the then Chancellor of the Exchequer, he had never had much faith in attempts by the G5 or G7 to fix exchange rates. He was perfectly happy with a floating DM against the dollar.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Martin Stanley (Department of Trade and Industry) and Sonia Phippard (Cabinet Office).

Yours sincerely

Charles Powell

CHARLES POWELL

John Gieve, Esq.,
HM Treasury