PRIME MINISTER

MEETING WITH KARL OTTO POEHL

You are seeing Karl Otto Poehl briefly tomorrow afternoon. There are three matters on which you will want to concentrate:

- Discussions in the EC on EMU. He shares a short-term tactical interest with us in slowing down progress on EMU, but his longer-term aims are different. He wants an absolutely independent European Central Bank, and opposes the idea of a parallel currency. We cannot therefore look to him for dependable support. But he is in no hurry to move on to Stage II, and he could be some help to us over the period of the IGC in persuading the German Government not to rush ahead too fast.

  He may criticise us for placing ourselves outside the main debate, and therefore having little opportunity to influence it. You might say that you would like to see Britain and Germany working more closely together on EMU, but that requires him to exercise his influence to persuade the German Government to take a more responsible and practical line. At the moment they are only interested in demonstrating how "European" they are.

- The Cost of German Unity. Poehl is said to be worried about how the costs are going to be financed, and has spoken of the need to reduce public expenditure (or, implicitly, raise taxation). This ought to be another factor encouraging a cautious approach on EMU.

- The wider economic outlook in the light of the Gulf crisis. You will want to find out how he expects markets to move over the next few months: and see what you can divine of his expectations for German monetary policy and interest rates.

There is a telegram from the Embassy in Bonn in the folder.

CDP

CDP

7 November 1990

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

7 November 1990

Charles Powell Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDON
SW1

Dear Charles,

PRIME MINISTER'S MEETING WITH DR POEHL

... I attach some notes for the Prime Minister's meeting with Dr Poehl.

Yours,
T Tarkowski

T TARKOWSKI
Private Secretary

ecl.nm/emubrief/19

PRIME MINISTER'S MEETING WITH DR POHL, 8 NOVEMBER

Background note

Pohl has criticised openly the European Council Conclusions on EMU, which he does not believe form a "proper basis" for IGC discussions. In particular, he is critical of the proposal that a new monetary institution be set up at the beginning of Stage 2 to coordinate monetary policy and supervise developments of the ecu (see comments attached).

2. The Bundesbank has continued to emphasise the need for:

- economic criteria rather than timetables to decide moves between stages;

- a lengthy Stage 2

- very strict convergence criteria (eg inflation largely eliminated) for the move to Stage 3.

3. Pohl remains unattracted by the UK proposals for an EMF and hard ecu, believing that they would confuse responsibility for monetary policy.

(153)

KARL OTTO PÖHL IN BERLIN : 31 OCTOBER

The following are extracts from a speech given by Karl Otto Pöhl, President of the German Bundesbank, at an event organised by the Frankfurter Allgemeine Zeitung (FAZ) on 31 October in Berlin. They are taken from the FAZ of 2 November , and are reported in quotes. There is no text of the whole speech available.

" This (the outcome of the European Council) is not, in my opinion, a proper basis for such a far reaching decision as the introduction of monetary union in Europe".

" In particular the way this Communique describes the second stage of monetary union is almost incomprehensible to me".

" We do not need a new institution (to coordinate monetary policy) ; we are already able to do that today".

" I do not understand that at all because we do not need a European Central Bank to supervise the development of the ECU ".

" It is not a matter of delaying or accelerating; it is simply a matter of taking the right decisions".

Bonn
4 November 1990

Line to take

- European Council in Rome unhelpful. No practical decisions. Agree with Pohl's assessment.

- Stage 2, as defined by Eleven in Rome, little more than empty shell. A new monetary institution without a role. Responsibility for monetary policy would be confused. Pohl right to point this out.

- By contrast, British proposals makes role of EMF clear: management of hard ecu. National central banks would retain responsibility for national monetary policies.

- As made clear in the House on 30 October, we intend to be part of the further economic and monetary development of the Community and believe that next year solutions will be found to enable the Community to go forward as twelve.

- How does Pohl see developments before and during IGC? How does he see the German position evolving? What are the lessons of German monetary union?

MEETING RECORD
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GERMANY: Anglo-German Relations Pt 5

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bcc PC

10 DOWNING STREET

LONDON SW1A 2AA

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.

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 if 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.

<u>Objective Standard</u>

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

Foreign and Commonwealth Office

RESTRICTED

London SW1A 2AH

7 November 1990

Dear Charles,

CDP 7/xi

Call on the Prime Minister by the President of the Bundesbank

The main topic when Herr Pöhl calls at 5.30 on 8 November will no doubt be EMU. The Treasury are providing briefing separately and you may have seen Bonn telno 1409 (further copy enclosed). You may also like to have some political background.

With elections due in Germany on 2 December, the CDU/CSU, with about 45% in most polls, have a lead of some 14% over the SPD. Kohl told the Foreign Secretary on 26 October that he hoped to gain an absolute majority to avoid the risk of the FDP switching horses to the SPD at some point before the next election. The CDU are not talking about this publicly for fear of alienating voters who would prefer the CDU to have to rely on what they see as the moderating influence of Genscher and the FDP (who also seem likely to do well). Kohl is leaving nothing to chance.

The SPD, despairing of overhauling the CDU/CSU, are looking to the longer term: next year's Land elections, in which they hope to regain control of the Upper House; and the 1994 Federal Elections, by which time they hope the costs of integrating the GDR will lead the electorate to repent of their support for Kohl and swift unification.

The Prime Minister might like to ask Pöhl about the costs of unification: what will be the effect on growth and on inflation? Will Kohl be forced to raise taxes after the election?

I am copying this letter to Tancred Tarkowski (HM Treasury).

Yours ever,

Richard Gozney

(R H T Gozney)
Private Secretary

C D Powell Esq
10 Downing Street

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POEHL'S CALL ON THE PRIME MINISTER

SUMMARY
1. POEHL IS CRITICAL OF THE OUTCOME OF THE EUROPEAN COUNCIL AND WORRIED ABOUT THE COST OF UNITY. HE IS BEING CAREFUL ABOUT WHAT HE SAYS IN PUBLIC IN THE RUN UP TO THE ELECTIONS, BUT HIS DIFFERENCES WITH THE FEDERAL GOVERNMENT ARE NONETHELESS APPARENT. THE BUNDESBANK PROBABLY SEE THE UK AS POTENTIAL ALLIES IN SLOWING DOWN THE EMU BANDWAGON, THOUGH THEY DO NOT SHARE OUR ULTIMATE AIMS.

DETAIL
2. THE PRESIDENT OF THE BUNDESBANK WILL CALL ON THE PRIME MINISTER AT 5.30 ON 8 NOVEMBER. YOU MAY THEREFORE WELCOME THE FOLLOWING SUMMARY OF HIS VIEWS.

3. AS PREVIOUSLY REPORTED BY LETTER, POEHL WAS HIGHLY CRITICAL OF THE OUTCOME OF THE EUROPEAN COUNCIL WHEN HE SPOKE AT AN EVENT ORGANISED BY THE FRANKFURTER ALLGEMEINE ZEITUNG ON 31 OCTOBER IN BERLIN. HE SAID THAT IT WAS NOT IN HIS OPINION A PROPER BASIS FOR SUCH A FAR REACHING DECISION AS THE INTRODUCTION OF MONETARY UNION IN EUROPE. IN PARTICULAR HE FOUND THE WAY THE COMMUNIQUE DESCRIBED THE SECOND STAGE OF MONETARY UNION ALMOST INCOMPREHENSIBLE. HE WAS SCORNFUL OF THE PASSAGE ON OVERSEEING THE DEVELOPMENT OF THE ECU: IN HIS VIEW THERE WAS NO NEED FOR A NEW INSTITUTION TO SUPERVISE THE DEVELOPMENT OF THE ECU OR TO CO-ORDINATE MONETARY POLICY BECAUSE 'WE ARE ALREADY ABLE TO DO THAT TODAY'.

4. POEHL AVOIDED DIRECTLY CRITICISING THE DECISION OF ELEVEN HEADS OF GOVERNMENT TO SET A DATE FOR THE START OF STAGE 2. HE SAID HOWEVER THAT THE SUBSTANCE WAS MORE IMPORTANT THAN THE DATE. THE COMMUNITY HAD OFTEN SET DEADLINES WHICH IT FAILED TO MEET. IT WAS

NOT A MATTER OF DELAYING OR ACCELERATING, BUT SIMPLY A MATTER OF TAKING THE RIGHT DECISIONS. THE SECOND STAGE DEPENDED ON THREE ELEMENTS: PREPARATION OF THE CONSTITUTION OF A CENTRAL BANK TOGETHER WITH A DECISION ON ITS LOCATION: ADAPTION OF NATIONAL LEGISLATION TO PROVIDE FOR THE HANDING OVER OF MONETARY RESPONSIBILITY OF THE CENTRAL BANK: AND THE ACHIEVEMENT OF THE NECESSARY ECONOMIC CONVERGENCE, ON WHICH THERE WAS A LONG WAY TO GO.

5. POEHL THOUGHT THAT THE LITMUS TEST OF THE COMMUNITY'S READINESS TO MOVE TO STAGE 2 WOULD BE WHETHER IT ACCEPTED THE NEED TO TRANSFER SOVEREIGNTY TO A TRULY INDEPENDENT EUROPEAN CENTRAL BANK. HE HAD NO INTENTION OF BEING A BRAKE ON PROGRESS, BUT THE START OF STAGE 2 WOULD BE A POINT OF NO RETURN, AND THE ESSENTIAL ELEMENT WAS THAT A EUROPEAN CENTRAL BANK SHOULD BE NO LESS EFFECTIVE IN THE CONTROL OF INFLATION THAN THE BUNDESBANK.

6. COMMENTING ON THE COST OF FINANCING GERMAN UNITY, POEHL SAID THAT HE WAS OPPOSED TO AN UNRESTRICTED CALL ON THE CAPITAL MARKET. 'IF TAX INCREASES AND OVERSTRETCHING THE CAPITAL MARKETS ARE TO BE AVOIDED, OTHER FORMS OF FINANCING GERMAN UNITY MUST BE BROUGHT INTO PLAY', IE CUTS IN GOVERNMENT EXPENDITURE. A SUBSEQUENT SPEAKER CONCLUDED THAT THE LOGIC OF POEHL'S APPROACH WAS THAT HE FAVOURED TAX INCREASES BUT WAS NOT PREPARED TO SAY SO. A BUNDESBANK OFFICIAL SUBSEQUENTLY TOLD US THAT POEHL WAS HESITANT ABOUT ADVOCATING TAX RISES, PARTLY BECAUSE OF THE PROXIMITY OF THE FEDERAL ELECTIONS, PARTLY BECAUSE TAXATION WAS NOT DIRECTLY HIS FIELD OF RESPONSIBILITY AND PARTLY BECAUSE SOME FORMS OF INCREASED TAXATION WOULD RISK REDUCING THE ABILITY OF THE PRIVATE SECTOR TO INVEST IN THE GDR.

COMMENT

7. POEHL IS BEING CAREFUL ABOUT WHAT HE SAYS IN PUBLIC IN THE RUN UP TO THE GENERAL ELECTION. HE HAS NOT THEREFORE DIRECTLY CRITICISED THE SETTING OF A DATE FOR STAGE 2 OF EMU NOR HAS HE REFERRED OPENLY TO WHAT IS THOUGHT TO BE HIS VIEW THAT TAX INCREASES WILL BE NEEDED TO FINANCE UNIFICATION. HIS OFFICIALS HAVE PLAYED DOWN THE RECENT ADJUSTMENT OF THE LOMBARD RATE (MY TELNO 1393) AS A PURELY TECHNICAL MEASURE. A GAP BETWEEN THE FEDERAL GOVERNMENT AND THE BUNDESBANK ON SOME CENTRAL ISSUES IS NEVERTHELESS BECOMING APPARENT.

8. WE HAVE NO RECENT INFORMATION ON HOW POEHL CURRENTLY SEES THE BRITISH POSITION. A PREVIOUS SPEECH IN BERLIN ON 25 OCTOBER, BY

FAX TO ECD(I), SPELLED OUT IN DETAIL HIS DOUBTS ABOUT THE HARD ECU PROPOSAL. FOLLOWING THE EUROPEAN COUNCIL TIETMEYER (MEMBER OF THE CENTRAL BANK COUNCIL) TOLD OUR CONSUL-GENERAL IN FRANKFURT THAT HE WAS AFRAID THAT THE BRITISH WOULD HAVE ISOLATED THEMSELVES. IT WAS IMPORTANT THAT THE BRITISH SHOULD REMAIN IN THE DEBATE IN ORDER TO HAVE A CHANCE OF INFLUENCING IT. IN THOSE CIRCUMSTANCES HE IMPLIED THAT IT WOULD BE POSSIBLE TO COOPERATE IN MAKING SURE THAT THINGS DEVELOPED SENSIBLY. THE BUNDESBANK PROBABLY SEE THE UK AS POTENTIALLY USEFUL ALLIES IN SLOWING DOWN THE EMU BANDWAGON TO AN ACCEPTABLE PACE, EVEN IF WE DISAGREE ABOUT THE DIRECTION IT SHOULD BE GOING.

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