PO/CH/NL/727
Part. A

PO/CH/NL/727 Part A.

ECONOMIC AND MONETARY UNION
(EMU)

Starts: 10/02/1989
ENDS: 14/06/1989

chex.rm/jmt1/14

FROM: J M G TAYLOR
DATE: 10 February 1989

PS/SIR P MIDDLETON

LETTER FROM WALTER ELTIS

The Chancellor has seen Walter Eltis' letter of 8 February to Sir Peter Middleton.

2. He agrees with Sir Peter that Eltis' proposals for his speech in Paris seem OK. However, he thinks that if Eltis can bear to have a text, it might be better for his own protection.

J M G TAYLOR

pso.jt/Sargent/4.13.2

From: S D H SARGENT
Date: 13 February 1989

SIR PETER MIDDLETON

LETTER FROM WALTER ELTIS

... I attach a draft reply to Walter Eltis' letter of 8 February.

S-l

S D H SARGENT

P8ii

pso.jt/Middleton/2.13.2

J. [illegible]

DRAFT LETTER FROM: Sir Peter Middleton

TO: Walter Eltis Esq
Director General
National Economic Development Office
Millbank Tower
Millbank
LONDON
SW1P 4QX

Thank you for your letter of 8 February about your invitation from David Henderson to speak at an OECD seminar in May on obstacles to monetary union.

2. I have mentioned this to the Chancellor, who would be content for you to speak along the lines proposed in your letter. He agrees that it would probably be as well for you to use a prepared text on this occasion.

[PEM]

Ex Rats

FROM: S J DAVIES (MP1)
DATE: 11th April 1989
x 4600

CHANCELLOR

cc Sir P Middleton - 80/2
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Barrie
Mr Courtney
Mr Savage
Miss Beckett
Mrs Chaplin

Not read

CURRENT ACCOUNT IMBALANCES UNDER THE GOLD STANDARD

After reading a piece by Gavyn Davies on European Monetary Union, which drew parallels between EMU and the gold standard, you asked in January for a note on the history of current account imbalances under the gold standard. I apologise for the delay in replying.

2. I now attach a note prepared by Samantha Beckett in MP1 which gives a resume of the way the gold standard worked and sets out data for eight of the countries that participated in the gold standard. The data confirm what Gavyn Davies said about "persistent and substantial current account deficits" coexisting with stable exchange rates: Germany and the UK ran large current account surpluses over the 1980-1981 period, while Sweden and Norway were in large deficit for about the whole period.

3. The data on the US (taken from Department of Commerce Historical Statistics) is not quite what we had expected - showing only a relatively small current account deficit, which persisted only to the mid 1890s. However, the cumulated deficit up to the mid 1890s was actually quite significant relative to trade flows.

Sgd

S J DAVIES

CURRENT ACCOUNT IMBALANCES UNDER THE GOLD STANDARD

1. An international monetary system based on gold bullion existed on a global scale for a third of a century, from 1880 to 1914. Later some 50 nations participated in the inter-war gold standard, which is usually dated from Britain's return to gold in 1925 to sterling's devaluation in 1931.

2. The gold standard was a fixed exchange rate system under which balance of payments balance was supposed to be achieved automatically through internal adjustment provided certain rules were adhered to.

3. The three basic features of a gold standard regime are (i) interconvertibility between domestic money and gold at a fixed official price, (ii) freedom for private citizens to import and export gold, and (iii) a set of rules relating the quantity of money in circulation to a country's gold stock.

The balance of payments adjustment mechanism

4. Under a fixed exchange rate system balance of payments adjustment must take place through price and income adjustments in the domestic economy. The exchange rate between two countries on a gold standard cannot vary (except for a narrow margin determined by the cost of shipping gold internationally).

5. According to the rules of the gold standard if country X is in balance of payments deficit with country Y, gold, or currency backed by gold should flow from country X to country Y, causing a contraction of the money supply in X. As a consequence interest rates should rise in X, and wages and prices fall, while interest rates should fall in Y and wages and prices rise, until external equlibrium is achieved. For both external and internal balance in the deficit country, a reduction in real wages is required. The gold standard mechanism uses, in effect, financial policy for external balance and wage flexibility for internal balance.

6. These 'automatic' adjustment forces were strengthened and speeded up by central banks through the so-called 'rules of the game'. Discount-rate policy and open-market interventions would actively raise interest rates and tighten credit in the deficit countries, while lowering interest rates and expanding credit in the surplus countries. This would both cushion balance of payments and monetary transfers in the short term, by stimulating compensatory capital movements from the surplus to the deficit countries, accelerating the downward readjustment of prices and costs in the latter countries and their upward readjustment in the first.

<u>**Data for seven countries participating in the gold standard**</u>

7. Balance of payments and national accounts data covering the gold standard era is readily available for eight countries and is shown, with sources, in the table attached. The sources all note

the possible unreliability of their nineteenth century and interwar data, and much information that would have been desirable is missing.

8. All countries for which data are given show periods of sustained current account imbalance under the gold standard, either surplus or deficit. Of these only Italy was forced off the gold standard in the period 1890-1914. It seems probable, therefore, that chronic deficits on current account such as those of Norway from 1890 to 1914 or those of Sweden throughout most of the pre-war gold standard era were financed by capital inflows from those countries' more developed European neighbours.

9. Historical data reveal that the United Kingdom ran persistent surpluses on current account for more than a century, without any tendency whatsoever towards equlibrium. These current account surpluses were nearly fully absorbed by Britain's investments abroad. The received view in the literature is that in the United States, net capital inflows from Europe, primarily Britain, financed large and growing deficits on current account throughout most of the nineteenth century. These are said to have shifted to net capital exports around the turn of the century as the United States finally turned from chronic deficits to equally chronic surpluses on current account. The data (attached) show the United States with small current account deficits in every year from 1882-1897, but these are generally declining after 1888 and move to sustained current account surpluses in 1897. Germany and the United Kingdom are shown to be in current account surplus for every year of the pre-war gold standard.

Successes and failures of the fixed exchange rate regime

10. The appeal of a gold standard can be traced to the belief that it provides price and exchange rate stability. Though empirical studies do not reveal any clear-cut superiority in terms of price stability, there can be little dispute that the classical gold standard provided exchange rate stability. Only one of the seven countries examined here, Italy, was forced off the gold standard. However exchange rate stability may in part have been attributable to conservative gold export policies. Scammell (1965) and Cassel (1936) remark that Continental central banks were prepared to actively discourage attempts to obtain gold for export. Spain and Latin American countries did not experience exchange rate stability; instead their currencies remained inconvertible for extended periods.

11. In general developed countries were capital exporters and less developed countries capital importers during this period. A slowdown of capital exports could help relieve, in developed countries, any pressures on central bank reserves arising from unfavourable developments in other balance of payments transactions. Certain countries which relied on capital flows for balance in their combined current and capital accounts were unwilling or unable to retain the volume of capital imports they required when more developed countries acted to slow or reduce their capital exports.

12. Nor were they often willing or able to bring about sufficient and fast enough domestic deflation to maintain external balance in

the absence of these capital imports. Thus 'periphery' countries did not maintain fixed exchange rates with the rest of the gold standard currencies; instead, they were frequently forced off the standard in times of recession. Major devaluations of the period were those of Portugal, Argentina, Italy, Chile, Bulgaria and Mexico.

Conclusion

13. Provided certain rules are adhered to the gold standard as a monetary system provides automatic adjustments to maintain overall balance of payments balance for member nations.

14. In practice there seems to have been no forces leading to balance on the current account except perhaps in the extremely long-run. Instead, capital flows responding to interest-rate differences and the pattern of investment opportunities, helped to finance current account imbalances for very long periods. All countries for which data is supplied show periods of sustained current account imbalance, either surplus or deficit.

15. In general exchange rate stability was maintained between developed countries' currencies but the cyclical pattern of international capital movements led to devaluation and suspended convertibility in many countries on the 'periphery' of the standard.

16. Certain strains inherent in the internal and external adjustment process under a gold standard led to its final

breakdown. During the inter-war period countries such as France and the United States managed to accumulate a large proportion of the world's gold bullion and yet resisted sufficiently expansionary policies to bring about external balance. Other countries, including Britain, found their gold reserves dwindling which threatened the convertibility of their currencies. Unwilling to pursue the severe deflationary course that large losses of gold implied, Britain suspended the gold standard in 1931.

SAMANTHA BECKETT

Current Account Imbalances Under the Gold Standard

YEAR	UK Current Account % of GNP	GERMANY Current Account % of GDP	ITALY Current Account % of GNP	SWEDEN Current Account % of GNP	NORWAY Current Account % of GDP	CANADA Current Account % of GNP	US Current Account % of GDP	JAPAN Current Account % of GNP
1875	4.2	-	-0.2	-2.9	-3.5	-	-1.0	-
1876	2.3	-	0.5	-2.8	0.6	-	0.1	-
1877	0.8	-	-0.6	-4.6	-3.8	-	0.8	-
1878	1.7	-	0.8	-2.7	-0.1	-	1.8	-
1879	2.6	-	-0.3	-1.4	0.5	-	0.9	-
1880	2.4	1.7	0.7	-1.8	1.1	-	0.5	-
1881	4.4	2.1	0.8	-4.0	0.4	-	0.6	-
1882	4.3	2.6	0.6	-2.8	2.5	-	-0.3	-
1883	3.4	1.5	0.6	-4.5	0.5	-	-0.2	-
1884	5.0	2.6	-0.7	-5.6	0.6	-	-0.4	-
1885	4.6	2.7	-2.9	-6.4	-	-	-0.1	-
1886	5.8	2.6	-2.3	-5.5	1.2	-	-0.5	-
1887	6.2	2.2	-3.7	-4.0	2.4	-	-0.9	-
1888	6.3	3.3	-1.1	-3.3	2.7	-	-1.2	-
1889	5.5	2.6	-1.6	-4.4	1.9	-	-0.8	-
1890	6.9	1.8	-1.5	-4.5	-1.2	-	-0.7	-
1891	4.5	1.5	0.2	-2.6	-4.1	-	-0.5	-
1892	4.0	0.8	0.5	-2.2	-2.3	-	-0.2	-
1893	3.6	1.5	0.3	0.5	-1.9	-	-0.5	-
1894	3.1	2.6	1.7	-0.6	-2.8	-	0.1	-
1895	3.4	1.3	1.3	0.3	-4.2	-	-0.6	-
1896	3.0	2.2	1.7	1.4	-4.6	-	-0.1	-
1897	2.2	2.3	2.4	0.3	-4.4	-	0.2	-
1898	1.6	2.6	1.9	-2.8	-6.2	-	1.1	-
1899	2.7	1.2	3.1	-4.4	-7.3	-	1.0	-
1900	1.7	1.3	1.3	-3.4	-6.2	-	1.0	-
1901	0.9	1.3	2.5	-3.0	-7.3	-	0.9	-
1902	1.1	1.5	3.1	-3.8	-5.8	-	0.3	-
1903	2.0	1.3	2.6	-2.3	-3.9	-	0.5	-
1904	2.4	1.8	2.8	-4.7	-4.5	-	0.3	-
1905	4.0	3.4	4.4	-3.1	-4.1	-	0.4	-10.3
1906	5.4	1.3	3.0	-2.9	-3.5	-	0.3	-0.8
1907	7.0	0.4	0.6	-3.0	-5.1	-	0.2	0.1
1908	6.7	1.3	-0.5	-2.1	-5.4	-	0.4	-1.6
1909	6.2	0.9	-1.0	-3.0	-4.3	-	-0.3	0.1
1910	7.2	1.6	0.1	-0.6	-2.1	-	-0.3	-1.2
1911	8.2	1.3	0.1	1.0	-4.0	-	0.1	-1.7
1912	7.9	0.9	-0.4	0.9	-3.2	-	0.1	-1.9
1913	8.6	-	0.4	0.8	-0.1	-	0.3	-1.7
1914	4.9	-	1.2	2.7	-1.7	-	-0.2	-0.1
1915	-1.7	-	-3.2	5.9	5.0	-	2.6	4.6
1916	2.4	-	-9.5	9.9	10.1	-	4.7	10.4
1917	1.1	-	-15.5	9.3	-1.9	-	4.7	11.4
1918	-5.1	-	-15.4	3.6	2.8	-	3.1	7.2
1919	-0.8	-	-9.1	-5.5	-1.1	-	5.2	2.5
1920	5.4	-	-8.8	-5.7	-11.5	-	3.9	-0.4
1921	3.6	-	-4.3	-0.6	-9.9	-	2.3	-1.6
1922	4.2	-	-2.0	1.6	-5.9	-	0.9	-1.2
1923	4.0	-	-1.1	0.1	-5.4	-	0.6	-3.6
1924	1.7	-	0.3	0.0	-3.6	-	1.1	-4.4
1925	1.1	-3.0	-0.7	0.9	-1.3	-	0.8	-1.7
1926	-0.4	1.8	-0.5	1.3	-0.1	4.1	0.5	-2.3
1927	2.0	-3.3	-0.4	2.6	-1.2	-0.2	0.7	-1.1
1928	2.5	-1.4	-2.0	0.9	-2.8	-0.5	1.0	-1.1
1929	1.9	-0.2	-1.5	2.8	-0.9	5.1	0.7	0.2
1930	0.7	1.5	-1.1	1.0	-1.6	-5.9	0.7	-0.0
1931	-2.3	3.5	1.4	-1.5	-3.0	-3.7	0.2	-0.9
1932	-1.2	0.8	0.7	-1.1	1.4	-2.5	0.2	-0.2
1933	-0.2	0.5	-0.5	2.6	2.2	-0.1	0.2	-0.0
1934	-0.5	-0.8	-0.6	2.2	1.5	1.7	0.5	-0.2
1935	0.5	-0.1	-1.3	0.6	0.5	2.9	-0.1	1.0

SOURCES

1. Mitchell , European Historical Statistics.
2. Urquhart and Buckley , Historical Statistics of Canada.
3. Department of Commerce , Historical Statistics of the United States.
4. Ohkawa and Rosovsky , Japanese Economic Growth.

COMMITTEE FOR THE STUDY OF
ECONOMIC AND MONETARY UNION

12th April 1989

REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY

This report has been prepared in response to the mandate of the European Council "to study and propose concrete stages leading towards economic and monetary union".

Foreword

At its meeting in Hanover on 27th-28th June 1988 the European Council recalled that, "in adopting the Single Act, the Member States of the Community confirmed the objective of progressive realisation of economic and monetary union". The Heads of State and Government therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union. To that end they decided to entrust to a Committee, chaired by Mr. Jacques Delors, President of the European Commission, "the task of studying and proposing concrete stages leading towards this union".

In response to this request, the Committee has the honour to submit the attached Report. The ideas expressed and the proposals contained in the Report are put forward by the members of the Committee in their personal capacity. A collection of papers submitted to the Committee will be published.

Table of contents

I. Past and present developments in economic and monetary integration in the Community

1. The objective of economic and monetary union

1. In 1969 the Heads of State and Government, meeting in The Hague, agreed that a plan should be drawn up with a view to the creation, in stages, of an economic and monetary union within the Community. This initiative was taken against the background of major achievements by the Community in the 1960s: the early completion of the transition period leading to a full customs union, the establishment of the common agricultural policy and the creation of a system of own resources. At the same time the Bretton Woods system was showing signs of decline. The Werner Report, prepared in 1970, presented a plan for the attainment of economic and monetary union. In March 1971, following the Werner Report, member states expressed "their political will to establish an economic and monetary union".

2. Several important moves followed: in 1972 the "snake" was created; in 1973 the European Monetary Co-operation Fund (EMCF) was set up; and in 1974 the Council Decision on the attainment of a high degree of convergence in the Community and the Directive on stability, growth and full employment were adopted. Yet, by the mid-1970s the process of integration had lost momentum under the pressure of divergent policy responses to the economic shocks of the period.

3. In 1979 the process of monetary integration was relaunched with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU). The success of the EMS in promoting its objectives of internal and external monetary stability has contributed in recent years to further progress, as reflected in the adoption, in 1985, of the internal market programme and the signing of the Single European Act.

2. The European Monetary System and the ECU

4. The European Monetary System was created by a Resolution of the European Council followed by a Decision of the Council of Ministers and an Agreement between the participating central banks.

5. Within the framework of the EMS the participants in the exchange rate mechanism have succeeded in creating a zone of increasing monetary stability at the same time as gradually relaxing capital controls. The exchange rate constraint has greatly helped those participating countries with relatively high rates of inflation in gearing their policies, notably monetary policy, to the objective of price stability, thereby laying the foundations for both a downward convergence of inflation rates and the attainment of a high degree of exchange rate stability. This, in turn, has helped moderate cost increases in many countries, and has led to an improvement in overall economic performance. Moreover, reduced uncertainty regarding exchange rate developments and the fact that the parities of the participating currencies have not been allowed to depart significantly from what is appropriate in the light of economic fundamentals have protected intra-European trade from excessive exchange rate volatility.

The EMS has served as the focal point for improved monetary policy co-ordination and has provided a basis for multilateral surveillance within the Community. In part, its success can be attributed to the participants' willingness to opt for a strong currency stance. Also important has been the flexible and pragmatic way in which the System has been managed, with increasingly close co-operation among central banks. Moreover, the System has benefited from the role played by the Deutsche Mark as an "anchor" for participants' monetary and intervention policies. The EMS has evolved in response to changes in the economic and financial environment, and on two occasions (Palermo 1985 and Basle/Nyborg 1987) its mechanisms have been extended and strengthened.

At the same time, the EMS has not fulfilled its full potential. Firstly, a number of Community countries have not yet joined the exchange rate mechanism and one country participates with wider fluctuation margins. Secondly, the lack of sufficient convergence of fiscal policies as reflected in large and persistent budget deficits in certain countries has remained a source of tensions and has put a disproportionate burden on monetary policy. Thirdly, the transition to the second stage of the EMS and the establishment of the European Monetary Fund, as foreseen by the Resolution of the European Council adopted in 1978, have not been accomplished.

6. In launching the EMS, the European Council declared in 1978 that "a European Currency Unit (ECU) will be at the centre of the EMS". Apart from being used as the numeraire of the exchange rate mechanism and to denominate operations in both the intervention and credit mechanisms, the ECU serves primarily as a reserve asset and a means of settlement for EMS central banks. Although it is an integral part of the EMS, the ECU has for a number of reasons played only a limited role in the operating mechanisms of the EMS. One reason is that central banks have preferred to intervene intra-marginally; therefore, compulsory interventions and the build-up of intervention balances to be settled in ECUs have remained rather limited.

By contrast, the ECU has gained considerable popularity in the market place, where its use as a denominator for financial transactions has spread significantly. It ranks fifth in international bond issues, with a 6% market share. The expansion of financial market activity in ECUs reflects in part a growing issuance of ECU-denominated debt instruments by Community institutions and public sector authorities of some member countries, and in part the ECU's attractiveness as a means of portfolio diversification and as a hedge against currency risks.

International banking business in ECUs grew vigorously in the first half of this decade, but has moderated since then, although the creation of an ECU clearing system has contributed to the development and liquidity of the market, as has the issue of short-term bills by the UK Treasury. The lion's share of banking business represents interbank transactions, whereas direct business with non-banks has remained relatively limited and appears to have been driven primarily by officially encouraged borrowing demand in a few countries. ECU-denominated deposits by the non-bank sector have stagnated since 1985, suggesting that the ECU's appeal as a near money substitute and store of liquidity is modest. In addition, in the non-financial sphere the use of the ECU for the invoicing and settlement of commercial transactions has remained limited, covering at present only about 1% of the Community countries' external trade.

3. The Single European Act and the internal market programme

7. In January 1985 the Commission proposed realising the objective of a market without internal frontiers by the end of 1992. The detailed measures for the removal of physical, technical and fiscal barriers were set out in a White Paper, which specified the precise programme, timetable and methods for creating a unified economic area in which persons, goods, services and capital would be able to move freely. This objective was embodied in December 1985 in the Single European Act.

8. The Single European Act marked the first significant revision of the Treaty of Rome. It introduced four important changes in the Community's strategy for advancing the integration process. Firstly, it greatly simplified the requirements of harmonising national law by limiting harmonisation to the essential standards and by systematic adoption of mutual recognition of national norms and regulations. Secondly, it established a faster and more efficient decision-making process by extending the scope of qualified majority voting. Thirdly, it gave the European Parliament a greater role in the legislative process. Fourthly, it reaffirmed the need to strengthen the Community's economic and social cohesion, to enhance the Community's monetary capacity with a view to economic and monetary union, to reinforce the Community's scientific and technological base, to harmonise working conditions with respect to health and safety standards, to promote the dialogue between management and labour and to initiate action to protect the environment.

9. Over the last three years considerable progress has been made in implementing the internal market programme. In particular, it has been decided that eight member countries will have fully liberalised capital movements by 1st July 1990 and that the other member countries will follow suit after a period of transition.

In December 1988 the European Council, meeting in Rhodes, noted that "at the halfway stage towards the deadline of December 1992, half of the legislative programme necessary for the establishment of the large market is already nearly complete" and underlined "the irreversible nature of the movement towards a Europe without internal frontiers". There is, indeed, widespread evidence that the objective of a single market enjoys the broad support of consumers and producers and that their economic decisions are increasingly influenced by the prospects of 1992. The anticipation of a market without internal frontiers has generated a new dynamism and has contributed to the recent acceleration of economic growth in the Community.

4. Problems and perspectives

10. The completion of the single market will link national economies much more closely together and significantly increase the degree of economic integration within the Community. It will also entail profound structural changes in the economies of the member countries. These changes offer considerable opportunities for economic advancement, but many of the potential gains can only materialise if economic policy - at both national and Community levels - responds adequately to the structural changes.

By greatly strengthening economic interdependence between member countries, the single market will reduce the room for independent policy manoeuvre and amplify the cross-border effects of developments originating in each member country. It will, therefore, necessitate a more effective co-ordination of policy between separate national authorities. Furthermore, Community policies in support of a broadly balanced development are an indispensable complement to a single market. Indeed, the need to back up the removal of market barriers with a strengthening of common regional and structural policies was clearly recognised in the Brussels package of measures agreed in February 1988.

11. Although substantial progress has been made, the process of integration has been uneven. Greater convergence of economic performance is needed. Despite a marked downward trend in the average rate of price and wage inflation, considerable national differences remain. There are also still notable divergences in budgetary positions and external imbalances have become markedly greater in the recent past. The existence of these disequilibria indicates that there are areas where economic performances will have to be made more convergent.

12. With full freedom of capital movements and integrated financial markets incompatible national policies would quickly translate into

exchange rate tensions and put an increasing and undue burden on monetary policy. The integration process thus requires more intensive and effective policy co-ordination, even within the framework of the present exchange rate arrangements, not only in the monetary field but also in areas of national economic management affecting aggregate demand, prices and costs of production.

A tighter co-ordination of economic policy-making is required. In the monetary field, the problems of the EMS referred to above continue to exist. In the economic field, policy co-ordination remains insufficient. Especially in the area of fiscal policy, the 1974 Decision on economic convergence has not succeeded in establishing an effective foundation for policy co-ordination. The pressure for mutually consistent macro-economic policies has stemmed from the growing reluctance to change exchange rate parities. Such pressure has hitherto been lessened to some extent by the existence of capital controls in some countries and by the segmentation of markets through various types of non-tariff barriers, but as capital movements are liberalised and as the internal market programme is implemented, each country will be less and less shielded from developments elsewhere in the Community. The attainment of national economic objectives will become more dependent on a co-operative approach to policy-making.

13. Decision-making authorities are subject to many pressures and institutional constraints and even best efforts to take into account the international repercussions of their policies are likely to fail at certain times. While voluntary co-operation should be relied upon as much as possible to arrive at increasingly consistent national policies, thus taking account of divergent constitutional situations in member countries, there is also likely to be a need for more binding procedures.

14. The success of the internal market programme hinges to a decisive extent on a much closer co-ordination of national economic policies, as well as on more effective Community policies. This implies that in essence a number of the steps towards economic and monetary union will already have to be taken in the course of establishing a single market in Europe.

Although in many respects a natural consequence of the commitment to create a market without internal frontiers, the move towards economic and monetary union represents a quantum jump which could secure a significant increase in economic welfare in the Community. Indeed, economic and monetary union implies far more than the single market programme and, as is discussed in the following two Parts of this Report, will require further major steps in all areas of economic policy-making. A particular role would have to be assigned to common policies aimed at developing a more balanced economic structure throughout the Community. This would help to prevent the emergence or aggravation of regional and sectoral imbalances which could threaten the viability of an economic and monetary union. This is especially important because the adoption of permanently fixed exchange rates would eliminate an important indicator of policy inconsistencies among Community countries and remove the exchange rate as an instrument of adjustment from the member countries' set of economic tools. Economic imbalances among member countries would have to be corrected by policies affecting the structure of their economies and costs of production if major regional disparities in output and employment were to be avoided.

15. At its meeting on 27th-28th June 1988, the European Council confirmed the objective of economic and monetary union for the Community. In accordance with its mandate, the Committee has focused its attention on the task of studying and proposing concrete stages leading towards the progressive realisation of economic and monetary union. In investigating how to achieve economic and monetary union the Committee has examined the conditions under which such a union could be viable and successful. The Committee feels that concrete proposals towards attaining this objective can only be made if there is a clear understanding of the implications and requirements of economic and monetary union and if due account is taken of past experience with and developments in economic and monetary integration in the Community. Hence, Part II of this Report examines the principal features and implications of an economic and monetary union. Part III then presents a pragmatic step-by-step approach which could lead in three stages to the final objective. The question of when these stages should be implemented is a matter for political decision.

II. The final stage of economic and monetary union

1. General considerations

16. Economic and monetary union in Europe would imply complete freedom of movement for persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currencies and, finally, a single currency. This, in turn, would imply a common monetary policy and require a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field. These policies should be geared to price stability, balanced growth, converging standards of living, high employment and external equilibrium. Economic and monetary union would represent the final result of the process of progressive economic integration in Europe.

17. Even after attaining economic and monetary union, the Community would continue to consist of individual nations with differing economic, social, cultural and political characteristics. The existence and preservation of this plurality would require a degree of autonomy in economic decision-making to remain with individual member countries and a balance to be struck between national and Community competences. For this reason it would not be possible simply to follow the example of existing federal states; it would be necessary to develop an innovative and unique approach.

18. The Treaty of Rome, as amended by the Single European Act, provides the legal foundation for many of the necessary steps towards economic integration, but does not suffice for the creation of an economic and monetary union. The realisation of this objective would call for new arrangements which could only be established on the basis of a Treaty change and consequent changes in national legislations. For this reason the union would have to be embodied in a Treaty which clearly laid down the basic functional and institutional arrangements, as well as provisions governing their step-by-step implementation.

19. Taking into account what is already provided for in the EC Treaties, the need for a transfer of decision-making power from member states to the Community as a whole would arise primarily in the fields of monetary policy and macro-economic management. A monetary union would require a single monetary policy and responsibility for the formulation of this policy would consequently have to be vested in one decision-making body. In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macro-economic framework and be subject to binding procedures and rules. This would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public sector borrowing requirements and place binding constraints on the size and the financing of budget deficits.

20. An essential element in defining the appropriate balance of power within the Community would be adherence to the "principle of subsidiarity", according to which the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community would have to be confined specifically to those areas in which collective decision-making was necessary. All policy functions which could be carried out at national (and regional and local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union would remain within the competence of the member countries.

21. Economic union and monetary union form two integral parts of a single whole and would therefore have to be implemented in parallel. It is only for reasons of expositional clarity that the following sections look separately at an economic and a monetary union. The description begins with monetary union, chiefly because the principal features of an economic union depend significantly on the agreed monetary arrangements and constraints. But the Committee is fully aware that the process of achieving monetary union is only conceivable if a high degree of economic convergence is attained.

2. The principal features of monetary union

22. A monetary union constitutes a currency area in which policies are managed jointly with a view to attaining common macro-economic objectives. As already stated in the 1970 Werner Report, there are three necessary conditions for a monetary union:

- the assurance of total and irreversible convertibility of currencies;
- the complete liberalisation of capital transactions and full integration of banking and other financial markets; and
- the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.

The first two of these requirements have already been met, or will be with the completion of the internal market programme. The single most important condition for a monetary union would, however, be fulfilled only when the decisive step was taken to lock exchange rates irrevocably.

As a result of this step, national currencies would become increasingly close substitutes and their interest rates would tend to converge. The pace with which these developments took place would depend critically on the extent to which firms, households, labour unions and other economic agents were convinced that the decision to lock exchange rates would not be reversed. Both coherent monetary management and convincing evidence of an effective co-ordination of non-monetary policies would be crucial.

23. The three above-mentioned requirements define a single currency area, but their fulfilment would not necessarily mark the end of the process of monetary unification in the Community. The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen - for economic as well as psychological and political reasons - as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies. A single currency, provided that its stability is ensured, would also have

a much greater weight relative to other major currencies than any individual Community currency. The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of parities.

24. The establishment of a monetary union would have far-reaching implications for the formulation and execution of monetary policy in the Community. Once permanently fixed exchange rates had been adopted, there would be a need for a common monetary policy, which would be carried out through new operating procedures. The co-ordination of as many national monetary policies as there were currencies participating in the union would not be sufficient. The responsibility for the single monetary policy would have to be vested in a new institution, in which centralised and collective decisions would be taken on the supply of money and credit as well as on other instruments of monetary policy, including interest rates.

This shift from national monetary policies to a single monetary policy is an inescapable consequence of monetary union and constitutes one of the principal institutional changes. Although a progressively intensified co-ordination of national monetary policies would in many respects have prepared the way for the move to a single monetary policy, the implications of such a move would be far-reaching. The permanent fixing of exchange rates would deprive individual countries of an important instrument for the correction of economic imbalances and for independent action in the pursuit of national objectives, especially price stability.

Well before the decision to fix exchange rates permanently, the full liberalisation of capital movements and financial market integration would have created a situation in which the co-ordination of monetary policy would have to be strengthened progressively. Once every banking institution in the Community is free to accept deposits from, and to grant loans to, any customer in the Community and in any of the national currencies, the large degree of territorial coincidence between a national central bank's area of jurisdiction, the area in which its currency is used and the area in which "its" banking system operates will be lost. In these circumstances the effectiveness of national monetary policies will become increasingly dependent on co-operation among central banks. Indeed, the growing co-ordination of monetary policies will make a positive contribution to financial market integration and will help central banks gain the experience that would be necessary to move to a single monetary policy.

3. The principal features of economic union

25. Economic union - in conjunction with a monetary union - combines the characteristics of an unrestricted common market with a set of rules which are indispensable to its proper working. In this sense economic union can be described in terms of four basic elements:

- the single market within which persons, goods, services and capital can move freely;
- competition policy and other measures aimed at strengthening market mechanisms;
- common policies aimed at structural change and regional development; and
- macro-economic policy co-ordination, including binding rules for budgetary policies.

In defining specific rules and arrangements governing an economic union, the Community should be guided by two considerations.

Firstly, the economic union should be based on the same market-oriented economic principles that underlie the economic order of its member countries. Differences in policy choices may exist between member countries or, within the same country, in different periods. However, beyond such differences, a distinctive common feature of economic systems in Europe is the combination of a large degree of freedom for market behaviour and private economic initiative with public intervention in the provision of certain social services and public goods.

Secondly, an appropriate balance between the economic and monetary components would have to be ensured for the union to be viable. This would be essential because of the close interactions between economic and monetary developments and policies. A coherent set of economic policies at the Community and national levels would be necessary to maintain permanently fixed exchange rates between Community currencies and, conversely, a common monetary policy, in support of a single currency area, would be necessary for the Community to develop into an economic union.

26. The creation of a single currency area would add to the potential benefits of an enlarged economic area because it would remove intra-Community exchange rate uncertainties and reduce transactions costs, eliminate exchange rate variability and reduce the susceptibility of the Community to external shocks.

At the same time, however, exchange rate adjustments would no longer be available as an instrument to correct economic imbalances within the Community. Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to have an even impact on different regions or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level.

With parities irrevocably fixed, foreign exchange markets would cease to be a source of pressure for national policy corrections when national economic disequilibria developed and persisted. Moreover, the statistical measurement and the interpretation of economic imbalances might become more difficult because in a fully integrated market balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer play such a significant role as a guidepost for policy-making. Nonetheless, such imbalances, if left uncorrected, would manifest themselves as regional disequilibria. Measures designed to strengthen the mobility of factors of production and the flexibility of prices would help to deal with such imbalances.

27. In order to create an economic and monetary union the single market would have to be complemented with action in three interrelated areas: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needed to be reinforced or complemented; macro-economic co-ordination, including binding rules in the budgetary field; and other arrangements both to limit the scope for divergences between member countries and to design an overall economic policy framework for the Community as a whole.

28. Competition policy - conducted at the Community level - would have to operate in such a way that access to markets would not be impeded and market functioning not be distorted by the behaviour of private or public economic agents. Such policies would not only have to address conventional forms of restrictive practices and the abuse of dominant market positions, but would also have to deal with new aspects of antitrust laws, especially in the field of merger and takeover activities. The use of government subsidies to assist particular industries should be strictly circumscribed because they distort competition and cause an inefficient use and allocation of scarce economic resources.

29. Community policies in the regional and structural field would be necessary in order to promote an optimum allocation of resources and to spread welfare gains throughout the Community. If sufficient consideration were not given to regional imbalances, the economic union would be faced with grave economic and political risks. For this reason particular attention would have to be paid to an effective Community policy aimed at narrowing regional and structural disparities and promoting a balanced development throughout the Community. In this context the regional dimension of other Community policies would have to be taken into account.

Economic and monetary integration may have beneficial effects on the less developed regions of the Community. For example, regions with lower wage levels would have an opportunity to attract modern and rapidly growing service and manufacturing industries for which the choice of location would not necessarily be determined by transport costs, labour skills and market proximity. Historical experience suggests, however, that in the absence of countervailing policies, the overall impact on peripheral regions could be negative. Transport costs and economies of scale would tend to favour a shift in economic activity away from less developed regions, especially if they were at the periphery of the Community, to the highly developed areas at its centre. The economic and monetary union would have to encourage and guide structural adjustment which would help poorer regions to catch up with the wealthier ones.

A step in this direction was taken in February 1988 when the European Council decided to strengthen and reorganise the Community's regional and structural policies in several respects: the size of structural funds will be doubled over the period up to 1993, emphasis will be shifted from project to programme financing, and a new form of partnership will be established between the Community and the recipient regions. Depending upon the speed of progress, such policies might have to be strengthened further after 1993 in the process of creating economic and monetary union.

At the same time, excessive reliance on financial assistance through regional and structural policies could cause tensions. The principal objective of regional policies should not be to subsidise incomes and simply offset inequalities in standards of living, but to help to equalise production conditions through investment programmes in such areas as physical infrastructure, communications, transportation and education so that large-scale movements of labour do not become the major adjustment factor. The success of these policies will hinge not only on the size of the available financial resources, but to a decisive extent also on their efficient use and on the private and social return on the investment programmes.

Apart from regional policies, the Treaty of Rome, as amended by the Single European Act, has established the basis for Community policies in areas such as infrastructure, research and technological development, and the environment. Such policies would not only enhance market efficiency and offset market imperfections, but could also contribute to regional development. While respecting the principle of subsidiarity, such policies would have to be developed further in the process towards economic and monetary union.

Wage flexibility and labour mobility are necessary to eliminate differences in competitiveness in different regions and countries of the Community. Otherwise there could be relatively large declines in output and employment in areas with lower productivity. In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financing flows through official channels. Such financial support would be additional to what might come from spontaneous capital flows or external borrowing and should be granted on terms and conditions that would prompt the recipient to intensify its adjustment efforts.

30. Macro-economic policy is the third area in which action would be necessary for a viable economic and monetary union. This would require an appropriate definition of the role of the Community in promoting price

stability and economic growth through the co-ordination of economic policies.

Many developments in macro-economic conditions would continue to be determined by factors and decisions operating at the national or local level. This would include not only wage negotiations and other economic decisions in the fields of production, savings and investment, but also the action of public authorities in the economic and social spheres. Apart from the system of binding rules governing the size and the financing of national budget deficits, decisions on the main components of public policy in such areas as internal and external security, justice, social security, education, and hence on the level and composition of government spending, as well as many revenue measures, would remain the preserve of member states even at the final stage of economic and monetary union.

However, an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. In particular, unco-ordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community. Moreover, the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the co-ordination of national budgetary policies. Without such co-ordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance, or for the Community to play its part in the international adjustment process. Monetary policy alone cannot be expected to perform these functions. Moreover, strong divergences in wage levels and developments, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion.

To some extent market forces can exert a disciplinary influence. Financial markets, consumers and investors would respond to differences in macro-economic developments in individual countries and regions, assess their budgetary and financial positions, penalise deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints.

In the general macro-economic field, a common overall assessment of the short-term and medium-term economic developments in the Community would need to be agreed periodically and would constitute the framework for a better co-ordination of national economic policies. The Community would need to be in a position to monitor its overall economic situation, to assess the consistency of developments in individual countries with regard to common objectives and to formulate guidelines for policy.

As regards wage formation and industrial relations, the autonomous negotiating process would need to be preserved, but efforts would have to be made to convince European management and labour of the advantages of gearing wage policies largely to improvements in productivity. Governments, for their part, would refrain from direct intervention in the wage and price formation process.

In the budgetary field, binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country might have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financing while, however, permitting open market operations in government securities; thirdly, limit recourse to external borrowing in non-Community currencies. Moreover, the arrangements in the budgetary field should enable the Community to conduct a coherent mix of fiscal and monetary policies.

4. Institutional arrangements

31. Management of the economic and monetary union would call for an institutional framework which would allow policy to be decided and executed at the Community level in those economic areas that were of direct

relevance for the functioning of the union. This framework would have to promote efficient economic management, properly embedded in the democratic process. Economic and monetary union would require the creation of a new monetary institution, placed in the constellation of Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice). The formulation and implementation of common policies in non-monetary fields and the co-ordination of policies remaining within the competence of national authorities would not necessarily require a new institution; but a revision and, possibly, some restructuring of the existing Community bodies, including an appropriate delegation of authority, could be necessary.

32. A new monetary institution would be needed because a single monetary policy cannot result from independent decisions and actions by different central banks. Moreover, day-to-day monetary policy operations cannot respond quickly to changing market conditions unless they are decided centrally. Considering the political structure of the Community and the advantages of making existing central banks part of a new system, the domestic and international monetary policy-making of the Community should be organised in a federal form, in what might be called a European System of Central Banks (ESCB). This new System would have to be given the full status of an autonomous Community institution. It would operate in accordance with the provisions of the Treaty, and could consist of a central institution (with its own balance sheet) and the national central banks. At the final stage the ESCB - acting through its Council - would be responsible for formulating and implementing monetary policy as well as managing the Community's exchange rate policy vis-à-vis third currencies. The national central banks would be entrusted with the implementation of policies in conformity with guidelines established by the Council of the ESCB and in accordance with instructions from the central institution.

The European System of Central Banks would be based on the following principles:

Mandate and functions

- the System would be committed to the objective of price stability;

- subject to the foregoing, the System should support the general economic policy set at the Community level by the competent bodies;
- the System would be responsible for the formulation and implementation of monetary policy, exchange rate and reserve management, and the maintenance of a properly functioning payment system;
- the System would participate in the co-ordination of banking supervision policies of the supervisory authorities.

Policy instruments

- the policy instruments available to the System, together with a procedure for amending them, would be specified in its Statutes; the instruments would enable the System to conduct central banking operations in financial and foreign exchange markets as well as to exercise regulatory powers;
- while complying with the provision not to lend to public sector authorities, the System could buy and sell government securities on the market as a means of conducting monetary policy.

Structure and organisation

- a federative structure, since this would correspond best to the political diversity of the Community;
- establishment of an ESCB Council (composed of the Governors of the central banks and the members of the Board, the latter to be appointed by the European Council), which would be responsible for the formulation of and decisions on the thrust of monetary policy; modalities of voting procedures would have to be provided for in the Treaty;
- establishment of a Board (with supporting staff), which would monitor monetary developments and oversee the implementation of the common monetary policy;
- national central banks, which would execute operations in accordance with the decisions taken by the ESCB Council.

Status

- Independence: the ESCB Council should be independent of instructions from national governments and Community authorities; to that effect the members of the ESCB Council, both Governors and the Board members, should have appropriate security of tenure;
- Accountability: reporting would be in the form of submission of an annual report by the ESCB to the European Parliament and the European Council; moreover, the Chairman of the ESCB could be invited to report to these institutions. Supervision of the administration of the System would be carried out independently of the Community bodies, for example by a supervisory council or a committee of independent auditors.

33. In the economic field, in contrast to the monetary field, an institutional framework for performing policy tasks was already established under the Treaty of Rome, with different and complementary functions conferred on the European Parliament, the Council of Ministers, the Monetary Committee, the Commission and the Court of Justice. The new Treaty would therefore not have to determine the mandate, status and structure of a new institution but would have to provide for additional or changed roles for the existing bodies in the light of the policy functions they would have to fulfil in an economic and monetary union. It would have to specifically define these changes and determine the areas in which decision-making authority would have to be transferred from the national to the Community level.

General criteria

In order to ensure the flexible and effective conduct of policies in those economic areas in which the Community would be involved, several basic requirements would have to be fulfilled:

- where policies were decided and enacted at the Community level, there would have to be a clear distribution of responsibilities among the existing Community institutions, a distinction being made as to whether decisions related to the setting of broad policy directions or to day-to-day operations. By analogy with the structure of the European System of Central Banks, where the ESCB Council would determine the broad lines of monetary policy and the Board would be responsible for its day-to-day execution, a similar division of responsibilities could be envisaged in the economic field. The Council of Ministers would determine the broad lines of economic policy, while the implementation would be left to the national governments and the Commission in their respective areas of competence;

- in the event of non-compliance by member states, the Commission, or another appropriately delegated authority as envisaged in paragraph 31, would be responsible for taking effective action to ensure compliance; the nature of such action would have to be explored.

Single market and competition policy

In these two areas, the necessary procedures and arrangements have already been established by the Treaty of Rome and the Single European Act, which confer the requisite legislative, executive and judicial authority on the Community. The completion of the internal market will result in a marked easing of the overall burden of regulation for economic agents, but for the Community institutions it will mean a substantial addition to their executive and policing functions.

Community policies in the regional and structural field

The foundations for a more effective Community role in regional and structural development have recently been established, with both a doubling of the resources of structural funds and a reorganisation of policies as described earlier in this Report. These mechanisms would perhaps have to be further extended and made more effective as part of the process leading to economic and monetary union.

Macro-economic policy

The broad objective of economic policy co-ordination would be to promote growth, employment and external balance in an environment of price stability and economic cohesion. For this purpose co-ordination would involve defining a medium-term framework for budgetary policy within the economic and monetary union; managing common policies with a view to structural and regional development; formulating in co-operation with the ESCB Council the Community's exchange rate policy; and participating in policy co-ordination at the international level.

New procedures required for this purpose would have to strike a balance between reliance on binding rules, where necessary, to ensure effective implementation and discretionary co-ordination adapted to particular situations.

In particular it would seem necessary to develop both binding rules and procedures for budgetary policy, involving respectively:

- effective upper limits on budget deficits of individual member countries; exclusion of access to direct central bank credit and other forms of monetary financing; limits on borrowing in non-Community currencies;
- the definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance, comprising both the national and the Community positions.

34. The new Treaty laying down the objectives, features, requirements, procedures and organs of the economic and monetary union would add to the existing Community institutions (European Parliament, European Council, Council of Ministers, Commission and Court of Justice) a new institution of comparable status, the European System of Central Banks. With due respect for the independent status of the ESCB, as defined elsewhere in this Report, appropriate consultation procedures would have to be set up to allow for effective co-ordination between budgetary and monetary policy. This might involve attendance by the President of the Council and the President of the Commission at meetings of the ESCB Council, without power to vote or to block decisions taken in accordance with the rules laid down by the ESCB Council. Equally, the Chairman of the ESCB Council might attend meetings of the Council of Ministers, especially on matters of relevance to the conduct of monetary policy. Consideration would also have to be given to the role of the European Parliament, especially in relation to the new policy functions exercised by various Community bodies.

5. Economic and monetary union in the context of the world economy

35. The establishment of an economic and monetary union would give the Community a greater say in international negotiations and enhance its capacity to influence economic relations between industrial and developing countries.

36. The responsibility for external trade policy has been assigned to the Community in the Treaty of Rome, and the Commission, acting as the Community's spokesman, represents all the member countries in multilateral trade negotiations. This role will be strengthened with the completion of the single market, which has the potential to stimulate multilateral trade and economic growth at the global level. However, this potential can only be exploited to the full in an open trading system, which guarantees foreign suppliers free access to the Community market and, conversely, guarantees exporters from the Community free access to foreign markets. The removal of internal trade barriers within the Community should constitute a step towards a more liberal trading system on a worldwide scale.

37. The creation of an economic and monetary union would increase the role of the Community in the process of international policy concertation. In the monetary field this would involve short-term co-operation between central banks in interest rate management and exchange market interventions as well as the search for solutions to issues relating to the international monetary system. In the economic field, the formulation of a policy mix would allow the Community to contribute more effectively to world economic management.

38. The institutional arrangements which would enable the Community to fulfil the new responsibilities implied by its increased weight in the world economy are partly in place or would be implemented in the process of creating an economic and monetary union. In the area of external trade policies and, to some extent, in the field of co-operation with developing countries, the responsibilities have already been attributed to the Community. With the establishment of the European System of Central Banks the Community would also have created an institution through which it could participate in all aspects of international monetary management. As far as

macro-economic policy co-ordination at the international level is concerned, the Community as such is currently represented only at the summit meetings of the major industrial countries. In order to make full use of its position in the world economy and to exert influence on the functioning of the international economic system, the Community would have to be able to speak with one voice. This emphasises the need for an effective mechanism for macro-economic policy co-ordination within the economic and monetary union.

III. Steps towards economic and monetary union

39. After defining the main features of an economic and monetary union, the Committee has undertaken the "task of studying and proposing concrete stages leading towards this union". The Committee agreed that the creation of an economic and monetary union must be viewed as a single process. Although this process is set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process.

A clear political commitment to the final stage, as described in Part II of this Report, would lend credibility to the intention that the measures which constitute stage one should represent not just a useful end in themselves but a firm first step on the road towards economic and monetary union. It would be a strong expression of such a commitment if all members of the Community became full members of the EMS in the course of stage one and undertook the obligation to formulate a convergent economic policy within the existing institutions.

Given that background, commitment by the political authorities to enter into negotiations on a new Treaty would ensure the continuity of the process. Preparatory work for these negotiations would start immediately. At the end of this Report suggestions are made regarding the procedures to be followed for the further development of aconomic and monetary union.

1. Principles governing a step-by-step approach

40. In designing a step-by-step approach along the path to economic and monetary union the general principle of subsidiarity, referred to earlier in this Report, as well as a number of further considerations, would have to be taken into account.

41. Discrete but evolutionary steps. The process of implementing economic and monetary union would have to be divided into a limited number of clearly defined stages. Each stage would have to represent a significant change with respect to the preceding one. New arrangements coming into force at the beginning of each stage would gradually develop their effects and bring about a change in economic circumstances so as to pave the way for the next stage. This evolutionary development would apply to both functional and institutional arrangements.

42. Parallelism. As has been argued in Part II, monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community. Parallel advancement in economic and monetary integration would be indispensable in order to avoid imbalances which could cause economic strains and loss of political support for developing the Community further into an economic and monetary union. Perfect parallelism at each and every point of time would be impossible and could even be counter-productive. Already in the past the advancement of the Community in certain areas has taken place with temporary standstill in others, so that parallelism has been only partial. Some temporary deviations from parallelism are part of the dynamic process of the Community. But bearing in mind the need to achieve a substantial degree of economic union if monetary union is to be successful, and given the degree of monetary co-ordination already achieved, it is clear that material progress on the economic policy front would be necessary for further progress on the monetary policy front. Parallelism would have to be maintained in the medium term and also before proceeding from one stage to the next.

43. Calendar. The conditions for moving from stage to stage cannot be defined precisely in advance; nor is it possible to foresee today when

these conditions will be realised. The setting of explicit deadlines is therefore not advisable. This observation applies to the passage from stage one to stage two and, most importantly, to the move to irrevocably fixed exchange rates. The timing of both these moves would involve an appraisal by the Council, and from stage two to stage three also by the European System of Central Banks in the light of the experience gained in the preceding stage. However, there should be a clear indication of the timing of the first stage, which should start no later than 1st July 1990 when the Directive for the full liberalisation of capital movements comes into force.

44. Participation. There is one Community, but not all the members have participated fully in all its aspects from the outset. A consensus on the final objectives of the Community, as well as participation in the same set of institutions, should be maintained, while allowing for a degree of flexibility concerning the date and conditions on which some member countries would join certain arrangements. Pending the full participation of all member countries - which is of prime importance - influence on the management of each set of arrangements would have to be related to the degree of participation by member states. However, this management would have to keep in mind the need to facilitate the integration of the other members.

2. The ECU

45. The Committee investigated various aspects of the role that the ECU might play in the process of economic and monetary integration in Europe.

46. Firstly, the Committee examined the role of the ECU in connection with an eventual move to a single currency. Although a monetary union does not necessarily require a single currency, it would be a desirable feature of a monetary union. The Committee was of the opinion that the ECU has the potential to be developed into such a common currency. This would imply that the ECU would be transformed from a basket of currencies into a genuine currency. The irrevocable fixing of exchange rates would imply that there would be no discontinuity between the ECU and the single currency of

the union and that ECU obligations would be payable at face value in ECUs if the transition to the single currency had been made by the time the contract matured.

47. Secondly, the Committee considered the possibility of adopting a parallel currency strategy as a means of accelerating the pace of the monetary union process. Under this approach the definition of the ECU as a basket of currencies would be abandoned at an early stage and the new fully-fledged currency, called the ECU, would be created autonomously and issued in addition to the existing Community currencies, competing with them. The proponents of this strategy expect that the gradual crowding-out of national currencies by the ECU would make it possible to circumvent the institutional and economic difficulties of establishing a monetary union. The Committee felt that this strategy was not to be recommended for two main reasons. Firstly, an additional source of money creation without a precise linkage to economic activity could jeopardise price stability. Secondly, the addition of a new currency, with its own independent monetary implications, would further complicate the already difficult endeavour of co-ordinating different national monetary policies.

48. Thirdly, the Committee examined the possibility of using the official ECU as an instrument in the conduct of a common monetary policy. The main features of possible schemes are described in the Collection of papers submitted to the Committee, which represent personal contributions.

49. Fourthly, the Committee agreed that there should be no discrimination against the private use of the ECU and that existing administrative obstacles should be removed.

3. The principal steps in stage one

50. Stage one represents the initiation of the process of creating an economic and monetary union. It would aim at a greater convergence of economic performance through the strengthening of economic and monetary policy co-ordination within the existing institutional framework. In the institutional field, by the time of the transition to stage two, it would be necessary to have prepared and ratified the Treaty change.

51. In the economic field the steps would centre on the completion of the internal market and the reduction of existing disparities through programmes of budgetary consolidation in those countries concerned and more effective structural and regional policies. In particular, there would be action in three directions.

Firstly, there would be a complete removal of physical, technical and fiscal barriers within the Community, in line with the internal market programme. The completion of the internal market would be accompanied by a strengthening of Community competition policy.

Secondly, the reform of the structural funds and doubling of their resources would be fully implemented in order to enhance the ability of Community policies to promote regional development and to correct economic imbalances.

Thirdly, the 1974 Council Decision on economic convergence would be replaced by a new procedure that would strengthen economic and fiscal policy co-ordination and would, in addition, provide a comprehensive framework for an assessment of the consequences and consistency of the overall policies of member states. On the basis of this assessment, recommendations would be made aimed at achieving a more effective co-ordination of economic policies, taking due account of the views of the Committee of Central Bank Governors. The task of economic policy co-ordination should be the primary responsibility of the Council of Economic and Finance Ministers (ECOFIN). Consistency between monetary and economic policies would be facilitated by the participation of the Chairman of the Committee of Central Bank Governors in appropriate Council meetings. In particular, the revised 1974 Decision on convergence would:

- establish a process of multilateral surveillance of economic developments and policies based on agreed indicators. Where performances were judged inadequate or detrimental to commonly set objectives, policy consultations would take place at the Community level and recommendations would be formulated with a view to promoting the necessary corrections in national policies;
- set up a new procedure for budgetary policy co-ordination, with precise quantitative guidelines and medium-term orientations;
- provide for concerted budgetary action by the member countries.

52. In the monetary field the focus would be on removing all obstacles to financial integration and on intensifying co-operation and the co-ordination of monetary policies. In this connection consideration should be given to extending the scope of central banks' autonomy. Realignments of exchange rates would still be possible, but an effort would be made by every country to make the functioning of other adjustment mechanisms more effective. Action would be taken along several lines.

Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented.

Secondly, it would be important to include all Community currencies in the EMS exchange rate mechanism. The same rules would apply to all the participants in the exchange rate mechanism.

Thirdly, all impediments to the private use of the ECU would be removed.

Fourthly, the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new Decision. According to this decision the Committee of Central Bank Governors should:

- formulate opinions on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would normally be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets;
- express opinions to individual governments and the Council of Ministers on policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public by the Chairman of the Committee;
- submit an annual report on its activities and on the monetary situation of the Community to the European Parliament and the European Council.

The Committee could express majority opinions, although at this stage they would not be binding. In order to make its policy co-ordination function more effective, the Committee would set up three sub-committees, with a greater research and advisory role than those existing hitherto, and provide them with a permanent research staff:

- a monetary policy committee would define common surveillance indicators, propose harmonised objectives and instruments and help to gradually bring about a change from ex post analysis to an ex ante approach to monetary policy co-operation;
- a foreign exchange policy committee would monitor and analyse exchange market developments and assist in the search for effective intervention strategies;
- an advisory committee would hold regular consultations on matters of common interest in the field of banking supervision policy.

53. A number of Committee members advocated the creation of a <u>European Reserve Fund (ERF)</u> that would foreshadow the future European System of Central Banks. The main objectives of the ERF would be:

- to serve as a training ground for implementing a better co-ordination of monetary analysis and decisions;
- to facilitate, from a Community point of view, the concerted management of exchange rates and possibly to intervene visibly (in third and participating currencies) on the foreign exchange market at the request of the participating central banks;
- to be the symbol of the political will of the European countries and thus reinforce the credibility of the process towards economic and monetary union.

The resources of the Fund would be provided by the pooling of a limited amount of reserves (for instance 10% at the start) by participating central banks. The Fund would, moreover, require a permanent structure and staff in order to carry out its tasks, viz.:

- managing the pooled reserves;
- intervening on the exchange markets as decided by the members;

- analysing monetary trends, from a collective perspective, in order to enhance policy co-ordination.

All EC central banks would be eligible to join the Fund. However, membership would be subject to their participation in the exchange rate mechanism, the reason being that the EMS implies specific constraints on monetary policy and foreign exchange interventions, both of which require a common approach on the part of the central banks concerned.

The ERF would consist of:

- a Board of Directors, which would comprise, ex officio, the Governors of all the central banks participating in the ERF;
- an Executive Committee, whose members would be selected by the Committee of Governors on the basis of competence. This Executive Committee would be small in size, consisting of three or four members who would have direct responsibility for the different departments of the ERF;
- the three Committees, namely the Foreign Exchange Policy Committee, the Monetary Policy Committee and the Committee on Banking Supervision Policy;
- two departments: a Foreign Exchange and Reserve Management Department and a Monetary Policy Department.

54. Other members of the Committee felt that the creation of an ERF was not opportune at this stage. Their reservations stem from the following considerations:

- too much emphasis is placed on external considerations; common interventions by such a Fund cannot be a substitute for economic adjustment to correct imbalances within the Community;
- the proposal involves an institutional change which, in accordance with Article 102A of the amended Treaty of Rome, would fall under the procedure stipulated in Article 236 and require a new Treaty; the setting-up of a Fund under the same procedures as those applied in establishing the EMS is not considered possible;

- they consider that some functions of the Fund could be performed by the Committee of Governors if it were given wider powers; thus there is no need to set up a new institution immediately;
- what, in the view of these members, is essential is co-ordination of intervention policies rather than the technique of common interventions. Such co-ordination can provide the necessary training ground while avoiding the unnecessary complication of instituting an additional intervention window.

4. The principal steps in stage two

55. The second stage could begin only when the new Treaty had come into force. In this stage the basic organs and structure of the economic and monetary union would be set up, involving both the revision of existing institutions and the establishment of new ones. The institutional framework would gradually take over operational functions, serve as the centre for monitoring and analysing macro-economic developments and promote a process of common decision-making, with certain operational decisions taken by majority vote. Stage two must be seen as a period of transition to the final stage and would thus primarily constitute a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would remain at this stage with national authorities. The precise operating procedures to be applied in stage two would be developed in the light of the prevailing economic conditions and the experience gained in the previous stage.

56. In the economic field, the European Parliament, the Council of Ministers, the Monetary Committee and the Commission would reinforce their action along three lines.

Firstly, in the area of the single market and competition policy the results achieved through the implementation of the single market programme would be reviewed and, wherever necessary, consolidated.

Secondly, the performance of structural and regional policies would be evaluated and, if necessary, be adapted in the light of experience. The resources for supporting the structural policies of the member states might have to be enlarged. Community programmes for investment in research and infrastructure would be strengthened.

Thirdly, in the area of macro-economic policy, the procedures set up in the first stage through the revision of the 1974 Decision on convergence would be further strengthened and extended on the basis of the new Treaty. Policy guidelines would be adopted by majority decision. On this basis the Community would:

- set a medium-term framework for key economic objectives aimed at achieving stable growth, with a follow-up procedure for monitoring performances and intervening when significant deviations occurred;
- set precise - although not yet binding - rules relating to the size of annual budget deficits and their financing; the Commission should be responsible for bringing any instance of non-compliance by member states to the Council's attention and should propose action as necessary;
- assume a more active role as a single entity in the discussion of questions arising in the economic and exchange rate field, on the basis of its present representation (through the member states or the Commission) in the various fora for international policy co-ordination.

57. In the monetary field, the most important feature of this stage would be that the European System of Central Banks would be set up and would absorb the previously existing institutional monetary arrangements (the EMCF, the Committee of Central Bank Governors, the sub-committees for monetary policy analysis, foreign exchange policy and banking supervision, and the permanent secretariat). The functions of the ESCB in the formulation and operation of a common monetary policy would gradually evolve as experience was gained. Some possible schemes for co-ordinating monetary policies in the course of this stage are discussed in the Collection of papers submitted to the Committee. Exchange rate realignments would not be excluded as an instrument of adjustment, but there would be an understanding that they would be made only in exceptional circumstances.

The key task for the European System of Central Banks during this stage would be to begin the transition from the co-ordination of independent national monetary policies by the Committee of Central Bank Governors in stage one to the formulation and implementation of a common monetary policy by the ESCB itself scheduled to take place in the final stage.

The fundamental difficulty inherent in this transition would lie in the organisation of a gradual transfer of decision-making power from national authorities to a Community institution. At this juncture, the Committee does not consider it possible to propose a detailed blueprint for accomplishing this transition, as this would depend on the effectiveness of the policy co-ordination achieved during the first stage, on the provisions of the Treaty, and on decisions to be taken by the new institutions. Account would also have to be taken of the continued impact of financial innovation on monetary control techniques (which are at present undergoing radical changes in most industrial countries), of the degree of integration reached in European financial markets, of the constellation of financial and banking centres in Europe and of the development of the private, and in particular banking, use of the ECU.

The transition that characterises this second stage would involve a certain number of actions. For instance, general monetary orientations would be set for the Community as a whole, with an understanding that national monetary policy would be executed in accordance with these global guidelines. Moreover, while the ultimate responsibility for monetary policy decisions would remain with national authorities, the operational framework necessary for deciding and implementing a common monetary policy would be created and experimented with. Also, a certain amount of exchange reserves would be pooled and would be used to conduct exchange market interventions in accordance with guidelines established by the ESCB Council. Finally, regulatory functions would be exercised by the ESCB in the monetary and banking field in order to achieve a minimum harmonisation of provisions (such as reserve requirements or payment arrangements) necessary for the future conduct of a common monetary policy.

As circumstances permitted and in the light of progress made in the process of economic convergence, the margins of fluctuation within the exchange rate mechanism would be narrowed as a move towards the final stage of the monetary union, in which they would be reduced to zero.

5. <u>The principal steps in stage three</u>

58. The <u>final stage</u> would commence with the move to irrevocably locked exchange rates and the attribution to Community institutions of the full monetary and economic competences described in Part II of this Report. In the course of the final stage the national currencies would eventually be replaced by a single Community currency.

59. <u>In the economic field</u>, the transition to this final stage would be marked by three developments.

Firstly, there might need to be a further strengthening of Community structural and regional policies. Instruments and resources would be adapted to the needs of the economic and monetary union.

Secondly, the rules and procedures of the Community in the macro-economic and budgetary field would become binding. In particular, the Council of Ministers, in co-operation with the European Parliament, would have the authority to take directly enforceable decisions, i.e.:

- to impose constraints on national budgets to the extent to which this was necessary to prevent imbalances that might threaten monetary stability;
- to make discretionary changes in Community resources (through a procedure to be defined) to supplement structural transfers to member states or to influence the overall policy stance in the Community;
- to apply to existing Community structural policies and to Community loans (as a substitute for the present medium-term financial assistance facility) terms and conditions that would prompt member countries to intensify their adjustment efforts.

Thirdly, the Community would assume its full role in the process of international policy co-operation, and a new form of representation in arrangements for international policy co-ordination and in international monetary negotiations would be adopted.

60. <u>In the monetary field</u>, the irrevocable locking of exchange rates would come into effect and the transition to a single monetary policy would

be made, with the ESCB assuming all its responsibilities as foreseen in the Treaty and described in Part II of this Report. In particular:

- concurrently with the announcement of the irrevocable fixing of parities between the Community currencies, the responsibility for the formulation and implementation of monetary policy in the Community would be transferred to the ESCB, with its Council and Board exercising their statutory functions;
- decisions on exchange market interventions in third currencies would be made on the sole responsibility of the ESCB Council in accordance with Community exchange rate policy; the execution of interventions would be entrusted either to national central banks or to the European System of Central Banks;
- official reserves would be pooled and managed by the ESCB;
- preparations of a technical or regulatory nature would be made for the transition to a single Community currency.

The change-over to the single currency would take place during this stage.

6. <u>One or several Treaties</u>

61. <u>Legal basis</u>. The Committee has examined the scope for progress in economic and monetary integration under the present legal provisions in force in each member country. This investigation has shown that under present national legislations no member country is able to transfer decision-making power to a Community body, nor is it possible for many countries to participate in arrangements for a binding ex ante co-ordination of policies.

As has been pointed out in paragraph 18 of this Report, the Treaty of Rome, as amended by the Single European Act, is insufficient for the full realisation of economic and monetary union. There is at present no transfer of responsibility for economic and monetary policy from member states to the Community. The rules governing the EMS are based on agreements between the central banks concerned and are not an integral part of Community legislation. Without a new Treaty it would not be possible to take major additional steps towards economic and monetary union. The process of integration based on a step-by-step approach requires, however, a clear understanding of its content and final objective, its basic functional and institutional arrangements and the provisions governing its gradual implementation. A new political and legal basis would accordingly be needed. A new Treaty would establish not only the objective but also the stages by which it is to be achieved and the procedures and institutions required to move forward at each stage along the way. Political agreement would be required for each move to be implemented.

A new Treaty would also be required to ensure parallel progress in the economic and in the monetary fields. The appropriate institutional and procedural arrangements to that effect should also be set out in the Treaty.

62. The Committee has not investigated in detail the possible approaches by means of which the objective of economic and monetary union and its implementation would be embodied in the new Treaty. There would be basically two options. One procedure would be to conclude <u>a new Treaty for each stage</u>. The advantage of this procedure would be that it would explicitly reaffirm the political consensus at each stage and would allow for modification of the form the following stage should take in the light of experience with the current stage. At the same time, this approach might prove unwieldy and slow, it might not safeguard the overall consistency of the process sufficiently and it might carry the risk that parallel progress on the monetary and non-monetary sides might not be respected. In any event, if this procedure were chosen it would be crucial that the first Treaty laid down clearly the principal features of the ultimate objective of economic and monetary union.

63. Alternatively, it could be decided to conclude <u>a single comprehensive Treaty</u> formulating the essential features and institutional arrangements of economic and monetary union and the steps by which it could be achieved. Such a Treaty should indicate the procedures by which the decision would be taken to move from stage to stage. Each move would require an appraisal of the situation and a decision by the European Council.

7. Suggested follow-up procedure

64. If the European Council can accept this Report as a basis for further development towards economic and monetary union, the following procedure is suggested.

65. The Council and the Committee of Governors should be invited to take the decisions necessary to implement the first stage.

66. Preparatory work for the negotiations on the new Treaty would start immediately. The competent Community bodies should be invited to make concrete proposals on the basis of this Report concerning the second and the final stages, to be embodied in a revised Treaty. These proposals should contain a further elaboration and concretisation, where necessary, of the present Report. They should serve as the basis for future negotiations on a revised Treaty at an inter-governmental conference to be called by the European Council.

Annex I

Excerpts from the Conclusions of the Presidency presented after the meeting of the European Council in Hanover on 27th-28th June 1988

5. Monetary union

The European Council recalls that, in adopting the Single Act, the member states confirmed the objective of progressive realisation of economic and monetary union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr. Jacques Delors, President of the European Commission.

The Heads of State and Government agreed to invite the President or Governor of their central banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite:

- Mr. Niels Thygesen, Professor of Economics, Copenhagen;
- Mr. Lamfalussy, General Manager of the Bank for International Settlements in Basle, Professor of Monetary Economics at the Catholic University of Louvain-la-Neuve;
- Mr. Miguel Boyer, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.

List of members of the Committee

Jacques Delors (Chairman)
Frans Andriessen
Miguel Boyer
Demitrius J. Chalikias
Carlo Azeglio Ciampi
Maurice F. Doyle
Willem F. Duisenberg
Jean Godeaux
Erik Hoffmeyer
Pierre Jaans
Alexandre Lamfalussy
Jacques de Larosière
Robert Leigh-Pemberton
Karl Otto Pöhl
Mariano Rubio
José A.V. Tavares Moreira
Niels Thygesen

Rapporteurs:

Gunter D. Baer
Tommaso Padoa-Schioppa

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 01-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

HM TREASURY – MCU
- 9 MAY 1989
FIM1
EST
21240/89

8th May, 1989

The Rt. Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer,
House of Commons,
London SW1A 0AA.

Dear Chancellor,

I write in my capacity as Chairman of the European Committee of the B.I.E.C. which was set up last year to try to ensure that the Government and the City see eye to eye in the run-up to 1992. It brings together senior practitioners from the City with senior officials from Whitehall and the Bank of England (see membership list attached).

2. At its meeting on 4th May the Committee discussed the Delors report which paints a Chinese-style picture of EMU, with the foreground and the distant mountains clearly delineated and the mist covering everything in between. The Committee took the view that the report's "in for a penny, in for a pound" thesis is unsound and that it would be preferable to concentrate discussion of it on the proposals for stage one, moving towards "the objective of progressive realization of EMU" (Hanover European Council conclusions) in a pragmatic way, step by step.

3. There was concern about the risk of confrontation between the U.K. and other member governments. The latter seem to have worked up a head of steam on the issue and there is a risk that, unless the U.K. can let some of the pressure blow away by engaging the others in constructive discussion, they will try to put into action their present mutterings about going ahead without us. It would not, of course, be easy to set up a monetary institution separate from, and in parallel with, the E.C. institutions, but they might try it if they were cross enough with us. The City members of the European Committee all feel concern, in varying degrees, about the potential damage to our interests if this were to happen. The challenge to the City from Paris, Luxembourg, Amsterdam and Frankfurt is going to be quite strong in a number of fields in the 1990s. The psychological and practical effects of exclusion from European monetary arrangements would be likely to become progresively more damaging and business would be drawn away from London to other centres.

/4.

BUTLER
→
CX
8/5

4. Michael Franklin (the Deputy-Chairman), Jeremy Morse and I would be most grateful if you could find the time fairly soon to discuss with us how to get the E.C. discussions moving in a constructive and acceptable direction. We are also asking the Prime Minister to give us the opportunity for a talk.

Yours ever

Michael

Sir Michael Butler

MDB/MML

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 May 1989

Dear Duncan,

I enclose a copy of a letter which the Prime Minister has received from Sir Michael Butler of Hambros Bank Limited.

I should be grateful if you would let me have a draft Private Secretary reply, to reach this office by Tuesday, 23 May.

Please could you co-ordinate your reply with Richard Gozney (Foreign and Commonwealth Office), to whom I am copying this correspondence.

Yours sincerely,

Charles Powell

10 MAY 1989

EC1 MB
Brow

CHARLES POWELL

Duncan Sparkes Esq
HM Treasury

cc Mrs. Thorpe

PS/PM
21344/89

R9/14

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 01-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

8th May, 1989

Charles Powell, Esq.,
Private Secretary to the Prime Minister,
House of Commons,
London SW1A 0AA.

Dear Charles,

I write in my capacity as Chairman of the European Committee of the B.I.E.C. which was set up last year to try to ensure that the Government and the City see eye to eye in the run-up to 1992. It brings together senior practitioners from the City with senior officials from Whitehall and the Bank of England (see membership list attached).

2. At its meeting on 4th May the Committee discussed the Delors report which paints a Chinese-style picture of EMU, with the foreground and the distant mountains clearly delineated and the mist covering everything in between. The Committee took the view that the report's "in for a penny, in for a pound" thesis is unsound and that it would be preferable to concentrate discussion of it on the proposals for stage one, moving towards "the objective of progressive realization of EMU" (Hanover European Council conclusions) in a pragmatic way, step by step.

3. There was concern about the risk of confrontation between the U.K. and other member governments. The latter seem to have worked up a head of steam on the issue and there is a risk that, unless the U.K. can let some of the pressure blow away by engaging the others in constructive discussion, they will try to put into action their present mutterings about going ahead without us. It would not, of course, be easy to set up a monetary institution separate from, and in parallel with, the E.C. institutions, but they might try it if they were cross enough with us. The City members of the European Committee all feel concern, in varying degrees, about the potential damage to our interests if this were to happen. The challenge to the City from Paris, Luxembourg, Amsterdam and Frankfurt is going to be quite strong in a number of fields in the 1990s. The psychological and practical effects of exclusion from European monetary arrangements would be likely to become progresively more damaging and business would be drawn away from London to other centres.

/4.

4. Michael Franklin (the Deputy-Chairman), Jeremy Morse and I would very much welcome a chance to discuss the way forward with the Prime Minister. I should be grateful if you could ask her if she could be kind enough to find the time within the next week or two.

Yours ever

Michael

Sir Michael Butler

MDB/MML

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23/5

FROM: N P WILLIAMS
DATE: 15 MAY 1989
EXT: X5561

Approved in draft. NPW 15/5

1. MISS O'MARA
2. CHANCELLOR

cc Economic Secretary
Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Odling-Smee
Mr Peretz
Mrs M E Brown
Mr Nelson

Ch/ Do you want such a meeting?
If so when?
Who would you like to attend?
Content for me to reply as drafted?
Julie 15/5

I will speak to Sir M Butler on the telephone.

EMU: SIR MICHAEL BUTLER'S LETTER ON BEHALF OF BIEC

1. Sir Michael Butler has written to you in his capacity as Chairman of the European Committee of the BIEC asking whether he, Michael Franklin and Sir Jeremy Morse could discuss with you fairly soon how to get EMU discussions "moving in a constructive and acceptable direction." In essence, Sir Michael is concerned about the risk of confrontation with other member governments and the development of a "two-tier" Europe which, he believes, will have damaging consequences for the City.

2. We suggest you might see these senior City people provided you can fit a meeting into your diary.

3. You will also wish to be aware that Sir Michael Butler has asked to discuss the same points with the Prime Minister. If you agree to see Sir Michael, then we shall advise No.10 that there is no need for a separate meeting.

4. I attach a draft reply for Mrs Thorpe to send if you are content.

NPW

N P WILLIAMS

UNCLASSIFIED

WILLIAMS → Cx 15/5

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UNCLASSIFIED

DRAFT LETTER TO:

Sir Michael Butler
Hambros Bank Ltd
41 Tower Hill
London EC3N 4HA

The Chancellor has asked me to thank you for your letter of 8 May. He would be happy to meet you and your colleagues to discuss the issues you raised and I therefore suggest your office might get in touch with me to discuss a suitable date.

Diary Secretary

31/5

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

LE DELEGUE GENERAL

Mr. Nigel LAWSON
Minister of Finance
H.M. Treasury
Parliament Street
SWIP 3AG LONDON
UNITED KINGDOM

CHANCELLOR
24 MAY 1989
Mr PERETZ
PS/EST, PS/PMG
SIR P MIDDLETON
SIR T BURNS, MR WICKS.
MR SCHOLAR,
MR H P EVANS
MR ODLING-SMEE
MR RILEY, MRS M BROWN
MR GIEVE, MISS O'MARA,
MR CHAPLIN, MR TYRIE

19th May 1989

Dear Sir,

The Association for the Monetary Union of Europe would kindly like to bring to your attention the comments made by our Board of Directors on the economic and monetary report recently submitted by the DELORS Committee.

Our Association, established at the end of 1987, now comprises some 170 firms employing approximately three and a half million people and having a total turnover around 300 billion ecus.

We hope that the enclosed comments will be helpful for your preparation of the forthcoming meeting of the European Council in Madrid.

Yours faithfully,

Bertrand de MAIGRET

Encl.

Mr Williams
Could you prepare a PS reply – perhaps mentioning our new T Bill programme & enclosing a copy of the Chatham House speech?
DLP
25/5

ASSOCIATION POUR L'UNION MONETAIRE DE L'EUROPE
26 Rue de la Pépinière - 75008 Paris
Tél. : 33 (1) 45 22 33 84 - Télex : 282438 - Fax : 33 (1) 45 22 33 77

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

COMMENTS ON THE ECONOMIC AND MONETARY REPORT SUBMITTED BY THE DELORS COMMITTEE

The Board of Directors of the Association for the Monetary Union of Europe met in London on 3 May 1989, chaired by Mr. Cornelis van der Klugt (PHILIPS Chairman), with the participation of Mr. Giovanni Agnelli (FIAT Chairman), Mr. François-Xavier Ortoli Chairman of TOTAL-CFP), Mr. Brian Garraway (Deputy Chairman of B.A.T Industries), Mr. Solvay (Chairman of the Board of Directors of SOLVAY & Cie.), Mr. Papalexopoulos (Vice -President of TITAN), Mr. Mentré (Chairman of CREDIT NATIONAL), Mr. Plachetka (Office of Chancellor H. SCHMIDT), Mr. Merkle represented by Dr. Ahnefeld (Robert BOSCH), Mr. Pininfarina represented by Mr. Mondello (CONFINDUSTRIA), Mr. Tesch represented by Mr. Ahlborn (ARBED), and Mr. MARCH represented by Mr. Cuervo (MARCH Group).
After studying the report recently issued by the committee headed by Mr. Jacques Delors, the Board adopted the following declaration:

The Association for the Monetary Union of Europe pays tribute to the quality of the "Report on Economic and Monetary Union in the European Community" and which reflects to a large extent the proposals which the Association itself submitted to the European Parliament, and to the President of the European Communities Commission, in Strasbourg in January 1989.

It **notes that the report was unanimous, having been signed by the central bank governors and the other experts working under the chairmanship of Mr. Jacques Delors.** This unanimity from figures of such high standing in the economic and monetary sphere constitutes powerful encouragement for moving towards economic and monetary union. It is a natural progression from observation of the results derived from ten years experience of the European Monetary System (E.M.S.).

The last decade has demonstrated that the E.M.S has contributed to economic stability and has not transferred the volatility of exchange rates to interest rates. On the contrary, during that period, the countries fully involved (Belgium, Denmark, France, Ireland, Italy, Luxemburg, Netherlands, West Germany) have reduced interest-rate fluctuations. This stability has lowered business costs, facilitated companies' investment strategies, and contributed to more uniform competitive conditions between member countries.

Over the same period, Sterling which is not a member of the E.M.S exchange rate mechanism, has suffered from some very sharp fluctuations against the currencies of those eight countries, both in value and in interest rates.

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While contributing to the reduction of inflation rates, the E.M.S. has not had the recessionary effect that some people predicted.

Economic and monetary union should be pursued concurrently. In view of growing economic integration and the interdependance of Community members a passive "wait-and-see" attitude towards monetary union might jeopardise the benefits of economic convergence already set in train.

The Association for the Monetary Union of Europe would like the European Council meeting to be held in Madrid next June to address three main questions:

1) Will monetary stability be the objective of all Community member countries from now on ?

Along with the freedom of capital movements scheduled for implementation by June 1990, a decision by all the 12 EEC member states to be full members of the E.M.S would enable businesses to embark on investment strategies with a Community wide dimension. The EEC would cease to be divided into separate monetary zones and there would be substantial savings to business from being able to transact all EC business in the same currency.

Companies might then be able to obtain the greatest possible benefit from economies of scale inherent in the single market i.e. lower costs, increase productivity, reduction of prices to consumers, and therefore improving Europe's competitiveness with the rest of the world and increasing the opportunities for employment.

Disagree

Agree

Hence it is essential for all countries whose currencies are used in the composition of the Ecu to pledge to gradually accept the same disciplines. It is equally important to make a swift decision on the new composition of the Ecu, taking full account of the economic weight of the countries directly concerned.

2) Will the Ecu be Europe's currency ?

The "Report on Economic and Monetary Union" is too timid on this point. The fact is that **a formal decision to develop the Ecu so that it gradually replaces the national currencies in transactions between member countries would allow considerable savings.** It would lead to a substantial reduction in costs connected with the multiplicity of currencies used in trading goods and services either in imports and exports, or, in the management of company financial, accounting and commercial functions.

European citizens, who increasingly travel , would benefit directly from removing the cost of changing currencies, which will seem to them to be a kind of modern toll once the restrictions on exchange controls have disappeared from the internal borders.

Use of a common currency would also improve financial reporting and statistics and lead to a better informed market place.

Finally, **standardization of industrial products and the adoption of the metric system were the initial stages in a overall attempt to simplify the transaction of business. This must now be continued at a monetary level.**

3) If all member states agree with the objective, why not make progress and negotiate as swiftly as possible ?

By adopting the Single Act, the European Council unanimously confirmed the objective of gradual implementation of economic and monetary union. Similarly, it entrusted the committee headed by Mr. Jacques Delors with the task of "studying and proposing the concrete stages that should lead to gradual realization of economic and monetary union".

A formal decision by the European Council for a programme of economic and monetary union would allow gradual construction of the institutional mechanisms which would give the Community the ability to speak with a single voice in major international negotiations, to counter speculative currency movements, and to contribute to bringing about a healthier world economy.

Absence of substancial progress would help maintain the wait-and-see attitude that is restraining Community dynamics. It would encourage currency intervention as an aid to national competitiveness.

Hence there should be no delay in starting a debate that should lead to a clear and precise commitment on the part of member states in monetary affairs.

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3.25.1

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25 January 1989

PLEASE NOTE EMBARGO

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WHAT SORT OF EUROPEAN FINANCIAL AREA?

Speaking today at the Royal Institute of International Affairs, the **Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP,** set out the UK's approach to the financial and monetary dimension of European integration. The text of his speech is attached. The main points are:-

The Single Market

"The Single Market offers an historic opportunity for Europe and thus for Britain ... it is a decisive step towards a more liberal Europe ... It is about freedom of movement of goods, for services and for capital ... ending of protective barriers ... exposing Europe to competition."

..."there are others in Europe [for whom] this liberal, free market vision of 1992 is not altogether to their taste. So they are trying to claw back lost ground, substituting ... supra national regulation ... [or] seeking to make [the Community] an exclusive club. In this critical struggle over the future of Europe, there is no doubt where Britain stands."

"It would be the height of folly for Europe to dismantle internal trade barriers only to erect new ones against the rest of the world."

[Mutual recognition of different national standards within Europe] "is a completely logical extension of consumer sovereignty, and a vital ingredient of the Single Market. It is the true market approach, exposing regulation itself to competition, with the result that, over time, countries will be obliged to concentrate on what really matters, not on preserving inefficient industries or protecting vested interests."

Tax Approximation

"Enforced tax approximation is in no way a necessary feature of the Single Market....It is widely recognised as being politically impossible at least so far as excise duties on alcohol and tobacco are concerned."

"I have therefore put forward, on behalf of the United Kingdom, a market based approach [which] does not attempt to impose harmonised tax rates but instead allows market forces to produce the incentive for such closer convergence as is desirable. At the same time, the UK proposals envisage an early and substantial reduction in border formalities for commercial traffic within the EC."

"For individual travellers, I proposed that we should make large and progressive increases in the "tax paid" allowances on goods brought back from other Member States, with the eventual aim of having no limit at all, except probably for alcohol and tobacco."

"The present limit is some £250. I believe that a realistic first step - which should be taken as soon as possible - would be to quadruple that limit, so that £1,000 of tax paid goods could be imported from another Community country without any need to make a Customs declaration at all."

"The harmonisation of taxes on savings is clearly not a requirement of the single market."

Economic and Monetary Union

"It is clear that Economic and Monetary Union implies nothing less than European Government - albeit a federal one - and political union: the United States of Europe. That is simply not on the agenda now, nor will it be for the foreseeable future."

The Chancellor noted that M.Delors said last week that the European Council would be presented with a plan for establishing economic and monetary union involving amendments to the Treaty of Rome. He commented "any attempt to persuade the nations of the European Community to accept this as a prescription would be deeply divisive and damaging. Certainly, neither the British Government nor the British Parliament is prepared to accept the further Treaty amendments which the President of the Commission evidently envisages".

"We must set our sights clearly on the important and practical steps that are needed to implement the Single Market by 1992. In that context, EMU is essentially a damaging diversion. We must recognise it as such, and press ahead resolutely with removing barriers to the free movement of people, goods, services and capital - the true goal of the Single Market - for the benefit of the peoples of a freer Europe."

"Thus it is that the Single Market offers an historic opportunity. But if Europe takes the other road, of red tape, bureaucracy, supranational intervention and protectionism, Euro-sclerosis would be more than mere talk; it would be a reality. And the dream of 1992 would have become nightmare. We must not allow that to happen.

4/89

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CHANCELLOR OF THE EXCHEQUER'S SPEECH AT THE ROYAL INSTITUTE FOR INTERNATIONAL AFFAIRS, CHATHAM HOUSE, 25 JANUARY 1989

WHAT SORT OF EUROPEAN FINANCIAL AREA?

I am most grateful to the Royal Institute for International Affairs for arranging this meeting. It is the lot of Finance Ministers that their speeches on international topics tend to be made overseas at the various international meetings which are a regular part of the calendar. So it is a particular pleasure to be giving this speech here tonight, on home territory.

My subject tonight is "what sort of European Financial Area?" - a new bit of jargon dreamt up by the European Commission in 1987 when it put forward its proposal for the complete freedom of capital movements within the Community, and which has come to encompass the financial and monetary dimension of European integration.

That is the core of what I want to discuss this evening. But it cannot be divorced from the wider issues of the Single Market and 1992.

The Single Market offers an historic opportunity for Europe and thus for Britain. It was implicit in the original Treaty of Rome that we should move towards unimpeded freedom of movement for goods, for services, for people, and for capital. But after some important early steps, primarily on the free movement of goods, progress stalled, or at best advanced only at a snail's pace. As President Delors noted last week, it took eighteen years for the Community to adopt a directive on the mutual recognition of architects' qualifications, and sixteen years for a similar one on pharmacists.

The fresh impetus given by the Single European Act, with its objective of removing all barriers by 1992, was long overdue. It was a development which Britain played a major part in creating. And it is one which has now caught the attention of business and of the public more generally. We are at long last on the march towards achieving the prime objective of the original Treaty.

The Single Market is a radical step. And it is a decisive step towards a more liberal Europe, one based on freeing up markets. It is about <u>freedom</u> of movement for goods, for services and for capital. It is about the ending of protective barriers, whether direct or indirect. It is about exposing Europe to competition, in the belief that greater competition is the spur to greater efficiency, and the key to economic success.

As the Prime Minister put it in her Bruges speech in September:

> "The aim of a Europe open for enterprise is the moving force behind the creation of the Single European Market by 1992 ... It means action to <u>free</u> markets, to <u>widen</u> choice and to produce greater economic convergence through <u>reduced</u> government intervention."

But there are others in Europe who have only now begun to realise - rather late in the day, after they have signed up to it - that this liberal, free-market vision of 1992 is not altogether to their taste. So they are trying to claw back lost ground, substituting a concept of 1992 based on supranational regulation, not so much one where barriers are broken down, but one where restrictions and controls are levelled up.

And there are yet others who, even if they feel obliged to accept that a liberal regime within the Community is now inescapable, are seeking to make it an exclusive club; one where members enjoy the benefits but the rest of the world is allowed across the doorstep only under strict supervision; one where the Single Market is defined not by its commitment to liberalisation, but by the barriers erected around it.

The contrast between the two rival visions of Europe has become very clear. On the one hand an over-regulated, bureaucratic, protectionist Europe, where uniform standards are enforced by new directives and new regulations from Brussels, where outsiders are excluded, and where competition is seen as a threat, rather than a challenge to greater efficiency; a Europe in which "regulate and protect" might be the motto. On the other hand, there is the vision of a deregulated, free market, open Europe, one where competition is seen as the key to improved economic performance; one driven by consumer choice, by transferring sovereignty not to Brussels but to the people.

In this critical struggle over the future of Europe, there is no doubt where Britain stands.

We have consistently fought to break down barriers, to reduce protection, and to free up trade. Not just within Europe: it would be the height of folly for Europe to dismantle internal trade barriers only to erect new ones against the rest of the world. Fortress Europe would increasingly be isolated from the opportunities which the globalisation of the world economy is bringing. Just as it makes no sense for Britain to isolate herself from what it happening in Europe, so it makes no sense for Europe to seek to isolate herself from the rest of the world.

I was encouraged to read that President Delors, in his speech to the European Parliament last week, said

> "Economically speaking, it would be absurd for the largest exporter in the world to close its frontiers to foreign products ... Europe would be the first victim of mounting protectionism, particularly since the Community is more dependent than its partners on international trade."

I wholly endorse that view. But actions as well as words are needed.

Another area where the rival visions of the Community are seen is the so-called "social dimension" of 1992. Having spent getting on for ten years gradually removing the dead hand of corporatism in Britain, I have to say that we have no intention of accepting its reintroduction at the European level. The attempt to level up all sorts of so-called "worker protection" provisions is a sure way not of protecting jobs but of destroying them, as employers become burdened with unnecessary regulations and increased costs. And grandiose attempts to reduce regional disparities by ever-greater resource transfers is likely to be no more successful at the Community level than it has been within individual countries. Subsidising industries and subsidising regions destroys their will to compete, and thus their ability to compete.

Nor are we prepared to see protectionism introduced under the guise of "reciprocity". Europe certainly needs to drive a hard bargain with the rest of the world: and it is an important objective to persuade other countries to open <u>their</u> markets. But, all too often, proposals for "reciprocity" go far beyond this legitimate aim, and seek either to impose constraints on bilateral trade - which is protectionism at its worst - or to make such unreasonable and doctrinaire demands for the terms of Community access to other markets that the predictable result is no access at all. Looked at from another angle, the effect of creating major obstacles to foreign firms who want to set up in the Community is all too likely to be that business is simply diverted elsewhere.

In short, the United Kingdom is committed to breaking down barriers, so that the Single Market really is a free trade area. And as the barriers come down, it is up to business and industry to meet the challenge this presents. If they are not capable of seizing the opportunities within a deregulated Europe, they will have little hope of competing successfully in world markets.

All the signs are that most of British industry is now well equipped to take on these challenges, with the record growth in profitability, productivity and investment over recent years all serving to strengthen industry's position very considerably. Forward-looking firms are now increasingly planning their operations, and their investments, with 1992 in mind.

But there is much still to do before we complete the Single Market. Far too many barriers are still standing. The Cecchini Report found that eliminating multiple national standards was much the most significant step which was needed to secure the full benefits of the Single Market. And a glance through the sixteen volumes and nearly 6,000 pages of research material on "The Cost of Non-Europe" reveals in graphic detail how innocent-sounding national requirements for testing or certification can impose very substantial costs on firm in one Community country seeking to export to another.

To take just one small example - and there are many others - the French regulations for wood-working machines require the testing, in France, of every variant of every type of machine a manufacturer produces, even if the machine is fully approved in another Member State. This inevitably adds greatly to the costs, and to the time required - it takes six months to a year to get approval in France compared to two to three months in other countries.

There is a vital principle here, one that lies at the heart of the Single Market. Past attempts to agree common standards, common regulations, common rules for authorising businesses have almost always got bogged down in a morass of technical detail. Different countries have different approaches and do not see why they should change their ways. The breakthrough of the Single Market was the acceptance of the principle that there is no reason why these national differences cannot continue, applied to a country's own products and businesses, <u>provided</u> each country accepts that firms and products approved in one country should be free to compete throughout the Community and that people should be free to purchase goods and services from anywhere within the Community.

This is a completely logical extension of consumer sovereignty, and a vital ingredient of the Single Market. It is the true market approach, exposing regulation itself to competition, with the result that, over time, countries will be obliged to concentrate on what really matters, not on preserving inefficient industries or protecting vested interests.

In so far as there are areas - and I believe there are very few - where a convincing case can be made for a common Community regulation, the important and related principle is that this must never be, as so many instinctively assume, harmonisation on the average of existing national regulations, but harmonisation on the best - which means on the minimum the situation requires. Individual countries can go further than this if they wish to, on the wholly non-discriminatory basis I have already described; but they have to accept the economic consequences.

Needless to say, in common with all other Community countries, the UK is not without its own regulations and barriers which appear to impose substantial costs, and the Government has for some time been subjecting them to scrutiny. But I think it is fair to say that, in general, the protectionist impact of technical standards is considerably more extensive in other countries than it is here.

And as well as trying to remove unnecessary barriers of our own, the United Kingdom has been in the forefront in promoting practical steps to free up trade within the Community. In the financial area, for example, it was we who took the lead in pressing for freedom of capital movements. We have long been urging the need for the liberalisation of trade in insurance, where significant progress has been made over the past year. And we have been active in negotiating for a true internal market in banking and investment services, where important draft Directives are now before the Council.

The liberalisation of trade in financial services is of particular importance, not just to Britain, the home of Europe's leading financial centre, but to Europe as a whole. For, like it or not, financial services are likely to remain for the foreseeable future one of the fastest growing industries in the world. And of all businesses, it is the most mobile. Europe cannot afford not to provide it with an environment in which it can flourish as well - if not better - than anywhere else in the world.

Public procurement, too, is another key area where opening up the market to competition within Europe can bring enormous benefits. For public purchases amount to some 15 per cent of the Community's GDP, and the Single Market would fail if they were to be excluded from the breaking down of barriers to competition.

We also need to ensure fair competition between companies in the field of takeovers and mergers. The UK has a tradition of an open and liberal regime. But many other countries maintain barriers, usually of an indirect or covert nature, which have the effect of preventing capital markets from operating efficiently. We must look for a level playing field. But we must equally avoid the trap, here as elsewhere, of building up new barriers under the guise of harmonisation, or of creating new centralised powers. A so-called Community "industrial policy" would be just as misconceived as past national "industrial policies" have been.

There is much hard and detailed work to be done in getting agreement on progress in these and in other crucial areas. There are few more politically difficult endeavours than the removal of discriminatory national barriers. And the temptation is always present to concentrate, not on this difficult, vital but often humdrum task, but on some headline-catching grand design instead.

Tax approximation

One proposal which has certainly grabbed the headlines has been that on indirect tax approximation - and in particular the harmonisation of VAT and excise duty rates within narrow bands. As is well known, on the basis of the current proposals, this would mean the enforced abandonment of the United Kingdom's zero rates on such items as food and children's clothing. We have already made our objections to these proposals perfectly clear. But what is equally clear from the Commission's own studies is that enforced tax approximation is in no way a necessary feature of the Single Market. The Cecchini Report itself estimates that multiple technical standards and regulations are something like seven times as costly as all border controls put together; and the UK experience is that the costs of dealing with differing indirect tax rates in turn account for only a small proportion of the total costs of border controls.

Moreover, indirect tax approximation is not an end in itself, but is seen by its proponents as an intermediate objective towards the declared goal of removing fiscal frontiers. It follows that if we can secure the final objective without going through the intermediate step of tax approximation, there is clearly little point in wasting any more time on that, not least since it is now widely recognised as being politically impossible at least so far as excise duties on alcohol and tobacco are concerned. Within the spirit of the Single Market, I have therefore put forward, on behalf of the United Kingdom, a market-based approach to dealing with fiscal frontiers. This approach does not attempt to impose harmonised tax rates, but instead allows market forces to produce the incentive for such closer convergence as is desirable.

At the same time, the UK proposals envisage an early and substantial reduction in border formalities for commercial traffic within the EC, with controls increasingly taking place inland at traders' premises as part of the normal system of VAT and excise control, rather than at the frontier. Moreover, making greater use of the domestic VAT control systems would be far simpler than the bureaucratic proposals by the Commission for a "Clearing House" to account for VAT owing on goods exported from one Member State to another.

The new Commission is discussing with Member States how these issues might best be taken forward. But in the meantime the British Customs and Excise will in any case be taking steps later this year to speed up the processing of Community freight traffic through our ports by their new "fast lane" proposals.

For individual travellers, I proposed that we should make large and progressive increases in the "tax paid" allowances on goods brought back from other Member States, with the eventual aim of having no limit at all, except probably for alcohol and tobacco.

The present limit is some £250. I believe that a realistic first step - which should be taken as soon as possible - would be to quadruple that limit, so that £1000 of tax paid goods could be imported from another Community country without any need to make a Customs declaration at all. That would be a major step towards reducing Customs formalities for individuals, thus breaking down fiscal frontiers and enlarging individual freedom.

But it is not only in the field of indirect taxes where there is pressure for harmful and unnecessary harmonisation. Next month, the Commission is due to bring forward proposals aimed at reducing tax avoidance following the abolition of exchange controls, and these seem likely to include some form of enforced withholding tax on the income from savings.

The harmonisation of taxes on savings is clearly not a requirement of the Single Market - indeed not even its most ardent proponents pretend that it is. Instead, it is advocated by those who argue that the abolition of exchange controls could increase the scope for tax avoidance and even evasion, as savings are transferred from one Community country to another. In other words, having accepted the principle of freedom of capital movements, they are seeking to escape from its consequences.

In fact, fears about tax avoidance are greatly exaggerated. There was similar concern expressed about the risks in the UK when we abolished exchange controls in 1979. But our experience since then gives absolutely no reason to suppose that those concerns had any foundation. And only this month socialist Sweden committed itself to ending exchange controls, without seeing any need to try to negotiate special new arrangements with other countries to counter avoidance.

Freedom of capital movements was something which the UK had taken the lead in urging. It was finally achieved in June last year. It was a remarkable and historic step. All European Community member states are now committed to the complete elimination of exchange controls, most of them by the middle of next year. This is something which would have been unthinkable ten years ago. It has, quite rightly, been recognised that freedom of capital movements _is_ an essential element of the Single Market, and that, in any case, exchange controls were becoming increasingly irrelevant, if not counterproductive, in today's global markets.

Nor can I accept the case for the enforced harmonisation of business taxes. Here again, market forces can be allowed to do the job. The House of Lords Select Committee put the point well in its report a couple of months ago:

> "There seems little need for the Community to force the harmonisation of company taxation. ... provided tax rates remain broadly in line, [we] do not believe that there will be significant misallocation of resources within the Community."

Moreover, both in the taxation of savings and in company taxation, we must be aware of the wider world context. There is no gain at all to the Community if the effect of introducing harmonised restrictions within the Community is simply to divert business or savings outside the Community altogether. And in today's global markets that is all too likely to be the result.

Where enforced harmonisation is absolutely necessary, the objective must, to repeat, be to harmonise on the best, which invariably means the _minimum_. Where it is not necessary, which is normally the case, the answer must be to leave it to market forces to produce a distribution of business and of tax rates that satisfies the different objectives of different countries, who will inevitably have different priorities, not least as to the level of public expenditure - which at the end of the day must match the level of taxation. Harmonising on the mean - let alone harmonising on the most restrictive - will satisfy no-one except the bureaucrats and will serve only to turn Europe into a financial backwater, at great cost to its people.

EMU

A potentially much more significant diversion from the important but difficult work still needed if we are to complete the Single Market by 1992, is the pressure from some quarters for a dramatic leap forward beyond the Single Market towards so-called Economic and Monetary Union or EMU.

After the turmoils of the early and mid-1970s, the Community made an important step towards greater monetary co-operation with the setting up of the European Monetary System in 1979. Since then, the UK has consistently promoted practical steps to increase monetary co-operation further - both within the Community and more widely in the G7.

We have, for example, been a strong advocate of greater use of the ecu. Our issue of Ecu Treasury Bills , begun last autumn, has provided the short-term, high quality instrument which the market needed to underpin its liquidity. And we have been urging others to join us in making greater use of the ecu in foreign exchange reserves, and in intervention.

We also see a wider role for cross-holdings of individual Community currencies. A diversification of reserve holdings provides greater flexibility than holding only dollars.

And, most important of all for developing greater monetary co-operation and paving the way for the Single Market, the UK took the lead, as I have said, in pressing for the adoption of the directive on the freedom of capital movements.

The UK has not yet, of course, joined the exchange rate mechanism of the EMS. As the Prime Minister has pointed out on a number of occasions we will join the exchange rate mechanism when we believe that the time is appropriate. Subject to the overriding need to bear down on inflation, we fully accept the advantages of reducing currency fluctuations, though sterling's status as an internationally held currency inevitably makes that more difficult than is the case with the other currencies that are linked to the Deutschemark in the EMS.

Clearly, some of the problems over sterling's joining the ERM have diminished over time: for example, it is no longer seen as a so-called petro-currency. And, as 1992 approaches and the proportion of our trade with other EC countries continues its long-term increase, it is clear that exchange rates against other European countries will become increasingly important.

But the difference between full membership of the EMS and Economic and Monetary Union could not be more fundamental.

The EMS is an agreement between independent sovereign states whose economic policies remain distinct and different. By close co-operation, they can achieve greater stability of exchange rates, and - as we have seen - reinforce their efforts to bring down inflation.

Economic and monetary union, by contrast, is incompatible with independent sovereign states with control over their own fiscal and monetary policies.

It would be impossible, for example, to have irrevocably fixed exchange rates while individual countries retained independent monetary policies. Quite apart from the theoretical problems, it is clear that such a system could never have the credibility necessary to persuade the market that there was no risk of realignment. Thus EMU inevitably implies a single European currency, with monetary decisions - the setting of monetary targets and of short-term interest rates - taken not by national Governments and/or central banks, but by a European Central Bank.

Nor would individual countries be able to retain responsibility for fiscal policy. With a single European monetary policy there would need to be central control over the size of budget deficits and, particularly, over their financing. New European institutions would be required, to determine overall Community fiscal policy and agree the distribution of deficits between individual Member States.

These are not technical issues. The setting up of a European Central Bank or a new European institution to determine Community fiscal policies go to the very heart of nationhood. What organisation would really be the government? It is clear that Economic and Monetary Union implies nothing less than European Government - albeit a federal one - and political union: the United States of Europe. That is simply not on the agenda now, now will it be for the foreseeable future.

Although some have argued that the gold standard provides an example of monetary union operated by independent states, it was in fact very far from monetary union. Under the gold standard, the cooperation was informal and not institutionalised; and although countries could see advantages to them in maintaining their parity against gold, they were free to change if it seemed in their national interest to do so. The gold standard acted as an important and beneficial discipline, but allowed countries to pursue separate and independent economic policies within that framework.

It is also instructive to consider the evolution of Germany in the 19th century. The Customs Union or Zollverein which was formed in 1834 neither required, nor in itself led to, monetary union. It was only 40 years later, after Bismarck had imposed political union under Prussian hegemony, that monetary union and a common currency followed.

As the Prime Minister said in Bruges:

> "My first guiding principle is this: active cooperation between independent sovereign states is the best way to build a successful European Community. To try to suppress nationhood and concentrate power at the centre of a European conglomerate would be highly damaging and would jeopardise the objectives we seek to achieve."

This is by no means a narrow view held only by the British Government. Within the UK, for example, the House of Lords Select Committee said

> "The Committee do not believe it is helpful to say that monetary union will or will not come by a certain date. Whether or not the individual political leaders of Europe consider a common currency and a European central bank to be one of the Community's ultimate goals, they are not ready to take such a step at this time. If political rhetoric focuses on distant objectives and emotive ideology, needless divisions tend to arise."

Again, from a difficult perspective, the recent annual report of the German Council of Experts on Overall Economic Development - the so-called "five wise men" - conceded the essential point:

> "Hasty institutional agreements on monetary union would greatly damage the process of unification by creating the illusion that the absence of the wish for political unification can be overcome by fast progress on monetary policy. Inevitable disappointments would ensue, causing delay if not regression in the integration process: only the knowledge that monetary union is not possible without political union can prevent such a development."

There are some who might argue that the goal of monetary union is of such importance that we should impose whatever political union is necessary to achieve it. This is not only unacceptable to the

British people: it is wholly counter to the realities of national identity. You have only to look at the current problems of the Soviet Union to see a reminder of how strong these forces are.

The European Council, in Hanover last year, nonetheless decided to set up a committee to examine possible steps towards economic and monetary union. The Committee is chaired by Jacques Delors, and made up largely of Central Bank Governors, in a personal capacity. It is due to complete its work in time for the Council of Finance Ministers - ECOFIN - to consider the results before the next European Council in Madrid in June.

M. Delors referred to the work of this group in his statement to the European Parliament last week. He said that economic and monetary union could be achieved only by a further institutional change, to set up a European central banking system and a framework for enhancing the consistency and effectiveness of national economic policies. The European Council would be presented with a plan for the establishment of economic and monetary union, and progress towards that

> "would be considerably facilitated by an appropriate institutional framework. If this is the case, it will be necessary, as in 1985, to open the way for another inter-Governmental conference to prepare institutional provisions designed, like those of the Single Act, to amend the Treaty of Rome".

As an expression of personal opinion, fair enough. But any attempt to persuade the nations of the European Community to accept this as a prescription would be deeply divisive and damaging. Certainly, neither the British Government nor the British Parliament is prepared to accept the further Treaty amendment which the President of the Commission evidently envisages.

Indeed, the overwhelming question one is left with is this: how can it be, little more than three years after the Treaty amendment achieved by the Single European Act, with so much still to do to achieve the goal of the Single Market by 1992, how can it be that this great boulder should so carelessly be thrown into the pool?

Even if complete economic and monetary union were desirable, would it not be more rational to say: let us devote all our energies and resources to the completion of the Single Market, if humanly possible by 1992, and only then, after it has been in place for a sufficient time to demonstrate the benefits it confers, let us consider whether we wish to take the steps necessary to proceed towards EMU.

But that is not what is happening.

It is difficult to escape the conclusion that this divisive and intensely difficult new issue has been propelled into the forefront of European debate at this time either out of culpable carelessness, or as a smokescreen to obscure a lack of sufficient progress towards the Single Market - or, worse, as a means of running away from taking the practical but difficult steps the Single Market requires, running away from the challenge of freedom.

For it is an observable fact that those nations that are most vocal about their support for EMU now, tend to be those that are most assiduous in preserving barriers to free trade within the Community.

The experience of the United Kingdom in the '80s has demonstrated decisively that it is supply side reforms that are the key to better economic performance. But reforming the supply side is often neither easy nor very newsworthy, and there are always those who seek short cuts and instant answers. This Government has succeeded to the extent that it has because it has consistently ignored those calls, and been prepared to submit every aspect of the British economy to rigorous and radical scrutiny to see whether the rules and restrictions built up over generations still serve any useful purpose or, as is so often the case, merely stifle enterprise.

The same lessons apply to the European Community too. The Single Market is a great prize, and one whose significance is being increasingly recognised right around the world. But to cross the final hurdles to 1992 still requires a great deal of hard, detailed work, to hack away at the remaining barriers and clear the ground for wider competition, more efficient industry and greater consumer choice. And uncomfortable vested interests in each and every Member State will be challenged and disturbed.

It is inevitable that there are those who tire quickly of this, and flutter towards the flame of Economic and Monetary Union, or other great ideas. And others who have never much liked hacking away at regulations and bureaucracy anyway, and are only too keen to escape into dreams of EMU instead.

We must have none of that. We must set our sights clearly on the important and practical steps that are needed to implement the Single Market by 1992. In that context, EMU is essentially a damaging diversion. We must recognise it as such, and press ahead resolutely with removing barriers to the free movement of people, goods, services and capital - the true goal of the Single Market - for the benefit of the peoples of a freer Europe.

From time to time we hear talk of the dangers of Euro-sclerosis. It reminds one of the British disease. Of course the Europe of 1989 is in much better shape than the Britain of 1979. But the sense of falling behind, the dangers of taking an "easy" interventionist, protectionist, state-subsidy route out of the problems posed by heightened international competition, are not so very different. And many of the cures we took in Britain ten years ago are relevant to the Europe of today. Governments must try to do less. By deregulating and allowing markets to work, Europe can compete successfully in the 21st century. And the lessons of a decade ago are equally relevant: individuals and businesses, not bureaucrats, create jobs and prosperity.

Thus it is that the Single Market offers an historic opportunity. But if Europe takes the other road, of red tape, bureaucracy, supranational intervention and protectionism, Euro-sclerosis would be more than mere talk; it would be a reality. And the dream of 1992 would have become a nightmare. We must not allow that to happen.

ASSOCIATION FOR THE MONETARY UNION OF EUROPE

LE DÉLÉGUÉ GÉNÉRAL

Mr. Nigel LAWSON
Minister of Finance
H.M. Treasury
Parliament Street
SWIP 3AG LONDON
UNITED KINGDOM

CH/EXCHEQUER
REC. 24 MAY 1989
ACTION Mr PERETZ
COPIES TO PS/EST, PS/PMG
SIR P MIDDLETON
SIR T BURNS, MR WICKS,
MR SCHOLAR,
MR H P EVANS
MR ODLING-SMEE
MR RILEY, MRS M BROWN
MR GIEVE, MISS O'MARA,
MR CHAPLIN, MR TURIE

19th May 1989

Dear Sir,

The Association for the Monetary Union of Europe would kindly like to bring to your attention the comments made by our Board of Directors on the economic and monetary report recently submitted by the DELORS Committee.

Our Association, established at the end of 1987, now comprises some 170 firms employing approximately three and a half million people and having a total turnover around 300 billion ecus.

We hope that the enclosed comments will be helpful for your preparation of the forthcoming meeting of the European Council in Madrid.

Yours faithfully,

Bertrand de MAIGRET

Encl.

ASSOCIATION POUR L'UNION MONETAIRE DE L'EUROPE
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ASSOCIATION FOR THE MONETARY UNION OF EUROPE

COMMENTS ON THE ECONOMIC AND MONETARY REPORT SUBMITTED BY THE DELORS COMMITTEE

The Board of Directors of the Association for the Monetary Union of Europe met in London on 3 May 1989, chaired by Mr. Cornelis van der Klugt (PHILIPS Chairman), with the participation of Mr. Giovanni Agnelli (FIAT Chairman), Mr. François-Xavier Ortoli Chairman of TOTAL-CFP), Mr. Brian Garraway (Deputy Chairman of B.A.T Industries), Mr. Solvay (Chairman of the Board of Directors of SOLVAY & Cie.), Mr. Papalexopoulos (Vice -President of TITAN), Mr. Mentré (Chairman of CREDIT NATIONAL), Mr. Plachetka (Office of Chancellor H. SCHMIDT), Mr. Merkle represented by Dr. Ahnefeld (Robert BOSCH), Mr. Pininfarina represented by Mr. Mondello (CONFINDUSTRIA), Mr. Tesch represented by Mr. Ahlborn (ARBED), and Mr. MARCH represented by Mr. Cuervo (MARCH Group).
After studying the report recently issued by the committee headed by Mr. Jacques Delors, the Board adopted the following declaration:

The Association for the Monetary Union of Europe pays tribute to the quality of the "Report on Economic and Monetary Union in the European Community" and which reflects to a large extent the proposals which the Association itself submitted to the European Parliament, and to the President of the European Communities Commission, in Strasbourg in January 1989.

It **notes that the report was unanimous, having been signed by the central bank governors and the other experts working under the chairmanship of Mr. Jacques Delors.** This unanimity from figures of such high standing in the economic and monetary sphere constitutes powerful encouragement for moving towards economic and monetary union. It is a natural progression from observation of the results derived from ten years experience of the European Monetary System (E.M.S.).

The last decade has demonstrated that the E.M.S has contributed to economic stability and has not transferred the volatility of exchange rates to interest rates. On the contrary, during that period, the countries fully involved (Belgium, Denmark, France, Ireland, Italy, Luxemburg, Netherlands, West Germany) have reduced interest-rate fluctuations. This stability has lowered business costs, facilitated companies' investment strategies, and contributed to more uniform competitive conditions between member countries.

Over the same period, Sterling which is not a member of the E.M.S exchange rate mechanism, has suffered from some very sharp fluctuations against the currencies of those eight countries, both in value and in interest rates.

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While contributing to the reduction of inflation rates, the E.M.S. has not had the recessionary effect that some people predicted.

Economic and monetary union should be pursued concurrently. In view of growing economic integration and the interdependance of Community members a passive "wait-and-see" attitude towards monetary union might jeopardise the benefits of economic convergence already set in train.

The Association for the Monetary Union of Europe would like the European Council meeting to be held in Madrid next June to address three main questions:

1) Will monetary stability be the objective of all Community member countries from now on ?

Along with the freedom of capital movements scheduled for implementation by June 1990, a decision by all the 12 EEC member states to be full members of the E.M.S would enable businesses to embark on investment strategies with a Community wide dimension. The EEC would cease to be divided into separate monetary zones and there would be substantial savings to business from being able to transact all EC business in the same currency.

Companies might then be able to obtain the greatest possible benefit from economies of scale inherent in the single market i.e. lower costs, increase productivity, reduction of prices to consumers, and therefore improving Europe's competitiveness with the rest of the world and increasing the opportunities for employment.

Hence it is essential for all countries whose currencies are used in the composition of the Ecu to pledge to gradually accept the same disciplines. It is equally important to make a swift decision on the new composition of the Ecu, taking full account of the economic weight of the countries directly concerned.

2) Will the Ecu be Europe's currency ?

The "Report on Economic and Monetary Union" is too timid on this point. The fact is that **a formal decision to develop the Ecu so that it gradually replaces the national currencies in transactions between member countries would allow considerable savings.** It would lead to a substantial reduction in costs connected with the multiplicity of currencies used in trading goods and services either in imports and exports, or, in the management of company financial, accounting and commercial functions.

European citizens, who increasingly travel , would benefit directly from removing the cost of changing currencies, which will seem to them to be a kind of modern toll once the restrictions on exchange controls have disappeared from the internal borders.

Use of a common currency would also improve financial reporting and statistics and lead to a better informed market place.

Finally, **standardization of industrial products and the adoption of the metric system were the initial stages in a overall attempt to simplify the transaction of business. This must now be continued at a monetary level.**

3) If all member states agree with the objective, why not make progress and negotiate as swiftly as possible ?

By adopting the Single Act, the European Council unanimously confirmed the objective of gradual implementation of economic and monetary union. Similarly, it entrusted the committee headed by Mr. Jacques Delors with the task of "studying and proposing the concrete stages that should lead to gradual realization of economic and monetary union".

A formal decision by the European Council for a programme of economic and monetary union would allow gradual construction of the institutional mechanisms which would give the Community the ability to speak with a single voice in major international negotiations, to counter speculative currency movements, and to contribute to bringing about a healthier world economy.

Absence of substancial progress would help maintain the wait-and-see attitude that is restraining Community dynamics. It would encourage currency intervention as an aid to national competitiveness.

Hence there should be no delay in starting a debate that should lead to a clear and precise commitment on the part of member states in monetary affairs.

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Points to make

On **Stage 1:** See Delors paras 51 & 52

i) agree that priority should be given over the next few months for working up revised texts on the 1964 and 1974 Council Decisions;

Single text - based on 1964

ii) important that these revised texts should (a) reflect up-to-date economic thinking (goodbye to fine tuning and all that), (b) include more emphasis on the medium-term and structural policies, (c) be procedurally flexible and not overload Brussels Committee structure (nor, indeed, Finance Ministers and Central Bank Governors);

iii) Madrid agreement to proceed with Stage 1 requires completion of single market in financial services, and Community wide capital liberalisation:

- reasonable progress being made in some areas: welcome agreement on 2nd Banking Directive. But need to move faster in others, notably life assurance and investment services;

- also important to ensure that unnecessary restrictions on market access are lifted. May take form of excessive regulation of what financial services can be offered in particular markets and the way they are to be sold. Can amount to hidden barriers to trade;

- full capital liberalisation due by 1 July 1990 for eight major EC countries. Essential for single market. Must include: removal of all remaining controls by Italy and France; rapid progress by remaining four member states (Ireland, Greece, Spain, Portugal) towards removal of controls; [USE WITH CARE: careful scrutiny of excessively restrictive regulatory obstacles eg controls on overseas investment by savings institutions].

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Preparatory work
involves discussion
issues

POINTS TO MAKE

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On **Stages 2 and 3:**

i) resist suggestions that there should be an early IGC (stress Madrid conclusions that such a conference "would be pr~~o~~eceeded by full and adequate preparation");

ii) such preparatory work needs to be comprehensive and thorough: the Delors Report left much important ground uncovered, and key questions unanswered. UK intends to play a full part in this work;

iii) key questions which need to be addressed include the following (NB this is <u>not</u> a comprehensive list):

- are there any alternative models of EMU which should be considered, in particular: (a) other possible forms of monetary union (eg the parallel currency approach, competing currencies, an extended EMS and a new gold standard); (b) the type of Community Central Bank required eg full-blown ESCB or some reduced-form arrangement;

- how should we define economic union (the E in EMU) - not spelled out in the Report;

- the role of fiscal policy in an EMU: how much or little fiscal coordination would be needed;

- the implications of an EMU for other aspects of Community business, eg single market policy, regional policy, the flexibility of prices and wage rates within a competitive internal market;

- questions of democratic accountability, not only of the proposed ESCB but of the other EC institutions which would have an enhanced role under an EMU;

iv) all these questions for discussion are without prejudice to the UK's stated position on the desirability of moving to Stages 2 and 3 in the foreseeable future, and on the timing of an IGC.

Background

1. The EMU discussion is billed as a follow-up to Madrid, but we do not expect any substantive discussion. The Presidency seem to expect the Commission to outline their timetable for bringing forward proposals, but there seems to be some confusion within the Commission about how rapidly these might appear, even on Stage 1 where early decisions on revised texts for the 1964 and 1974 Council Decisions are required to meet the 1 July 1990 deadline.

2. The Chancellor might like to use the occasion, however, to register the main lines of current UK thinking both on Stage 1 and on the preparatory work leading to an IGC.

BACKGROUND

CONSEIL ECOFIN

DOC. DE SEANCE N° 1

Bruxelles, le 10 juillet 1989

PROJET DE CONCLUSIONS DU CONSEIL

concernant la communication de la Commission sur la situation économique dans la Communauté

Le Conseil a procédé au deuxième examen de la situation économique dans la Communauté, conformément à l'article 3 de la décision "convergence" de 1974.

Le Conseil partage les grandes lignes de l'analyse faite par la Commission dans sa communication en date du 28 juin 1989. A la lumière des conclusions du Conseil Européen de Madrid, il a pris note avec intérêt du caractère plus explicite des prises de position de la Commission et espère que celui-ci conduira à une plus grande efficacité dans la coordination des politiques économiques.

Il est d'avis que les orientations de politique économique convenues dans le rapport économique annuel 1988/89 et confirmées lors de l'examen de la situation économique au mois de mars restent valables.

Toutefois, le maintien à moyen terme des résultats positifs atteints en matière de croissance, d'emploi et d'investissement exige, alors que l'environnement extérieur apparaît moins favorable,

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que tout soit mis en oeuvre pour combattre les anticipations inflationnistes et éviter qu'elles ne s'incorporent dans l'évolution des coûts salariaux. Il est également essentiel, dans la perspective du marché intérieur, que les efforts entrepris vers une plus grande convergence économique ne se relâchent pas et qu'ils s'intensifient dans le domaine des équilibres extérieurs et budgétaires.

lignes

Dans ce domaine de la politique budgétaire, le Conseil note qu'un consensus peut s'établir sur quelques ~~règles~~ de conduite à moyen terme : le financement non-monétaire des déficits publics, la stabilisation ou la réduction de la dette, la maîtrise de l'expansion des dépenses, la recherche d'une structure des dépenses et des recettes plus favorable aux conditions d'offre.

Le Conseil partage l'avis de la Commission selon lequel la mise en oeuvre de ces lignes de conduite implique dans l'immédiat une orientation rigoureuse des politiques budgétaires dans l'ensemble de la Communauté. Il est important, en particulier, que l'amélioration des conditions économiques soit mise à profit en Belgique, aux Pays-Bas, en Irlande et au Portugal pour poursuivre activement les efforts engagés vers la réduction des déséquilibres budgétaires et le niveau relatif de la dette publique. Une action résolue en ce sens doit être rapidement entreprise en Italie et en Grèce.

pso.vh/Simon/Tburns

UNCLASSIFIED

FROM: S D H SARGENT
DATE: 19 May 1989

SIR T BURNS
MR WICKS
MR LANKESTER
MR SCHOLAR
MR RIG ALLEN
MR PERETZ
MRS BROWN

J KERR (FCO)

THE EMS AND THE UK

I attach some seminar notes on the EMS which Sir Alan Walters has recently sent to Sir Peter Middleton.

S D H SARGENT
Private Secretary

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Table 22. Variability of Bilateral Nominal Exchange Rates Against Non-ERM Currencies, 1974–1985[1]

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Average 1974–78	Average 1979–85
Belgium	36.6	40.8	29.4	31.1	45.7	33.8	43.9	53.1	57.1	52.3	36.1	57.0	36.7	47.6
Denmark	32.6	33.6	25.5	30.6	39.0	30.3	38.8	53.7	45.9	47.3	34.0	55.9	32.3	43.7
France	34.1	34.5	47.8	27.0	45.9	35.6	44.4	60.7	57.6	65.1	39.7	61.8	37.8	52.1
Germany, Fed. Rep. of	34.3	35.1	30.0	32.6	46.4	39.3	45.9	48.1	33.1	38.6	36.3	53.5	35.7	[illegible]
Ireland	18.1	47.5	61.4	25.7	32.3	29.1	43.4	57.7	36.8	63.9	39.2	65.4	37.0	47.6
Italy	24.8	28.7	70.4	26.3	39.9	32.0	53.9	65.0	39.9	55.6	39.2	50.0	38.0	47.9
Netherlands	35.4	38.9	35.4	28.8	45.7	32.5	40.6	57.6	33.1	45.8	42.2	66.5	36.8	45.5
Average ERM[1]	**30.8**	**37.0**	**42.8**	**28.9**	**42.1**	**33.2**	**44.4**	**56.6**	**43.4**	**52.6**	**38.1**	**58.6**	36.3	46.7
Austria	44.0	38.0	33.4	35.3	46.9	49.9	45.5	51.5	35.3	43.1	40.7	62.5	39.5	46.5
Canada	12.9	16.7	17.0	34.1	36.1	18.3	18.3	17.0	24.6	7.3	23.5	26.8	23.4	19.4
Japan	33.3	22.1	22.1	59.5	96.7	68.3	64.7	48.5	54.5	18.4	33.6	84.8	46.7	53.3
Norway	30.5	40.2	30.7	34.4	42.4	29.9	30.0	42.9	61.1	22.7	42.3	51.7	35.6	40.1
Sweden	33.4	37.3	25.8	64.2	38.7	30.6	28.2	65.5	79.7	24.4	30.3	48.8	39.9	43.9
Switzerland	63.1	28.1	18.7	57.4	72.8	38.1	43.0	62.1	46.4	29.1	44.2	72.4	48.0	47.9
United Kingdom	25.7	56.4	82.5	34.4	48.8	54.0	34.4	79.9	43.7	26.4	51.1	75.7	49.6	52.2
United States	24.3	24.7	22.2	41.3	58.2	37.2	38.2	40.5	43.5	14.8	35.2	59.5	34.2	38.4
Average non-ERM[2]	**33.4**	**32.9**	**31.5**	**45.1**	**55.1**	**40.8**	**37.8**	**51.0**	**48.6**	**23.3**	**37.6**	**60.3**	39.6	42.8
Average European non-ERM[2]	**39.3**	**40.0**	**38.2**	**45.1**	**49.9**	**40.5**	**36.2**	**60.4**	**53.2**	**29.2**	**41.7**	**62.2**	42.5	46.2

Sources: International Monetary Fund. *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Weighted average (MERM weights) of variability of bilateral nominal exchange rates against non-ERM currencies, with variability measured by coefficient of variation (multiplied by 1,000) of average monthly bilateral exchange rates.

[2] Unweighted average.

Table 25. Variability of Bilateral Real Exchange Rates Against Non-ERM Currencies, 1974–85[1]

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Average 1974–78	Average 1979–85
Belgium	42.8	35.7	31.0	27.9	40.8	36.6	50.6	56.4	50.5	44.6	36.0	55.9	35.6	47.2
Denmark	38.7	41.5	38.7	28.9	38.3	35.2	40.9	50.0	41.9	44.2	32.7	54.4	37.2	42.7
France	34.7	31.1	38.5	27.2	44.8	41.3	41.7	52.6	51.7	51.0	36.2	64.2	35.3	48.4
Germany, Fed. Rep. of	29.1	43.4	24.3	27.8	38.7	35.8	58.9	50.1	33.8	42.2	40.5	49.9	32.7	44.5
Ireland	25.3	49.3	36.7	25.6	29.6	29.6	44.5	52.4	37.1	52.6	38.7	65.8	33.3	45.8
Italy	26.4	23.9	49.2	26.4	36.0	48.6	38.1	51.1	34.6	36.5	34.1	50.4	32.4	41.9
Netherlands	30.6	36.6	38.4	25.4	39.8	35.1	48.9	61.4	34.6	48.3	44.9	63.1	34.2	48.0
Average ERM[1]	**32.5**	**37.3**	**36.7**	**27.0**	**38.3**	**37.5**	**46.2**	**53.4**	**40.6**	**45.6**	**37.6**	**57.7**	34.4	45.5
Austria	34.9	42.5	30.4	29.6	39.2	43.3	56.4	55.2	36.9	46.0	42.8	59.3	35.3	48.6
Canada	14.0	14.8	17.2	26.5	36.4	22.8	18.3	22.1	25.3	8.4	25.1	26.4	21.8	21.2
Japan	30.6	21.4	28.1	52.6	84.9	84.6	37.0	59.7	59.6	21.9	37.6	82.0	43.5	57.5
Norway	23.2	36.5	28.5	30.3	39.3	35.9	29.8	43.2	53.1	20.4	40.7	34.2	31.6	39.6
Sweden	28.6	32.7	28.8	48.0	32.1	33.2	29.8	66.8	73.7	18.7	29.1	49.6	34.0	43.0
Switzerland	53.6	36.4	14.8	50.1	61.1	33.8	52.8	62.7	42.8	33.2	48.2	67.2	43.2	48.7
United Kingdom	30.0	30.4	62.6	33.3	43.0	77.2	36.8	69.8	42.6	25.5	47.6	81.9	39.9	54.5
United States	24.9	21.1	23.6	35.9	51.8	46.5	36.7	47.1	44.7	16.6	37.6	58.6	31.4	41.1
Average non-ERM[2]	**30.0**	**29.5**	**29.2**	**38.3**	**48.5**	**47.2**	**39.7**	**53.3**	**47.3**	**23.9**	**38.6**	**59.9**	35.1	44.3
Average European non-ERM[1]	**34.1**	**35.7**	**33.0**	**38.3**	**42.9**	**44.7**	**41.1**	**59.5**	**49.8**	**28.8**	**41.7**	**62.5**	36.8	46.9

Sources: International Monetary Fund. *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Weighted average (MERM weights) of variability of bilateral real exchange rates (nominal exchange rates adjusted for relative consumer price movements—wholesale prices for Ireland) against non-ERM currencies, with variability measured by the coefficient of variation (multiplied by 1,000) of average monthly bilateral exchange rates.

[2] Unweighted average.

Source: Ungerer et al. (1986)

The EMS and the UK

Notes for a Seminar - Princeton Feb 13th 1989

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A.A. Walters.

It is well known that the EMS (or strictly the ERM) has reduced the variability of nominal exchange rates among members (see Wegner (1897). However, as Vaubel (1988) has shown, the performance of the EMS countries in other respects is inferior to the non-EMS countries Comparing years before and after the establishment of the EMS, we find:

1. Nominal and real exchange rate variations vis-à-vis (eight) other major OECD currencies have on average increased more for the ERM currencies than for the other OECD currencies or the other European OECD currencies (Ungerer et al., 1986, Tables 22 and 25).
2. Nominal effective exchange rate variations have on average decreased less for the ERM currencies than for the other European OECD currencies (Ungerer et al., 1986, Table 28).[1)]
3. The average annual rate of depreciation vis-à-vis the DMark has on average decreased less for the ERM currencies than for other major European OECD currencies (calculated from Lehment, 1987, Table 2 a).
4. Expected exchange rate changes as proxied by the standard deviation of long or short term interest rates have increased among the ERM currencies; they have grown a little less, but since 1979 have been larger, than among the other major OECD countries (Ungerer et al., 1986, Tables 43 and 44; Harbrecht, Schmid, 1987, Figures 12 and 15).

1) This cannot be explained by the fact noted by Wegner (p. 14) that "a number of European countries such as Austria and Switzerland are quasi-members of the EMS, and others such as the United Kingdom have tacitly accepted exchange rate targeting in recent years".

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5. The weighted average of the inflation rates decreased much more slowly, and in 1986 was still a little higher, in the ERM countries than in the rest of the OECD (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1; 1985, Figure 4; Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 3). It also decreased more slowly in the EMS than in the other European OECD countries although it is still lower in the former than in the latter group (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1).
6. If the seven years before and after the establishment of the EMS are compared, the standard deviation of inflation rates shows an increase among the ERM currencies but a decrease among the other major OECD currencies (Collins, 1987, Table 2). Over the whole life of the EMS, the dispersion of inflation rates has also been much larger among the ERM currencies than among the major OECD currencies (Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 5; de Grauwe, 1985, Figure 3). For the more recent past, this is not true any longer (Collins; Harbrecht, Schmid, ibid.) but there remair the fact that inflation convergence took longer in the EMS than in the rest of the OECD.
7. From December 1978 to December 1985, bid-ask spreads vis-à-vis the DMark increased for the average of ERM currencies, and they increased more for the ERM currencies than for an average of other major European OECD currencies (Lehment, 1987, Tables 4a and 4b).
8. Since the establishment of the EMS, all old members of the EEC[1)] have experienced larger growth rates in their trade with non-ERM countries than with other ERM countries (de Grauwe, 1985, Table 2).

1) As de Grauwe points out, this is not true for Denmark and Ireland which joined the EC customs union at a later stage and may still have been benefitting from entry-induced trade creation.

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9. Real growth of investment and GDP was much slower in the ERM countries than in the other OECD countries; compared with 1973-78, it declined more in the ERM-countries than in the other major OECD countries; in the other European OECD countries, investment has even increased (de Grauwe, 1987, Table 1).[1)]

To sum up: the exchange rate mechanism of the EMS does not seem to have contributed to reducing nominal effective exchange rate variations, inflation and inflation differences of the member currencies, or to increasing intra-ERM trade, investment and growth in the member countries.

The EMS exchange rate arrangement is a cartel of national money producers with a price leader. Cartels are inherently unstable; ceteris paribus, they raise price (here: the price of holding money) and reduce the output (here: real money balances). The EMS money supply cartel is neither a necessary nor an efficient step on the way to a common European currency.

Whether such a single European currency should be "the final objective of the Community", as Wegner (p. 29) suggests, is an open question to which politicians and economists cannot know the answer. It depends on the trade-off between price level stability and transaction costs. As I have argued elsewhere (Vaubel 1987), only individual money users possess the knowledge and incentive required to make that choice. The optimal way of finding out whether currency union is efficient and, if so, of bringing it about is unrestricted currency competition or "choice in currency" (Hayek 1976). The European Currency Unit (ECU) can be instrumental in this process, especially if its weights are permitted to respond to revealed currency preferences (Vaubel 1987).

1) "The disinflationary stance and the high real interest rates of the 1980s" emphasized by Wegner (p. 26) do not explain this difference, since disinflation was faster in the other OECD countries.

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Table 28. Variability of Nominal Effective Exchange Rates, 1974–85[1]

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Average 1974–78	Average 1979–85
Belgium	18.6	23.2	27.6	9.4	15.4	9.3	14.5	14.5	35.9	20.2	8.3	18.6	18.8	17.3
Denmark	21.0	18.5	24.8	18.0	14.4	17.3	20.1	24.4	19.5	27.6	14.0	32.1	19.3	22.1
France	26.3	21.9	40.3	5.4	17.0	14.9	18.3	31.5	40.8	40.4	17.4	34.6	22.2	28.3
Germany, Fed. Rep. of	25.7	23.6	36.5	20.2	20.4	23.0	23.9	22.4	15.9	15.2	18.6	30.2	25.3	21.3
Ireland	10.8	39.6	63.1	16.3	19.9	12.4	22.9	23.3	10.7	39.4	17.0	33.4	29.9	22.7
Italy	31.6	5.4	63.4	14.7	20.2	8.6	28.9	39.3	15.7	28.9	12.7	15.7	27.1	22.1
Netherlands	15.9	19.5	33.5	8.1	16.8	11.0	13.1	26.0	14.7	14.6	16.9	33.2	18.8	18.3
Average ERM[2]	21.4	21.7	41.3	13.1	17.7	13.8	20.2	25.9	21.9	26.6	15.7	28.3	23.1	21.8
Austria	31.4	21.4	31.8	17.2	14.2	32.9	22.4	23.9	10.0	20.5	20.6	35.6	23.2	23.7
Canada	6.8	15.1	16.2	33.2	39.5	14.3	7.2	17.3	19.8	11.1	14.6	33.3	22.2	16.8
Japan	31.5	10.0	21.7	53.6	85.5	71.0	70.3	21.4	35.1	24.2	11.4	56.4	40.4	41.4
Norway	15.3	25.6	26.6	21.5	23.1	8.8	7.4	10.3	44.1	8.6	25.8	17.6	22.4	17.5
Sweden	24.4	22.8	21.2	60.7	1.9	14.6	4.3	49.6	67.1	4.3	5.3	11.8	26.2	22.4
Switzerland	54.7	13.0	24.8	54.0	59.4	18.4	18.5	55.9	24.1	6.9	25.8	48.3	41.2	28.3
United Kingdom	12.2	41.8	71.6	12.7	26.2	40.2	30.1	58.3	20.0	23.5	33.2	51.0	32.9	36.6
United States	18.7	29.9	7.5	14.3	35.7	10.3	23.6	48.8	44.3	30.4	43.6	61.1	21.2	37.4
Average non-ERM[2]	24.4	22.5	27.7	33.4	35.7	26.3	23.0	35.7	33.1	16.2	22.5	39.4	28.7	28.0
Average European non-ERM[2]	27.6	24.9	35.2	33.2	25.0	23.0	16.5	39.6	33.1	12.7	22.1	32.9	29.2	25.7

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff calculations.

[1] Based on the IMF's multilateral exchange rate model (MERM) and monthly data. Variability is measured by the coefficient of variation (multiplied by 1,000) of average monthly effective exchange rates.

[2] Unweighted average.

Source: Ungerer et al. (1986)

Tabelle 2a: Durchschnittliche jährliche Änderung des DM-Außenwerts gegenüber anderen europäischen Währungen in v.H.

		März 1973 - März 1979			März 1979 - März 1986		
I.	Belgischer Franc	2.0	2.3[a]	6.0[a]	3.7	2.8[a]	3.
	Dänische Krone	4.1			4.0		
	Holländischer Gulden	.8			.7		
II.	Französischer Franc	6.1	9.7[a]		4.2	4.5[a]	
	Irisches Pfund	10.0			3.3		
	Italienische Lira	12.9			5.9		
III.	Norwegische Krone	4.6	7.0[a]		2.3	2.9[a]	
	Schwedische Krone	6.5			4.5		
	Pfund Sterling	10.0			2.0		

[a]ungewichteter Durchschnitt

Quelle: Deutsche Bundesbank, Monatsberichte, verschiedene Ausgaben. (Lehment)

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Table 44. Long-Term Interest Rates, 1974–85[1]

(Monthly averages in percent)

	1974	1975	1976	1977	1978	Average 1974–78	1979	1980	1981	1982	1983	1984	Average 1979–84	1985
Belgium	8.7	8.5	9.1	8.8	8.4	*8.7*	9.5	12.0	13.7	13.6	11.9	12.0	*12.1*	10.6
Denmark	14.5	13.1	13.2	13.4	14.5	*13.7*	15.8	17.7	18.9	20.4	14.5	13.9	*16.9*	. . .
France	10.5	9.5	9.2	9.6	9.0	*9.6*	9.5	13.0	15.7	15.6	13.6	12.4	*13.3*	. . .
Germany, Fed. Rep. of	10.4	8.5	7.8	6.2	5.8	*7.7*	7.4	8.5	10.4	9.0	7.9	7.8	*8.5*	6.9
Ireland	16.9	14.6	15.5	11.3	12.8	*14.2*	15.1	15.3	17.3	17.1	13.9	14.6	*15.6*	12.6
Italy	9.9	11.5	13.1	14.6	13.7	*12.6*	14.0	16.1	20.6	20.9	18.0	14.9	*17.4*	. . .
Netherlands	9.8	8.8	8.9	8.1	7.7	*8.7*	8.8	10.2	11.6	10.1	8.6	8.3	9.6	7.3
Arithmetic average ERM	11.5	10.6	11.0	10.3	10.3	*10.7*	11.4	13.3	15.5	15.2	12.6	12.0	*13.3*	. . .
Standard deviation	2.8	2.3	2.7	2.8	3.1	*2.5*	3.2	3.1	3.5	4.3	3.3	2.7	*3.2*	. . .
Difference between highest and lowest value	8.2	6.1	7.7	8.4	8.7	*6.5*	8.4	9.2	10.2	11.9	10.1	7.1	*8.9*	. . .
Coefficient of variation	0.24	0.21	0.25	0.27	0.30	*0.23*	0.28	0.23	0.23	0.28	0.26	0.22	*0.24*	. . .
Weighted average	10.3	9.5	9.4	9.1	8.6	. . .	9.6	11.8	14.4	13.8	12.0	11.0	. . .	. . .
Australia	9.1	9.8	10.2	10.3	9.1	*9.7*	9.8	11.6	14.0	15.3	14.3	13.8	*13.1*	14.1
Austria	9.7	9.6	8.8	8.7	8.2	*9.0*	8.0	9.2	10.6	9.9	8.2	8.0	*9.0*	7.8
Canada	8.9	9.0	9.2	8.7	9.3	*9.0*	10.2	12.5	15.2	14.3	11.8	12.8	*12.8*	11.0
Japan	9.3	9.2	8.7	7.3	6.1	*8.1*	7.7	9.2	8.7	8.1	7.4	6.8	*8.0*	6.3
New Zealand	6.1	6.3	8.3	9.2	10.0	*8.0*	12.0	13.3	12.8	12.9	12.2	12.6	*12.6*	17.7
Norway	7.1	7.3	7.3	7.4	8.4	*7.5*	8.6	. . .	12.3	13.2	12.9	12.2	9.9	. . .
Portugal	. . .	. . .	9.7	10.8	16.2	*7.3*	16.7	16.7	16.7	16.8	. . .	21.5	*14.7*	. . .
Sweden	7.8	8.8	9.3	9.7	10.1	*9.1*	10.5	11.7	13.5	13.0	12.3	12.3	*12.2*	12.3
Switzerland	7.1	6.4	5.0	4.1	3.3	*5.2*	3.4	4.8	5.6	4.8	4.5	4.7	*4.6*	4.7
United Kingdom	14.8	14.4	14.4	12.7	12.5	*13.8*	13.0	13.8	14.7	12.9	10.8	10.7	*12.7*	10.6
United States	8.1	8.2	7.9	7.7	8.5	*8.1*	9.3	11.4	13.7	12.9	11.3	12.5	*11.9*	11.0
Arithmetic average non-ERM	8.8	8.9	9.0	8.8	9.2	*8.6*	9.9	11.4	12.5	12.2	9.6	11.6	*11.0*	. . .
Standard deviation	2.3	2.2	2.2	2.1	3.1	*2.0*	3.2	3.0	3.0	3.2	4.1	4.2	*2.8*	. . .
Coefficient of variation	0.26	0.25	0.24	0.24	0.34	*0.23*	0.32	0.27	0.24	0.27	0.42	0.36	*0.23*	. . .

Source: International Monetary Fund, *International Financial Statistics*, various issues.

[1] Long-term government bond yields.

Table 43. Short-Term Interest Rates, 1974–85[1]

(Monthly averages in percent)

	1974	1975	1976	1977	1978	Average 1974–78	1979	1980	1981	1982	1983	1984	Average 1979–84	1985
Belgium	9.3	4.6	8.3	5.5	5.2	6.6	8.0	11.2	11.5	11.4	8.2	9.5	*10.0*	8.3
Denmark	13.3	6.5	10.3	14.5	15.4	*12.0*	12.6	16.9	14.8	16.4	12.0	11.5	*14.0*	10.0
France	12.9	7.9	8.6	9.1	8.0	*9.3*	9.0	11.8	15.3	14.9	12.5	11.7	*12.5*	9.9
Germany, Fed. Rep. of	8.9	4.4	3.9	4.1	3.4	4.9	5.9	9.1	11.3	8.7	5.4	5.5	7.7	5.2
Ireland	11.3	10.0	10.8	7.7	8.4	9.6	13.5	15.4	13.5	13.2	10.1	8.7	*12.4*	. . .
Italy	14.6	10.6	15.7	14.0	11.5	*13.3*	11.9	17.2	19.6	20.2	18.5	17.3	*17.5*	15.2
Netherlands	9.2	4.2	7.3	3.8	6.2	*6.1*	9.0	10.1	11.0	8.1	5.3	5.8	*8.2*	6.3
Arithmetic average ERM	11.4	6.9	9.3	8.4	8.3	*8.8*	10.0	13.1	13.9	13.3	10.3	10.0	*11.8*	. . .
Standard deviation	2.1	2.5	3.4	4.1	3.8	*2.9*	2.5	3.1	2.8	4.0	4.3	3.7	*3.2*	. . .
Difference between highest and lowest value	5.7	6.4	11.8	10.7	12.0	*8.3*	7.6	8.1	8.6	12.1	13.2	11.8	9.8	. . .
Coefficient of variation	0.19	0.36	0.36	0.49	0.45	*0.33*	0.26	0.24	0.20	0.30	0.42	0.37	*0.27*	. . .
Weighted average	11.2	6.6	7.9	7.5	6.7	. . .	8.4	11.8	14.1	13.0	10.3	10.1	. . .	. . .
Japan	12.5	10.7	7.0	5.7	4.4	*8.1*	5.9	10.9	7.4	6.9	6.4	6.1	*7.3*	6.5
Norway	8.1	7.5	7.4	9.8	9.4	*8.4*	8.4	11.2	12.3	13.9	12.3	12.7	*11.8*	. . .
Sweden	7.5	7.8	7.9	10.0	7.2	*8.1*	8.2	12.2	14.4	13.3	10.9	11.8	*11.8*	13.8
United Kingdom	11.4	10.2	11.1	7.7	8.5	*9.8*	13.0	15.1	13.0	11.5	9.6	9.3	*11.9*	11.6
United States	10.5	5.8	5.0	5.5	7.9	*6.9*	11.2	13.4	16.4	12.3	9.1	10.2	*12.1*	8.1
Arithmetic average non-ERM	10.0	8.4	7.7	7.7	7.5	*8.3*	9.3	12.6	12.7	11.6	9.7	10.0	*11.0.*	. . .
Standard deviation	1.9	1.8	2.0	1.9	1.7	*0.9*	2.5	1.5	3.0	2.5	2.0	2.3	*1.9*	. . .
Coefficient of variation	0.19	0.22	0.26	0.25	0.23	*0.17*	0.27	0.12	0.24	0.21	0.20	0.23	*0.17*	. . .

Source: International Monetary Fund, *International Financial Statistics*, various issues.

[1] In general call money rates, 3-month treasury bill rates for the United Kingdom.

Source: Ungerer et al. (1986)

Table 2: CPI Inflation Rates

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	3/72-3/79	3/79-3/86	3/79-3/82	3/80-3/86
Belgium	7.6	5.5	7.1	4.8
Denmark	8.9	7.1	11.9	4.8
France	8.7	8.3	13.4	6.0
Germany	4.3	3.3	5.6	1.9
Italy	13.0	12.3	18.6	9.4
Netherlands	6.5	3.6	6.4	2.3
U.S.	6.8	5.7	10.6	3.6
Japan	10.8	6.2	5.5	10.5
U.K.	12.2	7.7	14.2	5.2
Switzerland	4.1	3.5	5.0	2.6

	3/72-3/79 avg	3/72-3/79 std	3/79-3/86 avg	3/79-3/86 std	3/79-3/82 avg	3/79-3/82 std	3/80-3/86 avg	3/80-3/86 std
EMS	8.2	2.6	6.7	3.4	10.5	4.6	4.9	2.5
Non-EMS	7.6	3.3	5.3	1.7	8.1	4.5	4.8	3.1

Source: Collins (1987)

Table 1 : Macroeconomic performance of EMS and non-EMS industrialized countries.

	EMS	Non-EMS	European Non-EMS
Growth of GDP (yearly average)			
1973-78 :	2.8	2.9	1.9
1979-85 :	1.7	2.7	1.8
Growth of Investment (yearly average)			
1973-78 :	1.4	2.8	-0.2
1979-85 :	0.3	2.5	0.4
Inflation rate (yearly average)			
1973-78 :	9.1	9.6	12.5
1979-85 :	8.3	6.9	8.8
1985 :	4.6	3.8	5.9

Source : OECD, Main Economic Indicators

Note : (1) The Non-EMS countries are the following : Austria, Norway, Sweden, Switzerland, Finland, Spain, UK, Canada, US, Japan. The European Non-EMS consists of the same countries excluding the US, Japan and Canada.
(2) The averages of each group of countries are obtained using GDP weights.

Source : de Grauwe (1987)

Tabelle 3 - Inflationsraten in OECD-Ländern(a)

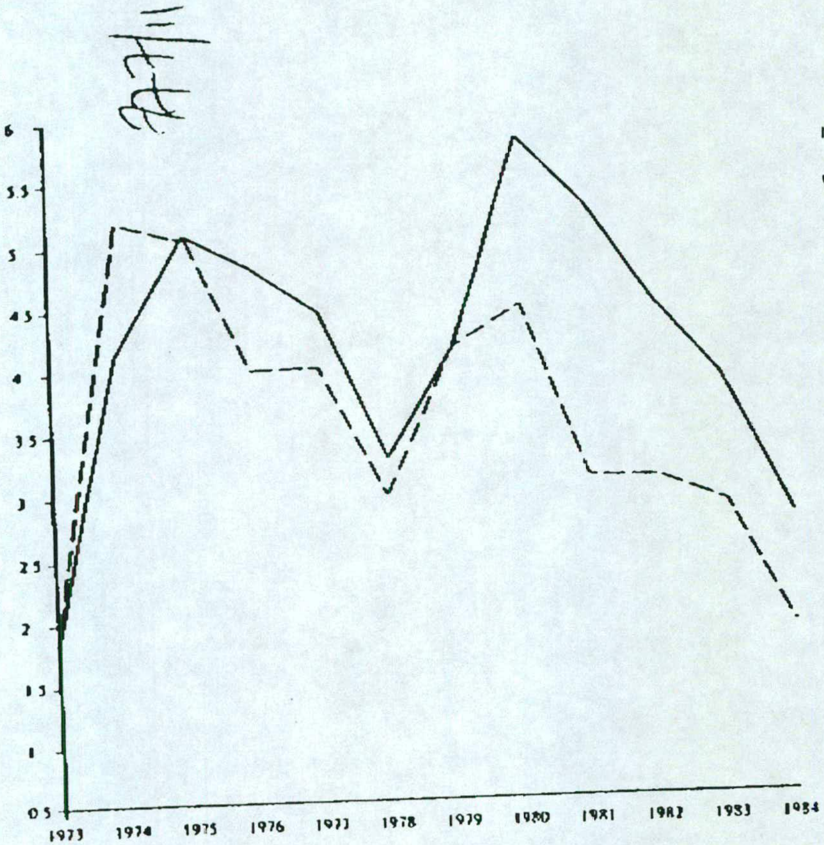
Jahr	EWS-Länder	OECD insgesamt	OECD-Europa	OECD ohne EWS-Länder	OECD-Europa ohne EWS-Länder
1979	8,5	9,8	10,6	10,1	14,3
1980	11,7	12,9	14,3	13,2	18,5
1981	11,5	10,5	12,2	10,3	13,2
1982	10,4	7,8	10,5	7,1	10,7
1983	8,5	5,2	8,2	4,3	7,7
1984	6,6	5,2	7,4	4,7	8,6
1985	5,5	4,5	6,5	4,2	7,9
1986	2,7	2,6	4,0	2,6	5,9
- Veränderung 1986 gegenüber 1979:	-5,8	-7,2	-6,6	-7,5	-8,4
- Veränderung 1985/86 gegenüber 1979/80:	-6,0	-7,8	-7,2	-8,3	-9,5

(a) Anstieg der Verbraucherpreise gegenüber dem Vorjahr (Gewichtung nach OECD).

Quelle: OECD [a; b]; eigene Berechnungen.

Aus: Schede, Sinn (1987)

Figure 3: Standard Deviation of national inflation rates in the EMS and in Non-EMS Industrial Countries.
(In per cent)

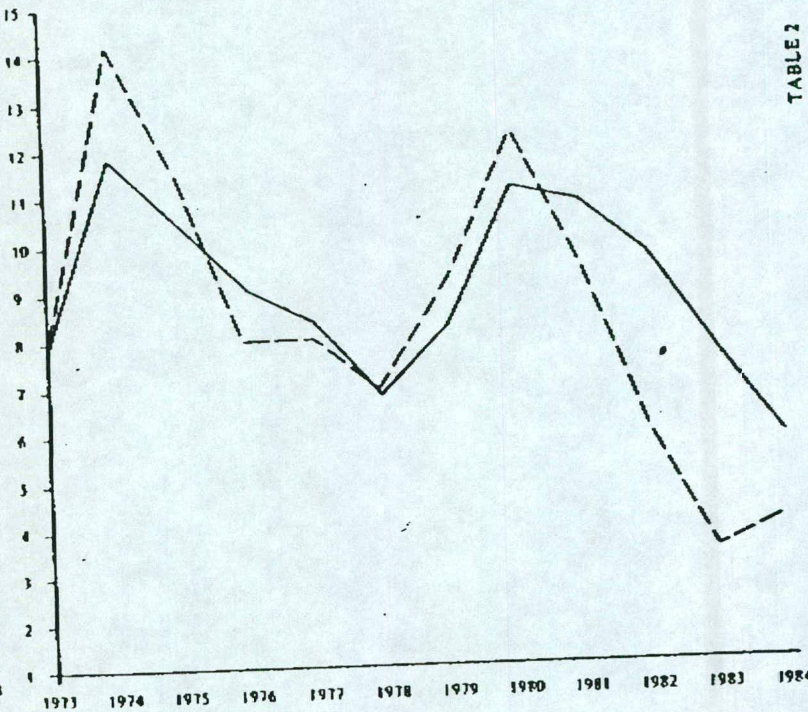


——— EMS
– – – Non EMS

Source: IMF, International Financial Statistics

Note: The non-EMS industrial countries are the US, the UK, Japan, Canada, Austria, Norway, Sweden, Switzerland
The standard deviation here measures the deviation of national inflation rates from the weighted mean inflation rate in each group of countries.

Figure 4: Average Inflation Rates in the EMS and in the Non-EMS Industrial Countries.
(In percent)



——— Inflation EMS
– – – Inflation Non-EMS

Source: IMF, International Financial Statistics.

Note: The inflation rates in each group of countries are weighted averages. The weights are obtained from GDP figures.
See also notes of Figure 3

Source: de Grauwe (1985)

TABLE 2

Average Yearly Growth of Trade (Export & Import), 1979–84

	with EMS countries	with non-EMS countries
Old EEC members	0.3	
Belgium	1.3	
France	1.4	
Germany	0.4	
Netherlands	0.4	
Italy		
New EEC members	2.8	
Denmark	5.9	
Ireland	4.1	
United Kingdom		

Source: IMF, Direction of Trade.
*The same countries as in Figure 1.

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Tabelle 4 a: Abstand des Geld- und Briefkurses vom Mittelkurs im amtlichen Frankfurter Devisenhandel in v.H.[a]

	Dezember 1970	Dezember 1978		Dezember 1985	
I. Belgischer Franc	.13	.16	.15	.20	.18
Dänische Krone	.12	.17		.22	
Holländischer Gulden	.11	.12		.12	
II. Französische Franc	.15	.18	.20	.24	.27
Irisches Pfund	.11	.19		.23	
Italienische Lira	.17	.22		.34	
III. Norwegische Krone	.12	.16	.18	.18	.20
Schwedische Krone	.11	.19		.24	
Pfund Sterling	.11	.19		.19	

[a] Amtliche Devisenkurse gegenüber der D-Mark an der Frankfurter Börse.

Quelle: Deutsche Bundesbank, Monatsberichte, verschiedene Ausgaben.

Tabelle 4 b: Abstand des Geld- und Briefkurses vom Mittelkurs im Düsseldorfer Sortenhandel in v.H.

	Ende Dezember 1978		Ende Dezember 1985	
I. Belgischer Franc	2.0	1.9	2.0	2.1
Dänische Krone	2.5		3.2	
Holländischer Gulden	1.3		1.2	
II. Französische Franc	2.6	3.0	2.7	3.1
Irisches Pfund	-		2.4	
Italienische Lira	3.4		3.5	
III. Norwegische Krone	2.8	2.5	2.7	2.5
Schwedische Krone	2.4		2.7	
Pfund Sterling	2.4		2.1	

Quelle: Handelsblatt, verschiedene Ausgaben. (Lehment)

=> Jonathan

From: Nigel Spearing MP

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HOUSE OF COMMONS
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COPIES TO	PS/CHX 2, PS/PMG, Sir. P. Middleton, Sir. T. Burns, Mr Lankester,

Mr. Scholar, Mr. Allen, Mr. Evans, Mr. Wicks, Mrs Brown, Miss O'Mara, Mrs Chaplin, Mr Tyrie

EUROPEAN LEGISLATION COMMITTEE

19 May 1989

Dear John,

At its meeting on 10 May, the Committee recommended that the House should give further consideration to the Report of the Committee for the Study of Economic and Monetary Union. The Committee also asked me to write to you to make clear that, in view of the fact that the report is to be discussed at the European Council at the end of June, it considers that it would be highly desirable for the debate to be held in good time before that meeting. I hope, therefore, that you will make every effort so to arrange the debate, in order that the Prime Minister may go to the European Council with the benefit of the view of the House on this extremely important topic.

I am sending a copy of this letter to Peter Lilley.

Yours sincerely,

Nigel S

Chairman

The Rt Hon John Wakeham MP
Lord President of the Council and
Leader of the House of Commons
House of Commons,
London SW1A OAA

copy: Peter Lilley Esq MP, Economic Secretary to Treasury

Walter Eltis
Director General
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NEDO

22 May 1989

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Sir Peter Middleton GCB
Permanent Secretary
H M Treasury
Parliament Street
London SW1P 3AG

Dear Peter,

I very much hope you will like this paper which I have written for my OECD Seminar in Paris on Thursday this week, May 25.

The two days between now and then is of course far too short a time for you to absorb its content. Therefore, when I present the paper in Paris, it will be headed "Draft: not to be quoted without the author's permission" and I shall give a copy only to David Henderson.

I am giving a Seminar on the same subject in Oxford University on May 30 and I should like to release the paper immediately after the Seminnar, on Wednesday May 31. It would therefore be very kind if you could let me know by May 30 whether there are passages in the paper which you would strongly advise me to amend or delete before it is released.

Yours ever,

Walter

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pso.vh/Simon/DP(Eltis)

UNCLASSIFIED

FROM: S D H SARGENT
DATE: 23 May 1989

MR PERETZ

cc PS/Chancellor
Sir T Burns
Mr Wicks
Mr Lankester
Mr Monck
Mr Scholar
Mr RIG Allen
Mr Gieve

OBSTACLES TO EMU: PAPER BY WALTER ELTIS

I attach a paper which Walter Eltis is planning to give at an OECD Seminar in Paris on Thursday, 25 May. He is not, however, planning to release the paper until 31 May.

2. The Chancellor gave his agreement in February to Eltis speaking to the OECD Seminar on this subject (papers attached). If, however, there are any comments which need to be made before the paper is delivered, we should need to get them to Mr Eltis **by early afternoon on Wednesday.** However, we have until the end of the week to make drafting suggestions, since the paper will not actually be released until 31 May.

S D H SARGENT
Private Secretary

DRAFT: Not to be quoted without the Author's permission.

THE OBSTACLES TO EUROPEAN MONETARY UNION

Walter Eltis

The potential disadvantages from European Monetary Union are macroeconomic, including in particular the diminishing control that individual countries would be able to exercise over macroeconomic policy. Could the microeconomic benefits outweigh these costs?

The transactions costs involved in currency exchanges range from perhaps ½-1% of total currencies bought and sold for large business transactions (including the cost of cover in the forward market) to 2½-3% for tourist exchanges, and these amounts would be saved on all intra-European trade and tourism if the twelve countries of the European Community merged their national moneys into a single currency. The real resources equivalent to these transactions costs could be redeployed in due course from the banking and financial sector to other branches of commerce, industry or agriculture and contribute extra goods and services in place of the fundamentally unproductive currency exchanges they are now used to maintain. Still greater benefits would arise through the reduction of the risks and uncertainties at present involved in production in one European economy for sale in another. Foreign exchange fluctuations can wipe out the profit margins earned through efficient production, and the forward markets in foreign currency only allow such risks to be covered twelve months ahead, for the market for two or three year forward currency is too thin to allow all but the smallest companies to cover substantial production costs when receipts will accrue in other currencies two or three years in the future. The adoption of a single European currency would eliminate these risks so far as intra-European trade is concerned.

The microeconomic benefits from such reductions in risk and transactions costs cannot be quantified with any precision, but it would be surprising if they amounted to more than 5-6% of intra-European trade, for total benefits could hardly be expected to exceed three times the actual currency transaction costs. In that event the microeconomic benefits would come to at most 1-1½% of the combined National Incomes of the European Community, since intra-European trade averages some 20% of total European GNPs.

The macroeconomic costs of Monetary Union (or benefits if it leads some countries to adopt better policies) are potentially of a far larger order of magnitude, so their nature must be examined to ascertain whether they would be likely to outweigh the limited though important microeconomic advantages. The Delors Committee's "Report on Economic and Monetary Union in the European Community" published on 12 April 1989 recommends that the European Community proceed towards Monetary Union in three stages.

Stage One which should commence no later than 1 July 1990 would involve the full participation of all the countries of the Community in the Exchange Rate Mechanism of the European Monetary System.

Stage Two which would follow as soon as the difficulties associated with Stage One had been mastered would involve the setting up of a European System of Central Banks through the participation in this of the present Central Banks of the Community countries. This European System of Central Banks would intervene in foreign exchange markets, using funds drawn from the present national central banks, and set guidelines for monetary and fiscal policies, and the nature of the guidelines that individual countries were expected to follow would be decided by majority voting. At the same time the margins of permitted exchange rate variation would gradually be reduced to zero.

Stage Three which would follow as soon as the difficulties involved in Stage Two had been mastered would involve the adoption of irrevocably fixed exchange rates between the currencies of the twelve members of the European Community, which would be equivalent to the adoption of a single European currency, and the European Currency Unit (the ECU) could develop into this. At the same time the European System of Central Banks would become an authority which determined monetary policy at the European level (via a system of majority voting) including changes in the money supply, the rates and conditions on which money could be borrowed in the twelve countries of the Community and the appropriate stance of fiscal policy in each country.

The United Kingdom's particular problem in 1989-90 is whether to proceed to Stage One, involving full membership of the European Monetary System's Exchange Rate Mechanism. In taking this decision, the United Kingdom will naturally be guided by the advantages and disadvantages it perceives in Stage Three - full Monetary Union. It might be worthwhile to incur economic costs in Stage One if the advantages that Stage Three offered were sufficient, while acceptance of Stage One could be hazardous if it implied a commitment to proceed to Stages Two and Three if this was regarded as disadvantageous.

The present paper will first discuss the potential advantages and disadvantages of full United Kingdom membership of the Exchange Rate Mechanism which is what Stage One principally involves, and then consider the case for and against full Monetary Union as seen from the standpoint of the United Kingdom.

Would Full Membership of the Exchange Rate Mechanism (the ERM) be Advantageous or Disadvantageous to the United Kingdom?

It has been United Kingdom policy since 1979 that Sterling will join the ERM as soon as conditions are appropriate. Some have found this postponement of United Kingdom membership puzzling, because it is widely believed that the countries that joined the Mechanism when it was first set up in March 1979 are now deriving considerable benefits. Italian inflation exceeded West German inflation by 10 percentage points in 1979, while French Inflation was 6½% faster. Today Italian inflation exceeds German inflation by only 3½ percentage points while inflation in France is only 1½% more rapid than German inflation. Ten years' membership of the ERM has therefore reduced Italian inflation by 6½ and French inflation by 5 percentage points relative to the West German rate. These are very considerable benefits.

But the advocates of immediate United Kingdom membership do not always recall that it has taken ten years for France and Italy to achieve this degree of inflation convergence during which the Franc and the Lira have been devalued many times against the D Mark. In fact since March 1979, despite membership of the ERM the Lira has fallen 40% and the Franc 33% relative to the D Mark, while Sterling without the benefits of membership has fallen no more than 17%. Sterling has thus fallen a good deal more slowly outside the ERM than the Franc and the Lira within it. It is therefore strange that advocates of membership speak as if it would lend a degree of credibility that is at present lacking to the exchange rate of Sterling against the D Mark. France and Italy had the advantage of this credibility, but their currencies nonetheless fell considerably faster than Britain's. The periodic devaluations of the Franc and the Lira did not occur irregularly in response to market pressures and the changing intervention policies of the French and Italian authorities. Instead they occurred after full discussion of the case for exchange rate realignments by all the participants to the ERM. After official meetings new rates were announced during weekends when markets were closed, and those who had been able to predict these realignments were able to cash in substantial profits at the expense of their countries' central banks which had been obliged to defend the previous parity ranges. The agreed realignments of the Franc and the Lira relative to the D Mark were in every case downward and noone was in any doubt that this was the only possible direction they could go.

Sterling in contrast has both risen and fallen relative to the D Mark and major adjustments could occur at any time when markets were open. The dates of realignments were not predictable and the United Kingdom authorities were not required to consult a variety of other central banks and governments in a manner that nowadays produces widespread press speculation and occasional leakages of information. Italian nationalised industries have found it useful to shift large sums out of Liras on the day prior to realignments.

Because France and Italy entered the ERM with substantially faster inflation than West Germany their currencies could only move downwards so currency traders and speculators were offered one way options. They could make money by correctly predicting an agreed devaluation, but they could not lose from selling French and Italian currency because realignments would never favour the Franc or the Lira. Currency traders and speculators did not speculate entirely costlessly because they sacrificed higher Franch and Italian interest rates on the funds they used to hold foreign currencies. But the interest rate differential that a country has to maintain in order to deter financial operators from switching away from a currency that is expected to be devalued can be enormously high. There tends to be extensive press speculation prior to currency realignments within the ERM because the Treasuries and Central Banks of seven countries are involved and it only takes a single indiscretion in one country to alert informed opinion that adjustments are on the agenda. If currency traders take it that there is then a 25% probability that a particular currency will be devalued by, for instance, 5% within a month, holders of that currency will have a 25% expectation of losing 5% in a month, or of losing money at an annual rate of (approximately) 60%. To compensate for a 25% probability of losing money at a rate of 60% per annum, an interest rate advantage of approximately 15% is required, which means that French and Italian interest rates have needed to be something like 15% above German rates in any month in which a 5% devaluation was strongly perceived as being on the European agenda.

The French and Italian governments have attempted to limit these potential speculative pressures through exchange controls (which are due to be dismantled in 1990) rather than by raising domestic interest rates to a level high enough to contain them. But exchange controls can only be applied to Franc and Lira accounts which are actually controllable by the French and Italian authorities. There are other funds in these currencies which are not subject to control, so there are two interest rate levels for Franc and Lira deposits, domestic rates for funds subject to exchange control and offshore rates for accounts which can be moved freely. The excess of offshore over domestic interest rates for Franc and Lira deposits that are shown in Figures 1 and 2 indicate the possible extent to which French and Italian domestic interest rates would have had to rise in the absence of exchange controls in order to contain speculative pressures prior to currency realignments. In the case of both currencies the gaps widened sharply prior to most realignments (and their dates are shown by the vertical lines on the charts) and they have on occasion been as high as 10 to 15%. There were of course periods when there were substantial excess offshore interest rates without immediate realignments, and others where realignments occurred without evidence of prior speculative pressure, but in a considerable number of cases, currency realignments were anticipated by markets (somebody in one or more countries talked - or else market analysts and governments perceived that an adjustment was inevitable at about the same time and for similar reasons).

The French and Italian authorities had the means to contain speculative attacks if they wished by borrowing from the Bundesbank and the other central banks that participate in the ERM, so the French and Italian governments had considerable financial resources available to them to sustain parities when they actually wished to. But if they subsequently concurred with the market that a parity change was desirable or at least inevitable, they will have had to repay most of the funds advanced by the Bundesbank at the parities in operation at the time of repayment. Such debts are denominated in ECU'S of which the Franc constitutes about one-fifth. If the Bank of France borrowed the ECU equivalent of 10 billion Francs from the Bundesbank in order to defend the Franc and there was a 10% devaluation before the loan was repaid, it will have incurred no loss on the fifth of these ECUs that were denominated in Francs but the value of the remaining four-fifths will have been raised one-tenth relatively to the Franc so the Bank of France will have had to repay 10.8 billion Francs to the Bundesbank and incur a loss (in its own currency) of 0.8 billion Francs. The counterpart to this loss will have been a 0.8 billion Franc profit to the private sector participants in currency markets who successfully anticipated that a Franc devaluation would occur.

Devaluations of the Franc and the Lira were extensive and frequent in the early years after 1979, but they were so uncomfortable and financially expensive when they occurred that after about 1983 the French and Italian governments made increasing efforts to avoid them. The Franc has now held its parity against the D Mark for almost three years, and French inflation has been brought very close to the German level, while the Italian success in bringing inflation down has been almost as great. The French and Italian governments have made great efforts to run their domestic monetary policies in a manner that exerts downward pressure on inflation, and the desire to avoid devaluation within the ERM has been a powerful motivating force to this end. But a price has had to be paid. It has been estimated that the average real exchange rate of the Lira has risen some 10% relative to the D Mark within the ERM while the relative real exchange rate of the Franc has also risen considerably. This continual overvaluation of the Franc and the Lira relative to the D Mark has exerted a steady downward pressure on inflation - and it has in fact been the principal means used to achieve this. But at the same time French and Italian employment and the relative profitability of export industries have suffered. Now in 1989 the task of bringing inflation into line with the German rate has almost been achieved. Should Britain go down the same road?

British policy on when it will be right to become a full member of the ERM was carefully expressed by Mr David Peretz, Under Secretary of HM Treasury's Monetary Group in his evidence to the House of Lords Select Committee on the European Communities in June 1988. When he was asked by the Chairman (Lord Kearton), "what are the right conditions for joining the exchange rate mechanism?", he replied

> "As rates of inflation converge in the Community, as economic performance converges generally and as exchange rates come to be more stable, it becomes easier to contemplate the step."

French and Italian inflation rates had not converged with German inflation in 1979, which is why these countries had to devalue so frequently and regularly, and to the extent that the United Kingdom's inflation rate now exceeds Germany's, Sterling would be subject to similar pressures. Mr Peretz's emphasis on the importance of a prior convergence of inflation rates underlines that the United Kingdom authorities are entirely aware of the potential difficulties which would arise if Britain joined the ERM with substantially faster inflation than West Germany.

These would exceed those that France and Italy encountered in the early 1980s because the United Kingdom has no exchange controls to help contain adverse pressures on Sterling prior to realignments. These will be particularly intense if there are actually occasions when markets expect a downward adjustment in Sterling, because of the importance of the City of London as a financial centre, and as a consequence of the very large funds that individuals in City firms can make use of over weeks or weekends to speculate on their own account. If Partners and Directors are offered one way options, they will make vastly greater profits at the expense of the Bank of England, than the Banks of France and Italy lost in similar circumstances.

It is therefore especially important that when Britain joins the ERM, the exchange rates on entry are ones which can be held. The United Kingdom's inflation rate of consumer prices is currently 5½ percentage points faster than Germany's, and Britain's GDP deflator rose 6.6% in 1988 while Germany's rose 2.0% which indicates an excess United Kingdom inflation rate of about 4½%. But it is manufacturing trade competitiveness that is especially important and here unit labour costs have been rising at approximately the same rate in the United Kingdom and West Germany. Unit wage costs in West German manufacturing industry rose 1.2% in 1988, while they rose 1.6% in the United Kingdom, so the excess rise of United Kingdom costs in manufacturing industry appears to be as little as ½ a percentage point. United Kingdom wages are rising far faster than Germany's but productivity is also rising much more rapidly (from a considerably lower level) with the result that British industry is maintaining a nearly stable relative unit labour cost level. If this trend can be sustained, Brtish industry would be able to maintain its competitiveness with German industry at a stable Sterling/D Mark exchange rate. That of course will only occur if productivity continues to advance far more rapidly in British than in German industry. In the last three years unit labour costs in manufacturing industry have actually risen a little faster in Germany than in the United Kingdom. The figures for both productivity and earnings growth are subject to extensive revision, and if the United Kingdom's rate of growth of manufacturing output slows in 1990 and 1991 from the annual 7-8% rates achieved in 1986-88, productivity growth will slow too, but so will the rate of increase of wages.

It would be unduly optimistic to imagine that because British unit wage costs in manufacturing rose at about the same rate as Germany's from 1986 to 1989, United Kingdom inflation where it matters most is already down to the German level. If the United Kingdom GDP deflator and consumer price indices continue to rise 4-5% faster than Germany's, competitiveness outside manufacturing and in due course in manufacturing itself are bound to be adversely influenced from time to time, but long term balance could probably be sustainable if the underlying rate of United Kingdom inflation could be reduced by something like 2 percentage points so that the excess rise of the United Kingdom GDP deflator became 2½% instead of the present 4½%. This would allow British manufacturing industry to remain competitive even if the rate of productivity growth fell back by 2 or 3 percentage points from the exceptional rates achieved from 1986 to 1989.

If United Kingdom entry into the ERM reduced the expected rate of inflation in Britain, that could theoretically cut the underlying inflationn rate by the 2 percentage points that is needed, but United Kingdom wage bargaining appears to be much more influenced by current inflation than by theoretical expectations of future inflation. The underlying Brtish inflation rate has remained close to 5% since 1983 while average earnings growth has been firmly set in the 7-9% range. Successful ERM membership is likely to require an underlying inflation rate of 3% and average earnings growth of no more than 5-6% and it is unlikely that this will be achievable without a period in which markers are sufficiently tight for companies and workers to find it difficult to obtain the rates of price and wage increases that they have become accustomed to since 1983. Whether such a period of downward pressure on price and wage increases occurs outside the ERM prior to membership, or else within it as in France and Italy where it was the disciplines of membership that brought inflation down, is a question which only the United Kingdom government can answer.

It may be added that if the United Kingdom joins the ERM and fails to bring inflation down, the consequent periodic downward adjustments to the exchange rate need not necessarily be as painful as they were for France and Italy. There is at present a permitted range of fluctuation of 2.25% around a central rate and where there are realignments, both the central rate and the lowest permitted rates are lowered. If the central rate for Sterling is originally 100, then Sterling is allowed to fall to 97.75 or to rise to 102.25. If there is subsequently an agreed 2%

downward realignment, Sterling's central rate will be reduced to 98 and the lowest permitted rate to 95.75. If that realignment was agreed when Sterling was actually under pressure and at the bottom of its range at 97.75, it would fall at once towards 95.75 and give profits to those who had sold it short, but what if the realignment was agreed when Sterling was in the middle of its range at 100 and under no immediate pressure? Under these circumstances there would be no necessary short term fall so hasty sellers of sterling would gain nothing, but there would be a reduction in the lowest permitted rate from 97.75 to 95.75. The Bank of England would then be entirely free to allow Sterling to fall from 100 to 95.75 at any time it wished. The rate does not then have to fall in the particular weekend when Ministers and Bankers meet, but it could fall precisely when it appeared operationally most expedient to make the adjustment. To achieve this important improvement in intervention policy, rates would need to be adjusted, not in response to immediate market pressures, but so far as possible in advance of these. The key consideration is that provided a currency is not at the floor of its permitted range on the day of a realignment, Central Banks will have some discretion over the timing of reductions in actual exchange rates, which can reduce the opportunities for market operators to make quick and easy profits.

The French and Italian authorities have not in general managed to combine smooth downward movement in their permitted exchange rates and reductions in actual rates at times of their own choosing. Actual rates and the permitted rates have tended to come down in the same weekends, and devaluations generally occurred when the Franc and the Lira were close to the floor of their permitted ranges. It may be that the Bank of England would do better, but it would be optimistic to count unduly on the possibility that it would have sufficient room for manoeuvre within the permitted parity ranges to be able to choose the timing of devaluations. Britain will only be comfortable within the ERM if it does not need to devalue regularly, and for this the underlying level of United Kingdom inflation will need to come down, though perhaps by no more than 2 percentage points.

If United Kingdom inflation is successfully brought down towards the German level, a further difficulty could arise within the ERM. If

British and German inflation rates are similar, and the Sterling/D Mark exchange rate is not expected to move significantly in the medium term, British and German interest rates will necessarily converge. But if British short term rates come down to the far lower German level, bank lending will grow far faster in London than in Frankfurt. The German banking system is partly controlled through required reserve and liquidity ratios, but these are no longer used in London where the growth of bank lending is mainly constrained by the level of interest rates. An initial successful reduction of United Kingdom inflation within the ERM which significantly lowered United Kingdom interest rates might therefore call for the reintroduction of minimum reserve and liquidity requirements in London to constrain bank lending which could otherwise grow far too rapidly to allow a low inflation rate to be sustained.

Mr Peretz's other conditions where British membership could be more readily contemplated, a more general convergence of economic policy and greater stability of exchange rates should not be lost sight of. The most important consideration here is that successful ERM membership would stabilise Sterling in relation to the D Mark but not against the Dollar and the Yen. The Sterling/Dollar rate has some influence on the Sterling level of commodity prices, since the price of for instance oil is fixed in dollars in the short term. A fall in Sterling relative to the Dollar therefore adds to United Kingdom inflation, which is something the British authorities wish to be free to take into account in their exchange rate policy. If Sterling joins the ERM, its exchange rate will have to move parallel with the D Mark, so any volatility in the Dollar/D Mark rate will produce equal and inescapable fluctuations in the Dollar/Sterling rate. The Dollar will remain volatile so long as the twin United States deficits remain substantial because high United States interest rates will continue to be required to finance them from time to time.

The Dollar will become more stable in 1990 and 1991 if by then the twin deficits are successfully reduced and that would make it easier for the United Kingdom to find an acceptable rate for entry to the ERM. Whether it chooses to take advantage of this could depend quite significantly on whether it is judged that United Kingdom inflation which the government is in any case determined to bring down will be more easily reducible inside or outside the ERM.

If the United Kingdom does decide to join the ERM in 1990 or 1991, the benefits and difficulties in proceeding towards full Monetary Union will come onto the agenda, and the next part of this paper is concerned with some of the principal issues.

The Implications for the United Kingdom of Progressing from Membership of the Exchange Rate Mechanism towards Monetary Union.

There may be circumstances where it will be judged to be in the United Kingdom's interests to become a full member of the ERM, and it is indeed declared United Kingdom policy to join when conditions are appropriate. But if such a step is regarded as a move towards the implementation of Stage One of the Report of the Delors Committee rather than an isolated action that is judged to be in the United Kingdom's interests because it will assist policies to stabilise inflation, then entry into the ERM would oblige the United Kingdom to incur a series of further far reaching obligations. This is because paragraph 39 of the Delors Report includes the statement that:

> Although this process is set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process.

If a decision by the United Kingdom to join the ERM would now be regarded in Europe as a commitment in addition to move gradually towards full monetary union, some of the implications that this would have must be considered.

According to the Delors Committee, a movement towards monetary union would require "<u>a transfer of decision making power</u> from member states to the Community as a whole ..... in the fields of monetary policy and macro-economic management" (para. 19). This is because if individual countries each freely pursue their own monetary and fiscal policies in the context of a system of fixed or nearly fixed exchange rates, then:

> To some extent market forces can exert a disciplinary influence. Financial markets, consumers and investors would respond to differences in macro-economic developments in individual countries and regions, assess their budgetary and financial positions, penalise deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaption of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints (para. 30).

The form these constraints would take would be extensive, for:

> A monetary union would require a single monetary policy and responsibility for the formulation of this policy would consequently have to be invested in one decision-making body. In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macro-economic framework and be subject to binding procedures and rules. This would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public sector borrowing requirements and place binding constraints on the size and financing of budget deficits (para.19).

The Delors Committee explains how far reaching supranational control over the detailed budgetary policies of individual countries would need to be:

unco-ordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community. Moreover, the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the co-ordination of national budgetary policies. Without such co-ordiantion it would be impossible for the Commmunity as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance, or for the Community to play its part in the international adjustment process." (para.30)

The co-ordination of the budgetary policies of the member countries mean that:

binding rules are required that would: firstly, impose effective upper limits on budget deficits of individual member countries of the Community, although in setting these limits the situation of each member country <u>might</u> have to be taken into consideration; secondly, exclude access to direct central bank credit and other forms of monetary financinng while, however permitting open market operations in government securities; thirdly limit recourse to external borrowing in non-Community currencies (para.30).

If any of these binding rules are broken:

the Commission, or other appropriately delegated authority ... would be responsible for taking effective action to ensure compliance; the nature of such action would have to be explored. (para.33).

Since Italian governmments drawn from five political parties have been unable to reduce the Italian budget deficit below 10% of the national income, it is difficult to imagine how "the Commission or other appropriately delegated authority" will actually be able to take "effective action to secure compliance"..

The Delors Committee expressed concern above that the Community should "play its part in the International Adjustment Process," and one reason why macro-economic policy co-ordination is seen as important is that:

> the Community as such is currently represented only at the summit meetings of the major industrial countries. In order to make full use of its position in the world economy and to exert influence on the functioninng of the international economic system, the Community would have to be able to speak with one voice. This emphasises the need for an effective mechanism for macro-economic policy co-ordination within the economic and monetary union. (para. 38).

If the Community is to be represented in a wider range of international economic summit meetings (presumably by the Commission) and exert a helpful influence by speaking with one voice, what it would actually say, and how its supra-national economic policy stance would be determined, become major questions that need to be examined.

The monetary and exchange rate policies of the Community would be determined by a newly create European Institution, the European System of Central Banks (ESCB). The Council of the ESCB would consist of the Governors of the central banks of the participating countries together with other members appointed by the European Council of Ministers. It can perhaps be assumed that this proposed arrangement would allow the larger Community countries, West Germany, France, the United Kingdom and Italy to have two members of the Council of the ESCB while Belgium, Denmark, Greece, Ireland, the Netherlands, Portugal and Spain would have only one. It would require a new Treaty to set up the ESCB and to describe its constitution and functions since there is no provision for such an institution in the Treaty of Rome and this Treaty would set out how the Council would arrive at decisions in the event of disagreement between its members. In that event, according to the Delors Committee, "modalities of voting procedures would have to be provided for in the Treaty." The members of the Council would all of course, be appointed by their governments in the first instance, but it is recommended that they should subsequently have "an appropriate security of tenure". In the case of central bank Governors appointments are normally for periods of four or five years after which governments have the option of renewing an appointment, or else appointing a new Governor. It can be assumed analogously that members of the Council of the ESCB would be appointed by the government of their own countries in the first instance, enjoy four or five years of uninterruptable tenure, and depend on the subsequent support of their governments for continued membership of the Council (or an alternative appointment of equivalent distinction and influence). The implementation of the policies determined by the Council would be the responsibility of a Board, and the members (drawn from the participating countries in a balanced manner) would enjoy a similar securuity of tenure for four or five years at a time.

The Delors Committee has set out two broad economic objectives which the Council and the Board of the ESCB would be asked to meet. First, the ESCB "would be committed to the objective of price stability." (para.32) But in addition the Community would adopt macro-economic policy guidelines which it expected the ESCB to implement to "set a medium-term framework for key economic objectives aimed at achieving steady growth, with a follow up procedure for monitoring performance and intervening when significant deviations occurred." (para.56)

Unfortunatley the objectives of price stability and the achievemenet of steady growth are not always compatible. For instance, in 1973 OPEC'S increase in the price of oil raised the rate of inflation in all industrialised countries. The Bundesbank which gave overwhelming priority to a price stability objective reacted by declining to expand the German money supply sufficiently to finance the extra inflation that the initial rise in the price of oil produced. In consequence growth was interrupted, but the post-OPEC German inflation rate peaked at no more than 8%. The Bank of England had a more accommodating monetary policy with the result that inflation was allowed to rise from 10% in 1972 to a peak rate of 28%. Central banks can thus give over-riding priority to a price-stability objective like the Bundesbank in which case inflation will rise less when there is a supply shock like the OPEC rise in the oil price, or they can give priority to the achievement of steady growth like the Bank of England in the period of the Heath and Wilson governmments in which case there will be considerably more acceleration of inflation.

How would the ESCB be likely to react when it is faced by a similar conflict between the objectives of steady growth and price stability?

The German appointed members of the Council could be expected to favour policies which would sustain price stability, whether they reflected the judgements of the German government or those of the Bundesbank, but what of the others? An interesting insight into possible French thinking can be derived from evidence which Professor Charles Wyplosz of the distinguished French Management College INSEAD gave to the House of Lords Select Committee on the European Communities in July 1988.

> I have a strong perception that France in a sense is held hostage by Germany via the exchange rate and France is not able to resume what I would consider a healthy growth rate (Question.155).
>
> There is a widespread feeling, of which I am sure you are all aware that Germany is calling the shots within the EMS. German policy choices do not have to be shared necessarily by all countries; each country has its choices. The benefit of co-ordination or co-operation is that I give you something and you give me something. In my view there is not enough of this two-way trading going on within the EMS. (Question 165).
>
> My hunch indeed is that Germany is peculiar in its abhorrence or fear of inflation; more so than any other country in Europe. The current situation is that this abhorrence has dominated the whole of the European Monetary System. (Question 168)

It is evident that if French governmment appointees reflected the widely held opinions that Professor Wyplosz expresses here, they would vote for monetary policies which would favour the maintenance of growth rather than price stability in any situations where these were not immediately compatible.

A similarly anti-German and anti-price stability statement has been expressed by Miguel Boyer, President of the Banque exterieure d'Espagne, a Spanish nominated member of the Delors Committee in an interview he gave to Le Monde in July 1988.

> Imaginez qu'un Etat l'unite monetaire de l'Europe c'est accepter la domination de l'Allemagne, c'est-a-dire d'un pays au taux de chomage tres faible qui peut pour autant se permettre de realiser une politique tres orthodoxe de stabilite des prix. Mais si l'on admet cet argument, dans la mesure ou il est de toute maniere impossible de faire bande a part, la seule solution consiste a jouer le jeu de l'unite monetaire europeenne en amenant de l'interieur, la RFA a assouplir sa position.
>
> It est evident que certains pays europeens connaissent une situation sociale plus difficule, et ont donc besoin de croitre plus rapidement. Il s'agit d'etablir un moyen terme entre leurs preoccupations et celles des pays les plus avances. C'est-a-dire de convaincre a la fois la RFA de croitre un peu plus vite et les pays aux tendances inflationnistes d'etre un peu moins laxistes. La realisation de l'unite monetaire europeenne suppose tout autant de lutter contre les excedents excessifs de balance des paiements que contre les deficits excessifs.

M. Boyer adds that it is vital that a European Central Bank should not be:

> un organe de technocrates completement independant de tous les pouvoirs politiques. Il est evident que la Banque centrale europeenne devra rendre des comptes devant le Parlement europeen. Mais c'est un Parlement refletant des situations nationales tres diverses, ou ceux preoccupes d'abord par la stabilite des prix devront se mettre d'accord avec ceux pour qui la lutte contre le chomage constitue la principale priorite.

Professor Charles Goodhart formerly of the Bank of England underlined the significance of the question of the political independence of a future European central bank, and how this related to the desire of France and other european countries to effect a change in Bundesbank monetary policies, in his evidence to the House of Lords Committee in July 1988:

> the French are concerned that the present working of the European monetary system is effectively dominated by the Germans. They do what they want independently, and everyone tags along with them. The French view of a European Central Bank, I think, is one in which the members thereof would effectively act as representatives of their country, subject to political control by the Ministry of Finance, and one which would have some form of weighted voting system that would make the votes effectively determined by the government of the day. The German view of a single European Central Bank ... is that [this] would be totally independent of any political control those appointed to it would have complete independent ability to choose policy and would have constitutional independence from their Ministry of Finance ... I believe that there is a contradiction at present between the desire of the French and probably the Belgians ... to have a political control over the federal organisation, and the desire of the Germans, supported probably by the Dutch and maybe the Danes, to have complete independence. (Questions 206-7)

M. Rocard, the Prime Minister of France underlined the relevance and appropriateness of these statements by Wyplosz, Boyer and Goodhardt in an interview he gave to the Financial Times on 24th October 1989:

> his main pre-occupation was with West Germany and the need for Bonn to revise its nationalistic economic policies. ... "The German population is already diminishing by 0.5 to 0.6 per cent a year, so if you have a gross national product which grows by zero, it means the per capita gross national product growth is 0.5 to 0.6 per cent. They don't need growth. Whereas the other member states and France most because of our strong demography, still need growth."
>
> Mr Rocard explained the attitude of the Bundesbank partly by its constitutional autonomy from Bonn, but partly by the make-up of its governing board which was constituted by representatives of the Lander.
>
> The French government would continue to call for the constitution of a European central bank and would make the required concessions to

German sensibilities to get it. "It is an absolute necessity, and we shall concede that it has to be politically autonomous to reassure the Germans. I do not believe that monetary authorities can escape any relationship with political authorities; you cannot fight a war without the central bank working with the government. But Europe deserves some sacrifices".

The battle lines are therefore very clear. France and Spain certainly and doubtless other countries also will work within the ESCB to achieve a European monetary policy that attaches higher priority to growth and employment, and lower priority to price stability than the policies of the Bundesbank which have dominated the present European Monetary System. Constitutionally there are similar battle lines where France, Spain, etc., believe that the ECSB should be subject to continual and even short term political control which can be expected to favour policies which take risks with inflation in order to stimulate growth, while Germany, etc., believe that the ESCB should be independent of government interference.

The interview with M. Rocard explains why France has been ready to acquiesce in a degree of independence from government interference for the ESCB in its contributions to the work of the Delors Committee. The recommendation in the report that the members of the Council of the ESCB should be free to act independently of the governments that appointed them, and the statement that the ESCB should be committed to the objective of price stability may well have been French concessions that had to be made to obtain German agreement.

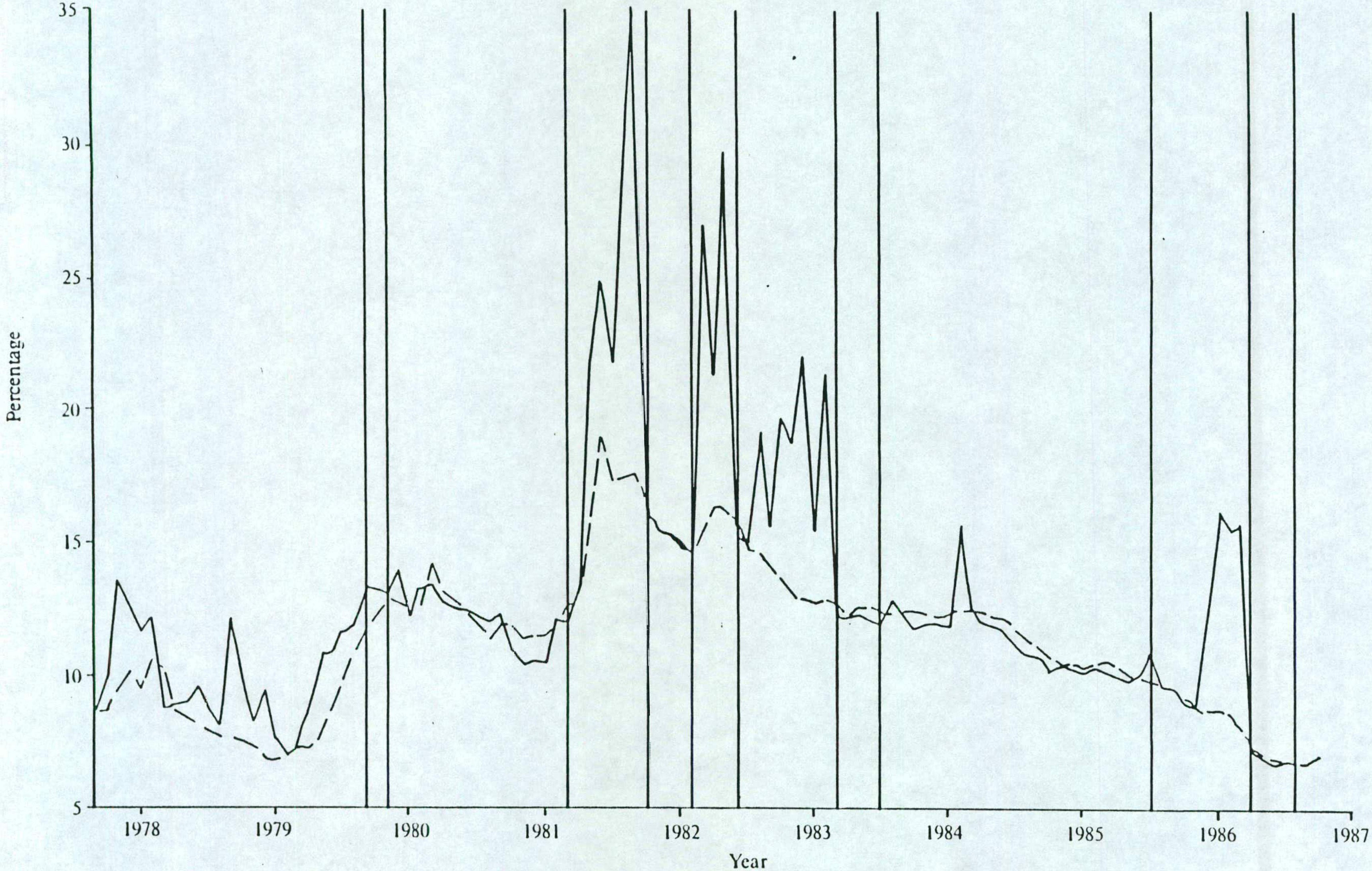
But the words in the Delors report and in any subsequent treaty will not actually determine the behaviour of the members of the Council of the ESCB if this is established. They will be appointed by their countries' governments for terms of no more than four or five years. The tradition of some European countries is that such government appointees work in any case to further their countries' interests as perceived by their elected governments, while others will be aware that their future careers (including prospects of reappointment) will depend on how their performance is regarded by their own governments. The British tradition in contrast is to transfer loyalties entirely to European institutions but that is by no means the continental practice. It can be inferred therefore that if the European Community proceeds to form an ESCB along the lines envisaged in the Delors report, the voting of several members of the Council on questions involving the growth of the money supply, and the general level of European interest rates will reflect the priority that several European governments attach to short term growth over the control of inflation, and a number of the members of the Council will vote in line with the current wishes of their national governments, and not to further the declared aim of the ESCB to maintain price stability.

It would therefore be a considerable error to assume that the ESCB would act with the financial prudence that the Bundesbank has demonstrated in the management of the European Monetary System, for The Bundesbank Governor and the other German appointed member of the Council of the ESCB may well be outvoted. If Britain were to join the ESCB, the chances that the Bundesbank Governor would not be outvoted would of course be enhanced, and the possibility that the ESCB would genuinely offer Europe prospects of price stability would be increased, but the British and German Councillors could be be dragged into the pursuit of the kind of growth directed monetary and fiscal policies (which had the unfortunate side effect that they added to inflation) which were so fashionable before the Bundesbank took the lead in the reduction of European inflation rates in 1979.

It is a matter of political judgement whether the United Kingdom will risk committing the financial future of the economy to an institutional arrangement which could force a degree of inflation into Britain which the government of the day would prefer to avoid. Unfortunately British membership of the Exchange Rate Mechanism of the European Monetary System which would be a lesser commmitment has been represented by the Delors Committee as if it carries an implicit commitment to proceed towards full monetary union. That adds a political dimension to this decision which could otherwise have been taken largely on the economic arguments which are finely balanced.

The interesting question that remains is how fully aware the Germans are of the inflationary risks they will be taking if they proceed towards a monetary union that is based on the present membership of the ERM. They must surely be aware of the differences in the way in which they and some of their EMS partners expect a European Central Bank to be controlled, and Professor Charles Goodhart has remarked that "the whole thing may fall apart on that political dispute", but this should not be taken for granted. Germany may be about to embark on a monetary adventure which can have many outcomes, and which on present indications the United Kingdom will prefer to avoid.

Mr Eltis was Fellow and Tutor in Economics at Exeter College, Oxford from 1963-1988, and he is now Director General of the National Economic Development Office. The analysis in this article and the opinions expressed are entirely personal.



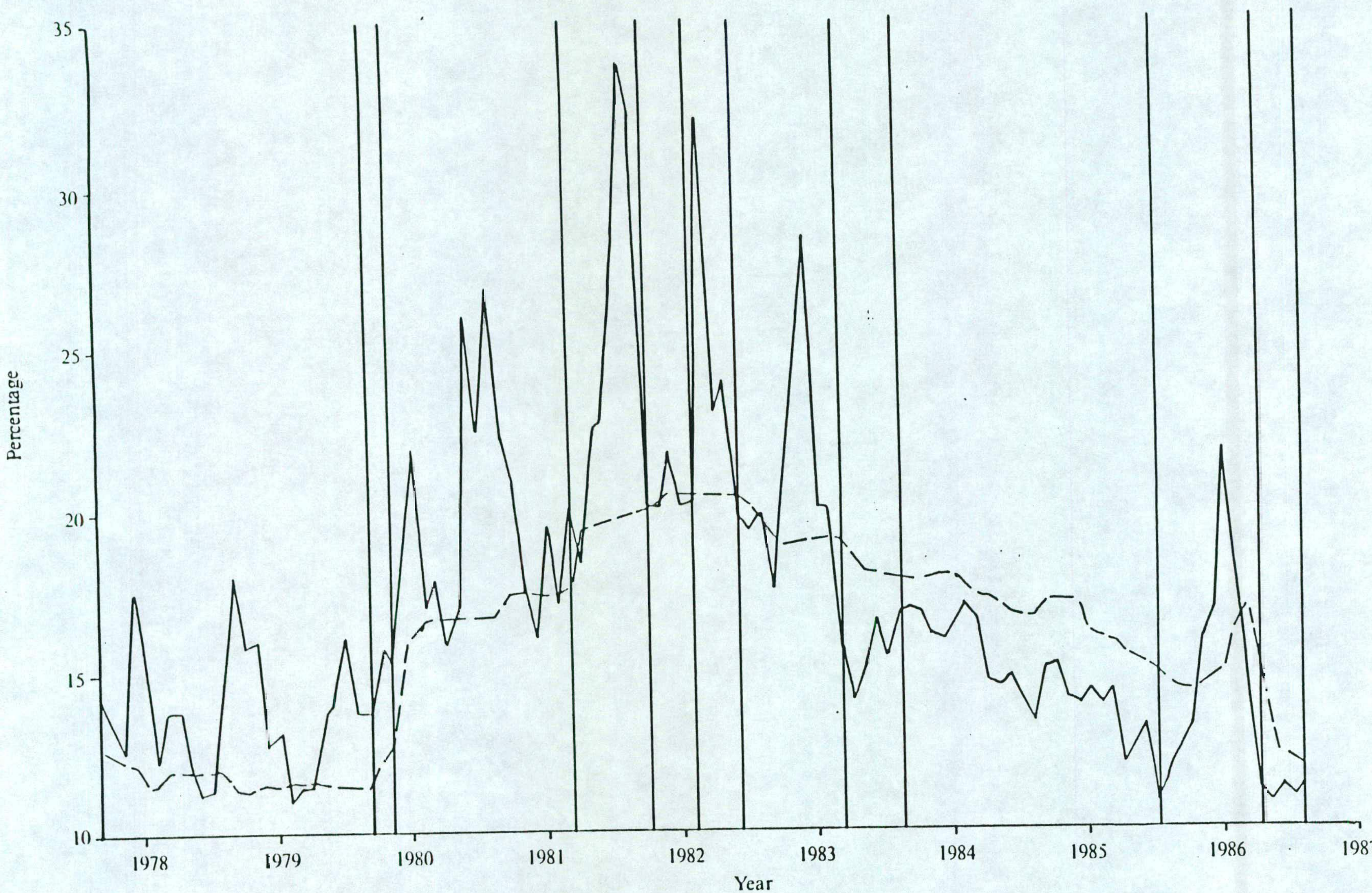
France off shore rate

France on shore rate

Vertical rules show dates of realignment

Note: The interest rate data are not fully maturity compatible

Source: Chase Manhattan; Bank of England



Italy off shore rate

Italy on shore rate

Vertical rules show dates of realignment

Note: The interest rate data are not fully maturity compatible

Source: Chase Manhattan; Bank of England pso.jt/Middleton/2.13.2

NEDO

cc PS/Chancellor

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 4360

Sir Peter Middleton GCB
Permanent Secretary

Walter Eltis Esq
Director General
National Economic Development Office
Millbank Tower
Millbank
LONDON
SW1P 4QX

14 February 1989

Dear Walter,

Thank you for your letter of 8 February about your invitation from David Henderson to speak at an OECD seminar in May on obstacles to monetary union.

I have mentioned this to the Chancellor, who would be content for you to speak along the lines proposed in your letter. He agrees that it would probably be as well for you to use a prepared text on this occasion.

Yours ever

Peter

P E MIDDLETON

Director General
Walter Eltis
Direct Line 01-211 5386
Secretary 01-211 3073

NEDO

8 February 1989

National Economic Development Office
Millbank Tower, Millbank
London SW1P 4QX

Telex 945059 NEDO G
Fax 01-821 1099
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Sir Peter Middleton KCB
Permanent Secretary
H M Treasury
Parliament Street
London SW1P 3AG

Chancellor,

This seems ok

Dear Peter,

David Henderson and I have been discussing a seminar that he is likely to invite me to give at OECD in Paris in the last week of May and the subject that appeals to us both would be "Obstacles to monetary union". It is David's advice that the French would not understand the meaning of "Chatham House rules" so we ought to assume that anything I said <u>might</u> be quoted outside and its significance misinterpreted.

I spoke on approximately this subject in the Political Economy Club on February 1st and what I said there was entirely aligned with the Chancellor's robust Chatham House speech. I naturally spent far more time on the economic issues than the political. Unfortunately none of your colleagues was at the Political Economy Club, but Keith Joseph and John Flemming were among the twenty five who dined.

I started with the EMS and our difficulties in joining because if we cannot do this then a fortiori we cannot contemplate going on to monetary union. I used David Petetz's evidence to the House of Lords on 14 June 1988 as a statement of the conditions where we might be able to join

> "As rates of inflation converge in the community, as economic performance converges generally and as exchange rates come to be more stable, it becomes easier to contemplate the step."

and explained what the difficulties for us would be if we joined before those conditions were met. In particular, so long as our inflation rate is considerably faster than Germany's, there is a risk that holders of financial assets will be offered one way options on future exchange rate movements as in 1964-67 which could lead to enormous potential gains to the financial sector at the expense of the taxpayer, since the Central Bank would be bound to supply foreign currency at official rates until these were renegotiated.

24

FROM: J M G TAYLOR
DATE: 23 May 1989

PMP

MR N P WILLIAMS (MP1)

cc PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Odling-Smee
Mr Peretz
Mrs M Brown
Mr Nelson

EMU: SIR MICHAEL BUTLER'S LETTERS ON BEHALF OF BIEC

Thank you for the draft replies you provided to Sir Michael Butler's letters to the Chancellor and to Charles Powell.

2. The Chancellor spoke to Sir Michael this morning, and they agreed that it would be best for Sir Michael to concentrate his efforts on a meeting with the Prime Minister. The drafts have ... been amended accordingly (copies attached.).

J M G TAYLOR
Private Secretary

TAYLOR → WILLIAMS 23/5

IN STRICT CONFIDENCE

The Delors Committee Report on Economic and Monetary Union (EMU)

Paper by the Chairman of the European Committee

Given the Delors Committee's terms of reference (see Annex) and the views of its Chairman, it was natural that its report should try to sketch out a blue-print for getting from where we are now to a complete EMU in which there would be irrevocably locked parities or a single currency. As far as the result is concerned, "sketch" is, however, the operative word.

A "three stage" approach.

2. The first stage, which could be implemented by decision of the Council and without Treaty amendment, is described in comprehensible outline. One can see what is proposed and the outline seems sensible, though no doubt one could argue about the detail. But the picture drawn of the second stage, which would constitute the majority of the journey from here to there, is done with a very broad brush. A European System of Central Banks (ESCB) would "absorb the previously existing institutional monetary arrangements" and "begin the transition from the coordination of independent national monetary policies ..... to the formulation and implementation of a common monetary policy by the ESCB itself .....". There is almost no clue as to how this very tricky exercise would be carried through. The details, including the choice of different methods of monetary control, would be very important. A real blue-print might have contained five or for that matter ten stages instead of three.

An Independent ESCB.

3. The report states, apparently without supporting argument, that the ESCB "should be independent of instructions from national Governments and Community authorities". This is not self-evident,

/except

except perhaps to the Bundesbank, in a Community in which other central banks are subordinate to Finance Ministers. The case would have to be closely argued in relation to the division of responsibility for macro-economic management and the degree of political integration. The report wisely assumes that, even after attaining EMU, "a degree of autonomy in economic decision-making" would have to remain with individual member countries and a "balance be struck between national and Community competences". Personally, I should want to get nearer the moment when a decision had to be taken before deciding between the various possible options e.g. wholly independent ESCB, ESCB under direction of ECOFIN Council (with or without external Board members) or no ESCB - see paragraph 8.

In for a penny, in for a pound.

4. Perhaps the most controversial statement in the Report is "the creation of an economic and monetary union must be viewed as a single process. .....the decision to enter upon the first stage should be a decision to embark on the entire process". Governments, including the British Government, are committted to "the objective of a progressive realization of Economic and Monetary Union" (see Annex). But they do not need to decide now on more than what to do next. Given the vagueness of the description of the second stage, it would have been more convincing if the Committee had recommended that the Community embark on the first stage in the near future and consider the content of a possible second stage in, say, 1993 after the completion of the single market. It would also have been less of a gauntlet thrown down in front of the British Prime Minister.

Attitudes in other Member States.

5. A dangerous element in the present situation is that the Bruges speech and subsequent statements by the Prime Minister and the Chancellor have created a psychology among many European politicians,

/bankers

bankers and opinion-formers which welcomes such a challenge to Mrs. Thatcher. Many of them are saying that Europe must now take the road to EMU whatever happens, with the British if possible but without them if necessary. This line may, in part, reflect a conviction that in the last resort the U.K. will not wish to be left out of any institutional developments in the monetary field in Europe. Mrs. Thatcher's willingness to come to reasonable compromises over the Single European Act in 1985 and the Community budget in 1987 has left many of their negotiators with the impression that she is often prepared to move a long way from her opening negotiating positions. They also point to the wording on EMU which she accepted in the Single European Act and at the Hanover European Council. In my view, there is a significant risk that they will underestimate the extent of the Prime Minister's opposition to further Treaty amendment in the monetary field, will push the negotiations to breaking point and then find it is politically difficult not to go ahead with a new Treaty without us.

6. The Milan European Council demonstrated that other Heads of Government are prepared to use majority voting on a procedural proposal to call a Conference to amend the Treaty. A similar challenge may therefore arise as early as the Madrid European Council in June.

7. Outright British opposition to any Treaty drafting would place the others in a difficult position. To go ahead and draft Treaty amendments which could not be approved and ratified wthout the U.K. would set them on a collision course from which it would be politically embarrassing to back down. On the other hand to move directly to drafting a new monetary Treaty without the U.K. (and perhaps Denmark) would create very serious problems. Many of the actions envisaged in the Delors Committee report are within the competence of the Treaty of Rome, as amended by the Single European Act. It would not be easy to draft a new monetary treaty which could co-exist with the European Community as it now is. But it might prove politically unacceptable simply to accept a British veto if that was all that was on offer in Madrid.

/Sovereignty

Sovereignty and The British Government's Attitude.

8. In stating his opposition to the Delors proposals, the Chancellor has placed great emphasis on sovereignty. To object to moving towards EMU on sovereignty grounds rather than for pragmatic reasons is at the other extreme from the "in for a penny, in for a pound" thesis. The difficulty with the argument is that the sharing of sovereignty is a question of degree. By signing the Treaty of Rome, accepting all the legislation passed since 1958, signing and ratifying the Single European Act and by accepting in principle the single market programme in the Cockfield White Paper we have moved (at a rough estimate) somewhere between one third and two thirds of the way down the road from co-operation between Sovereign States to the degree of sharing of sovereignty postulated by the sort of EMU sketched out for Phase 3 of the Delors proposals. It seems odd, and provocative to the others, to come out against any more sharing, especially since we are committed to a great deal of it in the Single Market programme. Moreover, one could invent practical forms of EMU in which less (or indeed more) sovereignty was shared, e.g. permanently locked currencies, as under the gold standard, but with advanced economic and monetary co-operation (under the present unanimity rules) between national governments and central banks in the Council and a Committee of Central Bank Governors. (The pros and cons of such options would need to be carefully considered). Sharing or retaining sovereignty is relative, not absolute; and the U.K. is more likely to avoid damaging confrontation if we argue our case on practical grounds.

X

The Position of the European Committee.

9. Should the private sector members of the European Committee take a position at this stage, for putting to the Chancellor and the P.M.? In my view, the importance of the issue to the City is very great. Whatever happens, there will be strong challenges to the City's

/position

position as the leading financial centre in the European time-zone from Paris, Luxembourg, Amsterdam and Frankfurt. If at any stage some form of ESCB is to be created, the U.K., should be a member and it should, if possible, be in London. It would be extremely damaging to the City's position if an ESCB were to be created elsewhere without the participation of the U.K.

10. I therefore propose that we should recommend to Ministers that:-

(a) they join in the discussion of how to make progress in the direction of EMU in a constructive spirit;

(b) they attack the "in for a penny, in for a pound" thesis as unsound and unpragmatic or simply take the line that it is unnecessary in Stage 1;

(c) they express readiness to work in a pragmatic spirit on the proposals for Stage 1 of the Delors report, with a view to decisions before July 1990, and progressive implementation in parallel with the Single Market programme;

(d) if necessary, they argue that it will be easier to see how to make further progress after Stage 1 once it is nearing completion and that the Delors Committee's route through Stage 2 to Stage 3 will not necessarily prove the right model when the time comes;

(e) they suggest that, given the need during 1990-92 to concentrate the attention of all 12 governments on the remaining difficult steps

/necessary

necessary to complete the single market, the more controversial proposals for Stages 2 and 3, such as the ESCB, together with other options, should be discussed further at the European Council in December 1992.

11. The European Committee should also express the wish to remain in close touch with officials and, if necessary, Ministers as the debate on the Delors report proceeds.

MDB/MML
27th April, 1989'

Extract from Hanover Council Conclusions June 1988

5) MONETARY UNION

The European Council recalls that, in adopting the Single Act, the Member States confirmed the objective of progressive realization of Economic and Monetary Union.

They therefore decided to examine at the European Council meeting in Madrid in June 1989 the means of achieving this Union.

To that end they decided to entrust to a Committee the task of studying and proposing concrete stages leading towards this Union.

The Committee will be chaired by Mr Jacques DELORS, President of the European Commission.

The Head of State and Government agreed to invite the President or Governor of their Central Banks to take part in a personal capacity in the proceedings of the Committee, which will also include one other member of the Commission and three personalities designated by common agreement by the Heads of State or Government. They have agreed to invite :

- Mr Niels THYGESEN, Professor of Economics, Copenhagen,
- Mr LAMFALUSSY, Director-General of the Bank for International Settlements in Basle, Professor of Monetary Economics at the Catholic Univerty of Louvain-la-Neuve
- Mr Miguel BOYER, President of "Banco Exterior de España".

The Committee should have completed its proceedings in good time to enable the Ministers for Economic Affairs and for Finance to examine its results before the European Council meeting in Madrid.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

23 May 1989

Charles Powell Esq
No.10 Downing Street
London SW1

Dear Charles

Your letter of 9 May asked for a draft reply to this letter to the Prime Minister from Sir Michael Butler.

The Chancellor thinks it would be worthwhile for the Prime Minister to see Sir Michael and his colleagues. I attach a draft reply.

Yours sincerely

J M G TAYLOR
Private Secretary

DRAFT LETTER TO:

Sir Michael Butler GCMG
Hambros Bank Ltd
41 Tower Hill
London EC3N 4HA

Thank you for your letter of 8 May.

The Prime Minister would be happy to see you and your colleagues. I shall be in touch to arrange a suitable time.

CHARLES POWELL

mg.ee/dlcp/24.5-est

RESTRICTED

From : D L C Peretz (MG)
Date : 24 May 1989
x 4460

ECONOMIC SECRETARY

cc PS/Chancellor
PS/PMG
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Evans
Mrs M Brown
Miss O'Mara o/r
Miss Simpson
Mrs Chaplin
Mr Tyrie

Ch

If we have to have a debate we should book a provisional date with Murdo now. Quite a narrow window between TCSC report (19 June) and European Council (27 June), especially given Welsh Party Conference on 23 June. Try for 20 or 21 June?

AA

OK - but prefer 21st

EUROPEAN LEGISLATION COMMITTEE : REQUEST FOR A DEBATE ON EMU

I understand that the Lord President would like a steer on how to react to the proposal in Mr Spearing's letter of 19 May, in case the matter is raised at business questions this Thursday.

2. We can hardly refuse to have a debate before the Madrid Council. On the other hand, there is a perfectly good reason for seeking to put it off until quite close to the time. The TCSC are taking evidence, first from the Governor (today), and then from the Chancellor (on 12 June), and planning (we are told, in confidence) to produce a report by 19 June. Mr Higgins would certainly want to have any debate delayed until his Committee's report is available.

3. I am not aware of any convenient economic or European debate planned between now and the Madrid Council, to which the Delors Report could be tacked on. But that must be a possibility.

4. However, I assume the Lord President need say no more at present than that he will certainly try to arrange a suitable opportunity before the Madrid Council at which the report can be debated. If you and the Chancellor thought this appropriate, he might add that no doubt the House would find it most helpful to

hold such a debate after the TCSC had completed their present enquiry into the subject, which he believed was likely to be in mid-June.

D L C PERETZ

mg.ee/dlcp/24.5-chan

SECRET

From : D L C Peretz (MG)
Date : 24 May 1989
x 4460

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Mr Wicks
Mr Scholar
Miss O'Mara o/r
Mr Gieve
Mr N P Williams

END-MONTH RESERVES POSITION

The true underlying fall in the reserves this month, after today's operations, now stands at around $850 million. This is of course a good deal bigger than when I put my note to you on 19 May.

2. The market is now expecting a fall in the reserves of this order, however, - if anything probably slightly larger. We and the Bank would therefore recommend publishing a figure more or less in line with the true underlying fall - ie somewhere around $800 million.

3. Are you content with this? It would be helpful to have an answer by tomorrow morning, since with the Bank Holiday next week there is not much dealing time left this month to do any necessary swaps.

Ian Polin

pp D L C PERETZ

mg.ee/dlcp/24.5-pspm

UNCLASSIFIED

1. Keith Akroyd
2. 11.30 today
3.

From : D L C Peretz (MG)
Date : 24 May 1989
x 4460

PS/SIR P MIDDLETON

cc PS/Chancellor
Sir T Burns
Mr Wicks
Mr Lankester
Mr Monck
Mr Scholar
Mr R I G Allen
Mr Gieve
Mr Grice

OBSTACLES TO EMU : PAPER BY WALTER ELTIS

The subject of course is a sensitive one, but we have already agreed that Walter Eltis should give this paper, and given that - and that it is to be presented in a personal capacity - I think it steers a reasonably safe course.

2. I would only want to pass on three fairly minor comments :

i) towards the end of the second paragraph on page 1, the reason why taking forward cover is only a partial solution is more that it is difficult to cover against unknown future payments and receipts, not so much that the forward market beyond 2 or 3 years is thin.

ii) the discussion in the paragraph on the turn of pages 4 and 5 might make the point that it is because of these factors that ERM members are able to maintain interest rates at different levels, even in the absence of exchange controls.

iii) the discussion that follows, on exchange controls, should acknowledge that the French government has now abolished all controls other than some relatively minor controls on individuals; and that flows have been liberalised to a sufficient degree since 1986 to make it very difficult to open up interest rate differentials between domestic French francs and offshore French francs.

5

3. Finally, while there can be no objection to Walter Eltis' use of my words, I should perhaps point out that I said rather more, as follows :-

> "As rates of inflation converge in the Community, as economic performance converges generally and as exchange rates come to be more stable, it becomes easier to contemplate the step. The difficulty has always been that sterling is a large internationally traded currency very much open to speculative flows with large financial markets. This has made it a rather more difficult step for the British government to contemplate than for some other governments. Perhaps I should say that I am confining myself to the economic arguments. There are of course political arguments, for and against, that have to be considered as well."

DLCP

D L C PERETZ

pso.vh/Simon/DPtwo

UNCLASSIFIED

~~DF 31/5~~
Eltis

FROM: S D H SARGENT
DATE: 25 May 1989

MR PERETZ

cc PS/Chancellor
Sir T Burns
Mr Wicks
Mr Lankester
Mr Monck
Mr Scholar
Mr RIG Allen
Mr Gieve
Mr Grice

OBSTACLES TO EMU: PAPER BY WALTER ELTIS

Thank you for your minute of 24 May. I passed your comments on to Mr Eltis who was happy to take them all on board in the version which is to be released next week. He has promised to send an advance copy of this, together with the covering press release.

S D H SARGENT
Private Secretary

fim.jf/day/5.25.5M

Thanks. Sir MB is wrong to suggest (this para 8) that I would, tho' I agree [illegible], develop the argument further: the Ch Ho posn (incidentally) [illegible] rather more coherent than any of theirs. He is also wrong about the gold standard (see X): [illegible] (or the [illegible] stage of [illegible] [illegible]) [illegible] stage 3 (or the single currency).

FROM: J ODLING-SMEE (FIM)
DATE: 26 MAY 1989
Ext: 4469

PS/CHANCELLOR

cc: PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Peretz
Mrs Brown
Mr N P Williams
Mr Nelson

Ch/
You will recall Sir MB plugging this paper when you spoke to him on the telephone. I am amused by 'X' + 'Y' - neither of which he mentioned, curiously enough.
[illegible] 26/5

EMU: SIR MICHAEL BUTLER'S LETTERS ON BEHALF OF BIEC

... You asked about the attached paper which Sir Michael Butler mentioned in his conversation with the Chancellor. He wrote it himself and presented it at the meeting of the BIEC European Committee which I attended on 4 May. The private sector members of the Committee were not very interested in Sir Michael Butler's conclusions (paragraph 10, on which his letter to the Chancellor was based), which they saw as being largely procedural.

X/ Y/

2. Most of the discussion, prompted partly by me, was about whether and how the UK would be affected if we were left outside the movement towards EMU. However, it was too much influenced by the narrow issue of the effects of locating an ESCB in another European city, following paragraph 9 of Sir Michael Butler's minute. The only useful thought that I came away with was that many City people's perceptions of the potential damage to the UK stemmed from a feeling that foreign (especially European) financial institutions would perceive that the UK was somehow outside Europe and so financial business would be shifted to other European centres, even though a rational calculation did not merit such a response.

JO-S

J ODLING-SMEE

mg2.cc/Williams/91g1.26.5

UNCLASSIFIED

File: ERMP A/56

FROM: N P WILLIAMS (MG1)

DATE: 26 May 1989

X 5561

1. MR PERETZ

2. CHANCELLOR

cc PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr H P Evans
Mr Odling-Smee
Mr Riley
Mrs M E Brown
Mr Gieve
Miss O'Mara o/r
Mr Chaplin
Mr Tyrie

Ch. Content for me to write as proposed? (I suggest deleting the last sentence).

OK

LETTER FROM M DE MAIGRET: ASSOCIATION FOR THE MONETARY UNION OF EUROPE

M de Maigret has written to you to bring to your attention before the European Council in Madrid the comments of the Board of Directors of the Association for the Monetary Union of Europe on the report of the Delors Committee. The Association has been prominent in advocating swift progress towards EMU and a large role for the ecu. It counts many prominent industrialists among its members. A draft PS reply is attached.

NPW

N P WILLIAMS

UNCLASSIFIED

mg2.cc/Williams/91g2.26.5

pls type as final from Duncan. copy list as cover minute.

DRAFT LETTER TO:

M Bertrand de Maigret
Association Pour L'Union Monetaire De L'Europe
26 Rue de la Pépinière
75008 Paris
France

26 May 1989

The Chancellor has asked me to thank you for your letter of 19 May, enclosing comments made by the Association's Board of Directors on the report of the Delors Committee. He set out the Government's position on the economic and monetary development of Europe in the speech he made at the Royal Institute of International Affairs at Chatham House on 25 January (copy enclosed). He noted in particular the comments in your paper about the development of the ecu, and the contribution the UK has made in this respect with the launch last year of the Government's programme of Treasury bills payable and denominated in ecu.

FROM: N E Sheinwald

DATE: 31 May 1989

cc: PS
PS/Lord Glenarthur
PS/PUS
PS/Sir J Fretwell
Mr Bayne
Mr Kerr
Mr Grant, News Dept
Mr Collecott, ECD(E)
Mr Ramsden, WED
Mr Arthur
Mr Parker, Cabinet Off
Mrs Brown, HMT
Mrs Le Guen, D/Employ
Mr Stow, DTI
Chanceries: Paris, Madrid, Bonn, UKRep, Brussels

cc PS/Chancellor and
PS/Economic Secretary
PS/Sir P Middleton
Mr Wicks
Mr Lankester
Mr RIG Allen
Mr Gieve
Mr Mercer
Ms Symes

PS/Mrs Chalker

Some v. revealing glimpses. 2-p[illegible] but let me have the answers for questions in the margins @ x & y.

DELORS' FIGARO INTERVIEW

A 1. I attach a translation of Delors' interview in Le Figaro on 25 May.

Nigel Sheinwald

N E Sheinwald
European Community Department (Internal)

NS2ACY/1

STS 349/89

Article from "Le Figaro" of 25 May 1989

Straight talk from Jacques Delors

. Margaret Thatcher does not see the building of Europe in the same way as her partners do . The German position has not shifted . We have just registered the highest rate of growth for twelve years.

Report compiled by Franz-Olivier Giesbert and Henri de Kergorlay

LE FIGARO - Are you disappointed by the way in which the Finance ministers of the Twelve greeted the Delors report on economic and monetary union last weekend?

JACQUES DELORS - No, because the twelve Finance ministers praised the quality of the report and recommended that we begin to examine how it can be put into effect. But an unequivocal commitment is required by the heads of State and Government. Because the report forms a coherent whole. It is true that it proposes a political and institutional leap without which it would not be possible to achieve close and fruitful cooperation in the matter of economic and monetary policies. The proposal is that we should proceed realistically, in a number of stages, depending on observed economic trends. To split up this overall proposal would be a serious mistake and result in the failure of a plan which is essential for economic prosperity and social progress.

- Margaret Thatcher has been extremely vigorous in opposing this plan. Do you believe it is possible to take Europe forward while Britain is dragging its feet?

- The British Minister expressed his appreciation of the report on a technical level, but he considers it too soon to call for political commitment and a treaty at this stage.

. .

- So Britain has already replied, and the answer is no!

- As I have said, the heads of State and Government will resolve the matter. It is not my intention to add fuel to the flames. But it is clear that if the Twelve decide to move towards economic and monetary union, it would help to give an even greater impetus to the building of Europe, while boosting their respective economies.

- If Margaret Thatcher rejects your plan, what will you do?

- The proposal is flexible and realistic. It comprises three stages, without specifying a timetable for transition from one stage to another. In approving the plan, each of the EEC partners will be like a traveller leaving Brussels for Marseilles by train. He will always have the option of getting out at Paris or Lyons if the journey fails to come up to his expectations. There will be nothing to stop him.

As regards Great Britain, two questions arise: will she buy a ticket and, if so, will she go the whole way?

- Do you not feel that the main obstacle to Europe, today, is Margaret Thatcher?

- Margaret Thatcher does not see the building of Europe in the same way as her partners do. As she emphasised in her Bruges speech, she believes that the ultimate aim must be a single extended market, together with cooperation between twelve sovereign States. But in signing the Single European Act, Britain has already accepted that the extended market should be accompanied by common policies, and consequently by a process of economic and political integration. On this last point, I would refer you to the preamble to the Single European Act.

. .

- Were you in favour of Britain's entry to the EEC?

- Of course.

- In retrospect, wasn't that a mistake? Now that Europe is constantly being built by eleven with one dissenting, can it not be said that de Gaulle was right and that Europe should be built without Great Britain?

NB!

- That is incorrect. In the end, Great Britain has been won over to each of my proposals for relaunching the building of Europe.

- There is another point on which Margaret Thatcher disagrees with you and the other eleven countries of the Community and that is "social Europe". She considers the only valid model in this connection to be the British one.

- There are many subtle differences between the champions of the social space. Since our Community is founded on respect for national variations when they manifest themselves, I believe that Europe will be pluralist or there will be no Europe. Nor should some people, seeing themselves as new crusaders, regard their own way of doing things as so good that they have to impose it on others.

X French, 88!

- And that is the case with Great Britain ...?

- When the Commission puts forward a proposal on a social matter I try to ensure that it will be acceptable to Great Britain. But when a British minister says that only his view is the correct one, it makes it increasingly difficult for the Twelve to get on together. For everyone to be able to form his own opinion, I should probably recall our social priorities: combatting unemployment, assisting less-favoured regions, rural development, improving working conditions, promoting the basic rights of workers and cooperation between management and labour ...

- After the British problem, you now have a German problem. As François Mitterrand said: "No liberalisation of capital without agreement on the taxation of savings." The Federal Republic seems to be in no hurry to decide on that.

- That is not what Helmut Kohl told me and Europe cannot be built, to my mind, without a climate of trust. No-one should therefore undermine our agreement.

- What do you think of the shift in the German position?

- There has been no shift in the German position. Both the German government currently in power and the leaders of the Social Democrat opposition regard the building of Europe as the only way in which the Federal Republic will one day be able to reconcile liberty and fraternity. What I am telling you is true today. Will it still be true in three or four years' time? That is the question and it explains the urgent need for effective progress in the building of Europe and the importance of a political decision in favour of economic and monetary union.

- Was not Germany more closely attached to Europe a few years ago?

- No. Mr Genscher, the Minister for Foreign Affairs of the Federal Republic, has always taken a very European line. But if Europe does not move forward or if West Germany's partners constantly impugn its motives, I cannot vouch for the future.

- Why, despite all these difficulties, has there been a sudden transition from Euro-pessimism to Euro-optimism?

[illegible] many?!

- Because we have just registered the highest rate of growth for twelve years and the highest level of investment for twenty-one years. And because Europe has created 1 800 000 jobs in a single year. All these facts demonstrate the renewed energy of the European economy. I do not believe that such excellent economic results would have been achieved, despite a supportive international environment, without the objective of 1992 and the Single European Act. The climate has been profoundly altered by these two factors: the Europeans believe in themselves once more.

- Who conceived the idea of the 1992 Single Market?

!

- It was my idea, as I am happy to recall, and I am proud of it, because it shows that things can be changed by the force of ideas and persuasion, and not simply by bringing the power structure into play.

- How did the idea come to you?

- Once I had been appointed President of the Commission and before taking up office six months later, I toured the European capitals, in the customary manner. I told the various people I spoke to that "The building of Europe has been paralysed by your arguments. You have settled them by adopting the compromise proposed by François Mitterrand. Now, a new driving force must be found to enable us to move forward again." That driving force could not be an institutional change. Or defence. And not currency either. Since none of those issues had unanimous support, there was at the time no consensus on those three subjects. I therefore argued for the effect of scale to be gained from an extended economic space: "Since 1973 we have been in relative decline compared with the United States and the new Pacific powers. If you remove the barriers between you, you will create an extended market which will restore your vitality." Being wary of grand declarations which have no results, I thought that a date should be set to oblige them to put into effect what they had decided. Hence 1992 ...

Was the idea of 1992 not in fact a brilliant publicity gimmick on Séguéla lines ?

If you had told me at the time that it would be a great success in publicity terms, I would have been surprised. But if you want a comparison, the role of the 1992 programme in showing the way ahead and its effect as a mobilising force are similar to the French-style planning of the fifties and sixties.

In the USA, the States have not unified their legislation. Was it really necessary for the European countries to do so for Europe to move forward ?

There is no historical equivalent for what we are doing. Nor is there any equivalent for what the United States has done. That is why I never speak of the "United States of Europe".

What is the difference between the two processes ?

There is a considerable difference. The United States were established with one language and one frame of mind, that of the aggregation factors ? In its first phase, from 1950 to 1982, the theme of the Common Market was Robert Schuman's dictum : "There must never again be war between us". Since 1984, there is my idea that "we must unite to survive". There could indeed be a danger of our countries turning into museums that the Japanese and the Americans would come and visit. It is vital that the Europeans unite to ensure prosperity and social progress, and also our influence in the world.

. .

You speak only of economic identity. But why do you deny the cultural identity of Europe ?

There is no economic identity. There is a community of economic interests. And there is, in the same way, a community of cultural interests. There must always be respect for pluralism, wealth in diversity : the Treaty gives us no powers in cultural matters.

We therefore act indirectly through the Media programme which encourages innovation in disseminating culture, through scientific cooperation which will enable us to win the battle for the television of the future (high definition) and by urging our Governments to cooperate in encouraging the production and broadcasting of European works...

What aspects of this Europe of the Twelve are most effective in mobilising public opinion ?

First, the idea of a European currency, then the removal of frontiers and, finally, the possibility of going to study and work in other countries. Hence our student exchange programmes (Erasmus and Comett I).

The removal of frontiers is not proceeding very fast ?

Some people fear that the disappearance of customs checks will result in freedom of movement for drugs and terrorists. The Germans take that view, as Helmut Kohl recently told me, and that is why he put forward the idea of a European FBI. That is the path we must take, strengthening cooperation between our security services.

How do you see the Community's relations with Eastern bloc countries and the Soviet Union at a time when East-West relations are developing at a rapid rate ?

There has been a Soviet Ambassador to the European Community in Brussels for some months. We are preparing a trade and cooperation agreement between the EEC and the Soviet Union. Moscow feels the need to be informed of what we are doing. The Soviet leaders have now accepted our existence after thirty years of sulking !

What is the right attitude to take towards Gorbachev ?

I have repeatedly argued that our twelve countries should adopt a joint and positive attitude towards the Soviet leader's initiatives. The idea of such joint action is taking root all too slowly...

To say the least ...

At the last Foreign Affairs Council in Granada, there was agreement on the principle that joint analysis and a joint approach are needed. It is in that spirit that we shall determine the content of our trade and economic cooperation agreements with the USSR, Poland and Bulgaria, having already signed agreements with Hungary and Czechoslovakia.

The six Western European countries belonging to the European Free Trade Association (Sweden, Norway, Finland, Iceland, Austria and Switzerland) are afraid of being excluded from the extended single market that will be established by the Twelve from 1 January 1993.

We discussed this in March during talks between the Foreign Ministers of the Twelve and the Six. My view is clear and I stated it unequivocally to the Member States of EFTA : "If you apply for accession, we cannot accept your application for entry for several years because we must first consolidate what we are doing as a Community of twelve. I have suggested another way of enabling those countrie reap the benefits of the extended market and increase o cultural and scientific exchanges.

What is certain is that, for East and West alike, we represent a focal point for trade - that is obvious - a also politically.

What form might the Europe of tomorrow take ?

We might see a Europe of concentric circles. In the centre would be those who want to go as far as possible, that say those who want political union.

Without Great Britain ?

That is a matter for that country to decide. But I should add that there would be a second circle open to those who do not want political union. The vision of an extended Europe should be in our minds but it should not distract us from our aim, which is to build a political community, not merely an economic and social one.

FROM: J M G TAYLOR
DATE: 31 MAY 1989

PMP

MR ODLING-SMEE

cc PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Peretz
Mrs Brown
Mr N P Williams
Mr Nelson

EMU: SIR MICHAEL BUTLER'S LETTERS ON BEHALF OF BIEC

The Chancellor was grateful for your note of 26 May.

2. He has commented that Sir Michael Butler is wrong about sovereignty (his paragraph 8), though the Chancellor agrees that he needs to develop his own argument further: the Chatham House position contained rather more assertion than analysis of this. Sir Michael Butler is also wrong about the gold standard: currencies were not <u>permanently</u> (in the sense of <u>irrevocably</u>) locked as they would be in Delors stage 3 (and the single currency).

J M G TAYLOR

PSP

BF ~~13/6~~

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 June 1989

Dear Duncan,

X

I wrote to you on 9 May about the letter to the Prime Minister from Sir Michael Butler. The Prime Minister will be seeing Sir Michael on 15 June and I should be grateful for some briefing for the meeting.

Yours sincerely,

Charles Powell

CHARLES POWELL

Duncan Sparkes, Esq.,
H. M. Treasury.

CH/EXCHEQUER

REC.	01 JUN 1989 ✓ 1/6
ACTION	Mr NP Williams
COPIES TO	Mr Peretz,
	MR Odling-Smee
	Mr R.G Allen
	Mr M Brown
	Mr Neilson

POWELL → SPARKES 1/6

chex.ps/ds2/58

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

5 June 1989

M Bertrand de Maigret
Association pour l'Union
Monetaire de l'Europe
26 Rue de la Pepiniere
75008 Paris
FRANCE

pmp

Dear Monsieur de Maigret,

The Chancellor has asked me to thank you for your letter of 19 May, enclosing comments made by the Association's Board of Directors on the report of the Delors Committee. He set out the Government's position on the economic and monetary development of Europe in the speech he made at the Royal Institute of International Affairs at Chatham House on 25 January (copy enclosed).

Yours sincerely,

Duncan Sparkes

DUNCAN SPARKES
Assistant Private Secretary

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr H P Evans
Mr Odling-Smee
Mr Peretz
Mr Riley
Mrs M Brown
Mr Gieve
Miss O'Mara
Mr N P Williams
Mrs Chaplin
Mr Tyrie

3.25.1

H. M. TREASURY

Parliament Street, London SW1P 3AG. Press Office 01 270 5238
Facsimile 270 5244
Telex 9413704

PLEASE NOTE EMBARGO

25 January 1989

NOT FOR PUBLICATION, RELEASE, OR USE ON CLUB TAPES BEFORE 18.00 HOURS ON 25 JANUARY 1989

WHAT SORT OF EUROPEAN FINANCIAL AREA?

Speaking today at the Royal Institute of International Affairs, **the Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP,** set out the UK's approach to the financial and monetary dimension of European integration. The text of his speech is attached. The main points are:-

The Single Market

"The Single Market offers an historic opportunity for Europe and thus for Britain ... it is a decisive step towards a more liberal Europe ... It is about freedom of movement of goods, for services and for capital ... ending of protective barriers ... exposing Europe to competition."

..."there are others in Europe [for whom] this liberal, free market vision of 1992 is not altogether to their taste. So they are trying to claw back lost ground, substituting ... supra national regulation ... [or] seeking to make [the Community] an exclusive club. In this critical struggle over the future of Europe, there is no doubt where Britain stands."

"It would be the height of folly for Europe to dismantle internal trade barriers only to erect new ones against the rest of the world."

[Mutual recognition of different national standards within Europe] "is a completely logical extension of consumer sovereignty, and a vital ingredient of the Single Market. It is the true market approach, exposing regulation itself to competition, with the result that, over time, countries will be obliged to concentrate on what really matters, not on preserving inefficient industries or protecting vested interests."

Tax Approximation

"Enforced tax approximation is in no way a necessary feature of the Single Market....It is widely recognised as being politically impossible at least so far as excise duties on alcohol and tobacco are concerned."

"I have therefore put forward, on behalf of the United Kingdom, a market based approach [which] does not attempt to impose harmonised tax rates but instead allows market forces to produce the incentive for such closer convergence as is desirable. At the same time, the UK proposals envisage an early and substantial reduction in border formalities for commercial traffic within the EC."

"For individual travellers, I proposed that we should make large and progressive increases in the "tax paid" allowances on goods brought back from other Member States, with the eventual aim of having no limit at all, except probably for alcohol and tobacco."

"The present limit is some £250. I believe that a realistic first step - which should be taken as soon as possible - would be to quadruple that limit, so that £1,000 of tax paid goods could be imported from another Community country without any need to make a Customs declaration at all."

"The harmonisation of taxes on savings is clearly not a requirement of the single market."

Economic and Monetary Union

"It is clear that Economic and Monetary Union implies nothing less than European Government - albeit a federal one - and political union: the United States of Europe. That is simply not on the agenda now, nor will it be for the foreseeable future.'

The Chancellor noted that M.Delors said last week that the European Council would be presented with a plan for establishing economic and monetary union involving amendments to the Treaty of Rome. He commented "any attempt to persuade the nations of the European Community to accept this as a prescription would be deeply divisive and damaging. Certainly, neither the British Government nor the British Parliament is prepared to accept the further Treaty amendments which the President of the Commission evidently envisages".

"We must set our sights clearly on the important and practical steps that are needed to implement the Single Market by 1992. In that context, EMU is essentially a damaging diversion. We must recognise it as such, and press ahead resolutely with removing barriers to the free movement of people, goods, services and capital - the true goal of the Single Market - for the benefit of the peoples of a freer Europe."

"Thus it is that the Single Market offers an historic opportunity. But if Europe takes the other road, of red tape, bureaucracy, supranational intervention and protectionism, Euro-sclerosis would be more than mere talk; it would be a reality. And the dream of 1992 would have become nightmare. We must not allow that to happen.

4/89

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

CHANCELLOR OF THE EXCHEQUER'S SPEECH AT THE ROYAL INSTITUTE FOR INTERNATIONAL AFFAIRS, CHATHAM HOUSE, 25 JANUARY 1989

WHAT SORT OF EUROPEAN FINANCIAL AREA?

I am most grateful to the Royal Institute for International Affairs for arranging this meeting. It is the lot of Finance Ministers that their speeches on international topics tend to be made overseas at the various international meetings which are a regular part of the calendar. So it is a particular pleasure to be giving this speech here tonight, on home territory.

My subject tonight is "what sort of European Financial Area?" - a new bit of jargon dreamt up by the European Commission in 1987 when it put forward its proposal for the complete freedom of capital movements within the Community, and which has come to encompass the financial and monetary dimension of European integration.

That is the core of what I want to discuss this evening. But it cannot be divorced from the wider issues of the Single Market and 1992.

The Single Market offers an historic opportunity for Europe and thus for Britain. It was implicit in the original Treaty of Rome that we should move towards unimpeded freedom of movement for goods, for services, for people, and for capital. But after some important early steps, primarily on the free movement of goods, progress stalled, or at best advanced only at a snail's pace. As President Delors noted last week, it took eighteen years for the Community to adopt a directive on the mutual recognition of architects' qualifications, and sixteen years for a similar one on pharmacists.

The fresh impetus given by the Single European Act, with its objective of removing all barriers by 1992, was long overdue. It was a development which Britain played a major part in creating. And it is one which has now caught the attention of business and of the public more generally. We are at long last on the march towards achieving the prime objective of the original Treaty.

The Single Market is a radical step. And it is a decisive step towards a more liberal Europe, one based on freeing up markets. It is about <u>freedom</u> of movement for goods, for services and for capital. It is about the ending of protective barriers, whether direct or indirect. It is about exposing Europe to competition, in the belief that greater competition is the spur to greater efficiency, and the key to economic success.

As the Prime Minister put it in her Bruges speech in September:

> "The aim of a Europe open for enterprise is the moving force behind the creation of the Single European Market by 1992 ... It means action to <u>free</u> markets, to <u>widen</u> choice and to produce greater economic convergence through <u>reduced</u> government intervention."

But there are others in Europe who have only now begun to realise - rather late in the day, after they have signed up to it - that this liberal, free-market vision of 1992 is not altogether to their taste. So they are trying to claw back lost ground, substituting a concept of 1992 based on supranational regulation, not so much one where barriers are broken down, but one where restrictions and controls are levelled up.

And there are yet others who, even if they feel obliged to accept that a liberal regime within the Community is now inescapable, are seeking to make it an exclusive club; one where members enjoy the benefits but the rest of the world is allowed across the doorstep only under strict supervision; one where the Single Market is defined not by its commitment to liberalisation, but by the barriers erected around it.

The contrast between the two rival visions of Europe has become very clear. On the one hand an over-regulated, bureaucratic, protectionist Europe, where uniform standards are enforced by new directives and new regulations from Brussels, where outsiders are excluded, and where competition is seen as a threat, rather than a challenge to greater efficiency; a Europe in which "regulate and protect" might be the motto. On the other hand, there is the vision of a deregulated, free-market, open Europe, one where competition is seen as the key to improved economic performance; one driven by consumer choice, by transferring sovereignty not to Brussels but to the people.

In this critical struggle over the future of Europe, there is no doubt where Britain stands.

We have consistently fought to break down barriers, to reduce protection, and to free up trade. Not just within Europe: it would be the height of folly for Europe to dismantle internal trade barriers only to erect new ones against the rest of the world. Fortress Europe would increasingly be isolated from the opportunities which the globalisation of the world economy is bringing. Just as it makes no sense for Britain to isolate herself from what it happening in Europe, so it makes no sense for Europe to seek to isolate herself from the rest of the world.

I was encouraged to read that President Delors, in his speech to the European Parliament last week, said

> "Economically speaking, it would be absurd for the largest exporter in the world to close its frontiers to foreign products ... Europe would be the first victim of mounting protectionism, particularly since the Community is more dependent than its partners on international trade."

I wholly endorse that view. But actions as well as words are needed.

Another area where the rival visions of the Community are seen is the so-called "social dimension" of 1992. Having spent getting on for ten years gradually removing the dead hand of corporatism in Britain, I have to say that we have no intention of accepting its reintroduction at the European level. The attempt to level up all sorts of so-called "worker protection" provisions is a sure way not of protecting jobs but of destroying them, as employers become burdened with unnecessary regulations and increased costs. And grandiose attempts to reduce regional disparities by ever-greater resource transfers is likely to be no more successful at the Community level than it has been within individual countries. Subsidising industries and subsidising regions destroys their will to compete, and thus their ability to compete.

Nor are we prepared to see protectionism introduced under the guise of "reciprocity". Europe certainly needs to drive a hard bargain with the rest of the world: and it is an important objective to persuade other countries to open <u>their</u> markets. But, all too often, proposals for "reciprocity" go far beyond this legitimate aim, and seek either to impose constraints on bilateral trade - which is protectionism at its worst - or to make such unreasonable and doctrinaire demands for the terms of Community access to other markets that the predictable result is no access at all. Looked at from another angle, the effect of creating major obstacles to foreign firms who want to set up in the Community is all too likely to be that business is simply diverted elsewhere.

In short, the United Kingdom is committed to breaking down barriers, so that the Single Market really is a free trade area. And as the barriers come down, it is up to business and industry to meet the challenge this presents. If they are not capable of seizing the opportunities within a deregulated Europe, they will have little hope of competing successfully in world markets.

All the signs are that most of British industry is now well equipped to take on these challenges, with the record growth in profitability, productivity and investment over recent years all serving to strengthen industry's position very considerably. Forward-looking firms are now increasingly planning their operations, and their investments, with 1992 in mind.

But there is much still to do before we complete the Single Market. Far too many barriers are still standing. The Cecchini Report found that eliminating multiple national standards was much the most significant step which was needed to secure the full benefits of the Single Market. And a glance through the sixteen volumes and nearly 6,000 pages of research material on "The Cost of Non-Europe" reveals in graphic detail how innocent-sounding national requirements for testing or certification can impose very substantial costs on firm in one Community country seeking to export to another.

To take just one small example - and there are many others - the French regulations for wood-working machines require the testing, in France, of every variant of every type of machine a manufacturer produces, even if the machine is fully approved in another Member State. This inevitably adds greatly to the costs, and to the time required - it takes six months to a year to get approval in France compared to two to three months in other countries.

There is a vital principle here, one that lies at the heart of the Single Market. Past attempts to agree common standards, common regulations, common rules for authorising businesses have almost always got bogged down in a morass of technical detail. Different countries have different approaches and do not see why they should change their ways. The breakthrough of the Single Market was the acceptance of the principle that there is no reason why these national differences cannot continue, applied to a country's own products and businesses, <u>provided</u> each country accepts that firms and products approved in one country should be free to compete throughout the Community and that people should be free to purchase goods and services from anywhere within the Community.

This is a completely logical extension of consumer sovereignty, and a vital ingredient of the Single Market. It is the true market approach, exposing regulation itself to competition, with the result that, over time, countries will be obliged to concentrate on what really matters, not on preserving inefficient industries or protecting vested interests.

In so far as there are areas - and I believe there are very few - where a convincing case can be made for a common Community regulation, the important and related principle is that this must never be, as so many instinctively assume, harmonisation on the average of existing national regulations, but harmonisation on the best - which means on the minimum the situation requires. Individual countries can go further than this if they wish to, on the wholly non-discriminatory basis I have already described; but they have to accept the economic consequences.

Needless to say, in common with all other Community countries, the UK is not without its own regulations and barriers which appear to impose substantial costs, and the Government has for some time been subjecting them to scrutiny. But I think it is fair to say that, in general, the protectionist impact of technical standards is considerably more extensive in other countries than it is here.

And as well as trying to remove unnecessary barriers of our own, the United Kingdom has been in the forefront in promoting practical steps to free up trade within the Community. In the financial area, for example, it was we who took the lead in pressing for freedom of capital movements. We have long been urging the need for the liberalisation of trade in insurance, where significant progress has been made over the past year. And we have been active in negotiating for a true internal market in banking and investment services, where important draft Directives are now before the Council.

The liberalisation of trade in financial services is of particular importance, not just to Britain, the home of Europe's leading financial centre, but to Europe as a whole. For, like it or not, financial services are likely to remain for the foreseeable future one of the fastest growing industries in the world. And of all businesses, it is the most mobile. Europe cannot afford not to provide it with an environment in which it can flourish as well - if not better - than anywhere else in the world.

Public procurement, too, is another key area where opening up the market to competition within Europe can bring enormous benefits. For public purchases amount to some 15 per cent of the Community's GDP, and the Single Market would fail if they were to be excluded from the breaking down of barriers to competition.

We also need to ensure fair competition between companies in the field of takeovers and mergers. The UK has a tradition of an open and liberal regime. But many other countries maintain barriers, usually of an indirect or covert nature, which have the effect of preventing capital markets from operating efficiently. We must look for a level playing field. But we must equally avoid the trap, here as elsewhere, of building up new barriers under the guise of harmonisation, or of creating new centralised powers. A so-called Community "industrial policy" would be just as misconceived as past national "industrial policies" have been.

There is much hard and detailed work to be done in getting agreement on progress in these and in other crucial areas. There are few more politically difficult endeavours than the removal of discriminatory national barriers. And the temptation is always present to concentrate, not on this difficult, vital but often humdrum task, but on some headline-catching grand design instead.

Tax approximation

One proposal which has certainly grabbed the headlines has been that on indirect tax approximation - and in particular the harmonisation of VAT and excise duty rates within narrow bands. As is well known, on the basis of the current proposals, this would mean the enforced abandonment of the United Kingdom's zero rates on such items as food and children's clothing. We have already made our objections to these proposals perfectly clear. But what is equally clear from the Commission's own studies is that enforced tax approximation is in no way a necessary feature of the Single Market. The Cecchini Report itself estimates that multiple technical standards and regulations are something like seven times as costly as all border controls put together; and the UK experience is that the costs of dealing with differing indirect tax rates in turn account for only a small proportion of the total costs of border controls.

Moreover, indirect tax approximation is not an end in itself, but is seen by its proponents as an intermediate objective towards the declared goal of removing fiscal frontiers. It follows that if we can secure the final objective without going through the intermediate step of tax approximation, there is clearly little point in wasting any more time on that, not least since it is now widely recognised as being politically impossible at least so far as excise duties on alcohol and tobacco are concerned. Within the spirit of the Single Market, I have therefore put forward, on behalf of the United Kingdom, a market-based approach to dealing with fiscal frontiers. This approach does not attempt to impose harmonised tax rates, but instead allows market forces to produce the incentive for such closer convergence as is desirable.

At the same time, the UK proposals envisage an early and substantial reduction in border formalities for commercial traffic within the EC, with controls increasingly taking place inland at traders' premises as part of the normal system of VAT and excise control, rather than at the frontier. Moreover, making greater use of the domestic VAT control systems would be far simpler than the bureaucratic proposals by the Commission for a "Clearing House" to account for VAT owing on goods exported from one Member State to another.

The new Commission is discussing with Member States how these issues might best be taken forward. But in the meantime the British Customs and Excise will in any case be taking steps later this year to speed up the processing of Community freight traffic through our ports by their new "fast lane" proposals.

For individual travellers, I proposed that we should make large and progressive increases in the "tax paid" allowances on goods brought back from other Member States, with the eventual aim of having no limit at all, except probably for alcohol and tobacco.

The present limit is some £250. I believe that a realistic first step - which should be taken as soon as possible - would be to quadruple that limit, so that £1000 of tax paid goods could be imported from another Community country without any need to make a Customs declaration at all. That would be a major step towards reducing Customs formalities for individuals, thus breaking down fiscal frontiers and enlarging individual freedom.

But it is not only in the field of indirect taxes where there is pressure for harmful and unnecessary harmonisation. Next month, the Commission is due to bring forward proposals aimed at reducing tax avoidance following the abolition of exchange controls, and these seem likely to include some form of enforced withholding tax on the income from savings.

The harmonisation of taxes on savings is clearly not a requirement of the Single Market - indeed not even its most ardent proponents pretend that it is. Instead, it is advocated by those who argue that the abolition of exchange controls could increase the scope for tax avoidance and even evasion, as savings are transferred from one Community country to another. In other words, having accepted the principle of freedom of capital movements, they are seeking to escape from its consequences.

In fact, fears about tax avoidance are greatly exaggerated. There was similar concern expressed about the risks in the UK when we abolished exchange controls in 1979. But our experience since then gives absolutely no reason to suppose that those concerns had any foundation. And only this month socialist Sweden committed itself to ending exchange controls, without seeing any need to try to negotiate special new arrangements with other countries to counter avoidance.

Freedom of capital movements was something which the UK had taken the lead in urging. It was finally achieved in June last year. It was a remarkable and historic step. All European Community member states are now committed to the complete elimination of exchange controls, most of them by the middle of next year. This is something which would have been unthinkable ten years ago. It has, quite rightly, been recognised that freedom of capital movements is an essential element of the Single Market, and that, in any case, exchange controls were becoming increasingly irrelevant, if not counterproductive, in today's global markets.

Nor can I accept the case for the enforced harmonisation of business taxes. Here again, market forces can be allowed to do the job. The House of Lords Select Committee put the point well in its report a couple of months ago:

> "There seems little need for the Community to force the harmonisation of company taxation. ... provided tax rates remain broadly in line, [we] do not believe that there will be significant misallocation of resources within the Community."

Moreover, both in the taxation of savings and in company taxation, we must be aware of the wider world context. There is no gain at all to the Community if the effect of introducing harmonised restrictions within the Community is simply to divert business or savings outside the Community altogether. And in today's global markets that is all too likely to be the result.

Where enforced harmonisation is absolutely necessary, the objective must, to repeat, be to harmonise on the best, which invariably means the minimum. Where it is not necessary, which is normally the case, the answer must be to leave it to market forces to produce a distribution of business and of tax rates that satisfies the different objectives of different countries, who will inevitably have different priorities, not least as to the level of public expenditure - which at the end of the day must match the level of taxation. Harmonising on the mean - let alone harmonising on the most restrictive - will satisfy no-one except the bureaucrats and will serve only to turn Europe into a financial backwater, at great cost to its people.

EMU

A potentially much more significant diversion from the important but difficult work still needed if we are to complete the Single Market by 1992, is the pressure from some quarters for a dramatic leap forward beyond the Single Market towards so-called Economic and Monetary Union or EMU.

After the turmoils of the early and mid-1970s, the Community made an important step towards greater monetary co-operation with the setting up of the European Monetary System in 1979. Since then, the UK has consistently promoted practical steps to increase monetary co-operation further - both within the Community and more widely in the G7.

We have, for example, been a strong advocate of greater use of the ecu. Our issue of Ecu Treasury Bills , begun last autumn, has provided the short-term, high quality instrument which the market needed to underpin its liquidity. And we have been urging others to join us in making greater use of the ecu in foreign exchange reserves, and in intervention.

We also see a wider role for cross-holdings of individual Community currencies. A diversification of reserve holdings provides greater flexibility than holding only dollars.

And, most important of all for developing greater monetary co-operation and paving the way for the Single Market, the UK took the lead, as I have said, in pressing for the adoption of the directive on the freedom of capital movements.

The UK has not yet, of course, joined the exchange rate mechanism of the EMS. As the Prime Minister has pointed out on a number of occasions we will join the exchange rate mechanism when we believe that the time is appropriate. Subject to the overriding need to bear down on inflation, we fully accept the advantages of reducing currency fluctuations, though sterling's status as an internationally held currency inevitably makes that more difficult than is the case with the other currencies that are linked to the Deutschemark in the EMS.

Clearly, some of the problems over sterling's joining the ERM have diminished over time: for example, it is no longer seen as a so-called petro-currency. And, as 1992 approaches and the proportion of our trade with other EC countries continues its long-term increase, it is clear that exchange rates against other European countries will become increasingly important.

But the difference between full membership of the EMS and Economic and Monetary Union could not be more fundamental.

The EMS is an agreement between independent sovereign states whose economic policies remain distinct and different. By close co-operation, they can achieve greater stability of exchange rates, and - as we have seen - reinforce their efforts to bring down inflation.

Economic and monetary union, by contrast, is incompatible with independent sovereign states with control over their own fiscal and monetary policies.

It would be impossible, for example, to have irrevocably fixed exchange rates while individual countries retained independent monetary policies. Quite apart from the theoretical problems, it is clear that such a system could never have the credibility necessary to persuade the market that there was no risk of realignment. Thus EMU inevitably implies a single European currency, with monetary decisions - the setting of monetary targets and of short-term interest rates - taken not by national Governments and/or central banks, but by a European Central Bank.

Nor would individual countries be able to retain responsibility for fiscal policy. With a single European monetary policy there would need to be central control over the size of budget deficits and, particularly, over their financing. New European institutions would be required, to determine overall Community fiscal policy and agree the distribution of deficits between individual Member States.

These are not technical issues. The setting up of a European Central Bank or a new European institution to determine Community fiscal policies go to the very heart of nationhood. What organisation would really be the government? It is clear that Economic and Monetary Union implies nothing less than European Government - albeit a federal one - and political union: the United States of Europe. That is simply not on the agenda now, now will it be for the foreseeable future.

Although some have argued that the gold standard provides an example of monetary union operated by independent states, it was in fact very far from monetary union. Under the gold standard, the cooperation was informal and not institutionalised; and although countries could see advantages to them in maintaining their parity against gold, they were free to change if it seemed in their national interest to do so. The gold standard acted as an important and beneficial discipline, but allowed countries to pursue separate and independent economic policies within that framework.

It is also instructive to consider the evolution of Germany in the 19th century. The Customs Union or Zollverein which was formed in 1834 neither required, nor in itself led to, monetary union. It was only 40 years later, after Bismarck had imposed political union under Prussian hegemony, that monetary union and a common currency followed.

As the Prime Minister said in Bruges:

> "My first guiding principle is this: active cooperation between independent sovereign states is the best way to build a successful European Community. To try to suppress nationhood and concentrate power at the centre of a European conglomerate would be highly damaging and would jeopardise the objectives we seek to achieve."

This is by no means a narrow view held only by the British Government. Within the UK, for example, the House of Lords Select Committee said

> "The Committee do not believe it is helpful to say that monetary union will or will not come by a certain date. Whether or not the individual political leaders of Europe consider a common currency and a European central bank to be one of the Community's ultimate goals, they are not ready to take such a step at this time. If political rhetoric focuses on distant objectives and emotive ideology, needless divisions tend to arise."

Again, from a difficult perspective, the recent annual report of the German Council of Experts on Overall Economic Development - the so-called "five wise men" - conceded the essential point:

> "Hasty institutional agreements on monetary union would greatly damage the process of unification by creating the illusion that the absence of the wish for political unification can be overcome by fast progress on monetary policy. Inevitable disappointments would ensue, causing delay if not regression in the integration process: only the knowledge that monetary union is not possible without political union can prevent such a development."

There are some who might argue that the goal of monetary union is of such importance that we should impose whatever political union is necessary to achieve it. This is not only unacceptable to the

British people: it is wholly counter to the realities of national identity. You have only to look at the current problems of the Soviet Union to see a reminder of how strong these forces are.

The European Council, in Hanover last year, nonetheless decided to set up a committee to examine possible steps towards economic and monetary union. The Committee is chaired by Jacques Delors, and made up largely of Central Bank Governors, in a personal capacity. It is due to complete its work in time for the Council of Finance Ministers - ECOFIN - to consider the results before the next European Council in Madrid in June.

M. Delors referred to the work of this group in his statement to the European Parliament last week. He said that economic and monetary union could be achieved only by a further institutional change, to set up a European central banking system and a framework for enhancing the consistency and effectiveness of national economic policies. The European Council would be presented with a plan for the establishment of economic and monetary union, and progress towards that

> "would be considerably facilitated by an appropriate institutional framework. If this is the case, it will be necessary, as in 1985, to open the way for another inter-Governmental conference to prepare institutional provisions designed, like those of the Single Act, to amend the Treaty of Rome".

As an expression of personal opinion, fair enough. But any attempt to persuade the nations of the European Community to accept this as a prescription would be deeply divisive and damaging. Certainly, neither the British Government nor the British Parliament is prepared to accept the further Treaty amendment which the President of the Commission evidently envisages.

Indeed, the overwhelming question one is left with is this: how can it be, little more than three years after the Treaty amendment achieved by the Single European Act, with so much still to do to achieve the goal of the Single Market by 1992, how can it be that this great boulder should so carelessly be thrown into the pool?

Even if complete economic and monetary union <u>were</u> desirable, would it not be more rational to say: let us devote all our energies and resources to the completion of the Single Market, if humanly possible by 1992, and only then, after it has been in place for a sufficient time to demonstrate the benefits it confers, let us consider whether we wish to take the steps necessary to proceed towards EMU.

But that is not what is happening.

It is difficult to escape the conclusion that this divisive and intensely difficult new issue has been propelled into the forefront of European debate at this time either out of culpable carelessness, or as a smokescreen to obscure a lack of sufficient progress towards the Single Market - or, worse, as a means of running away from taking the practical but difficult steps the Single Market requires, running away from the challenge of freedom.

For it is an observable fact that those nations that are most vocal about their support for EMU now, tend to be those that are most assiduous in preserving barriers to free trade within the Community.

The experience of the United Kingdom in the '80s has demonstrated decisively that it is supply side reforms that are the key to better economic performance. But reforming the supply side is often neither easy nor very newsworthy, and there are always those who seek short cuts and instant answers. This Government has succeeded to the extent that it has because it has consistently ignored those calls, and been prepared to submit every aspect of the British economy to rigorous and radical scrutiny to see whether the rules and restrictions built up over generations still serve any useful purpose or, as is so often the case, merely stifle enterprise.

The same lessons apply to the European Community too. The Single Market is a great prize, and one whose significance is being increasingly recognised right around the world. But to cross the final hurdles to 1992 still requires a great deal of hard, detailed work, to hack away at the remaining barriers and clear the ground for wider competition, more efficient industry and greater consumer choice. And uncomfortable vested interests in each and every Member State will be challenged and disturbed.

It is inevitable that there are those who tire quickly of this, and flutter towards the flame of Economic and Monetary Union, or other great ideas. And others who have never much liked hacking away at regulations and bureaucracy anyway, and are only too keen to escape into dreams of EMU instead.

We must have none of that. We must set our sights clearly on the important and practical steps that are needed to implement the Single Market by 1992. In that context, EMU is essentially a damaging diversion. We must recognise it as such, and press ahead resolutely with removing barriers to the free movement of people, goods, services and capital - the true goal of the Single Market - for the benefit of the peoples of a freer Europe.

From time to time we hear talk of the dangers of Euro-sclerosis. It reminds one of the British disease. Of course the Europe of 1989 is in much better shape than the Britain of 1979. But the sense of falling behind, the dangers of taking an "easy" interventionist, protectionist, state-subsidy route out of the problems posed by heightened international competition, are not so very different. And many of the cures we took in Britain ten years ago are relevant to the Europe of today. Governments must try to do less. By deregulating and allowing markets to work, Europe can compete successfully in the 21st century. And the lessons of a decade ago are equally relevant: individuals and businesses, not bureaucrats, create jobs and prosperity.

Thus it is that the Single Market offers an historic opportunity. But if Europe takes the other road, of red tape, bureaucracy, supranational intervention and protectionism, Euro-sclerosis would be more than mere talk; it would be a reality. And the dream of 1992 would have become a nightmare. We must not allow that to happen.

INTERNATIONAL MONETARY FUND

TO :

FROM:

I agree with the EST. That we cannot resist [illegible] a debate on that (that is why I favoured linking it with the 6-month report - it can explain). As to timing, I think we *shld* wait for the TCSC report.

Ch

I spoke to Murdo about this and he was very much inclined to resist the call for a debate, getting the Lord President to say "very difficult at this stage of session; got to wait for TCSC; can't guarantee anything". PS/LP inclined to same view. EST, however, is keen to get debate out of the way quickly (ie *before* TCSC) and feels it is difficult to resist Parliamentary pressure to have a debate on this subject.

What do you think? Advantage

of a debate would be to demonstrate to PM & others the hardened feelings on EMU/ERM & the dangerous hole she's in. But with Ted Heath, Heseltine etc all bound to speak, is a debate the best way? I can't see it being a very attractive proposition.

AA

EUROPEAN LEGISLATION COMMITTEE. REQUEST FOR A DEBATE ON EMU

est.ld/james/5 jun/PS CHX

For Prayers Wednesday

FROM: S M A JAMES
DATE: 5 June 1989

PS/CHANCELLOR

cc: PS/Paymaster General
PS/Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr R I G Allen
Mr Peretz
Mr Evans
Mrs M Brown
Miss O'Mara
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

OK? (*)

EUROPEAN LEGISLATION COMMITTEE : REQUEST FOR A DEBATE ON EMU

The Economic Secretary has already discussed with the Chancellor David Peretz's note of 24 May on Mr Spearing's request for a debate on EMU. The Economic Secretary plans to write tomorrow to the Lord President along the lines of the attached draft, subject to the Chancellor's comments.

S M A JAMES
PRIVATE SECRETARY

(* do you really want another debate ?!)

Prayers

est.ld/Drafts/1 Jun/LordPresid

DRAFT LETTER TO LORD PRESIDENT OF THE COUNCIL

I have seen Nigel Spearing's letter to you of 19 May recommending that a debate should take place on the Delors Report on Economic and Monetary Union before the European Council at the end of June.

have discussed this with the Chancellor, and

I believe we should agree to his request. However it would be best not to have a debate until after both the Euroelections and the publication of the TCSC's report on EMU (which should be out by 19 June). A debate around 21 June therefore looks best.

— and preferably on that date —

PETER LILLEY

FROM: A C S ALLAN
DATE: 5 June 1989

BF 6/6

MR R I G ALLEN (EC)

cc PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Gieve
Mr Mercer
Ms Symes
Mr Pickford

DELORS' FIGARO INTERVIEW

The Chancellor has seen the translation of Delors' interview in La Figaro on 25 May, which contains some very revealing glimpses.

2. He would be grateful to know:

(i) what the original french was that has been translated as "pluralist" on page 3; and

(ii) of the 1,800,000 jobs which Delors says (on page 5) Europe has created in a single year, how many were in the UK?

ACSA

A C S ALLAN

DELORS INTERVIEW

For TCSC folder (Monday) ✓

FROM: SUSIE SYMES
DATE: 6 JUNE 1989
Ext: 4441

RWA. 7/6

1. MR R I G ALLEN ✓

2. CHANCELLOR

cc: PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Gieve
Mr Mercer
Mr Pickford
Mr Deane
Mr Ramsden

DELORS' FIGARO INTERVIEW

You asked about the original French, translated as pluralist, from Delors' interview in Le Figaro of 25 May. Delors said '... je crois que l'Europe sera pluraliste ou ne sera pas'. (Full text attached.)

2. You also asked how many of the 1,800,000 jobs, which Delors says were created in the EC in a single year, were created in the UK. It is not clear where Delors got his figure from. Latest OECD figures for 1988 give new jobs as 1,600,000 of which 770,000 (48 per cent) were in the UK. Composite EC figures, estimated by us from the latest Eurostats and the March Quarterly Economic Review, are about 1,500,000 new jobs of which only 450,000 (30 per cent) were in the UK, but these were probably constructed before latest UK figures were available. UK figures suggest that 640,000 new jobs were created in the UK from December 1987 to December 1988. (There are some differences on the precise definitions used, but these should not produce major discrepancies.)

Susie Symes

SUSIE SYMES

25 MAR 89 WF 100/19

PA 100/19

LE FIGARO

Les quatre vérités de Jacques Delors

● *Margaret Thatcher n'a pas la même conception de la construction européenne que ses partenaires* ● *Il n'y a pas de dérive allemande* ● *Nous avons connu le plus fort taux de croissance depuis douze ans.*

SUPPLEMENTARY MESSAGE

N° OF PAGES

LEADER +

25 MAY 1989

(2)

LE FIGARO

PROPOS RECUEILLIS PAR FRANZ-OLIVIER GIESBERT ET HENRI DE KERGORLAY

LE FIGARO. – **Etes-vous déçu de l'accueil réservé par les ministres des Finances des Douze, le week-end dernier, au rapport Delors sur l'union économique et monétaire ?**

JACQUES DELORS. – Non, puisque les douze ministres des Finances ont loué la qualité du rapport et recommandé que l'on s'engage dans l'étude de sa mise en œuvre. Mais il faudra au niveau des chefs d'Etat et de gouvernement un engagement sans équivoque. Car ce rapport forme un tout. Il propose, c'est vrai, un saut politique et institutionnel sans lequel il ne serait pas possible d'aboutir à une coopération étroite et fructueuse des politiques économiques et monétaires. Il suggère de progresser, en plusieurs étapes et, d'une manière réaliste, en fonction des évolutions concrètes des données économiques. Découper cette proposition globale en tranches serait une grave erreur et conduirait à l'échec d'un projet vital pour la prospérité économique et le progrès social.

converge

– Margaret Thatcher s'est opposée, avec la dernière énergie, à ce projet. Croyez-vous qu'il soit possible de faire avancer l'Europe quand la Grande-Bretagne traîne les pieds ?

– Le ministre anglais a dit son appréciation du rapport sur le plan technique, mais il pense que demander dès maintenant un engagement politique et un traité, c'est prématuré.

– La Grande-Bretagne a donc déjà répondu : c'est non !

– Les chefs d'État et de gouvernement, je l'ai dit, trancheront. Je n'ai pas l'intention de mettre de l'huile sur le feu. Mais il est clair que si les Douze décident d'aller vers l'union économique et monétaire, cela contribuerait à donner un élan encore plus grand à la construction européenne, tout en dynamisant leurs économies respectives.

– Si Margaret Thatcher refuse votre plan, qu'allez-vous faire ?

– La proposition est souple et réaliste. Elle comprend trois étapes sans précision de date pour passer de l'une à l'autre. Chacun des partenaires de la CEE, en approuvant ce projet, se trouvera dans la situation d'un voyageur quittant Bruxelles pour Marseille par le train. Il lui est toujours possible de descendre du train à Paris ou à Lyon si le voyage ne correspond pas à son attente. Rien ne l'en empêchera.

En ce qui concerne la Grande-Bretagne, deux questions se posent : prendra-t-elle un billet pour ce convoi et, si oui, ira-t-elle jusqu'au bout ?

> *92 ? Vous m'auriez dit que ce serait un grand succès publicitaire, j'aurais été étonné.*

– N'avez-vous pas le sentiment que le principal obstacle à l'Europe, aujourd'hui, c'est Margaret Thatcher ?

– Margaret Thatcher n'a pas la même conception de la construction européenne que ses partenaires. Comme elle l'a souligné dans son discours de Bruges, elle pense que le but final doit être un grand marché, plus une coopération entre douze États souverains. Or, en signant l'Acte unique, la Grande-Bretagne a déjà accepté que le grand marché soit accompagné de politiques communes, et par conséquent d'un processus d'intégration économique et politique. Je vous renvoie, sur ce dernier point, au préambule de l'Acte unique.

– Vous étiez pour l'entrée de la Grande-Bretagne dans la CEE ?

– Bien sûr.

– Rétrospectivement, n'était-ce pas une erreur ? Aujourd'hui que l'Europe se fait tous les jours à onze contre un, ne peut-on pas dire que de Gaulle avait raison et qu'il fallait faire l'Europe sans la Grande-Bretagne ?

– C'est inexact. Sur chacune de mes propositions de relance de la construction européenne, la Grande-Bretagne a fini par se rallier.

– Il y a un autre point sur lequel Margaret Thatcher s'oppose à vous et aux onze autres pays de la communauté : c'est l'Europe sociale. Elle considère que, sur ce plan, le seul modèle valable est le modèle britannique.

– Entre les avocats de l'espace social, il y a beaucoup de nuances. Notre Communauté étant fondée sur le respect des diversités nationales lorsqu'elles s'expriment, je crois que l'Europe sera pluraliste ou ne sera pas. Encore ne faudrait-il pas que certains, se prenant pour de nouveaux croisés, considèrent que leur modèle est tellement bon qu'ils doivent l'imposer aux autres.

– Et c'est bien le cas de la Grande-Bretagne... ?

– Quand la commission avance une proposition sur le plan social, je fais en sorte qu'elle soit acceptable par la Grande-Bretagne. Mais quand un ministre britannique dit que seule sa conception est la bonne, cela rend de plus en plus difficile la vie à douze. Sans doute est-il nécessaire de rappeler, pour que chacun puisse se faire une opinion, quelles sont nos priorités sociales : la lutte contre le chômage, l'aide aux régions défavorisées, le développement rural, l'amélioration des conditions de travail, la promotion des droits fondamentaux des travailleurs, la concertation entre les partenaires sociaux...

– Après le problème britannique, vous avez maintenant un problème allemand. François Mitterrand a dit : « Pas de libéralisation des capitaux sans entente sur la fiscalité de l'épargne. » Or, là-dessus, la RFA ne paraît pas pressée de trancher.

– Ce n'est pas ce que m'a dit Helmut Kohl et il n'y a pas, à mes yeux, de construction européenne sans un climat de confiance. Il ne faudrait donc pas que notre pacte subisse un coup de canif. undergo

– Que pensez-vous de la dérive allemande ?

– Il n'y a pas de dérive allemande. Les dirigeants allemands au pouvoir, comme les responsables de l'opposition sociale-démocrate, considèrent que la construction européenne est le seul moyen pour la RFA de concilier, un jour, liberté et fraternité. Ce que je vous dis est valable pour aujourd'hui. En sera-t-il de même dans trois ou quatre ans ? Telle est la question qui se pose et qui justifie l'urgence d'une forte avancée de la construction européenne, d'où l'importance d'une décision politique en faveur de l'Union économique et monétaire.

?relancer de?

– L'Allemagne n'était-elle pas mieux arrimée à l'Europe il y a quelques années.

– Non, M. Genscher, le ministre des Affaires étrangères de la RFA, a toujours été sur une ligne très européenne. Mais si l'Europe n'avance pas ou si l'Allemagne de l'Ouest fait l'objet de la part de ses partenaires d'un procès permanent d'intention, je ne réponds pas de l'avenir.

– Pourquoi, malgré toutes ces difficultés, est-on subitement passé de l'euro-pessimisme à l'euro-optimisme ?

– Parce que nous avons connu le plus fort taux de croissance depuis douze ans et le plus grand montant d'investissements depuis vingt et un ans. Parce qu'aussi, l'Europe a créé 1 800 000 emplois en une seule année. Autant de réalités qui montrent la vigueur retrouvée de l'économie européenne. Je ne crois pas que l'on aurait obtenu des résultats économiques aussi bons, malgré un environnement international porteur, sans l'objectif 1992 et l'Acte unique. Le climat s'en est trouvé profondément changé : les Européens croient à nouveau en eux-mêmes.

– Qui a eu l'idée du Marché unique de 1992 ?

– J'en suis l'auteur, pourquoi ne pas le rappeler, et j'en suis fier, car cela montre que l'on peut faire progresser les choses avec des idées et la capacité de convaincre et pas simplement en jouant des rapports de force.

– Comment l'idée vous est-elle venue ?

– Dès que j'ai été désigné président de la Commission et avant de prendre mes fonctions, six mois plus tard, j'ai fait, comme il était de coutume, le tour des capitales européennes. J'ai dit à mes différents interlocuteurs : « La construction européenne a été paralysée par vos querelles. Vous les avez réglées en adoptant le compromis présenté par F. Mitterrand. Maintenant, il faut trouver un nouveau moteur pour repartir de l'avant. » Ce moteur, ce ne pouvait pas être un saut institution-

LE FIGARO

25 MAY 1989

3

nel. Ni la défense. Et pas davar. [illegible] la monnaie. Aucun de ces [illegible]e recueillant, à l'époque, l'u[illegible]nité. Il n'y avait pas alors de consensus sur ces trois thèmes. J'ai donc plaidé l'effet de dimension d'un grand espace économique : « Depuis 1973, nous sommes en déclin relatif par rapport aux États-Unis et aux nouvelles puissances du Pacifique. Si vous supprimez les barrières entre vous, vous réaliserez un grand marché qui vous redonnera du tonus. » Me méfiant des grandes déclarations non suivies d'effets, je me suis dit qu'il fallait leur fixer une date pour les obliger à réaliser ce qu'ils avaient décidé. D'où 1992...

– Cette idée de 1992, n'était-ce pas, en fait, une géniale idée de publicitaire, un « gimmick » à la Séguéla ?

– Vous m'auriez dit à l'époque que ce serait un grand succès publicitaire, j'aurais été étonné. Mais, si vous voulez une comparaison, le programme 1992 joue un rôle analogue, des points de vue de l'éclairage de l'avenir et de l'effet mobilisateur, à la planification à la française des années 50 et 60.

– Les États américains n'ont pas unifié leurs législations. Était-il vraiment nécessaire que les pays européens unifient les leurs pour faire avancer l'Europe ?

– Ce que nous faisons est sans équivalent historique. Ce qu'ont fait les États-Unis était aussi sans équivalent. C'est pourquoi je n'emploie jamais l'expression : « États-Unis d'Europe ».

– Quelle est la différence entre les deux démarches ?

– Elle est considérable. Les États-Unis ont été constitués avec une même langue et un même état d'esprit, celui des facteurs d'agrégation ? Il y a eu, dans la première phase du Marché commun, de 1950 à 1982, le leitmotiv de Robert Schuman : « Plus jamais la guerre entre nous ». Il y a, depuis 1984, mon idée que « l'union est nécessaire pour assurer la survie ». Le risque serait, en effet, que nos pays soient transformés en musées que les Japonais et les Américains viendraient visiter. L'unité des Européens est vitale pour assurer aussi bien la prospérité et le progrès social que notre rayonnement dans le monde.

– Vous ne parlez que de l'identité économique. Mais pourquoi niez-vous l'identité culturelle de l'Europe ?

– Il n'y a pas d'identité économique. Il y a une communauté d'intérêts économiques. Et il y a, de la même façon, une communauté d'intérêts culturels. Toujours le respect du pluralisme, la richesse dans la diversité : le traité ne nous donne pas compétence en matière culturelle.

Nous agissons donc de manière indirecte : par le programme Media qui encourage les innovations en matière de diffusion culturelle, par une coopération scientifique qui nous permettra de gagner la bataille de la télévision (haute définition) de demain, par l'incitation à nos gouvernements de coopérer pour encourager les productions et la diffusion d'œuvres réalisées par des Européens...

– Quels sont les thèmes qui mobilisent le plus les citoyens de cette Europe des Douze ?

– D'abord, l'idée d'une monnaie européenne, puis la suppression des frontières et, enfin, la possibilité d'aller étudier et travailler chez les autres. D'où nos programmes d'échange d'étudiants (Erasmus et Comett I).

– La suppression des frontières n'avance pas vite.

– Certains redoutent que la disparition des contrôles douaniers aboutisse à la libre circulation de la drogue et des terroristes. C'est le cas des Allemands, Helmut Kohl me l'a dit encore récemment. C'est pourquoi, d'ailleurs, il avait lancé l'idée d'un FBI européen. C'est dans cette direction qu'il faut aller, en renforçant la coopération entre nos services de sécurité.

– Comment voyez-vous les rapports de la Communauté avec les pays de l'Est et l'Union soviétique à un moment où les rapports Est-Ouest sont en pleine évolution ?

– Il y a, depuis quelques mois, un ambassadeur soviétique à Bruxelles auprès de la Communauté européenne. Nous préparons un accord de commerce et de coopération entre la CEE et l'Union soviétique. Moscou ressent le besoin d'être informé sur ce que nous faisons. Les dirigeants soviétiques ont maintenant accepté notre existence après trente ans de bouderie !

– Quelle doit être la bonne attitude face à Gorbatchev ?

– J'ai, à maintes reprises, plaidé pour que nos douze pays aient une attitude commune et propositionnelle vis-à-vis des initiatives du numéro un soviétique. L'idée de cette action commune ne progresse que trop lentement...

– C'est le moins qu'on puisse dire...

– Au dernier conseil des Affaires étrangères, à Grenade, on m'a donné raison sur le principe : il faut une analyse et une approche communes. C'est dans cet esprit que nous allons définir ce que seront nos accords de commerce et de coopération économique avec l'URSS, la Pologne et la Bulgarie, après avoir déjà signé des accords avec la Hongrie et la Tchécoslovaquie.

– Les six pays de l'Europe occidentale regroupés dans l'Association européenne de libre échange (Suède, Norvège, Finlande, Islande, Autriche et Suisse) s'inquiètent d'être exclus de ce grand marché unique qui sera mis en place par les Douze à partir du 1er janvier 1993.

– Nous en avons discuté au mois de mars dernier entre ministres des Affaires étrangères des Douze et des Six. Mon point de vue est clair, et je l'ai dit nettement aux États membres de l'Aele : « Si vous demandez votre adhésion, nous ne pouvons pas accepter votre entrée avant plusieurs années, car il nous faut d'abord approfondir ce que nous faisons à douze. » Mais j'ai suggéré une autre voie pour permettre à ces pays de bénéficier des avantages du grand marché et d'accroître nos échanges culturels et scientifiques.

Ce qui est certain, c'est que pour l'Est comme pour l'Ouest, nous représentons un pôle d'attraction, commercialement, c'est évident, mais aussi politiquement.

– Quelle forme pourrait prendre l'Europe de demain ?

– Nous pourrions avoir une Europe à cercles concentriques. Il y aurait au centre ceux qui veulent aller le plus loin possible, c'est-à-dire jusqu'à l'union politique.

– Sans la Grande-Bretagne ?

– C'est à ce pays d'en décider. Mais j'ajoute qu'il y aurait un deuxième cercle ouvert à ceux qui ne veulent pas aller jusqu'à l'union politique. La vision de la grande Europe doit être présente, mais ne doit pas nous distraire de notre ambition : la construction d'une communauté politique, et pas seulement économique et sociale.

Mr Allan.

NOTE FOR THE RECORD

cc : J O Kerr Esq CMG, FCO
R G Lavelle Esq CB, Cab Off
N Wicks Esq, HM Treasury
T Lankester Esq, HM Treasury
W Hyde Esq, Home Office
G Reid Esq, Dept/Employment
Heads of Section
Mr Elliott

MADRID EUROPEAN COUNCIL

1. I called on 5 June on the Secretary-General of the Council to find out how he had got on when he and the Chairman of Coreper had seen the Spanish Prime Minister last Friday for their first preparatory meeting for the Madrid European Council.

2. Ersboell said that he and Westendorp had had an hour with Gonzalez (Solbes had also been there), about equally divided between the substance of the European Council meeting and the procedures. So far as the latter were concerned, Gonzalez had agreed that the draft conclusions should be worked up by the Council Secretariat in close cooperation with the Presidency (Westendorp) and the Commission (Williamson). He would have a further meeting with Ersboell and Westendorp shortly before the European Council itself to review the state of the preparations.

3. Ersboell said Gonzalez had broadly approved the subject coverage which he and Westendorp had put forward (please see my Note for the Record of 25 May). Ersboell had counselled him to allow plenty of time for debate on the two most contentious subjects (EMU and the Social Dimension) so that the air could be cleared by the debate. An attempt to bounce through conclusions on these subjects without a full debate would be doomed to failure. Even with a debate it might not be possible to agree anything; but there would be some chance. Gonzalez had appeared to accept this advice.

/4.

4. Ersboell made no secret of the fact that the discussion with Gonzalez had basically focused on a complete set of draft European Council conclusions, indeed he showed me the draft but would not let me take a copy. The reason he gave for not handing over a copy was that it was still too early (three weeks from the European Council); and the text he showed me had in any case been the object of a number of remarks by the Spaniards of which he would take account in the next draft. But he promised that a little later on in the process he would let me have a text, recognising that we would not betray his confidence and that our possession of such a text would be useful in preparing for what was going to be a very difficult European Council.

Economic and Monetary Union

5. Ersboell began by explaining that the Spaniards were more and more inclined, in the light of the reasonably constructive discussion at S'Agaro and the press line agreed there, to think that they might be able to pull off the trick of getting the whole follow-up procedure to the Delors Group Report agreed at Madrid and not left over to the French Presidency. He had encouraged them in this view since he considered that it was more likely that the Community could get by without a major crisis on this issue if the future procedures were broadly settled at Madrid than if they were discussed confrontationally at Madrid and the procedural decisions were left to the French Presidency. In the latter circumstance, he regarded the chances of avoiding a major crisis as very small since the French (and Delors) seemed determined to press the IGC point. Ersboell said he had explained to Gonzalez how easy it would be for Mitterrand to sound sweetly reasonable at Madrid, should there be a confrontational debate between the Prime Minister and Delors, by saying that clearly everyone needed more time to think about the matter and it could all be taken up again at Paris.

6. Ersboell then showed me the section he had drafted for European Council conclusions on Economic and Monetary Union. It contained broadly the following elements:-

(i) reference to Economic and Monetary Union texts in the Single European Act and in the Hanover European Council conclusions.

/(ii)

(ii) Welcome for the Delors Group Report (but not endorsement of it)

(iii) Agreed definition of Economic and Monetary Union as consisting of:- (In what level of detail?)

(a) fixed exchange rates

(b) high degree of coordination of economic policies

(c) a stage by stage approach with unanimous agreement being required at each stage, no timetable being set, and the passage from one stage to another being contingent on the degree of implementation of the previous stage

(d) extensive continuing autonomy of economic policy decision-making by the member states with only those decisions which had to be taken centrally being so taken.

Ersboell explained that these four points, and in particular (c) should be seen as an alternative to paragraph 39 of the Delors Group Report.
(copy attached)

(iv) Decision to start Stage 1, which would consist of the Stage 1 measures set out in the Delors Group Report, on 1 July 1990.

(v) A reference of a non legally-binding kind to all EC currencies being brought into the exchange rate mechanism either within two years or by 1 July 1992 (this paragraph began with the words "It is important that ...").

(vi) A remit to ECOFIN in the exact terms of the S'Agaro agreed press line ie ECOFIN to work up urgently the details of Stage 1 measures and to prepare the practical implications of Stages 2 and 3 so that a decision on an Inter Governmental Conference could be taken in due course.

(vii) A review procedure under which the European Council would consider progress in mid-1993. Ersboell explained that this formula was designed to imply that no decision would be taken on an Inter Governmental Conference until 1993 but, since it did not actually say so, it would be

/possible

possible for the French to argue that the issue could be raised (and conceivably decided) earlier than that.

Social Dimension

7. On this subject too Ersboell showed me a text which had the following elements:-

(i) Reference to the Single European Act and Hanover conclusions.

(ii) Recognition that social policy was an area where the diversity of historical and economic experience of the member state must be taken fully into account.

(iii) Approving references to all the Community decisions that had already been taken on the structural funds, the job creating potential of the Single Market, health and safety at work and the social dialogue and an encouragement to continue with that.

(iv) A reference to the Commission's draft social charter ("noted with interest") and an undertaking to follow that up and try to work up a Solemn Declaration to be agreed at the Paris European Council and to act as a broad but non legally-binding charter for subsequent member state and Community action.

8. Ersboell commented that in this area the Spaniards were still hankering after some success of their own at the Madrid European Council but they had no idea how to achieve it. They also had certainly not discarded totally the possibility of simply having a stand-off at Madrid with the conclusion that positions could not be reconciled. But their preferred option was likely to be a text of the sort he had described, assuming that discussion at the 12 June Social Affairs Coucil did not make that look completely impossible.

Frontiers

9. Ersboell said the Spaniards were being extremely sensible on this. They were seeking no more now than a simple endorsement of the work programme annexed to the Coordinators' Report.

/Tax

Tax Questions

10. Ersboell said both taxation of savings and indirect taxation were firmly embedded in the section of the conclusions on the Single Market and did not seek to take any substantive decisions. On the taxation of savings they merely gave a fair wind to a search for ways of ensuring that the liberalisation of capital movements did not lead to an increase in tax evasion, without saying how this would be done.

11. I said that I would rather not comment in detail on what he had shown me and told me for a day or two. I would like to discuss it with one or two people in London before reverting to him. On the EMU section there were clearly points which would give us great difficulty, particularly the definition of Economic and Monetary Union, to which we had never so far subscribed in any detailed way, and the setting of a date for the inclusion of sterling in the Exchange Rate Mechanism. But, on the other hand, some of the rest of what he had shown me seemed close to our own thinking. On the social dimension I could tell him straight away that this approach would not do. It opened the way clearly to the negotiation of a Social Charter. But the Social Charter draft which Ms Papandreou had put round was fundamentally objectionable to us in both its substance and in its proclaimed purpose of serving as a quarry for future Community legislation. Some parts of the text he had shown me could be useful generalities but we would not endorse the Commission's draft even in the most cursory way. It would be better to rest simply on the Rhodes Council text and, if the discussions in the autumn were to have any hope of progress it would need to be made explicitly clear by the European Council that any general principles would need to be implemented by the member states in a pluralistic way and not by the Community in the form of uniform, mandatory arrangements.

12. On frontiers I said the approach seemed a sensible one. It was important to keep away from yet another discussion of first principles, the two opposing views on which were set out quite clearly in the Report of the Coordinators Group. On taxation, I advised strongly against seeking to put any substantive points in the European Council conclusions. It would be better to refer back to work in progress under the aegis of ECOFIN (the 19 June ECOFIN seemed likely to bless further work on indirect taxation and also some further discussion on how to discourage tax evasion after capital liberalisation).

/13.

13. I should add, for good order, that Ersboell's text had sections on the non-fiscal aspects of the Single Market, on the environment, on external relations and on People's Europe which I had no time to read or to discuss with him. We agreed to meet again and continue the discussion when I had had some reactions from London.

DHannay

D H A Hannay

6 June 1989

HOLDSWORTH

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
Sir Trevor Holdsworth
President

cc Helpful

CBI

B.F. for Holdsworth dinner on ? Friday

CH/EXCHEQUER
REC. 12 JUN 1989
ACTION Mr Peretz
COPIES TO BAEST, B/PMG, Sir P Middleton, Sir T Burns, Mr Wicks, Mr Scholar, Mr H P Evans, Mr Odling-Smee, Mr R Tegh, Mr M Brown, Mr Grice, Miss O'Mara, Mr Chaplin, Mr Tyrie

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London
SW1P 3AG

9 June 1989

Dear Nigel

European Economic and Monetary Union

I thought it would be helpful to write, prior to the June Summit of European Community leaders in Madrid, to give the CBI's preliminary reaction to the proposals of the recent report of the Committee for the Study of Economic and Monetary Union set up by the European Council last June.

This is a complex and far-reaching subject and the issues it raises are being examined in detail by a special working group of the CBI's Economic and Financial Policy Committee, chaired by David Lees, Chairman of the Committee and of GKN plc. However, we have already had the opportunity to discuss this subject within the Economic and Financial Policy Committee and my President's Committee. From these discussions, there are a number of issues on which business opinion is already clear and we hope the UK Government will take these into account in presenting the British position in Madrid.

Firstly, exchange rate instability is a great handicap to business, and with 1992 drawing closer, stability against European currencies is particularly crucial. The CBI has for some years now supported UK entry into the Exchange Rate Mechanism of the EMS. The implicit link, established in the Report, between this move and a fundamental commitment to economic and monetary union appears to place a further obstacle in the way of UK entry. We do not believe this linkage is necessary and believe that it should still be possible for the UK to join the ERM, without any further strings attached.

Indeed, the discussions surrounding the Delors Committee report have, in our view, strengthened the case for the UK joining the Exchange Rate Mechanism of the EMS as soon as possible. It is likely that the terms and conditions attached to membership will change, as a part of any further steps that are taken towards monetary union; and while we are seen as part-time members of the European Monetary System, our ability to influence such a change is weakened. The terms on which we can join the zone of exchange rate stability within Europe, which the ERM has created, may therefore become less favourable as time passes.

../2

Secondly, we are in sympathy with the stage-by-stage approach set out in the report and believe that a genuinely evolutionary approach is desirable. The decision to embark on the more far-reaching second and third stages of the proposals should therefore await the satisfactory completion of the initial steps, which will need to include the participation of the UK in the existing Exchange Rate Mechanism.

Thirdly, a single European currency may offer considerable benefits to British business by removing the need for foreign exchange transactions within the Community and the exposure to exchange risk that this brings. But this should not be achieved at any price. Indeed, the ability to realign under the present Exchange Rate Mechanism offers a degree of flexibility to national economies in correcting imbalances which would be lost under a fixed exchange rate system.

Finally, CBI members are concerned about the concentration of power over fiscal decisions in the hands of Community institutions implied by the report. Such "binding fiscal rules" are not only undesirable, in that they may well be used to raise the tax burden on business, but are probably not necessary, even if Europe is to move towards a single currency.

I hope these comments are helpful and I look forward to being able to provide a more considered reaction in due course.

Yours sincerely

Trevor

Sir Trevor Holdsworth

108g.mg.ld/Williams/(1)12.6min

UNCLASSIFIED

FROM: N P WILLIAMS (MG1)
DATE: 13 June 1989
EXT: 5561

1. MISS ~~O'MARA~~
2. CHANCELLOR

This has also been cleared with FIM (Mr Odling-Smee sits on the European Committee of the BIEC)

ROM 13/6

cc Economic Secretary
Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Odling-Smee
Mr Peretz
Mrs M E Brown
Mr Nelson

Ch/ Content for us to send to N° 10? Anything to add following your own conversation with Sir Michael? DIS

OK

PRIME MINISTER'S MEETING WITH SIR MICHAEL BUTLER

The Prime Minister will be seeing Sir Michael Butler on 15 June. Sir Michael requested the meeting with a view to discussing how to get EMU discussions "moving in a constructive and acceptable direction". In particular, he is concerned about the risk of confrontation with other member governments and the development of a "two-tier" Europe which, he believes, will have damaging consequences for the City. You spoke to Sir Michael after he asked for a similar meeting with you.

2. No 10 have requested briefing for the meeting and I attach a draft PS letter. The draft provides some background on Sir Michael's views (as expressed in his paper to the European Committee of the BIEC) and identifies some issues that the Prime Minister might like to raise. It eschews, quite deliberately, putting forward a line to take since we presume the purpose of the meeting is to allow Sir Michael to make his points.

NPW

N P WILLIAMS

UNCLASSIFIED

108g.mg.ld/Williams/(1)12.6min

pls type as final from DS to Charles Powell unclassified copy list as above

DRAFT LETTER TO MR POWELL, NO 10

PRIME MINISTER'S

MEETING WITH SIR MICHAEL BUTLER: 15 JUNE

You asked for briefing for the meeting Sir Michael Butler requested with the Prime Minister, which has been fixed for 15 June. Sir Michael is an Executive Director of Hambros Bank and Chairman of the European Committee of the British Invisible Exports Council.

Sir Michael has already put forward his ideas on the implications for the City of the development of a "two-tier" Europe at the European Committee of the British Invisible Exports Council. He is concerned about the risk of confrontation between the UK and other member governments on EMU and fears that, unless the UK can deflect the pressure by engaging in constructive discussion, other member governments may agree to a monetary treaty without the UK. He believes that the exclusion of the UK from European monetary arrangements would have damaging consequences for the City. Sir Michael concludes that the Government:-

(i) should join in the discussion on EMU in a constructive spirit;

(ii) attack the thesis that the decision to embark on the first stage of EMU is a decision to embark on the whole process (paragraph 39 of the Delors Committee

Report) as neither sound nor pragmatic, and simply unnecessary for Stage 1;

(iii) express a readiness to work on proposals identified in Stage 1 of the Delors Committee Report, with a view to progressive implementation in parallel with the Single Market programme;

(iv) if necessary, argue that decisions on Stage 2 and 3 would be best made in the light of experience when Stage 1 is nearing completion; and

(v) the more controversial proposals for Stages 2 and 3 should be discussed further at the European Council in December 1992.

We assume the Prime Minister will wish to use this meeting primarily to discover Sir Michael's views in more detail, as representing those of a senior and respected City figure. She may like to ask him to elaborate on his thinking, particularly in relation to the implications he sees for the City which has established a pre-eminent position as a financial centre in the European time-zone. She might also invite Sir Michael to comment on the strength of competition that the City will, in any event, face from Continental centres in the 1990s and the appropriate response.

Sir Michael has expressed the view that the UK should show its willingness to work on proposals identified in Stage 1 of the

Delors Committee Report. He will be aware that the UK has not only proposed practical measures to enhance monetary cooperation in Europe, but has taken measures ahead of other member governments. We removed exchange controls in 1979, launched a programme of Treasury Bills denominated and payable in ecu last autumn, and hold ecu and a variety of Community currencies in our reserves. The Prime Minister might like to ask Sir Michael what more he thinks we should do.

Specific ways in which the UK's approach to EMU could affect us include:-

(i) our influence over the shape of the Single Market in the financial services field; and

(ii) perceptions by overseas investors (eg Japanese companies) that the UK is a good country to invest in.

The Prime Minister might like to ask Sir Michael whether he thinks that the UK will in fact be affected in these and other ways.

SIGNED

chex.ps/ds2/115

cc PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr R I G Allen
Mr Odling-Smee
Mr Peretz
Mrs M Brown
Miss O'Mara
Mr N P Williams
Mr Nelson

Treasury Chambers, Parliament S
01-270 3000

14 June 1989

Charles Powell Esq
10 Downing Street
LONDON
SW1

PWP

SPARKES → POWELL 14/6

Dear Charles,

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Yours sincerely.

Duncan Sparkes

DUNCAN SPARKES
Assistant Private Secretary