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PART ENDS

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Lords. Session 1989-90 3rd Report.
Select Committee on the European Communities
A COMMUNITY SOCIAL CHARTER
Ordered to be printed 5 December 1989
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Signed J. Gray Date 15/8/2016

PREM Records Team

PART 6 ends:-

Lord Joseph to PM _ 30.4.90
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PART 7 begins:-

FCO to CDP 2/5/90

FROM: The Rt Hon. The Lord Joseph CH PC

The Rt Hon. Mrs Margaret Thatcher MP
The Prime Minister
10 Downing Street
SW1A 2AA

30 April 1990

PRIVATE AND CONFIDENTIAL

Dear Margaret,

After Alan Walters had spoken to me about covert exchange controls I had a word with Gordon Pepper and Gordon recommended me to consult Graham Bishop of Salomon's who follows the subject closely. Just in case it may be useful to you and your advisers I enclose a batch of relevant recent papers by Graham Bishop together with a copy of a letter from him to me dated 25th April.

I have also sent copies of all this material to Nicholas Ridley and to Ralph Harris.

No need whatsoever to reply to me.

Yours as ever,

Keith

These documents are originals & must be returned to CF.

EURO POL
CENS PA 7

RETURN TO C/E

1992 and Beyond

Higher Bank Capital = Securitisation

by
Graham Bishop
(01) 721-3921 (London)

March 1990

Salomon Brothers

European Business Analysis

The author wishes to thank Bruce Brittain and many other colleagues in and outside of Salomon Brothers, in addition to Ann O'Kelly, who carried out initial research and final production.

Based on a speech given in Paris on January 29, 1990, at the Business Research International conference "Securitisation in Europe."

1992 and Beyond

Higher Bank Capital = Securitisation

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Graham Bishop
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Higher Bank Capital = Securitisation

by
Graham Bishop
(01) 721-3921 (London)

Introduction and Summary

Five years ago, uniform international capital adequacy requirements for banks seemed a remote possibility. However, in July 1988, the Bank for International Settlements (BIS) published capital adequacy guidelines, and in December 1989, the European Community (EC) finance ministers signed the Solvency Ratio Directive that, ultimately, gives the BIS standards legal force throughout the EC from January 1991.

The capital adequacy standards will take effect in a financial environment radically altered by the drive towards a single European market. **We believe that the interaction of these forces will cause spectacular change in the banking environment over the next five years:**

- Financial liberalisation and the creation of a "level playing field" for *all* financial services will benefit European consumers, both as savers and as borrowers, in the form of lower costs and increased choice.

- Banks will face increased competition on their loan assets, while growing depositor sophistication will increase the cost of their deposit liabilities. Thus, there will be a powerful squeeze on profit margins as costs rise and revenues fall.

- But bank shareholders are already dissatisfied with the return on equity. Because of the capital adequacy requirements, they are contributing new equity — either in cash or higher dividends foregone. They wish to see the return on equity rising, not falling because of shrinking margins.

- Banks will have to respond to investor concerns by unbundling their balance sheets and selling off their prime loan assets. Therefore, securitisation will play the key role in both providing better and cheaper financial services to consumers and in solving the banking system's strategic problem.

- Banks, overcapitalised on the basis of shrunken balance sheets, may repurchase significant chunks of their equity — boosting shareholder value substantially.

The first section of this report discusses the capital adequacy requirements and their implications for bank profitability. The second section considers how banks can maximise the efficiency of their capital structure. The third section analyses the dramatic transformation of the financial environment resulting from the drive to create a "level playing field" for all financial intermediaries.

Bank Capital Adequacy Requirements

Banks have been forced to increase their capital sharply in recent years. From January 1991, EC banks will have to comply with the legal requirements on capital adequacy contained in the Solvency Ratio Directive.

The Background to Bank Regulation

Banking regulation is usually a product of specific banking crises, rather than of analysis from first principles.

- The Barings Crisis of 1890 established the principle that the central bank would be the "lender of last resort." This removes the risk of a domino effect within the financial system, undermining the working of the physical economy.

- Between 1930 and 1935, 9,000 banks failed in the US — out of a total of 24,000. The Federal Deposit Insurance Law, passed in 1933, required the national Government not only to supervise banks, but also to guarantee small deposits. The general public became assured of the safety of their bank deposits, ruling out contagious panic when a bank ran into trouble. Thus, "moral hazard" was abolished for small savers.

During the 1960s, the "cult of the equity" gathered force. Bank stock prices responded to earnings growth, so management accelerated the twin processes of "leveraging the balance sheet" and increasing the yield on assets. In today's jargon, they reduced capital ratios and bought riskier assets, secure in the knowledge that depositors would not suffer, due to the lender of last resort and deposit insurance.

Inevitably, the results of these policies emerged: in Britain, the "secondary banks" collapsed in 1974; in West Germany, Herstatt Bank disappeared overnight; and the long-running less-developed-country (LDC) debt crisis started in 1982 with Mexico. The magnitude of the problem unfolded gradually, creating concern for the health of banks.

Banking regulations were imposed, at first piecemeal and then in a more coordinated manner. However, the abolition of moral hazard had led to a general public presumption that the "competent authority" would bail out all sorts of investors — not merely small, and therefore presumed unsophisticated, depositors. The US led the way, rescuing Continental Illinois and the Federal National Mortgage Association (Fannie Mae).

The current thrift industry bail-out in the US has produced a gigantic bill. The final cost is likely to exceed $200 billion — some estimates put it at $400 billion or nearly $2,000 for every person in the US. Regulators are now taking a new look at the problem. In Europe, the discussions on economic and monetary union within the EC seem to be moving towards an agreement that countries running excessive budget deficits will not be bailed out. This is likely to toughen the attitude towards rescuing financial institutions.

However, regulators believe that society will not let them withdraw free deposit insurance. If taxpayers are becoming restless about the cost of this free insurance, then banks must be required to have sufficient resources to remove the risk of failure. Hence, the capital adequacy requirements.

The Cooke Committee Rules

The major central banks, through the Cooke Committee of the BIS, have agreed that banks should have a minimum capital ratio of 8% of risk-weighted assets. They have defined both capital and a system for weighting the assets to allow for apparent riskiness. These standards have been adopted well beyond the Cooke Committee countries and seem likely to become global standards. The EC has adopted them in the Own Funds and Solvency Ratio Directives.

There is virtually no chance of a relaxation of these standards for banks. Therefore any future development of the financial system must take them as a starting point — no matter what competitive inequalities may appear to result.

Figure 1. Definition of Bank Capital According to the Cooke Committee Rules

Tier I	Equity, disclosed reserves.
Tier II	**This must be less than Tier I.**
Upper	Reserves (undisclosed, revaluation, general losses). Hybrid (debt/equity mixture).
Lower	**This must be less than 50% of Tier I.** Subordinated Debt.

The "tier" structure makes it abundantly clear that the regulators have focused on capital that is "freely and immediately available to meet unforeseen future losses."

Tier I and Tier II capital combined must amount to at least 8% of risk-weighted assets — assets are assigned risk-weightings of 0%, 20%, 50% or 100%, according to category. The regulators have imposed tough standards of capital adequacy on banks specifically to ensure that the taxpayer is protected against further calls on deposit insurance. (This approach may be too harsh. For example, we are not aware of residential mortgage loss rates reaching even 1% annually in recent times. Yet mortgage banks in West Germany are still required to have at least 4% capital to back their mortgage business — although a substantial portion of that is commercial rather than residential.)

Existing Capital Ratios

Although the minimum capital ratio has been set at 8%, most banks will want to — or will be obliged to — stay well above that minimum. Figure 2 sets out existing ratios for several countries.

Figure 2. Bank Capital Ratios, End-1988

	Tier I	Tiers I and II
Australia	5.7%	9.1%
France	3.9	7.5
Japan	4.1	8.2
Spain	NA	10.9
UK	5.9	10.3
US (Money Centre)	6.4	10.3

NA Not available.
Source: Salomon Brothers Inc.

This suggests that a capital ratio of 10% or more will become a benchmark. Competitive pressure will lead banks to emphasise the safety of money deposited with them and thus will focus publicity on the amount of their "excess" capital. This is already happening in the US and UK. At the other end of the spectrum, French banks, for example, are likely to be hovering close to the minimum capital requirements. The French enabling legislation for securitisation (*titrisation*) may well provide the solution — by shrinking the balance sheet.

The Implications for Profitability

Because Tier II capital cannot exceed Tier I equity, a 10% capital ratio implies a minimum shareholder equity of 5%. Shareholders will demand a return on this capital and, even more importantly, on their equity

proportion. Regulators should be concerned that banks, armed with free deposit insurance, will take ever-greater risks to produce an adequate return on these extra resources.

Figure 3. Comparison of Return on Equity[a] for Banks by Country, 1985-88

	1985	1986	1987	1988	Average
Australia	16.7%	14.6%	12.6%	14.3%	14.5%
France	11.3	13.5	11.0	11.8	11.9
Japan	11.8	12.8	13.4	13.9	12.9
Spain	15.1	17.9	17.4	21.6	18.0
Switzerland	9.3%	9.1%	8.1%	8.0%	8.6%
UK	13.1	16.1	(3.8)	18.7	11.0
US (Money Centre)	13.9	13.7	(13.5)	21.5	8.9
West Germany	10.5	14.6	7.5	9.2	10.4

[a] Net income as percentage of average equity.
Source: *European Banking Integration in 1992*, Thomas H. Hanley et al. Salomon Brothers Inc, June 1989.

The data highlight two points: first, the volatility of returns. This is most pronounced in the UK and US — where heavy provisions against LDC debts have caused overall losses. Shareholders cannot now regard banking as a low risk, stable business. Second, average returns range widely between countries — from Spanish banks at the top to Swiss banks at the bottom. (However, the Swiss banks' position may owe more to accounting conventions than true profitability.)

How do the banks compare with the other opportunities available to investors in the equity markets? Figure 4 shows return on equity for some major markets.

Figure 4. Return on Equity — Total Market, 1985-88

	1985	1986	1987	1988	Average
France	9.8%	9.8%	10.3%	13.0%	10.7%
UK	10.1	11.5	12.7	12.8	11.7
US	9.6	8.9	10.6	13.1	10.5
West Germany	15.9	18.2	15.9	12.6	15.6

Source: Datastream.

The lower volatility of returns within each country is striking. Moreover, in three of four countries, the total market's rate of return is higher than that of banks. Taking a simple average of these four markets, the rate of return is 12%, while that of their banks is only 10.5%. In sum, banks produced lower returns and had higher earnings volatility.

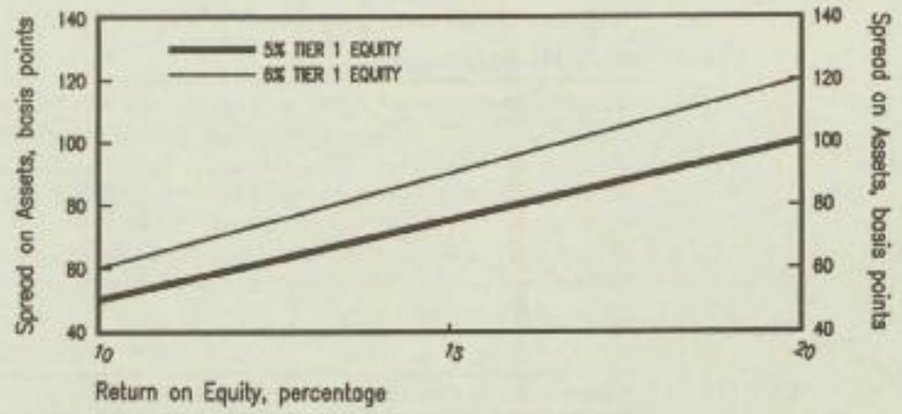
Although comparisons across markets are always difficult, shareholder pressure will force banks at least to maintain their return on equity and, more likely, look for some increase. This does not sit well with the regulatory requirement to increase the amount of capital for a given level of business. These diametrically opposed requirements will inevitably produce strains. Figure 5 shows some simple consequences.

After paying all the expenses of being in business, including the cost of Tier II capital, a well-capitalised and profitable bank will need to earn 75-100 basis points on its loan assets simply to earn the necessary return on shareholder equity. The precise size of that spread will depend critically on the chosen relationship between Tier I and Tier II capital. It will also depend on the target return on equity: many bankers talk of a 15% target — which seems a reasonable premium over the total market to allow for the evident risks.

Tier I

Tier II

Figure 5. Spreads and Return on Equity



Source: Salomon Brothers Inc.

Maximising the Efficiency of the Capital Structure

In many countries there are still no clear official guidelines on the detailed rules to be applied. This is becoming urgent because the Solvency Ratio Directive, and therefore the Own Funds Directive, is scheduled to become effective on January 1, 1991 — now only nine months away.

Tier I capital is the ultimate loss absorber, so the regulators have drawn the definition tightly. The only qualifying securities are "issued and fully paid ordinary shares/common stock and noncumulative perpetual preferred stock (but excluding cumulative preferred stock)."

Preferred Stock Issues

Noncumulative perpetual preferred stock is therefore the only "nonequity" route to raise extra Tier I capital. During 1989, just under $2 billion was issued, of which nearly half was by EC banks (see Figure 6).

Figure 6. Tier I Capital — Noncumulative Perpetual Preferred-Stock Issues, 1989
(Dollars Equivalent in Millions)

Issuer	Amount
Allied Irish Banks	$175.0
Bankers Trust	215.0
Barclays	316.2
Barclays	183.8
Chase Manhattan	100.0
Citicorp	$62.5
Citicorp	62.5
Citicorp	125.0
Continental Bank	285.0
Royal Bank of Scotland	200.0
Westpac	100.0
Total	**$1,825.0**

The Cooke Committee rules permit two types of instrument for raising Tier II capital from the market — hybrid and subordinated debt. As shown in Figure 1, subordinated debt must be less than 50% of Tier I capital, due to the "fixed maturity and inability to absorb losses except in liquidation." Moreover, the original maturity must be over five years and must be

amortised out of the capital over the last five years of its life. The restrictions on proportion and maturity of this "lower" Tier II debt h[illegible] focussed attention on the creation of "upper" Tier II capital.

Variable-Rate Notes

Variable-rate notes (VRNs) have been issued widely and the amount outstanding now exceeds $4.5 billion equivalent. UK banks and building societies dominate the list of issuers — principally because the UK supervisors have made detailed rules on eligibility. UK building societies account for nearly 40% of the dated, sterling issues: VRNs enable mutual organisations, such as building societies, to raise upper Tier II capital. This has implications for other mutual banks throughout Europe that need additional capital.

Figure 7. Tier II Capital — Variable-Rate Note Issues

Issuer	Size (Millions)	Maturity (Years)	Launch Margin Over LIBOR[a]
Sterling			
National Westminster	£300	20	12.5bp
Lloyds	200	10	25.0
Bristol & West Building Society	150	5	10.0
TSB	100	15	25.0
Leeds Permanent Building Society	50	5	10.0
Leeds Permanent Building Society	50	12	25.0
Alliance & Leicester Building Society	50	10	35.0
Total, Sterling Dated	**£800**		
National Westminster	£350	Perpetual	37.5bp
Total, Sterling	**£1,100**		
US Dollar			
National Westminster	$200	20	25.0bp
National Westminster	100	23	20.0
Great Western Financial	200	4	20.0
Total, US Dollar Dated	**$500**		
National Westminster	$350	Perpetual	50.0bp
National Westminster	150	Perpetual	40.0
National Westminster	500	Perpetual	35.0
Allied Irish	400	Perpetual	62.5
Bank of Ireland	300	Perpetual	50.0
Bank of Scotland	300	Perpetual	40.0
State Bank of Victoria	250	Perpetual	37.5
Total, US Dollar Perpetual	**$2,250**		
Total, US Dollar	**$2,750**		

[a] The launch margin is heavily influenced by the specific terms and conditions.
LIBOR London inter-bank offered rate. Bp Basis point.

A variable-rate note is a floating-rate note where the coupon is set at a margin over LIBOR that is agreed anew on each quarterly reset date via a Dutch auction mechanism. If that margin is unacceptable to a specific investor, he can put the bonds back to the underwriter at par. If, in limited circumstances, the remarketing agent cannot agree with the issuer on the coupon reset margin, then the coupon is set at a maximum spread — at the Alternative Coupon Reset Margin. This is typically LIBOR plus 100 basis points or more, and there is *no* put option in this circumstance. This mechanism ensures that the investor is always assured of a return commensurate with the credit standing of the issuing bank — even if some future problems arise. The difference between the launch margin and its cap represents the investor's cushion against future problems. Once that cushion is used up, the investor loses the right to put the bonds at par and will then share any incremental credit problems via a decline in the bond's price. Naturally, the issuing bank cannot also be the underwriter, or the effect would be to repurchase its capital.

These comments merely touch upon a substantial topic. The appropriate level, and type, of Tier II capital will be one of the principal determinants of a bank's return on its Tier I equity (see box on page 13 where the implications for Dutch banks are used as an example). This is the key measure for shareholders when evaluating investment alternatives.

The Consequences

Superficially, the direct effects of the new capital adequacy requirements are simple: the shareholders have contributed new equity — in cash or higher dividends foregone — and they want a higher rate of return on all their equity. The obvious solution is to widen margins. But this is more easily said than done, because the provision of credit is a fiercely competitive business. The ability to provide a sufficient volume of Tier II capital will thus be a crucial ingredient in satisfying shareholders' demand for adequate returns on the Tier I equity at the top of the pyramid.

Another component of the solution is the pursuit of fee-generating business — life insurance sales, for example. Originating and then securitising extra loans is only another method of generating fee income.

An alternative approach for a bank with inadequate capital resources is to shrink the balance sheet. Securitisation may have a role in this, but the natural ambition of bankers is to maintain a large balance sheet. That undoubtedly means that securitisation will not be the preferred route. Therefore, the conclusion must be that the new capital adequacy standards for banks will not — *by themselves* — create a general need for asset-backed securities markets.

A Level Playing Field for All Financial Services

The EC's single market programme — "1992" for short — set the ultimate objective of liberalisation: "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured" (Article 13 of the Single European Act). Stage One of the Delors Committee Report on Economic and Monetary Union is a powerful restatement of the single market objectives. It involves the creation of a single financial area free of all barriers to financial integration, "where banking, securities and financial instruments are offered uniformly." The implementation of Delors Stage One has been agreed by the EC Heads of State and is due to commence on July 1, 1990. Whatever the status of discussions on a single European currency, and everything that that implies for monetary policy, a single market for financial services has become inevitable and irreversible.

The European Commission's aim is to provide complete freedom of choice for the consumer. To this end, the Commission is working on a set of Directives affecting every aspect of financial services. Consumer protection and prudential regulation are being balanced against the risk of stifling innovation and competition to such an extent that the consumer pays

excessive prices for outmoded products — it is easy for vested interests to cry "consumer protection" when they really want to protect their own interests.

The European financial services industry is still based upon a series of compartments created by national tax and regulatory regimes. The European Commission aims to change this — the difficulty of harmonising 12 systems for banking, insurance, pensions, and so on has led to an analysis of regulation from first principles. Brussels now places a new and explicit emphasis on providing a "level playing field" for all financial intermediaries.

- The Second Banking Directive, by using the principle of home country control, allows banks to operate on a "single banking passport" anywhere in the EC.
- The UCITS directive allows EC-wide marketing of qualifying mutual funds.
- Last December, Sir Leon Brittan, EC Commissioner for Competition, announced that creating a single market in insurance was now a priority. Using the same principle of home country control, directives are being drafted, for both life and nonlife insurance, to allow insurance companies to operate on a "single insurance passport."
- He went on to state that proposals are also being drafted to ensure a level playing field for pension services.
- The concept of the level playing field has already been incorporated into EC law — the Solvency Ratio Directive states that "the Commission ..... undertakes to examine whether the Directive as a whole significantly distorts competition between credit institutions and insurance companies and, in the light of that examination, to consider whether any remedial measures are justified."

Given the size of insurance companies and pension funds, a level playing field has immense implications for competition.

Stripped of the baggage of history — terminology, tax treatment, regulatory requirements, and tradition — the economic functions of long-term savings products are very similar. For the saver, there is not much difference between a bank deposit with a fixed rate, for example, for five years, and a bond mutual fund specialising in five-year bonds. A life insurance policy is a savings product, with attached insurance against premature death. If the insurance company simply buys five-year bonds for its life fund, then all three types of intermediary — bank, bond fund and insurance company — are competing with the same savings product; death insurance could be purchased separately.

Another example comes from the asset side of the institutional balance sheet: a residential mortgage is simply a legal charge on a house — possibly the borrower's family home. Traditionally, it has been assumed that the funds from the borrowing were used to pay for the house. However, there is no economic reason why this should be true. If a borrower looks at his entire portfolio of assets and chooses to finance some expenditure by borrowing it on the finest terms, then a loan secured on the family home will be the best guarantee of repayment. The only concern of the banker, and in turn the bank's supervisor, is whether the loan can be repaid, not the moral worth of the borrowing. In the UK, for example, this is already the case.

This blurring of distinctions between what used to be separate financial transactions has increased competition between intermediaries. Banks now seek to cater for all the financial needs of their customers — in West Germany, this approach is called *Allfinanz* and in France *Bancassurance*; the UK does not seem to feel the need of a neat name!

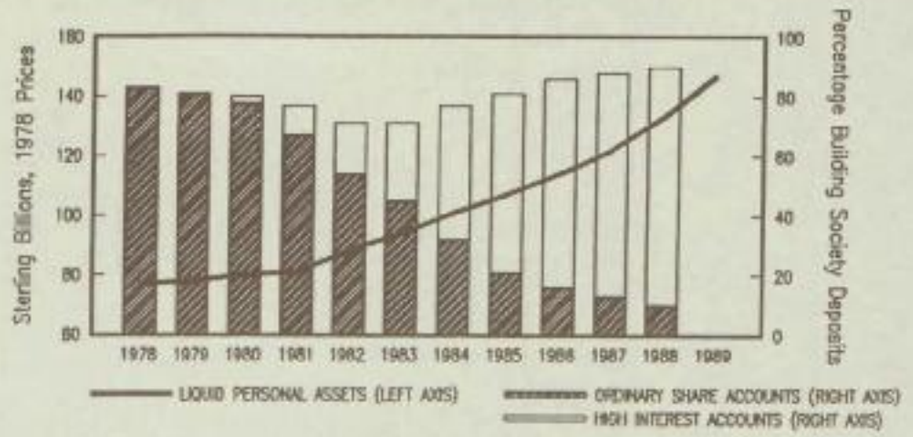
Such transactions are becoming easier for the consumer, who now has wider choice and greater control over financial decisions. It is clear that this freedom of choice, once attained, cannot be taken away from savers/borrowers who are also electors. However, the bank regulator's job has become more complex and that of the controller of monetary policy a nightmare: consumers are rendering impossible a neat classification of their financial transactions into the different monetary aggregates, with awkward consequences for the conduct of monetary policy. The discussions on European monetary union have yet to focus on this problem, despite an excellent summation in the European Commission's *Annual Economic Report*, 1989-90.

The Battle for Consumer Savings

The population of Europe is greying. This involves a rising level of financial saving for old age, a need heightened by growing doubts about how social security systems will cope. There is also a lagged effect from the Second World War, which caused a massive destruction of personal wealth. The postwar generation is now in the process of handing its rebuilt wealth on to the next generation, often in the form of housing property. But the middle-aged and middle class already have a house, and do not need their parents' house. Instead, financial intermediaries hope that the wealth will be held in the form of financial assets, which they will help manage — for a fee. Hence, the intensifying battle for consumer savings.

In this competitive environment, where traditional boundaries will become blurred and even disappear, two selling points remain: efficient service and investment performance. We believe that the steady rise in consumer sophistication will be matched by a drive for higher performance. UK building society depositors provided a classic example of this during the 1980s.

Figure 8. Liquid Personal Assets Versus Building Society Holdings, 1978-89



Sources: Building Societies Association; Financial Statistics (CSO)

The line in Figure 8 shows that the personal sector's holdings of liquid assets have roughly doubled since 1981 — after allowing for the effect of inflation. The banking system was liberalised in that period and the building societies faced competition. The results were dramatic. Savers switched almost entirely from "ordinary share accounts" paying interest at a discount of 30% or more to the market rate, into "high interest" (read market rate) accounts. Ordinary share accounts have now virtually disappeared — from 80% of funds to nothing in one decade. Note that the building societies' customer base is drawn from the least financially sophisticated section of the population.

The same trends are becoming apparent in West Germany, as savers put their extra money into life insurance or bond funds — rather than 2½% savings deposits. The benefits to West German consumers of competition for savings could be as remarkable as they were for British savers.

The implications of EC-wide financial liberalisation are spectacular.

Result I: Competition on Bank Liabilities

The ageing of the population has two distinct effects: first, older people have had a longer time to save financial assets and second, they have become more financially sophisticated. They may have quite a high risk tolerance for their incremental assets, balanced by an expected higher return. The converse may be even more true: they may not be prepared to sacrifice any return to reduce a risk they believe to be remote.

It is already apparent that major corporate depositors are not willing to give up any yield in order to invest in "guaranteed" bank deposits. The commercial paper market demonstrates clearly that investors do not rate banks better than some major companies — despite the superior creditworthiness of banks assumed by the Cooke Committee's risk weighting system of assets.

A key management problem for small institutions, such as the regional banks in France, will be the creation of more sophisticated products. Otherwise, there will be a sharp increase in the concentration of bank deposits, as customers search for better value. The rapid spread of "high interest" retail deposit accounts in the UK underlines savers' willingness to attach virtually no value to the implicit guarantee for bank deposits. **For the banks, this is the worst possible outcome — the loss of submarket funding.**

Result II: Competition on Bank Assets

The consumer of credit has two basic choices: to borrow from a bank or to borrow from "the market." If a borrower seeks credit directly from the capital market, there is no need for that buffer of capital imposed on banks to protect the saver on the other side of the transaction. At its simplest, the individual who personally buys a bond issued by a company has willingly accepted the credit risk involved, and there is no public policy reason to offer any sort of guarantee.

Ignoring transaction costs, a bank with market-rate funding will have to charge to the borrower the 75-100 basis points attributable to capital requirements, in order to provide the shareholders with the required return on equity. Over time, this cost differential seems bound to push borrowers towards the capital market, when access permits.

Major companies and sovereign borrowers, whose borrowing needs come in market-sized chunks, have shown the way over the past few years. Retail borrowers were shut out until securitisation became possible. The consequent swift growth of the mortgage-backed bond market in the US demonstrates the demand and led Salomon Brothers to introduce the concept to the sterling markets in 1987.

Pooling small loans is not new — King Frederick the Great of Prussia popularised the concept 200 years ago. What is new is the total separation between the loans and any obligation by the originator. The advance of technology also makes it possible to handle a stream of payments — partly interest and partly principal — which would have been impossible even a few years ago. The market has therefore been able to expand beyond the simple, fixed-rate mortgage and can now cope with the complexities of both car loans and credit card receivables.

This development is crucial for the banks, because such loans are their core assets. If the banks begin to lose competitiveness in their prime, high-margin assets, then they will have no option but to compete directly by unbundling their balance sheets and securitising some of these prime assets.

Result III: Securitisation

Origination

The speed of development of the market in securitised assets will be governed by (i) the will of originators and (ii) the response of the regulators. The many regulatory impediments are usually the legacy of history. However, their progressive removal hinges upon the goodwill of the regulators. The speed at which regulators are convinced of the probity, and usefulness, of these markets will therefore be a limiting factor on their development.chang

Banks will seek to originate securitised assets, either to shrink their balance sheet or to generate fee income. It is already clear that they will not be the only originators. The blurring of the boundaries between banks and insurance companies in the savings market will be mirrored in the credit market. Thus, the *Bancassurance* phenomenon will be seen on both sides of the balance sheet.

The immediate example is the UK mortgage market, where insurance companies have become active providers of mortgage funds, but have also securitised the mortgages to preserve their balance sheet strength. Their motivation is selling the houseowner other products, such as life insurance, rather than becoming mortgage bankers.

There is also substantial potential for nontraditional originators. In the US, General Motors and Ford use cheap credit as a marketing aid for their products. Volkswagen's US activities show that European companies have taken this example to heart. Major retailers could be a fertile source of credit card receivables for the same reason.

The impulse to securitise varies from country to country. In the UK, the residential mortgage market was highly developed before securitisation was introduced in 1987. However, the rising cost of retail funds relative to the market, combined with a perception of poor service and high costs, opened the way to disintermediate the existing mechanisms. This "arbitrage" opportunity may have receded, but the major potential remains — giving different, nontraditional suppliers of mortgages access to funds.

The process in France will be very different. The regulators have set the pace by creating a new legal framework for *titrisation*. The specific intention was to provide the undercapitalised French banking system with a possible solution. In Italy, the incentive is different again. A major competitive innovation for residential mortgages is likely to be much higher loan-to-value ratios than the current 50%. The rising wealth and sophistication of the Italian consumer is also likely to make them increasingly willing to finance the purchase of durables with debt, rather than savings.

In several countries — Italy and Spain, in particular — the operation of withholding tax is a major problem for securitisation. Without such taxes, the legal and regulatory problems would be solved by utilising tried and tested systems from elsewhere in the EC. Thus, withholding tax has emerged as one of the critical barriers to spreading the benefits of liberalisation.

Buyers of Securitised Assets

The buyers of these assets will include bond and money market funds, insurance companies and pension funds, among others. This group of institutions is the very essence of the capital market. A bond fund, for example, is the classic gatherer of retail funds, which it on-lends — purely at the investor's risk and therefore without need of "adequate capital."

Banks will also be buyers of securitised assets. A key condition of their participation will be whether the securitised assets are accorded the same risk weighting as the underlying assets — in other words, if there is a level playing field when the security holder is in the same effective position as the asset holder. At present, the Cooke Committee's rules have not provided that level playing field for mortgages. However, this topic is certainly under discussion, and it seems probable that logic will prevail.

The attractions of securitised assets to banks are very clear: they are prime and they are liquid. Some banks will always have access to submarket deposits — whether due to lack of investor sophistication or to regulation — and a bank with significant submarket funding should find these assets very attractive.

Impact on Banks

Many bankers will look at securitisation with horror. They should not. Instead, they should view it as a positive opportunity. First, they can maximise their distribution capacity and raise their *turnover*, rather than *volume*, of assets. The result will be a series of fee incomes rather than just one interest spread. The second opportunity is the chance of improving shareholder value substantially. The bank may have just gone to great lengths to increase capital to meet the new standards. By unbundling the balance sheet and selling off assets, it will be heavily overcapitalised. An obvious solution is to repurchase equity. This could enhance the performance of bank shares — perhaps substantially!

Bankers who do not turn securitisation to their advantage may find that their prime assets gradually melt away over the next few years. Pressured by shareholders seeking adequate returns on their equity, and believing the depositors to be well protected by implicit taxpayer guarantees, they may be tempted to make too much use of excessively high-yielding assets — lower-quality leveraged buyouts, for example — perhaps without proper credit research and risk control discipline. There is an ultimate and inevitable result: the bank fails, changes ownership — at a cost to the public — and the process that led to the current levels of bank capital will ratchet another notch forward.

A Specific Example

The Dutch banking system is well known as mature and solid. Based on Netherlands Bank data for the system as a whole, the risk-weighted capital ratio is probably between 10% and 11% — substantially above the 8% minimum requirement. Tier II capital is only about 2½ percentage points of the total. Accordingly, there is no reason to securitise any assets for the sole purpose of boosting capital ratios. If, for example, half of the mortgages were securitised — as the easiest asset to securitise — then capital ratios would be boosted to around 12%-13%, or 50%-60% above the minimum.

The impact on profitability is potentially more interesting. Based on a sample of leading Dutch banks, return on equity is about 9%-10%, which is low by international standards. To increase market share within the system, a competitive bank could boost profits by securitising half of its mortgage portfolio (15% of aggregate assets), retaining fee income and correspondingly expanding its origination of new mortgages. This would push the return on equity up in tandem.

At that stage, the capital ratios would seem excessively high. Shareholder value could be dramatically enhanced by issuing Tier II debt and raising it from 3% of assets to 5%. The resulting cash could be used to retire equity and bring the Tier I ratio down from the 9%-10% range to 7%-8%. The capital base would remain extremely strong by any standards — perhaps excessively. However, the repurchase of one quarter or more of the bank's equity would radically improve the return on the remaining equity, as well as have a dramatic impact on shareholder value.

Conclusion

The financial services industry of Europe faces a period of change that has few precedents. The tide of political opinion is sweeping us towards monetary union: the changes in our financial environment are still unclear, but will be vast. The raw material of our industry is the very money that is to be "united." Changes in EC-wide financial regulation are unleashing competitive pressures onto the new level playing field. An inevitable result will surely be the emergence of a major market in asset-backed securities.

* * *

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Market Discipline CAN Work In The EC Monetary Union, (with Dirk Damrau and Michelle Miller) November 1989. The lessons from other monetary unions (Canada, Australia, West Germany); the New York City crisis of 1975. The market can be a more effective sanction on fiscal profligacy than binding rules.

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Italian Public Debt at the Dawn of Monetary Union — A Foreigner's View, Graham Bishop, February 1990. An analysis of Italy's debt problems, highlighting the short maturity and proposing a major foreign borrowing programme in other EMS currencies to stabilise the stock of debt.

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1992 and Beyond

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By
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721-3921 (London)

February 1990

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European Business Analysis

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Italian Public Debt at the Dawn of Monetary Union — A Foreigner's View[1]

By
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At the Strasbourg Summit in December 1989, the Heads of Government of the European Community (EC) agreed that an Intergovernmental Conference to prepare the road to European monetary union would meet "under the auspices of the Italian authorities" before the end of 1990. Italy will thus once again launch an historic process — as it did with the Single European Act in Milan in 1985.

Some believe that Italy's public debt is one of the greatest obstacles to achieving monetary union. We disagree with that view. If the approach of monetary union is seen as an opportunity to break away progressively from the constraints of the past, then it will be received as a constructive development and not a threat. **We believe that Italy could be the single biggest gainer from monetary union.**

Lower Interest Rates

The most obvious, and dramatic, benefit from monetary union is the potential for lower interest rates. As far as nominal interest rates are concerned, as monetary union approaches, differentials should narrow due to the removal of devaluation fears. If the process reaches the intended conclusion of a common currency, the differentials should be minor, reflecting pure credit considerations — the ability of the Government to repay its debt in a currency that it can no longer print. The potential saving to Italy would be large, whether in real or nominal rates. Although Italy's traditional real premium was eroded during 1989, as monetary policy was tightened throughout the EC, during 1988 and much of 1987 Italian real interest rates were one to two percentage points above the average of the other European Monetary System (EMS) members. A one-percentage-point reduction in the nominal short-term rate equates to about 0.5% of gross national product (GNP) in the first year alone, due to its impact on the interest cost of public debt.

Looked at another way, these potential savings represent the direct cost to the Italian taxpayer of the current financial system. This system includes exchange controls, taxation, the nature and efficiency of the market for debt and the role of the intermediaries who channel, or perhaps fail to channel, Italian and foreign savings into that market.

Why Foreigners Shun the Italian Bond Market

Why do investors require an apparent "risk premium" to persuade them to hold lira instruments? What do they fear?

Devaluation

We believe that the danger of lira devaluation is now much reduced — the last major such devaluation within the EMS was in 1985. In January 1990, Italy narrowed the lira's fluctuation margin within the EMS's exchange rate mechanism (ERM) from ±6% to ±2.25%, so that the currency is now constrained within the lower third of its previous band. Exchange controls were also reduced further and are scheduled to be removed entirely by July 1, 1990, underlining Italy's commitment to monetary union. Thus, the approach of monetary union should diminish lira risk.

Debt Crisis

There is frequent talk of a debt crisis in Italy. Continual announcements of the sale of staggering quantities of Government debt — punctuated by tales of failed auctions — lend credibility to these stories. Yet the truth is that Italian debt levels are not that excessive. The relative indebtedness of the EMS member Governments and the corresponding short-term interest rates do not suggest that Italian debt is so high that it warrants a risk premium on interest rates.

[1] Based on a speech given on December 4, 1989, at the Seminar *La Gestione Del Debito Pubblico E I Mercati Finanziari* at the Centre for Monetary and Financial Economics at Universita Commerciale Luigi Bocconi, Milan, Italy.

Figure 1. Debt as a Percentage of GNP Versus Three-Month Interest Rates

	Debt as Percentage of GNP 1989E	3-Month Interest Rates Jan [illegible]90
Luxembourg	9%	10%
France	35	11
West Germany	43	8
Spain	44	15
UK	44	15
Denmark	62	12
Portugal	75	
Netherlands	78	8
Greece	82	
Italy	99	13
Ireland	111	12
Belgium	127	10
All EC	58.4%	

E Estimate.
Sources: European Commission, *Financial Times*.

Short Debt Maturity

However, the short maturity of Italian public debt magnifies the impression of a debt crisis dramatically. The average life of the public debt is now under three years. Thus, on average, debts equal to one third of GNP must be refinanced each year. In our view, 1990 will be a particularly difficult year, with redemptions equal to 40% of GNP. When the new deficit is added in, bonds equivalent to 4%-5% of GNP will need to be issued *each month*. Corresponding data are difficult to compile for other EC States, but the average life of their public bond markets is revealing. Bonds are defined as securities with more than one year remaining life. UK bonds have the longest life, at 10.9 years. Among the major countries, West German bonds have the shortest life, at 5.4 years.

Bewildering Array of Instruments

To a foreigner, the array of debt instruments is bewildering and comparisons are further complicated by three different withholding tax regimes, depending on the date of original issue.

Figure 2. Principal Italian Government Securities, February 1989 (Italian Lira in Trillions)

Type	Maturity Range		No. of Issues	Market Size	Average Issue Size
BOT	3-12 Months	Discount Bill	42	Lit245	Lit5.8
BTP	2-5 Years	Fixed Coupon	54	146	2.7
CCT	5-10 Years	Floating Coupon	86	346	4.0
Others[a]			35	38[b]	1.1
Total			217		

[a] Including ECU-indexed, option, inflation-linked.
[b] July 1989.
BOT Buoni Ordinari del Tesoro — Treasury bills.
BTP Buoni del Tesoro Poliennali — Treasury bonds.
CCT Certificati di Credito del Tesoro — Treasury credit certificates.
Source: Bank of Italy.

Low Institutionalisation

Foreign financial institutions form the impression that Italian markets are unsophisticated, because they perceive a lack of entities with a correspondingly dominant role to their own. Typically, these pension funds and life insurance companies would expect to see Italian institutions, such as themselves, holding more than half of the Government's debts.

In Italy, however, Government debt directly held by individuals has been substituted for bank deposits on a dramatic scale during the 1980s. Not only are the institutions irrelevant to marketing Government debt, but they also seem to have limited relevance to Italian savers — hence their small role in the financial system. Even worse in the debt management context, they put much of their assets into real estate.

Figure 3. Distribution of Italian Government Debt, December 1988

Private/Foreign	66%
Banks	17
Mutual Funds	3
Pension Funds	1
Insurance Companies	2
Others	11
Total	100%

Source: Bank of Italy.

We believe the low penetration of the savings market by long-term financial institutions is probably the single biggest problem for debt management. Banks must remain prudent and match their assets to the type of liabilities (in the form of saving accounts) that they can sell to the public. Other institutions are so small that, even if they took an extraordinary view and held all their Government debt in the form of CTOs (Certificati del Tesoro con Opzione — six-year fixed-rate Treasury bonds), it would make hardly any difference to the average life of the Government's total debt.

The lack of regulation and transparency in the Italian financial markets is also a major deterrent to foreigners. The foreigner may easily lump the equity and bond markets together, the reputation of one affecting the other. Thus, an efficient and well-structured Government bond market would enhance the attractions of Italian financial markets in general.

The example of France shows what can be done over a period. This market of bewildering complexity was drastically simplified and, in a brilliantly-executed policy, transformed into a highly-liquid market, making it extremely attractive to foreigners. Yields have fallen drastically.

The Opportunities of 1992

Institutionalisation of Savings

Italy should seize the opportunity offered by 1992. The Italian savings market should be opened up to the other financial intermediaries of Europe, so they can market the type of savings products that have been welcomed by the population elsewhere.

Figure 4. Life Insurance Premiums Per Person, 1987 (US Dollar Equivalents)

Italy	**$74.4**
France	381.7
West Germany	594.9
UK	705.8
USA	$678.6
Japan	1,460.7

Source: Swiss Re.

The natural result, in due course, would be an institutionalisation of personal savings that, judged by experience elsewhere, would transform the maturity structure of personal savings. This is surely the prerequisite condition for the Government to lengthen its debt maturity. However, the time lags would be significant — certainly three or four years before a serious impact could be expected.

Maturity Transformation

The more immediate and direct approach would be to satisfy the existing desire of these foreign institutions for high-quality long-term debt. This approach involves selling a lump of long-dated debt in addition to the existing lump of short debt — the "barbell" approach.

Such a plan can succeed only when foreigners' fear of the Italian bond markets has been overcome, which will require a carefully planned and thoroughly implemented marketing strategy. Initially, it will also require a sufficient reward to offset the perceived risk.

Market Needs

A glance at the Government bond markets of Europe reveals that the emerging "standard" European Government bond is a straightforward ten-year fixed-rate bullet issue. West Germany, France and the Netherlands issue this type in large quantity. They ensure liquidity with issue sizes of DM4 billion or more (Lit3 trillion) and an efficient secondary market.

Using this standard bond, Italy should implement a major borrowing programme in as many as possible of the other EMS currencies. The dawning era of monetary union offers Italy the possibility to sell to foreigners debt denominated in their own EC currencies with a diminished risk of devaluation losses — on either side.

Such a programme would be characterised by a progressive build-up of a highly-liquid yield curve, paralleling that of domestic Government debt. These liquid ten-year bonds would eventually shorten to become seven and then five years and so on, providing an opportunity to reopen the issue, if conditions seemed right.

The Deutschemark offers the greatest interest saving. However, the Dutch guilder is not far behind, followed by the French franc. Superficially, the UK's budget surplus has created a shortage of long-dated sterling debt. However, the higher interest rates and, more importantly, the lack of commitment to joining the ERM makes sterling debt much less attractive to Italy.

The implicit exposure of the Italian taxpayer to a major devaluation of the lira within the EMS would reinforce dramatically the credibility of the new currency relationship. Given the depth of the long-term capital markets of the EC member states, we believe that such a programme could make a significant impact on Italy's debt structure within a year or two. However, this is only part of the solution.

Simplify the Domestic Bond Market

The second part of the solution is the creation of a corresponding ten-year lira bullet bond market. The popularity of CCT (Certificati di Credito del Tesoro — variable rate Treasury certificates) shows that Italian savers are sensitive to the reward of an extra 50 basis points in yield compared with that of BOT (Buoni Ordinari del Tesoro — Treasury bills). Nonetheless, the economic characteristics of a ten-year fixed-rate issue are radically different from those of a floating-rate issue. Moreover, Italian long-term savings intermediaries are simply too small to create a sizeable maturity transformation of the debt. Foreigners, therefore, play a critical role in launching and sustaining such a market.

Consider the return that would be required by an Italian saver: CCTs presently yield 14.9% before tax for the next one-year coupon period; CTOs, if held to their six-year maturity, yield 13.6%, again before tax. A ten-year fixed-rate issue should, therefore, in today's conditions, need to carry a coupon of at least 14% to attract Italian savers. In the end, the only way of knowing for certain is to auction the bonds and see what the market really is prepared to pay.

How attractive would a 14% lira bullet bond be to foreigners? Assuming that the first part of the long-term approach was in place, then the institutions of Europe and the world would have been fully educated about the Italian Government's lira indebtedness — they are already familiar with the foreign currency credit standing. Amid the intense debate on monetary union, foreign investors would look at the Italian commitment, demonstrated by the twin actions of narrowing the lira's flucuations (in practice, this could be even narrower than the new, formal commitment of ±2.25%) and launching a major EMS borrowing programme. They would undoubtedly find an Italian Government yield of, say, about 9% in Deutschemarks or 14% in lira an overwhelmingly attractive return.

Figure 5 shows, under some simple assumptions, the pattern of returns that may be achieved by investors in European bonds in the run-up to monetary union. Figure 5 uses two possible dates — five years ahead and ten years ahead — and assumes that there are no parity changes between these currencies in that time. Our vision of the completed monetary union assumes, perhaps unrealistically, that there will be no differentials between the yields of each country's bonds.

Figure 5. Total Returns of European Government Bonds

Country	10-Year Bond Yield[a]	Monetary Union in 5 Years[b]	Monetary Union in 10 Years[b]
Italy	**14.0%**	**208**	**331**
Spain	14.2	210	335
UK	11.3	182	282
Denmark	12.0	187	291
France	9.9	165	251
West Germany	8.6	151	228

[a] Annual payment or equivalent. [b] Feb 19, 1990 = 100

Note: Total return: capital gain plus income. Convergence of interest rates is assumed to be linear and coupons are reinvested tax-free.

Source: Salomon Brothers Inc.

The relative returns are striking and justify the view that such lira bonds would be highly attractive. Believers in monetary union would be rewarded — if it occurred — with a 50% higher return than the Deutschemark investment in only five years.

Implications of Capital Flows

Undoubtedly, balancing the capital flows involved would be a difficult task. To the extent that the EMS borrowing programme created capital inflows and substituted for lira debt, then lira interest rates should fall sufficiently to persuade Italian residents that it was worth investing abroad. Perhaps they might even buy their own Government bonds, but denominated in Deutschemarks or other currencies, rather than lira. This would partly offset capital outflows. Another component would be the reduction in capital inflows caused by Italian citizens borrowing foreign currency to invest in lira assets. This whole process of balancing flows would be given a further twist by foreigners buying Italian Government ten-year lira bonds.

The overall result would be a sharp fall in Italian interest rates, as well as the direct benefit of low-cost EMS borrowings. This would capture the savings for the Italian taxpayer. More properly, it would remove the cost imposed by the inefficiency of the existing Italian financial system. In addition, this balancing act would have been achieved by utilising — fully and vigorously — the freedoms of 1992 by "borrowing" the sophistication and efficiency of the rest of Europe's financial system.

This policy must only be adopted in the full knowledge that it would expose Italy's budgetary policies to the rigours of market discipline. One of the key aspects of the discussions on the Delors Committee Report is the method of curbing budgetary excesses. We recently argued[2] strongly that "binding budgetary rules" are unnecessary. A key safeguard against this disciplinary process occurring too abruptly is that the average life of a

[2] See, *Market Discipline CAN Work In The EC Monetary Union*, Salomon Brothers Inc, November 1989.

Government's debts should be sufficiently long. This underlines the critical importance of stabilising Italy's debt portfolio by lengthening the life.

Structure of the Bond Market

This policy may well create the right investment attractions to draw investors, and especially foreigners, towards longer-maturity lira bonds. However, the whole exercise will be doomed to failure if foreign investors continue to fear being trapped in an illiquid secondary market. The 1988 reforms do not yet appear to have succeeded in creating the aura of an efficient, liquid, transparent and well-regulated market.

Liquidity

The problem of the low institutionalisation of the market resurfaces as soon as liquidity is considered. Half to three quarters of an issue may be locked away in the hands of retail investors who do not trade them. Thus, the free float of issues can be very low. Despite the newly-introduced primary dealer system, it can be very difficult to deal in amounts even of $5 million equivalent in the secondary market. This compares extremely unfavourably with the liquidity that the world's major financial institutions enjoy in other markets.

Figure 6. Typical Dealing Size for Two- to Five-Year Fixed-Rate Bonds

US	$200-300 million
UK	20-25
West Germany	20-25
Japan	30-40
France	10-15
Italy	4

Source: Salomon Brothers Inc.

Figure 6 shows the sizes at which Salomon Brothers was prepared to deal on standard terms in a particular week (the Italian sizes were those indicated by various Italian banks, but only for those securities where the primary dealers were committed to making a market). Although some Italian issues are now being reopened in order to increase the size, this policy must be radically extended.

Bond Borrowing

The crucial secondary market liquidity will not appear simply because of the size of an issue. Careful attention must also be paid to the ability of dealers to borrow bonds, so that they can be short of a particular issue while they await the appearance of a genuine seller. The Bank of Italy may have a crucial role here — its holdings are nearly twice the combined holdings of the nonbank financial intermediaries. Bond borrowing can solve the delivery problem and can also be used to hedge the dealers' economic risk that yields may change.

Effective bond borrowing facilities have other uses. They enable dealers to arbitrage anomalies in the yield curve that might otherwise persist. It also enables the dealers to spread out the distribution of new issues by dealing in the expected issue's maturity area.

Repurchase Agreements

There is also a need for the opposite facility — repurchase agreements, or *pronti contro termine*. A dealer that has provided a liquid market to his customer may now be long of a sizeable position. Initially, he will require adequate "own-funds" — this is the subject of a key EC Directive on capital adequacy for securities dealers. Secondly, the dealer will need access to competitively-priced finance for this position. Such finance can take the form of a sale to another institution with a repurchase agreement — a repo — or collateralised loan facilities. The new capital adequacy standards, laid down by the Bank for International Settlements and incorporated into the EC by the Solvency Ratio Directive, should make such lending an attractive business for commercial banks.

Futures Market

Experience elsewhere has shown that the existence of a futures market can play a critical role in generating liquidity. Once ten-year fixed-rate lira issues have been made by the Italian Government, a futures contract should be initiated as soon as possible. Naturally, the specification should follow the successful models of the Bund, gilt and matif contracts to facilitate the management of risk.

Questions of bond borrowing, repos and futures may seem mere technical details. In fact, they are the foundation of a securities dealer's ability to offer customers a liquid market for bonds. Therefore, these technical aspects need to be thoroughly organised, so that the current absence of a "dealer culture" can be overcome. There must be no confusion of legal aspects of ownership of borrowed or lent securities, or of the tax implications — is it a taxable sale? — or of the creditworthiness of all the parties. The present system of forward purchases (or sales) is not nearly sufficient to create proper liquidity in the market.

Taxation

The Italian Finance Ministry announced in January 1990 that it was reviewing taxation on income and capital gains ahead of the July 1, 1990, deadline to remove all remaining exchange controls. While taxation is a large and complex topic, two aspects are noteworthy. First, withholding tax creates many distortions because of the variety of rates and the different treaties concluded with different countries. This results in a discrimination against investors from different EC states and can hardly be seen as being in the spirit of 1992. It is widely stated that there is a *six-year delay* in repaying this tax, where appropriate. This is inordinate and simply makes foreigners, as well as residents, pay more attention to the after-tax yields when making comparisons with other currencies. Perhaps part of the campaign to attract foreign investors should include the abolition of the withholding tax.

Second, the impact of Italian withholding tax on the whole ECU bond market leads to a serious distortion in the pattern of relative returns. This type of distortion can only serve to stunt the growth of this market — again, hardly in the spirit of 1992. This is particularly true when the result is a forced payment by some other Member States to the Italian Treasury.

Conclusion

1992 and the approach of monetary union gives Italy a unique opportunity to remove the costs inherent in the existing financial system. This opportunity should not be missed.

* * *

I problemi associati al prestito di obbligazioni, accordi di riacquisto e contratti a termine potrebbero apparire meri dettagli tecnici. Di fatto, rappresentano le fondamenta dell'abilità di un negoziatore di titoli di offrire al cliente un mercato liquido delle obbligazioni. Di conseguenza, questi aspetti tecnici necessitano di un'approfondita organizzazione in modo da poter superare l'attuale assenza di una "cultura del negoziatore." Non deve esservi confusione di aspetti legali di proprietà di titoli presi in prestito o prestati o di implicazioni fiscali (si tratta forse di una vendita tassabile?) o del valore del credito di tutte le parti. L'attuale sistema di acquisto (o vendita) per consegna differita non basta a creare un'adeguata liquidità del mercato.

Tassazione

Il Ministero delle Finanze Italiano ha annunciato nel gennaio 1990 una revisione delle imposte sul reddito e sui redditi di capitale prima del 1° luglio 1990, scadenza per l'eliminazione di tutti i restanti controlli sui cambi. Nonostante la tassazione rappresenti un argomento ampio e complesso, due sono gli aspetti degni di nota. In primo luogo le trattenute fiscali creano molte distorsioni a causa della varietà dei tassi e dei vari trattati conclusi con diversi paesi. Questo porta ad una discriminazione verso gli investitori provenienti da diversi stati della Comunità Europea e può difficilmente essere considerata come parte dello spirito del 1992. Si dice spesso che esista un ritardo di *sei anni* nel rimpagamento di questa tassa, laddove necessario. Questo crea confusione spingendo stranieri e residenti a prestare più attenzione ai rendimenti al netto di tasse in occasione di confronti con altre valute. Probabilmente una parte della campagna rivolta ad attirare investitori stranieri dovrebbe prevedere l'abolizione delle trattenute fiscali.

In secondo luogo, l'impatto delle trattenute fiscali italiane sull'intero mercato delle obbligazioni in ECU comporta una grave distorsione dello schema dei rendimenti relativi. L'unica conseguenza di questo tipo di distorsione potrebbe essere l'arresto della crescita di questo mercato, che ancora una volta, si inquadra difficilmente nello spirito del 1992. Questo appare particolarmente vero quando il risultato è un pagamento forzato da parte di alcuni Stati Membri al Tesoro Italiano.

Conclusione

Il 1992 e l'avvicinarsi dell'unione monetaria offrono all'Italia l'opportunità unica di eliminare i costi insiti all'attuale sistema finanziario. E' un'occasione da non lasciarsi sfuggire.

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Il Debito Pubblico Italiano all'Alba dell'Unione Monetaria — Il Punto di Vista di uno Straniero

Di
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721-3921 (Londra)

Febbraio 1990

Salomon Brothers

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Il Debito Pubblico Italiano all'Alba dell'Unione Monetaria — Il Punto di Vista di uno Straniero[1]

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In occasione del vertice di Strasburgo del dicembre 1989, i Capi di Governo della Comunità Europea hanno convenuto la preparazione di una Conferenza Intergovernativa per aprire la strada all'Unione Monetaria Europea "sotto gli auspici delle autorità italiane" prima della fine del 1990. Ancora una volta l'Italia si farebbe promotrice di un processo storico, come già fece nel 1985 con l'Atto Unico Europeo a Milano.

Alcuni ritengono che il debito pubblico italiano rappresenti uno dei maggiori ostacoli per il raggiungimento dell'unione monetaria. Non siamo d'accordo con questo punto di vista. Se l'avvicinarsi dell'unione monetaria viene visto come un'opportunità per staccarsi progressivamente dalle costrizioni del passato, esso verrà allora percepito come uno sviluppo costruttivo e non come una minaccia. Siamo convinti che l'Italia sarà il paese che trarrà i maggiori vantaggi dall'unione monetaria.

Riduzione dei Tassi di Interesse

Il vantaggio più evidente e rilevante che deriverebbe dalla realizzazione dell'unione monetaria sarebbe la potenziale riduzione dei tassi di interesse. Per quanto riguarda i tassi di interesse nominali, con l'avvicinarsi dell'unione monetaria, le differenze dovrebbero ridursi, venendo meno i timori associati alla svalutazione. Se il processo raggiungerà l'obiettivo prefisso di una valuta comune, le differenze dovrebbero diminuire, rispecchiando puri e semplici elementi di finanza pubblica — la capacità del Governo di ripagare il proprio debito in una valuta che non può più emettere liberamente. Ne deriverebbe per l'Italia un considerevole risparmio potenziale, sia in tassi nominali che reali. Sebbene il tradizionale "premio Italia" sia stato eroso nel corso del 1989, a causa di un irrigidimento della politica monetaria in tutti i Paesi della Comunità Europea, durante il 1988 e gran parte del 1987, i tassi di interesse reali italiani si trovavano di uno o due punti al di sopra della media degli altri membri del Sistema Monetario Europeo (SME). Una riduzione di un punto dei tassi nominali a breve termine corrisponderebbe approssimativamente allo 0,5% del prodotto nazionale lordo (PNL) solo per il primo anno, a causa del suo impatto sul costo degli interessi del debito pubblico.

Considerati sotto un altro punto di vista, questi potenziali risparmi rappresentano il costo diretto per il contribuente italiano dell'attuale sistema finanziario. Questo sistema include controlli sui cambi, tassazione, natura ed efficienza del mercato nei confronti del debito e ruolo degli intermediari che convogliano, o forse non riescono a convogliare, i risparmi italiani e stranieri in quel mercato.

Perchè Gli Stranieri Evitano Il Mercato Italiano Delle Obbligazioni?

Perchè gli investitori richiedono un apparente "premio di rischio" per convincersi a conservare titoli in lire? Che cosa temono?

Svalutazione

Riteniamo che il pericolo della svalutazione della lira sia ora molto ridotto. L'ultima significativa svalutazione di questo genere nell'ambito dello SME è avvenuta nel 1985. Nel gennaio 1990, l'Italia ha fatto rientrare il margine di fluttuazione della lira all'interno del meccanismo dei tassi di cambio dello SME, dal ±6% al ±2,25%, in modo tale che la valuta si trovi ora limitata entro il terzo inferiore della banda precedente. Anche i controlli sui cambi sono stati ulteriormente ridotti e se ne prevede la totale eliminazione per il 1º luglio 1990, il che evidenzia l'impegno italiano per il raggiungimento dell'unione monetaria. Per tale ragione, l'avvicinarsi dell'unione monetaria dovrebbe ridurre il rischio della lira.

[1] Da un intervento del 4 dicembre 1989 in occasione del Seminario "La Gestione del Debito Pubblico e i Mercati Finanziari" presso il Centro di Economia Finanziaria e Monetaria dell'Università Commerciale Luigi Bocconi, Milano, Italia.

Crisi del Debito

Si parla spesso di una crisi del debito italiano. Continui annunci di vendite di sbalorditive quantità di debito pubblico — alternati a notizie di aste di collocomento disertate — conferiscono credibilità a queste voci. Tuttavia, la verità è che i livelli del debito italiano non sono così considerevoli. Il relativo indebitamento degli Stati membri dello SME ed i corrispondenti tassi di interesse a breve termine suggeriscono che il debito italiano non è così elevato da giustificare un premio netto sui tassi di interesse.

Figura 1. Confronto tra Incidenza del Debito sul PNL e Tassi di Interesse Trimestrali

	Debito come Percentuale del PNL 1989S	Tassi di Interessi Trimestrali 26 gennaio 1990
Lussemburgo	9%	10%
Francia	35	11
Germania Occidentale	43	8
Spagna	44	15
Regno Unito	44	15
Danimarca	62	12
Portogallo	75	
Paesi Bassi	78	8
Grecia	82	
Italia	99	13
Irlanda	111	12
Belgio	127	10
Comunità Europea	58,4%	

S Stima
Fonti: Commissione Europea, *Financial Times*.

Debito a Breve Scadenza

La breve scadenza del debito pubblico italiano ingigantisce l'impressione di una crisi del debito. La vita media del debito pubblico è ora inferiore a tre anni. Per tale ragione, in media, i debiti pari ad un terzo del Prodotto Nazionale Lordo devono venire rifinanziati ogni anno. A nostro parere, il 1990 sarà un anno particolarmente difficile, con rimborsi pari al 40% del Prodotto Nazionale Lordo. Considerando anche il fabbisogno del nuovo deficit, sarà necessario emettere, su *base mensile,* obbligazioni equivalenti al 4%-5% del Prodotto Nazionale Lordo. E' difficile raccogliere dati corrispondenti per gli altri Stati della Comunità Europea, tuttavia la vita delle obbligazioni pubbliche sui loro mercati è significativa. Le obbligazioni sono definite come titoli caratterizzati da più di un anno di vita. Le obbligazioni del Regno Unito hanno la vita più lunga, 10,9 anni di media. Tra i paesi più importanti, le obbligazioni della Germania Occidentale hanno la vita più corta, 5,4 anni di media.

Stupefacente Varietà di Titoli

Per uno straniero, la varietà di titoli del debito italiano è stupefacente ed i confronti sono ulteriormente complicati da tre diversi regimi di trattenute fiscali, a seconda della data di emissione originaria.

Figura 2. Principali Titoli dello Stato Italiano, febbraio 1989
(Lire italiane in migliaia di miliardi)

Tipo	Gamma di Maturazione		Numero di Emissioni	Volume del Mercato	Volume Medio Emissione
BOT	3-12 mesi	Titolo Scontato	42	Lit245	Lit5,8
BTP	2-5 anni	Cedola Fissa	54	146	2,7
CCT	5-10 anni	Cedola Fluttuante	86	346	4,0
Altro[a]			35	38[b]	1,1
Totale			217		

[a] Inclusi quelli indicizzati sull'ECU, le opzioni e quelli legati all'inflazione.
[b] Luglio 1989. BOT Buoni Ordinari del Tesoro. BTP Buoni del Tesoro Poliennali. CCT Certificati di Credito del Tesoro.
Fonte: Banca d'Italia.

Bassa Istituzionalizzazione

Gli istituti finanziari stranieri hanno l'impressione che i mercati italiani siano scarsamente sofisticati, perchè avvertono una carenza di investitori istituzionali che rivestano un ruolo dominante corrispondente al loro. Di norma, queste compagnie assicurative e fondi pensionistici si aspetterebbero di vedere gli equivalenti istituti italiani detenere, come loro, più della metà del debito dello Stato.

In Italia, invece, nel corso degli anni '80 il debito pubblico ha rimpiazzato i depositi bancari quale forme di risparmio finanziario delle famiglie. Gli investitori istituzionali non solo sono estranei alla commercializzazione del debito pubblico, ma sembrano anche rivestire scarsa importanza per i risparmiatori italiani — da qui il loro ruolo irrilevante all'interno del sistema finanziario. Questa situazione si riflette anche nella gestione dei loro portafogli dove impegnano gran parte delle proprie attività nei beni immobili.

Figura 3. Distribuzione del Debito dello Stato Italiano, Dicembre 1988

Privato/Estero	66%
Banche	17
Fondi Comuni di Investimento	3
Fondi Pensionistici	1
Compagnie Assicurative	2
Altro	11
Totale	100%

Fonte: Banca d'Italia.

Riteniamo che la scarsa penetrazione del mercato dei risparmi da parte degli investitori istituzionali finanziari a lungo termine rappresenti probabilmente l'unico problema significativo per la gestione del debito. Le banche devono essere caute ad abbinare le proprie attività al tipo di passività (in forma di conti di risparmio) che possono vendere al pubblico. Altri istituti sono di dimensioni così ridotte che, anche se adottassero politiche straordinarie e mantenessero la totalità del loro debito pubblico in forma di Certificati del tesoro con opzione (CTO), non cambierebbe in modo rilevante la vita media del debito totale dello Stato.

La mancanza di regolamentazione e di trasparenza a livello dei mercati finanziari italiani costituisce anche uno dei principali deterrenti per gli stranieri. Lo straniero può facilmente confondere i mercati delle azioni ordinarie e delle obbligazioni, e la reputazione dell'uno influenzerebbe quella dell'altro. Per tale ragione, un mercato delle obbligazioni efficiente e ben strutturato potenzierebbe le attrattive dei mercati finanziari italiani nel loro complesso.

L'esempio della Francia mostra che cosa è possibile fare nell'arco di un dato periodo. Questo mercato di sorprendente complessità è stato drasticamente semplificato e, grazie ad una politica brillantemente condotta, trasformato in un mercato fortemente liquido ed estremamente allettante per gli stranieri. Si è così registrata una drastica diminuzione dei rendimenti.

L'opportunità del 1992

Istituzionalizzazione dei Risparmi

L'Italia dovrebbe cogliere l'opportunità offerta dal 1992. Il mercato italiano dei risparmi dovrebbe venire aperto agli altri intermediari finanziari europei, in modo tale che essi possano commercializzare il genere di prodotti di risparmio che è stato favorevolmente accolto dalla popolazione di altri paesi.

Figura 4. Premi di Assicurazione sulla Vita Per Persona, 1987
(Equivalente in dollari USA)

Italia	**$74,4**
Francia	361,7
Germania Occidentale	594,9
Regno Unito	705,8
USA	$678,6
Giappone	1,460,7

Fonte: Swiss Re.

Il naturale risultato, a tempo debito, sarebbe un'istituzionalizzazione dei risparmi personali che, giudicata in base alle esperienze raccolte altrove, trasformerebbe la struttura della maturazione dei risparmi personali. Questa è sicuramente la condizione preliminare affinché lo Stato possa prolungare la scadenza del proprio debito. Tuttavia trascorrerebbero significativi intervalli di tempo, almeno tre o quattro anni prima che si preveda il verificarsi di un impatto considerevole.

Trasformazione della Scadenza

L'approccio più immediato e diretto sarebbe quello di soddisfare l'attuale desiderio di questi istituti stranieri per un debito a lungo termine di alta qualità. Questo approccio consiste nella vendita di titoli a lunga scadenza in aggiunta all'attuale insieme di titoli a breve termine — l'approccio del "bilanciamento dei pesi."

Tale progetto potrà avere successo solo quando si sarà riusciti a superare la paura che gli stranieri hanno dei mercati italiani delle obbligazioni, il che richiederà una strategia di mercato attentamente studiata e approfonditamente applicata. Inizialmente sarà anche necessario un premio adeguato che controbilanci il rischio percepito.

Esigenze del Mercato

Uno sguardo ai mercati europei delle obbligazioni di Stato rivela che l'obbligazione governativa europea "standard" emergente è un'emissione decennale a reddito fisso. Germania Occidentale, Francia e Paesi Bassi emettono un grande numero di questo genere di titoli. Essi garantiscono liquidità con volumi di emissione pari a 4 miliardi o più di DM (tremila miliardi di lire) ed un efficiente mercato secondario.

Utilizzando questa obbligazione standard, l'Italia dovrebbe realizzare un importante programma di prestiti nel maggior numero possibile di altre valute SME. L'era nascente dell'unione monetaria offre all'Italia la possibilità di vendere a stranieri debiti nelle valute della Comunità Europea con minor rischio di perdita per svalutazioni, per entrambe le parti.

Tale programma sarebbe caratterizzato da una progressiva formazione di una curva dei rendimenti ad elevata liquidità, parallela a quella del debito nazionale del Governo. Queste obbligazioni liquide decennali tenderebbero infine a diventare settennali, dopodiché quinquennali e così via, offrendo l'opportunità di riaprire le emissioni, in presenza di condizioni idonee.

Il marco tedesco offre il maggiore risparmio di interessi. Seguono a breve distanza il fiorino olandese e quindi il franco francese. L'eccedenza budgetaria del Regno Unito ha determinato una scarsezza di debito in sterline a lungo termine. Tuttavia, i maggiori tassi di interesse e, cosa più importante, la mancanza di impegno per il raggiungimento del meccanismo dei tassi di cambio rendono il debito in sterline molto meno allettante per l'Italia.

Inoltre, l'implicita esposizione del Tesoro e del contribuente italiano ad una maggiore svalutazione della lira nell'ambito dello SME rafforzerebbe notevolmente la credibilità del rapporto della nuova valuta. Considerata la profondità dei mercati finanziari a lungo termine degli Stati membri della

Comunità Europea, riteniamo che tale programma potrebbe esercitare un impatto significativo sulla struttura del debito italiano nel giro di uno o due anni. Questa rappresenta tuttavia solo una parte della soluzione.

Come Semplificare il Mercato Nazionale delle Obbligazioni

La seconda parte della soluzione consiste nella creazione di un corrispondente mercato di titoli decennali a reddito fisso in lire. La popolarità dei Certificati di Credito del Tesoro (CCT) rivela la sensibilità del risparmiatore italiano nei confronti di un rendimento di 50 punti in più rispetto a quello dei Buoni Ordinari del Tesoro (BOT). Ciononostante, le caratteristiche economiche di un'emissione decennale a tasso fisso sono nettamente diverse da quelle di un'emissione a tasso fluttuante. Inoltre, gli intermediari italiani specializzati nella gestione del risparmio a lungo termine sono semplicemente troppo piccoli per poter trasformare in modo consistente la durata del debito. Gli stranieri svolgerebbero dunque un ruolo importante nel lanciare e sostenere un simile mercato.

Considerate quale rendimento verrebbe richiesto da un risparmiatore italiano; attualmente i CCT rendono il 14,9% al lordo di tasse per il prossimo periodo di un anno; i CTO, qualora conservati fino alla loro scadenza di sei anni, rendono il 13,6% sempre al lordo di tasse. Di conseguenza, vista l'attuale situazione, un'emissione decennale a tasso fisso dovrebbe avere una cedola almeno del 14% per poter allettare il risparmiatore italiano. In ultima analisi, l'unico modo per ottenere dati sicuri è quello di vendere all'asta le obbligazioni e vedere quanto il mercato in realtà è disposto a pagare.

Fino a che punto un titolo a reddito fisso in lire al 14% potrebbe attirare gli stranieri? Presupponendo che la prima parte dell'approccio suggerito sia già stato attuato, gli investitori istituzionali europei e mondiali sarebbero già completamente informati in merito all'indebitamento dello Stato italiano; conoscerebbero già il credito della valuta. Durante l'acceso dibattito sull'unione monetaria, gli investitori stranieri considererebbero l'impegno italiano dimostrato dalle azioni contemporanee di riduzione delle fluttuazioni della lira (in pratica tale riduzione potrebbe essere addirittura inferiore al nuovo impegno formale del ±2,25%) e del lancio di un importante programma di prestiti in valute SME. Giudicherebbero senz'altro un rendimento dello Stato italiano, diciamo, del 9% in marchi tedeschi o del 14% in lire, un utile irresistibilmente interessante.

La Figura 5 illustra, in ipotesi, gli utili che gli investitori potrebbero ottenere con i titoli europei nella corsa verso l'unione monetaria. La Figura 5 utilizza due possibili date: cinque anni e dieci anni e presuppone che non avvengano fra queste valute cambiamenti in parità. La nostra visione dell'avvenuta unione monetaria presuppone, forse irrealisticamente, che non vi siano differenze fra i rendimenti delle obbligazioni di ciascun paese.

Figura 5. Utili Totali delle Obbligazioni Statali Europee

Paese	Rendimento Obbligazioni decennali[a]	Unione Monetaria fra 5 Anni[b]	Unione Monetaria fra 10 Anni[b]
Italia	**14,0%**	**208**	**331**
Spagna	14,2	210	335
Regno Unito	11,3	182	282
Danimarca	12,0	187	291
Francia	9,9	165	251
Germania Occidentale	8,6	151	228

[a] Pagamento annuale o equivalente. [b] Feb 19, 1990 = 100.

Nota: Utile totale: plusvalenza più reddito. Si presuppone una convergenza dei tassi di interesse lineare e le cedole vengono reinvestite esenti da tasse.

Fonte: Salomon Brothers Inc.

Gli utili relativi sono sorprendenti e giustificano l'opinione secondo la quale dette obbligazioni in lire sarebbero decisamente interessanti. I sostenitori dell'unione monetaria verrebbero compensati, se questa si verificasse, con un utile del 40% in più rispetto all'investimento in marchi tedeschi nel giro di soli cinque anni.

Implicazioni sui Flussi di Capitale

Senza dubbio, il bilanciamento dei flussi di capitale interessati, rappresenterebbe un'ardua impresa. Se il programma prestiti SME creasse afflussi di capitale e sostituisse il debito in lire, i tassi di interesse in lire registrerebbero una diminuzione sufficiente da convincere i residenti italiani della convenienza degli investimenti all'estero. Potrebbero addirittura acquistare le obbligazioni del loro Paese ma in marchi tedeschi o in altre valute piuttosto che in lire. Questo controbilancerebbe in parte le uscite di capitale. Un'altra componente sarebbe la riduzione degli afflussi di capitale provocata dai cittadini italiani che prendono in prestito valuta straniera per investire in titoli in lire. Un'ulteriore scossa a questo processo di bilanciamento dei flussi verrebbe dall'acquisto da parte di stranieri di obbligazioni decennali in lire dello Stato italiano.

Il risultato globale sarebbe una netta diminuzione dei tassi di interesse italiani nonché il beneficio diretto per le casse dello Stato grazie ai prestiti in valute SME. Questo attirerebbe risparmi a vantaggio del contribuente italiano. Più precisamente, annullerebbe il costo imposto dall'inefficienza dell'attuale sistema finanziario italiano. Inoltre, questa operazione di bilanciamento verrebbe conclusa utilizzando pienamente ed efficacemente le libertà del 1992 "prendendo in prestito" la complessità e l'efficienza del sistema finanziario del resto dell'Europa.

Questa politica deve venire adottata soltanto nella piena consapevolezza del fatto che esporrebbe le politiche budgetarie italiane alla severa disciplina di mercato. Uno dei punti chiave delle discussioni sulla Relazione della Commissione Delors è rappresentato dal metodo per tenere a freno gli eccessi budgetari. Abbiamo di recente dibattuto[2] l'inutilità di "norme budgetarie vincolanti." Un punto chiave di difesa contro la troppo brusca evoluzione di questo processo disciplinario consisterebbe in una durata sufficientemente lunga della vita media dei debiti di uno stato. Questo evidenzia l'enorme importanza della stabilizzazione del portafoglio debiti italiano tramite l'aumento della durata.

Struttura del Mercato delle Obbligazioni

Questa politica potrebbe creare anche le attrattive di investimento adeguate per richiamare gli investitori, in particolar modo stranieri, verso obbligazioni in lire a scadenza più lunga. Tuttavia, tale politica sarà destinata al fallimento se gli investitori stranieri continueranno a temere di restare intrappolati in un mercato secondario a scarsa liquidità. Le riforme del 1988 non sembrano ancora essere riuscite a creare l'aura di un mercato efficiente, liquido, trasparente e ben regolamentato.

Liquidità

Il problema della scarsa istituzionalizzazione del mercato riemerge non appena viene presa in considerazione la liquidità. Da metà a tre quarti di un'emissione può essere bloccata nelle mani di investitori al dettaglio che non mettono le obbligazioni in commercio. Di conseguenza la libera fluttuazione delle emissioni può essere decisamente limitata. Malgrado il sistema di distribuzione primario di recente introduzione, può risultare molto difficile trattare sul mercato secondario somme persino equivalenti a 5 milioni di dollari. Questo risulta estremamente sfavorevole rispetto alla liquidità di cui godono i maggiori istituti finanziari mondiali in altri mercati.

[2] Cfr. *Market Discipline CAN Work In The EC Monetary Union*, Salomon Brothers Inc. Novembre 1989.

Figura 6. Volume Tipico di Operazioni di Titoli a Tasso Fisso da Due a Cinque Anni

USA	200-300 milioni di dollari
Regno Unito	20-25
Germania Occidentale	20-25
Giappone	30-40
Francia	10-15
Italia	4

Fonte: Salomon Brothers Inc.

La Figura 6 illustra i volumi che Salomon Brothers era disposta a trattare in condizioni "standard" in una data settimana (i volumi italiani sono quelli indicati da varie banche italiane, ma soltanto per quei titoli per cui i principali negoziatori erano impegnati a trattare). Benché alcune emissioni italiane siano oggi in fase di riapertura, per aumentarne il volume, appare la necessità di estendere in maniera radicale questa politica.

Prestito di Obbligazioni

L'importante liquidità del mercato secondario non si deduce semplicemente dal volume di un'emissione. E' necessario fare anche attenzione all'abilità dei negoziatori nel prendere in prestito obbligazioni così da poter permettersi di essere a corto di una particolare emissione nell'attesa di trovare un venditore vero. La Banca d'Italia potrebbe svolgere in questo caso un ruolo importante, le sue posizioni sono circa il doppio rispetto all'insieme delle posizioni di intermediari finanziari diversi da banche. Il prestito di obbligazioni può risolvere il problema della consegna e può anche essere utilizzato per arginare il rischio economico per i negoziatori rappresentato dal cambiamento di rendimenti.

Efficienti strutture di prestito delle obbligazioni hanno altri utilizzi. Consentono ai negoziatori l'arbitraggio delle anomalie nella curva di rendimento che potrebbero altrimenti persistere. Consentono anche ai negoziatori di ampliare la distribuzione di nuove emissioni trattando nella prevista area di scadenza dell'emissione.

Accordo di Riacquisto

Vi'è anche l'esigenza della struttura opposta: gli accordi di riacquisto o pronti contro termine. Un negoziatore che ha fornito un mercato liquido al suo cliente potrebbe disporre ora di una posizione consistente. Inizialmente avrà bisogno di adeguati "fondi propri" e questo è l'argomento di una direttiva chiave della Comunità Europea sull'adeguatezza del capitale per i negoziatori di titoli. Secondariamente, il negoziatore dovrà poter accedere ad un sistema finanzario di prezzi competitivi per questa posizione. Questo potrebbe assumere la forma di una vendita ad un'altra istituzione con un accordo di riacquisto, o "repo," o strutture di mutuo collateralizzate. Le nuove norme di adeguamento del capitale, messe a punto dalla Banca Internazionale dei Regolamenti ed incorporate nella Comunità Europea tramite la Direttiva sul Coefficiente di Solvibilità, dovrebbero fare del detto prestito un'attività interessante per le banche commerciali.

Mercato a Termine

L'esperienza fatta altrove ha mostrato che l'esistenza di un mercato a termine può svolgere un ruolo importante nella creazione di liquidità. Una volta che lo Stato italiano avrà emesso titoli decennali in lire a tasso fisso, sarà necessario avviare il prima possibile un contratto a termine. Naturalmente le specifiche dovranno seguire i modelli di successo dei contratti "Bund," "Gilts" e "Matif" allo scopo di agevolare la gestione del rischio.

I problemi associati al prestito di obbligazioni, accordi di riacquisto e contratti a termine potrebbero apparire meri dettagli tecnici. Di fatto, rappresentano le fondamenta dell'abilità di un negoziatore di titoli di offrire al cliente un mercato liquido delle obbligazioni. Di conseguenza, questi aspetti tecnici necessitano di un'approfondita organizzazione in modo da poter superare l'attuale assenza di una "cultura del negoziatore." Non deve esservi confusione di aspetti legali di proprietà di titoli presi in prestito o prestati o di implicazioni fiscali (si tratta forse di una vendita tassabile?) o del valore del credito di tutte le parti. L'attuale sistema di acquisto (o vendita) per consegna differita non basta a creare un'adeguata liquidità del mercato.

Tassazione

Il Ministero delle Finanze Italiano ha annunciato nel gennaio 1990 una revisione delle imposte sul reddito e sui redditi di capitale prima del 1º luglio 1990, scadenza per l'eliminazione di tutti i restanti controlli sui cambi. Nonostante la tassazione rappresenti un argomento ampio e complesso, due sono gli aspetti degni di nota. In primo luogo le trattenute fiscali creano molte distorsioni a causa della varietà dei tassi e dei vari trattati conclusi con diversi paesi. Questo porta ad una discriminazione verso gli investitori provenienti da diversi stati della Comunità Europea e può difficilmente essere considerata come parte dello spirito del 1992. Si dice spesso che esista un ritardo di *sei anni* nel ripagamento di questa tassa, laddove necessario. Questo crea confusione spingendo stranieri e residenti a prestare più attenzione ai rendimenti al netto di tasse in occasione di confronti con altre valute. Probabilmente una parte della campagna rivolta ad attirare investitori stranieri dovrebbe prevedere l'abolizione delle trattenute fiscali.

In secondo luogo, l'impatto delle trattenute fiscali italiane sull'intero mercato delle obbligazioni in ECU comporta una grave distorsione dello schema dei rendimenti relativi. L'unica conseguenza di questo tipo di distorsione potrebbe essere l'arresto della crescita di questo mercato, che ancora una volta, si inquadra difficilmente nello spirito del 1992. Questo appare particolarmente vero quando il risultato è un pagamento forzato da parte di alcuni Stati Membri al Tesoro Italiano.

Conclusione

Il 1992 e l'avvicinarsi dell'unione monetaria offrono all'Italia l'opportunità unica di eliminare i costi insiti all'attuale sistema finanziario. E' un'occasione da non lasciarsi sfuggire.

* * * * *

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RETURN TO C/F.

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1992 And Beyond

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Summary

Monetary union... In June 1988, the European Council "confirmed the objective of progressive realisation of economic and monetary union." The Delors Committee was appointed to propose "concrete stages leading towards this union." In purely economic terms, there are probably two principal requirements for such a union to be credible and permanent:

- Fiscal prudence — to guard against inflation; and
- Internal balance — to prevent weaker countries from becoming impoverished.

Through budgetary rules... The Delors Committee's *Report On Economic And Monetary Union in the European Community*, published in April 1989, stresses the need for the coordination of fiscal and budgetary policy to achieve "internal balance." To achieve fiscal prudence, it proposes to set binding budgetary rules, to exclude monetary financing and put limits on external borrowing. In its choice of tactics, the Committee specifically took the view that — as a major alternative policy — market forces could not be relied upon to provide the necessary discipline to prevent the development of budgetary excesses.

Or market discipline? On the contrary, market forces have exerted powerful disciplinary pressures — when given the freedom to do so. This study explores the factors that enable — and are technically necessary for — the markets to sense the need for discipline and then to exert it progressively. We define this discipline as, initially, a widening of the differential in the price of the debt of the deteriorating debtor compared with the European average. Further down the road, there is the inevitable, ultimate sanction of market discipline: the markets may no longer be willing to provide credit at any reasonable price.

Three necessary conditions Three conditions must be satisfied in order for market discipline to work properly as markets fulfill their natural function:

- Capital must be able to move freely;
- Full information must be available on the creditworthiness, and the debts, of the borrower; and
- The markets must be convinced that there is no possibility of a bail-out — that there are no formal or implicit guarantees that obligations will be met.

Whether governments choose to pay attention to the market's message — and whether they do so at an early or a late stage — remains their own sovereign political decision. In principle, this decision corresponds to their willingness to abide by the overall budgetary controls suggested in the Delors Committee Report — the only difference is the source of the disciplinary pressure.

Market discipline can readily provide the flexibility to respond to changed circumstances — and the certain and final sanction of rejection from the credit markets. But can "detailed binding budgetary rules" offer the same combination of flexibility and certainty of ultimate sanction — and what is their final sanction?

Lessons From Other Monetary Unions

The European Community (EC) has barely, if at all, started to construct a federal system of government, and it would be premature to conclude that there is any broad political consensus to "build a nation." Indeed, many people oppose this concept and it may not even be appropriate for Europe. The Delors Committee Report states that, "even after attaining economic and monetary union, the Community would continue to consist of individual nations with differing economic, social, cultural and political characteristics." Monetary union is not a new concept, so other examples should be analysed to identify their objectives, the methods used to achieve those objectives and the problems.

The history of monetary unions suggests that the desire to build a nation has been a critical factor in determining the extent of central Government assistance in a financial crisis. A key reason for the emergency assistance has been pinpointed as the belief that the union's international credit standing would be damaged, with a corresponding impact on its ability to borrow or refinance debt abroad. This factor may have been a real constraint for a developing nation looking to attract capital. However, the mature States of the European Community are, if anything, in the opposite position. Over the past 30 years, the Community's members have only run significant collective current account deficits during each of the two "oil shock" years. Thus, there is no aggregate Community need to import capital. The absence of this requirement will have a vital bearing on the design of European monetary union, because it is not necessary to attract risk-averse and volatile foreign investors. Instead, it is sufficient merely to avoid frightening domestic investors to the point where they feel obliged to protect themselves by exporting their capital.

It is instructive to look at the mechanisms that have evolved in other monetary unions, such as Australia, West Germany and Canada. Australia and West Germany are "tight" federal systems, where the central Government exerts such a degree of fiscal control that credit distinctions between the constituent states are almost nonexistent: this is, in fact, the precise intention of these systems.

Canada, on the other hand, has a much "looser" federal system, where individual credit ratings exert considerable market discipline on the provinces. In contrast to Australia and West Germany, the Canadian system sets out to apply a measure of market discipline — and has succeeded. Interestingly, Canada unites this market discipline with a successful and wide-ranging system of monetary transfers to the provinces — without this being seen as an implicit guarantee of provinces' budgetary deficits.

Australia

"Tight" unions with budget control, not market discipline

The Australian central or Commonwealth Government, through a Loan Council system functioning since 1933 (and a dominant role in revenue collection assumed during World War II and not acceded back to the States since that time), has obtained *de facto* control over the fiscal policies of each of the six States. Differences in the States' borrowing terms in the domestic market are determined more by liquidity and technical considerations than by any marked distinction in fiscal policies or budgetary priorities. Both American rating agencies (Moody's and Standard and Poor's) have recognised that Commonwealth Government fiscal control and explicit budgetary support are more important than differences in State fiscal policies and have assigned ratings to all of the States, borrowing authorities and State-owned enterprises that are identical to those of the Commonwealth (Aa2/AA). This is discussed further in Appendix I (see page 8).

West Germany

The Federal Republic of Germany represents a strong commitment to federation, primarily because of provisions in the 1949 Basic Law aimed at achieving homogeneous living standards throughout the Republic and allocating responsibility for "financial and economic harmony" on a nationwide scale to the Federal Government. The Federal Government supervises a fiscal equalisation system that attempts to provide all citizens with a roughly uniform standard of public services. More importantly, it exerts significant control over the budgetary policies of the 11 States, or Länder, through a Fiscal Planning Council that attempts to coordinate overall fiscal policy in carrying out the stable growth mandate of the Federal Government. Moreover, the Länder are permitted to borrow only for investment purposes, and the Federal Government can impose ceilings and rules regarding terms, conditions and timing for borrowings by all levels of Government if national economic balance is disturbed by such activities. This is discussed further in Appendix I (see page 8).

"Loose" unions with market discipline

The monetary unions represented by the federal systems in Canada and the United States are much looser fiscally and politically and thus more market-oriented than those in Australia or West Germany. The Federal Government in the United States has historically taken a benign role in regional development, and there is no concerted effort to reduce economic disparities among the 50 States.

Canada

Canada's vast geography but small population has caused the Canadian Federal Government to become deeply involved in alleviating regional inequalities and contributing to economic development in remote or economically depressed areas. Nevertheless, Canada's implicit credit support for its provinces is much more subtle than Australia's or that of the Federal Republic of Germany, falling far short of either control over fiscal policy or a guarantee of creditworthiness. The domestic provincial bond market in Canada does "rank" the provinces according to typical credit measurements: laxity or tightness of fiscal policy, economic dynamism and political commitment to budgetary stabilisation. A similar "ranking" of the provinces exists in the other international markets in which they borrow (primarily the Yankee and Eurobond markets).

Provincial concern about the ratings of the two Canadian agencies and the two US agencies (and thus the cost of servicing debt), and a spate of provincial downgrades by these agencies between 1980 and 1987, is undoubtedly one of the reasons why almost all of the provinces have reduced their budgetary deficits in the past three years. The Canadian monetary union, because it combines significant economic support with only an extremely vague "guarantee" of fiscal support, is probably the best existing example of a monetary union in which market sanctions work well against the constituent members. This is discussed further in Appendix I (see page 9).

Applying the Lessons

Binding budgetary rules can be circumvented

The New York City debt crisis of 1975 provided a classic example of the problems of a monetary union. Probably the most powerful lesson is that a determined administration could circumvent any prudent constitutional arrangements. In this case, the legislative "check" of the superior body — New York State — failed entirely, because New York State systematically permitted its checks to be avoided by abuses of borrowing powers. Moreover, New York State had little moral standing to enforce these checks, because its own finances were parlous — also due to budgetary excesses.

Looking at the growth of European "pork barrel" politics — perhaps exemplified by the EC's Common Agricultural Policy — there can be little confidence that late-night, budget cooperation deals would not fall into the same trap. That would be the precise moment when "vital national interests" were at stake and could easily warrant a threat to leave the union. The EC's proposed "binding budgetary rules" could well be vulnerable under these circumstances. How can these rules be enforced? What is the ultimate sanction that corresponds to the financial markets' undoubted ability to cut off new supplies of credit?

New York City, for example, succeeded in circumventing the rules and chose to ignore the ever-rising interest rate signals from the market. Having ignored this stage of the market's discipline, the City's fiscal imprudence was finally brought to a halt by the brutal discipline of total rejection, rather than the application of any budgetary rules. This is discussed further in Appendix II (see page 14).

This example of the failure of constitutional rules to prevent budgetary excesses raises two issues. First, how can the EC impose rules? What will the sanctions be? Second, how can the rules be specified in a manner that takes proper account of the variation of conditions both between Member States and over time? There must be a risk that the rules will be too easily circumvented by creative accounting or, alternatively, too rigid and therefore arbitrary.

Conditions necessary for market discipline

If binding budgetary rules are one end of the spectrum of possible policies, then strict market discipline is the other end. This will require lenders to be explicitly clear that the donors of financial support will not pay more than they have already willingly agreed. As monetary financing is precluded by the proposed fact of monetary union, Member States will have to borrow from the financial markets — principally those that intermediate the pool of all Community savings. We believe that the financial markets can provide the "check" of market discipline if the agreed "balance," such as revenue transfer, is exceeded. **The ultimate check will be a complete withdrawal of new credit supplies.**

In summary, there are three obvious conditions that must be satisfied for market discipline to work properly.

Free movement of capital

First, savers must not be legally coerced into lending money to a particular state. This coercion may be the effective result of exchange controls or perhaps controls on the investment of assets, which are no longer necessary for proper, prudential regulation. The historic agreement in June 1988 to end exchange controls within the EC was the key step forward in achieving this goal.

Full information

Second, to make an informed judgement, savers must be fully informed about creditworthiness, including the debts of the state in question. Although much of the obvious data is already published by the European Commission, probably very few investors are aware of this fact. However, in many states, much government finance is transacted through private placements, where maturity and interest rate sensitivity are not necessarily published. Full data on the maturity structure of all of the debt servicing obligations likely to be faced by a government, even under the worst circumstances, are essential if the markets are to form a proper judgement of the risks.

The critical problems are likely to arise in the very areas that are not obvious, for example, entities or corporations that are owned by, or associated with, the public sector. Should their debts be included? What about "moral obligations?" Binding budgetary rules will inevitably encourage creative accounting. A review of the New York City debt crisis of 1975 provides a lesson on creative public finance. It might be appropriate to categorise the types of public sector debtors. Member States should then be required to report those institutions that fall within those categories and provide timely and continuing details of their debts and servicing obligations on the basis of standardised accounting. Correspondingly, the European Commission should be required to collate and publish these reports. (A thorough clarification of the exact standing of many debtors is already necessary to manage the risk-weighting system that will be imposed on banks by the EC's Solvency Ratio Directive.)

No bail-out

The third and single most critical condition — that a fiscally imprudent state will not be bailed out by the Community — should probably be incorporated in an amendment to the Treaty of Rome itself. Such an amendment could well include specific measures to eliminate the possibility of formal guarantees or other powers to ensure the solvency and liquidity of Member States.

Subsidiary legislation should spell out the requirements necessary to make Member States' overall indebtedness transparent to investors, including standardised accounting. It should also set minimum prudential standards of debt management (the corollary to those that the Member States have just imposed on their banking system by setting minimum capital standards). It may be necessary to prohibit the European System of Central Banks from purchasing public sector debt, which would negate the market's discipline. Prudent debt management can ensure that this disciplinary process becomes progressively tougher only over many years.

This subsidiary legislation should be subject to majority voting, so that any moves against abuses cannot be blocked by the abuser. Correspondingly, it would be extraordinary if a blocking minority could not be mustered to prevent any significant weakening.

The intention of such tactics is to put the financial markets on notice that there can be no formal guarantee of any Member State by the others. Theoretically, such a treaty amendment could be reversed, but the financial markets would be aware of the difficulties and lengthy timescale for unanimous agreement and ratification. In the event that a Member State reached financial crisis, such a process would be too lengthy and uncertain to give investors any comfort that they would be paid on time. Thus, any real signs of impending crisis would induce a flight by investors sufficient to send a clear and visible signal of the price of that State's debt.

(If the cause of the financial crisis were not fiscal imprudence, but some major national disaster, for example, then there are already mechanisms available that the other Member States could use to volunteer extra assistance during the adjustment.)

Even if the market is convinced that there are no explicit and formal guarantees, or other methods of ensuring that obligations are met, how can it be convinced that there are no implicit guarantees? Resource transfers are important in gluing a monetary union together and maintaining internal balance. The difficulty is in achieving the balance between first, supporting the poorer constituents sufficiently to make credible their continued membership of the union, and second, effectively offering an implicit guarantee. The Canadian system provides a fascinating example of how far-reaching transfers of resources can be combined with a considerable measure of market discipline.

If these three conditions are met, then it seems inconceivable that the financial markets would fail to observe the signs of progressive financial deterioration and charge an appropriate premium for extra loans. Indeed, markets already make credit distinctions between the EC States when they

borrow outside their domestic currency. These States are extremely sensitive about the terms on which they borrow, precisely because it is a reflection of their creditworthiness. This is discussed further in Appendix III (see page 18).

The United States has provided a lesson in the perils of even starting down the "bail-out" road. Moral obligations can become a serious budgetary item, as shown by the bail-out of the thrift industry. At a cost to the public of well over $150 billion, the bail-out in effect protects all depositors — not merely those who are formally insured. **The European Community should learn this lesson thoroughly.**

Building in the Safeguards

Gradual application of market discipline

Given the sudden and drastic withdrawal of new credit supplies from New York City in 1975 and the less developed countries (LDC) after 1982, there may be concern that the disciplining process could be too abrupt. Indeed, the Delors Committee Report specifically raised this issue. European monetary union must be designed to exert discipline in a progressive manner: first, a steady increase in the relative price of debt, and then — only after a lengthy period — a withdrawal of new supplies of credit at any reasonable price.

Prudent debt management

A key feature of the New York City and LDC crises was the combination of floating interest rates and very short debt maturities. While both types of debt have their place in a debt portfolio, strict prudential guidelines for debt management could create the necessary buffer. This could provide a reasonable number of years for the problem to be recognised by the markets, accepted by the government and electors and for an adjustment programme to be formulated and implemented. There could be provision for a minimum average life of a Member State's debt of at least five years (New York City recovered in six years — although greatly assisted by the effects of a period of double-digit inflation). Thus, any difficulty in selling new debt would compound progressively over several years — correspondingly exerting a cumulative increase in the severity of the discipline. At this stage, it would be important to prevent the growing liquidity crisis from being unintentionally escalated by the effect of floating interest rates rising sharply. Therefore, there should be a prudently low limit on the proportion of the floating-rate debt.

Prevent the central bank from negating market signals

It would be critical that the central bank — the European System of Central Banks — was not obliged, or persuaded, to negate the markets' signals by purchasing the debt of the deteriorating country. The quantity of money in the economy can readily be controlled by purchases of private sector securities — as the West German Bundesbank, for example, does with its "repurchase agreements."

Diversified financial assets

In a nation state, there may be merit in requiring the financial system to hold large volumes of "safe" assets — government obligations. In a crisis, the central bank will control the interest rate on the risk-free asset by providing liquidity to the system through purchases of these assets. This will convert the crisis from that of rising interest rates into one of a falling currency, but will preserve the solvency of the domestic financial system. Moreover, the government has the power to ensure that these obligations are met — by printing more money, if necessary. Naturally, this only solves the very short-run problem.

However, in a monetary union, the opposite asset policy is appropriate. The central bank must not offset the market's signals by purchases of public debt, nor may the government print more money to meet its

obligations. Therefore, the "safe asset policy" will no longer be one of concentrating on domestic government obligations. Prudence will then dictate that the financial system should diversify its asset holdings widely among the various public and commercial entities, because none have the power to stave off default by creating more money. Instead, the only safe assets are those that are the liabilities of prudently financed and managed entities.

A diversified asset portfolio will ensure that the financial system is not overexposed to any single state. The banks will then be able to resist pressure for additional loans and, correspondingly, the EC as a whole will not have to contemplate a bail-out to protect the solvency of the financial system of Europe.

Conclusion

We believe that a monetary union can be developed in modern Europe. The fear of losing national sovereignty is widespread and is exacerbated by proposals for "binding budgetary rules." Such rules may be useful for other purposes, but are not necessary for attaining monetary union. So, if the objective is limited solely to a desire for such union, rather than nation building, then the lessons from other unions point a way forward, based on the economic freedoms that are an explicit objective of the Treaty of Rome. **We believe that free movement of capital can induce the fiscal prudence that is one of the two principal conditions for achieving a credible and permanent monetary union.**

The second condition is internal balance. In Appendix IV (see page 23), we analyse the resource transfers already planned by the EC. Specifically, the doubling of the "structural funds" agreed at the 1988 Brussels Summit was a clear, intentional step towards evening out regional disparities by providing significant assistance to less developed areas. These resources, if properly utilised, have the potential to ignite a boom that will produce a more rapid growth in prosperity than anything seen in the past 20 years. If such a boom were to occur, it seems unlikely that the creditworthiness of any Member State would be questioned on grounds of relative poverty or desire to leave the union. **Accordingly, we believe the EC is well on the way to passing a key test of its ability to operate a monetary union.** However, policy must not be steered so far to the other side of the narrow channel that market discipline is undermined by equating large resource transfers with an implicit guarantee.

An historic prize is within Europe's grasp.

Australia

Close fiscal control

The Australian Commonwealth provides a close parallel with the monetary union envisaged in the Delors Committee Report, in which a central authority heavily influences constituent fiscal policies.

Under the Financial Agreement of 1927, the Commonwealth Government is empowered to borrow on behalf of the six States and, during the annual Conference of State Premiers, State Governments have to submit their borrowing plans to a Loan Council dominated by the Commonwealth Government. In 1936, a gentleman's agreement expanded the Loan Council's authority to impose limits on semi-government and local authority borrowings as well. In the early 1980s, each State established a borrowing authority that was not technically subject to Loan Council limits or included through the gentleman's agreement. To bring the increasingly important borrowing authorities under the auspices of the Loan Council, the gentleman's agreement was cancelled in June 1984, and "global limits" were imposed on all public sector borrowing by each State. International borrowing is further limited as a percentage (22% in 1989) of each State's global limit. In exchange for global limits on their borrowing, the Commonwealth Government has granted these authorities (and, thus, the States) access to international capital markets that had previously been closed to them.

No individual credit ratings

The fiscal relationship between the federal constituents is so tight in this monetary union that market forces do not distinguish between the States in terms of individual State creditworthiness. Internationally, this is reflected in the fact that all of the rated States have received the same ratings (Aa2/AA) as the Commonwealth Government, and borrowing terms are essentially the same. In the domestic market for State semi-public (borrowing agency) securities, liquidity and technical structure are more important than fiscal differences in determining borrowing terms. No State has taken advantage of this situation by running a consistently large fiscal deficit in comparison to other States. Moreover, it is doubtful that any State could pursue such a policy with the firm control over State finances exercised by the Commonwealth Government.

Australia's tight federal system, and the strong fiscal control exercised by the Commonwealth Government over the States, makes the Australian system a poor model for a European monetary union in which market discipline is to be exercised on budgetary balances.

West Germany

Revenue distribution

The Federal Republic of Germany consists of the Central Government (the Bund) and 11 States (the Länder). The Federal Republic has a strong commitment to federation, primarily because of provisions in the 1949 Basic Law aimed at achieving homogeneous living standards throughout the Republic and allocating responsibility for "financial and economic harmony" on a nationwide scale to the Federal Government. Economic and financial unity stems from a constitutionally mandated system of tax allocation and revenue redistribution (Finanzausgleich) designed to redress economic imbalances among the Länder, as well as from the sharing of financial burdens between the Central Government and the Länder. Revenue distribution occurs in three ways: the distribution of taxation authority and tax revenues between the Central Government and the Länder; "vertical revenue equalisation," whereby the Central Government contributes revenues to the Länder; and "horizontal revenue equalisation," whereby the Länder redistribute revenues among themselves. Other factors contribute to the unity of the system, including investment grants made by the Central Government to economically weaker Länder, the constitutional requirement for the Central Government and the Länder to coordinate their expenditures to ensure overall economic balance, and the authority of the Central Government to impose limits on borrowing by the Länder under certain circumstances.

Central fiscal control

The Federal Government exerts significant control over the budgetary policies of the Länder by means of a Fiscal Planning Council, which is an attempt to coordinate overall fiscal policy in carrying out the stable growth mandate of the Federal Government. Moreover, the Länder are permitted to borrow only for investment purposes, and the Federal Government can impose ceilings and rules regarding terms, conditions and timing for borrowings by all levels of government, if national economic balance is disturbed by such activities.

No credit differentiation

The Länder borrow in their own name, and the Federal Government is not liable for their debts. However, the unique structure of the Federal Republic provides the Länder with a level of credit safety very close to that of the Federal Republic and without significant variation among them. The fiscal relationship between the Central Government and the Länder is so tight that market forces scarcely distinguish between the Länder.

Like Australia, the Federal Republic's strong fiscal control over the fiscal policy of the Länder makes the West German system an equally poor model for a European monetary union in which market discipline is exercised on budgetary balances. The Federal Government's heavy hand in determining the optimal level of borrowing for a balanced national economic policy, and an extensive revenue transfer system, limits the market's need to exercise discipline on Länder fiscal policies, even if Länder deficits merited such discipline.

Canada

Summary

Canada has a looser federal system than Australia or West Germany. Canada's vast geography but small population has caused the Canadian Federal Government to become deeply involved in alleviating regional inequalities and contributing to economic development in remote or economically depressed areas. Nevertheless, Canada's implicit credit support for its ten provinces is much more subtle than Australia's or that of the Federal Republic of Germany, falling far short of either control over fiscal policy or a guarantee of creditworthiness. The Canadian provinces are individually ranked by both the domestic provincial and the international bond markets. Provincial concern about ratings (and thus the cost of servicing debt) is undoubtedly one of the reasons why almost all of the provinces have reduced their budgetary deficits in the past three years. Thus, Canada provides a very interesting model for a monetary union in which market discipline regulates budgetary balance.

Strong financial linkages

Although the Canadian federal system is looser than the federal systems of either Australia or West Germany, mechanisms have been implemented that provide implicit Central Government support for the individual provinces. These mechanisms should not be construed as reassurance that the Canadian Federal Government can or will directly prevent a province from pursuing misguided policies or that it formally guarantees payments on provincial debt. There is no national review of state borrowing as exists in Australia (although this has been seriously discussed in Canada), nor is there a direct attempt to ensure the fiscal solvency of individual provinces as with the West German financial equalisation system. Nevertheless, the financial linkages between the Federal and provincial Governments provide a series of buffers that constitute an important safety net against rapid economic decline and fiscal deterioration at the provincial level. This safety net is comprised of several specific linkages.

The nation-building role of the Federal Government

The Canadian Government has felt the need to play a very active part in economic development and regional policy to ensure Canada's independence from the United States and its coherence as a nation. Canada's enormous size and sparse population has necessitated strong public sector leadership in transportation, communications, population settlement and the utilisation of vast natural resources. Moreover, linguistic, ethnic and geographical differences are natural centrifugal forces in Canada, and the Federal Government historically has been the primary impetus in countering these forces.

Regional development programmes

Efforts to compensate for regional disparities and provincial geography were included in the original British North American Act in 1867. The 1982 Constitution reiterates the national commitment to regional development, and the system of regional subsidisation and economic development flourishes today. In 1987, regional development programmes were decentralised: a Federal department became responsible for programmes in Quebec and Ontario, and two new regional agencies were established — the Western Diversification Programme (covering Saskatchewan, Alberta, Manitoba, and British Columbia) and the Atlantic Canada Opportunities Agency (involving Newfoundland, Prince Edward Island, New Brunswick, and Nova Scotia) are currently responsible for disbursing Federal development assistance within their respective regions.

Much of the Federal Government's current regional development assistance is more subtle than that embodied in these specific initiatives. Tax rebates, assistance to regionally-specific activities (such as wheat production, petroleum extraction, forestry or fishing) and federally-funded megaprojects are among the tools used by recent Canadian Governments to prevent a widening of provincial economic disparities.

Through these economic assistance and development programmes, the Federal Government helps to prevent any province from deteriorating economically to the point where its creditworthiness could seriously be questioned. There is no firm evidence that these specific programmes have reduced economic disparities between provinces, and some continue to lag in terms of economic growth and industrial development, but the Federal Government has periodically ensured that this lag is not critical.

Intergovernmental revenue sharing

Canada maintains a sophisticated revenue-sharing arrangement between the Federal and provincial levels of government. Since the 1930s, the Federal Government has transferred an increasing amount of its revenues to the provinces (although the rate of increase has slowed in the 1980s) so that provincial governments can carry out the educational, health and social welfare maintenance roles delegated to them by the Constitution. The Federal Government uses a large share of the taxing power in Canada, while the provinces have seen their constitutional duties increase with the development of a modern welfare state. Transfer payments are an important compromise between the fiscal power of the Federal Government and the expanding public services burden of the provinces. Both of Canada's major intergovernmental revenue-sharing schemes include strong equalisation components.

Comparable levels of public services

The Constitution Act of 1982 commits the Federal Government to "ensuring that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." The formal system of equalisation has evolved since the Rowell-Sirois Commission publicised its proposals for reforming Canada's fiscal arrangements in 1941. The Commission asserted that a formal equalisation grant system was required "to make it possible for every province to provide, for its people, services of average Canadian standards and...will thus alleviate distress and shameful conditions which weaken national unity

and handicap many Canadians." The system that developed from these recommendations is set forth in the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act of 1987.

Canada's system of intergovernmental revenue sharing has two components: the first is conditional programmes that include the Established Programmes Financing (EPF) transfers and cost-sharing programmes such as the Canada Assistance Plan (CAP). The second component is the system of unconditional transfers known as equalisation and stabilisation payments programmes.

Per capita transfers

The EPF transfers are granted by the Federal Government on an equal per capita basis to help defray the costs of national health and post-secondary education programmes. A progressive national tax system applied to a country with marked regional income disparities, coupled with the per capita nature of these conditional grants to the provinces, has a strong equalising impact. A second form of Federal transfer involves cost sharing. Under the largest of these programmes, the Federal Government shares 50% of the cost of welfare assistance under the CAP.

Unconditional transfers

Unlike the EPF and CAP transfers, equalisation payments are totally unconditional transfers, explicitly aimed at narrowing differences in the ability of provinces to provide public services. The payments are made from the Federal treasury and so have no effect on the financial position of the wealthy provinces. The poorer provinces, however, receive revenues from the equalisation programme. The equalisation formula determines an average level of fiscal capacity or average national tax capacity by calculating the average of five representative provinces (currently British Columbia, Manitoba, Ontario, Quebec and Saskatchewan). Provinces in which fiscal capacity falls below the average level receive payments to align them with the national standard.

Stabilisation programmes

While equalisation helps to stabilise the revenues of recipient provinces, a separate stabilisation programme exists to compensate all provinces for an unexpected decline in tax revenue. This programme is most likely to apply to the western resource-dependent provinces, which could suffer from a drop in resource-related revenue. The programme has been used only once — for British Columbia in fiscal 1982-83. Nevertheless, it provides an important safety net for those provinces, which are outside the scope of the equalisation programme. Provinces often cite the stabilisation programme as assurance to investors that provincial revenue will not fall below a certain level, thereby affecting the province's ability to service debt.

Clearly, the Federal transfer arrangements provide an important source of fiscal support for the less wealthy provinces. The Atlantic provinces in particular rely heavily on fiscal transfer payments, with equalisation providing between 30% (Newfoundland) and 21% (Nova Scotia) of total revenue. The constitutional goal of enabling provinces to provide reasonably comparable levels of public service is, to a large degree, met by the transfer payment system. **Most important, at least in terms of provincial credit standing, the Federal Government's contribution to revenues in the poorer provinces makes them decisively stronger fiscally than they would be in the absence of such Federal support.**

Historical precedent

During the early 1930s, before the current Federally supported revenue-sharing arrangements had been legislated, the Federal Government rescued at least three provinces that experienced financial difficulties. British Columbia, Manitoba and Saskatchewan each received emergency Federal assistance in the depths of the depression between 1933 and 1936, when they were threatened with having to default on outstanding bonds. In at least five cases, under both Conservative (up to November 1935) and Liberal (after November 1935) leadership, the Federal Government granted loans to these provinces to avert a liquidity crisis and to prevent default or

delayed payments to bondholders. Officials in both Governments during this period emphasised their concern about the ramifications of provincial delays or defaults on the ability of the Federal Government to borrow internationally on favourable terms.

In only one instance did the Federal Government permit a province to default. In 1936, an actively centralist Liberal Government demanded that a province accept Federal supervision of its finances under a loan council scheme, which would oversee provincial debt accumulation before the province could receive Federal funds. A devolutionist provincial Government refused to accept this proviso, as did several other provinces that received emergency loans. Despite possible national credit ramifications of a provincial default, the Federal Government stood firm, and the province defaulted on one bond issue. The province eventually accepted Federal Government fiscal supervision and subsequently received Federal loans; by 1945, all creditors had been fully compensated for all principal and interest that had been suspended.

The current revenue-sharing system and economic support mechanisms make such individual provincial financial crises highly implausible. Nonetheless, the experience of the 1930s illustrates that, even before the development of the modern federal system in Canada, the Federal Government provided direct support to ailing provinces. Although this experience does not guarantee that the Federal Government will again come to the financial assistance of a province, it is an important precedent in determining the strength of Federal-provincial financial links and assessing the likelihood of Federal emergency support.

The market still sends clear signals

Despite the strong financial linkages between the Canadian Federal Government and the provinces, both the international and domestic debt markets distinguish quite clearly between the credit quality of the ten provinces and thus send clear messages on fiscal appropriateness to the provincial governments. In the domestic provincial bond market, there is a yield spread of up to 50 or 60 basis points between the stronger (fiscally and economically) provinces and the weaker provinces. A spread gap of around 40 basis points exists between Ontario and the weaker provinces in the United States Yankee bond market.

Credit ratings

Although the ratings spectrum among the provinces is overly wide considering the implicit Federal Government support, both the international and domestic rating agencies assign significantly different ratings to the various provinces. This reflects an informed, objective judgement on the credit quality of the Canadian provinces based on economic strength, budgetary deficits, overall debt levels and political commitment to fiscal adjustment. Figure 1 summarises the diversity of the ratings.

Figure 1. Credit Ratings of the Canadian Provinces

Province	Moody's	Standard & Poor's	Canadian Bond Rating Service
Alberta	Aa1	AA+	AA
British Columbia	Aa2	AA+	AA+
Manitoba	A1	A+	AA-
New Brunswick	A1	A+	A
Newfoundland	Baa1	A-	BBB
Nova Scotia	A2	A-	A-
Ontario	Aaa	AAA	AAA
Prince Edward Island	NR	NR	BBB+
Quebec	Aa3	AA-	AA
Saskatchewan	A1	AA-	AA-

Note: Moody's Investors Service and Standard & Poor's are New York-based rating agencies which rate the provinces' international issues. Canadian Bond Rating Service is a Montreal-based agency that rates the provinces' Canadian issues.

Between 1981 and 1986, all of the Canadian provinces saw their budgetary deficits and debt increase significantly. The world recession of the early 1980s, the precipitous fall in the price of oil in 1985, weak world markets for commodity exports, increasing debt servicing requirements, and pressure on the Federal Government to reduce its own deficit and thus slow the increase in transfer payments to the provinces were the major factors contributing to fiscal pressure and mounting debt. The provincial budgetary deficits reached an average of 12.4% of revenues in fiscal 1987. The credit deterioration was most obvious in rating action during the period. The ratings of all nine provinces that borrow internationally were lowered at least once between 1981 and 1987 — two provinces were downgraded twice. This was a clear market signal that deteriorating financial circumstances would result in more expensive borrowing terms.

Since 1987, virtually all of the provinces have reversed this downward fiscal trend. The anticipated average budgetary deficit as a percentage of revenues is expected to decline to 3.4% in fiscal 1990 (ending March 31, 1990) and new borrowing by the provinces should be at the lowest level in almost a decade. As a result of this improved performance, two provinces have had their ratings raised since 1988 (none has been lowered). Additionally, in June 1989, Standard & Poor's placed four provinces on a positive rating outlook list (one had been upgraded a week earlier and the other four have stable rating outlooks). Although a buoyant Canadian economy was the primary contributor to vastly improved provincial fiscal performance, the market sent clear signals through the pricing and ratings of provincial debt.

Despite strong linkages between the Canadian Federal Government and the provinces, the market continues to distinguish among the provinces in terms of fundamental credit quality. **The lack of an explicit Federal Government guarantee to come to the assistance of a financially distressed province (i.e., only a vague commitment of support), has ensured that the market continues to send signals on the appropriateness of provincial budgetary policies.**

* * *

Appendix II: The 1975 New York City Debt Crisis

This section analyses one of the incidents often cited as an example of the failure of market discipline: New York City's fiscal crisis of 1975 (a brief history of events is given on page 16). This crisis involved specific factors that seem unlikely to be present in the EC or can readily be avoided by proper structuring of the monetary union of Europe.

The Delors Committee Report specifically refers, in paragraph 30, to the risk that market forces will be too weak and slow or, alternatively, too sudden and disruptive. We believe that a study of this leading example provides valuable lessons on how market discipline can be used as a genuine and simpler alternative to binding budgetary rules.

The lessons relevant for EC monetary union

- Probably the most powerful lesson is that a determined administration could circumvent any prudent constitutional arrangements. In this case, the "check" of the superior legislative body — New York State — failed entirely, because New York State systematically permitted its checks to be avoided by abuses of borrowing powers. Looking at the growth of European "pork barrel" politics — perhaps exemplified by the EC's Common Agricultural Policy — there can be little confidence that late-night, budget cooperation deals would not fall into the same trap. That would be the precise moment when "vital national interests" were at stake and could easily warrant a threat to leave the union.

- The speed and severity of the crisis, when it ultimately arrived, can be traced directly to the progressive increase in the proportion of short-term debt. This occurred partly because it was easier to avoid the statutory debt limits with short-term debt, but also partly because of the fatal illusion that it was "cheaper," due to the positive yield curve. This problem underlines the need for stable debt servicing expenditure. Public policy should always favour stability and the avoidance of a liquidity crisis, even at the cost of higher, current interest costs. **The nature of the debt portfolio should be disclosed — fully and in a readily accessible and comprehensible form — so that the markets can make a proper judgement.**

- As New York City was part of a monetary union, it had no possibility of escape through printing more money. Therefore, its default could not be along an inflationary route — it had to threaten a formal failure to pay obligations, when due. This put its financial system directly at risk, rather than indirectly via the problems of inflation. Although this risk did not crystalise, there would have been even less of a reason for the central authority of the political federation to contemplate the need for a bail-out if its financial system had possessed a more widely-diversified portfolio of assets.

New York City's fiscal crisis is particularly instructive, because it happened to the public authority within which one of the world's most sophisticated financial markets flourishes. Moreover, the higher legislative body was, systematically and publicly, persuaded to override the constitutional checks intended to prevent exactly this type of crisis. The persuasion was not difficult, because that higher body was also in financial difficulties. The EC's binding budgetary rules could well be as vulnerable.

How the Constitutional Checks and Balances Were Avoided

The roots of the problem go back to the 1960s. New York City's Charter required a balanced budget (paragraph 1515). The crisis arose because of abuses of both short- and long-term borrowing powers, as well as the use of Public Benefit Corporations to avoid statutory debt limits. The operating expense budget was to be balanced by setting the real estate tax (the major revenue source) at the level necessary to achieve that balance, although

subject to a ceiling. There was a separate capital budget for capital projects and borrowing was permitted — but subject to limits laid down by the State of New York.

The State limited the maturity of debt to the "probable usefulness" of the life of the project. The city sought, and obtained, numerous amendments to this law; effectively, operating expenses were capitalised. Despite criticism as early as 1966 about whether these were really capital projects, the practice grew, and borrowing for current expenses rose from 4% of the city's funds in 1965 to 53% in 1975.

Abuses of short-term borrowing centred on Revenue Anticipation Notes (RANs), Tax Anticipation Notes (TANs) and Bond Anticipation Notes (BANs). RANs were simple borrowings against tax revenue due to be paid in the following budget year, but which accrued in the current year. In the 1965-75 decade, RANs increased sixfold. This process failed to allow for budgetted revenue that, for whatever reason, was never collected. This problem became most acute with TANs, which were largely used to anticipate real estate taxes. By 1975, US$380 million of TANs were outstanding against taxes receivable of $502 million — per annual report. However, the State auditors ultimately reckoned that revenues unlikely to be collected amounted to $408 million of that total.

BANs were another significant misuse of short-term borrowing powers, because they allowed temporary financing, for example, for the construction period of a project, prior to "permanent" financing by a bond issue. By continuously rolling over BANs, cheaper financing was provided due to the positive yield curve and, helpfully, no principal had to be repaid.

Public Benefit Corporations (PBCs) were created by the State of New York to run revenue-producing facilities, such as public utilities. Increasingly, these PBCs began to finance non-revenue-producing activities, yet their bonds were still held to be a "moral obligation" of the sponsoring authority. A "full faith and credit" commitment was not previously necessary, because the revenue stream would repay the bonds. These off-balance-sheet commitments became large — New York State public authorities had $15 billion of "nonguaranteed" debt outstanding in 1977, versus only $3.7 billion of guaranteed debt.

The resultant debt portfolio

Figure 2. City of New York Combined Debt Position, 1965-76 (Dollars in Billions)

	1965	1970	1975	1976
Net City Funded Debt	$3.9	$4.4	$6.6	$6.5
Net MAC Debt	—	—	—	$3.5
Net Debt of PBCs	—	—	—	$0.9
Subtotal	$3.9	$4.4	$6.6	$10.9
Short-Term Debt	0.5	1.3	4.5	2.1
Total Net Debt	$4.4	$5.7	$11.3	$13.0
Net Debt Per Capita	$571	$716	$1,513	$1,753
Net Debt as Pct. of Personal Income	16.0%	15.0%	22.9%	25.0%

MAC Mutual Assistance Corporation. PBC Public Benefit Corporation.
Source: Annual Reports of the Comptroller.

In its 1981 rationale for the restoration of a credit rating to New York City, Standard & Poor's noted that the city's reliance on long-term bond issues to finance operating expenses had begun to weaken the market for its bonds even in the late 1960s. As a result, BANs had become particularly attractive, as they were also cheaper. The resulting build-up in short-term

debt flooded the municipal market with New York City paper — which accounted for perhaps 40% of total volume at the peak. When the market would no longer buy city paper at any reasonable price, the scale of the short-term liabilities inexorably led on to a liquidity crisis as they fell due in enormous quantities and could not be rolled over. Figure 2 sets out the rapid growth in total debt and its shortened maturity. It also illustrates the role of Public Benefit Corporations — the total debt was nearly 10% higher than was readily visible, because of the off-balance-sheet nature of their debts.

Brief History of the Crisis

By 1974, creditworthiness problems were already apparent and the State of New York set up the Stabilisation Reserve Corporation (SRC) to help raise funds for New York City. Drastic budget cuts were proposed, including heavy lay-offs of workers, but the credibility of these proposals was increasingly questioned.

Figure 3. The Events of 1975

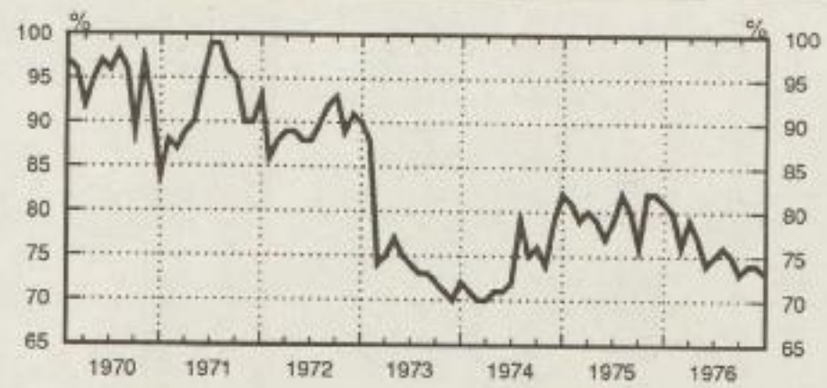
February	Legality of SRC challenged. Urban Development Corporation (of New York State) defaulted on the rollover of short-term debt, souring market perceptions about New York-related paper. Failure of TAN sale after it was found that the pledged tax payments would not exist.
March	Short-term city notes offered for sale at yields close to twice those offered by other municipalities; only 40% sold.
April	Standard & Poor's suspended its "A" rating, citing "New York City's rapidly deteriorating ability to raise money in the capital market... the possible inability or unwillingness of the major underwriting banks to continue to purchase the City's notes and bonds..."
June	State of New York created Municipal Assistance Corporation (MAC) with a "moral obligation" to repay its bonds. Specific New York City tax revenues were pledged to MAC, which was authorised to borrow up to $3 billion, principally to refinance short-term city debt with long-term MAC bonds.
July	MAC bonds rated "A" and the largest-ever municipal financing was attempted. Half was left with the underwriters, despite yields 50% above comparable bonds.
September	Special audit by the State reveals that the city's cumulative budget deficit was effectively understated substantially. State of New York created Emergency Control Board; MAC's borrowing authority raised to $5 billion — $2 billion needed to keep city afloat until November — the crisis becomes acute.
October	President Ford reaffirmed his stand against a Federal bail-out.
December	State of New York passed Moratorium Act to allow MAC to offer bonds due in 1986 in exchange for bonds that had matured in July — or the holders would face a three-year principal moratorium and a reduced interest rate.

Thereafter, the immediate crisis eased. However, as the full magnitude of the debts unfolded, MAC's borrowing powers were raised in 1978 and again in 1980 to $10 billion (although $4 billion of this was "new money," rather than refinancing). Even then, the city's debt structure was still felt to be too short — 50% of debt was due within five years and 75% within ten years. The subsequent burst of double-digit inflation helped New York City enormously by raising tax revenues relative to the debts. In March 1981, Standard & Poor's restored a credit rating of BBB to New York City's obligations, symbolising the end of the financial crisis.

The impact on financial markets

Despite the publicity and discussion about the potential implication of default, our data reveal that the markets as a whole were little affected. The interest on municipal bonds was tax-exempt and therefore always yielded less than Treasury securities. Figure 4 sets out the long-run history of the ratio of prime municipal yields as a percentage of pretax Treasury bond yields. The rise in the ratio in the second half of 1974 suggests some anticipation of the problem, but it still remained well below the peaks of the beginning of the decade. Even within the municipal bond market, the severe crisis of one of the largest issuers was recognised as a specific, rather than general, problem. The spread between medium grade and prime long-term municipal bonds averaged 40-50 basis points in 1974 and 60-70 basis points in 1975, depending on maturity. Although this spread hovered around 100 basis points at the height of the crisis, within a year it had collapsed back to 20 basis points.

Figure 4. 30-Year Prime Municipal Yields as a Percentage of Pretax Yields on 30-Year Governments, 1970-76



Source: Salomon Brothers Inc.

There was some fear that the banking system would be undermined by default, because it held $7 billion of New York's $12 billion of securities. The New York City banks held $2 billion of city securities and, for six of the 12 banks, the holdings amounted to 70% of their equity. The Federal Reserve Board emphasised its willingness to fulfill its role as lender of last resort and no problems materialised.

* * *

Existing Market Differentiation

One of the questions raised by the debate over monetary union is whether the international capital markets will differentiate between the constituent parts of a monetary union. The Canadian provinces, where credit ratings range from Aaa/AAA to Baa1/A- and where borrowing costs between the strongest and weakest provinces diverge by about 40 basis points, provide a good example of this differentiation between credits within a monetary union.

While a European monetary union does not yet exist, it is interesting to note the range of market discrimination that is currently exercised regarding the external debt of the Member States of the European Community. One must examine how and why these distinctions are drawn to determine whether they would remain after the formation of a monetary union.

Borrowing costs

Evidence of market discrimination is found in the borrowing costs faced by different borrowers. While factors such as maturity, size of an issue, its structure and market conditions clearly contribute to the pricing of a new bond issue, much of the price differentiation is related to the credit fundamentals and credit rating of a country. Under current conditions, the yield spread for a new fixed-rate bond issue might be 50-60 basis points — for example, between Italy and Greece.

Secondary market trading

Another example of market differentiation is provided by bonds of sovereign issuers trading in the secondary market. As shown in Figure 5, a spread of nearly 40 basis points exists between one of the strongest members of the European Community (the United Kingdom) and one of its weaker members (Portugal). Even allowing for liquidity and structural factors, this is a significant credit differential.

Figure 5. Eurodollar Floating-Rate Note Market
(Discount Margin Versus Six-Month LIBOR, Mid-Market, at Oct 31, 1989)

United Kingdom[a]	(33)bp
Republic of Italy	(33)
Credit Foncier (Gtd. France)	(20)
Kingdom of Belgium	(19)
Kingdom of Denmark	(18)
RENFE (Gtd. Spain)	(16)
Republic of Ireland	(2.5)
Republic of Portugal	5.5

[a] Three-month LIBOR. Bp Basis point.

The Eurodollar straight bond market provides another example of this differentiation. A seven-year bond issued by the European Community itself trades at 45 basis points, and a six-year bond issued by the Republic of Italy at perhaps 50 basis points, over comparable US Treasuries. Reflecting market differentiation, a comparable Kingdom of Denmark issue trades in a substantially wider range, at 70 basis points over US Treasuries.

Credit ratings

Among other factors, market differentiation reflects the range of credit ratings assigned to sovereign issuers. One or both of the two major rating agencies, Moody's Investors Service and Standard & Poor's, have rated the debt of all of the members of the European Community. These ratings range from triple A to triple B, spanning the full investment grade spectrum (see Figure 6). (In cases where no sovereign debt is outstanding, the rating agencies have assigned implicit ratings.) The example of the Canadian provinces suggests that even within a monetary union, a range of credit ratings (as well as borrowing costs and secondary market trading spreads) would persist. (This would hold true for the domestic debt of countries, as well as for their external obligations).

Figure 6. Credit Ratings of EC Member States

	Moody's	Standard & Poor's
France	Aaa	AAA
West Germany	Aaa	AAA
Netherlands	Aaa	AAA
United Kingdom	Aaa	AAA
Luxembourg	Aaa	NR
Italy	Aaa	AA+
Belgium	Aa1	AA+
Denmark	Aa1	AA
Spain	Aa2	AA
Ireland	Aa3	A+
Portugal	A1	A
Greece	NR	BBB

NR Not rated.

Sovereign credit assessment

A key factor in determining market differentiation is the way in which market participants, including the rating agencies, institutional investors and underwriters, analyse and assess various sovereign credits. A wide array of information is available to the analyst interested in arriving at a credit judgement regarding a sovereign borrower. Finance ministries and central banks publish timely and reliable data on the finances of sovereign borrowers. International entities, such as the Organisation for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), and the European Community itself, regularly monitor the economies of European sovereigns. Because these countries are industrialised democracies with free political debate and highly educated populations, issues related to sovereign credit quality are fully debated in the press, in professional journals and in public political forums.

The methodology for assessing sovereign credit is explored in detail in the publications of rating agencies and other sources.[1] In focusing on a country's creditworthiness in foreign bond markets, rating agencies and analysts have concentrated on assessing the size of, trends in, and the serviceability of a sovereign's external debt. In doing so, they must examine many factors. Standard & Poor's, for example, looks at *political* factors such as the political system, social environment and external relations; and *economic* factors such as the debt burden, international liquidity, balance of payments flexibility, economic structure, growth performance, economic management and economic outlook to arrive at a rating judgment.

Changing focus of sovereign assessment

The development of a monetary union will change the focus of sovereign credit analysis, narrowing the number of factors on which a market judgment of creditworthiness can be based. In a monetary union, a country's *external* balance will become irrelevant for the creditworthiness of constituent members; the current account balance will be the concern of the monetary union as a whole. Instead, a country's *internal* balance (its budget deficit or surplus) will become more important. Other factors, such as inflation, growth rates and living standards will remain relevant indicators, and under a monetary union are expected to converge. Increasingly, rating agencies and credit analysts will focus on the budget deficit and levels of internal debt to assess relative creditworthiness, as they do in the case of the Canadian provinces. Through these credit judgments and the market discrimination they engender, the market will exert discipline on the fiscal policies of members of the monetary union.

[1] See *Credit Quality in the Yankee Market — Sovereign-Backed Issuers Offer Opportunity*, by John F.H. Purcell, Michelle B. Miller, Dirk W. Damrau, Salomon Brothers Inc, November 10, 1988.

Trends in the Indebtedness of EC Member States

International investors are familiar with the data on external debt and debt servicing capacity. This is one of the key ingredients for the application of market discipline to external debt. However, those same international investors are probably not so familiar with the internal indebtedness of some Member States. An increase in knowledge will be necessary as the international markets focus on the internal debt, once that is known to have become more like external debt — that it cannot be inflated away.

Government borrowing

For the EC as a whole, Government borrowing has declined recently to 3% of gross domestic product (GDP) (see Figure 7). This is well below the levels seen in the early 1980s, but is still half as high again as the much criticised US budget deficit. Moreover, the degree of fiscal stimulus is barely below the "crisis response" to the first "oil shock" in the mid 1970s. The persistently high, even rising, deficits of Greece and Italy stand out — at roughly seven and three times the Community average, respectively.

Figure 7. General Government Lending (Borrowing), **1974-90E** (As a Percentage of GDP)

	1974-81	1982-85	1986	1987	1988	1989E	1990E
Belgium	(6.6)%	(10.0)%	(8.8)%	(7.0)%	(6.5)%	(6.0)%	(5.7)%
Denmark	(1.4)	(5.6)	3.5	1.8	0.2	0.1	0.7
France	(1.0)	(2.9)	(2.7)	(2.0)	(1.4)	(1.2)	(1.1)
Greece	—	(9.9)	(12.5)	(12.3)	(14.9)	(19.9)	(20.0)
Ireland	(10.5)%	(11.5)%	(11.1)%	(9.1)%	(3.7)%	(3.7)%	(1.5)%
Italy	(8.4)	(11.5)	(11.7)	(11.2)	(10.6)	(10.3)	(9.8)
Luxembourg	1.4	2.3	3.1	2.5	2.5	2.4	2.8
Netherlands	(2.9)	(6.2)	(6.0)	(6.5)	(4.9)	(4.4)	(4.2)
Portugal	—	(10.4)%	(7.2)%	(6.9)%	(6.5)%	(6.0)%	(6.1)%
Spain	(1.3)%	(5.7)	(6.1)	(3.6)	(3.2)	(2.6)	(2.4)
UK	(3.8)	(3.1)	(2.4)	(1.5)	0.8	1.5	1.1
West Germany	(3.0)	(2.2)	(1.3)	(1.9)	(2.1)	0.0	(0.4)
All EC	(3.7)%[a]	(5.3)%	(4.8)%	(4.3)%	(3.6)%	(2.9)%	(2.9)%
US	(1.4)	(4.2)	(4.4)	(2.3)	(1.8)	(1.8)	(1.7)
Japan	(3.5)	(2.6)	(1.1)	(0.3)	0.5	0.4	0.4

[a] EC without Greece and Portugal. E Estimate.
Source: European Commission, Annual Economic Report, 1989.

Gross public debt

Figure 8. Gross Public Debt, 1973-90E (As a Percentage of GDP)

	1973	1985	1986	1987	1988	1989E	1990E
Belgium[a]	63.2%	115.4%	118.8%	125.5%	127.5%	126.6%	126.0%
Denmark	8.8	74.5	67.2	63.9	64.0	61.6	58.1
France	22.7	33.2	33.7	35.1	35.7	35.4	35.2
Greece[b]	19.5	57.9	58.3	66.6	73.9	82.1	91.8
Ireland[b]	54.7%	104.7%	115.7%	118.5%	115.4%	110.9%	105.3%
Italy	54.2	84.0	88.5	92.9	96.1	98.5	100.5
Luxembourg	20.4	13.8	13.6	12.2	10.1	9.1	7.9
Netherlands[a]	43.4	69.7	71.7	75.3	77.4	78.3	78.5
Portugal	—	69.5%	68.4%	71.7%	74.5%	75.3%	76.3%
Spain	12.8%	47.2	48.0	48.3	44.1	43.8	42.0
UK	66.1	57.3	56.2	54.6	49.1	44.1	40.4
West Germany	18.6	42.5	42.7	44.0	44.7	43.4	42.7
All EC	37.4%[c]	56.9%	57.7%	59.4%	59.1%	58.4%	57.8%

[a] Excludes social security funds. [b] Central Government only. [c] Excluding Portugal. E Estimate.
Source: European Commission, Annual Economic Report, 1989.

The impact on the Community's indebtedness of such large and persistent borrowing is hardly surprising. Figure 8 shows that gross debts, in relation to GDP, have risen by nearly two thirds since the eve of the first oil shock and now stand at almost 60% of Community GDP.

Reviewing the individual components, Danish indebtedness may have risen spectacularly, but it is still only just above average and falling. Only Belgium is more than twice as indebted as the Community average. The two countries facing the most rapid deterioration — Greece and Italy — are in different positions. After a long period of sharp relative deterioration, Greece has only recently seriously exceeded the Community's average indebtedness. Italy is already 60% above average. Interestingly, among the major countries, France is noticeably least indebted and the UK's level may soon be lower than that of West Germany.

Interest payments

Total indebtedness equals 60% of output, therefore, interest payments on such an accumulated debt are heavy budgetary expenditure items (see Figure 9). Indeed, for the EC as a whole, interest payments are 4.8% of GDP. Not surprisingly, Belgium and Greece have conspicuously heavy interest burdens — at about twice the EC average. Both Greece and Italy borrow afresh all their interest payments.

Figure 9. Interest Payments on Public Debt, 1973-90E (As a Percentage of GDP)

	1973	1985	1986	1987	1988	1989E	1990E
Belgium	3.3%	10.6%	11.1%	10.5%	10.2%	10.5%	10.6%
Denmark	1.3	9.9	8.8	8.3	8.1	7.6	7.1
France	0.8	2.3	2.9	2.8	2.7	2.7	2.8
Greece	1.0	5.4	5.7	7.6	8.3	9.6	10.5
Ireland	3.6%	10.3%	9.8%	9.7%	9.4%	8.9%	8.5%
Italy	2.2	8.0	8.6	8.1	8.2	9.0	9.1
Luxembourg	0.9	1.1	1.1	1.1	0.9	0.8	0.7
Netherlands	2.8	6.3	6.2	6.2	6.0	6.0	5.9
Portugal	—	7.9%	9.2%	7.8%	7.7%	7.9%	7.8%
Spain	0.6%	3.2	3.8	3.5	3.3	3.4	3.5
UK	3.6	4.9	4.5	4.3	3.9	3.5	3.1
West Germany	1.1	3.0	3.0	2.9	2.8	2.7	2.6
All EC	1.9%[a]	5.0%	5.0%	4.8%	4.7%	4.8%	4.8%

[a] Excluding Portugal. E Estimate.
Source: European Commission, Annual Economic Report, 1989.

Perhaps a more relevant consideration is the proportion of Government revenues that are preempted by interest charges, which gives a measure of fiscal flexibility. The Community divides sharply: the statistical average is that 11% of revenues are required for interest charges, but five States preempt roughly 9% or less. Five others already commit 22%-26% of their revenue to interest payments.

From this data alone, it seems that the Community as a whole has passed the worst of its debt deterioration relative to output — indebtedness has virtually stabilised, interest payments are declining slightly and the proportion of revenues committed to interest payments has fallen noticeably. However, these trends are far from uniform and there are conflicting examples.

The existing, readily available data is interesting, but may not tell the whole story. The bondholder is particularly interested in the certainty of interest and principal repayments even under adverse economic circumstances. Does the data include all entities that are formally guaranteed? And any obligations that these entities may have undertaken? What about "moral obligations," whether formal or merely implicit due to national prestige or the like?

There is insufficient readily available data to enable international investors to judge the stability of these debt portfolios. In many States, much Government finance is transacted through private placements, where maturity and interest rate-sensitivity are not necessarily published. F data on the maturity structure of all the debt servicing obligations likely to be faced by the Government, even under the worst circumstances, is essential if the markets are to form a proper judgement of risk.

* * *

Appendix IV: Internal Balance Within the European Community

A key element of any monetary union is that none of the constituents should be, or become, so disadvantaged that their best interests might be served by leaving the union. Adequate levels of resource transfer are vital if the less-developed members are not to be penalised by the markets simply because they have greater development finance needs.

Are the disparities in the wealth of EC Member States so great, or so unlikely to narrow, that the creditworthiness of these States might be doubted, or perhaps their ability, or desire, to remain within a European monetary union?

Regional Disparities

The 12 EC Member States can readily be split into two groups for analytical purposes: the four less advanced countries, Greece, Spain, Ireland and Portugal — Eur-4, and the remaining eight — Eur-8.

Figure 10. Per Capita GDP at Current Market Prices and Purchasing Power Standards, 1989 (Eur-12 = 100)

	1989[a]
Eur-8	
Luxembourg	124.9
West Germany	113.5
France	108.4
UK	108.2
Denmark	107.1
Italy	102.7
Netherlands	102.6
Belgium	100.3
Eur-8 Weighted Average	107.7
Eur-4	
Spain	75.6
Ireland	63.1
Portugal	55.5
Greece	51.1
Eur-4 Weighted Average	67.8

[a] European Commission Autumn 1988 forecasts.
Source: Eurostat and Commission Services.

With per capita GDP in the Eur-4 countries only 61.1% of that of the four strongest countries, there is clearly a wide discrepancy between the two groups. However, that discrepancy has already narrowed substantially, and is likely to narrow further in the years ahead. Thirty years ago, long before any of these countries had joined the EC, the Eur-4's per capita GDP was only 45% of that of the four strongest countries. The ratio reached its peak, at 63.5%, in 1975 and then fell back with the recession after the first "oil shock." Despite above-average growth since then, Eur-4 per capita GDP has slipped because their population growth rate has been about three times that of Eur-8.

Since the late 1960s, the ratio of the original six members of the EC has converged to reach 90% of the average, so that degree of convergence between the Eur-12 and Eur-4 countries is likely to be readily acceptable. To reach that target by 1992, the Eur-4 would have to achieve an implausibly high growth differential of 5.6% annually. However, over a decade, that convergence could be achieved with a differential slightly above the 2.3% average recorded in the period 1961-73. Over two decades, the required differential is only 1.4% annually.

Planned Resource Transfers

The Member States have already agreed a major programme of resou transfers to the least advanced countries. At the Brussels Summit in February 1988, the EC agreed to double the size of the "structural funds" by 1992. Figure 11 indicates the scale of the resource transfer, including that agreed at the Brussels Summit. For the four less-advanced countries as a group, this transfer could exceed 2% of their GDP, but the three poorest could receive between 3% and 6%.

Figure 11. Resources Allocated Through Structural Funds and Financial Instruments in 1987 and 1992-93E (As a Percentage of GDP)

	Structural Funds[a]	Financial Instruments[b]	Total
1987			
Greece	1.46%	0.41%	1.87%
Ireland	1.86	0.71	2.57
Portugal	2.56	1.24	3.80
Spain	0.46	0.29	0.76
Eur-4	0.88%	0.42%	1.30%
1992-93E[c]			
Greece	2.63%	0.72%	3.36%
Ireland	3.22	1.22	4.44
Portugal	4.23	2.05	6.28
Spain	0.77	0.46	1.22
Eur-4	1.44%	0.69%	2.13%

[a] Regional Fund, Social Fund, European Agricultural Guidance And Guarantee Fund, including commitments and provisional figures. [b] European Investment Bank and New Community Instrument, including loan agreements; Euratom, including loans paid out and provisional figures. [c] Figures are based on the following two, very tentative, assumptions for 1992-93. (1) Grants under the structural funds are doubled in real terms for the four less-advanced countries and Italy, and held constant for other countries, as percentage of real GDP. (2) Loans under the financial instruments are up by 100% in real terms for the four less-advanced countries and Italy, and held constant for other countries, as percentage of real GDP. The figures for 1992-93 should by no means be interpreted as forecasts; they are only points of reference for discussions.
Source: Commission Services.

Even before taking these transfers into account, the Commission forecast that the Eur-4's per capita GDP would rise somewhat, to 63.5% of Eur-8's by 1992. However, the Commission also hypothesises about the potential impact of such large transfers. The ideal circumstances are that this support is fully reflected in an increase of the investment/GDP ratio and that marginal capital productivity recovers to the levels of the late 1960s. The Eur-4's per capita GDP growth in 1992 would then be 7.5% instead of 3.9%. Such a growth path could narrow the wealth gap substantially, taking per capita GDP to over 75% of Eur-8's.

These resources, if properly utilised, have the potential to ignite a boom that will produce a more rapid growth in prosperity than anything seen in the past 20 years. If such a boom were to occur, it seems unlikely that any Member State's creditworthiness would be questioned on grounds of relative poverty.

Accordingly, we believe the European Community is well on the way to passing a key test of its ability to operate a monetary union. However, policy must not be steered so far to the other side of the narrow channel that market discipline is undermined by equating large resource transfer with an implicit guarantee.

* * *

Other Titles In "1992 And Beyond" Series

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The Madrid Summit — European Monetary Union IS Coming, Graham Bishop, Salomon Brothers Inc, July 1989.

An Introduction to the European Community, Graham Bishop and Ann O'Kelly, Salomon Brothers Inc, October 1989.

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1992 and Beyond

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RETURN TO C/F

Creating an EC Monetary Union with Binding Market Rules

Introduction

In a recent report, we expressed the view that the ultimate market sanction — cutting off further credit supplies — could enforce fiscal prudence in a more flexible way than was possible under any system of "binding budgetary rules."[1] Flexibility remains, but the sanction is certain.

Administrative budgetary rules will be more difficult to develop and apply. At a minimum, they should require European Community (EC) finance ministers to exert peer group pressure by vigorously, and publicly, warning on budgetary excesses. The key question is how effective these rules can be in creating a binding sanction. Irrespective of success on this score, the simple fact that market discipline *does* have a final sanction demands that a financial structure be created that would not collapse under the weight of this sanction. The system must be designed to perfect, rather than eliminate, market discipline and so to complement budgetary rules.

In this report, we set out the basic principles necessary to ensure that market discipline is certain and that it operates slowly and progressively, rather than abruptly and catastrophically.

A deterrent deters only if all parties know that it is capable of working effectively and that the will to use it exists. Our proposed deterrent involves a series of ever-tougher credit crunches before the final sanction: the withdrawal of new credit. If the electors of a particular state are bent on ruin, then they will be made painfully aware for several years of their progress down the long and bumpy slope to fiscal collapse.

The will to use the deterrent is another matter entirely. A plan that relies for success on the structure of the financial markets must recognise that it cannot negate political will. The political system that creates a financial structure today can change it at any stage in the future. Today's generation can merely put in place a set of rules that will require lengthy, careful and widespread debate about the consequences of any change.

Our plan has two components: a statement of principle that the fiscally imprudent will not be bailed out; and a set of measures to create a financial structure that is manifestly strong enough to make that principle credible. If a structure is so weak and flawed that a significant default would inevitably cause the system to collapse, then no one — market participant or politician in the country at risk — is likely to believe in the "no bail-out" principle.

[1] *Market Discipline CAN Work in the EC Monetary Union*, Salomon Brothers Inc, November 1989.

The "No Bail-Out" Principle

This principle should be enshrined in the Treaty of Rome. This would represent the EC's strongest possible statement of its intention to break with past practices of solving problems at the taxpayers' expense. Every participant in the whole process would be conscious of this express intention. Investors would recognise the lengthy procedures that would be necessary before such a provision could be removed; if an investor were operating on the cynical assumption of an ultimate bail-out, this alone would ensure uncertainty about the timely payment of principal and interest.

The Structure of the Financial System

Financial systems are normally structured on the assumption that central government debts, if not those of the public sector as a whole, are free of credit risk. This assumption, explicitly restated in the Cooke Committee rules for the capital adequacy standards of banks, has been incorporated into Community law through the Solvency Ratio Directive. The assumption that central government debts carry no credit risk is based, in part, on a government's power to tax, but this power has limits when labour and capital are freely mobile: New York City demonstrated this in 1975. And the Single Market programme aims to create such mobility.

In the final analysis, however, a government can always print money to repay the nominal amount of its debts. (The consequences for the real value of the debts are a separate issue.) **The essence of the Delors Committee Report is that, when monetary union occurs, Member States should lose this power to create money to repay their debts,** thus eliminating a fundamental tenet of current financial regulation.

The consequences of this change, when incorporated in the financial framework, will be the key to ensuring that market discipline *does* work in the EC monetary union. The directives that create this structure should be subject to qualified majority voting. On the one hand, an abuser will be unable to stop measures to halt the abuse. On the other hand, a blocking minority should be able to prevent a serious weakening of the system.

Six elements should be embedded in the structure of the financial system:

Free Flow of Capital

The Single Market programme — restated in Stage 1 of the Delors Committee Report proposals — must be fully implemented and the market for financial services completely liberalised. Exchange controls must be removed. Finally, the free flow of capital requires the removal of the secondary barriers created by regulations on the investment of institutional assets beyond those necessary for prudential supervision.

Full Information

All participants must be aware of the full magnitude of a debtor's obligations in order to assess its debt servicing capacity. This must include the contingent liabilities of entities beyond the central government, such as public sector and state-guaranteed bodies. The Prospectus Directive (89/298/EEC) already requires publication of "information necessary to enable investors to make an informed assessment of the financial position of the issuer." However, Articles 2 and 5 exempt Member States and their subsidiary bodies from this requirement.

The position of commercial trading entities owned by the state — in particular, banks and insurance companies — must also be considered, as should that of private banks whose major business is gathering retail funds, purchasing government debt and holding it to maturity. The risk weighting system for bank assets, set out in the Solvency Ratio Directive, already requires a careful clarification of the exact status of these entities.

Accounting conventions and practices must be standardised sufficiently so that fully comparable data can be published promptly — perhaps by the European Commission. Prior to a common currency, the exact status of liabilities represented by notes and coins may present a problem, but that will be removed once they become the liability of the new central bank.

Powers of the ESCB

The ultimate reason for the proposed creation of the European System of Central Banks (ESCB) is the need for EC-wide control of monetary policy. (The supervision of banks and of the payments system are issues for separate discussion. Historically, these two roles have conflicted with the conduct of sound monetary policy. Hence, separate technical agencies may be better placed to perform these regulatory functions.)

The ESCB should be prohibited from holding public sector debt. This would prevent its open-market operations from masking the emergence of a credit spread between different Member States and would remove completely any risk of direct monetary financing of government deficits. While an absolute prohibition may seem severe, it would remove temptation. For example, even if the ESCB did not specify the assets it wished to receive in response to a general offer to purchase securities outright (rather than with a repurchase option), the market would very likely sell its worst assets. Thus, the ESCB would find its portfolio skewed towards the deteriorating state. In effect, this state would then have preempted a disproportionate share of any monetary financing. All risk of monetary financing can be removed (as advocated by paragraph 32 of the Delors Committee Report) by this prohibition.

The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money. Central banks have developed a wide variety of techniques for open-market operations involving private instruments. For example, the Swiss National Bank utilises the spot and forward foreign exchange markets, because government debt levels are negligible. The Bank of England, in the past, has used a large portfolio of prime trade bills. The Bundesbank's principal method of controlling liquidity is the scale of the repurchases of "Lombard-eligible" assets, which are primarily private sector.

"Large Exposure" Rules

The prudential regulation of any financial institution generally involves a limit on the exposure to any single debtor (or group of associated debtors): at a certain threshold of exposure, separate reports to the supervisor are often required, and exposure above the level where a loss would be catastrophic to the whole institution is prohibited.

Currently, the EC does not apply exposure limits to central government debts, which are seen as free of credit risk. **The crucial, and essential, change is the recognition that, in a European monetary union, public debt will involve credit risk.** Hence, some limits should be applied, even though public debt will remain the best credit within the Community. Exposure limits would be set out in the directives governing the particular type of institution. Two examples illustrate how this could be done by amending existing texts:

- Article 22, paragraph 1 of the UCITS Directive (85/611/EEC), which liberalises mutual funds, limits the exposure to any one entity to 5%. Paragraph 3 raises this to 35% for "securities issued by a Member State...", while Article 23 raises the limit for such securities to 100%, but "in accordance with the principle of risk-spreading," exposure to this one debtor must be in at least six different securities.

- The Recommendation on Large Exposures of Credit Institutions (87/62/EEC) proposes a limit of 40% of own funds in Article 4, paragraph 1. Paragraph 4 then states that "the competent authorities may fully or partially exempt... the public authorities of any of the Member States."

The recognition that public debt carries some risk, even if only a small degree, argues that these exemptions from accepted prudential standards of risk diversification be removed.

Given the aggregate of the cash value of these limits on each institution, a Member State should have adequate borrowing power within the Community. As a broad concept, the financial institutions within a given Member State might have an aggregate limit equivalent to 60% of that state's gross national product (GNP) — providing that the corresponding individual institutional limits were not so large that default would undermine the institution. As the existing debt levels of the Community average out at 60% of GNP, institutions within a "prudent" Member State would not be compelled to change their behaviour. A further 60% of GNP as an aggregate credit limit for that Member State might be spread amongst the financial institutions elsewhere in the Community.

A financing envelope equal to 120% of GNP — nearly matching the heaviest debt burden within the Community currently — might seem lax. In reality, however, this would represent a major obstacle. Once a state had used up its domestic credit limits, its total reliance on nondomestic institutions would be a powerful brake on further borrowing. Even under the best conditions, a major state rarely has had a substantial proportion of its total debt held by foreigners. Spreading limits of even 60% of GNP around the rest of the EC would probably imply quite low limits at individual institutions, reducing the risk to the Community's financial system of a default.

Because total exposure limits would be based on GNP, the financing of a reasonable annual deficit should face few impediments. A state's relative debt burden would rise only if its new deficits exceeded the growth rate of its GNP. Thus, this approach would create a cumulatively tougher financing problem for "excess" deficits, but only if these were sustained for several years.

If a Member State wished to be ever more indebted, then it would have to raise the funds from non-Community institutions (or directly from individuals) — a difficult and expensive process. External creditors would be on notice, from the public warnings of the group of EC finance ministers, and would undoubtedly demand a significant premium.

Marking to Market of Public Debt

If the price of a country's debt begins to deteriorate, then all financial institutions should be obliged to recognise this immediately, marking the asset down to the new market price and deducting the loss from their capital bases. Provided that the market price accurately reflects the risk of default, then the financial system would adjust continuously, and the actual event of default would not create a shock; the loss provisions would have been made every day along the way.

Member States would have to be encouraged to issue debt in a marketable form, so that the market for such debt would be genuinely liquid and substantial and the market price would be seen as a reliable indicator. All nonmarket debt would be valued using the appropriate rate interpolated from the yield curve. For valuation purposes, nonmarket debt should be valued at a penal yield premium, perhaps one percentage point above the

corresponding market yield. The same principle could be applied to nonmarket debt outside the Member State's own currency. The applicable yield curve would simply be that of the domestic government.

If all public debt were marked to market, any decline in the market price would force both institutions and supervisors to recognise fully the magnitude of their exposure. The direct impact on capital would create a rising disincentive for banks, for example, to continue lending to such a state.

An additional benefit of a mark-to-market system would be an improvement in the system's response to monetary policy changes. To the extent that the yield curve moved to reflect a rise in official short-term rates, then the impact on bank capital would constrain the growth of bank credit.

Prudential Standards for Public Debt Maturity

As the maturity of a debt portfolio shortens, the risk of a sudden liquidity crisis rises correspondingly. In some cases, confidence can be shaken by events that are completely outside the control of the debtor, who then will have difficulty in rolling over maturing debt, resulting in is a rapidly deepening liquidity crisis; the New York City crisis of 1975 was a classic example. Instead of a gradual slide over several years to fiscal ruin, the debtor is catapulted there with little warning.

The risk of a liquidity crisis is particularly difficult for markets to price, because while the debt burden itself may be acceptable, it may be poorly structured. This problem is well known to supervisors of financial institutions. A corresponding "prudential supervision" of public debt portfolios will be necessary. The "average life" of the debts will be the critical factor in allowing the relevant parties sufficient time to recognise the problem and adjust policy accordingly. Although there are no obvious historical precedents, it took New York City six years to recover its credit rating after its crisis. Perhaps five years might be an appropriate minimum average life. The occasional tremors of a liquidity crisis in Italy suggest that an average life of less than three years is definitely too short.

The Solvency Ratio Directive has just introduced a system of risk weighting for bank assets. This approach could readily be used to develop a sliding scale of risk weights for public sector debt based on average portfolio life.

However, a better method might be to build on the mark-to-market approach and introduce a sliding scale of required write-offs for all financial institutions, rather than merely singling out the banking system. (The concept of a regulatory requirement for standard write-offs against substandard debt is not new. Perhaps the most public example is the Bank of England's matrix for Less Developed Country debts.) The appropriate sliding scale is a matter of debate, but the clear intention would be to force the financial system to write down asset values sufficiently such that a serious default would already have been fully provided for in the capital of those institutions holding the debt. Therefore, the threat of a disastrous default — as an alternative to a forced bail-out — would be widely recognised as hollow.

Naturally, compulsory write-offs against capital would be a major disincentive to any financial institution considering the provision of further funds to a country sliding towards a liquidity crisis and a correspondingly heightened risk of default — even if only a partial default. As soon as such write-offs become significant, institutions would require a yield premium to compensate them for the loss. Thus, the sliding scale of write-offs should induce a progressive rise in interest costs as the debts' average life declined.

Conclusions

Our plan is based upon a matrix approach. Along one axis is a set of exposure limits for Community financial institutions. These limits would be low enough to ensure that the default of a public borrower would not undermine any institution. On the other axis of the matrix is the price effect. Taking a level playing field approach to all financial institutions, the marking to market of all public debt would progressively freeze out of the credit markets those countries about whose creditworthiness the market became concerned for any reason. Hence, at the moment of threatened default, the financial system would already have written off the problem, so the threat could then be viewed entirely in the political context.

All these mechanisms would merely serve to put all parties — politicians, regulators, electors, and investors — on notice that a problem is growing. They would create a series of ever-tougher credit crunches. Ultimately, they would ensure that the final sanction of withdrawing further credit supplies is not catastrophic for the financial system of the Community. They would not withdraw the right of any Member State to slide down the bumpy slope to fiscal ruin.

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July 18, 1989

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The Madrid Summit — European Monetary Union IS Coming

The monetary landscape of Europe is changing irreversibly. In June 1988, the European Community (EC) Heads of State agreed to abolish exchange controls. They also set up a committee chaired by EC President Jacques Delors to study "concrete steps leading towards the progressive realisation of economic and monetary union" (EMU). **The Heads of State considered the resulting "Delors Report" at the Madrid Summit on June 26/27, 1989, and agreed to the following agenda:**

- The first stage of Economic and Monetary Union will begin on July 1, 1990;
- The preparatory work will be undertaken for an intergovernmental conference to lay the ground for subsequent stages, which would meet after the first stage had begun in 1990.

On July 10, just ten days into the six-month French presidency of the European Council, the EC finance ministers agreed on an aggressive timetable for the preparatory work.

This report analyses these developments from the perspective of the business opportunities that will open up for the financial services industries. Genuine liberalisation of these industries is likely to lead to such a degree of financial integration that monetary union will, effectively, be created by market forces.

The Council has requested the adoption of the "provisions necessary for the launch of the first stage" (see text of communiqué on page 5). The Delors Report names the creation of a Single Financial Area as a key step in Stage One, and much work has already been achieved towards this end, but there are shortcomings in some of the measures and proposals. Current political commitment provides an excellent opportunity to ensure that the "provisions necessary" do, in practice, create a genuinely liberal financial market. This, in turn, will develop a powerful market discipline that should obviate the need for complex and bureaucratic budgetary coordination policies and minimise any functions that need to be delegated to a European System of Central Banks.

On balance, remarkable strides have been made towards achieving the Single Financial Area that will realise the European Council's decision in Madrid. Given a continuation of that degree of political commitment, the remaining problems can be overcome, permitting progress towards monetary union.

Principal Stage One Steps

The Delors Report describes Stage One as "the initiation of the process" of creating EMU. For practical business purposes, the key steps are as follows:

- **"In the economic field ...firstly, there would be a complete removal of physical, technical and fiscal barriers. The completion of the internal market would be accompanied by a strengthening of Community competition policy."**

• "In the monetary field the focus would be on removing all obstacles to financial integration... 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."

The first statement merely reaffirms the principles of the 1992 programme. However, the second statement comprises a remarkably powerful and clear definition of the liberalised financial services market that we should now expect to unfold. **The Heads of State, in accepting Stage One of the Delors Report, have implicitly set a "quality standard" for the directives,** as well as the areas to be covered.

Impact of financial innovation

There is an implicit timetable: Stage One requires not only the approval and enforcement of the directives, but also their "*full implementation.*" The importance of this point may have been overlooked: it implies the enactment of enabling legislation in each of the 12 member states. Only then — and probably after a considerable time lag — will the full consequences of liberalisation unfold as financial intermediaries offer new products. The willingness of consumers to purchase these products will determine the degree of permanent and substantial financial innovation that will exist in the Community.

The Delors Report states that "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)." The "preparatory work" to develop the "provisions necessary" for the new EC institutions, such as the European System of Central Banks, will certainly need to analyse these "monetary control techniques." The analysis will be difficult in the absence of practical evidence of liberalisation in the markets — and even more difficult if the legislative programme has not even been agreed.

To proceed beyond Stage One to the "subsequent stages" of monetary union requires revision of the Treaty of Rome by an intergovernmental conference. Currently, it seems probable that this conference will be called by majority vote at the earliest possible opportunity — shortly after July 1, 1990. However, because conference decisions require *unanimous* voting, such an early date could be premature: Stage One will have only just started and if any major parts of the Single Financial Area have not even been approved — including agreement on strengthening competition policy — it would be hard to feel that there was enthusiastic, unanimous support for the more difficult stages ahead.

The Single Financial Area — Can The EC Achieve Its Target?

The genuinely liberalised financial markets envisaged by the Delors Report are a quantum leap from the status quo, but progress seems to be accelerating. The French Presidency of the EC could be crucial in creating a climate where the Single Financial Area appears a realistic probability.

The following actions highlight the progress made to date:

Abolition of exchange controls

This historic and far-reaching measure was agreed in June 1988. The major EC countries have agreed to abolish the few remaining controls by July 1, 1990. The most visible exchange controls have, effectively, been abolished already, and the European Monetary System (EMS) has survived remarkably well at a time of sharp dollar fluctuations. The only remaining controls are those preventing individuals from holding foreign currency bank deposits. Evidence, particularly from the UK, indicates that individuals do not diversify their transaction balances — only their savings — so freeing liquid balances should not create a crisis.

Overall, the agreement to abolish visible exchange controls was *the* change that has probably made the drive towards some form of monetary union irreversible, because of the need to remove the risk of destabilising capital flows. Under *current* scenarios, there seem few reasons to expect abolition of the remaining visible exchange controls in the EC to destabilise the EMS.

However, there is still an array of restrictions on the investment policies of many financial institutions, which has a similar economic effect to exchange controls. These restrictions are analogous to the "nontariff" barriers that have always bedevilled liberalisation of trade in physical goods, and they amount to invisible exchange controls.

Mutual funds

On October 1, 1989, the directive on Undertakings for Collective Investment in Transferable Securities (UCITS) — the first liberalisation — comes into effect. This directive permits qualifying mutual funds to be sold freely throughout the EC. Tested against the Heads of State "quality standard," the directive falls short, because money market funds are not permitted. However, the principal opponent of such funds — West Germany — is about to permit its own mutual funds to have up to 49% of their assets in money market instruments. Bundesbank President Pöhl recently accepted the likelihood of further changes in West Germany.

Banking

The Spanish Presidency succeeded in obtaining the Council's agreement on a common position — the vital hurdle — on the Second Banking Directive and the Solvency Ratio Directive. The Second Banking Directive permits an EC bank to offer — in any EC country — the services for which it is authorised in its home country. The Solvency Ratio Directive is the measure that implements the risk-weighted capital adequacy standards proposed by the Cooke Committee of the Bank for International Settlements. Together, these measures seem to go a long way towards meeting the quality standard for banking services (including mortgages). This freedom is expected to be extended fully to foreign banks' services.

Investment services

The proposed Investment Services Directive would give nonbanks and financial intermediaries the same freedoms as those given to banks by the Second Banking Directive. Progress on this "EC passport" for investment banks seems to be lagging, because, in general, it is only UK-based entities that are affected. In the capital markets, an uneven playing field for banks and nonbanks would not be compatible with the "quality standard."

Insurance

The directives already approved and proposals made so far do not, realistically, begin to measure up to the Heads of State "quality standard." The problem stems from the European Court of Justice 1986 rulings on whether there was sufficient harmonisation of EC law to give consumers adequate protection. As a result, the current proposals have avoided the individual consumer and, certainly for the nonlife risks, concentrated on freeing insurance for medium- to larger-sized companies. This focus avoids the very area where the European consumer — who is also the elector — hopes to see tangible benefits from enhanced international competition. However, the Commission plans to address this problem in 1990.

If they are to be prudently and efficiently managed in the liberalised market, insurance companies' assets must reflect properly the type of liabilities undertaken to the public. Thus, foreign assets would not be appropriate where the premiums are likely to be paid out again as claims in a short period. At the other end of the spectrum, a life insurance policy that participates in profits is essentially a savings vehicle with attached insurance against death. That savings element should be free to be invested in an internationally diversified, profit-maximising portfolio.

Life insurance companies play a key role in the EC's capital markets: as the repository of much of the Community's long-term savings, they are major buyers of long-term Government bonds. With a choice of assets constrained only by prudence, the capital markets will have the genuine freedom, not only to judge the budgetary position of member states, but also to exert discipline by moving assets accordingly. The same principles should apply to pension funds.

Unless liberalisation of insurance — both assets and liabilities — meets the Heads of State "quality standard," a vital component of the Single Financial Area will be missing.

Securities issuance

The Prospectus Directive goes some way towards harmonising conditions for issuing securities by requiring member states to recognise a prospectus published in another member state. However, many member states continue to impose conditions that restrict issuance — originally for the proper purpose of ensuring an orderly market. Typically, conditions comprise the nationality of the lead-manager, nationality of the applicable law, physical location of the securities, and nationality of the paying agent. Even the most liberal country — the UK — requires the lead-manager of sterling issues to have a full UK presence. Although the original purpose of these regulations remains necessary, the current regulations have the effect of discriminating against lead-managers outside the member state. If issuance is restricted, then free circulation of financial instruments is effectively limited — contrary to the spirit of the "quality standard." "Mutual recognition" of other member states' standards is necessary.

Competition policy

UK Prime Minister Thatcher has emphasised, particularly, that the European Council had accepted the need for strengthening the Community's competition policy — as specified in Stage One of the Delors Report.

Competition policy potentially covers a wide area, but the current principal topic is the proposed merger regulation. This regulation would give the European Commission power to review "large mergers." The raising of the definition of "large" — perhaps to an annual turnover of ECU5 billion, declining over a period to ECU2 billion — has overcome many objections. There seems to be a reasonable chance that this measure could be approved later this year. However, Prime Minister Thatcher may have broadened the requirement of an acceptable competition policy by highlighting the Delors Report's call for a reduction in state aid.

It seems quite feasible that the EC can meet the "strengthening of Community competition policy" condition set for Stage One.

* * *

Appendix

Extracts from **Presidency Conclusions — European Council**
Madrid, 26 and 27 June 1989

"The European Council, meeting in Madrid, reviewed the situation and the prospects for progress towards European Union.

"...The completion of the Internal Market and the strengthening of economic and social cohesion were the priority objectives of this new chapter in the history of the Community.

"...The European Council noted that the forward thrust in achievement of the Internal Market was making an ever-increasing contribution to expansion and improvement in the employment situation. This thrust had hitherto resulted mainly from the decisions taken to remove technical barriers to trade. It was now necessary to make similar progress towards the elimination of physical and fiscal obstacles with a view to achieving an area without internal frontiers by 31 December 1992 in accordance with the provisions of Article 8a of the Single Act.

"The growing rate at which decisions were being taken meant that well over half the measures listed in the White Paper had been adopted. The Council recalled certain priority fields identified at its meetings in Hanover and Rhodes, and welcomed the fact that important decisions had been taken in the areas of public contracts, banking and financial services, the approximation of technical standards and transport. However, it noted that there were still decisions to be taken in these priority fields, including transport, in particular cabotage, and asked the Council to intensify its work in these sectors.

"The European Council invited the Commission to submit to the Council the remaining proposals provided for in the White Paper at the earliest opportunity, and expected the Council to finalise adoption, as quickly as possible, of the instruments that would permit the completion of the Internal Market.

Economic and Monetary Union

"The European Council restated its determination progressively to achieve Economic and Monetary Union as provided for in the Single Act and confirmed at the European Council meeting in Hanover. Economic and Monetary Union must be seen in the perspective of the completion of the Internal Market and in the context of economic and social cohesion.

"The European Council considered that the report by the committee chaired by Jacques Delors, which defines a process designed to lead by stages to Economic and Monetary Union, fulfilled the mandate given in Hanover and provided a good basis for further work. The European Council felt that its realization would have to take account of the parallelism between economic and monetary aspects, respect the principle of "subsidiarity" and allow for the diversity of specific situations.

"The European Council decided that the first stage of the realization of Economic and Monetary Union would begin on 1 July 1990.

"The European Council asked the competent bodies (the ECOFIN and General Affairs Councils, the Commission, the Committee of Central Bank Governors and the Monetary Committee):

"(a) to adopt the provisions necessary for the launch of the first stage on 1 July 1990;

"(b) to carry out the preparatory work for the organization of an intergovernmental conference to lay down the subsequent stages; that conference would meet once the first stage had begun and would be preceded by full and adequate preparation."

Other Titles in the "1992 and Beyond" Series

Fortress Europe, Graham Bishop, Salomon Brothers Inc, October 1[illegible].

Banking — Will Liberalisation Itself Lead to a Common Currency?, Graham Bishop, Salomon Brothers Inc, February 1989.

The Long March to European Monetary Union — Two Practical Steps, Graham Bishop, Salomon Brothers Inc, May 1989.

European Banking Integration in 1992 — The Competitive Challenges Facing U.S. Multinational Banks, Thomas H. Hanley *et al*, Salomon Brothers Inc, June 1989.

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Amendments to the German Insurance Supervisory Law

German insurance companies are governed by the Law on the Supervision of Insurance Companies (Versicherungsaufsichtsgesetz - VAG). This stipulates how insurance companies may invest their committed assets. Committed assets are divided into the coverage fund, covering the premium or legal reserve in life insurance, and "other committed assets," covering existing liabilities from insurance contracts and technical reserves as well as reserves for policyholder dividends.

At present, the committed assets must be invested "in assets located within the territory of application of this law" (i.e. the Federal Republic of Germany). There is a catalogue of permitted investments (the Deckungsstockregelungen), as follows:

- Loans secured by mortgages on property within the Federal Republic.
- Domestic bearer bonds or registered bonds.
- DM bonds issued abroad, if they have been admitted for regular trading on a domestic exchange - however these may not exceed 5% of committed assets.
- Claims entered on the Debt Register of Bund or Land.
- In fully paid shares admitted to regular trading on a domestic exchange. Shares of any one corporation may not exceed 5% of the capital stock of that corporation.
- All investment in equities may not exceed 20% of the coverage fund or 25% of other committed assets.
- Other committed assets may be invested in fully paid shares admitted for regular trading on a foreign exchange. Investment in foreign equities may not exceed 20% <u>of the total limit for equities</u>.
- In debts secured by mortgages, securities issued within this country and admissible as a security for loans by the Bundesbank, or registered bonds.
- In loans to the Federal Government or the Laender.
- Real estate - this is regulated in detail. Real estate covered by a building, in the process of being built on or about to be built on. Investment in commercial property may not exceed 10% of committed assets and investment in real estate either in the process of being built on or about to be built on may not exceed 5%. Investment in property for the business operations of insurance company requires official approval.
- Shares of separate property accounts managed by a domestic investment corporation containing domestic real estate.

- Congruency rules: for foreign currency liabilities, the coverage stock should be invested in assets expressed in the same currency and conforming to the above regulations.

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25th April 1990

Lord Joseph
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Dear Lord Joseph

Following our telephone conversation, I have pleasure in enclosing two sets of the publications I sent you. Naturally, I am honoured that you wish to send them on to the Prime Minister and Mr Ridley. I would also be very happy to elaborate on them, if that would be helpful.

For your information, I have a very good working relationship with the 'European" officials at both Treasury and Bank of England. Contacts at the DTI are limited to areas of specifically regulatory concern - for example, on the Capital Adequacy Directive. At the political level, I shall be meeting Peter Lilley next week, as well as talking to the Conservative Finance Committee. In the European context, I have regular contact with the European Democratic Group - especially Sir Christopher Prout and John Stevens.

Salomon Brothers takes no political views so I also circulate my material to the Labour Party. I have yet to receive any response at all! I shall take up your suggestion of writing to Sir Alan Walters.

Thank you for your interest in my work - I will always be pleased to discuss these topics as I believe they are amongst the key issues at this turning point in Europe's history.

Yours sincerely,

Graham Bishop

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In January 1989, draft new regulations were circulated. These proposed farreaching changes, broadening the present detailed catalogue of permissible investments. However, this comprehensive draft was put on ice in 1989 until after the November 1990 elections.

The Federal Government then proposed a new draft of some far less comprehensive changes. This looks like being adopted unchanged.

The main points of this new Jan 1990 draft are as follows:

- 5% of the coverage fund and 20% of other committed assets may be invested abroad - foreign investments already permitted by the regulations must be included in this amount. The authorities may allow further exceptions to this rule in individual cases.

- The total limits on equities are raised to 30% of the coverage fund and 30% of other committed assets (from 20% and 25% respectively). The limits on foreign equities remain at 20% of the total permissible for equities (and must be included in the overall limits above).

  The draft makes the point that this increase in the equity limit is beyond what is required by EC law and goes on to say: "Additionally, it is to be noted in this connection that the existing insurance supervisory law allows insurance companies to engage in futures business by means of which exchange and interest rate risk for assets and in building up a stake may be eliminated. Within this significant framework the insurance sector can contribute to the development of the German Futures Exchange."

- Real Estate: the existing detailed regulations are replaced by the following:

  [The committed assets may be invested:] "In real estate covered by a building, in the process of being built on or about to be built on in the immediate future as well as in rights equivalent to real property; the insurance company must check the appropriateness of the purchase price on the basis of an appraisal by a sworn expert or in a similar manner."

  This removes the present limit of 5% of committed assets for real estate under construction and 10% for commercial property. Approval of property investments for the business operations of insurance companies is no longer required.

- Congruency rules: Committed assets are to be invested in assets in the same currency as the expected liabilities.

  The draft includes a new "Appendix C" which takes into German law the matching rules contained in the appendix of the Second Directive on Non-Life Insurance. The main points are as follows:

  Cover and liabilities are to be in the same currency. However, 5% of the coverage fund and 20% of other committed assets may remain unmatched. 50% of the amounts expressed in the currencies of other EC member states may be invested in ECU assets.

Ann O'Kelly
February 1990

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1992 And Beyond

The Long March To European Monetary Union

Two Practical Steps:

- **West Germany Should Abolish Its "Exchange Controls"**
- **Sterling Should Be Excluded From The ECU**

by
Graham Bishop

May 1989

Salomon Brothers

Speech given at the London School of Economics' Financial Markets Group Conference on "A Single European Currency," London, May 9, 1989.

The author wishes to thank Ann O'Kelly for her unstinting assistance in the research for this speech — especially the translation of so many legal proposals.

1992 And Beyond

The Long March to European Monetary Union

Two Practical Steps:

- **West Germany Should Abolish Its "Exchange Controls"**
- **Sterling Should Be Excluded From The ECU**

by
Graham Bishop

It is a great honour to discuss this historic topic with such a distinguished group. My task today is to put forward the views of a practical financial businessman: I am an analyst of business opportunities for Salomon Brothers International Limited — a securities firm headquartered in London, with a subsidiary bank in Frankfurt and offices in Madrid and Zürich. I want to propose two important practical steps towards monetary union: first, West Germany should abolish those regulations that are effectively exchange controls; and second, sterling should be excluded from the European Currency Unit (ECU).

There has been renewed debate in the past year about the steps required to achieve monetary union, which reached a climax with the recent publication of the Delors Report. Much of the debate focussed on grand theories, such as the impact on national sovereignty — in other words, the view from the "top down." As a student of practical financial services, I would like to share with you a day-to-day business view, or the "bottom up" approach.

Business people are trying to determine what the citizens of Europe are actually prepared to do with their money and savings. If, in the fullness of time, consumers who are also electors *are* prepared to put their savings where the politicians' mouths are, then this will represent a very powerful statement of political will — with far-reaching implications. If they are *not*, then the debate about a European System of Central Banks will simply remain a grand theory for many years to come.

In this discussion, I feel rather like an infantryman in the trenches. The generals and the infantry are united in sensing that a historic victory is possible. The generals are clustered around a map that supposedly charts the road to the final objective — monetary union. They have given some of the infantry the freedom to go "over the top" and to set off on the long march down that road. As encouragement, the generals say they will probably arrange for some of the bigger landmines to be removed from the road. The whole army knows that if no one takes any steps at all, then victory will definitely not be achieved.

While I would like to comment briefly on some aspects of the generals' broad strategy, my position as an infantryman in the trenches means that I am primarily concerned with the landmines. I would like to discuss two of these in particular, although there are, of course, many others. Dodging these particular landmines will be two major steps on the long march to monetary union.

I have no doubt that genuine and complete liberalisation of financial services will itself lead to a common currency.

I would now like to comment on four aspects of the Delors Report:

- Coordination of budget policy;
- The alternative to devaluation;
- Parallelism and the ECU; and
- Participation.

I should first define my use of the term "monetary union." My analysis assumes that this ideal state of "monetary union" will be attained over a lengthy period of time and in an evolutionary manner — not suddenly imposed in a revolutionary fashion.

In this context, the Werner Committee Report of 1971 still seems extremely relevant. For example, in its definition of monetary union it said: "the Community currencies will be assured of total and irreversible mutual convertibility free from fluctuations in rates and with immutable parity rates, or preferably they will be replaced by a sole Community currency."

With that definition as background, I shall make four observations on the Delors Report:

The first is ***coordination of budget policy***. This topic is at the heart of the debate on national sovereignty. Specifically, the Report calls for upper limits on budget deficits of member states; and the definition of the overall stance of fiscal policy, *including* the size and financing of the aggregate budgetary balance. As there will not be much national economic sovereignty left at the end of such a process, I question if it is necessary to impose such rigidity — with all its overtones of "central planning." Indeed, a cursory comparison of the budgetary positions of the UK and the Federal Republic of Germany does not reveal a clear link with monetary growth, price stability or external balance. Instead of this coordination, could we safely rely on the operation of market forces? A glance at the results of monetary union within two different federal systems is revealing.

Figure 1. Canadian Provinces, Total Debts and Budget Deficits

	Debts[a]	Deficits[b]
Saskatchewan	54.2%	27.8%
Newfoundland	62.4	18.5
Nova Scotia	45.3	16.8
New Brunswick	53.9	13.7
Manitoba	50.1	12.5
Alberta	14.1	11.8
British Columbia	28.8	9.1
Quebec	39.2	5.9
Ontario	25.0	4.6

[a] Estimates of direct and guaranteed debt as of March 31, 1988 as a percentage of Gross Provincial Product.
[b] Fiscal 1985-89 average as a percentage of revenues.
Source: See *Canada and the Provinces, A New Framework for Assessing Provincial Credit*, Purcell, Miller et al, Salomon Brothers Inc, December 1988.

My first example is Canada, in which the largest Provincial budget deficit is six times the smallest, and the largest ratio of accumulated debt is more than four times the smallest. The credit ratings of the Provinces vary from AAA to A, and the bond market currently charges the best-rated borrower 10.6% for ten-year money and the worst rated an extra 45 basis points.

Clearly, there is a very wide and sustained divergence of fiscal policy within this monetary union, and the credit markets *do* distinguish between the constituents — but certainly nothing resembling the spread of 700 or so basis points which would probably exist between ten-year West German and Italian Government bonds — if there were corresponding bonds. Precisely because it *is* a monetary union, the Provinces cannot finance themselves by printing money and eventually devaluing. The financial markets can exclude that risk and therefore look solely at the credit quality. Before the 1930s, Canadian revenue-sharing arrangements were not well developed and several Provinces threatened defaults during the Depression — although only one occurred. The existence of adequate revenue-sharing arrangements now gives the financial markets sufficient comfort that the risk of crisis is limited.

My second example is the monetary union operated in West Germany by the Federal States (the Länder):

Figure 2. West German States — Total Debts and Budget Deficits
(As a Percentage of Gross State Product)

	Total Debt 1982	Total Debt 1986	Budget Deficit 1986
North-Rhine Westphalia	13.5%	17.2%	1.3%
Bavaria	8.1	8.3	0.4
Baden-Württemberg	10.4	10.3	0.3
Lower Saxony	15.7	17.7	1.2
Hesse	11.7	12.6	0.8
Rhineland Palatinate	15.1	17.3	1.2
Hamburg	14.8	17.7	1.4
Berlin (West)	23.6	20.4	0.9
Schleswig-Holstein	20.2	23.1	1.3
Bremen	32.7	42.1	3.0
Saarland	20.8	28.5	2.6
Weighted Average	**13.3%**	**15.0%**	**0.9%**

Source: See *The West German Federal System: Credit Implications for the Länder*, Purcell, Miller et al, Salomon Brothers Inc, September 1987.

The range of fiscal policy and indebtedness is even wider than in Canada: the largest deficit ratio is over seven times the smallest and the greatest indebtedness is more than five times the smallest. Yet the credit spreads are much narrower than in Canada — perhaps only five to ten basis points. The explanation lies in the *Finanzausgleich* — the revenue equalisation system that makes the financial markets regard the credit of the Länder as very close to that of the Federal Republic itself.

Both these monetary unions operate among entities with a range of fiscal policies probably wider than that among the sovereign nation states of the Community itself. Yet, the credit markets do not seriously differentiate between the constituents. The reason, of course, is that the monetary union operates within a political federation — with the naturally consequential revenue-sharing arrangements — *which the markets believe to be implicit guarantees.*

Without such implicit guarantees, would highly mobile capital be prepared to finance fiscal profligacy? The answer is, at a price and for a while. But the price would be measured in percentage points of yield rather than basis points. The citizens of that nation-state would be well aware that they were paying dearly for their fiscal imprudence. The fiscal crisis of New York City in the mid-1970s shows how far the financial markets are prepared to extend credit to a constituent of a monetary union *until* the profligacy becomes unacceptable. Then the invisible hand of the market showed itself to be a more powerful and rigorous disciplinarian than the Council of the European System of Central Banks is ever likely to be. Yield levels virtually doubled, followed by several years of extreme fiscal austerity.

My conclusion is that a monetary union can tolerate a very wide range of fiscal policies in the context of a political federation that offers implicit guarantees to its constituents. Without effective federation and/or guarantees, financial markets have exerted, and will exert again in the

future, a powerful disciplinary force on fiscal imprudence. If there is a genuinely free capital market, then rigid, centralised budget controls may be unnecessary.

Dissenters often say that political union is a necessary condition of monetary union. The close linkage between the two is frequently illustrated by the example of German Unification in the nineteenth century. It is pointed out — as highly significant — that the Reichsbank (forerunner of the Bundesbank) was founded in 1875, four years *after* the political union of 1871. However, in a recent paper,[1] Holtfrerich showed that an effective parallel currency was established in 1838 by the Dresden Coin Convention. A silver standard was created, with coins that were legal tender throughout all states participating in the *Zollverein* — the Customs Union. This *preceded* political union by more than 30 years.

My second topic is ***the alternative to devaluation.*** The Delors Report certainly underlines the need for the availability of adequate funds to "promote regional development and to correct economic imbalances" within a monetary union. How are those funds to be provided? The Report speaks only of the reform and strengthening of structural funds and regional policies. As a representative of the financial services industry, I am naturally curious about why the private sector is not mentioned. Shouldn't worthwhile investment projects be funded by bond issues on the European capital market, subscribed by institutions drawing upon voluntary savings throughout Europe? If the projects are not seen as worthwhile, or will strain the credit rating of the issuer, then the discipline of the market will soon be applied.

Therefore, I would argue that the correction of economic imbalances — as a condition for monetary union — will be satisfied most easily by ensuring the free movement of long-term capital — which requires freedom for both borrowers and lenders. "Stage one" of the Delors programme requires, in effect, members to eschew devaluation and "make the functioning of other adjustment mechanisms more effective." Genuine liberalisation of the capital markets is a key mechanism.

My third topic is ***parallelism and the ECU.*** The Report makes the point, powerfully and correctly, that "monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community." That said, it seems surprising that the Committee "was of the opinion that the ECU has the potential to be developed into such a common currency." Eventually that will be true but, in the meantime, trying to promote the ECU as a common currency before there is that "sufficient degree of convergence" is *already* damaging the Community.

The ECU has existed for some time, but does not seem to have caught the imagination of the European peoples. Its share of external bank loans has hovered around 2%-3% since 1986. Its share of bond issues has risen from 3% in that year to about 6% in 1988. This may appear to be progress — but these modest percentages are of *external* transactions. The significance of ECU transactions to the *total* transactions of Europe's citizens is minimal — at best!

If a new market is really filling a need, it takes off. Issuance of sterling mortgage-backed bonds started in 1987 and £4 billion were issued in 1988. After five years of effort, the "booming" ECU market of 1988 issued about a £7 billion equivalent. The ECU has failed to cross that threshold of acceptance and the momentum has been lost. In reality, the people of

[1] See *The Monetary Unification Process In Nineteenth-Century Germany: Relevance And Lessons For Europe Today*, by Carl-Ludwig Holtfrerich, in *A European Central Bank?*, M. De Cecco and A. Giovannini, Cambridge University Press, 1989.

Europe do not regard the ECU as a genuine alternative, or as a parallel currency. Not enough people trust its stability sufficiently to be prepared to hold their savings in ECU financial assets. The credibility of monetary union will only be damaged as the ECU limps along with such a miserably small role — shunned by the overwhelming majority of European savers.

My final observation on the Report itself is to welcome the comments on ***Participation*** — "influence on the management of each set of arrangements would have to be related to the degree of participation by member states."

Not all the generals seem to be agreed on whether the goal is a good one, but the chiefs of staff have formulated a reasonable plan and the infantry has been given permission — in fact, encouraged — to set off down the road. As good capitalists, the infantry is eager to get their share of the expected fruits of victory. In the absence of a better plan to create even larger fruits of victory, it seems proper for the enthusiastic generals to leave their dissident colleagues in the desert and lead the rest of the army forward to the promised land.

The scene is now set for a two-speed Europe.

Two Steps Forward

In discussing the generals' grand strategy, I have stressed that there may well be tasks that can be achieved quite simply by the infantry — provided it has the necessary freedom to avoid the more obvious roadblocks.

These practical, micro-economic problems certainly include a number of thorny issues. These issues must have a leading place on the "macro" agenda. As Chancellor Lawson pointed out in his recent Chatham House speech, there "is still a great deal of hard, detailed work to hack away at the remaining barriers and clear the ground for wider competition... uncomfortable vested interests will be challenged and disturbed." The difficulty in shaking off the power of those vested interests was vividly illustrated when, two months later in his Budget speech, the Chancellor extended Personal Equity Plan tax relief to include "unit trusts investing mainly in UK equities." Was this the raising of a new barrier?

However difficult it is to remove the barriers, this essential task must not be shirked. Nor should it be. The financial services infantry has begun to realise the magnitude of the prize available and, as good capitalists, is eager to obtain its share. Genuine liberalisation of the road ahead will create a rush that, in itself, will ensure victory. But dreams alone are not enough: the practical problems must be solved — though with the ideals firmly in mind.

Step One: The Federal Republic of Germany should abolish its "Exchange Controls"

Many people believe that the historic Directive in June last year sounded the death-knell of exchange controls within the Community. In a narrow legal sense, it is true that the battle has already been won. Sadly, in the economic sense relevant to freedom of choice and monetary union, such a notion is quite wrong. When it comes to international investment, the great bulk of the funds will be channelled through the long-term savings institutions: mutual funds, pension funds and life insurance companies. Thus, regulations governing the assets that these institutions can purchase could *still* amount to a second tier of exchange controls.

Even within the domestic market, regulations requiring these institutions to hold a certain percentage of their assets in Government bonds, for example, can seriously distort the flow of savings into that asset class — at the clear

expense of those areas starved of funds. Classic examples of this regulation can be found in the French mutual funds (Sicavs) or Italian life insurance. This is not to say that someone in France should be denied the opportunity to invest in Government bonds through a fund or that an Italian should not be able to buy an insurance policy that guarantees certain payments — where Government bonds would be the proper asset to match the liability. The financial intermediary's objection is to the compulsion — the saver is not free to choose.

Do these controls matter? Is there significant damage done to savers by regulations originally intended to protect them? Is the potential for crossborder flows sufficiently large that it might have a material impact in stabilising the European Monetary System (EMS) by private sector capital flows, offsetting flows from trade imbalances. The answer to all these questions is an unequivocal **YES**. Let me illustrate by example.

We are all regularly reminded that West Germany has no exchange controls. I would like to dispute the economic truth of that statement. I am using West Germany as a detailed example, not because I want to upset my friends there, but because the Deutschemark *is* the anchor of the EMS and therefore flows in and out of Deutschemarks are absolutely critical.

It is true that money is fungible so, if a trade imbalance is to be financed, the source should be immaterial. However, the LDC debt crisis is still such a vivid reminder of the perils of relying on short-term "hot" money that it may be more prudent to look for sources of medium- to long-term funds — to match the timescale of the necessary structural trade adjustment. These flows of funds will finance regional policy and are the "other adjustment mechanisms" referred to in the Delors Report. They *are* the alternative to devaluation.

However, it would be alarming, and very risky, if all these long-term trade adjustments were to be financed by short-term funds — bank deposits, ECU Treasury bills, or the like. Therefore the freedom for long-term savings institutions to make long-term investments is crucial — IF the adjustments are prudently financed.

Ideally, such sources of funds should, by their nature, indulge in "stabilising" speculation. If the Deutschemark/French franc were trading at its DM3.43 limit and "the market" feared a 3% devaluation of the franc, a long-term buyer of ten-year Government bonds might still purchase French bonds yielding 8.6%, rather than the 6.7% West German bonds. During the bond's life, such an investor would reckon on nearly 20% extra return from this French bond — if only one devaluation occurred. If that investor believed — for whatever reason — that monetary union might occur within that bond's life, then the decision to buy the French bond would be a "no-brainer." Thus, the "speculative" purchase would create a stabilising flow of funds into the franc. If the investor were a corporate treasurer whose financial year-end was in three months, then the three-month deposit rates would add only 0.5% extra interest in the period that the francs were held. Faced with a serious risk of a 3% devaluation, the corporate treasurer would probably indulge in "destabilising" speculation and sell the francs. In this simplified example, *if* long-term financial intermediaries were forbidden to own foreign bonds, then the ultimate saver *is damaged* by losing the chance of making an extra 20% and, second, the flow of private capital is in only one direction, the franc devalues, the credibility of the ERM is damaged, and dreams of monetary union are postponed another year or two.

The West German current account surplus with the rest of the EC is so massive that many commentators talk about the need for a major Deutschemark revaluation. The alternative policy — and one which supports the concept of monetary union — is to ensure a corresponding capital outflow. Foreigners may add to, or subtract from, their stock of West German assets but, over the years, the dominant factor is likely to be the domestic savers and their wish to diversify their holdings.

Figure 3. Acquisition of Financial Assets by West German Households, 1987

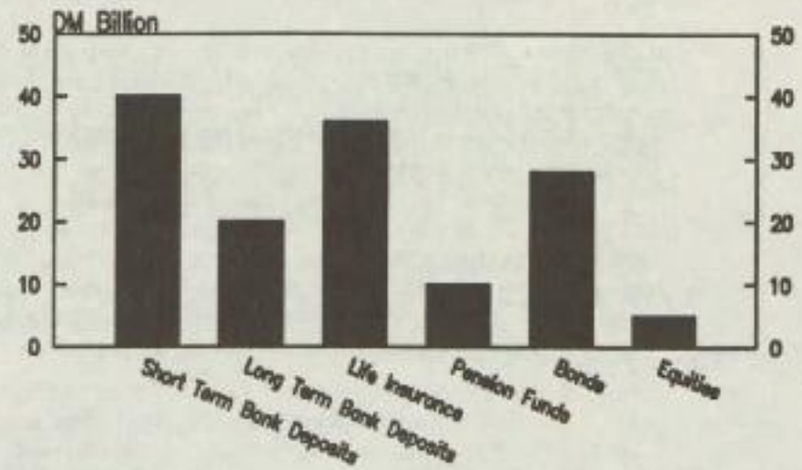


Figure 3 shows the pattern of acquisition of financial assets by West German households in 1987. The striking feature is the scale of the investment in life insurance. The life company is merely an intermediary between the retail saver and the ultimate user of the funds. In turn, the life insurance companies put about 80% of their inflows into fixed-income instruments. This highlights the enormous importance of competitive returns from such instruments — if they are to be attractive to West German savers.

The purpose of this figure is to illustrate that, if a European citizen is to have the true economic freedom to express his preference along the risk-return profile, then the chosen financial intermediary must *also* have the corresponding freedom to invest in assets that match the liability that the intermediary has undertaken to the saver.

However, a subsidiary implication of Figure 3 is the simple, but unstated, assumption that "life insurance" is nothing but another form of long-term saving — together with an attached contract for insurance against early death. "Death insurance" can easily be purchased separately, leaving the return from the "life insurance" contract as a straightforward competitor to bank deposits, bonds or equities. Historically, death insurance has been thought to be "good" and therefore encouraged with tax incentives. Over the years, these tax benefits have gradually been spread away from death insurance and towards the "life insurance" savings product. The UK has been particularly vigorous recently in "levelling the tax playing field" for the different savings media — the West German life companies may well be fearful that such concepts will be an unwelcome export from the UK. This may explain their reluctance to damage any illusions about the savings nature of a life policy.

Then there would have to be a rigorous conceptual — if not actual — separation of death insurance and a managed investment portfolio where the saver shares directly in the long-term results of the management expertise BUT has no guarantee of the rate of return. The portfolio of assets required to match such a profit-sharing type of liability may be radically different from that required to meet a guaranteed, insurance liability. This subsidiary implication is absolutely critical: the type of liability sold by the insurance company will govern — quite properly — the nature of the assets it holds.

As the battle heats up for retail savings in West Germany, the competition between banks and insurance companies — the *Allfinanz* debate — has the potential to create a sharp change in the type of liabilities that insurance companies want to sell. The example of banking products — especially mortgages — shows that genuine liberalisation of financial services would, itself, lead to a common currency.[2] On this occasion, I shall use the example of life insurance in general and West German life insurance in particular.

In West Germany, the medium- to long-term savings markets have historically been dominated by the life insurance companies. The *Versicherungsaufsichtsgesetz* (VAG), or Law on Insurance Supervision, specifies that assets held to meet contractual insurance liabilities — the "coverage stock" assets, which represent 90%-95% of the companies' assets — must be one of 12 specified types. If a proposed asset type is not on that list, it may not be purchased — end of discussion. Foreign assets are not on that list — except of course to back foreign insurance! **Thus, this obscure regulation prevents the dominant part of long-term West German savings from going abroad. I contend that this is economically equivalent to an exchange control and should therefore be abolished.**

West Germany is not alone in having such investment restrictions, and I have only cited these regulations at such length because of their importance in controlling the flows of long-term funds which are so vital if monetary union is to be anything other than a dream. This is also the moment to pay tribute to the liberalisation measures being proposed in West Germany to implement EC obligations. These have not attracted as much attention as such revolutionary plans warrant. But I believe that the *combined* effect of the freedom to issue securities within West Germany AND a substantial broadening of the investment powers of insurance companies and mutual funds *will be revolutionary* in the fullness of time.

My only criticism of these proposals is that they do not go far enough. On the question of currency diversification, the proposal says "for life insurance [currency matching] should always be used, because here the obligations are usually expressed in a particular currency." There are ways of mitigating the rigours of this prohibition, but they fall within the 30% of assets permitted to be invested in everything other than bonds and real estate. Thus, in one stroke, this proposal misses the point of the growing structural upheaval in the savings market. As a result, it fails to give any credit to the concepts of modern portfolio theory and prudent diversification of assets — within and *across* currencies.

If the West German insurance companies were not constrained by this regulation, what proportion of their assets might be held abroad? In the UK, the corresponding long-term institutions, at the end of 1986, had 12% of their assets abroad, while pension funds had 17% abroad. In the Netherlands, a substantial sample of private pension funds had 17% of their assets abroad at the end of 1987. Importantly, 11% of their fixed-income portfolios were held abroad. Dutch insurance companies had only 5% of assets abroad, but, in their public bond portfolios, 38% were foreign. I feel it is not unreasonable to postulate that, *if unconstrained*, West German insurance companies might put 10% of their assets abroad, once they had varied their policies. That total would represent a private sector capital outflow of approximately DM50 billion — a colossal sum. For perspective, it would amply cover West Germany's 1988 current account surplus with the other EC member states. Would such flows help to stabilise the EMS if they stayed within it?

[2] See *1992 And Beyond: Banking — Will Liberalisation Itself Lead To A Common Currency?*, Salomon Brothers Inc, February 1989.

These examples establish beyond doubt that controls on eligible assets DO matter. Unfortunately, the response to these conjectures by the vested interests concerned is highly predictable: "West German savers are very cautious and would be concerned if their savings were invested abroad."

It is worth examining what "cautious West German savers" have actually done when they have had freedom of choice — rather than being constrained by the cultural caution imposed on their intermediaries by regulation. Bundesbank data shows that, in 1986, West German households put DM36 billion into life insurance and DM10 billion into bond funds. Interestingly, even in 1986, 40% of that DM10 billion went into foreign bond funds. In the first half of 1988, they put about 14% more into insurance than in 1986, but flows into bond funds were up 400% on the 1986 figures. For 1988 as a whole, German households astonishingly sold over DM1 billion of domestic bond funds and invested DM32 billion into bond funds investing internationally.

Figure 4. Total Rates of Return, Dec 1986-Mar 1989

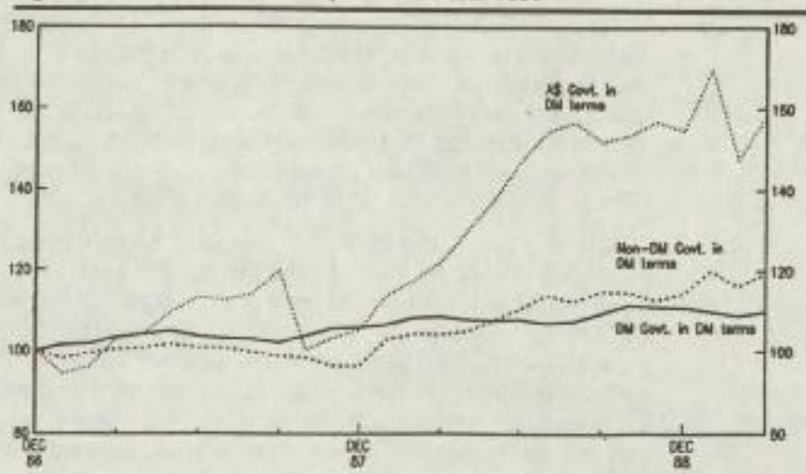


Figure 4 shows a remarkable expression of freedom of choice in selecting higher returns — even at higher risk, as the Australian example indicates. The proposal to introduce withholding tax was certainly a factor, but is more likely to have influenced only the split between West German or Luxembourg-based funds. Whatever the reason, the fact remains that West German savers moved their money — on a huge and decisive scale — out of the regulatory "protection" of the West German authorities, into another EC member state — Luxembourg. Having taken this crucial step, probably about *three-quarters of the funds were invested in European bond markets.* The Luxembourg funds hold virtually no Deutschemark investments. Some of these funds left European currencies altogether and will have contributed to the EMS group's weakness versus other currencies, such as the dollar. The positive side of this account will be the potential scale of the capital inflows attracted by a unified European capital market. I believe the implications of these movements are enormous — the largest pool of long-term savings in Europe *is* prepared to look across EC borders when extra returns are available, especially if the exchange risk is modest. The flows are already measured in tens of billions of marks — even while exchange controls are still applied to the bulk. Based on last year's behaviour, the potential for enormous, *and stabilising*, intra-EMS flows is crystal clear.

Other countries have shown the courage necessary to abandon such outmoded restrictions, even where the influence on the demand for Government debt is uncertain. The Netherlands has a large public deficit and one of the higher ratios of accumulated public debt to GNP. Yet, a year ago, the Dutch Government changed the law for the Civil Servants' Pension Fund — which accounts for half of Dutch pension assets. This fund will now be allowed to invest 5% of its assets abroad. This may not be complete freedom, but it is a courageous start.

I have highlighted West Germany's covert "exchange controls" because of the importance of the Deutschemark as the anchor of the EMS and the strains created by West Germany's trade imbalance with the rest of the EC. From the trenches, exchange controls are a particularly obvious landmine for the financial services infantry. However, some of the generals who are most enthusiastic about the grand strategy have yet to demonstrate to the infantry a corresponding enthusiasm for the removal of their national landmines. Unless they do, the advance may turn out to be very half-hearted, no matter how glittering the prize on the other side of the minefield.

Step Two: Sterling should be excluded from the ECU

In my initial comments on the Delors Report, I made the point that "trying to promote the ECU as a common currency is already damaging the Community." I would like to elaborate on that comment and propose a remedy — principally, that sterling should be excluded from the ECU.

What is the ECU? It is a weighted basket of the member states' currencies. The enthusiasts wish it to become, indeed, believe it is already, a parallel currency and therefore several steps down the road to monetary union — a quasi "common currency." But there is a logical flaw in this process: membership of the ECU follows from the political act of joining the Community — as we are about to see when the Spanish and Portuguese currencies are included later this year.

Whatever the future hopes may be, current economic convergence is *NOT* a condition of membership. As the Delors Report itself notes, "monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable." Self-evidently, that degree of convergence does not presently exist. So, that symbol of monetary union — the ECU — only endures because, for the overwhelming majority of the Community, it is economically non-existent! In short, the ECU is a severe case of putting the cart before the horse. The structure is nothing more than a political gesture rather than a market-driven response to real economic needs.

What is required to get the horse in front of the cart? Why aren't people prepared to hold their savings in ECU financial assets? These are perfectly reasonable questions. I believe the root of the problem lies in the ECU's composition, which is set out in Figure 5.

Figure 5. Composition of the ECU

	Weighting (Apr 25, 1989)
In Exchange Rate Mechanism	
Plus or minus 2¼% fluctuation band	
Deutschemark	34.6%
French Franc	18.6
Dutch Guilder	10.9
Belgian Franc	8.5
Luxembourg Franc	0.3
Danish Krone	2.7
Irish Pound	1.1
Subtotal	76.7%
Plus or minus 6% fluctuation band	
Italian Lira	9.2%
Outside Exchange Rate Mechanism	
British Pound	13.4%
Greek Drachma	0.7
Subtotal	14.1%
Total	**100.0%**

As is very well known, not all of these currencies — sterling, to name the obvious — participate in the Exchange Rate Mechanism (ERM). Even within the ERM, the Italian lira has wider margins of fluctuation than the plus or minus 2¼% bands. This composition permits a significant degree of volatility in the ECU relative to its constituents. This situation will only get worse in September 1989, when the routine recomposition takes place and the peseta and escudo are likely to be included in the ECU.

To state the obvious: for a financial transaction to take place, both borrower and lender must feel that it satisfies their economic needs. Continuing the focus on the sources of long-term funds, is there any advantage to an investor who holds a bond in the lowest interest rate currency — the Deutschemark — in switching into a corresponding ECU bond? This will be the question facing the portfolio managers of the West German insurance companies I discussed earlier — ONCE they are legally allowed to hold such assets.

Figure 6. Relative Performance of DM and ECU Bonds, Dec 84-Mar 89

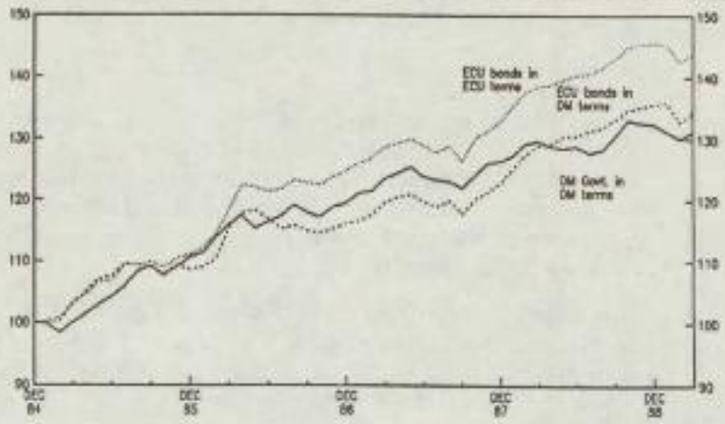


Figure 6 sets out the results such an investor would have achieved since the end of 1984. In summary, the return of the ECU bonds in ECU terms was 10% higher than West German Government bonds, but most was lost by the 7% depreciation of the ECU versus the DM. Even worse, there was a significant degree of currency volatility, making the whole exercise less predictable. This is not a picture that one would expect to induce large-scale flows out of DM into ECU and, not surprisingly, they did not occur.

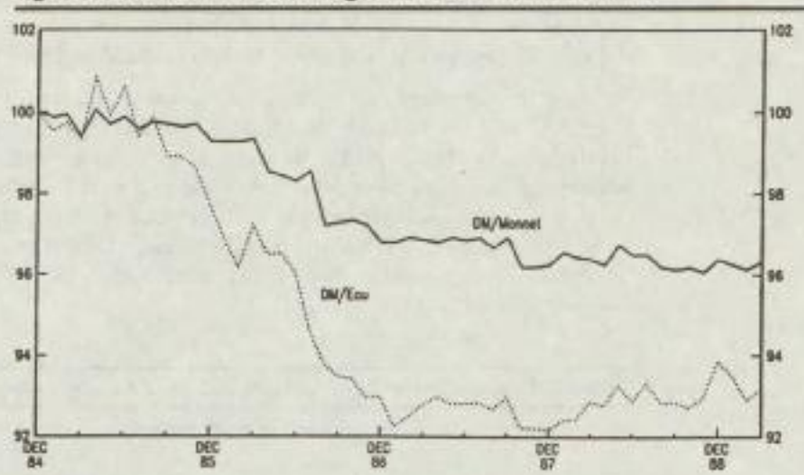
The key failure to create an attractive investment occurred because of (i) currency volatility, and (ii) depreciation. Both problems are inherent in the composition of the ECU. Perhaps the solution would be the creation of a new basket of the currencies with a "sufficient degree of convergence."

Many people advocate the greater use of ECU as a prelude to a "common currency," and *The Economist*, for example, has been suggesting that it should be renamed the "Monnet." This would honour one of the Community's founding fathers. It also has the pragmatic advantage of sounding to the man-in-the-street more like the word for cash — rather than conjuring up visions of some peculiar Australian bird called an emu. But perhaps the name "Monnet" *should* be given to this new basket of currencies, because it really could be the horse which pulls the cart towards a common currency.

This "Monnet" would only consist of the currencies within the narrow, plus or minus 2¼%, ERM band. Presumably, Italy will match its enthusiasm for the ideal of monetary union with the practical step of giving up its wider fluctuation band. The "Monnet" would then account for 86% of the present

ECU. By definition, the volatility will be slashed and the depreciation risk eliminated — to the extent that the EMS is not realigned.

Figure 7. Deutschemark Exchange Rates of ECU and Monnet



Historically, such a basket would have functioned significantly better than the ECU. Figure 7 compares the Deutschemark exchange rate of both the ECU and the Monnet. Naturally, the Monnet would not have been perfect — there were devaluations during the period. Nonetheless, volatility would have been much lower and the depreciation about half that of the ECU — at about 0.9% annually.

It is difficult to estimate how much would have flowed through to a bondholder. Calculations of a "theoretical" ECU yield require a number of assumptions and, in practice, market yields have fluctuated significantly below the "theoretical" levels.

Starting from today and looking forward, ten-year ECU bonds — of mixed credit quality — yield 8.6%. This is about 1.9% above corresponding West German Government bonds and identical to corresponding French Government bonds, for example. Theoretically, a Monnet Government bond would also yield 8.6%. To the extent that the Delors Report is accepted and implemented, a West German investor could look for an extra 1.9% annually of yield in a basket of currencies ever more firmly committed to stable exchange rates.

If that turns out to be true, the gain is the entire 1.9% annually. If the history of the last four years or so is repeated, the yield is still 1% above the 6.8% available on Government bonds, whereas if the ECU's history is repeated, the gain will be virtually nothing. Worse, one quarter or more of the ECU's members are not even prepared to commit themselves to reasonable "stability."

This is the type of scenario that should cause rational West German investors to shift large sums of money into the Monnet. I established earlier just how rational they are, and how large the potential funds. For a borrower, these calculations apply in reverse: the greatest advantage will accrue to borrowers in higher yielding currencies — Danish krone or Italian lira, for example — where the lower interest cost, but diminished currency risk, will be major attractions. This natural arbitrage process would tend to drive long-term interest rates in all the constituent currencies together. When issuers and investors become convinced of the likelihood of monetary union, the only remaining differences in rates would reflect credit preceptions — just as they still do in the monetary unions of Canada and the Federal Republic of Germany.

The Monnet — defined in this way — could make a major contribution to monetary union, even though it would superficially emphasise the existence of a two-speed Europe — those outside the ERM and those who are fully committed. However, the Monnet membership would be open to any country that wished to commit itself — credibly — to the *full* rigours of the ERM. If all EC member states joined, then the ECU and Monnet would become identical. Once this had occurred — or perhaps even before — the permitted margins of fluctuation within the ERM could be tightened progressively. The Monnet would then approach, correspondingly, the definition of a parallel currency. Once the fluctuation margins had been narrowed to zero and the constituent currencies were, as the Werner report put it, "free from fluctuations and with immutable parity rates," monetary union would, at that distant time, have been achieved and the Monnet could be the "sole Community currency."

Conclusion

This step-by-step approach, while lacking the glamour and immediate appeal of a dramatic declaration of political theory, instead offers a practical and concrete approach. It will build on the foundations already laid by the successful aspects of the EMS — its stability is a prerequisite for the Monnet to become widely accepted. Corresponding steps simply require the savers of Europe to be allowed, through their financial intermediaries, the freedom to express their wishes with their own money. If they are moved to use this freedom and make rational decisions, then they will, by their own individual and practical decisions, propel us towards the goal of monetary union.

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When Will Sterling Join the ERM? — Domestic Versus European Timetables

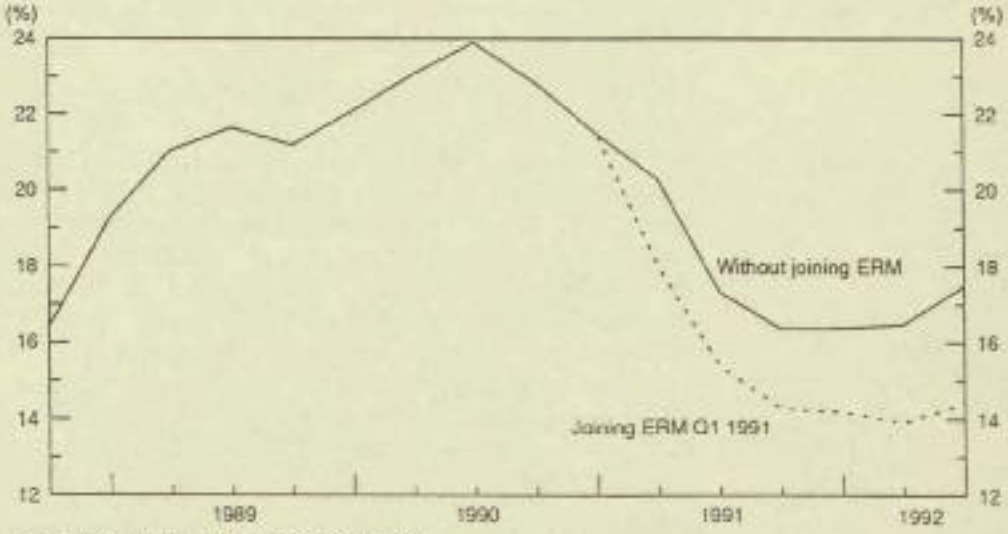
Introduction and Summary

ERM an Escape Route From UK Political and Economic Woes...

Chancellor Major reaffirmed the UK's commitment to join the Exchange Rate Mechanism (ERM) in his Budget speech, but stated that "progress on reducing inflation is a vital precondition." The UK Government, beset by problems, may focus solely on its own electoral timetable, governed by the June 1992 deadline. We believe the Government's chances for reelection rest on its ability to create a combination of mortgage rates below 10% and an inflation rate no higher than 5%. However, it is doubtful that this can be achieved by the election deadline, on present policies. But joining the ERM could dramatically raise the odds on reaching this goal in time. We believe the preferred route — on UK grounds alone — would be:

- entry at the beginning of 1991;
- with a 2¼% central rate band; and
- with the lower end of the band fixed at the current market rate.

Figure 1. Mortgage Plus Inflation Rates and the Exchange Rate Mechanism, 1989-92E



E Estimate. ERM Exchange rate mechanism.

...But EC Plans a Common Currency Soon

The European Community (EC) timetable is different. The just-completed European Commission report on how EMU is to be achieved — being debated this weekend by EC finance ministers — involves a rapid move to a single currency. **The dilemma looming for the UK concerns more than ERM membership: it is nothing less than a commitment to accept a common European currency by the mid-1990s.**

In this report, we analyse these two timetables separately, given the UK's conditions for entering the ERM. **We conclude that the risk of an historic split between the UK and Europe is significant.**

The UK Timetable

On present trends, the Conservative Party is set to lose the next election. The outcome will be determined by the ability of Mrs. Thatcher's Government to reduce inflation and interest rates sharply, and time is running out. Recent events have reinforced fears that wage inflation in the UK can only be reduced if the economy is tipped into recession. However, it will be hard to engineer a cycle of recession and recovery in which a post-recession combination of rising activity and subdued inflation can be established ahead of the June 1992 election deadline. There is no indication, either in likely budgetary or current monetary developments, that the Government is willing to take stern action to reduce near-term wage expectations.

Political and Economic Conundrum

Furthermore, the Government faces a policy dilemma very different from past experience. Whereas the economy reached cyclical troughs in January 1981 and January 1986, some 40 months and 24 months before the end of the five-year parliamentary term, respectively, the next election is already no more than 26 months away, and there is no sign that the trough in the present cycle has been reached. One key characteristic of this cycle is that it has been extended by official policy, thereby allowing insufficient time for a recovery in both economic and political fortunes.

Figure 2. Election and Policy Cycles, 1979-90E

Election	May 79	June 83	May 87
Economic Peak	May 79	Aug 84	Aug 88
• Months From Last Election	0	14	15
• Months to End of Parliamentary Term	60	46	45
Economic Trough	Jan 81	Jan 86	May 90E
• Months from Last Election	20	31	36
• Months to End of Parliamentary Term	40	29	24
Monetary Policy Easing	July 80	Mar 85	Sept 90E
• Months from Last Election	14	26	40
• Months to End of Parliamentary Term	48	34	20

E Estimate.

If the current cycle had been "normal," monetary policy would already have been eased. As Figure 2 shows, interest rates were lowered from July 1980 and March 1985, some 14 and 26 months, respectively, after elections. This time around, monetary policy has yet to be eased, and it is already 34 months after the last election. It is far from clear whether rates will be brought down within the next six months, and even possible that the next move will be upward. In fact, the previous Chancellor attempted to ease policy in the standard cyclical fashion, but the move was hidden within the framework of exchange rate policy: short-term rates were reduced sharply in the first half of 1988 as the exchange rate surged, but the policy shift extended the boom in a rapidly-overheating economy, sowing the seeds for an almost-unprecedented period of monetary tightening that has persisted since mid-1988.

Perhaps the closest parallel is the enforced relaxation of monetary policy in 1977 as the authorities attempted to curb a sharp rise in sterling. That attempt had to be reversed, and the subsequent spike in interest rates in 1978-79 may have contributed to the Labour Government's defeat in 1979.

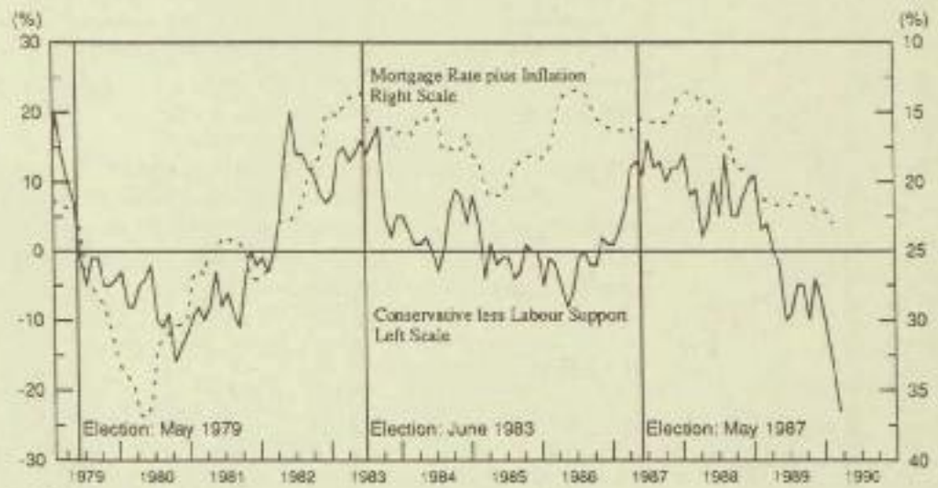
Essentially, Chancellor Major's problem is that past policy errors have desynchronised the economic and political cycles, and there is no easy way that domestic economic policy can resynchronise the two cycles before the next election.

Mortgage Rates Will Erode Party Support

The Government faces a conflict between economic and political goals. If winning the election depends on lowering interest rates and sustaining rates at lower levels for a significant period, then the economy should already have cooled off sufficiently to allow the process of monetary easing to begin, without incurring excessive inflation or currency risks. However, demand pressure is still high, wage settlements show no signs of coming down, and European central banks could tighten policies further in the near term: monetary easing will be too risky for the Chancellor. Such a move might push sterling down and wages up and have to be reversed in the run-up to the election in the most politically damaging fashion. On this basis, we predict that mortgage interest rates will remain at current levels for an uncomfortably long time and are likely to further erode support for the Conservatives.

Although the absolute level of support for the Conservatives is not as low as in 1985-86, it may be wrong to dismiss the 1989-90 Party losses as no more than a symptom of "mid-term blues." Opinion polls show that the Conservative Party faces the largest shortfall in popular support versus the Labour Party since 1971. Prospects for reelection appear bleak, given the fall in support for the Alliance, which may have been the repository of protest votes in 1985-86. The resolution of internal differences within the Labour Party may have provided a more solid underpinning for the Labour vote, perhaps suggesting that the Government will have greater difficulty regaining support ahead of the election than prior to the last two elections.

Figure 3. Mortgage Plus Inflation Rates and Opinion Polls, 1979-90E



E Estimate.

Against this backdrop, the UK economy will not provide the essential conditions in 1991 or first-half 1992 that would give Mrs. Thatcher a good chance of winning the election: a combination of inflation no higher than 5% and mortgage interest rates below 10%.

Economic performance is likely to be improving relative to the dismal 1989-90 experience, but inflation will only briefly dip below 5% — and underlying inflation, stripping out mortgage interest rates, will stick [illegible]%. Thus, monetary policy easing of sufficient size to reduce mortgage rates to desired levels will risk a sterling crisis that would then threaten a reversal of policies. Similarly, the maintenance of an extremely tight monetary stance might succeed in reducing inflation to desired levels, but at the expense of an election-losing mortgage rate well into double digits.

Sterling an Important Policy Constraint

In addition, the impact of a (politically) necessarily expansionary budget in 1991 will — while providing the mechanism for a welcome upturn in demand — eat into the budget surplus and erode the trade balance. Sterling may prove to be a more important constraint on policy than we have concluded. Certainly, the risks are all on one side, suggesting that sterling's downside will be tested by the markets during the critical run-up to the election.

There appear to be two options for the timing of the election — autumn 1991 and spring 1992. Without external support, neither date is attractive. In each case, a policy of resisting an excessive fall in sterling will leave the mortgage rate at a floor of 11%, too high for electoral comfort and above the 10% level ruling ahead of the last two elections. Taxes will likely be cut in the 1991 budget to support demand ahead of the election, resulting in a rise in the trade deficit from the second quarter of next year, immediately cutting away one of the props for the pound. An alternative stern strategy, in which fiscal policy is held tight, would break the pattern of every preelection budget since 1969, and appears almost inconceivable for a Government lagging badly in the polls. Taking risks with the exchange rate has featured in recent election strategies, but the difference between 1991 and the years in which the last two elections were held is that the economy will be operating with much greater demand pressure — measured by the trade deficit. Hence, inflation and exchange rate risks will be higher.

Conservative Party tacticians are likely to conclude that the mortgage and inflation rates will need to show a better performance than prior to the previous two elections, since the shortfall in popular support versus the Labour Party is far larger. Without external support, however, easing monetary policy sharply to encourage a reduction in mortgage interest rates will founder on the rocks of lower sterling and higher inflation. A tight policy aimed at driving inflation down will leave mortgage rates stranded and may encourage a politically debilitating rising unemployment trend. Either way, Mrs. Thatcher's Government looks unlikely to meet the critical economic conditions for reelection.

The ERM Escape Route

This conclusion may already be leading to a reconsideration of alternative strategies. In particular, the requirement that sterling be supported through a period of falling interest rates will draw attention to the external support offered by membership of the ERM.

Recent discussions of possible ERM membership have focussed on: (1) the need to enter at a highly competitive exchange rate to help cut the trade deficit; and (2) the potential instability of UK policy as a result of joining a system centred on lower inflation, lower interest rate economies, which might lead to a switchback in UK interest rates. We contend that longer-term policy conflicts will take a back seat in attempts to secure possible short-run benefits of membership ahead of the election. Our concern is therefore with the period up to mid-1992.

Timing of ERM Entry

If managed carefully, ERM membership ahead of the next election will permit interest rates to be lowered significantly without generating increased inflation pressure over the relevant time horizon. Entry into the ERM may take place at the current exchange rate, or at a rate significantly higher or lower than the current market rate. The advantages of a low rate lie in its sustainability over a longer period, given high UK inflation, and in a relatively low level of associated interest rates. The advantages of a high rate are tied to the more immediate dampening effects on inflation. Thus, the critical influences on the choice of entry rate are:

- the relative priority attached to the long and short term; and
- the relative priority attached to lowering inflation and cutting interest rates.

Figure 4. Table of Simulation Results, 1991-92E

	1991E				1992E			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Outside ERM								
RPI	6.9%	5.4%	5.5%	6.0%	5.6%	5.6%	6.1%	6.4%
Mortgage Rates	13.0	11.5	10.5	10.0	10.5	11.5	11.0	11.0
DM/£	DM2.65	DM2.62	DM2.59	DM2.54	DM2.54	DM2.50	DM2.47	DM2.44
GDP	1.4%	2.0%	3.1%	4.1%	4.3%	3.9%	3.1%	2.7%
Low Entry Rate								
RPI	6.6%	5.1%	5.0%	5.3%	5.1%	5.4%	6.5%	7.3%
Mortgage Rates	11.0	10.5	7.5	7.0	8.0	9.5	10.0	11.0
DM/£	DM2.59	DM2.57	DM2.55	DM2.52	DM2.50	DM2.47	DM2.47	DM2.47
GDP	1.7%	2.5%	3.9%	5.1%	5.4%	4.6%	3.3%	2.4%
High Entry Rate								
RPI	7.0%	5.6%	5.5%	5.7%	4.9%	4.5%	5.0%	5.6%
Mortgage Rates	14.0	12.5	11.5	10.0	10.0	11.0	11.5	11.5
DM/£	DM2.77	DM2.74	DM2.70	DM2.69	DM2.65	DM2.67	DM2.69	DM2.70
GDP	1.22%	1.4%	2.3%	3.3%	3.6%	3.8%	3.3%	2.6%
Current Entry Rate								
RPI	6.6%	5.0%	4.9%	5.2%	5.0%	5.0%	5.6%	6.0%
Mortgage Rates	11.0	10.0	9.0	8.5	8.5	9.5	10.0	10.0
DM/£	DM2.69	DM2.65	DM2.64	DM2.64	DM2.64	DM2.64	DM2.64	DM2.64
GDP	1.6%	2.3%	3.5%	4.5%	4.4%	4.0%	3.0%	2.4%

E Estimate. GDP Gross domestic product. RPI Retail price index.

In our view, the Government's poor support will compel Mrs. Thatcher to take a short-term view. This will bias the decision towards a higher entry rate. A commitment to stabilize the pound against low interest rate currencies — backed up by bilateral support arrangements — will lead to a reduction in the risk premium attached to sterling for a comparatively short period of time.

ERM Entry at a High Exchange Rate

Consider the example of sterling entering the ERM at a rate set 5% above the current market rate. A reduction in sterling's risk premium might generate the conditions for a 100-basis-point reduction in short-term interest rates, but a higher entry rate will offset about half of this effect. Our simulations suggest that interest rates would, in this case, be brought down more rapidly than if sterling stayed outside the ERM, but progress would be slow. In addition, the favourable effects on inflation of lower import costs would be outweighed for four quarters by the negative impact on retail price inflation of the relatively high level of mortgage interest rates.

Thus, a high entry rate policy might yield relatively large benefits in the second year after entry, but not until then. This option therefore rules out the possibility of holding an election in the autumn of 1991. The restricted timing options might well prove the critical negative factor for such a policy, because of the nightmare threat of the need to hoist interest rates to defend an uncompetitive currency ahead of the election. In addition, our model suggests that the combination of lower interest rates and a somewhat firmer pound could only be sustained if wages react downward to reductions in interest rates and retail price inflation, and to the implied firmer discipline of the ERM.

ERM Entry at a Low Exchange Rate

We also consider the case of the Government adopting a low exchange rate, for example, 5% below the current rate. Our model-based simulations suggest that short-term interest rates might be brought down to a low of 7% within a year of entry, easily meeting the criterion of a 10% mortgage rate prior to the election. Retail price inflation would fall, but only because of the artificial impact of lower mortgage rates. In contrast, underlying inflation would turn up six months after the devaluation and accelerate over the following year. Eventually, then, such a stance would sow the seeds of its own failure. The best time to hold an election, in this environment, would be within a year of entry into the ERM.

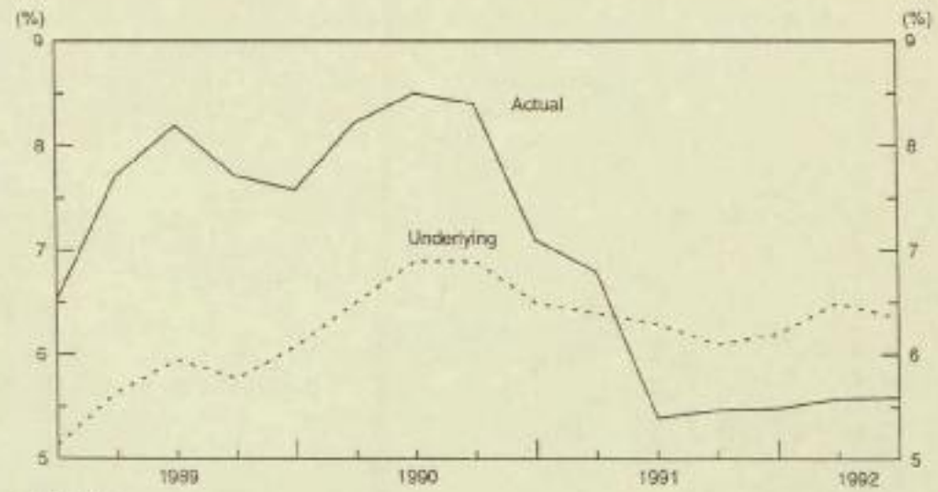
The best outcome would reflect a downward adjustment to wage growth in response to lower interest rates: the benefits in terms of lower inflation and interest rates would be considerable. The worst outcome would be an upward reaction in wages to higher underlying inflation (i.e., to the fall in sterling), but our simulations suggest that the overall impact on headline inflation would still be downward for six quarters from the date of ERM membership.

The key conclusion, therefore, is that entering the ERM at a somewhat lower exchange rate will secure temporary benefits to interest rates and retail price inflation, unless wages react violently upwards. Entry at the beginning of 1991 at a lower exchange rate cannot be ruled out, but the Conservative Party would require a sharp improvement in the opinion polls to permit entry on such terms, as it would raise too many inflation threats if the election was delayed until 1992.

ERM Entry at Current Exchange Rates

The compromise option of entering the ERM at close to the current exchange rate may offer the best balance between lowering inflation dangers and reducing interest rates, while avoiding restrictions on the timing of the General Election. As with all options, the benefits flowing from a reduction in the risk premium attached to sterling are likely to prove transitory, but would get the Government past the election. We calculate that setting the lower end of a 2¼% band at the current market rate would permit short-term interest rates to be cut to a floor of 8½%-9% well within a year of entry and held close at that level for another six months. Critically, this could be the best option for headline inflation: if sterling enters the ERM at the beginning of 1991, the combination of a stable currency and lower interest rates will bring retail price inflation down to 5% by mid-year and hold the rate at that level throughout the following 12 months.

Figure 5. Underlying and Actual Inflation, 1989-92E



E Estimate.

We conclude that wage uncertainties rule out ERM entry at an aggressive exchange rate, while devaluation would risk another twist in the wage/price spiral. Entry at the current exchange rate offers large electoral benefits. Persistent wage pressures might suggest that the UK should enter the system with a wider Spanish-style 6% central rate band, but such a policy would leave currency risk at a higher level and thereby reduce the Government's ability to cut interest rates. Once again, longer-term stabilisation goals might well be sacrified in the interest of reducing rates ahead of the election.

As for timing, the domestic inflation rate adds to the other arguments for a narrow window of opportunity early next year. Inflation will remain close to 8% throughout the second half of 1990, and underlying inflation will drift up over at least the next six months. The real threat of currency instability if entry takes place while underlying inflation is rising should rule out that route this year. Similarly, entry needs to be no later than the early months of 1991, if the option of holding a late-1991 election is not to be ruled out. So the preferred option is likely to be entry:

- at the beginning of 1991;
- with a 2¼% central rate band; and
- with the lower end of the band fixed at the current rate, thereby permitting a very modest appreciation in the market rate in response to currency inflows.

RETURN TO C/F

The "Madrid Conditions"

At the Madrid Summit of the EC Heads of Government in June 198[illegible] the UK Government reaffirmed its intention to join the ERM but impos[illegible] conditions. One condition — reducing inflation — is an entirely internal UK problem. The others — completion of the internal market, abolition of exchange controls, a free market for financial services and the strengthening of competition policy — relate to the EC and essentially involve the implementation of Stage One of the Delors Committee Report.

Progress on Competition Policy...

Much has been achieved since that summit. Competition policy has been strengthened substantially by the passage of the Merger Regulation in December 1989. This gives the European Commission power to vet large mergers that have an EC dimension. The Commission has announced a major toughening of its attitude to state subsidies, and the proposed Directive on Public Procurement opens up 15% of the Community's gross national product (GNP) to competition.

...Exchange Controls...

Even more dramatic strides have been taken in the monetary field. Exchange controls have been falling like dominos in France and Italy, and the trivial controls remaining in Italy should be abolished by the June deadline. Exchange controls impeding the movement of substantial capital flows remain only in Spain and are obvious candidates for progressive relaxation well ahead of Spain's 1992 deadline — as the counterpart to Spain's bold and successful joining of the ERM at the time of the Madrid Summit.

In a strongly *communautaire* gesture, Belgium and Luxembourg abolished their two-tier exchange rate system on March 1, 1990, rather than resist until their 1992 limit. Belgium also cut its withholding tax rate from 25% to 10% and drastically simplified the reclaim procedure to help capital mobility. Italy voluntarily gave up its wide fluctuation bands within the ERM in January, as proof of its commitment to monetary union.

...ECU Issuance...

Both France and Italy have continued to expand their issuance of debt dominated in European currency units (ECU). France now has ECU 1.6 billion of long-term bonds outstanding and Italy has ECU 11.3 billion of bills and bonds in issue. The UK's ECU 2.8 billion of bills pales in comparison. Even West Germany, in the form of the State development bank, Kreditanstalt für Wiederaufbau (KfW), has just issued ECU 200 million of five-year bonds — targeting them specifically at West German savers.

...and a Single Market for Finance

Corresponding strides have been made in the liberalisation of financial services. The keystone of the new structure is the Second Banking Directive that gives banks a "European passport" to do business throughout the EC. This directive, and its associated measure on prudential supervision, was passed in December 1989. The measure allowing the free sale of mutual funds — the UCITS Directive — came into operation in October 1989, even though some states have lagged in passing their domestic enabling legislation. EC Commissioner Brittan has promised a "framework Directive" for life insurance and pension funds.

The Community component of the UK's conditions for ERM membership can now be regarded as satisfied, as was recently recognised by both Chancellor Major and Deputy Prime Minister Sir Geoffrey Howe. Only the UK's internal condition of lower inflation remains, and the Chancellor has now refined that to an inflation rate "proximate" to that of the rest of the EC.

RETURN TO C/F

German Reunification — Is it Cause for Delay?

While the deadline for a decision on UK membership of the ERM draws nearer, the system itself is now being questioned due to uncertainty about the implications of German reunification. It seems likely, however, that the West German authorities will try very hard to adjust policy to enable the Deutschemark to maintain its current EMS parity. In such a powerful and political context, the implications of any scenario other than an unchanged Deutschemark are profound, extending well beyond economic topics and perhaps even serving as a test for a reunited Germany's intentions towards the rest of Europe. German reunification is not, therefore, a reason to delay UK entry into the ERM.

The European Timetable

The Madrid Summit "asked the competent bodies to adopt the provisions necessary for the launch of the first stage [of EMU] on July 1, 1990." This has been done. The proposal on cooperation between central banks, which amended a 1964 decision, extends the role of the committee of central bank governors and provides for it to be consulted in advance of national decisions on monetary policy. The proposal on the "attainment of progressive convergence of economic performance during Stage One of EMU," which replaced a 1974 decision, provides for the Council to undertake "multilateral surveillance [of] all aspects of economic policy in both the short-term and medium-term perspectives." These proposals completed the approval process when passed by the European Parliament in February 1990.

Initiating EMU

Thus, the condition laid down by the Madrid Summit for the start of Stage One on July 1, 1990, has been fulfilled. The key steps in Stage One — "the initiation of the process" of creating EMU — are:

- "In the economic field... a complete removal of physical, technical and fiscal barriers ...completion of the internal market would be accompanied by a strengthening of Community competition policy."
- "In the monetary field the focus would be on removing all obstacles to financial integration. 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. Thirdly, all impediments to the private use of the ECU would be removed."

As we have noted, considerable strides have been taken in these areas in recent months, and the completion of Stage One looks inevitable. Nonetheless, the timescale is likely to be lengthy. The "full implementation" of all the liberalisation measures by means of national enabling legislation may take a couple of years from the dates stated in the Directives — often January 1, 1993. Regrettably, but realistically, it may be 1995 before Stage One can legitimately be declared complete.

Completing EMU — The IGC

However, the EC timetable is already focussing on the next step. At the Strasbourg Summit in December 1989, "following a discussion on the calling of an Intergovernmental Conference (IGC) charged with preparing an amendment of the Treaty [of Rome] with a view to the final stages of

EMU, the President of the European Council noted that the necessary majority existed for convening such a conference," that is, Mrs. Thatcher's dissenting voice was outvoted. It was agreed that the IGC would meet before the end of 1990.

The previous Madrid Summit stipulated the carrying out of "full and adequate preparation" for the organisation of an IGC. To this end, the Commission has drawn up a report on how EMU is to achieved. This report, which is to be discussed at an informal meeting of EC finance ministers at Ashford Castle in Ireland this weekend, calls for the creation of a new independent Community institution, EuroFed, which would direct monetary policy and be subject to democratic scrutiny. EuroFed would also control the issuance of a single currency, the ECU. The report recognises that the "binding budgetary rules" proposed by the Delors Committee have met serious political objections. In a very welcome move, it states that "there is virtual agreement on two rules which could appear in the Treaty" — no "bailing-out" of fiscally imprudent Member States and no monetary financing or priority access to the market for public authorities. Budgetary cooperation would take the form of medium-term financial strategies, combined with mutual surveillance. As this surveillance is already occurring, these cooperation procedures must be acceptable to the UK Government. Moreover, the commitment to a "no bail-out" approach may represent a decisive turn towards an acceptance of market discipline — thereby shifting significantly towards the philosophy of the UK Government and raising the chances of agreement on the budgetary issues.

Rapid Passage to Definitive EMU

The report recommends "that the Community prepare for a relatively rapid passage from the beginning of Stage One to the definitive EMU, including a common currency." This would correspond to Stage Three of the Delors Committee proposals, but with a crucial distinction: a market-driven approach to the regulation of public finances. If the technical discussions of the finance ministers do not uncover any major obstacles, then the process moves to the foreign ministers' meeting on April 21. Inevitably, the agenda for such a meeting will be broader and could include the question of institutional reform of the Community to hasten the original, though ultimate, goal of political unity. Already, there are proposals to hold an IGC on this topic. These aspects will undoubtedly surface at the special Summit in Dublin on April 28 on Eastern Europe, as well as at the European Council Summit in June.

The Strasbourg Summit specified that the IGC, which meets "under the auspices of the Italian authorities," should draw up its own agenda and timetable. Creation of the complex language of a Treaty could take a year, although both France and West Germany are pressing for a faster resolution. Based on the experience of the Single European Act, ratification of the Treaty by each of the 12 national parliaments could take another two years. The completion of Stage One could thus coincide with the ratification of the Treaty, followed by a formal decision to move rapidly through Stage Two to Stage Three, complete with a common currency. The enhanced cooperation envisaged by Stage Two will, in practice, be in operation from now on.

Agreement in Principle by Year-End?

However, changes to the Treaty of Rome have to be unanimous, so the Treaty making process can only begin once there is an agreement in principle to proceed. As hosts, Italy will have a particular influence on drawing up the IGC agenda, so it is very likely that such an agreement in principle will be put before the December 1990 Summit in Italy — presenting the UK with a major dilemma.

Conclusion

The UK Government may debate ERM membership purely in terms of its own internal electoral and economic timetable. However, the EC has *its* timetable *and* a powerful commitment to EMU. The 11 other states seem set on proceeding to EMU with, or without, the UK, even if they have to leave the door open — as they have done with ERM membership. The dilemma looming for the UK is thus much bigger than ERM membership; it is nothing less than a commitment to accept a common European currency by the mid-1990s.

UK objections to Stages Two and Three of the Delors Committee proposals centre on the loss of budgetary powers and thus economic sovereignty; taking account of this, the EC has now moved some way towards an acceptance of market discipline. If the UK can make a commitment in December to an ultimate common currency — aided by the EC's move towards the acceptance of market discipline instead of binding budgetary rules — early ERM membership would be a natural consequence. If such a commitment remains unacceptable, it would be inconsistent to join the ERM at the very moment that it acquires this new and unacceptable objective. Presumably, UK membership could only be temporary, undermining the idea that ERM membership will add credibility to counter-inflation policy.

We conclude that the risk of an historic split between the UK and Europe is significant and will rise rapidly in the second half of this year.

* * * * *

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

30 April 1990

Dear John,

FINANCIAL SERVICES MARKETS IN THE EC

I submitted to the Prime Minister over the weekend the two papers, "German Hidden Exchange Controls" and "Obstacles to a Free Market in Financial Services in Europe", which you sent me earlier.

The Prime Minister has noted that Germany does have some restrictions on the issue of foreign currency bonds for the purposes of monetary control. She wonders why the UK does not apply similar restrictions.

The answer to this question might perhaps usefully be covered in the papers already in preparation within Treasury on possible revisions to techniques of monetary control.

Yours ever,

Barry

BARRY H. POTTER

John Gieve, Esq.,
HM Treasury

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FILE MRM 7

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 April 1990

Dear Bob,

ERM: SECURITY INSTRUCTIONS

Thank you for your letter of 25 April setting out the proposed "ADSO" arrangements for handling papers about the timing and terms of entry for the United Kingdom into the Exchange Rate Mechanism.

I will of course ensure that material is handled in the manner suggested. It would however be helpful if we could add one further name to the attached list, that of Brian Griffiths in the Policy Unit. This would be on the basis that, while Professor Griffiths could see the papers, they would be held here in Private Office.

I am copying this letter to John Gieve (Chancellor's Office).

Yours ever,

Barry

BARRY H. POTTER

R. J. Evans, Esq.,
HM Treasury

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pso.jt/Evans/3.26.4.90

SECRET: ADSO

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HM Treasury

Sir Peter Middleton GCB
Permanent Secretary

Parliament Street
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Telephone 01 270 4360

A Turnbull Esq
10 Downing Street
LONDON
SW1

Ref No: RJE/1/1
Copy No: 2 of 4

26 April 1990

Dear Andrew,

ERM: POSSIBLE DATES

Following our conversation earlier today, I attach a draft submission setting out possible dates for joining the ERM up to the end of September 1990. Sir Peter Middleton has agreed that I should send it to you on a personal basis at this stage, so that you can consider the implications for the Prime Minister's forward diary.

Yours sincerely,

Bob Evans

R J EVANS
Private Secretary

SECRET: ADSO

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Copy 2 of 4 b

SECRET : ADSO

Chancellor,

My inclination would be to hold on to this for another. I would however like to let Mr Tyrrell have a copy on a strictly personal basis - so that he can warn me of problems with the PM's diary.

From : D L C Peretz (MG)
Date : 24 April 1990
x 4460

SIR PETER MIDDLETON

cc Sir T Burns
Mr Wicks
Mr H P Evans
Mr Scholar
Mr McIntyre

JOINING THE ERM : DATES

Em 25/4

As agreed with your office, I attach a draft note to go to No.10 about possible dates between now and the end of September. I have discussed the note in draft with Mr Wicks, and it reflects his comments.

2. I have checked the "possible" dates against the Prime Minister's diary, with Mr Potter. But I suggest that when you put this forward to the Chancellor's Office they should double check on the Prime Minister's diary before finally sending the note off.

3. The Chancellor might like to reflect on what the covering letter (and note, and footnote to the table) should say about the possibility of joining during Parliamentary recess. There are arguments both way. If we think a call for recall of Parliament could be resisted, then a date during recess has considerable attractions. When the subject has been considered in the past, we have thought the Chancellor would need to be able to make a statement in the House on the Monday after joining. But I understand that the Chancellor's initial view is that it should be possible to join during a recess.

4. On a separate point, the Chancellor will want to know that we are now arranging for the Attorney General to be asked to confirm his previous advice that no legislation is need (see paragraphs 19-23 of the note attached to Mr Wicks' minute of 28 March).

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5. We are working on the other aspects of joining the ERM touched on at the meeting with the Prime Minister on 17 April, and will also be working up with the Bank a note covering a more extended range of dates, up to March 1991.

DLCP

D L C PERETZ

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DRAFT LETTER

From : PPS

To : Mr Potter, No.10

JOINING THE ERM

It was agreed at the meeting on 17 April that the Treasury would let you have notes about the mechanics of joining the ERM.

2. As a first instalment, I attach a note about possible dates for joining between now and the end of September. You will see that there are several possible dates in July and September. [The Chancellor would like to consider further the arguments for and against joining while Parliament is in recess, but his initial view is that it would be possible to join during a Recess].

3. We are examining separately the question of the exchange rate at which we would want to join. This will have a bearing on timing, since the presumption must be that we join with central rates for the £ against the other ERM currencies that are close to the market rates at the time.

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POSSIBLE DATES FOR JOINING THE ERM

The attached table examines possible dates for joining the ERM up to the end of September 1990.

2. The following points should be noted :-

i) It is assumed that the procedure for joining would be triggered on a Friday, leaving a weekend - if needed - for settling the details, before markets open again on Monday. This is the timing followed for ERM realignments.

ii) The procedure is for the initial discussion of details to be between Finance Ministry and Central Bank representatives in the EC Monetary Committee. This means members of that Committee must be available for telephone consultation late on the Friday, and to meet, if necessary, on the Saturday. Since the German, Italian, French and UK Finance Ministry members of the Monetary Committee also attend meetings of the Summit Sherpas, the operation would be difficult on dates when there are Sherpa meetings. The Committee would have to meet without its Italian Chairman or UK, German and French Finance Ministry members.

iii) It is necessary to allow for the possibility of a full meeting of EC Finance Ministers and Governors in the course of the weekend.

iv) Dates during Parliamentary recess would be impossible if an immediate statement to Parliament were judged necessary.

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v) The Chancellor would need to be in the UK in the few days before and after joining. There would need to be ready contact with the Prime Minister, if she was overseas.

vi) It would be best, so far as possible, to avoid dates when exchange market turbulence can be predicted. A final decision on a date can however be left until very late - after, for example, it is known whether a set of monthly trade figures is likely to cause exchange market difficulties.

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SECRET

Date (Friday)	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments	PM's remarks
4 May	Impossible	Bank holiday on 7 May	Not sitting on 7 May	Chancellor at IMF Spring Meetings in Washington, start Saturday 5 May.	
11 May	Could be difficult	-	-	RPI	
18 May	Possible	-	-	Sherpas meeting in Paris on 18 May	✓
25 May	Possible* (but would need a reason for cancelling Scottish visit).	Bank Holiday on 29 May	Whitsun Recess	Chancellor in Scotland on 24-25 May	✓
1 June	Possible	Trade figures on 23 May. Public holidays France, Germany on 4 June.	Whitsun Recess ends on 1 June	-	✓
8 June	Possible	-	-	Chancellor at ECOFIN on 11 June. Prime Minister in USSR.	✓
15 June	Would be difficult	-	-	Sherpas meeting in USA.	✓
22 June	Possible (but could be difficult depending on Trade Figures).	Trade figures on 22 June	-	-	✓

Chris Powell 24/2/86

6

S E C R E T

Date	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments	
29 June	Would be difficult	-	-	Sherpas meeting in USA.	✓
6 July	Impossible	-	-	Chancellor/PM at Economic Summit on 9 July. Chancellor departs for Washington on 7 July.	×
13 July	Possible	French holiday on 14 July.	-	-	✓
20 July	Possible	Trade Figures on 23 July.	-	ECOFIN on 23 July	✓
27 July	Possible		Recess might have to be delayed.	-	Recess not too
4 August - 31 August	Impossible	Holidays in Europe.	Recess.	-	
7 September	Would be difficult	-	Recess.	Informal ECOFIN on 8-9 September. Prime Minister at Balmoral.	×
14 September	Possible*	-	Recess	-	✓

5

S E C R E T

Date	Possible/Could be difficult/would be difficult/ impossible	Important economic statistics, holidays, etc	Parliament	Other Comments	
21 September	Impossible	Trade figures.	Recess.	G7 Governors and Finance Ministers in Washington.	PM [illegible] & Europe
28 September	Would be difficult*		Recess.	IMF/IBRD Annual Meetings do not end until 27 September.	✓
5 October	Possible	—	Recess	ECOFIN ? Conservative Party conference on 9 Oct.	✓

* Impossible, if decided that Parliament must be sitting on the Monday after joining.

pso.jt/Evans/4.24.4.90

RESTRICTED

HM Treasury

Parliament Street
London SW1P 3AG
Telephone 01 270

4360

Sir Peter Middleton GCB
Permanent Secretary

B Potter Esq
10 Downing Street
LONDON
SW1

25 April 1990

Dear Barry,

ERM: SECURITY INSTRUCTIONS

I attach a copy of a minute which I have circulated within the Treasury instituting a special handling system for papers concerning the timing and terms of entry of the UK into the Exchange Rate Mechanism of the European Monetary System. As you will see these are closely modelled on the arrangements for BLO material and are covered by the codeword "ADSO".

I should be grateful if you would ensure that material which comes to No 10 bearing the ADSO caveat is accorded the appropriate level of protection and that matters concerning ERM entry are only discussed with individuals whose name appears on the attached access list.

Yours sincerely,

Bob Evans.

R J EVANS
Private Secretary

RESTRICTED

pso.jt/Evans/2.24.4.90

FROM: R J EVANS
DATE: 24 April 1990
EXT: 4360

SEE ATTACHED LIST

ERM: SECURITY INSTRUCTIONS

Decisions on the timing, and the terms of entry into the Exchange Rate Mechanism of the European Monetary System will be extremely market sensitive. For this reason, Sir Peter Middleton has decided to introduce a restricted handling system for papers which include discussion of either of these issues. This is the ADSO system.

2. All papers which discuss dates, terms of entry, including the width of ERM bands and the exchange rate at entry into the ERM and the administrative arrangements for entry will need to bear the security classification "SECRET: ADSO". They should only be circulated between individuals on the attached access list. The very existence of the list and the fact that details of ERM entry are under active consideration must under no circumstances be divulged to anyone not on the list.

3. In order to simplify arrangements the handling instructions for ADSO material have been modelled as closely as possible on those for Budget List Only documents. The attached handling instructions at Annex B are a reduced version of the Budget Security Instructions. Papers should circulate in modified BLO folders, a stock of which is held in Sir Peter Middleton's office. They should be kept separate from other material and Mr Rees in

EOG will be able to provide security boxes for those who require them.

4. These arrangements are the minimum necessary to ensure that market sensitive information is suitably protected and we have tried to make them as simple and unbureaucratic as possible. Any queries over the operation of the list system should be addressed to me in the first instance.

R J Evans

R J EVANS
Private Secretary

pso.jt/Evans/6.20.4.90

ANNEX A

ADSO - ACCESS LIST

1. **Ministers**

Chancellor
Chief Secretary

2. **Senior Officials**

Sir Peter Middleton
Sir Terence Burns
Mr N Wicks
Mr M Scholar
Mr H P Evans
Mr J Odling-Smee

3. **Private Offices**

Mr J Gieve
Mr T Tarkowski
Mr R J Evans
Ms C Evans
Mr A R Lyons
Mr N Davis
Mrs P Spragg
Miss J Todd
Mr J Coker
Mrs M Henson
Mrs J Henser
Mrs V Brown
Mrs D Crane
Mrs E Davies
Mrs J Fane

4. **MG**

Mr D Peretz
Miss E Engledow (Secretary)
Mr P McIntyre
Mrs P Hubbard (Secretary)
Mr J Grice
Mrs J Wright (Secretary)

5. **Other Treasury**

Mr P N Sedgwick
Mrs E Hollyer (Secretary)
Ms J Barber
Miss T Spencer (Secretary)
Mr C Riley
Miss P Collins (Secretary)

6. **Bank of England**

Governor
Deputy Governor
Mr P Tucker (PS to Governor)
Mr C Briault (PS to Deputy Governor)

7. **Other Whitehall**

Attorney General
Miss J Wheldon (Legal Secretary)
Mr A Turnbull (No 10)
Mr B Potter (No 10)
Mr C Powell (No 10)
Mr M Blythe (Treasury Solicitor's Dept)

ANNEX B

PREPARATION AND HANDLING OF SECRET: ADSO LIST ONLY DOCUMENTS

In addition to the normal security instructions regarding handling of **SECRET** documents, the following special instructions apply to the handling of **SECRET: ADSO LIST ONLY** documents:

(a) Documents may be typed by a Personal Secretary only if she is on the **ADSO** List. The typist's initials should appear on each page of the document. The originator is responsible for the security of the typed master, which must be given a number in the sequential series used for copies.

(b) All pages of the document should bear the marking: "**SECRET: ADSO**". Only one side of the paper should be used. Each copy of the document must be sequentially numbered, eg. copy No 3 of 5 Copies. A full record of copy numbers and recipients must be kept in the sender's security register.

(c) The documents must always be enclosed in the special distinguishing folder marked **SECRET: ADSO** for transmission. They must always be transmitted in double envelopes even if sent within the building. The inner envelope must bear a label marked **SECRET: ADSO** completed with the relevant details mentioned in paragraph (d) below. If more than one document is sent in one envelope, the reference number (see (d) below) of each document must be shown on the label. A receipt must always be obtained for all copies of "**SECRET: ADSO**" documents. It is the responsibility of the originator to ensure that a receipt is returned for each coy which has been sent out. These receipts must be retained.

(d) Titles of **SECRET: ADSO** documents are not to be shown on receipt forms (which are unclassified) or

on **SECRET: ADSO** labels. Instead the "reference no" or "title" section of the receipt form or label should show: the sender's security register and the copy no. eg. MCS/28/3.

(e) If they are being sent to other departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents should be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. In no circumstances may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2) and the Bank of England.

(f) Each recipient is responsible for ensuring that every **SECRET: ADSO** document is entered in the appropriate security register. He must do this himself if no one else is available or authorised to do it - this applies particularly at Grade 7 level. A document may be entered in the security register by the Personal Secretary or allocated Clerk from the information shown on the label, without opening the envelope. If this is done, the number of the security register entry is to be written on the label. The recipient of the document is to ensure that the security register number is shown and should copy it onto the document itself. In some areas, Personal Secretaries or Clerks may themselves be included on the list authorised to hand the material. In such cases only may they open the inner envelopes, in which case the security register number may be written on the document itself.

(g) Each copy of a **SECRET: ADSO** document is personal to its recipient. It may not be shown to any person not on the list in any circumstances. It may

be shown (but not copied) to a person who is on the list only if there is a real operational need for him to see it. The fact that a person is on the list does not mean that he must see all **SECRET: ADSO** documents. It is the recipient's responsibility to ensure that the document is not seen by any person who is not authorised to have access to it. It can be kept in the recipient's own security cupboard only if all persons who are entitled to know the combination number have been specifically authorised to handle **SECRET: ADSO** documents. Otherwise it will be necessary to store such documents in a separate document box or security cupboard whose combination number is known only to the recipients (and any authorised handler of such material). Officials who require additional security furniture for this purpose should requisition it as soon as possible from EOG2 (Ext 4859).

(h) It is essential that **SECRET: ADSO** documents are not left unattended by the person who is responsible for their custody - he must lock them away whenever he leaves his room.

(i) **SECRET: ADSO** documents may on no account be photocopied except by the originator (or his Personal Secretary, on his authority, if she is on the **ADSO** list). If a person not on the original list of copy addressees is subsequently to be given a copy of such a document, it must be provided by the originator and the name of the recipient properly recorded. He may retain a small stock of additional numbered copies of the document for this purpose (which are to be treated as accountable documents). If he needs to take an additional copy of the document, it must be numbered in the original series. The above rules as to handling and control of the document apply to additional copies.

(j) **SECRET: ADSO** documents may be taken out of the office to meetings only if this is absolutely unavoidable. They may be taken home only if the Permanent Secretary has given his prior approval, either for a particular occasion or generally for a particular individual. Permission will normally be given only if the person concerned has a security container at his home. Any documents taken out of the office must be carried in a locked briefcase, box or pouch and kept securely at all times. A record of these documents must be kept in the office security register and checked on return.

(k) Where a person only needs to see a part of a **SECRET: ADSO** document, he should be sent a copy only of the relevant extract. The copy extract should be given a number in the same series as the full copies. It should be given the security classification, appropriate to the sensitivity of the matter contained in it - the security classification at the top of the front page should be amended in manuscript if necessary. The recipient of the extract should treat it in accordance with the security classification shown on the document.

(l) If a **SECRET: ADSO** document is to be destroyed it is to be sent to the **ADSO** Security Officer in double envelopes, the inner envelope bearing the appropriate label, and marked for destruction. The Security Officer will carry out the destruction in accordance with the standing instructions.

2. If a sensitive document meets the criteria for classification as **TOP SECRET** (as defined in Annex 1 of the Treasury Security Instructions) it should be classified "**TOP SECRET: ADSO**". The distinguishing folder and address labels for **SECRET: ADSO** documents are to be used mended accordingly in manuscript. The instructions of paragraph 17 are to be followed,

except where the normal security instructions for **TOP SECRET** documents impose more stringent requirements, in which case those should be obeyed.

Queries

3. Any questions about the **ADSO** Security Instructions should be addressed to the **ADSO** Security Officer, who is **Bob Evans** in Sir Peter Middleton's Office (extension 4360).

chex.jp/jg1/62 **SECRET AND PERSONAL**

6(a-e)
B

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

25 April 1990

Barry Potter Esq
10 Downing Street
LONDON
SW1A 2AA

Dear Barry

ERM : SPAIN

... I attach a note addressing the questions in your letter of 23 April.

It is difficult to draw lessons for the UK from the Spanish experience after joining the ERM. Sterling is a much more widely traded international currency than the peseta; and Spanish financial markets are still underdeveloped, and subject to exchange controls and credit controls.

However, the attached note shows that it is not the case that interest rates, inflation and monetary growth have all risen since Spain joined the ERM in June last year. In fact Spanish interest rates have remained at approximately the same level since then, as has the Spanish rate of inflation. Money supply growth has fallen sharply, though this may partly be a result of credit controls driving borrowing and lending transactions into forms not included in the measure of broad money that the Spanish authorities target.

Yours

JGI.

JOHN GIEVE
Principal Private Secretary

b

ERM Membership : Spain

There are some similarities between the UK's economic situation and that of Spain when the peseta joined the ERM in June 1989. Notably :

- the Spanish economy had been growing exceptionally fast
- there was a rising rate of inflation : 6.9% in May 1989, compared with an average of 4.8%.
- high interest rates. A three month rate of around 15% just before joining the ERM.

There are also some differences, notably a government budget deficit in Spain equivalent to around 3% of GDP in 1989.

2. The main reason, however, for expecting experience with the £ to be different from that with the peseta is the much wider international use of the £ and much greater sophistication of our financial markets. The peseta is little used as an international investment currency, and Spanish financial markets are somewhat antiquated, with some exchange controls remaining in force. As a result the Spanish authorities are able to operate a variety of direct credit controls.

3. The attached charts show what has happened to the exchange rate, interest rates, monetary growth, and inflation since the peseta joined the ERM. The main points are as follows :-

a) Exchange rate. The peseta rose immediately after entry, from 64.33 per DM on 16 June 1989 (the day before entry) to 63.20 - an initial rise of around 2%. Over the period since then the peseta has fallen against the DM and then more recently risen again, but remained above its central rate of 65 per DM. Capital flows into the peseta that might have been expected, given the interest

rate premium over the DM, have been limited by rigidities in Spanish peseta markets, and also by official restrictions.

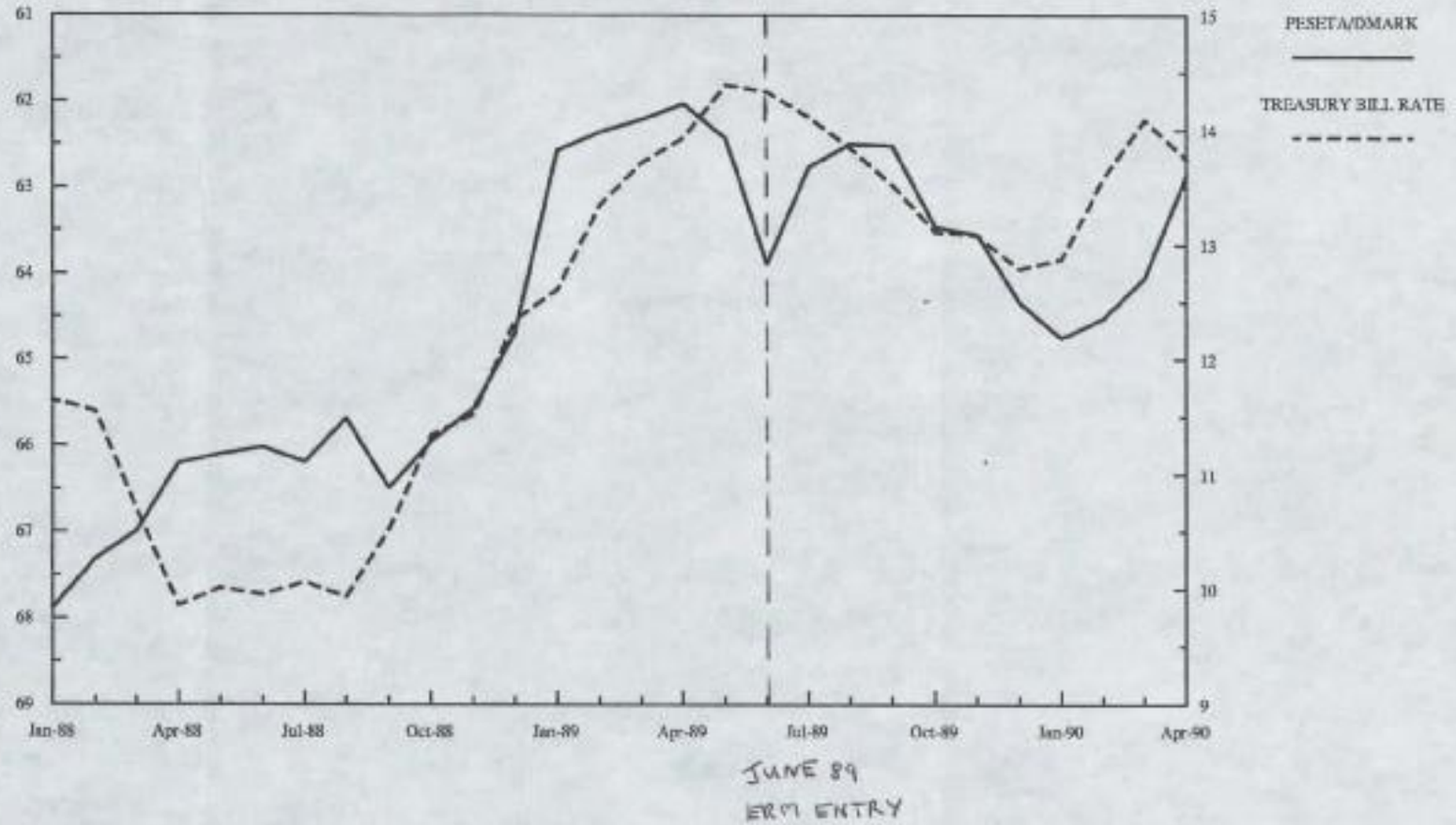
b) Interest rates. The initial rise in the peseta no doubt reflected the extra attraction of high peseta interest rates, once the perceived risk of devaluation was reduced by joining the ERM. This led immediately after joining to a significant fall in euro-peseta interest rates, but only a very slight fall in domestic interest rates, which was quickly reversed. (The difference between the two is the result of exchange controls). In July 1989 the official peseta interest rate was raised by ¾%, alongside some tightening of credit controls to try to reduce domestic monetary growth. Market interest rates now at much the same level as when Spain joined the ERM.

c) Monetary growth. The Spanish target a broad measure of money, rather like M4, called ALP. The target range for 1990 is 6½-9½%. Just before ERM entry, in Q2 1989, ALP was growing at an annual rate of 13¼%. The annualised rate of growth over the most recent three months (to February 1990) was 3½%. The Spanish authorities believe however that much of this very sharp slowing in monetary growth may be the result of credit controls acting to divert borrowing and lending into transactions that do not affect the measured money supply. Very recently these controls have been relaxed : in particular the compulsory reserve asset requirement has been reduced from 17% to 5%.

d) Inflation. The rate of inflation in Spain has changed little since joining the ERM. The annual rate remains around 7% - averaging 6.7% in the first three months of 1990, compared with 6.9% just before Spain joined the ERM.

SPAIN

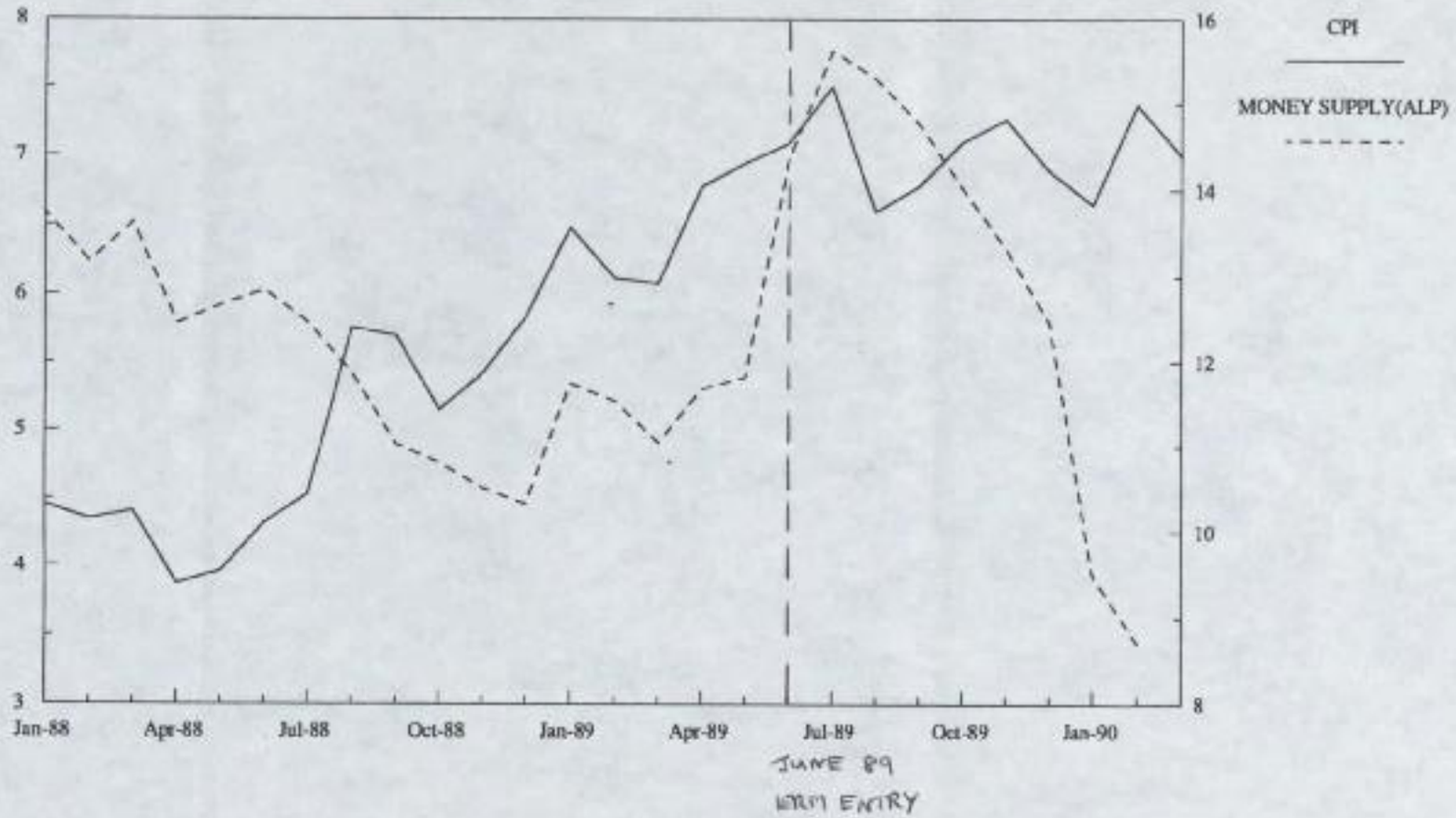
PESETA/DMARK EXCHANGE RATE AND TSY BILL RATE



9

SPAIN CPI AND MONEY SUPPLY(ALP)

% CHANGE ON A YEAR EARLIER



PRIME MINISTER

OBSTACLES TO A FREE MARKET IN FINANCIAL SERVICES IN THE EC

You asked me to look out two earlier papers on obstacles to a free market in financial services within the EC.

Not attached. Can I see attachment mt

I attach copies of the two papers which I think you have in mind. The first describes "hidden exchange controls" in Germany; the second, obstacles to a free market in financial services in general.

I have also spoken to Michael Scholar. He has re-read both papers and believes that they continue to represent the broad picture as known to the Treasury (although they were originally prepared before the Madrid Summit.)

He believes his earlier conclusion - that the measures in Germany could be defended as principally of a prudential and supervisory nature rather than hidden exchange controls - remains valid. The evidence is the similarity between internal German and Euro-deutschmark interest rates.

BHP

Germany has some restrictions on the issue of foreign currency bonds for purposes of monetary control. Why do we not have the same? mt

BARRY H. POTTER
25 April 1990
c:\economic\market (kk)

OBSTACLES TO A FREE MARKET IN FINANCIAL SERVICES IN EUROPE

The purpose of this note is to identify potentially removable obstacles to free competition in financial services in the European Community which are likely to remain once the main directives currently under discussion are implemented.

General issues

2. The "ideal" free market is one in which it is just as easy for a UK firm to sell its products (by local establishment or cross-border sale of services) in Milan or Athens as it is in Manchester. In practice of course a variety of cultural, linguistic and economic barriers will inevitability prevent achievement of this ideal and for the foreseeable future individual member states will insist on retaining controls on the way financial services are sold for consumer protection reasons.

3. We can classify obstacles to a free market into three broad types:

(i) Governmental: which in turn may be broken down into regulation, such as restrictions on overseas investment or the type of service which may be sold; and taxation, which may be used to discriminate in favour of domestic instruments;

(ii) Institutional or structural obstacles: which include restrictions on market access imposed by domestic producers through cartel arrangements, through cross shareholdings or through their dominance of distribution channels;

(iii) Cultural or consumer obstacles. Language differences are the most obvious barrier; but consumers may also have strong preferences for particular types of product and may be suspicious of unfamiliar products and companies. They may also prefer to buy from a company with a local office. National arrangements such as the nature, extent and financing arrangements of pension provision may also condition the demand for particular savings products. (These problems should be less severe in wholesale than in retail markets).

4. This list also provides us with a rough order of "tractability". Cultural obstacles are most intractable and there is almost certainly little to be done here. Regulation and taxation should certainly be on the agenda to the extent that they discriminate by country or currency. But we may well want to go further and say that regulatory arrangements which restrict freedom of services in ways which cannot be justified on consumer protection grounds should also receive attention even when there is no discrimination involved, because they fragment the European market. (We would presumably be more reticent about domestic tax arrangements.)

5. Institutional arrangements are a difficult grey area. For example, most European countries do not have "independent" channels for distributing financial products and this is a real obstacle to effective cross border marketing of financial services. (The UK by contrast not only has a significant sector giving independent financial advice, but requires such advisers to give best advice across available products which will in principle include products marketed into the UK from other Community countries.) However this may well be beyond the powers of the Commission, unless some restrictive practice on the part of the banks (or whatever) which dominate the distribution outlets can be proved.

6. For the sake of completeness we should note that even within an "ideal" single market a fourth kind of barrier would remain in the form of economic factors. There will always be costs attached to breaking into new markets (advertising, local establishment etc) or extending sales across a wider geographical area, even where costs of meeting local regulation are reduced to a minimum. Inherent economies of scale may also act as an effective barrier to entry.

Progress towards the single market

7. Annex 1 provides a brief summary of the progress being made in each main sector.

8. Freedom of capital movements (subject to a safeguard clause to protect monetary and exchange rate policies) has been agreed for eight of the largest member states from the middle of 1990 with the other four countries following at the end of 1992. But a variety of tax and regulatory distortions on capital flows are likely to remain (detail below).

9. Freedom of establishment (subject to local authorisation requirements) is guaranteed in principle by Article 52 of the Treaty of Rome, and this has been reinforced for banks and insurance companies by directives agreed in the 1970s

10. Freedom to provide cross border services on the basis of home country authorisation is closest to realisation for certain unit trusts. Insurance of large commercial non-life risks will follow in 1990 on the basis of a directive already adopted. Agreement is near on banking, and rather more distant for non-bank securities firms. Progress on life assurance and "mass risk" non-life insurance is expected to be very slow. It could be well into the next decade before significant advances are made.

11. In each case some form of European "passport" is offered but the host country retains control over the way the product is sold. In the case of UCITS the host country can impose its own (non-discriminatory) marketing rules. For credit institutions it can invoke a "public good" provision to apply local rules. Domestic conduct of business rules can be applied to investment services under the draft Directive. And in the case of insurance the directives now planned are geared towards the limited objective of removing host control of policy terms and conditions; harmonisation of conduct of business rules is beyond the horizon.

Obstacles to a free market

12. Against this background, the following are the most important areas where progress could be made towards greater openness in European financial markets.

(a) Removing regulations restricting the free movement of capital

13. EC member states which maintain formal exchange controls are generally taking steps to remove them in line with the Capital Liberalisation Directive. But disguised controls remain even in those countries such as Germany which profess to have established freedom of capital movements. Examples of such controls include:

* **restrictions on investment overseas by pension funds and life assurance companies**. Annexes 2 and 3 set out the available information. All countries supervise investments on prudential grounds, but some countries apply regulation of investment more strictly. Germany for example limits overseas investments by pension funds and insurance companies to 5 per cent of assets, and even these investments must be made through shares or investment trusts quoted on a German stock exchange. Liabilities in one currency must be matched by assets in the same currency. The UK imposes solvency requirements on insurance companies which allow considerable scope for overseas investment. (We do however require that 80% of sterling liabilities in the form of technical

reserves should be matched by sterling assets held in the UK.) We would stand to gain both in terms of fund management business and investment in UK companies if other countries' restrictions were relaxed. However, other countries could similarly gain if our restrictions were relaxed. UK consumers would gain in both cases.

* restrictions on investments made by other savings vehicles, trusts etc. In the UK the Trustee Investments Act which applies to certain trusts, friendly societies, charities and public sector funds prohibits investments overseas other than through UK quoted securities, and certain public sector debt. Examples from other countries are not immediately available but must be presumed to exist.

* restrictions on foreign currency borrowing It appears that Germany, which claims to have abolished all exchange controls, uses its Currency Act to prevent issues of foreign currency securities in Germany where both the issuer and the initial investor are resident in Germany. This is justified on monetary policy grounds.

14. The directive does however provide an escape clause. Article 4 states that the directive is "without prejudice to the right of Member States to take all requisite measures to prevent infringements of their laws and regulations inter alia in the field of taxation and prudential supervision of financial institutions.....". It is likely that many countries would argue that restrictions on overseas (or at least foreign currency) investment by savings institutions were necessary for prudential reasons. The borderline between something which is necessary in prudential terms and something which constitutes a hidden exchange control is very difficult to draw, as was found in the recently completed extension of the OECD Codes.

(a) Removing tax measures which discriminate in favour of domestic investments.

15. Such tax distortions are widespread: they include incentives to buy domestic securities (eg PEPs); preferential treatment for income from domestic bonds, deposits or dividends; and indirect taxation of securities purchases. Annex 4 gives details.

16. The Commission declared in its explanatory memorandum covering the Capital Liberalisation Directive that such tax distortions "should be eliminated" but "a pragmatic approach should be adopted with a view to adopting national tax schemes to the requirements".

(b) Real progress towards integration of insurance markets

17. The insurance sector stands out as an area where progress towards freedom of services has been particularly slow. Insurance markets are often highly regulated on the continent. In Germany, for example, the authorities lay down policy conditions, methods of calculating premium rates and, in the case of third party motor insurance, the premium rates themselves. It is illegal for German brokers to place insurance other than transport risks with insurers not authorised in Germany, and tax reliefs on life policy premiums are only available for policies with German companies. The market is dominated by a very small number of very large local firms, and general obstacles to share purchase mean that takeover is not a practical route into the market.

18. The non-life services directive marks a small step forward but allows countries to continue to impose tight regulation of "mass risk" insurance. Even if such regulation does not discriminate directly against foreign firms wishing to enter other markets, it has the effect of fragmenting the European market, reducing potential economies of scale, and pushing up entry costs. On life services, an area in which the UK industry is relatively sophisticated and developed, almost no progress has yet been made.

19. One example of current restrictions is the principle of "cumul" which allows a Member State to prevent an insurer from offering the same class of insurance both from an establishment in that state and by service provision from an establishment elsewhere. (This does not apply to the limited class of insurance covered by the first life and non-life services directive)

20. A further problem is that the present life directive bans "composite" insurers (which offer both life and non life insurance) from providing cross border insurance. This unnecessary restriction would harm UK interests as we are the only country in which composite insurers are common.

(c) Need to harmonise conduct of business arrangements

21. For a European passport to become effective, greater standardisation of marketing or conduct of business arrangements will be required, extending into mutual recognition of financial techniques. Countries are able to use conduct of business rules to favour products which are produced by their own firms and to disfavour those processed by foreign firms. This applies in all areas of financial services. In the case of mortgage credit for example it is currently illegal to conduct variable rate lending in Belgium. In the case of unit trusts compliance, local marketing rules may be designed with a bias towards local firms. (Could be expanded).

(d) Overcoming barriers to takeovers.

22. Although the thrust of the single market is to open markets to cross frontier business, in practice consumer preference and the need for local market knowledge will ensure that takeover of an established local firm is one of the most effective means of market entry. A reduction in barriers to takeovers will produce a freer market. The Commission are conducting an investigation of barriers to takeover at the request of the UK. The DTI have commissioned a parallel study. We expect that these will produce examples of barriers in other EC countries.

Conclusion

A number of areas have been identified where substantial further progress could be made towards a single market in financial services and towards integration of capital markets by full implementation of existing directives, by faster progress on directives under discussion and by bringing forward new proposals to extend current single market measures. These changes should bring benefits to UK firms, but we should recognise that pressure to reduce barriers in other countries will lead to some pressure to reduce our own, with scope for trade-offs and deals.

ANNEX 1

PROGRESS TOWARDS A SINGLE MARKET IN EACH SECTOR OF FINANCIAL SERVICES

CAPITAL LIBERALISATION

Capital Liberalisation Directive approved June 1988 requires removal of all exchange controls by end of June 1990 (end December 1992 for Spain, Portugal, Ireland and Greece). Precondition for cross border provision of investment services. Commission now investigating tax and regulatory obstacles to free movement of capital.

BANKING

Banks have freedom of establishment under 1977 Directive.

Second Banking Coordination Directive aims to provide European, "passport" for defined range of activities (including mortgage credit, and securities business done by banks) on basis of home state authorisation. Close to adoption. Associated directives on own funds and solvency ratios seek to harmonise standards of prudential supervision. Other draft directives under discussion deal with bank accounts and winding up of credit institutions.

MORTGAGE CREDIT

Draft Mortgage Credit Directive seeks to require mutual recognition of a limited range of "financial techniques" in housing finance market. Likely to be overtaken by Second Banking Directive.

CONSUMER CREDIT

Draft directive currently under discussion seeks to harmonise definitions of Annual Percentage Rate (APR) of charge for consumer credit.

LIFE INSURANCE

Life insurers have freedom of establishment in Europe under 1979 Directive, but all establishments must comply with host country authorisation requirements. First life services directive adopted by Commission in January 1989 seeks to provide freedom for cross border life insurance services for 'own initiative' insurance - where customer approaches the life office. Further directives are promised covering group and pensions business, and then individual life business. Progress expected to be slow.

NON LIFE INSURANCE

Non life insurers have freedom of establishment under 1973 directive, but all establishments must comply with host country authorisation requirements. First non life services directive adopted June 1988, to come into effect at end of June 1990. Provides nominal freedom of cross border services for all risks (except motor liability) but removes host country control of premium rates and policy terms only for large commercial risks. Further proposals to remove such controls on mass risks are due.

Directives have been adopted on legal expenses and credit and surety insurance (both adopted June 1987, with application by 1 July 1990). Further draft directives under discussion on accounts of insurance undertakings and winding up of insurance companies.

INVESTMENT SERVICES

Draft Investment Services Directive currently under discussion in Council Working Group. Aims to provide European passport based on home country authorisation for non-bank securities firms. Timetable uncertain.

UNIT TRUSTS

Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) adopted 1985, to come into effect October 1989. Establishes a European market for unit trust type instruments which meet prescribed conditions. Does not include "umbrella" funds, money funds etc, and allows host country marketing rules.

INVESTMENT TRUSTS

SECURITIES MARKETS

Community has already coordinated conditions for admissions of securities to stock exchange listing, listing particulars and publication of information by quoted companies. Further directives have been adopted by not yet implemented on listing particulars (adoption June 1987, implementation 1 January 1990); information on major shareholdings (adopted June 1988); and public offer prospectuses (common position December 1988). Draft proposals are under discussion on insider dealing (close to adoption) and takeover rules.

PENSIONS

There are no single market directives envisaged which address pensions directly. In most EC states employee pension contributions are paid direct to an insurance company under a group insurance scheme (rather than into a trust fund as in the UK). Hence pensions are being dealt with in the context of the proposed life services directives. Many German pensions are paid by companies on a pay-as-you-go basis.

ANNEX 2

RESTRICTIONS ON INVESTMENTS BY PENSION FUNDS

Belgium requires pension funds to invest a minimum of 15% of assets in Government Bonds, and prevents direct real estate investment outside Belgium.

Denmark permits investment of a small proportion of the assets of company pension funds abroad, provided that the liabilities are guaranteed.

France requires pension funds to have 50% of their assets invested in French Government loans at the end of each year. In addition, exchange controls prevent investment in real estate in other countries, including other member countries.

In the Netherlands the huge civil servants pension fund (ABP) is permitted to invest only 5% of its assets abroad.

Spain requires pension funds to be invested in Spanish securities.

West Germany bans investments by pensionkassen in foreign countries other than through quotations on a German Stock Exchange or through German investment trusts, in which German investments dominate. There is also a 5% limit to the total of investment abroad. No exception is made for investment in other member countries.

Sources: National Association of Pension Funds, Bank of England

ANNEX 3

RESTRICTIONS ON INVESTMENTS BY LIFE ASSURANCE COMPANIES

All EC countries (except the Netherlands) impose solvency requirements for life insurance companies which require liabilities to be covered by "prescribed" assets. Each country imposes a different definition of prescribed assets: these have the effect of limiting investments in different categories. The main features are:

* In Holland, insurance companies are required to provide a detailed account of assets and liabilities by currency to the insurance supervisor who can make recommendations. There are no regulations.

* Most countries require matching of assets with liabilities in the same currency. Exact matching is required in France and Germany (subject to permission of the insurance supervisor). Italy limits foreign currency assets to foreign currency liabilities. The UK requires that 80% of a liability in any currency (including sterling) should be matched by assets in that currency.

* All countries apart from the UK impose maximum or minimum limits on investments in different categories. For example in Belgium foreign transferable assets are limited to 25% of the total. Minimum investments in government stocks are prescribed in Belgium (15%) Greece (15%) and France (34%). Maximum investments in equities are laid down in all countries except the UK, France and Holland: Limits are 20% in Germany 15% in Italy and 25% in Belgium.

* All countries including the UK impose limits on individual investments. For example in the UK an investment in a listed company must not exceed 2½% of relevant assets. In Belgium, Germany, France and Italy

a shareholding must not exceed 5% of the capital of that company.

* In France, Belgium and Italy there are requirements to notify the authorities of (and in some cases seek approval for) disposal of assets.

Source: Committee European des Assurances Life Assurance Committee paper "Study on Choice of Investments" 1985

ANNEX 4

EXAMPLES OF TAX MEASURES WHICH DISTORT CAPITAL MOVEMENTS

Belgium Offers tax relief on pension plan contributions where at most 10% of the funds can be invested in foreign companies and these must be quoted on the Belgian Stock Exchange. Half the value of investments in new shares issued by "innovative companies established in Belgium" may be set against income tax. Employees receive tax relief for investing in the shares of their own company. Income from investments in Belgium bonds is free of tax up to a certain ceiling.

France The "Loi Monory" of 1978 allowed investments in shares of French companies (not proceeds of sales) to be set against income tax. (Now being gradually phased out). Retirement savings plans receive tax advantages when at least 75% of the money is invested in French companies. Income from public and private sector French bonds and dividends from French companies is free of tax up to a certain ceiling. Interest on deposits in certain savings accounts (received by residents or non residents) is tax free. Very roughly a half of french savings are untaxed, and the rest are taxed at penal rates.

Ireland Offers relief from income tax for purchase of shares in Irish manufacturing companies under a Business Expansion Scheme. Employees receive relief for purchase of new shares in their employing company.

Luxembourg Interest on domestic savings amount is exempt from tax up to a certain ceiling.

Netherlands Dividends on shares in Dutch companies are free of tax up to a certain ceiling.

Spain Grants tax credits equal to 10% of the value of investments in certain companies listed on the Spanish stock exchange.

UK Provides relief from income tax for investments through the Business Expansion Scheme in unquoted UK companies. Investments in Personal Equity Plans attract tax relief on dividends and capital gains up to defined limits. Investment must be made in UK quoted companies or UK authorised Unit Trusts holding at least 75% of their assets in UK securities. Tax reliefs are available for savings for retirement certain forms of which are subject to investment restrictions : appropriate personal pensions must be invested in..... and contracted out money purchase schemes cannot invest in ..... Income from National Savings Certificates deposits with National Savings Bank (up to £70 pa) and SAYE savings are tax free. Mortgage interest tax relief is only available for loans from financial institutions established in the UK.

Source: European Commission "National Tax Measures liable to introduce distortions in capital movements within the Community" January 1988, updated for UK only.

pso.jt/Evans/4.24.4.90

RESTRICTED

HM Treasury

Parliament Street
London SW1P 3AG
Telephone 01 270
4360

Sir Peter Middleton GCB
Permanent Secretary

Mr Tarnbull

B Potter Esq
10 Downing Street
LONDON
SW1

25 April 1990

Dear Barry,

ERM: SECURITY INSTRUCTIONS

I attach a copy of a minute which I have circulated within the Treasury instituting a special handling system for papers concerning the timing and terms of entry of the UK into the Exchange Rate Mechanism of the European Monetary System. As you will see these are closely modelled on the arrangements for BLO material and are covered by the codeword "ADSO".

I should be grateful if you would ensure that material which comes to No 10 bearing the ADSO caveat is accorded the appropriate level of protection and that matters concerning ERM entry are only discussed with individuals whose name appears on the attached access list.

Yours sincerely,

Bob Evans.

R J EVANS
Private Secretary

RESTRICTED

pso.jt/Evans/2.24.4.90

FROM: R J EVANS
DATE: 24 April 1990
EXT: 4360

SEE ATTACHED LIST

ERM: SECURITY INSTRUCTIONS

Decisions on the timing, and the terms of entry into the Exchange Rate Mechanism of the European Monetary System will be extremely market sensitive. For this reason, Sir Peter Middleton has decided to introduce a restricted handling system for papers which include discussion of either of these issues. This is the ADSO system.

2. All papers which discuss dates, terms of entry, including the width of ERM bands and the exchange rate at entry into the ERM and the administrative arrangements for entry will need to bear the security classification "SECRET: ADSO". They should only be circulated between individuals on the attached access list. The very existence of the list and the fact that details of ERM entry are under active consideration must under no circumstances be divulged to anyone not on the list.

3. In order to simplify arrangements the handling instructions for ADSO material have been modelled as closely as possible on those for Budget List Only documents. The attached handling instructions at Annex B are a reduced version of the Budget Security Instructions. Papers should circulate in modified BLO folders, a stock of which is held in Sir Peter Middleton's office. They should be kept separate from other material and Mr Rees in

EOG will be able to provide security boxes for those who require them.

4. These arrangements are the minimum necessary to ensure that market sensitive information is suitably protected and we have tried to make them as simple and unbureaucratic as possible. Any queries over the operation of the list system should be addressed to me in the first instance.

R J Evans.

R J EVANS
Private Secretary

pso.jt/Evans/6.20.4.90

ANNEX A

ADSO - ACCESS LIST

1. **Ministers**

Chancellor
Chief Secretary

2. **Senior Officials**

Sir Peter Middleton
Sir Terence Burns
Mr N Wicks
Mr M Scholar
Mr H P Evans
Mr J Odling-Smee

3. **Private Offices**

Mr J Gieve
Mr T Tarkowski
Mr R J Evans
Ms C Evans
Mr A R Lyons
Mr N Davis
Mrs P Spragg
Miss J Todd
Mr J Coker
Mrs M Henson
Mrs J Henser
Mrs V Brown
Mrs D Crane
Mrs E Davies
Mrs J Fane

4. **MG**

Mr D Peretz
Miss E Engledow (Secretary)
Mr P McIntyre
Mrs P Hubbard (Secretary)
Mr J Grice
Mrs J Wright (Secretary)

5. **Other Treasury**

Mr P N Sedgwick
Mrs E Hollyer (Secretary)
Ms J Barber
Miss T Spencer (Secretary)
Mr C Riley
Miss P Collins (Secretary)

6. **Bank of England**

Governor
Deputy Governor
Mr P Tucker (PS to Governor)
Mr C Briault (PS to Deputy Governor)

7. **Other Whitehall**

Attorney General
Miss J Wheldon (Legal Secretary)
Mr A Turnbull (No 10)
Mr B Potter (No 10)
Mr C Powell (No 10)
Mr M Blythe (Treasury Solicitor's Dept)

ANNEX B

PREPARATION AND HANDLING OF SECRET: ADSO LIST ONLY DOCUMENTS

In addition to the normal security instructions regarding handling of **SECRET** documents, the following special instructions apply to the handling of **SECRET: ADSO LIST ONLY** documents:

(a) Documents may be typed by a Personal Secretary only if she is on the **ADSO** List. The typist's initials should appear on each page of the document. The originator is responsible for the security of the typed master, which must be given a number in the sequential series used for copies.

(b) All pages of the document should bear the marking: "**SECRET: ADSO**". Only one side of the paper should be used. Each copy of the document must be sequentially numbered, eg. copy No 3 of 5 Copies. A full record of copy numbers and recipients must be kept in the sender's security register.

(c) The documents must always be enclosed in the special distinguishing folder marked **SECRET: ADSO** for transmission. They must always be transmitted in double envelopes even if sent within the building. The inner envelope must bear a label marked **SECRET: ADSO** completed with the relevant details mentioned in paragraph (d) below. If more than one document is sent in one envelope, the reference number (see (d) below) of each document must be shown on the label. A receipt must always be obtained for all copies of "**SECRET: ADSO**" documents. It is the responsibility of the originator to ensure that a receipt is returned for each coy which has been sent out. These receipts must be retained.

(d) Titles of **SECRET: ADSO** documents are not to be shown on receipt forms (which are unclassified) or

on **SECRET: ADSO** labels. Instead the "reference no" or "title" section of the receipt form or label should show: the sender's security register and the copy no. eg. MCS/28/3.

(e) If they are being sent to other departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents should be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. In no circumstances may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2) and the Bank of England.

(f) Each recipient is responsible for ensuring that every **SECRET: ADSO** document is entered in the appropriate security register. He must do this himself if no one else is available or authorised to do it - this applies particularly at Grade 7 level. A document may be entered in the security register by the Personal Secretary or allocated Clerk from the information shown on the label, without opening the envelope. If this is done, the number of the security register entry is to be written on the label. The recipient of the document is to ensure that the security register number is shown and should copy it onto the document itself. In some areas, Personal Secretaries or Clerks may themselves be included on the list authorised to hand the material. In such cases only may they open the inner envelopes, in which case the security register number may be written on the document itself.

(g) Each copy of a **SECRET: ADSO** document is personal to its recipient. It may not be shown to any person not on the list in any circumstances. It may

be shown (but not copied) to a person who is on the list only if there is a real operational need for him to see it. The fact that a person is on the list does not mean that he must see all **SECRET: ADSO** documents. It is the recipient's responsibility to ensure that the document is not seen by any person who is not authorised to have access to it. It can be kept in the recipient's own security cupboard only if all persons who are entitled to know the combination number have been specifically authorised to handle **SECRET: ADSO** documents. Otherwise it will be necessary to store such documents in a separate document box or security cupboard whose combination number is known only to the recipients (and any authorised handler of such material). Officials who require additional security furniture for this purpose should requisition it as soon as possible from EOG2 (Ext 4859).

(h) It is essential that **SECRET: ADSO** documents are not left unattended by the person who is responsible for their custody - he must lock them away whenever he leaves his room.

(i) **SECRET: ADSO** documents may on no account be photocopied except by the originator (or his Personal Secretary, on his authority, if she is on the **ADSO** list). If a person not on the original list of copy addressees is subsequently to be given a copy of such a document, it must be provided by the originator and the name of the recipient properly recorded. He may retain a small stock of additional numbered copies of the document for this purpose (which are to be treated as accountable documents). If he needs to take an additional copy of the document, it must be numbered in the original series. The above rules as to handling and control of the document apply to additional copies.

(j) **SECRET: ADSO** documents may be taken out of the office to meetings only if this is absolutely unavoidable. They may be taken home only if the Permanent Secretary has given his prior approval, either for a particular occasion or generally for a particular individual. Permission will normally be given only if the person concerned has a security container at his home. Any documents taken out of the office must be carried in a locked briefcase, box or pouch and kept securely at all times. A record of these documents must be kept in the office security register and checked on return.

(k) Where a person only needs to see a part of a **SECRET: ADSO** document, he should be sent a copy only of the relevant extract. The copy extract should be given a number in the same series as the full copies. It should be given the security classification, appropriate to the sensitivity of the matter contained in it - the security classification at the top of the front page should be amended in manuscript if necessary. The recipient of the extract should treat it in accordance with the security classification shown on the document.

(l) If a **SECRET: ADSO** document is to be destroyed it is to be sent to the **ADSO** Security Officer in double envelopes, the inner envelope bearing the appropriate label, and marked for destruction. The Security Officer will carry out the destruction in accordance with the standing instructions.

2. If a sensitive document meets the criteria for classification as **TOP SECRET** (as defined in Annex 1 of the Treasury Security Instructions) it should be classified "**TOP SECRET: ADSO**". The distinguishing folder and address labels for **SECRET: ADSO** documents are to be used mended accordingly in manuscript. The instructions of paragraph 17 are to be followed,

except where the normal security instructions for **TOP SECRET** documents impose more stringent requirements, in which case those should be obeyed.

Queries

3. Any questions about the **ADSO** Security Instructions should be addressed to the **ADSO** Security Officer, who is **Bob Evans** in Sir Peter Middleton's Office (extension 4360).

Sir M. Butler
8/5

DAS
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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

23 April 1990

EMU

I enclose a copy of a letter to the Prime Minister from Sir Michael Butler following up their meeting on 20 April. I should be grateful for advice on the points he makes and a draft reply.

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

C. D. POWELL

John Gieve, Esq.
HM Treasury

SECRET AND PERSONAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 April 1990

Dear John,

ERM

In the margins of a meeting on other matters, the Prime Minister has commented that, following entry into the Exchange Rate Mechanism, interest rates in Spain have risen, the money supply growth increased and their inflation remained on an upward trend.

The Prime Minister would be grateful for a note from the Treasury on what has happened in Spain and what lessons can be drawn from the Spanish experience.

I would be grateful if you could confine circulation of this letter to those with a strict need to know.

Yours ever,

Barry

Barry H. Potter

John Gieve, Esq.,
H.M. Treasury.

SECRET AND PERSONAL

(2)

HAMBROS BANK LIMITED

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

23rd April, 1990

The Rt. Hon. Mrs. Margaret Thatcher,
Prime Minister,
10, Downing Street,
London, S.W.1.

Prime Minister
Michael Butler, further thoughts.
CDP 23/4.

Dear Prime Minister,

E.M.U.

I have been thinking about our conversation on Friday all the weekend and I would be most grateful if you would consider a few thoughts arising out of it. The handling of this issue over the next few months is going to have major consequences for the future of the City, our influence in Europe in the 1990s and the outcome of the next election. I am convinced that you will be able to work out a line that you can sell in Parliament and which will enable you to get your way in the European Council. But I am afraid you are not there yet.

2. Economic and monetary union can cover quite a wide range of structures, ranging from federations like Switzerland (where the cantons nevertheless still have quite a lot of autonomy) to something much less centralized. Your E.C. colleagues, with their tendency to call things by grander names than they warrant, will be happy to call a structure with minimal centralization "EMU". You have already largely won the battle over control of fiscal and macro-economic policy. But you cannot hope to sell them a definition of monetary union which does not include as its aim either permanently fixed parities or a single currency. To all of them this is what EMU has always meant. Permanently fixed parities does not necessarily imply centralization of economic decision-taking. Parities were fixed under the gold and gold exchange standards.

3. The advocates of a single currency see two advantages in it over permanently fixed exchange rates. First, there is is always a risk that such rates would not stay fixed. Second, there would be big savings on transaction costs. But I fully understand why you have political difficulties with the single currency idea. I see no reason why you should not continue to say that the British people will wish to retain the pound sterling. But I do not believe that, in the present state of opinion on the Continent, you will able to get your way and gain acceptance for an evolutionary Stage 2 without agreeing that in the last stage of EMU there will either be permanently fixed parities or a

/single

single currency. It ought to be possible to get it agreed that:-

(a) no move beyond Stage 2 can take place without a positive vote by national Parliaments as well as unanimity in the European Council; and

(b) the earliest time when a choice would need to be made between permanently fixed parities and a single currency will be at the end of Stage 2 (the hard ecu could continue alongside national currencies after the parities had been permanently fixed).

4. An evolutionary Stage 2 will probably last a long time. The Greeks, Italians, Spaniards, Portuguese and Irish will be unwilling to renounce the possibility of devaluation without agreement by the net contributors to massive resource transfers. The French and Germans will be as determined as we are to resist massive resource transfers. It will also probably take quite a few years of co-operation in the E.M.F. before monetary co-ordination really works well. But you will be suspected of delaying tactics if you stress how far away permanently fixed parities will be. Much the best line will be that the length of Stage 2 will depend partly on how well it works and partly on when all member States are ready permanently to renounce the possibility of devaluation.

5. You retain doubts about resisting speculative attacks in Stage 2 with fixed, but not permanently fixed, parities - still more about permanently fixed parities. You are right to question this. But please consider carefully the twin ideas in the paper I sent you of hard, freely convertible ecus and the self-cancelling creation of them (i.e. each ecu created in exchange for national currency means that much less national currency). This will improve the chances of resisting speculative attacks. (I am working on a short paper on this point with one or two examples which I hope to send to you later this week).

6. The hard ecu has the other advantages I mentioned:-

(a) its use would be counter-inflationary which the existing ecu would not;

(b) it would therefore meet the Bundesbank's objections to using the ecu rather than the D. Mark as the E.C.'s fledgeling currency;

(c) it would be a genuinely new and important proposal and therefore avoid accusations that, in proposing a European Monetary Fund, we are simply returning to an earlier French idea which they now consider out of date.

/7.

HAMBROS

7. To sum up, I wonder whether you could not take the line in Parliament that:-

(a) you accept that the "progressive realization of EMU" (Bremen and Madrid conclusions) has a lot of steam behind it and have no doubt that Britain will have much to contribute to the discussion about how to achieve it;

(b) you have throughout made it clear that Britain is determined to ensure that progress towards EMU does not centralize control over fiscal and macro-economic policy and you will continue to insist on this;

(c) the final stage of EMU will involve permanently fixed parities one day, but of course not before all member States have agreed to renounce devaluation for ever;

(d) in any case any great leap forward from Stage 1 to Stage 3 would risk failure and bringing EMU into disrepute and could cause serious shocks to the system; the British Government have therefore devised an original and coherent plan for Stage 2 as a contribution to the debate (describe hard ecu proposal, etc.) and in order to remove the risk of a premature move to Stage 3;

(e) if this plan is accepted, it will be for the markets to decide how much use to make of the ecu but you confidently predict a long life for the pound.

8. I do hope you find these thoughts helpful. I know that they will raise other questions in your mind, but my letter would be far too long if I tried to answer them in advance. Naturally I am at your service if you want me to try to do so.

Yours ever
Michael

Sir Michael Butler

MDB/MML

HAMBROS

CONFIDENTIAL

Meeting Regs
cc Master

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 April 1990

Dear John,

ECONOMIC AND MONETARY UNION

The Prime Minister had a talk this morning with Sir Michael Butler about his paper on the Second Stage of EMU.

Sir Michael Butler said the City's concern was that the United Kingdom should remain the centre of monetary developments in Europe. They were nervous about the possibility that the other EC Member States might forge ahead without us if we did not subscribe to the aim of EMU. The general assumption in the City was that the EC would inexorably move ahead to full EMU, and there was a surprising (to him) lack of concern at the prospect of a common currency.

Sir Michael Butler continued that he thought the Prime Minister was right to want to retain a sensible element of national control over national policies. The proposals in his paper would give the UK a position in further discussion of EMU which other Member States would regard as credible. The Delors group had left a gap after Stage 1 of EMU. The idea of jumping straight from Stage 1 to Stage 3 was just rhetoric and not practicable. He therefore strongly recommended that the Government should put forward a proposal for an enlarged and strengthened Stage 2. A carefully orchestrated campaign would be required to promote the proposal. This would be more effective if in the meantime the United Kingdom were to join the ERM.

The Prime Minister said that we were very grateful for the work which had gone into the paper. The Treasury had been working in parallel on proposals which were not dissimilar. We had a number of technical difficulties with the Sir Michael's paper. The Germans did not like the concept of a parallel currency.

Sir Michael Butler said that the most important element in the paper was the proposal for a hard écu, which could never depreciate. This would be taken as evidence of the seriousness of our commitment to beat inflation. The Prime Minister asked whether the same effect could not be achieved by linkage to the DM. Sir Michael said that there was no guarantee that the DM would always be the strongest currency. He had discussed with

CONFIDENTIAL

Sir Alan Walters, who had agreed that they would be seen as a strongly, counter-inflationary. Moreover the hard écu was the only really new feature in the paper. Other aspects of it resembled the proposals which the French Government had already put forward to the Delors group. Without the new element, it would simply be seen as backtracking. He was aware that the Bundesbank had always been against the écu because they regarded it as a mediocre currency, but the proposal for a hard écu cut the ground from under their feet. Moreover, the Commission and the French would prefer a hard écu to the DM. He was very ready to discuss the proposals further with the Treasury and the Bank of England.

The Prime Minister accepted that our paper on competing currencies had not commanded much support in the Community, and that we needed to put forward further proposals. Our own thinking was in a generally similar direction to that in Sir Michael's paper. But she did not want our proposal to appear to relate to Stage 2 of Delors alone. It would go considerably further and represented the most which she could envisage for the time being. It should be described as the "next stage" rather than Stage 2. She could not accept a commitment to full EMU as defined in the Delors report. Parliament had already rejected this.

Sir Michael Butler said he had started from the same position as the Prime Minister when he had embarked on the paper. But after talking to many people in Europe, he had concluded that the only way for the United Kingdom to remain in the game was to accept the goal of permanently fixed parities or a single currency. It would be impossible to get away without having at least the aim of full EMU incorporated in any agreement, although it might not be necessary to give any detailed definition of it. It ought not to be too difficult for us to subscribe to a long term aim. We should not give the impression that our own proposal was the last word.

The Prime Minister said she was not proposing to do so: our proposal would be presented as the next stage. But we could not pour ourselves into the Delors mould, which had already been rejected by Parliament. Sir Michael Butler said that he had to advise the Prime Minister that it would be impossible to get away without stating the ultimate aim of permanently fixed currencies. We ought to be able to write into the Treaty that the Community could only move from one stage of EMU to another by unanimity. How and when to go beyond the next stage could be left vague. The Prime Minister said firmly that there was no need to take a decision on the final goal or on a single currency at this stage. We did not know what the Community would be like in ten years time.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and to Sonia Phippard (Cabinet Office).

Yours sincerely,

Charles Powell

John Gieve Esq
HM Treasury.

PRIME MINISTER

MEETING WITH SIR MICHAEL BUTLER

Sir Michael Butler is coming in to see you tomorrow morning for a brief word about his paper on EMU. His purpose is to persuade you to adopt something like the proposal in his paper for the second stage of EMU, either in a speech or a letter to your fellow Heads of Government.

You did, of course, discuss this with the Chancellor of the Exchequer and others yesterday. You accepted the need to put forward a new proposal which would include an institution, and thus satisfy the demand elsewhere in the Community for treaty amendment. To that extent, we were already committed to doing what Michael Butler suggests. You asked for an appraisal of the differences between the Butler proposal for Stage 2 and the proposal in the Treasury paper. It may be possible to combine elements from both of them.

The key judgement is whether our proposal would secure the support of the other Eleven. The clear implication of Michael Butler's note is that if you did put forward a substantive proposal for Stage 2, then we have a chance of postponing Stage 3 to the Greek Kalends. The view taken by the Chancellor, however, was that other Member States might be attracted by our ideas for Stage 2, but would still demand a commitment to the objective of full economic and monetary union as defined in Stage 3 of the Delors plan, and insist that this be embodied in any treaty amendment. That would not be acceptable to you.

Single Currency

So the two questions you might put to Michael Butler are:

- How can we best ensure that our proposal for Stage 2 is accepted by the others as all that it is necessary for the community to agree upon for now (subsuming Stages 2 and 3 of Delors), without any commitment to full EMU?

- If they still insist on commitment to full EMU, is there any procedural device which would enable them to sign up to this goal, but would not commit us to it?

CDP

CDP

19 April 1990

jd c:butler

chex.jp/ttl/8 **CONFIDENTIAL**

(2)

Prime Minister

Some belated advice for your meeting with Sir Richard Butler tomorrow. Paras. 8-11 of the accompanying note spell out objections to his version of a European Monetary Fund.

CDP 19/4

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

19 April 1990

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Charles,

SIR MICHAEL BUTLER'S PAPER ON EMU

I understand that, following her letter of 11 April, Sir M Butler is coming to see the Prime Minister tomorrow about the paper by Mr Paul Richards which he sent her on 28 March, with the blessing of his BIEC (Europe) Committee.

As you know, the Treasury's view is that the approach set out in paragraphs 2.34-2.42 of Nigel Wicks' Interdepartmental Group's report is preferable to the Richards approach, though they have some similarities, and the Richards proposals are certainly worth considering further.

... I attach a critique of the Richards proposals, prepared by officials here, which points up some of the technical difficulties which would need to be addressed, which the Prime Minister may find interesting. It also argues that although many of the conclusions of the Richards paper are similar it goes further towards setting up a fully fledged central bank - albeit fettered - than the more neutral proposal for a Currency Board in the interdepartmental Report.

The paper goes on to suggest that the Germans might have some difficulty with an EMF along the lines proposed by the Richards paper. While it is true that the Germans will see difficulties with the proposal for a parallel currency, there are other aspects - eg the "strong ecu" - which they could find attractive.

Sir Michael Butler may well not want to get involved in discussion of the details. It is more likely that he will want to discuss the politics of the situation, and the need to be seen to take a constructive part in Community discussions. We suggest the Prime Minister takes the following line in discussion :

(i) Thank Sir Michael Butler and Mr Richards for their constructive and imaginative contribution to the debate. This is well worth considering further, and it will be interesting to see what our Community partners make of it.

(ii) Explain our reasons for believing that the approach must be an evolutionary one.

(iii) Acknowledge that more thought will be needed on the practical meaning of an evolutionary approach beyond Stage one, and what institutional developments might be compatible with it.

(iv) Recognise that the Richards approach has some attractions compared with the Delors proposals, though clearly there are technical difficulties which would need to be addressed.

(v) Point out that the Germans may not be attracted to some aspects of the idea.

(vi) Encourage Sir Michael and his group to continue to think about these issues.

Tarcwed Tarkowski

T TARKOWSKI
Private Secretary

The next stage in an evolutionary approach to Monetary Union

The main author of this paper is Mr Paul Richards of Samuel Montagu. It has been adopted by Sir Michael Butler's BIEC (Europe) Committee. We understand that there has been some confusion in Brussels about its status. At his recent presentation on EMU to the Central Bank Governors' Committee, Delors referred to it as a "second" British paper, with some interesting ideas.

Summary of the Main Points

2. The paper is based on the assumption that the UK aim should be for a revision to the Treaty allowing Stage 2 to commence but one consistent with the UK objectives of competition, subsidiarity and price stability. Going as far as that, the paper argues, implies setting up a Community institution with decision-taking powers of some kind. So the question is what institutional structure would best achieve the UK objectives. Its answer is along the following lines:

(a) the Stage 2 European System of Central Banks would consist of existing national central banks and a new European Monetary Fund (EMF). The former would administer existing national currencies straightforwardly;

(b) the EMF would take responsibility for a completely redefined ecu, which would become an entirely separate "dual" European currency. It would also take over the administration of the EMS and would provide a permanent secretariat to service the ERM, the European Monetary Co-operation Fund, the Committee of Central Bank Governors and its various sub-committees, and so on;

(c) although the EMF would be the monetary authority for a quite separate currency, its actions would be fettered. In particular: (i) it could only issue its ecu money in exchange for European national currencies at the going exchange rate so that there would be no addition to total European money to cause extra inflationary pressure; (ii) the EMF would be bound to ensure that its ecu was at least as strong as any other European national currency. In practice, that would mean it could revalue against other Community currencies but that it could never be devalued against any other European currency. In this sense, the newly-defined ecu would set "the standard for the best" rather than being a measure of the average European currency, as at present. Richards hopes this would meet the usual German objection to parallel currencies;

(d) the EMF would have to conduct the normal range of central banking functions to implement what was required of it: setting interest rates, conducting open-market operations, engaging in intervention;

(e) there would be no compulsion to use the ecu. Individuals and companies would be free to choose national currencies or the ecu as they saw fit. The element of currency competition in the original UK paper would therefore be maintained;

(f) it would be for separate decision whether to proceed to Stage 3 later on. But in the light of experience of Stage 2, Community members might decide not to progress to this later Stage at all.

Appraisal

3. The paper represents a well thought out and coherent set of proposals. At the least, they provide a further illustration of our point that there are a number of possible approaches to monetary union and that Delors is not the only way open. There are some similarities with the proposals for Stage 2 in the recent

report of the Interdepartmental Group, but also a crucial difference.

4. Like the Richards paper, the Interdepartmental Group Report argues that there may be a case for supporting interim institutional developments in Stage 2. It illustrates the possible functioning of a new institution with the working title of a European Monetary Fund (confusingly, as it happens, the same title that Richards calls his new institution). The functions of the Interdepartmental Group Report EMF would be :

i) to run a range of administrative functions currently performed by the Commission and others - managing the ERM amongst them;

ii) to co-ordinate intervention against third currencies (without pooling of Reserves);

iii) creating and running a Currency Board to issue ecu bank notes for general circulation.

5. Neither of these first two functions are greatly in tension with Richards' proposals. The Interdepartmental Group Report EMF would have a slightly wider range of administrative functions than Richards suggests. In particular, it would manage and monitor Community financing decisions, including recommending conditions for Community loans to member states (a function largely carried out by the Commission at present). Moreover, Richards' EMF would be restricted to conducting intervention in the newly-defined ecu rather than co-ordination national intervention against third currencies. But extending the role of the EMF in both of these directions would not change fundamentally the nature of Richards' proposal.

6. The key difference is in the monetary policy competence of the two versions of the EMF. Both proposals take as given that a full-blown parallel currency - a new ecu managed by an independent ecu central bank - is probably undesirable and certainly unacceptable to most Community members. The Interdepartmental

Group Report proposal limits the new institution only to currency board activities for just this reason. It could issue ecu notes but only ones fully backed by EMF holdings of the composite national currencies which make up the ecu. That would allow an ecu note circulation to come into being but in a way guaranteed to be monetarily neutral.

7. The Richards proposal would not incorporate this direct monetary neutrality. His EMF would have freedom to manage its currency, subject to the requirement that its currency had to be at least as strong as the strongest Community currency.

8. In this respect, it is therefore misleading to suggest that the Richards proposals represent an evolutionary approach to monetary union. In one step, the foreign exchange markets would be presented with an entirely new currency embodying the unique property of never depreciating (at least against other European currencies): only appreciating. Although Richards may be right to see only gradual movement away from national currencies to the new currency for transactions purposes, speculative movements in funds would be most unlikely to be gradual. There would probably be enormous swings into and out of the national currencies as investors weighed up the interest rate differentials together with the new currency's guaranteed non-depreciation. One-way bets in currency markets generally do not produce stable trading conditions and the new currency would have this feature built-in.

9. These doubts relate to a further set of uncertainties as to how precisely the Richards EMF would control its currency. He supposes that it would use the usual central bank techniques of setting short term interest rates, conducting open market operations in longer term debt and intervening against other currencies. There are potential difficulties in all these areas:

(a) to start with at least, there would be few assets denominated in the newly-defined ecu currency with which the EMF could conduct open market operations. There are some ecu-denominated assets on the existing definition but this would be irrelevant for Richards' purpose;

(b) the intervention that the EMF would have to carry out could be enormous, if the speculative flows turned out to be on the scale suggested in the previous paragraph. The EMF would be entirely mismatched by currency. Its liabilities would be the can-only-appreciate ecus, whilst its assets would be the depreciating currencies people had bought the ecus with in the first place. Interest rate differentials would compensate to some extent, but the potential losses (or gains) to which the EMF shareholders - the national central banks - would be subject would be large;

(c) the EMF could find that its interest weapon had to be used primarily to control short term capital flows into or out of its currency. That might prevent it from using rates to control longer term expansion of the ecu money supply to the growth rates needed to ensure the ecu remained appropriately strong. The EMF would need to make the same judgements in setting interest rates as any other monetary authorities. Like other monetary authorities, it would no doubt make mistakes from time to time.

10. It is, of course, possible that in practice the scheme might work. The problem is that it is such a leap in the dark that we just do not know. With such a degree of uncertainty on such a critical matter as monetary policy, it does not seem very likely that the Richards scheme would overcome German opposition towards parallel currencies, nor perhaps desirable that it should.

11. Indeed, German worries would probably be particularly pronounced on at least two scores:

(a) generally, the scheme would involve a substantial surrender of monetary sovereignty - much greater than the more limited proposal for an ecu Currency Board, made in the Interdepartmental Group's Report.

(b) more specifically, at least in the short term, the most likely outcome would be the newly defined ecu becoming a

pseudo-deutschemark. It would be the deutschemark which was the strongest currency against which the new ecu would be fixed. It is most unlikely that the Germans would tolerate a currency looking to all intents and purposes just like the mark but outside the Bundesbank's control.

Summary

12. The Richards paper contains a coherent proposal for progress to monetary union which differs from Delors'. Some of the functions which Richards proposed European Monetary Fund would carry out - administrative functions, in particular - cause few difficulties. It addresses the question of giving more institutional content to Stage 2 of EMU, and reaches somewhat similar conclusions to those in the Interdepartmental Group Report, with one key difference. The Interdepartmental Group Report proposes creation of ecu Currency Board arrangements for issuing ecu bank notes in a neutral way that should have no impact on the operation of domestic monetary policy. The Richards Report on the other hand involves the creation of a fully-fledged, albeit fettered, European central bank with the ecu as a fully independent separate currency. It is in this area that the Richards proposals are most likely to run into heavy opposition, particularly from the Germans; and, indeed, where their wisdom is most open to question.

Meeting Record
Subject on Master.

CONFIDENTIAL AND PERSONAL

File
DAS
PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 April 1990

ECONOMIC AND MONETARY UNION

The Prime Minister had a meeting with the Chancellor of the Exchequer this afternoon to consider, in a preliminary way, our approach towards the next phase of discussion within the European Community of Economic and Monetary Union. The meeting had before it the Chancellor's minute of 9 April and the accompanying report to Ministers by a group of officials. Sir Peter Middleton and Mr Nigel Wicks were also present.

The Chancellor said that recent discussions in ECOFIN left him in no doubt that all other EC governments would be ready, at the Inter-Governmental Conference, to agree Treaty amendments which would adopt the definition of EMU in Stage 3 of the Delors report. There were differences of view about the length and substance of Stage 2 and consequently about when Stage 3 would be reached. In other words, most governments distinguished between drafting a Treaty and the actual move to EMU. But the goal of full EMU as described by Delors was shared by all except the United Kingdom.

This was the background against which we had to devise our negotiating position, and his minute set out various possible options. The United Kingdom did not find the Delors prescription acceptable. But our evolutionary approach had been brushed aside and was regarded by others as overtaken by events. If we were not prepared to engage in discussion on the basis that the goal should be full EMU as defined by Delors, there was a significant risk that the other Eleven member states would go ahead and sign a separate Treaty. This would be politically damaging. We should do our utmost to preserve a Community of Twelve and our influence in it. In short, we needed to devise a policy which would maximise our influence in the negotiations, and minimise our commitment to the outcome. It was on this basis that he recommended that we propose some institutional development in the form of a European Monetary Fund in Stage 2, and an "opting-in" mechanism for Stage 3.

There was no disagreement, in discussion, that we could not accept the substance of EMU as defined by Delors, ie a single currency (or fixed exchange rates) and a Central Bank. The House of Commons had made its opposition very plain. we had to find a way to delay and frustrate this ultimate objective, without placing ourselves outside the game. The Chancellor's proposal for a "opting-in" mechanism offered one means of achieving this. The disadvantage was that it involved signing up to the objective of full EMU. This was objectionable on practical grounds: it was simply wrong to be trying to centralise powers in the Community: and it made no sense to subscribe to EMU before we had any real idea of the consequences of GEMU. Moreover, if we signed up to the Delors definition, it would be represented that we were gradually being drawn along to adopt the substance.

On the other hand, the ideas in the Chancellor's minute and the report by officials for building up Stage 2 were ingenious and offered a way forward, as did the fairly similar ideas in the paper circulated by Sir Michael Butler. It would be helpful to have an appraisal of where the two papers coincided and where they differed. Both had the advantage that they offered a new institution, in the form of a European Monetary Fund, which would require treaty amendment. They both went significantly further than Delors Stage 2. The proposals should be further worked up. At the same time, we should be prepared to put forward Treaty amendments at the IGC incorporating the doctrine of subsidiarity.

The question remained how far the proposal for a European Monetary Fund would carry us. One tactic would be to present it as subsuming and substituting for both stage 2 and 3 of the Delors report. We would represent it as a sufficient step beyond Stage 1 for the foreseeable future, removing the need for any Treaty amendment defining a subsequent Stage of EMU. The other members of the Community would then be faced with a choice of our proposal, constituting a major step forward, agreed by Twelve: or a separate Treaty agreed by Eleven. Particularly if combined with other steps, then there would be a prospect of securing wider support for our proposal.

Against this, while other member states would probably welcome our proposal as an improvement and strengthening of Stage 2, they were unlikely to drop their insistence on Treaty amendments defining the goal of full EMU. Our only option then would be to find some procedural device which would enable the others to sign up to this goal, but would not commit us to it. This would be difficult.

Summing up the discussion, the Prime Minister said that she did not believe that the Government could subscribe to a Treaty amendment containing the full Delors' definition of EMU. Further work should be done in the first instance to develop our proposal for a European Monetary Fund which we could put forward as the most that it was necessary for the Community to agree upon for now. The proposal would need to be considered by a wider group of Ministers. Parliament should be given an opportunity to debate the proposal in due course, although it was unlikely to give rise to difficulties. We should also need to consider the tactical handling of the proposal within the Community, in

particular how we should present it: and whether we should put all our cards on the table at once (although we should have to put forward most of them to stand a chance of attracting the support of other member states). Further thought was needed on how to finesse attempts to impose a binding commitment in a Treaty amendment to full EMU.

I am copying this letter on a personal basis to Stephen Wall (Foreign and Commonwealth Office).

C. D. POWELL

John Gieve, Esq.
H.M. Treasury

4(a-c)

PRIME MINISTER

EMU

You have a meeting tomorrow with the Chancellor and Nigel Wicks to discuss EMU. You have read the Chancellor's note, although not (I think) the fuller paper by officials attached to it. You have also read Sir Michael Butler's paper, and my own note, all of which you will find in the folder.

The questions we need to address tomorrow are:

- has our present evolutionary approach, as set out in our paper on competing currencies, run out of steam? I am afraid the answer is that it has: not because it's a bad paper, but because it provides no new institutional step forward and does not therefore command support from other EC members.

- will a 'rejectionist' approach work? ie, if we simply refuse to accept Treaty amendment, will the others eventually back down? Or will they go ahead with a Treaty among Eleven? The best advice from all quarters is that they will so go ahead with a separate Treaty.

- does it matter if the Eleven go ahead without us? There is a difference here between standing aside from the beginning and negotiating right up to the final stage of Treaty amendment before deciding whether to join any new mechanism or institution ourselves. I would have thought the former would be in a difficult position to sustain, both within the Conservative Party and in the country in the run-up to a General Election. It is surely a better posture to be stuck in there, arguing our point of view and making clear what we cannot accept, than just standing aside.

- should we put forward some new proposals for Stage 2 of EMU? There are some ingenious proposals in the Butler paper and in the Treasury paper. Either of them would put us in a positive position of having some clear alternative proposals

to put forward. Neither involves erosion of Parliament's sovereignty. The differences between them are largely technical (you might ask the Chancellor or Nigel Wicks to explain them).

- can we sustain in the EC a position whereby Treaty Amendment is limited to Stage II, but detailed specification of Stage III is left for a subsequent Treaty? There is no doubt this would be a very good solution from our point of view: and one can certainly regard Michael Butler's paper as arguing for this (the Treaty revision which he proposes would deal only with Stage II). Had we joined the ERM in the interim, our credentials for arguing for a Stage II only Treaty would be stronger. The Chancellor and his officials - who are of course directly exposed to the debate in Europe - take the view that we shall not get away with this, and that we shall have to accept a Treaty which gives a full definition of EMU and the institutions necessary for its final stage (although on an 'opting-in' basis), if we are to get by. This judgment is perhaps the most crucial one. At least at this juncture we should surely be arguing (i) that the first task is to complete Stage I; (ii) that we are prepared to contemplate a substantial Stage II with an institution and therefore Treaty amendment; but (iii) we can only accept a general definition of Stage III without any attempt to define its institutions. We may in the end have to go beyond this: but we should start here.

- if we have eventually to accept that a Treaty will define Stage III and its institutions, is the Chancellor's 'opting-in' proposal a runner? The end result could be the same as standing aside from the whole debate now: that is a two-speed Europe. But at least it would be one in which we would be seen to have tried and put forward positive arguments of our own: and it would not happen for quite a long time. The Chancellor will argue that, without his 'opting-in' proposals for Stage III, our ideas for Stage II will be scorned by the others.

- timing of these proposals? You will want to ask the Chancellor when he intends to float these ideas, and in what form. If we go ahead with them, it will be important to derive the maximum political benefit.

C.D.P.

Charles Powell
17 April 1990

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FILE

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

11 April 1990

Further to my telephone call this morning I am writing to confirm that the EMU meeting will be held on Wednesday 18 April. The meeting will begin at 1500 hours and should last about 1½ hours.

I am copying this letter to the Private Secretaries to Sir Peter Middleton, Sir Terence Burns and to Nigel Wicks.

AMANDA PONSONBY (Mrs)

Alan Houmann, Esq.,
H.M. Treasury.

VLG

File

MFJ

cc: HMT

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

11 April 1990

Dear Michael

Thank you for your letter of 28 March.

The papers are an original and constructive contribution to the debate on economic and monetary union and I am most grateful to you and to Paul Richards for sending them to me. I should be happy to have a word with you about them, and will ask Charles Powell to fix a time.

Yours sincerely

Margaret

Sir Michael Butler, GCMG.

DSG

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

Dear Sir Michael

Thank you for your letter of 28 March.

The papers are an original and constructive contribution to the debate on economic and monetary union and I am most grateful to you and to Paul Richards for sending them to me. I should be happy to have a word with you about them, and will ask Charles Powell to fix a time.

Yours sincerely

Margaret Thatcher

Sir Michael Butler, GCMG.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

10 April 1990

ECONOMIC AND MONETARY UNION

You arranged for me to see a draft of a minute which the Chancellor is proposing to send the Prime Minister, setting out the way ahead on economic and monetary union. I have discussed the ideas in it with the Prime Minister, who acknowledges the strength of the arguments. I think the best step would be for the Chancellor to finalise his views and put the minute to the Prime Minister (preferably by tomorrow evening), but not to copy it to the Foreign Secretary or Sir Robin Butler at this stage. It could then be discussed at the meeting on 17 April. As I said to you yesterday, I think it would be helpful if the Prime Minister and the Chancellor were to have a private word before the meeting starts on both ERM and EMU. Arrangements are being made for that.

C. D. POWELL

John Gieve, Esq.,
H.M. Treasury.

STRICTLY PERSONAL

chex.ps/jg/29 CONFIDENTIAL AND PERSONAL

Prime Minister!
Charles P. will provide a brief before next Wednesday's discussion with the Chancellor & Mr Wicks.
BHP
12/4

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

PRIME MINISTER

ECONOMIC AND MONETARY UNION

At ECOFIN, I was very startled at the attitude of our European partners. It was clear that all of them were determined to agree a Treaty for full EMU. More worryingly, these were the Finance Ministers and the Central Bank Governors (including the Chairman of their Committee, Pohl) - who have generally been more reserved on this issue than Heads of Government or Foreign Ministers.

2. The precise terms of any Treaty are still hazy. But their presumption is that it would include provisions for some budgetary coordination, a central monetary institution operating a common monetary policy and, eventually, a single currency. At present such a Treaty would only be an expression of intent and when (or whether) it would ever be implemented is uncertain. Nonetheless we need to confront the issue now in order to decide our approach to their plans.

3. As you know the Interdepartmental Group (comprising officials from the Treasury, FCO, Cabinet Office, Bank of England and Brian Griffiths) have prepared a report covering strategy and tactics for the IGC and I attach this.

4. I have considered this Report carefully. In doing so, I have taken it as axiomatic that the Commons will not be prepared to be committed to binding EMU as defined by Delors. Nor would we wish it to be. We are attracted even less by the other strand of thinking that is appearing in the Community, on political union and further powers for the European Parliament. However, I also believe that it is very much in our interests to preserve a Community of 12 and to maximise our influence in it. This means we must carefully prepare our position in advance of the IGC and negotiate very hard to achieve it. Whatever position we take will be controversial in both Party and country and we will need to keep the electoral timetable in mind as it proceeds.

The Evolutionary Approach in the UK Paper

5. So far our approach has been to point out the objections of principle and practice to the Delors route. We have maintained that, while we are committed to EMU, the best way of achieving that goal is through the evolutionary approach set out in the UK paper. But that approach has not so far shaken the determination of the other Member States, let alone the main players, the FRG and France, to press ahead with the drafting of a Treaty. Nor is it likely to do so for the following reasons.

(i) Our paper was predicated on the assumption that there would be no Treaty change. But the establishment of, and the preparations for an IGC assume the opposite. Our paper is seen to have been overtaken by the decision to hold an IGC

(ii) Furthermore, the debate in the Community is proceeding on a fairly conceptual level. Our European partners are talking in terms of what would be required in a Treaty, not in terms of the practical and operational implications of moving to EMU which were the subject of our paper.

(iii) Our paper has also failed to command support as a credible alternative to the Delors definition of full monetary union. There seem to be three reasons for this. Firstly, we have been thought unwilling to accept the ultimate goal of EMU; secondly, the evolutionary approach is perceived as giving politically unacceptable primacy to the Bundesbank; and thirdly, our partners do not accept that the EMS could, even under our evolutionary process, evolve into one of fixed rates without some institutional underpinning. That is what they wish to see.

6. The uncomfortable truth is that, even if we were to intensify the presentation of the case in our evolutionary paper, this would not deflect other Member States from their determination to agree a Treaty.

7. There is, of course, no need for us to come to final decisions about our attitude to Treaty amendment before the IGC completes its work, which may be in the summer of 1991 or perhaps later. But we must have a strategy for the IGC and we must settle our negotiating tactics if we are to maximise the prospects of securing the best outcome.

Five Possible Strategies for an IGC

8. Against this background I see five broad strategies which could guide us in an IGC and its preparation.

9. First, we could make clear that we believe it premature to consider the drafting of a Treaty and that we would not be willing to put one forward for approval to the UK Parliament.

10. This would be, I suppose, just about reconcilable with our political commitments to EMU but it would make our participation and influence in the IGC and the preparatory discussions little more than nominal.

11. My judgement is that if we took this course, the momentum now behind EMU would lead the other eleven Member States to establish a separate Treaty on EMU. Such a Treaty of Eleven is, I am advised, legally feasible. Its consequences for the UK are not certain but would be likely over time to shift the balance of decision making from the Twelve to Eleven. More damagingly, it would be seen both at home and abroad as a move by the UK to distance itself from the European Community. Moreover, the breach within the Community would happen in the near future - perhaps as early as next year and before the next Election.

12. Such perceptions would be unhelpful for the exchange rate and for investor confidence generally, for example for the flow of Japanese inward investment. A Treaty of Eleven would give increased and unwelcome weight to German influence in the Community. You are better placed than I to judge the consequences for our relationship with the United States Government.

13. In party political terms, some of our colleagues in Parliament would welcome a move to distance ourselves from these developments in the Community. But others would regard this as the creation of "a two-tier Europe" and perhaps a step towards our eventual departure from the Community. It would be a hugely divisive Party issue for us and we may need the Whips' advice on the balance of Party opinion.

14. The Interdepartmental Group's report identifies in paragraph 1.9 four other possible options for an IGC. The first two are:

(i) **A new Treaty confined only to some interim "Stage 2" arrangements,** merely hinting at further developments beyond that on the route towards EMU, and leaving detailed specification of "Stage 3" institutions for a further Treaty.

(ii) **A Treaty mainly concerned with interim institutional arrangements,** but also defining EMU more specifically as a target; but again leaving detailed specification for "Stage 3" institutions for a further Treaty.

Both these options, which would require subsequent further Treaty change to provide for the final stage, present a sensible and pragmatic approach. But it is evident that other Member States want to go beyond them. Neither of these options would remotely secure the support of other Member States.

15. Another option - (iv) in the Interdepartmental Report - envisages:

(iv) **A comprehensive Treaty,** which gives a full definition of EMU and the institutions necessary for its final stage and which specifies stiff conditions that would have to be met before all Member States moved together to full EMU.

Even if this is acceptable to other Member States - and it may not be if it gives one country, however small, a block on the move to the final stage - I am clear that neither we, the Government, nor our Parliamentary colleagues would accept such a firm commitment

for this country to move to EMU and to accept its associated mechanisms, such as membership of the central monetary institution and a single currency. Such an outcome is not acceptable.

16. This leaves the third option identified in the Interdepartmental Report.

(iii) **A Treaty which gives a full definition of EMU and the institutions necessary for its final stage** (together with any transitional stage, if agreed) but then **allows an "opting in" mechanism** for Member States. This would allow them to join in the new Stage 3 arrangements at their own pace.

In more detail, such a Treaty might look as follows:

- **For economic union,** acceptance of binding budgetary surveillance procedures on the lines you have already agreed, but no unreasonable fetters - such as an enforceable limit on national Parliaments' powers to set budget deficits. We could not possibly accept that, either through stipulations in the amending Treaty regarding the level of "acceptable" budget deficits or through any other mechanism such as a Council decree in specific cases, or through the intervention of the Court of Justice.

- **For monetary union,** a stipulation in the Treaty that before its provisions involving a common monetary policy operated through a central monetary institution and any single currency took effect in any Member State, that Member State should have to "opt in" to the arrangements. Such decisions would have to be endorsed by national Parliaments. (We would need to consider the precise form of such endorsement.) This outcome would

probably require us to accept that Treaty change would embody the definition of EMU as a single monetary policy, a single Community monetary authority committed to price stability and irrevocably fixed currencies. As the officials' paper points out this would lead probably to a single currency too. [We did in fact accept a definition on these lines in 1973.]

If this option was adopted, it would provide the Community with its Treaty. It would maximise our negotiating position during the IGC. And it would leave us outside any currency union until or unless a future House of Commons decided to enter. (This is, of course, not remotely likely for as far ahead as I can see.)

Evaluation of the Five Strategies

17. All this is most uncomfortable, particularly against a background where some of our partners are talking in vague terms about political union (which is utterly unacceptable) and greater powers for the European Parliament (which we should oppose).

18. Maintaining our present stance and pushing the evolutionary approach in the UK paper will not succeed in distracting other Member States from a Treaty. At the extreme we could opt for a two-tier Community or even leave it. But the impact on our economy and on our wider political relations if that were to come about, or even if it were thought to be likely, would be enormous.

19. The 'opting in' Treaty seems to be the least undesirable option and the one I recommend we should work for as the outcome to the IGC. It would provide us with an opportunity for maintaining our influence in the Community while enabling the UK to decide later whether or not to move to the later stages of EMU. This seems to me to offer the maximum protection for our position consistent with our remaining an active partner in the Community.

20. In due course this "opting in" variant could lead to a two-speed Europe if other countries go ahead with monetary union and we do not. We may wish to make that choice but it is very much in our political and economic interest to delay the point at which it may occur and in the meanwhile to remain full members of the Community with influence over its development. The alternative is to have the immediate and certain breach of a new Treaty of 11, which would reduce our influence in Europe and more widely, and also bring considerable economic risks.

21. If we adopt the approach I recommend we will be in a better position to influence the negotiations before and during an IGC. I am sure we should aim to prolong these negotiations and delay as far as possible the implementation of any Treaty.

22. There are a number of points over which disagreement is likely to arise between Member States, for example political control over a central bank (where most Member States are arguing for Bundesbank type arrangements) and the call for additional resources for those countries who find it most difficult to adapt to a single currency. We will need to consider where to position ourselves on these issues to gain maximum tactical advantage.

Stage 2

23. More positively I think it will be in our interests to build up the so-called Stage 2 which, following the Informal ECOFIN, is to be the subject of discussion in the relevant Community Committees. Some, like the Germans, Dutch and Luxembourgers are arguing that the Community should proceed from Stage 1 to the full EMU of Stage 3 with either a short or indeed a non-existent Stage 2. The French Finance Minister is talking, in somewhat elliptical terms, of a substantial Stage 2.

24. A long Stage 2, after what I hope is a long Stage 1, would further put off the moment that Member States had to take decisions on entering the Stage 3 arrangements. But a Stage 2 would, I believe, only be worth running if it was seen to have real substance.

25. One possibility, based on a new institution called a European Monetary Fund, is described in the paper recently sent to you by Sir Michael Butler.

Have read not.

26. A preferable approach however, is set out in paragraphs 2.34-2.42 of the Interdepartmental Group's report. It also proposes a new institution called a European Monetary Fund, though one with different functions. The first attraction of this body is that it could take over existing functions performed by the Commission and others (itself a good idea which might be welcomed by France and by the Party). These include ERM management, promoting the ECU, managing certain Community financing facilities and providing an enhanced secretariat for the Community's monetary authority. It would also effectively run a currency board to issue ECU bank notes for general circulation which would exist together with national currencies; and it could have responsibility for coordinating intervention against third currencies.

Why?

Very similar to Butler approach

27. Acceptance of such institutional development in Stage 2 would not, I am certain, be sufficient by itself to persuade the rest of the Community against pursuing a Treaty for full EMU. (Indeed, if we were to float such ideas, without accepting that the Treaty would include arrangements for Stage 3, our intervention would be regarded as wrecking and would be counter-productive). But I think it would be worth running as a complement to the "opting in" approach I have recommended on full monetary union. It could have attractions for the French and other countries. At the least it would provide a further complicated subject for consideration, and would demonstrate that we were playing a full part in discussions.

If it gained support, it could postpone the point at which other countries moved to full union and, in the meanwhile, could diminish the Commission's authority in this field.

28. I would like to float the idea at technical level in the Community first before putting it forward as a formal UK initiative.

29. The Interdepartmental report raises many other important questions, but at this stage we need to focus on the central issues. I am sure you will wish to discuss them when we return after Easter.

John M.

[J.M.]

9 April 1990

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

6 April 1990

C D Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles,

SECOND STAGE OF EMU: LETTER FROM SIR MICHAEL BUTLER

Your letter of 29 March asked for an early draft reply to Sir Michael Butler's letter of 28 March, for the Prime Minister's signature.

The proposals attached to Sir Michael's letter were developed by Mr Paul Richards of Samuel Montagu. The Treasury has had some discussion with Mr Richards about his proposals. They are clearly ingenious and well thought out, though we do have some reservations about them.

As you know, the Chancellor is reflecting further on our approach to Community discussions on EMU and expects to be putting his thoughts to the Prime Minister shortly.

Meanwhile, the Chancellor suggests that the Prime Minister replies to Sir M Butler in terms of the draft letter attached. If the Prime Minister can find time in her diary to see Sir Michael, the Chancellor would not advise her against; and of course, if she does see him we will, of course, be happy to provide a full brief.

Yours sincerely,

Duncan Sparkes

p.p. T TARKOWSKI

DRAFT LETTER

From : Prime Minister

To : Sir Michael Butler

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

Thank you for your letter of 28 March.

The papers are an original & constructive ~~Mr Richards' paper is an interesting~~ contribution to the debate on economic and monetary union and I am most grateful to you and to him for sending ~~it~~ them to me. I ~~shall be studying the paper carefully and with interest.~~ think he happy to have a word with you about them, & will ask Charles Powell to fix a time.

M

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

6 April 1990

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

ECONOMIC AND MONETARY UNION

Following your discussion yesterday with Nigel Wicks, you may be interested to see the latest draft of the Chancellor's minute to the Prime Minister. This is not yet a final version and the Chancellor will look at it again over the weekend before sending if off next week.

... I also enclose a copy of the Wicks Report and a short note on our commitments to EMU.

Yours

JG

JOHN GIEVE

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

PRIME MINISTER

ECONOMIC AND MONETARY UNION

At ECOFIN, I was very startled at the attitude of our European partners. It was clear that all of them were determined to agree a Treaty for full EMU. More worryingly, these were the Finance Ministers and the Central Bank Governors (including the Chairman of their Committee, Pohl) - who have generally been more reserved on this issue than Heads of Government or Foreign Ministers.

2. The precise terms of any Treaty are still hazy. But their presumption is that it would include provisions for some budgetary coordination, a central monetary institution operating a common monetary policy and, eventually, a single currency. At present such a Treaty would only be an expression of intent and when (or whether) it would ever be implemented is uncertain. Nonetheless we need to confront the issue now in order to decide our approach to their plans.

3. As you know the Interdepartmental Group (comprising officials from the Treasury, FCO, Cabinet Office, Bank of England and Brian Griffiths) have prepared a report covering strategy and tactics for the IGC and I attach this.

4. I have considered this Report carefully. In doing so, I have taken it as axiomatic that the Commons will not be prepared to be committed to binding EMU as defined by Delors. Nor would we wish it to be. We are attracted even less by the other strand of thinking that is appearing in the Community, on political union and further powers for the European Parliament. However, I also believe that it is very much in our interests to preserve a Community of 12 and to maximise our influence in it. This means we must carefully prepare our position in advance of the IGC and negotiate very hard to achieve it. Whatever position we take will be controversial in both Party and country and we will need to keep the electoral timetable in mind as it proceeds.

The Evolutionary Approach in the UK Paper

5. So far our approach has been to point out the objections of principle and practice to the Delors route. We have maintained that, while we are committed to EMU, the best way of achieving that goal is through the evolutionary approach set out in the UK paper. But that approach has not so far shaken the determination of the other Member States, let alone the main players, the FRG and France, to press ahead with the drafting of a Treaty. Nor is it likely to do so for the following reasons.

(i) Our paper was predicated on the assumption that there would be no Treaty change. But the establishment of, and the preparations for an IGC assume the opposite. Our paper is seen to have been overtaken by the decision to hold an IGC

(ii) Furthermore, the debate in the Community is proceeding on a fairly conceptual level. Our European partners are talking in terms of what would be required in a Treaty, not in terms of the practical and operational implications of moving to EMU which were the subject of our paper.

(iii) Our paper has also failed to command support as a credible alternative to the Delors definition of full monetary union. There seem to be three reasons for this. Firstly, we have been thought unwilling to accept the ultimate goal of EMU; secondly, the evolutionary approach is perceived as giving politically unacceptable primacy to the Bundesbank; and thirdly, our partners do not accept that the EMS could, even under our evolutionary process, evolve into one of fixed rates without some institutional underpinning. That is what they wish to see.

6. The uncomfortable truth is that, even if we were to intensify the presentation of the case in our evolutionary paper, this would not deflect other Member States from their determination to agree a Treaty.

7. There is, of course, no need for us to come to final decisions about our attitude to Treaty amendment before the IGC completes its work, which may be in the summer of 1991 or perhaps later. But we must have a strategy for the IGC and we must settle our negotiating tactics if we are to maximise the prospects of securing the best outcome.

Five Possible Strategies for an IGC

8. Against this background I see five broad strategies which could guide us in an IGC and its preparation.

9. First, we could make clear that we believe it **premature to consider the drafting of a Treaty** and that we would **not be willing to put one forward for approval to the UK Parliament.**

10. This would be, I suppose, just about reconcilable with our political commitments to EMU but it would make our participation and influence in the IGC and the preparatory discussions little more than nominal.

11. My judgement is that if we took this course, the momentum now behind EMU would lead the other eleven Member States to establish a separate Treaty on EMU. Such a Treaty of Eleven is, I am advised, legally feasible. Its consequences for the UK are not certain but would be likely over time to shift the balance of decision making from the Twelve to Eleven. More damagingly, it would be seen both at home and abroad as a move by the UK to distance itself from the European Community. Moreover, the breach within the Community would happen in the near future - perhaps as early as next year and before the next Election.

12. Such perceptions would be unhelpful for the exchange rate and for investor confidence generally, for example for the flow of Japanese inward investment. A Treaty of Eleven would give increased and unwelcome weight to German influence in the Community. You are better placed than I to judge the consequences for our relationship with the United States Government.

13. In party political terms, some of our colleagues in Parliament would welcome a move to distance ourselves from these developments in the Community. But others would regard this as the creation of "a two-tier Europe" and perhaps a step towards our eventual departure from the Community. It would be a hugely divisive Party issue for us and we may need the Whips' advice on the balance of Party opinion.

14. The Interdepartmental Group's report identifies in paragraph 1.9 four other possible options for an IGC. The first two are:

(i) **A new Treaty confined only to some interim "Stage 2" arrangements,** merely hinting at further developments beyond that on the route towards EMU, and leaving detailed specification of "Stage 3" institutions for a further Treaty.

(ii) **A Treaty mainly concerned with interim institutional arrangements,** but also defining EMU more specifically as a target; but again leaving detailed specification for "Stage 3" institutions for a further Treaty.

Both these options, which would require subsequent further Treaty change to provide for the final stage, present a sensible and pragmatic approach. But it is evident that other Member States want to go beyond them. Neither of these options would remotely secure the support of other Member States.

15. Another option - (iv) in the Interdepartmental Report - envisages:

(iv) **A comprehensive Treaty,** which gives a full definition of EMU and the institutions necessary for its final stage and which specifies stiff conditions that would have to be met before all Member States moved together to full EMU.

Even if this is acceptable to other Member States - and it may not be if it gives one country, however small, a block on the move to the final stage - I am clear that neither we, the Government, nor our Parliamentary colleagues would accept such a firm commitment

for this country to move to EMU and to accept its associated mechanisms, such as membership of the central monetary institution and a single currency. Such an outcome is not acceptable.

16. This leaves the third option identified in the Interdepartmental Report.

(iii) **A Treaty which gives a full definition of EMU and the institutions necessary for its final stage** (together with any transitional stage, if agreed) but then **allows an "opting in" mechanism** for Member States. This would allow them to join in the new Stage 3 arrangements at their own pace.

In more detail, such a Treaty might look as follows:

- **For economic union,** acceptance of binding budgetary surveillance procedures on the lines you have already agreed, but no unreasonable fetters - such as an enforceable limit on national Parliaments' powers to set budget deficits. We could not possibly accept that, either through stipulations in the amending Treaty regarding the level of "acceptable" budget deficits or through any other mechanism such as a Council decree in specific cases, or through the intervention of the Court of Justice.

- **For monetary union,** a stipulation in the Treaty that before its provisions involving a common monetary policy operated through a central monetary institution and any single currency took effect in any Member State, that Member State should have to "opt in" to the arrangements. Such decisions would have to be endorsed by national Parliaments. (We would need to consider the precise form of such endorsement.) This outcome would

probably require us to accept that Treaty change would embody the definition of EMU as a single monetary policy, a single Community monetary authority committed to price stability and irrevocably fixed currencies. As the officials' paper points out this would lead probably to a single currency too. [We did in fact accept a definition on these lines in 1973.]

If this option was adopted, it would provide the Community with its Treaty. It would maximise our negotiating position during the IGC. And it would leave us outside any currency union until or unless a future House of Commons decided to enter. (This is, of course, not remotely likely for as far ahead as I can see.)

Evaluation of the Five Strategies

17. All this is most uncomfortable, particularly against a background where some of our partners are talking in vague terms about political union (which is utterly unacceptable) and greater powers for the European Parliament (which we should oppose).

18. Maintaining our present stance and pushing the evolutionary approach in the UK paper will not succeed in distracting other Member States from a Treaty. At the extreme we could opt for a two-tier Community or even leave it. But the impact on our economy and on our wider political relations if that were to come about, or even if it were thought to be likely, would be enormous.

19. The 'opting in' Treaty seems to be the least undesirable option and the one I recommend we should work for as the outcome to the IGC. It would provide us with an opportunity for maintaining our influence in the Community while enabling the UK to decide later whether or not to move to the later stages of EMU. This seems to me to offer the maximum protection for our position consistent with our remaining an active partner in the Community.

20. In due course this "opting in" variant could lead to a two-speed Europe if other countries go ahead with monetary union and we do not. We may wish to make that choice but it is very much in our political and economic interest to delay the point at which it may occur and in the meanwhile to remain full members of the Community with influence over its development. The alternative is to have the immediate and certain breach of a new Treaty of 11, which would reduce our influence in Europe and more widely, and also bring considerable economic risks.

21. If we adopt the approach I recommend we will be in a better position to influence the negotiations before and during an IGC. I am sure we should aim to prolong these negotiations and delay as far as possible the implementation of any Treaty.

22. There are a number of points over which disagreement is likely to arise between Member States, for example political control over a central bank (where most Member States are arguing for Bundesbank type arrangements) and the call for additional resources for those countries who find it most difficult to adapt to a single currency. We will need to consider where to position ourselves on these issues to gain maximum tactical advantage.

Stage 2

23. More positively I think it will be in our interests to build up the so-called Stage 2 which, following the Informal ECOFIN, is to be the subject of discussion in the relevant Community Committees. Some, like the Germans, Dutch and Luxembourgers are arguing that the Community should proceed from Stage 1 to the full EMU of Stage 3 with either a short or indeed a non-existent Stage 2. The French Finance Minister is talking, in somewhat elliptical terms, of a substantial Stage 2.

24. A long Stage 2, after what I hope is a long Stage 1, would further put off the moment that Member States had to take decisions on entering the Stage 3 arrangements. But a Stage 2 would, I believe, only be worth running if it was seen to have real substance.

25. One possibility, based on a new institution called a European Monetary Fund, is described in the paper recently sent to you by Sir Michael Butler.

26. A preferable approach however, is set out in paragraphs 2.34-2.42 of the Interdepartmental Group's report. It also proposes a new institution called a European Monetary Fund, though one with different functions. The first attraction of this body is that it could take over existing functions performed by the Commission and others (itself a good idea which might be welcomed by France and by the Party). These include ERM management, promoting the ECU, managing certain Community financing facilities and providing an enhanced secretariat for the Community's monetary authority. It would also effectively run a currency board to issue ECU bank notes for general circulation which would exist together with national currencies; and it could have responsibility for coordinating intervention against third currencies.

27. Acceptance of such institutional development in Stage 2 would not, I am certain, be sufficient by itself to persuade the rest of the Community against pursuing a Treaty for full EMU. (Indeed, if we were to float such ideas, without accepting that the Treaty would include arrangements for Stage 3, our intervention would be regarded as wrecking and would be counter-productive). But I think it would be worth running as a complement to the "opting in" approach I have recommended on full monetary union. It could have attractions for the French and other countries. At the least it would provide a further complicated subject for consideration, and would demonstrate that we were playing a full part in discussions.

If it gained support, it could postpone the point at which other countries moved to full union and, in the meanwhile, could diminish the Commission's authority in this field.

28. I would like to float the idea at technical level in the Community first before putting it forward as a formal UK initiative.

29. The Interdepartmental report raises many other important questions, but at this stage we need to focus on the central issues. I am sure you will wish to discuss them when we return after Easter.

30. I am sending a copy of this minute only to the Foreign & Commonwealth Secretary and to Sir Robin Butler.

[J.M.]

6 April 1990

ANNEX A

UK COMMITMENTS TO EMU

NB: All these commitments occur in documents which have no legal force or in the preamble or subheadings of legal documents. They are therefore political commitments only.

As a "future member of the EC", the UK agreed a communique in Paris following a conference of heads of state or government held from 19-21 October 1972. This communique reaffirmed "the resolve of the Member States of the enlarged Community to move irrevocably [towards] Economic and Monetary Union, by confirming all the details of the Acts passed by the Council and by the Member States' representatives on 22 March 1971 and 21 March 1972".

The preamble to the Single European Act (1985-86) records:

> "Whereas at their conference in Paris from 19 to 21 October 1972 the Heads of State or of Government approved the objective of the progressive realization of Economic and Monetary Union".

Article 20 of the SEA inserts a new chapter into the Treaty of Rome entitled "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)". The new Article 102a which follows does not refer specifically to EMU but mentions cooperation and "the convergence of economic and monetary policies which is necessary for the further development of the Community".

The Hanover Council conclusions (June 1988) read as follows:-

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

The Madrid Council conclusions (June 1989) read:-

> "The European Council restated its determination progressively to achieve Economic and Monetary Union as provided for in the Single Act and confirmed at the European Council meeting in Hanover".

THE DEFINITION OF EMU

The European Monetary Cooperation Fund Regulation was agreed by the UK in 1973. Its fourth recital reads:-

> "Whereas the purpose of the Fund must be to contribute to the progressive establishment of an Economic and Monetary Union between the Member States of the European Economic Community which, in its final stage as regards its monetary aspects will have the following characteristics:
>
> i. either the total and irreversible convertibility, at irrevocable parities, of Community currencies against each other; or
>
> ii. the introduction of a common currency".

Paragraph 22 of the Delors Report states that:

> "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 Commission paper, presented to the informal ECOFIN on 31 March, accepts the Delors definition of EMU but shows greater enthusiasm for a single currency (developing from the ECU) and disputes the need for binding Community rules on the size of budget deficits.

10 DOWNING STREET

Prime Minister

I wonder whether you want to read the Chancellor's minute. I read it – but didn't like to mark it.

Are you content generally with the reasoning in my minute: and with the specific suggestion in the last para.? CDP.

Yes

SECRET AND PERSONAL

SUBJECT cc MASTER

3a-b

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 April 1990

Dear John,

EUROPEAN MONETARY ISSUES

At their bilateral yesterday afternoon, the Prime Minister and the Chancellor had a brief discussion about the position on a number of European monetary matters.

I should be grateful if you would ensure that this letter is seen only by those with a strict need to know.

The Chancellor said that he would shortly be sending to the Prime Minister a detailed paper prepared by officials on the various options for handling discussions on progress towards economic and monetary union in the run up to the Inter-Governmental Conference. He would also be sending her a minute setting out his conclusions on the best way forward. The objective was to design the best strategy for protecting against rapid progress towards stages 2 and 3 of EMU and the erosion of national sovereignty, while ensuring that the UK was not excluded from the negotiating process. It was crucial to maximise our influence in the negotiations and on the way in which Europe would develop; and that influence was bound to be affected by developments in relation to future UK membership of the Exchange Rate Mechanism.

The Prime Minister said that there would be an opportunity at the seminar planned for Tuesday 17 April to discuss some of these issues and in particular to consider further the question of UK membership of the ERM. She looked forward to receiving the promised minute from the Chancellor. In considering further developments on EMU it was essential to avoid the loss of national sovereignty and the growth of central control. She commended to the Chancellor a recent IEA pamphlet by Mr. Frank Vibert, entitled "The New Europe: Constitutionalist or Centralist?". While the UK had indicated it was prepared to enter the ERM, subject to the appropriate conditions being met, moves towards central European control were an entirely different matter. There were serious dangers in the UK adopting a posture which implied that moves beyond ERM membership towards further economic and monetary integration

6

could be contemplated. If other member states wished to take such steps that was their concern, but the UK should make clear it was not prepared to participate in the process; if we made that position absolutely clear it was likely that, under pressure from the Bundesbank, Germany would also decline to move to further stages. The desirability of developing increasingly free trade relations with the USA and other countries, possibly via the GATT process, should be kept clearly in view; whereas tight centrally controlled blocks of countries should not be allowed to develop.

Yours,
Paul

PAUL GRAY

John Gieve, Esq.,
H.M. Treasury.

VALÉRY GISCARD D'ESTAING

Paris, le 5 avril 1990

Madame le Premier Ministre,

Dans la perspective du Conseil Européen de Dublin, il nous a paru utile au Chancelier SCHMIDT et à moi-même, au nom du Comité pour l'Union Monétaire de l'Europe que nous co-présidons, de faire part au Président du Conseil Européen et au Président de la Commission des Communautés Européennes de nos propositions pour accélérer la construction de l'Union Economique et Monétaire de l'Europe, que les développements récents en Europe de l'Est situent dans une perspective nouvelle.

Je vous prie de trouver ci-joint un double de cette correspondance. Nous connaissons votre attachement à la cause de l'Europe et espérons que de nouveaux progrès pourront être accomplis au niveau du Conseil Européen.

Je vous prie d'agréer, Madame le Premier Ministre, l'expression de ma haute considération, et celle de mon souvenir le meilleur.

V. Giscard d'Estaing

Mrs Margaret THATCHER
Premier Ministre

STS 285/90

Valéry Giscard d'Estaing

Paris, 5 April 1990

Dear Prime Minister,

In the run-up to the Dublin European Council, Chancellor SCHMIDT and I, acting on behalf of the Committee for European Monetary Union of which we are Co-Chairmen, considered that it would be helpful to inform the President of the European Council and the President of the Commission of the European Communities of our proposals to accelerate European Economic and Monetary Union, which has been given a new perspective by the recent developments in Eastern Europe.

Please find attached copies of those letters. We are aware of your commitment to the European cause and hope that it will be possible to make fresh progress at the European Council.

[Complimentary close]

[signed] Valéry Giscard d'Estaing

Meeting record
subject cc Master

file

LPO

2(a-b)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 March 1990

Dear John,

EXCHANGE RATE MECHANISM

The Prime Minister and the Chancellor had a brief discussion this morning about the timetable for the UK's membership of the Exchange Rate Mechanism of the EMS.

I should be grateful if you would ensure this letter is seen only by named individuals.

The Prime Minister said she had noted the press reports of the Select Committee evidence given the previous day by the Governor of the Bank of England. It was not clear whether these reports were accurate, but she did not take the view that the conditions for the UK's membership had yet been met. Significant further progress was still needed from our European partners. The UK's inflation rate was expected to rise to some 9 per cent over the coming months and we could not contemplate joining the mechanism in these circumstances. It was the Government's own responsibility to get inflation down. Moreover, it was still far from clear what would be the impact of moves towards monetary union in Germany; if this resulted in significant loosening of the monetary stance in Germany that would weaken the case for joining the mechanism. Although the issue of the timing of membership would need to be considered in the run-up to the next election, it would in any event be out of the question to publish a precise date by which the UK would join.

The Chancellor said he fully agreed with the Prime Minister that the UK was not currently in a position to join the mechanism on the basis of 2¼ per cent margins; it was also out of the question to set an advance date for joining, which would simply leave the UK at the mercy of the markets. However, he felt it was important to consider carefully in the near future the options for the date of joining; the issue was closely related to the necessary preparations for the Inter-Governmental Conference later this year.

Continuing, the Chancellor said that sterling remained vulnerable in the markets. The markets were getting used to operating on the notion that the present level of sterling required interest rates at the current high levels; this meant that the prospects for bringing interest rates down as and when that was judged appropriate on domestic policy grounds could be

jeopardised by the external position. Against that background, and bearing in mind the likely favourable impact of entry to the mechanism on political sentiment and in turn on sentiment in the markets, the prospects for bringing interest rates down while maintaining a firm exchange rate would be maximised if sterling was inside rather than outside the ERM. All this reinforced the need to take a careful look at the options for the date when the UK should join, at a time of our own choosing.

In further discussion the following points were raised:

- the inter-action of ERM entry and the IGC was complex. On the one hand, if by the time of the Conference the UK was still outside the ERM it was unlikely that other Member States would place much weight on the UK's views about the future development of European monetary arrangements. On the other hand, if the UK had joined the ERM by the time of the Conference the UK would then be in the position of arguing that there should be no further significant move towards European monetary integration; but other Member States might nonetheless take the view that, since the UK had at last taken the plunge and joined the mechanism, it would in due course drop its objections to further developments and accept moves towards Stages 2 and 3 of EMU. The Chancellor would shortly be sending the Prime Minister a paper discussing all aspects of the run-up to and handling of the IGC;

- although domestic economic conditions remained difficult to judge there were now significant signs that it could be appropriate to reduce interest rates before too long;

- the significance of external perceptions of the political strength of the Government for the attitude taken by the markets towards sterling should not be underestimated. There could also be a favourable political impact if the Government was to join the mechanism at a time of its own choosing. On the other hand if sterling entered the mechanism while the Government was still facing political difficulties this could have a substantial disruptive effect on the whole ERM.

The Prime Minister said that given diary pressures during the morning it was not possible to pursue the discussion further at this stage. The Chancellor said he would reflect further on the issues and would like to pursue the discussion on another occasion.

Yours,
Paul

PAUL GRAY

John Gieve, Esq.,
H.M. Treasury.

Sir M. BUTLER
9/4

ECL

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

Ack 29 March 1990

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

I should be grateful if you would let me have an early draft reply for the Prime Minister's signature.

I am copying this letter and enclosure to Richard Gozney (Foreign and Commonwealth Office) and Sonia Phippard (Cabinet Office).

(CHARLES POWELL)

Tancred Tarkowski, Esq.,
H.M. Treasury.

128/3

HAMBROS BANK LIMITED

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

28th March, 1990

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
Prime Minister,
10, Downing Street,
London, S.W.1.

Dear Prime Minister,

Second Stage of E.M.U.

1. I enclose a substantial paper prepared over the past few months by Paul Richards of Samuel Montagu after informal consultation with a number of key experts, together with a covering paper by myself as Chairman of the European Committee of the B.I.E.C. Both were approved at its meeting yesterday as a contribution to the debate and for the consideration of H.M.G.

2. I know how busy you are, but I hope that you may be able to find time to give these ideas early consideration. If the Government feels able to make them their own, the sooner they are put forward, the better the chances of British representatives securing a powerful position in the E.C. negotiations. At present Delors seems to be making a lot of the running. If you yourself were ready to put forward ideas on these lines, either in a speech or a letter to your E.C. colleagues, the hand of British negotiators would in my view be further strengthened.

3. The existence of this private sector initiative is now known by quite a wide circle. But we propose to take no action to publicise it while you are considering it. If its existence is leaked, we shall have to respond, but will try to do so in as helpful a way as possible.

4. I would be most grateful if you could find time to discuss this initiative with me before long.

5. I am copying this letter and its enclosures to the Chancellor and the Foreign Secretary.

Yours ever
Michael Butler.

Sir Michael Butler

MDB/MML

Copy: The Rt. Hon. Mr. John Major, M.P.,
The Rt. Hon. Mr. Douglas Hurd, M.P.

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28 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

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OPR
28 March 1990

28 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

SUMMARY

1. There appear to be three main ways in which the UK can approach the Inter-Governmental Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might lead to a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives of competition, subsidiarity and price stability.

It is the third approach that is considered in this paper.

2. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in the paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

3. In the alternative Stage 2 proposed in the paper, the European System of Central Banks would consist of the national central banks of member countries and a European Monetary Fund. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. Alongside national central banks, a European Monetary Fund would be established, which would be owned jointly by national central banks, and would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS.

4. In Stage 2, Community monetary policy would operate on the European Standard: that is, the equivalent of the Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would either be fixed (though not irrevocably fixed) at the outset in terms of the ECU, or they would float initially within very narrow margins and be fixed later. They would be convertible into (and out of) ECUs on demand.

5. The current definition of the ECU, which is based on 'the average' in the Community, would need to be changed. For the ECU to become a standard of 'the best' in the Community, its value would need to be as strong in terms of dollars as the strongest national Community currency. The European Monetary Fund would set ECU interest rates and conduct exchange intervention in ECUs against dollars to protect the external value of the ECU.

6. In Stage 2, the ECU would be issued by the European Monetary Fund as a dual currency in substitution for the national currencies of member countries on demand. Unlike the Delors plan, consumers in the Community would have freedom to choose whether, and if so when and to what extent, they wished to exchange their national currencies for ECUs. Exchange rates between member countries would not need to be fixed irrevocably first.

7. National authorities would cooperate within the European Monetary Fund in Stage 2 in exercising monetary control in national currency, and would act collectively through the European Monetary Fund in exercising control in ECUs. There is a question about whether the European Monetary Fund would need the power to implement monetary sanctions against 'profligate' national authorities.

8. The Community institution established in Stage 2 would take the form of a European Monetary Fund rather than a Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. New members (e.g. from EFTA and eventually from Eastern Europe) could be admitted to the European Monetary Fund with less difficulty than to a Central Bank. The UK would be able to put a strong case for locating the chief ECU operating arm of the European Monetary Fund at the Bank of England in London.

9. Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3.

10. A revision in the Treaty along the lines proposed in the paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) the principle of subsidiarity would be preserved;

(ii) the prospects for price stability would be enhanced; and

(iii) competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added.

28 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

INTRODUCTION

1. The purpose of this paper is to identify a route to monetary union that is consistent both with the UK's objectives and with a revision in the Treaty. The paper is set out in six sections, as follows:

(i) The first section considers different approaches to the Inter-Governmental Conference called to revise the Treaty, and distinguishes between 'beyond Stage 1' and Stage 2.

(ii) The second section outlines an alternative to the Stage 2 that is described in the Delors Report. The alternative Stage 2 is based on the establishment of a European Monetary Fund owned jointly by national central banks. The outline is then considered in more detail in the rest of the paper.

(iii) The third section examines the way in which the Community would operate during Stage 2 on a European Standard based on the ECU, which would need to be redefined first, and would then be issued as a dual currency in substitution for the national currencies of member countries on demand, with monetary control being exercised at national level and at Community level.

(iv) The fourth section explains the operations of the European Monetary Fund in ECUs, distinguishing between the note issue, open market operations, and exchange intervention in Community currencies and in dollars.

(v) The fifth section puts the case for an institution that takes the form of a European Monetary Fund in Stage 2 rather than a European Central Bank, for expanding its membership in future, and for locating its chief operating arm in London.

(vi) The final section concerns the timing for the introduction of Stage 2, its duration, and the revision in the Treaty that would be necessary to bring Stage 2 into effect.

THE INTER-GOVERNMENTAL CONFERENCE

2. The European Council agreed in Strasbourg on 8/9 December 1989 to call an Inter-Governmental Conference before the end of 1990 to revise the Treaty, despite UK opposition. In the absence of a viable alternative, the revision in the Treaty is likely to be based on the route to EMU described in Stages 2 and 3 of the Delors Report. The Treasury has put forward a UK alternative in a paper published in November 1989 on 'An evolutionary approach to EMU'. The Bank of England has recently elaborated on the UK alternative in a series of speeches by the Governor and the Deputy Governor. Both the Treasury and the Bank of England have emphasised the UK's commitment to complete Stage 1 (i.e. including sterling participation in the ERM), and suggested what should happen 'beyond Stage 1'.

Beyond Stage 1

3. The Treasury paper sets out (in paragraph 26) three fundamental principles for successful economic and monetary integration. They are: (i) to increase the influence of markets and competition; (ii) to respect the principle of subsidiarity; and (iii) to strengthen the forces tending to bring about stable prices. As the Treasury and the Bank of England have shown, these objectives can be achieved without the need for a new institution at Community level with decision-making power. National authorities can compete, within the framework of the single market and the EMS, with the objective of achieving price stability, while retaining responsibility for making decisions about monetary policy at national level. There is room for debate about whether price stability is more likely to be achieved if, in addition to a government commitment to achieve price stability and popular support, the central bank has statutory responsibility for achieving price stability too. But even if this is more likely, the decision to give the central bank statutory responsibility can be made at national level, and the central bank can remain democratically accountable at national level for carrying out the responsibility with which it has been entrusted. Consequently, in the UK's view, there is no need for an Inter-Governmental Conference or for a revision in the Treaty.

4. It is of course possible that developments in Eastern Europe in general, and the prospect of monetary union in Germany in particular, will help to persuade other Community member countries of the merits of the UK's position. But it seems likely that other member countries will still conclude that a revision in the Treaty is necessary, on the grounds: (i) that, whatever the case may be in the UK, other member countries would be very unlikely all to succeed in achieving price stability through decisions taken independently at national level; (ii) that, even if all members of the Community did succeed in achieving price stability eventually, the result would not conform with the definition of monetary union endorsed by all the participants on the Delors Committee: that is, a common monetary policy agreed at Community level with a common Community currency, or at least irrevocably fixed exchange rates; and (iii) that it is not possible to achieve monetary union on the Delors definition without a revision in the Treaty.

5. While the Treasury alternative meets the UK's objectives, it does not require a revision in the Treaty. By calling an Inter-Governmental Conference to revise the Treaty, the other member countries have indicated that the Treasury alternative does not in their view go far enough towards EMU. The question for them is not whether there should be a revision in the Treaty, but what form it should take. Stage 2 should in their view be the next stage to monetary union rather than 'beyond Stage 1'.

Stage 2

6. Given the UK's decision to participate in the Inter-Governmental Conference, there appear to be three main ways in which the UK can approach the Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might well be counter-productive. The other member countries might proceed to a new Treaty without the UK. The result would be portrayed as a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start. The other member countries can be expected to favour a revision in the Treaty of some sort. Otherwise, there would have been no point in calling an Inter-Governmental Conference in the first place.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives, and which would also carry sufficient support from other member countries that the UK's proposals would be agreed by the Community as a whole in the interests of securing unanimity among its members.

7. It is the third approach that is considered in this paper. The paper attempts to identify an alternative route to monetary union (i.e. from Stage 1 to Stage 3) to the route described in Stage 2 of the Delors Report. In doing so, the paper aims to build on the original Treasury alternative and adapt it to the new circumstances created by the Council's decision, while remaining consistent with the UK's objectives. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in this paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

8. As a result of considering the question of a Community institution with decision-making power, the paper also proposes a way of resolving the fundamental difficulty identified in paragraph 57 of the Delors Report. This lies in the organisation of a gradual transfer of decision-making power from national authorities, which have power to take all the decisions at the beginning of Stage 2, to a Community institution, which has power to take all the decisions at the beginning of Stage 3. The proposal in the Delors Report on economic union, involving the control of budget deficits and an increase in structural and regional transfers at Community level, is not discussed in detail in the paper, on the grounds that the Delors Committee's arguments on these two points have effectively been addressed already in paragraphs 29-31 of the Treasury paper.

OUTLINE OF AN ALTERNATIVE STAGE 2

9. Following the revision in the Treaty, the European System of Central Banks (ESCB) would consist in Stage 2 of the national central banks of member countries and a European Monetary Fund. The ESCB would have a monopoly of money creation in the Community, taking national central banks and the European Monetary Fund together. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. They would continue to compete within the framework of the single market and the EMS, through monetary operations denominated in their respective national currencies, with the objective of achieving price stability. But they would also cooperate to ensure sufficient convergence in their respective monetary policies that: first, exchange rates could either be fixed (though not irrevocably fixed) at the outset, or float initially within very narrow margins and be fixed later; and second, that interest rate differentials between their currencies could be reduced to the minimum.

10. Alongside national central banks, a European Monetary Fund (EMF) would be established. The EMF would be owned jointly by national central banks, which would subscribe its capital, and through which they would cooperate. The EMF would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS, including the ERM, 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.

In parallel to the EMF's coordinating role in monetary policy, ECOFIN would coordinate fiscal and macroeconomic policy in the Community, as at present.

11. In Stage 2, individual and business consumers in the Community would have the choice of transacting their business in national currencies or in ECUs. In other words, in addition to competing national monetary policies, there would be competition between national currencies and the ECU. If and when the ECU eventually emerged as the single European currency, the principle of subsidiarity would no longer apply, in the same way as it would not apply under the Treasury proposal for competing national monetary policies, if a national currency (e.g. the Deutsche mark) were to emerge as the single European currency. The main difference would be that, on the European Standard, the UK would have a say in the policy of the EMF. However, a more likely scenario on the European Standard would be that sterling would continue to be used in national transactions for some time, while ECUs were increasingly used in transactions between the UK and the rest of the Community, thereby reducing exchange rate uncertainty and (with the help of improvements in technology) reducing transactions costs.

12. The decision about when and to what extent to move towards monetary union would therefore be determined by the market preference of individual and business consumers in the Community for ECUs in substitution for national currency. That is an important difference between the route to monetary union set out in this paper and the route set out in the Delors Report. In the Delors Report, power to take decisions would be transferred from national level to Community level by administrative fiat before the issue of the ECU as a common currency, whereas under the scheme proposed in this paper, power to take decisions would only be transferred from national level to Community level to the extent of the demand for the ECU as a common currency among individual and business consumers in the Community.

THE EUROPEAN STANDARD

13. In Stage 2, Community monetary policy would operate on a European Standard: that is, the equivalent of a Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would either be fixed (though not irrevocably fixed) at the outset in terms of the ECU, or float initially within very narrow margins and be fixed later. They would be convertible into (and out of) ECUs on demand. The current definition of the ECU would be revised, so as to make the ECU a standard of 'the best' in the Community rather than 'the average'. Once redefined, the ECU would be issued as a dual currency in substitution for the national currencies of member countries on demand. National central banks would each retain separate responsibility for monetary policies denominated in their respective national currencies, and they would collectively take responsibility for the issue of ECUs. In both cases they would cooperate through the Committee of Central Bank Governors in their capacity as the Council of the EMF.

Redefinition of the ECU

14. As currently defined, the ECU does not represent a standard of 'the best' in the Community. It represents 'the average'. The current definition is based on a basket representing fixed weights of Community currencies, whose proportions are revised every five years, and at which point the currencies of new members of the Community are generally included. In the last revision, which took effect on 21 September 1989, the weight of the Deutsche mark in the ECU was reduced: (i) to offset its relative strength against other Community currencies over the previous five years; and (ii) to accommodate two new 'weak' currencies: i.e. the peseta and the escudo.

15. It is inconsistent to promote the use of the ECU, when it is based on 'the average', while following a monetary policy in the Community which is intended to represent 'the best'. If the ECU was to act as a standard of 'the best' in the Community rather than 'the average', the definition would need to be changed:

(i) One option would be to fix the existing currency composition of the ECU for all time, as proposed in the Treasury paper (paragraph 22). In those circumstances, the value of the ECU would strengthen over a period compared with its value if the currency basket were to be revised in the normal way every five years. But the ECU would still represent a variant of 'the average' rather than 'the best'.

(ii) A second option would be to reduce the number of currencies in the ECU basket to (say) the Deutsche mark, the French franc and sterling. An equivalent change has been made in the definition of the SDR (from sixteen currencies to five). But there might be political implications arising from the exclusion of some member countries from the composition of the ECU. And even if the number of currencies were significantly reduced, the ECU would still not represent 'the best' in the Community.

(iii) A third option would be to link the ECU to the Deutsche mark. A link to the Deutsche mark - a sort of European or 'E' mark - would have the advantage of simplicity, and would recognise the fact that the Deutsche mark is currently the most important single currency in the Community. But it might not be an acceptable solution for those member countries whose interest in monetary union is closely linked to the desire for a greater say in Community monetary policy than they currently enjoy in practice within the ERM. In addition, the link with the Deutsche mark would only represent 'the best' so long as the Deutsche mark continued to be the strongest currency within the Community. The onset of German monetary union suggests that this may not always be the case.

(iv) A fourth option would be to link the ECU to gold or some other non-currency indicator. A link to gold would avoid the need to create a new Community institution. But it would carry implications for the international monetary system beyond the Community. Some countries would be opposed to remonetising gold on principle, and in practice it would be difficult to agree on the price at which to fix the link between the ECU and gold. A link to any other non-currency indicator would be untested and would be likely to carry unacceptable risks.

(v) The final option would be for the ECU to be managed independently of national member currencies by Community central bank governors through the EMF, with the objective of setting a standard of 'the best' rather than 'the average'. The central parities of national currencies would be fixed (though not irrevocably fixed) in terms of the ECU, either with no margins or with very narrow margins. But the value of the ECU would no longer be determined by any particular mix of national currencies.

16. For the ECU to become a standard of 'the best' in the Community, its value would need to be as strong in terms of third currencies (e.g. the dollar) as the strongest national Community currency. This would mean that the central parities of Community member countries' national currencies could never be revalued in terms of the ECU, though they could be devalued. If a member country revalued the central parity of its national currency against other member countries' national currencies, the ECU would be revalued with it. So agreement would be needed prior to realignments in the central parities of member countries, as it is now. Unlike now, agreement would be needed with the EMF.

17. The (redefined) ECU would be 'the best' in the sense that its exchange rate would always be the strongest within the Community, with two qualifications. First, so long as member countries' exchange rates continued to fluctuate within very narrow margins of their central parities against the ECU, then the ECU could depreciate as well as appreciate against member countries' national currencies, though only within the narrow margins. Once exchange rates between member countries' national currencies were fixed, the ECU could never depreciate in terms of the currency of any member country. Second, the overall return on ECUs in comparison with the overall return on the national currencies of member countries would depend on interest differentials between them as well as exchange changes. So the overall return on ECUs over a period would not necessarily be higher than the return on member countries' national currencies, any more than the return on Deutsche marks at present is necessarily higher than the return on lire expressed in Deutsche marks.

18. If the ECU was going to be redefined from a basket of currencies representing 'the average' in the Community to an independently managed currency based on 'the best' in the Community, then it would be easier to implement the change in definition if exchange rates between member currencies were fixed (though not irrevocably fixed) first. The change in definition would also be easier to implement if a realignment in parities was not considered by the market to be in prospect in the short term. But there is no reason in principle why the change in definition could not be introduced, even if exchange rates were still floating within very narrow margins at the point of change.

19. There would have to be continuity between the external value of the new definition of the ECU and the old definition at the point of change. This would be necessary to reassure practitioners in the ECU market with contracts written in ECUs that were due to mature after the change in definition. There has been continuity at the point of change in the case of previous revisions in the definition of the ECU. The difference on this occasion would be that, after the change in definition, the ECU exchange rate and ECU interest rates

would not be determined by a new mix of component currencies. ECU interest rates would be set instead by Community central bank governors through the EMF, and the external value of the ECU exchange rate would be enforced by changes in interest rates and exchange intervention in ECUs against third currencies (e.g. the dollar). In setting ECU rates, the Council of the EMF would be guided by the objective of achieving price stability over a period of time. Making the ECU a standard of 'the best' in the Community would help to achieve this.

20. An additional option would be to redenominate the ECU when it was redefined by making one new (heavy) ECU equal to 10, 100 or 1000 old ECUs. Contracts written in old ECUs that matured after redenomination would be paid off in the appropriate number of new ECUs. Redenomination would help consumers to distinguish between the ECU and their national currencies, and enable a dual relationship to develop in each country between the ECU and national currency roughly equivalent to the relationship between pounds and pence. The use of a heavy ECU could also act as a psychological 'anchor' at Community level against inflation.

The ECU as a dual currency on the European Standard

21. Once the ECU had been redefined, it would be issued by the EMF in Stage 2 as a dual currency in substitution for the national currencies of member countries on demand. This would enable national currencies to be converted into ECUs on the European Standard, in the same way as national currencies could be converted into gold on the Gold Standard. The process of substitution would be similar to the process of substitution outlined in the Delors Report. The differences relate to the circumstances in which substitution could take place, and who would decide.

22. In the Delors plan, the ECU would be issued by the ESCB as a dual currency in substitution for national currencies once exchange rates were irrevocably fixed. The term 'dual currency' is used here - rather than 'parallel currency' - in the sense in which it is used by the Bundesbank in the collection of papers submitted to the Delors Committee (page 141). Under the alternative scheme presented in this paper, the ECU would be issued as a dual currency in the same way as proposed in the Delors plan, but there would be three differences from the Delors plan in the circumstances in which the substitution of ECUs for the national currencies of member countries would take place. First, exchange rates would not have to be fixed irrevocably. In fact, they might not even be fixed at all: they might still be floating within very narrow margins in the ERM, and there would be an objective of fixing them after a period of time. Second, the substitution of the ECU for national currencies would not take place on the basis of a bureaucratic decision at Community level. It would take place on the basis of market choices by individual and business consumers. Third, the decision would not be irreversible, as it would be in the Delors plan. Consumers could change their preference and convert back into national currency if they wished to do so.

23. There are two criticisms of the issue of the ECU as a parallel currency in the Delors Report (paragraph 47). One is that the issue of ECUs as a parallel currency would be inflationary. This would, of course, be true if ECUs were issued as a parallel currency in addition to national currencies rather than in place of them. But under the proposal set out in this paper, the issue of ECUs by the EMF would not be inflationary, as ECUs would only be issued in substitution for national currency. Second, the issue of ECUs would be accompanied by national monetary policies which would bear down on inflation. Third, ECUs already exist in the private market as a parallel currency. The creation of the EMF to control monetary policy for the ECU could ultimately become an additional means of bearing down on inflation by providing a mechanism for controlling the supply of ECUs, in exactly the same way as national central banks control the supply of national currencies.

24. The second criticism of the issue of the ECU as a parallel currency in the Delors Report is that the issue of a thirteenth currency would complicate the task of coordinating national monetary policies. This would not be the case under the alternative scheme set out in this paper. First, the relationship between the EMF's responsibility for the ECU and member central banks' responsibility for national currencies would be similar to the relationship between the Commission's responsibility for some categories of public expenditure and national governments' responsibility for others. Second, whatever configuration of ECUs and national currencies emerged, it would be quite clear at any particular point in time who had responsibility for taking monetary decisions in every case. Third, the task of coordinating national monetary policies would be easier for member countries to accept if it did not also involve transferring control of them irrevocably from national level to Community level first. As a result, the arrangements proposed in this paper should be less difficult to implement than the route to monetary union proposed in the Delors Report. The Guigou Committee has indicated the wide range of questions that would need to be settled in preparation for or by an Inter-Governmental Conference, if the Delors plan were to be implemented.

25. A separate criticism of a fixed exchange rate regime short of a single currency is that it is vulnerable to speculative attacks. This would of course apply to Stage 2 of the Delors Report as well as to the alternative Stage 2 presented in this paper. In the event of speculative attacks, national authorities on the European Standard would retain the option to change short term interest rates denominated in national currency, or in the last resort to devalue their exchange parity in terms of the ECU. But assuming that they decided not to do so, the response to a speculative attack from within the Community would be for national central banks to intervene in ECUs in unlimited amounts against their national currencies (or vice versa). There would be no need for sterilisation, as there would be no net monetary effect within the Community. If the speculative attack came from outside the Community, the EMF would intervene against the dollar (or the yen) in ECUs, and/or national central banks would intervene in national currency, and the net monetary effects of the intervention on the Community would be sterilised, where appropriate.

Monetary control on the European Standard

26. Monetary control within the Community during Stage 2 would be exercised at national level and Community level. National authorities would cooperate within the EMF in exercising control in national currency, and would act collectively through the EMF in exercising control in ECUs. The instruments for the exercise of monetary control in ECUs would be similar to the instruments for monetary control in national currency: the ability to influence ECU interest rates through open market operations in ECUs; and the ability to influence the ECU exchange rate by intervention in the exchange market. The EMF's operations in government securities would be confined to monetary management.

27. The monetary aggregates over which control would be exercised would include national currency, other Community currencies and ECUs, because it would no longer be appropriate to assume that residents of a particular member country would hold liquid assets denominated only in national currency. Notes and coin would be measured at national level, if ECU notes were not issued. If ECU notes were issued, then notes and coin would be measured at Community level by aggregating the sum of notes and coin in issue in national currencies and ECUs. Wider definitions of liquid assets would be measured at national level (and aggregated at Community level) by adding residents' holdings of liquid assets denominated in national currency, the national currencies of other Community countries and ECUs. These definitions would be identical to

the definitions that would be needed under the Treasury proposal for competing national monetary policies, with the exception of the inclusion of the ECU (in substitution for national currency). The problems of exercising monetary control within the Community would be no more difficult than they are at present, given the complete freedom of capital movements within the Community.

28. There is a question about whether the EMF would need the power in Stage 2 to exercise monetary sanctions against 'profligate' national authorities, and if so what the sanctions would be. In one sense, sanctions by the EMF would not be necessary. A member country which followed an inflationary policy would run the risk, either: (i) that residents would sell national currency for ECUs, with the effect that the national authorities concerned would lose control of national monetary policy to the EMF; or (ii) that interest rates would have to be raised to prevent this from happening, with the effect that national monetary conditions would be tightened; or (iii) that the member country was forced to devalue its exchange rate against the ECU to maintain the competitiveness of the local economy in the EC single market.

29. However, if it was generally agreed that sanctions were necessary in Stage 2 to reinforce efforts at Community level to secure price stability, some indicators of whether sanctions were required would be more useful than others. It might not be practicable to set similar monetary targets for all member countries, for the reasons set out in the Governor's speech of 16 January. Control over the size of member countries' budget deficits would not be effective, for the reasons set out in the Treasury paper (paragraph 29). Instead, the objective might be to prevent the monetary financing of budget deficits rather than controlling their overall level, and to agree that the Community would not bail out governments which run excessive budget deficits, as suggested in the Treasury paper (paragraph 24). National authorities would not in those circumstances be able to create more national currency to replace national currency that had been exchanged for ECUs.

30. One way in which the EMF might enforce sanctions would be by suspending (or threatening to suspend) the convertibility of the national currency of the member country concerned into ECUs. The procedure might work as follows. If a member country was in breach of its obligations, the EMF would bring it to the attention of ECOFIN. A decision would be taken by ECOFIN to invite the member country concerned to take corrective action. If corrective action was not taken within a given timescale, the EMF would have the power to suspend the convertibility of the member country's national currency into ECUs.

OPERATIONS OF THE EUROPEAN MONETARY FUND

31. The operations of the EMF in ECUs can be divided into three main categories:

(i) the issue of ECU notes and coin;

(ii) open market operations in ECUs; and

(iii) exchange intervention between ECUs and national Community currencies, and between ECUs and third currencies (e.g. dollars).

In each case, the objective would be that any exchange risk arising from the EMF's operations in ECUs would be borne by each member country in relation to the extent to which its currency was converted into ECUs, rather than by all member countries in proportion to their central banks' shareholdings in the EMF.

ECU notes and coin

32. It is not essential to the scheme that the EMF should issue ECU notes (and coin) on demand. It could be argued that the ECU would mainly be used for large-scale business transactions within the Community, and that notes would not be necessary, at least until later in Stage 2. If the EMF did not issue bank notes on demand, the European Standard would correspond to the Gold Bullion Standard, under which sterling was convertible into gold bullion on demand, but not into gold coins. However, as the ECU increased in importance, it is likely that there would be demand for ECU bank notes, from individuals and for small-scale business transactions, and there is no reason why this demand could not be met by the EMF in a way that was consistent with the principle of substitution. Legal restrictions on the issue of notes, which vary from country to country within the Community, would need to be removed first. There might also be advantages in making the ECU legal tender alongside the national currency in each member country, subject to a unanimous vote by ECOFIN first.

33. Payment for ECU notes would either be made in ECUs or in national currency (e.g. sterling). If payment was made in sterling, the proceeds could be handled in two main ways. One way would be for the issue of ECU notes to be backed by the sterling notes withdrawn from circulation in exchange for them. This would enable the exchange risk arising from the transactions and the profits from seignorage to be kept at national level. The other way would be to invest the proceeds in sterling gilt-edged. The effect would be to reduce the liabilities of the Issue Department of the Bank of England and increase the liabilities of the EMF, and to reduce the Bank of England's holdings of sterling gilt-edged and to increase the holdings of the EMF.

Exchange of £ notes for ECU notes

Bank of England

Liabilities	ECUm	Assets	ECUm
£ notes in issue	-100	£ gilt-edged	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU notes in issue	+100	£ gilt-edged	+100

34. The issue by the EMF of ECU bank notes and the investment of the proceeds in assets denominated in national currency would give rise to an exchange risk. This would be borne by the central bank whose currency had been substituted for ECUs, as happens at present in the case of purchases of foreign exchange by member countries from the IMF. The exchange cover could be provided by means of an exchange guarantee, or by denominating government securities purchased by the EMF in ECUs. If so, it would have the effect of giving an added incentive to member countries not to devalue their exchange rates. The profits earned by the EMF from seignorage (and from its other operations) would be distributable to shareholders.

Open market operations

35. In Stage 2, the EMF would act as lender of last resort to the ECU banking system. Left to itself, the market would set a level for ECU interest rates based on its assessment of the ECU's revised definition as equal to the central parity of the strongest currency in the Community rather than a weighted basket. While it might take time for the market to adjust to the revised definition, the ECU as redefined should be attractive both to investors as a strong currency and to borrowers as a result of low ECU interest rates. The EMF would be able to determine the level of ECU interest rates by open market operations in ECUs with the objective of reinforcing the Community's policy of bearing down on inflation. By determining ECU interest rates, the EMF would not initially determine Community monetary policy, because each national authority would make its own decision about interest rates in national currencies. But interest rates on ECUs would influence national monetary policy, because of the threat that, if national monetary policy was not sufficiently tight, residents could switch their liquid assets denominated in national currency ECUs. The degree of control by the EMF over national monetary policy would increase, once a critical mass of ECUs were in circulation in substitution for national currency.

Exchange intervention

36. Exchange intervention in Stage 2 can be divided into two categories:

(i) exchange intervention between members of the ESCB in Community currencies; and

(ii) exchange intervention between the currencies of members of the ESCB and the currencies of third countries (e.g. dollars).

37. Within the EMS, the parity grid consisting of bilateral exchange intervention points would be replaced by intervention margins for each currency in terms of the ECU. At sterling's lower intervention margin, the Bank of England would be obliged to buy the sterling offered by the market in exchange for ECUs. The Bank of England would finance the purchase of sterling by borrowing ECUs from the EMF. The ECU loan by the EMF would be financed by borrowing from the Bank of England the sterling offered by the market. The residual claims of the Bank of England and the EMF on each other would cancel out. At sterling's upper intervention margin, the mechanism would work the other way round. In either case, there would be no net monetary effect. The creation of ECUs by the EMF would be offset by the withdrawal of an equivalent amount of sterling by the Bank of England (or vice versa). An increase in the market's holdings of liquid assets denominated in ECUs would be offset by a reduction in the market's holdings of liquid assets denominated in sterling (or vice versa). The mechanism would be symmetrical, simultaneous and unlimited as to amount.

(i) Purchases of £ from the market at £'s lower intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
ECU liability to EMF	+100	£ claim on EMF	+100
Repayment of ECU liability	-100	Use of £ claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
£ liability to Bank	+100	ECU claim on Bank	+100
Repayment of £ liability	-100	Use of ECU claim	-100

(ii) Sales of £ to the market at £'s upper intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
£ liability to EMF	+100	ECU claim on EMF	+100
Repayment of £ liability	-100	Use of ECU claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU liability to Bank	+100	£ claim on Bank	+100
Repayment of ECU liability	-100	Use of £ claim	-100

38. Outside the EMS, national central banks would continue to intervene in their national currencies against third currencies (e.g. dollars), as at present. But the EMF would become responsible for intervention between the ECU and third currencies (e.g. dollars). If the EMF purchased dollars against ECUs, it would pay for the ECUs that it sold in exchange by issuing ECU securities. Conversely, if the EMF sold dollars against ECUs, it would use the proceeds to redeem ECU securities. As in the case of the EEA, the monetary effects of the EMF's exchange operations in dollars would depend on whether the ECU securities issued (or redeemed) by the EMF were purchased (or sold) by the banking system or by the non-bank private or overseas sectors. If the securities were purchased (or sold) by the non-bank private or overseas sectors, the monetary effect on the Community of the EMF's dollar operations would be sterilised.

39. A separate question that needs to be addressed is who would be responsible for issuing the ECU securities. While in principle the securities could be issued at Community level, in practice the rules of subsidiarity could apply. In that case, the EMF would pay for its net purchases of foreign exchange by increasing its net liabilities in ECUs to national authorities (pro rata). National authorities would then have the task of deciding whether, and if so how, to sterilise the monetary effects, within any guidelines agreed at a Community level. These would need to take account of the Bundesbank's policy of not sterilising the monetary effects of exchange intervention. To the extent that the monetary effects of exchange intervention were to be sterilised, this could be achieved by issuing securities to the non-bank private sector in local currency or in ECUs. The net sale of securities at national level would not be additional, because exchange intervention by the EMF in ECUs would substitute for exchange intervention that would otherwise have taken place in the national currency of member countries at national level.

(i) EMF purchases of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Sale of ECU securities to central banks	+100	Purchase of $ claims	+100

National central banks

Liabilities	ECUm	Assets	ECUm
Increase in money supply	+100	Purchase of ECU securities from EMF	+100
Reduction in money supply	-100	Sale of ECU securities to non-banks	-100

(ii) EMF sales of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Purchase of ECU securities from central banks	-100	Sale of $ claims	-100

National central banks

Liabilities	ECUm	Assets	ECUm
Reduction in money supply	-100	Sale of ECU securities to EMF	-100
Increase in money supply	+100	Purchase of ECU securities from non-banks	+100

40. In order to enable it to intervene in third currencies, the EMF would take over the assets and liabilities managed by the EMCF. The assets taken over would consist of dollars (and gold), representing 20% of the dollar (and gold) reserves of member countries. The liabilities would consist of the claims of national authorities in ECUs on the EMF, representing the counterpart to the EMF's holdings of dollars (and gold). There would be no monetary effects from the transfer. One option would be for the EMF to take over direct ownership of the proportion of dollar (and gold) reserves allocated to it. Alternatively, national authorities might decide to retain direct ownership of all their dollar (and gold) reserves. In that case, the EMF would manage as agent the initial proportion (say 20% of the total) allocated to it, in the same way as the Bank of England acts as manager of the EEA on behalf of the Treasury. The statutes of the EMF might need to provide for the circumstances in which a greater proportion of national authorities' foreign reserves would be put at the disposal of the EMF, subject to a unanimous vote by ECOFIN first. But in practice, an additional transfer of reserves should not be necessary for the foreseeable future, because the EMF would be able to use interest differentials to defend the external value of the ECU, as well as being able to use its foreign reserves in exchange intervention.

ORGANISATION OF THE EUROPEAN MONETARY FUND

41. The new institution established in Stage 2 would take the form of a European Monetary Fund rather than a European Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. (An EMF of a slightly different kind was envisaged as the next stage to monetary union in 1978, when it was originally agreed that the EMS should be established.) The EMF would have some similarities with the IMF in terms of its institutional form, though its role would differ: the primary role of the EMF would be to set a European monetary standard, not to act as a regional IMF providing short term balance of payments support. The EMF would be complementary to the EIB, in broadly the same way as the IMF is complementary to the World Bank.

Need for a Community institution

42. The question arises why an EMF would be needed in Stage 2 to take responsibility for the development of the ECU as a common currency, and why this could not be left to the private market. Of course, the private market can already substitute ECUs for national currency on demand. But there are drawbacks:

(i) The ECU cannot compete on a level playing field with the national currencies of Community countries while it is manufactured in the market rather than being issued with official backing as legal tender, as national currencies are.

(ii) To the extent that the circulation of the ECU does increase in substitution for national currency under the existing ECU definition, this is not necessarily desirable because the current definition represents 'the average' in the Community rather than 'the best'.

(iii) Although a link between the ECU and gold or the Deutsche mark would eliminate the need for a new institution, in the case of gold because no institution would be needed and in the case of the Deutsche mark because the Bundesbank would take overall responsibility at Community level, neither link would necessarily represent 'the best' in the Community, and both would have other disadvantages.

(iv) It would not be feasible to make the ECU a standard of 'the best' in the Community in Stage 2 while linking it permanently with any single Community currency or group of currencies. Consequently, the ECU would need to be independently managed at Community level.

(v) Although the implementation of ECU operations could be delegated to national central banks, a central institution would still be needed with powers to formulate a single monetary policy for the ECU, in the same way as a single monetary policy is formulated for each national currency at the moment.

43. So when Stage 2 began, following the revision in the Treaty, the EMF would be established as a Community institution with decision-making power over the ECU. Whether the EMF that was established would represent a new institution would be more problematic. In one sense, it would not be new, because it would take over the functions of the EMCF. In another sense, the institution would be a new one, because a revision in the Treaty would be required before it could be established.

The constitution of the European Monetary Fund

44. The EMF would be owned by national central banks rather than their governments. The constitutional arrangements relating to the statutory responsibility and accountability of national central banks currently vary from country to country. Insofar as monetary operations denominated in national currency are concerned, the existing constitutional arrangements would not change in Stage 2 in any way unless a particular country wished to change them (e.g. by giving the central bank statutory responsibility to achieve price stability while remaining democratically accountable at national level), in which case it would continue to be free to do so. Insofar as monetary operations denominated in ECUs are concerned, decisions would be taken at Community level through the EMF rather than at national level.

45. The constitution of the EMF would need to be discussed at the Inter-Governmental Conference. It might take the following form:

(i) The capital of the EMF would either be subscribed by national central banks in the same proportions as the EIB, or some other measure of economic and currency significance, such as the respective weights in the definition of the ECU basket at the time of the last revision.

EIB weighted voting and ECU basket weights

	EIB	ECU
Belgium	5	6
Denmark	3	2
Germany	10	23
Greece	5	1
Spain	8	4
France	10	14
Ireland	3	1
Italy	10	8
Luxembourg	2	...
Netherlands	5	7
Portugal	5	1
United Kingdom	10	10
	76	76

(ii) The Council of the EMF would consist of the governors of the national central banks of member countries and EMF Board members. The appointment of national governors to the Council of the EMF would run concurrently with their appointments at national level, and the relationship between national governors and their respective governments would reflect the constitutional arrangements in place in each case. EMF Board members would be appointed by ECOFIN. Their appointments would run for a fixed and long period of time (e.g. eight years). They could not be removed in normal circumstances.

(iii) Voting procedures would need to be discussed at the Inter-Governmental Conference. Decisions by the EMF might in some cases require unanimity, and in other cases might be made on the basis of qualified majority voting.

(iv) The Council of the EMF would have as its prime objective the achievement of price stability within the Community. Subject to this overriding objective, it would have an obligation to support the general economic policy set at Community level by the competent bodies.

(v) The Council of the EMF would be democratically accountable for achieving these objectives in four principal ways. First, the EMF would be established following a revision in the Treaty approved by national parliaments. Second, appointments to the Council of the EMF would be made by national governments and by ECOFIN. Third, the President of the EMF Council would be required to report on the EMF's policy from time to time to ECOFIN and the European Parliament. Fourth, although the EMF Council could not be dismissed en bloc, either by ECOFIN or by the European Parliament, the influence of the EMF would effectively be determined by the extent to which citizens within the Community chose to use ECUs in preference to their national currencies.

(vi) The Chairman of ECOFIN and the President of the Commission might be invited to participate in the proceedings of the EMF Council without a vote, and the President of the EMF Council might be invited to attend meetings of ECOFIN on a similar basis.

Expansion in membership

46. New members could be admitted to the EMF, which would be based on cooperation among its members, with less difficulty than to a European Central Bank, which would be based on central control. One option would be to confine membership to Community member countries. Another option would be to widen it, either at the outset or at a later stage, in anticipation of the expansion of Community membership (e.g. to include member countries from EFTA, and eventually from Eastern Europe). It is worth noting that membership of the BIS does not at present coincide precisely with membership of the Community, and includes Switzerland and Sweden.

Location and infrastructure

47. The policy arm of the EMF would be based, either at the BIS in Basle, or in a Community capital. The operations of the EMF would be carried out by the national central banks of member countries on the EMF's behalf, and by the ECU operating arm of the EMF. National central banks would continue to have responsibility for monetary policy denominated in their respective national currencies, including exchange intervention between national currencies and third currencies (e.g. dollars), and would undertake the exchange of national currencies into ECUs on demand on behalf of the EMF. The ECU operating arm of the EMF would be responsible for implementing decisions taken by the EMF relating to open market operations in ECUs and exchange intervention between ECUs and third currencies (e.g. dollars).

48. The UK would be able to put a strong case for locating the chief ECU operating arm of the EMF at the Bank of England in London. First, London is Europe's most important financial centre, as the survey in the November 1989 issue of the Bank of England Quarterly Bulletin shows. Second, the Bank of England has taken the initiative in promoting the use of the ECU (e.g. through the regular issue of ECU Treasury bills). Third, London would be in the best position to put in place the financial infrastructure necessary to support, at minimum cost, the full range of financial transactions in ECUs: payment and clearing arrangements, and settlement arrangements for banking and securities operations. To the extent that ECU systems are currently based elsewhere, the UK could take the initiative in coordinating them.

49. It is sometimes argued that there is no particular importance to be attached to the decision about whether the chief operating arm is located in London. The argument runs that London has developed as an international financial centre by carrying out financial transactions more cost-effectively than they are carried out in the host country of the currency concerned. One of the reasons for this is that London has advantages over competing financial centres in terms of language, skills and critical mass. But another reason is that London has been subject to a lighter level of regulation and control than most potential alternative centres.

50. This advantage is likely to be removed by the advent of the single financial market within the Community. In these circumstances, if the chief operating arm was based in another financial centre (e.g. Frankfurt, Paris or Luxembourg), the principal money, government debt and foreign exchange markets within the Community would be likely over a period of time to develop there, along with the clearing and settlement systems needed to support them. It would be advantageous for large financial institutions within the Community to build up a significant presence in the market where the chief operating arm was based, and the same considerations would apply to US and Japanese financial institutions requiring a European base. Of course, London would remain a financial centre, but its pre-eminent position in Europe would in due course be lost, and its relative position would over a period be likely to decline.

THE TIMING AND DURATION OF STAGE 2

51. One difference between the scheme set out in this paper and the scheme set out in the Delors Report is that Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3, which is the way in which Stage 2 is described in the Delors Report. As Stage 2 would become a significant step, it could take longer to prepare than it would take to prepare Stage 2 on the Delors model. The main questions that would need to be resolved first would be how stable exchange rates between members would need to be, how convergent their monetary policies would need to be, and how nearly price stability would need to be achieved in each member country, before the EMF began to issue ECUs in substitution for national currency. A measure of when the conditions would be right to begin Stage 2 would be when member countries were ready for the EMF to begin issuing ECUs as a dual currency on the European Standard. Until that point, cooperation between central banks within the Community could continue and intensify through existing informal arrangements during and 'beyond' Stage 1. But there would be no need for a new Community institution as such, or a revision in the Treaty.

52. Once Stage 2 had been introduced, progress towards Stage 3 would be determined by the time that it would take for the ECU to gain acceptance as a popular currency, and by the success of the EMF in fostering the ECU's acceptance within the Community. Unlike the Gold Standard, where the supply of gold was limited, it would be feasible on the European Standard to evolve from the use of the ECU as a standard to its use as the single Community currency, once a critical mass of ECUs was achieved. In this respect, the scheme goes further than the Delors Report, by proposing a way of resolving the problem identified in paragraph 57 of the Delors Report. Power would transfer from national level to Community level, but only to the extent that individual and business consumers within the Community decided to use ECUs rather than national currency.

53. An Inter-Governmental Conference would be needed under the proposal set out in this paper to prepare the way for a revision in the Treaty, but the path to monetary union that the Conference would consider would be different from the path set out in the Delors Report. The issues that would need to be considered in preparing the Conference, or by the Committee of Central Bank Governors outside it, would include: (i) membership of the EMF; (ii) its statutes; and (iii) the redefinition of the ECU. The revision in the Treaty resulting from the Conference would be roughly equivalent to Stage 2 of the Delors Report, though provision could be made in the Treaty for the circumstances and conditions in which the Community would move to Stage 3. One condition might be that the ECU should become the single (rather than a dual) currency when it represented more than a specified proportion (e.g. 80%) of liquid assets in each member country. But account would also need to be taken of the option available to holders of liquid assets denominated in ECUs to convert them back into national currency if they wished to do so.

54. It now looks as though the revision in the Treaty relating to monetary union in the Community will be preceded by monetary union in Germany. The question will no doubt arise whether German monetary union should be used as a model for the Community as a whole. German monetary union is similar to monetary union in the Community in the sense that monetary union is likely to precede political union. But the differences outweigh the similarities. The main differences are, first, that German monetary union represents the union of a single divided nation. The Community by contrast, is a group of sovereign nation states which has never been unified. Second, the Ostmark is not a convertible currency, leaving a potential overhang of unspent savings in East Germany. This is not the case in the Community, where all member currencies are fully convertible. Third, one of the main reasons why German monetary union is being proposed now is that the East German economy is near a state of collapse.

Not yet

CONCLUSION

55. In the event that a decision was taken at the Inter-Governmental Conference to revise the Treaty, a revision in the Treaty along the lines proposed in this paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) The principle of subsidiarity would be preserved. National central banks would remain directly accountable at national level under the constitutional arrangements in place in each country, and the EMF would act as a forum for the coordination of national monetary policies by means of cooperation rather than control.

(ii) The prospects for price stability would be enhanced. The European Standard would be based on 'the best' in the Community rather than 'the average'.

(iii) Competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added, with the market determining progress towards the common currency. In addition:

(iv) The EMF would be open-ended, so as to be able to accommodate new members (e.g. from EFTA and eventually from Eastern Europe) without disrupting the system.

(v) There would be a strong case for basing the ECU operating arm of the EMF in London.

56. Stage 2 would become a significant set of monetary arrangements in its own right, and not simply a process of transition to Stage 3. Once Stage 2 was introduced, individual and business consumers within the Community would decide when and to what extent to move towards monetary union. This would resolve the fundamental difficulty identified in the Delors Report relating to the circumstances in which decisions about monetary policy should be transferred from national level to Community level.

OPR
28 March 1990

Paper by the Chairman considered at the European Committee of the B.I.E.C. on 27th March, 1990

Stage 2 of Economic and Monetary Union

1. The attached paper, approved by the BIEC's European Committee on 27th March as a contribution to the discussion and for consideration by H.M.G. contains a proposal for Stage 2 of EMU.

2. The Delors report said very little about how to move forward after Stage 1; and the Commission is still concentrating on the requirements of Stage 3. This is unwise since an attempt to make a great leap forward after Stage 1 would almost certainly land the E.C. flat on its face. On the other hand, while the Treasury paper of 2nd November, 1989 contained interesting ideas for Stage 2, it has not had much impact on the debate because:-

(a) it appeared not to accept the generally agreed definition of full EMU, namely that there should at least be irrevocably fixed exchange rates (or a single currency);

(b) it was regarded not as a contribution but as an alternative to E.C. action to realise EMU in accordance with the Madrid conclusions.

3. The BIEC's European Committee believes that a well-thought-out proposal for Stage 2 would make a valuable contribution, fill a real gap and - provided that the British Government is prepared to subscribe to the generally agreed final Stage 3 aim of moving in the long run to irrevocably fixed exchange rates (or a single currency) - get the U.K. back into the centre of the discussion.

4. The proposal made here is consistent with the British Government's evolutionary approach. Its main features are:-

(a) co-ordination of macroeconomic and fiscal policy remains as at present with ECOFIN;

/(b)

(b) in replacement of the present EMCF and Central Bank Governors' committee, a new European Monetary Fund (EMF) is created to co-ordinate monetary and exchange rate policies; it is to be run by the Central Bank Governors and owned by the Central Banks of the Member States: the E.R.M. continues to operate, under the aegis of the EMF, (sterling having been included in Stage 1 in accordance with the Madrid conclusions) either with the present bands or possibly with fixed, but not irrevocably fixed, exchange rates;

(c) action is taken to strengthen the ecu by cutting it loose from the basket of currencies and to make it as strong as the strongest E.C. currency, i.e. it would no longer be possible to revalue a national currency against the ecu though it would remain possible to devalue;

(d) national currencies would be convertible into ecus (and vice versa) through the EMF, which would manage the ecu as a European standard with the objective of achieving price stability, and would act as lender of last resort in ecus;

(e) these arrangements should not lead to uncontrolled money creation since Central Banks would be under an obligation not to create national currency to replace that exchanged for ecus;

/(f)

(f) the two principles in the Treasury's 2nd November paper would be adopted i.e. no bail-outs of Member Governments with irresponsible fiscal or monetary policies and no monetary financing of budget deficits; the EMF would report persistent offenders to ECOFIN and, if corrective action were not taken, would be empowered to suspend convertibility into ecus of the currency concerned;

(g) the ecu would thus become a dual European currency alongside each national currency, and be at least as strong as the D-mark; the preferences of users would determine whether it gradually came to pre-dominate in cross-border transactions and thus a candidate to become the E.C.'s main (or even one day single) currency.

4. A system of weighted majority voting would have to be negotiated for the EMF Council, thus involving some extra sharing of sovereignty, but the EMF's charter would lay down in inescapable terms its duty to manage the ecu on the lines set out above. The constitutional relationship between governments and central banks would remain a matter for national governments and parliaments. Accountability to the British Parliament for the Governor's actions in the EMF could thus be maintained if Parliament so decided.

5. British Ministers could concede that the final Stage 3 aim should be incorporated in the new Treaty amendments to be agreed in the I.G.C. but could argue that it would be desirable to experience the working of the EMF in Stage 2 before deciding what further changes, either in the powers of the EMF or in the institutional arrangements, might (or might not) be required for Stage 3. Thus it would be for later decision whether a further I.G.C. would be needed to complete the move to Stage 3.

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6. The Bundesbank has always been reluctant to promote the present ecu because it is by definition less strong than the D-mark. The new ecu would by definition be at least as strong and could in the medium-term be stronger. In the early years of Stage 2, when ecus would still be a relatively small part of the total money of the E.C., there should be no difficulty in maintaining the necessary interest rate differential to ensure that it remains as strong as required. The markets will then come to assume that its strength will be maintained, as laid down in the Charter of EMF, and the interest rate differential with the strongest currency should normally be very small. The Bundesbank might find it difficult to argue convincingly against the proposal, particularly now that the strength of the D-mark over the next two or three years may be rather harder to maintain.

7. If Member Governments are serious about wanting to move on from Stage 1 to a final Stage 3 (when all Member Governments are prepared irrevocably to renounce any further devaluation of their currency), a proposal on these lines for Stage 2 should commend itself to them. It minimises the risks of unforeseen shocks to the system and provides a route towards full EMU which could prove practical if the markets come to accept the new ecu and if all Governments adopt responsible fiscal and monetary policies. It would indeed provide a serious deterrent to irresponsible policies in any Member State, including the U.K.

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

23 March 1990

Rt Minister

CDP 23/3.

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Charles,

BEREGOVOY AND EMU

The Chancellor of the Exchequer thinks that the Prime Minister should be aware of the letter attached from our Ambassador in Paris in which he reports a conversation with M Ambroise Roux, the President of the Association Francaise des Entreprises Privees (which represents the interests of the top 60 or so private sector companies in France). Roux informed the Ambassador, in the strictest confidence, that Beregovoy had told him some days ago that he had made clear to Mitterrand that EMU as defined in the Delors Report would not work, and that any attempt to make it work in France would have to be without Beregovoy's participation. Roux clearly wished that this information should reach the ears of the Prime Minister, but should not get back to anyone else in France.

The information is intriguing and the Chancellor intends, without of course divulging anything of Roux's conversation with the Ambassador, to use the informal ECOFIN at the end of the month (about which he is writing separately) to probe Beregovoy's views. Certainly there has been some debate within his Ministry about the Delors Report and its handling. The French Treasury were most unenthusiastic about Dumas' proposal for the establishment of the Guigou Group but were effectively overruled by Mitterrand, who is the arbiter of French policy on EMU. We also have some evidence that there was a school of thought in the French Treasury which saw the Delors Report's prescriptions as a denial of French monetary sovereignty. But others argued that the closely

integrated world monetary system left France in any event with little monetary freedom of action and to that extent French participation in the mechanism of the European System of Central Banks would not restrict it still further.

The indications are that the latter school seems to have won the argument. Certainly the French Treasury, and we believe Beregovoy personally, seems ready to espouse the ESCB and the currency developments proposed in the Delors Report as a means of securing further influence over Bundesbank policy. But there are certainly aspects of the Delors proposals with which senior officials in the French Treasury are unhappy. For example, they are unconvinced of the need for binding rules on budget deficits; while paying lip service to the proposal for an independent ESCB, they seem to be reluctant to isolate the institution entirely from political control in the way that the Germans wish; and they seem to be opposed to giving the ESCB responsibility for external (exchange rate) policy as well as for domestic monetary policy.

Beregovoy has also made clear his belief that there needs to be a substantial Stage 2 process before there can be any move to Stage 3.

The Chancellor will let the Prime Minister know if anything emerges from his conversations with Beregovoy during the informal ECOFIN.

I am sending a copy of this letter to Stephen Wall in the Foreign Secretary's office.

Tarkowski

T TARKOWSKI
Private Secretary

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A CCPS Backing (2)

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

Prime Minister

CDP 23/3

PRIME MINISTER

ECOFIN

The informal ECOFIN on 31 March/1 April will focus on two items: German economic and monetary unification; and the progress of economic and monetary union in the Community.

The discussion on Germany will give us a further opportunity (the day after our bilateral talks with the Germans) to probe their thinking, especially over the consequences of monetary union and eventual unification for our economies, and to enable Finance Ministers to emphasise the need for the Germany to consult Community partners closely. We will want to emphasise the need to avoid unsettling the markets and, in that respect, it is helpful that unification seems to be proceeding at a slower pace. On the consequences for the Community and its trade and finances I will be guided by our recent discussions in OD.

On EMU, as you know the interdepartmental group of officials have been doing the work envisaged in my Private Secretary's letter of 30 November 1989 and have raised a number of important questions. I would like to discuss these with you after I have tested the

temperature at the informal ECOFIN. At that meeting I will continue to take the line in the "Evolutionary Approach" paper we published in November and will probe the Delors prescription. Specifically, I will make the following points.

(i) The UK remains committed to an evolutionary approach - learning by doing.

(ii) The Delors report had little to say about what should follow on from Stage 1 - the institutions, and their functions - and I will be asking for an examination of these aspects by the Monetary Committee.

(iii) On budgetary policy rules, there is growing recognition of our case that there should not be binding limits on budget deficits. Instead, I will take the line we agreed (your Private Secretary's letter of 13 February) that there could be the following rules (which can be binding):

(a) no monetary financing of budget deficits;

(b) no Community bail out of governments running excessive fiscal deficits;

(c) in the context of Community mechanisms for lending to a Member State, a budgetary commitment as a condition of that loan;

(d) binding Community procedures for surveillance of national budgetary policies (it would be the procedures not the outcome that would be binding).

(iv) On the approach to monetary union, our evolutionary approach means the UK is ready, as our paper made clear, to consider gradual steps, such as removing further barriers to the use of Community currencies, including a greater use of the ecu.

We are bound to be asked both at the Council and at the Anglo German Summit whether our position on joining the ERM has changed. I am sure we have no choice but to stick to the Madrid conditions. If we were thought to be adding to these in any way we could only reduce our influence in the EMU discussions.

I am sending a copy of this minute to the Foreign & Commonwealth Secretary and to Sir Robin Butler.

John M.

[J.M.]
23 March 1990

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ECONOMIC AND MONETARY UNION: COMMISSION PAPER FOR ECOFIN

SUMMARY

1. COMMISSION PAPER ON EMU FOR INFORMAL ECOFIN FOLLOWS PREDICTABLE LINES, REJECTING THE UK APPROACH AS RISKING SYSTEMIC INSTABILITY. ON MONETARY POLICY IT FOLLOWS THE DELORS REPORT: CENTRAL MONETARY POLICY RUN BY INDEPENDENT CENTRAL INSTITUTION WITHIN FEDERAL STRUCTURE: COMMON CURRENCY (THE ECU): ACCOUNTABILITY TO, BUT NOT CONTROL BY, EUROPEAN PARLIAMENT AND COUNCIL. ON BUDGETARY POLICY, DEPARTS FROM DELORS PRESCRIPTION BY REJECTING BINDING CONSTRAINTS ON BUDGET DEFICITS IN FAVOUR OF BINDING PROCEDURES FOR SURVEILLANCE. SOME MACROECONOMIC ROLE FOR EC BUDGET ENVISAGED.

DETAIL

2. THE COMMISSION'S PAPER ON EMU HAS NOW BEEN SENT TO THE IRISH PRESIDENCY, WHO ARE CIRCULATING IT TO MEMBERS OF MONETARY COMMITTEE TODAY. IT HAS THREE MAIN SECTIONS: THE COSTS AND BENEFITS OF EMU: ANALYSIS OF ALTERNATIVE APPROACHES: AND, THE MAIN BODY OF THE PAPER, DESIGN OF THE PREFERRED SYSTEM.

COSTS AND BENEFITS OF EMU

3. COMPARES FULL EMU WITH THE STATUS QUO (ASSUMING FULL IMPLEMENTATION OF SINGLE MARKET). ARGUES THAT EMU WILL LEAD TO PRICE STABILITY: INCREASED EFFICIENCY THROUGH ELIMINATION OF TRANSACTION COSTS AND EXCHANGE RATE UNCERTAINTY: AN IMPROVEMENT IN THE INTERNATIONAL ECONOMIC BALANCE BY INCREASING THE COMMUNITY'S INFLUENCE ON INTERNATIONAL ECONOMIC AFFAIRS. FULL BENEFITS OF EMU ONLY AVAILABLE WITH SINGLE CURRENCY (AS OPPOSED TO IRREVOCABLY FIXED PARTIES). NO ATTEMPT AT QUANTIFICATION, BUT POTENTIAL IMPACT JUDGED TO BE NO LESS IMPORTANT THAN THE SINGLE MARKET (WHICH WAS ESTIMATED IN THE CECHINI REPORT AS UP TO 5 - 7 PERCENT OF GNP).

4. IT IS STATED THAT, BECAUSE OF THE RISKS OF SYSTEMIC INSTABILITY IN THE TRANSITION PERIOD, THE PASSAGE FROM THE BEGINNING

OF STAGE 1 TO THE DEFINITIVE EMU SHOULD BE RELATIVELY RAPID.

OTHER APPROACHES TO EMU

5. THE PAPER REJECTS THE UK APPROACH OF COMPETING MONETARY POLICIES ON THE ARGUMENT THAT THIS WILL CREATE SYSTEMIC INSTABILITY, DUE TO DIFFERENT MEMBER STATES ADOPTING DIFFERENT MONETARY POLICIES (NO REFERENCE IS MADE TO THE ARGUMENT THAT MARKET FORCES WILL ENSURE THAT COMPETITION WILL BE IN AN ANTI-INFLATIONARY DIRECTION). THE PAPER ALSO REJECTS: MONETARY UNION WITHOUT ANY MOVE TOWARDS ECONOMIC UNION, BECAUSE THIS WOULD PUT TOO MUCH STRAIN ON MONETARY POLICY: AND MONETARY UNION WITH FULL ECONOMIC UNION, SINCE THIS IS NOT NECESSARY TO ACHIEVE THE OBJECTIVE, AND THEREFORE CONFLICTS WITH THE PRINCIPLE OF SUBSIDIARITY.

DESIGN OF PREFERRED SYSTEM FOR EMU

6. THE MAIN LINES OF THE COMMISSION PRESCRIPTION FOR THE FINAL STAGE OF ECONOMIC AND MONETARY UNION ARE PREDICTABLE. THE APPROACH TO MONETARY UNION FOLLOWS CLOSELY THE PROPOSALS IN THE DELORS REPORT:

- A SINGLE COMMUNITY MONETARY POLICY, OPERATED THROUGH A FEDERAL SYSTEM OF CENTRAL BANKS (''EUROFED''), COMPRISING EXISTING NATIONAL BANKS AND A NEW CENTRAL INSTITUTION.
- COMMUNITY MONETARY POLICY AND EUROFED TO BE EXPLICITLY COMMITTED TO PRICE STABILITY, AND, SUBJECT TO THIS, TO THE SUPPORT OF THE GENERAL ECONOMIC POLICY OBJECTIVES OF THE COMMUNITY.
- CENTRAL INSTITUTION INDEPENDENT, CONTROLLED BY A COUNCIL MADE UP OF THE CENTRAL BANK GOVERNORS OF THE TWELVE MEMBER STATES AND A SMALLER NUMBER OF MEMBERS APPOINTED AT COMMUNITY LEVEL.
- ACCOUNTABILITY ENSURED BY REQUIREMENT TO PROVIDE REPORTS TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT, AND TO APPEAR AT HEARINGS BEFORE THE LATTER.
- EUROFED TO HAVE FULL RANGE OF MONETARY POLICY INSTRUMENTS, AND CONTROL OVER THE ISSUE OF THE ECU (WHICH IS TO BECOME THE SINGLE COMMON CURRENCY).
- NO FIRM VIEW EXPRESSED ON WHETHER EXTERNAL ASPECTS OF MONETARY POLICY (IE EXCHANGE RATE AND INTERVENTION POLICY) SHOULD BE SET BY EUROFED OR BY THE COUNCIL (IE ECOFIN), BUT STRESSES POTENTIAL IMPORTANCE OF EMU IN GIVING THE COMMUNITY A KEY ROLE IN THE MANAGEMENT OF THE INTERNATIONAL MONETARY SYSTEM.

7. ON ECONOMIC POLICY, REJECTS A KEY ELEMENT IN THE DELORS REPORT, BINDING LIMITS ON BUDGET DEFICITS, IN FAVOUR OF:

- NO MONETARY FINANCING OF PUBLIC DEFICITS:
- NO BAILING OUT OF MEMBER STATES (BUT NOT EXCLUDING AD HOC

CONDITIONAL ASSISTANCE),
- BINDING PROCEDURES FOR ENSURING CONVERGING BUDGETARY POLICIES, EMBODYING THE ''BID AND OFFER'' SYSTEM WHEREBY EACH MEMBER STATE WOULD SET OUT THE RULES AND LIMITS THAT IT WOULD BE PREPARED TO COMPLY WITH, WITH THE ADEQUACY OF THESE RULES TO BE DISCUSSED AND AGREED AT COMMUNITY LEVEL. THERE WOULD BE ''INSTRUMENTS OF GRADUATED COMMUNITY RESPONSE'' IN THE EVENT OF NON-COMPLIANCE (RESPONSE TO NON-COMPLIANCE TO BE FURTHER DEVELOPED IN THE CONTEXT OF THE DISCUSSION ON INSTITUTIONAL QUESTIONS).

8. THE SECTION ON ECONOMIC POLICY ALSO IDENTIFIES POLICY AREAS WHERE COMMUNITY INVOLVEMENT SHOULD INCREASE, AND PUTS THE CASE FOR A BIGGER ROLE FOR THE COMMUNITY BUDGET. POLICY AREAS IDENTIFIED ARE: COMPETITION POLICY, COMMERCIAL POLICY, RESEARCH AND DEVELOPMENT, EUROPEAN-WIDE INFRASTRUCTURE, LABOUR MARKETS AND THE ENVIRONMENT.

9. THE COMMUNITY BUDGET WOULD HAVE TO GROW TO FINANCE EXPENDITURE IN THESE AREAS, TO COVER POSSIBLE STRENGTHENING OF COMMUNITY STRUCTURAL POLICIES (INCLUDING DEVELOPING A MECHANISM FOR MAKING FINANCE AVAILABLE TO REGIONS EXPERIENCING UNEXPECTED ECONOMIC SHOCKS), AND TO GIVE THE COMMUNITY BUDGET A ROLE IN ''RE-ENFORCING THE SURVEILLANCE PROCESS''. THE PAPER ENVISAGES INTRODUCING COMMUNITY BORROWING TO FINANCE BUDGET EXPENDITURE, AND ''AN INCREASED CAPACITY ON THE REVENUE SIDE OF THE EC BUDGET''. (COMMENT: THE COMMISION HAVE CLAIMED TO US THAT THE INCREASE IN THE COMMUNITY BUDGET'S ROLE WOULD BE ONLY MARGINAL, AS DELORS HAS ALWAYS ARGUED).

NEXT STEPS

10. THE COMMISSION ARE NOT PRESSING FOR THIS PAPER TO BE DISCUSSED BEFORE THE INFORMAL ECOFIN, BUT WOULD NOT OBJECT TO A DISCUSSION. THE PRESIDENCY IS NOT CURRENTLY INTENDING TO SCHEDULE ANY PRELIMINARY DISCUSSION. THE PAPER WAS SENT TO BOTH REYNOLDS (FINANCE MINISTER) AND COLLINS (FOREIGN MINISTER) SO A DISCUSSION IS ALSO LIKELY AT THE NEXT FAC. COMMISSION PAPER ON INSTITUTIONAL ASPECTS OF EMU IS STILL UNDER PREPARATION, AND THE COMMISSION ARE ALSO DOING WORK ON THE MECHANISM FOR MOVING FROM THE CURRENT POSITION TO FULL EMU.

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BUTLER PAPER

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CONFIDENTIAL

12th March, 1990.

Charles Powell, Esq, CBE,
c/o 10, Downing Street,
London S.W.1.

Dear Mr. Powell,

Stage 2 of EMU

I attach a draft of a covering paper which I propose to table in the European Committee, to go with the longer paper which I sent you last week. I should be most grateful to receive any comments by Wednesday morning, 14th March.

Yours sincerely,

h. h. Sir Michael Butler

Written by Sir Michael Butler and
typed in his absence.

MDB/MML

Enc.

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DRAFT

Stage 2 of Economic and Monetary Union

1. The Treasury paper of 2nd November, 1989, though it contained interesting ideas, failed to get the U.K. back into the centre of the EMU debate because:-

(a) it was regarded not as a contribution but as an alternative to E.C. action to realize EMU in accordance with the Madrid conclusions;

(b) it appeared not to accept the generally agreed definition of full EMU, namely that there should at least be irrevocably fixed exchange rates (or a single currency);

2. At the other end of the spectrum, the Delors report said very little about how to move forward after Stage 1; and the Commission is still concentrating on the requirements of Stage 3. This is unwise since an attempt to make a great leap forward after Stage 1 would almost certainly land the E.C. flat on its face.

3. Provided that the British Government is prepared to subscribe to the generally agreed final Stage 3 aim of moving in the long run to irrevocably fixed exchange rates (or a single currency), a well-thought-out proposal for Stage 2 would fill a real gap and get the U.K. back into the centre of the discussion. The attached paper, approved by the BIEC's European Committee on 27th March, contains such a proposal. It is consistent with the British Government's evolutionary approach. Its main features are:-

(a) co-ordination of macroeconomic and fiscal policy remains as at present with ECOFIN;

(b) in replacement of the present EMCF and Central Bank Governor's committee, a new European Monetary Fund (EMF) is created to co-ordinate monetary and exchange rate policies; it is to be run by the Central Bank Governors and owned by the Central Banks of the Member States:

/(c)

(c) action is taken to strengthen the ecu by cutting it loose from the basket of currencies and to make it as strong as the strongest E.C. currency, i.e. it would no longer be possible to revalue a national currency against the ecu though it would remain possible to devalue; the ecu would become convertible into national currencies (and vice versa) and be managed by the EMF which would act as lender of last resort;

(d) money creation would be strictly controlled since Central Banks would be under an obligation not to create national currency to replace that exchanged for ecus;

(e) the two principles in the Treasury's 2nd November paper would be adopted i.e. no bail-outs of Member Governments with irresponsible fiscal or monetary policies and no monetary financing of budget deficits; the EMF would report persistent offenders to ECOFIN and, if corrective action were not taken, would be empowered to suspend convertibility with ecus of the currency concerned;

(f) the ecu would thus become a thirteenth currency, at least as strong as the D-mark; the preferences of users would determine whether it gradually came to pre-dominate in cross-border transactions and thus a candidate to become the E.C.'s main (or even one day single) currency.

4. A system of weighted majority voting would have to be negotiated for the EMF, thus involving some extra sharing of sovereignty, but the EMF's charter would lay down in inescapable terms its duty to manage the

/ecu

ecu on the lines set out above. The constitutional relationship between governments and central banks would remain a matter for national governments and parliaments. Accountability to the British Parliament for the Governor's actions in the EMF could thus be maintained if Parliament so decided.

5. British Ministers could concede that the final Stage 3 aim should be incorporated in the new Treaty amendments to be agreed in the I.G.C. but could agree that it would be desirable to experience the working of the EMF in Stage 2 before deciding what further changes, either in the powers of the EMF or in the institutional arrangements, might (or might not) be required for Stage 3. Thus it would be for later decision whether a further I.G.C. would be needed to complete the move to Stage 3.

6. The Bundesbank has always been reluctant to promote the present ecu because it is by definition less strong than the D-mark. The new ecu would by definition be at least as strong and could in the medium-term be stronger. In the early years of Stage 2, when ecus would still be a relatively small part of the total money of the E.C., there should be no difficulty in maintaining the necessary interest rate differential to ensure that it remains as strong as required. The markets will then come to assume that its strength will be maintained, as laid down in the Charter of EMF, and the interest rate differential with the strongest currency should normally be very small. The Bundesbank might find it difficult to argue convincingly against the proposal, particularly now that the strength of the D-mark over the next two or three years may be rather harder to maintain.

7. If Member Governments are serious about wanting to move on from Stage 1 to a final Stage 3 (when all Member Governments are prepared irrevocably to renounce any further devaluation of their currency), a

/proposal

proposal on these lines for Stage 2 should commend itself to them. It minimises the risks of unforeseen shocks to the system and provides a route towards full EMU which could prove practical if the markets come to accept the new ecu and if all Governments adopt responsible fiscal and monetary policies. It would indeed provide a serious deterrent to irresponsible policies in any Member State, including the U.K.

MDB/MML

12th March, 1990.

Written by Sir Michael Butler and typed in his absence.

FROM THE AMBASSADOR

BRITISH EMBASSY,
PARIS

SECOND PERMANENT SECRETARY'S OFFICE
OVERSEAS FINANCE SECTOR

~~ACTION~~

N H P Evans

COPIES TO

N L Wicks Esq CVO CBE
HM Treasury

9 March 1990

Dear Nigel,

BEREGOVOY AND EMU

1. On 5 March Monsieur Ambroise Roux, the President of the Association Française des Entreprises Privées (which represents the interests of the top 60 or so private sector companies in France) came to see me. Roux is a major industrialist, and a man of great influence in France, even though his sympathies are firmly with the right and not the left.

2. Although he came to see me ostensibly on another matter, it was clear that Roux's main purpose was to tell me, in the strictest confidence, that Bérégovoy had told him some days ago that he had made clear to Mitterrand that EMU as defined in the Delors report would not work, and that any attempt to make it work in France would have to be without Bérégovoy's participation. Roux said this was a confidence which he could impart to me and which could reach the ears of the Prime Minister, but should not get back to anyone else in France (since the source would be evident). Roux has /not told other members of the AFEP.

3. Roux said that Bérégovoy had a great admiration for the Prime Minister - including her views on EMU - and that we should find that, with the prospect of German unification, the Rocard government was perhaps closer to us on European Community issues than we might think. The tone would be more pro-European than ours but (in contrast to the even more evidently European ambitions of Mitterrand) on the substance pragmatism would prevail.

4. It is not easy to judge the significance of what Bérégovoy is alleged to have said to Mitterrand. Bérégovoy is known to have some doubts about the Delors report, having argued recently for a long drawn out Stage II with no clear indication as to whether or when there would

.../be

240/3

be a move to Stage III. He is also more of a nationalist and less of a federalist than Delors. Bérégovoy may have been signalling genuine doubts on these points to Mitterrand. But there may, too, have been a domestic political angle - with Bérégovoy, as a member of the Fabius faction in the Socialist Party, wanting to distance himself a little from a report so closely associated with Delors, member of a rival faction. (I think, incidentally, that Roux may have been exaggerating a little in describing Bérégovoy's admiration for the Prime Minister as extending to her views on EMU: respect might be a better word. And Bérégovoy remains firmly in favour of Sterling joining the ERM).

5. Nor is it easy to judge why Roux should have gone to the trouble to have passed Bérégovoy's remarks on to me in the evident hope that they would reach the Prime Minister though I know him reasonably well and 'see him around' quite frequently. And he expects me to have access to the Prime Minister. He certainly thought it important that she should know (see below)

6. The explanation may be that Roux, like many Frenchmen and women from all parts of the political spectrum, sees real need for a stronger Anglo-French alliance in the face of a renewed German threat, senses that Mitterrand is not responding actively enough to this need, and wants to signal that some at least in the French government take a more forward view. Whatever the explanation, I draw the conclusion that as a result of the imminent reunification of Germany there is confusion within the French administration on some important European topics, including EMU, and that we need to do all we can to get our own ideas across to French decision makers both inside and outside government. We are, of course, already in touch with you and the FCO about this.

7. Finally, I asked Roux whether he thought Bérégovoy's position itself was secure, given the rumours of a spring governmental reshuffle. He was categoric: Bérégovoy had been wounded by initial lack of whole-hearted support from Mitterrand, by disagreement over "no further privatisation, no renationalisation" and by the Société Générale affaire, but has regained lost ground and was now in a position where it would be extremely difficult to replace him. No other qualified candidate was in sight.

8. May I leave it to you to decide whether, and if so how, to pass the gist of this to No 10?

The simple explanation of Roux's approach is that he profoundly dislikes Delors Stage III and wishes to strengthen the hand of someone whose instinctive opposition to it is well known.

cc: J O Kerr Esq CMG, FCO

Ewen Fergusson

PA (Cancelled)
PCG
9/3

Yes, into the Ambassador. I would direct him to the Treasury

CDP 9/3

MR. POWELL

FINANCIAL COUNSELLOR AT THE FRENCH EMBASSY

I was rung late this afternoon by the French Embassy with a request that I should see the Financial Counsellor some time next week. He apparently wants to talk about various "European monetary matters", which I assume means ERM, EMU, German monetary union, etc.

I have provisionally agreed to see him next Wednesday morning. But I am in two minds about whether to go ahead with this. Have you had any contacts with the French on these issues recently?

Perhaps we could have a word on Monday morning.

PAUL GRAY

9 March 1990

Eco Pol : ETNB

PERSONAL

File

cc: Foreign/ Walters. EPA

cc FCO Embassy in Washington

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 March 1990

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

I don't know if you remember Michael Butler. He was for many years our Permanent Representative to the European Community. Since retiring, he has been a director of Hambros. But he continues to take a very close interest in EC affairs and occasionally comes in to talk to the Prime Minister.

He and one or two others in the City have concluded that, while the Treasury's original paper proposing an evolutionary approach to economic and monetary union is on the right lines, it does not go far enough to have any realistic chance of securing the support of other Community countries. They have therefore been putting their minds to how one might build on it, by inserting a new institution - a European Monetary Fund - while retaining the independence of national authorities and the advantages of competing currencies. They have produced the attached paper. It is still in draft and more work will be done on it. But if you had time to let me have any general comments, I should be extremely grateful. If you are over here, you might like to discuss it with Michael Butler any time before 15 March or after 26 March.

I hope you enjoyed your visit to Peru.

CHARLES POWELL

Professor Sir Alan Walters

Kho

PERSONAL

File (if not already on)

MR. GRAY
MR TURNBULL

cc: Professor Griffiths

EMU

Michael Butler has been working with some friends in the City on a paper putting forward an alternative to Stage 2 of Delors. His not unsound reasoning is that our own paper on an evolutionary approach to EMU has not attracted any significant support. The fact that there is agreement to hold n IGC means that there is bound to be <u>some</u> institutional change. We should therefore put forward proposals which meet our objectives of competition, price stability and subsidiarity, but <u>also</u> envisage some new institution.

The paper therefore proposes the creation of a European Monetary Fund <u>alongside</u> national central banks. The Monetary Fund would be the forum within which national governments would cooperate to bring about convergence of monetary policies which would favour price stability, but without surrendering their independence. The Fund would set a European Standard for member countries' exchange rates, based on 'the best' (i.e. the strongest currency in the Community rather than the average (i.e. presumably on the DM at present). This would be fixed - not rigidly but within bands - in terms of ECUs. The ECUs would in turn be issued by the Monetary Fund, not as a substitute for national currencies but in competition with them i.e. like our own proposal for competing currencies. The supposition would be that national currencies would continue to be used for domestic transactions, while ECUs would increasingly be used for transactions with other EC countries. There would not be a single currency, although theoretically it could develop that way.

The paper has not yet been finalised. I understand it is being discussed at official level with the Treasury. It seems to me a serious attempt to find something which has a better chance of gaining support in the EC than our present plan, without conceding a single Central Bank or currency, or surrendering the independence of national authorities.

I should very much welcome any comments which you and Brian Griffiths (to whom I am also sending a copy) may have. I propose to show it to Alan Walters when he is next over here.

CDP

(C. D. POWELL)
7 March 1990
a:\foreign\EMU

Draft: 4 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

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O.P. Richards
4 March 1990

Draft: 4 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

SUMMARY

1. There appear to be three main ways in which the UK can approach the Inter-Governmental Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might lead to a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives of competition, subsidiarity and price stability. It is the third approach that is considered in this paper.

2. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in the paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

3. In the alternative Stage 2 proposed in the paper, the European System of Central Banks would consist of the national central banks of member countries and a European Monetary Fund. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. Alongside national central banks, a European Monetary Fund would be established, which would be owned jointly by national central banks, and would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS.

4. In Stage 2, Community monetary policy would operate on the European Standard: that is, the equivalent of the Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would be fixed (though not irrevocably fixed) in terms of the ECU, and would be convertible into (and out of) ECUs on demand.

5. The current definition of the ECU, which is based on 'the average' in the Community, would need to be changed. For the ECU to become a standard of 'the best' in the Community, its value would need to be at least as strong in terms of dollars as the strongest national Community currency. The European Monetary Fund would set ECU interest rates and conduct exchange intervention in ECUs against dollars to protect the external value of the ECU.

6. In Stage 2, the ECU would be issued by the European Monetary Fund as a dual currency in substitution for the national currencies of member countries on demand. Unlike the Delors plan, consumers in the Community would have freedom to choose whether, and if so when and to what extent, they wished to exchange their national currencies for ECUs. Exchange rates between member countries would not need to be fixed irrevocably first.

7. National authorities would cooperate within the European Monetary Fund in Stage 2 in exercising monetary control in national currency, and would act collectively through the European Monetary Fund in exercising control in ECUs. There is a question about whether the European Monetary Fund would need the power to implement monetary sanctions against 'profligate' national authorities.

8. The Community institution established in Stage 2 would take the form of a European Monetary Fund rather than a Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. New members (e.g. from EFTA and eventually from Eastern Europe) could be admitted to the European Monetary Fund with less difficulty than to a Central Bank. The UK would be able to put a strong case for locating the ECU operating arm of the European Monetary Fund at the Bank of England in London.

9. The revision in the Treaty would cover Stage 2. Another Treaty would be needed to implement Stage 3. Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3. Once Stage 2 was introduced, the Community might decide to stay on the European Standard rather than moving on to Stage 3, at least for the foreseeable future.

10. A revision in the Treaty along the lines proposed in the paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) the principle of subsidiarity would be preserved;

(ii) the prospects for price stability would be enhanced; and

(iii) competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added.

Draft: 4 March 1990 Confidential

THE NEXT STAGE IN AN EVOLUTIONARY APPROACH TO MONETARY UNION

INTRODUCTION

1. The purpose of this paper is to identify a route to monetary union that is consistent both with the UK's objectives and with a revision in the Treaty. The paper is set out in six sections, as follows:

(i) The first section considers different approaches to the Inter-Governmental Conference called to revise the Treaty, and distinguishes between 'beyond Stage 1' and Stage 2.

(ii) The second section outlines an alternative to the Stage 2 that is described in the Delors Report. The alternative Stage 2 is based on the establishment of a European Monetary Fund owned jointly by national central banks. The outline is then considered in more detail in the rest of the paper.

(iii) The third section examines the way in which the Community would operate during Stage 2 on a European Standard based on the ECU, which would need to be redefined first, and would then be issued as a dual currency in substitution for the national currencies of member countries on demand, with monetary control being exercised at national level and at Community level.

(iv) The fourth section explains the operations of the European Monetary Fund in ECUs, distinguishing between the note issue, banking operations and exchange intervention in Community currencies and in dollars.

(v) The fifth section puts the case for an institution that takes the form of a European Monetary Fund in Stage 2 rather than a European Central Bank, for expanding its membership in future, and for locating its chief operating arm in London.

(vi) The final section concerns the timing for the introduction of Stage 2, its duration, and the revision in the Treaty that would be necessary to bring Stage 2 into effect.

THE INTER-GOVERNMENTAL CONFERENCE

2. The European Council agreed in Strasbourg on 8/9 December 1989 to call an Inter-Governmental Conference before the end of 1990 to revise the Treaty, despite UK opposition. In the absence of a viable alternative, the revision in the Treaty is likely to be based on the route to EMU described in Stages 2 and 3 of the Delors Report. The Treasury has put forward a UK alternative in a paper published in November 1989 on 'An evolutionary approach to EMU'. The Bank of England has recently elaborated on the UK alternative in a series of speeches by the Governor and the Deputy Governor. Both the Treasury and the Bank of England have emphasised the UK's commitment to complete Stage 1 (i.e. including sterling participation in the ERM), and suggested what should happen 'beyond Stage 1'.

Beyond Stage 1

3. The Treasury paper sets out (in paragraph 26) three fundamental principles for successful economic and monetary integration. They are: (i) to increase the influence of markets and competition; (ii) to respect the principle of subsidiarity; and (iii) to strengthen the forces tending to bring about stable prices. As the Treasury and the Bank of England have shown, these objectives can be achieved without the need for a new institution at Community level with decision-making power. National authorities can compete, within the framework of the single market and the EMS, with the objective of achieving price stability, while retaining responsibility for making decisions about monetary policy at national level. There is room for debate about whether price stability is more likely to be achieved if, in addition to a government commitment to achieve price stability and popular support, the central bank has statutory responsibility for achieving price stability too. But even if this is more likely, the decision to give the central bank statutory responsibility can be made at national level, and the central bank can remain democratically accountable at national level for carrying out the responsibility with which it has been entrusted. Consequently, in the UK's view, there is no need for an Inter-Governmental Conference or for a revision in the Treaty.

4. It is of course possible that developments in Eastern Europe in general, and the prospect of monetary union in Germany in particular, will help to persuade other Community member countries of the merits of the UK's position. But it seems likely that other member countries will still conclude that a revision in the Treaty is necessary, on the grounds: (i) that, whatever the case may be in the UK, other member countries would be very unlikely all to succeed in achieving price stability through decisions taken independently at national level; (ii) that, even if all members of the Community did succeed in achieving price stability eventually, the result would not conform with the definition of monetary union endorsed by all the participants on the Delors Committee: that is, a common monetary policy agreed at Community level with a common Community currency, or at least irrevocably fixed exchange rates; and (iii) that it is not possible to achieve monetary union on the Delors definition without a revision in the Treaty.

5. While the Treasury alternative meets the UK's objectives, it does not require a revision in the Treaty. By calling an Inter-Governmental Conference to revise the Treaty, the other member countries have indicated that the Treasury alternative does not in their view go far enough towards EMU. The question for them is not whether there should be a revision in the Treaty, but what form it should take. Stage 2 should in their view be the next stage to monetary union rather than 'beyond Stage 1'.

Stage 2

6. Given the UK's decision to participate in the Inter-Governmental Conference, there appear to be three main ways in which the UK can approach the Conference:

(i) One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future. This approach might well be counter-productive. The other member countries might proceed to a new Treaty without the UK. The result would be portrayed as a 'two-speed' Europe.

(ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further. If successful, this approach would have the effect of delaying the starting date of Stage 2. But it would fail to answer the question of what Stage 2 should contain when it did start. The other member countries can be expected to favour a revision in the Treaty of some sort. Otherwise, there would have been no point in calling an Inter-Governmental Conference in the first place.

(iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives, and which would also carry sufficient support from other member countries that the UK's proposals would be agreed by the Community as a whole in the interests of securing unanimity among its members.

7. It is the third approach that is considered in this paper. The paper attempts to identify an alternative route to monetary union (i.e. from Stage 1 to Stage 3) to the route described in Stage 2 of the Delors Report. In doing so, the paper aims to build on the original Treasury alternative and adapt it to the new circumstances created by the Council's decision, while remaining consistent with the UK's objectives. To embark on Stage 2 at all implies that a Community institution with decision-making power of some sort will be established. If a Community institution is not established, there is no need for a revision in the Treaty. The question that is considered in this paper is not, therefore, whether a Community institution is necessary but, given that a Community institution will be established if there is a revision in the Treaty, how that institution can be organised in such a way as to be consistent with the UK's objectives.

8. As a result of considering the question of a Community institution with decision-making power, the paper also proposes a way of resolving the fundamental difficulty identified in paragraph 57 of the Delors Report. This lies in the organisation of a gradual transfer of decision-making power from national authorities, which have power to take all the decisions at the beginning of Stage 2, to a Community institution, which has power to take all the decisions at the beginning of Stage 3. The proposal in the Delors Report on economic union, involving the control of budget deficits and an increase in structural and regional transfers at Community level, is not discussed in detail in the paper, on the grounds that the Delors Committee's arguments on these two points have effectively been addressed already in paragraphs 29-31 of the Treasury paper.

OUTLINE OF AN ALTERNATIVE STAGE 2

9. Following the revision in the Treaty, the European System of Central Banks (ESCB) would consist in Stage 2 of the national central banks of member countries and a European Monetary Fund. The ESCB would have a monopoly of money creation in the Community, taking national central banks and the European Monetary Fund together. National central banks would remain accountable at national level under the constitutional arrangements in place in each case. They would continue to compete within the framework of the single market and the EMS, through monetary operations denominated in their respective national currencies, with the objective of achieving price stability. But they would also cooperate to ensure sufficient convergence in their respective monetary policies that exchange rates could be fixed (though not irrevocably fixed), and interest rate differentials between their currencies reduced to the minimum.

10. Alongside national central banks, a European Monetary Fund (EMF) would be established. The EMF would be owned jointly by national central banks, which would subscribe its capital, and through which they would cooperate. The EMF would have three main functions:

(i) to set a European Standard for member countries' exchange rates based on 'the best' in the Community rather than 'the average';

(ii) to issue ECUs as a dual currency on the European Standard in substitution for the national currencies of member countries on demand; and

(iii) to take over the administration of the EMS, including the ERM, 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.

11. In Stage 2, individual and business consumers in the Community would have the choice of transacting their business in national currencies or in ECUs. In other words, in addition to competing national monetary policies, there would be competition between national currencies and the ECU. If the ECU eventually emerged as the single European currency, the principle of subsidiarity would no longer apply, in the same way as it would not apply under the Treasury proposal for competing national monetary policies, if a national currency (e.g. the Deutsche mark) were to emerge as the single European currency. The main difference would be that, on the European Standard, the UK would have a say in the policy of the EMF. However, a more likely scenario on the European Standard would be that sterling would continue to be used in national transactions, while ECUs were increasingly used in transactions between the UK and the rest of the Community, thereby reducing exchange rate uncertainty and (with the help of improvements in technology) reducing transactions costs.

12. The decision about whether to move beyond Stage 2 to monetary union, and if so when and to what extent, would therefore be determined by the market preference of individual and business consumers in the Community for ECUs in substitution for national currency. That is an important difference between the route to monetary union set out in this paper and the route set out in the Delors Report. In the Delors Report, power to take decisions would be transferred from national level to Community level by administrative fiat before the issue of the ECU as a common currency, whereas under the scheme proposed in this paper, power to take decisions would only be transferred from national level to Community level to the extent of the demand for the ECU as a common currency among individual and business consumers in the Community.

THE EUROPEAN STANDARD

13. In Stage 2, Community monetary policy would operate on a European Standard: that is, the equivalent of a Gold Standard, but with a link to the ECU rather than gold. The exchange rates of member countries would be fixed (though not irrevocably fixed) in terms of the ECU, and would be convertible into (and out of) ECUs on demand. The current definition of the ECU would be revised, so as to make the ECU a standard of 'the best' in the Community rather than 'the average'. Once redefined, the ECU would be issued as a dual currency in substitution for the national currencies of member countries on demand. National central banks would each retain separate responsibility for monetary policies denominated in their respective national currencies, and they would collectively take responsibility for the issue of ECUs. In both cases they would cooperate through the Committee of Central Bank Governors in their capacity as the Council of the EMF.

Redefinition of the ECU

14. As currently defined, the ECU does not represent a standard of 'the best' in the Community. It represents 'the average'. The current definition is based on a basket representing fixed weights of Community currencies, whose proportions are revised every five years, and at which point the currencies of new members of the Community are generally included. In the last revision, which took effect on 21 September 1989, the weight of the Deutsche mark in the ECU was reduced: (i) to offset its relative strength against other Community currencies over the previous five years; and (ii) to accommodate two new 'weak' currencies: i.e. the peseta and the escudo.

15. It is inconsistent to promote the use of the ECU, when it is based on 'the average', while following a monetary policy in the Community which is intended to represent 'the best'. If the ECU was to act as a standard of 'the best' in the Community rather than 'the average', the definition would need to be changed:

(i) One option would be to fix the existing currency composition of the ECU for all time, as proposed in the Treasury paper (paragraph 22). In those circumstances, the value of the ECU would strengthen over a period compared with its value if the currency basket were to be revised in the normal way every five years. But the ECU would still represent a variant of 'the average' rather than 'the best'.

(ii) A second option would be to reduce the number of currencies in the ECU basket to (say) the Deutsche mark, the French franc and sterling. An equivalent change has been made in the definition of the SDR (from sixteen currencies to five). But there might be political implications arising from the exclusion of some member countries from the composition of the ECU. And even if the number of currencies were significantly reduced, the ECU would still not represent 'the best' in the Community.

(iii) A third option would be to link the ECU to the Deutsche mark. A link to the Deutsche mark - a sort of European or 'E' mark - would have the advantage of simplicity, and would recognise the fact that the Deutsche mark is currently the most important single currency in the Community. But it might not be an acceptable solution for those member countries whose interest in a monetary union is closely linked to the desire for a greater say in a Community monetary policy than they currently enjoy in practice within the ERM. In addition, the link with the Deutsche mark would only represent 'the best' so long as the Deutsche mark continued to be the strongest currency within the Community. The onset of German monetary union suggests that this may not always be the case.

(iv) A fourth option would be to link the ECU to gold or some other non-currency indicator. A link to gold would avoid the need to create a new Community institution. But it would carry implications for the international monetary system beyond the Community. Some countries would be opposed to remonetising gold on principle, and in practice it would be difficult to agree on the price at which to fix the link between the ECU and gold. A link to any other non-currency indicator would be untested and would be likely to carry unacceptable risks.

(v) The final option would be for the ECU to be managed independently of national member currencies by Community central bank governors through the EMF, with the objective of setting a standard of 'the best' rather than 'the average'. The central parities of national currencies would be fixed (though not irrevocably fixed) in terms of the ECU. But the value of the ECU would no longer be determined by any particular mix of national currencies.

16. For the ECU to become a standard of 'the best' in the Community, its value would need to be at least as strong in terms of third currencies (e.g. the dollar) as the strongest national Community currency. This would mean that the central parities of Community member countries' national currencies could never be revalued in terms of the ECU, though they could be devalued. If a member country revalued the central parity of its national currency against other member countries' national currencies, the ECU would be revalued with it. So agreement would be needed prior to realignments in the central parities of member countries, as it is now. Unlike now, agreement would be needed with the EMF. The implications should also be considered of entrusting the EMF with the power to revalue the ECU against the central parities of all member countries' national currencies.

17. The (redefined) ECU would be 'the best' in the sense that its exchange rate would always be the strongest within the Community, with two qualifications. First, so long as member countries' exchange rates continued to fluctuate within narrow margins of their central parities against the ECU, then the ECU could depreciate as well as appreciate against member countries' national currencies, though only within the narrow margins. Once exchange rates between member countries' national currencies were fixed, the ECU could never depreciate in terms of the currency of any member country. Second, the overall return on ECUs in comparison with the overall return on the national currencies of member countries would depend on interest differentials between them as well as exchange changes. So the overall return on ECUs over a period would not necessarily be higher than the return on member countries' national currencies, any more than the return on Deutsche marks at present is necessarily higher than the return on lire expressed in Deutsche marks.

18. If the ECU was going to be redefined from a basket of currencies representing 'the average' in the Community to an independently managed currency based on 'the best' in the Community, then it would be easier to implement the change in definition if exchange rates between member currencies were fixed (though not irrevocably fixed) first. The change in definition would also be easier to implement if a realignment in parities was not considered by the market to be in prospect in the short term. But there is no reason in principle why the change in definition could not be introduced, even if exchange rates were still floating within narrow margins at the point of change.

19. There would have to be continuity between the external value of the new definition of the ECU and the old definition at the point of change. This would be necessary to reassure practitioners in the ECU market with contracts written in ECUs that were due to mature after the change in definition. There has been continuity at the point of change in the case of previous revisions

in the definition of the ECU. The difference on this occasion would be that, after the change in definition, the ECU exchange rate and ECU interest rates would not be determined by a new mix of component currencies. ECU interest rates would be set instead by Community central bank governors through the EMF, and the external value of the ECU exchange rate would be enforced by changes in interest rates and exchange intervention in ECUs against third currencies (e.g. the dollar). In setting ECU rates, the Council of the EMF would be guided by the objective of achieving price stability over a period of time. Making the ECU a standard of 'the best' in the Community would help to achieve this.

20. An additional option would be to redenominate the ECU when it was redefined by making one new (heavy) ECU equal to 10, 100 or 1000 old ECUs. Contracts written in old ECUs that matured after redenomination would be paid off in the appropriate number of new ECUs. Redenomination would help consumers to distinguish between the ECU and their national currencies, and enable a dual relationship to develop in each country between the ECU and national currency roughly equivalent to the relationship between pounds and pence. The use of a heavy ECU could also act as a psychological 'anchor' at Community level against inflation.

The ECU as a dual currency on the European Standard

21. Once the ECU had been redefined, it would be issued by the EMF in Stage 2 as a dual currency in substitution for the national currencies of member countries on demand. This would enable national currencies to be converted into ECUs on the European Standard, in the same way as national currencies could be converted into gold on the Gold Standard. The process of substitution would be similar to the process of substitution outlined in the Delors Report. The differences relate to the circumstances in which substitution could take place, and who would decide.

22. In the Delors plan, the ECU would be issued by the ESCB as a dual currency in substitution for national currencies once exchange rates were irrevocably fixed. Under the alternative scheme presented in this paper, the ECU would be issued as a dual currency in the same way as proposed in the Delors plan, but there would be three differences from the Delors plan in the circumstances in which the substitution of ECUs for the national currencies of member countries would take place. First, exchange rates would not have to be fixed irrevocably. In fact, they might not even be fixed at all: they might be floating within narrow margins in the ERM. Second, the substitution of the ECU for national currencies would not take place on the basis of a bureaucratic decision at Community level. It would take place on the basis of market choices by individual and business consumers. Third, the decision would not be irreversible, as it would be in the Delors plan. Consumers could change their preference and convert back into national currency if they wished to do so.

23. There are two criticisms of the issue of the ECU as a parallel currency in the Delors Report (paragraph 47). One is that the issue of ECUs as a parallel currency would be inflationary. This would, of course, be true if ECUs were issued as a parallel currency in addition to national currencies rather than in place of them. But under the proposal set out in this paper, the issue of ECUs by the EMF would not be inflationary, as ECUs would only be issued in substitution for national currency. Second, the issue of ECUs would be accompanied by national monetary policies which would bear down on inflation. Third, ECUs already exist in the private market as a parallel currency. The creation of the EMF to control monetary policy for the ECU could ultimately become an additional means of bearing down on inflation by providing a mechanism for controlling the supply of ECUs, in exactly the same way as national central banks control the supply of national currencies.

24. The second criticism of the issue of the ECU as a parallel currency in the Delors Report is that the issue of a thirteenth currency would complicate the task of coordinating national monetary policies. This would not be the case under the alternative scheme set out in this paper. First, the relationship between the EMF's responsibility for the ECU and member central banks' responsibility for national currencies would be similar to the relationship between the Commission's responsibility for some categories of public expenditure and national governments' responsibility for others. Second, whatever configuration of ECUs and national currencies emerged, it would be quite clear at any particular point in time who had responsibility for taking monetary decisions in every case. Third, the task of coordinating national monetary policies would be easier for member countries to accept if it did not also involve transferring control of them irrevocably from national level to Community level first. As a result, the arrangements proposed in this paper should be less difficult to implement than the route to monetary union proposed in the Delors Report. The Guigou Committee has indicated the wide range of questions that would need to be settled in preparation for or by an Inter-Governmental Conference, if the Delors plan were to be implemented.

25. A separate criticism of a fixed exchange rate regime short of a single currency is that it is vulnerable to speculative attacks. This would of course apply to Stage 2 of the Delors Report as well as to the alternative Stage 2 presented in this paper. In the event of speculative attacks, national authorities on the European Standard would retain the option to change short term interest rates denominated in national currency, or in the last resort to devalue their exchange parity in terms of the ECU. But assuming that they decided not to do so, the response to a speculative attack from within the Community would be for national central banks to intervene in ECUs in unlimited amounts against their national currencies (or vice versa). There would be no need for sterilisation, as there would be no net monetary effect within the Community. If the speculative attack came from outside the Community, the EMF would intervene against the dollar (or the yen) in ECUs, and/or national central banks would intervene in national currency, and the net monetary effects of the intervention on the Community would be sterilised, where appropriate.

Monetary control on the European Standard

26. Monetary control within the Community during Stage 2 would be exercised at national level and Community level. National authorities would cooperate within the EMF in exercising control in national currency, and would act collectively through the EMF in exercising control in ECUs. The instruments for the exercise of monetary control in ECUs would be similar to the instruments for monetary control in national currency: the ability to influence ECU interest rates through open market operations in ECUs; and the ability to influence the ECU exchange rate by intervention in the exchange market. The EMF's operations in government securities would be confined to monetary management.

27. The monetary aggregates over which control would be exercised would include national currency, other Community currencies and ECUs, because it would no longer be appropriate to assume that residents of a particular member country would hold liquid assets denominated only in national currency. Notes and coin would be measured at Community level by aggregating the sum of notes and coin in issue in national currencies and ECUs. Wider definitions of liquid assets would be measured at national level (and aggregated at Community level) by adding residents' holdings of liquid assets denominated in national currency, the national currencies of other Community countries and ECUs. These definitions would be identical to the definitions that would be needed under the Treasury proposal for competing national monetary policies, with the

exception of the inclusion of the ECU (in substitution for national currency). The problems of exercising monetary control within the Community would be no more difficult than they are at present, given the complete freedom of capital movements within the Community.

28. There is a question about whether the EMF would need the power in Stage 2 to exercise monetary sanctions against 'profligate' national authorities, and if so what the sanctions would be. In one sense, sanctions by the EMF would not be necessary. A member country which followed an inflationary policy would run the risk, either: (i) that residents would sell national currency for ECUs, with the effect that the national authorities concerned would lose control of national monetary policy to the EMF; or (ii) that interest rates would have to be raised to prevent this from happening, with the effect that national monetary conditions would be tightened; or (iii) that the member country was forced to devalue its exchange rate against the ECU to maintain the competitiveness of the local economy in the EC single market.

29. However, if it was generally agreed that sanctions were necessary in stage 2 to reinforce efforts at Community level to secure price stability, some indicators of whether sanctions were required would be more useful than others. It might not be practicable to set similar monetary targets for all member countries, for the reasons set out in the Governor's speech of 16 January. Control over the size of member countries' budget deficits would not be effective, for the reasons set out in the Treasury paper (paragraph 29). Instead, the objective might be to prevent the monetary financing of budget deficits rather than controlling their overall level, and to agree that the Community would not bail out governments which run excessive budget deficits, as suggested in the Treasury paper (paragraph 24). One way in which the EMF might enforce sanctions would be by suspending (or threatening to suspend) the convertibility of the national currency of the member country concerned into ECUs, subject to a vote by Ecofin first.

OPERATIONS OF THE EUROPEAN MONETARY FUND

30. The operations of the EMF in ECUs can be divided into three main categories:

(i) the issue of ECU notes and coin;

(ii) banking operations in ECUs; and

(iii) exchange intervention between ECUs and national Community currencies, and between ECUs and third currencies (e.g. dollars).

ECU notes and coin

31. It is not essential to the scheme that the EMF should issue ECU notes (and coin) on demand. It could be argued that the ECU would mainly be used for large-scale business transactions within the Community, and that notes would not be necessary, at least until later in Stage 2. If the EMF did not issue bank notes on demand, the European Standard would correspond to the Gold Bullion Standard, under which sterling was convertible into gold bullion on demand, but not into gold coins. However, as the ECU increased in importance, it is likely that there would be demand for ECU bank notes, from individuals and for small-scale business transactions, and there is no reason why this demand could not be met by the EMF in a way that was consistent with the principle of substitution. Legal restrictions on the issue of notes, which vary from country to country within the Community, would need to be removed first. There might also be advantages in making the ECU legal tender alongside the national currency in each member country, subject to a unanimous vote by Ecofin first.

32. Payment for ECU notes would either be made in ECUs or in national currency (e.g. sterling). If payment was made in sterling. The proceeds could be handled in two main ways. One way would be for the issue of ECU notes to be backed by the sterling notes withdrawn from circulation in exchange for them. This would enable the exchange risk arising from the transactions and the profits from seignorage to be left at national level. The other way would be to invest the proceeds in sterling gilt-edged. The effect would be to reduce the liabilities of the Issue Department of the Bank of England and increase the liabilities of the EMF, and to reduce the Bank of England's holdings of sterling gilt-edged and to increase the holdings of the EMF.

Exchange of £ notes for ECU notes

Bank of England

Liabilities	ECUm	Assets	ECUm
£ notes in issue	-100	£ gilt-edged	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU notes in issue	+100	£ gilt-edged	+100

33. The issue by the EMF of ECU bank notes and the investment of the proceeds in assets denominated in national currency would give rise to an exchange risk, which could be covered in one of two ways. One option would be for the central banks of member countries to cover the exchange risk jointly in their capacity as shareholders in the EMF. The other option would be for the central bank whose currency had been substituted for ECUs to take the

exchange risk, as happens at present in the case of purchases of foreign exchange by member countries from the IMF. The exchange cover could be provided in the case of the EMF by means of an exchange guarantee, or by denominating government securities purchased by the EMF in ECUs. If so, it would have the effect of giving an added incentive to member countries not to devalue their exchange rates. The profits earned by the EMF from seignorage (and from its other operations) would be distributable to shareholders.

Banking operations

34. Once the ECU had been redefined as an independent currency, the EMF would act as lender of last resort to the ECU banking system. The EMF would be able to establish the level of short term ECU interest rates by open market operations in ECUs with the objective of reinforcing the Community's policy of bearing down on inflation. The EMF would not determine Community monetary policy by means of its open market operations in ECUs, because each national central bank would make its own decision about national interest rates. But the interest rate on ECUs would influence national monetary policy, because of the threat that, if national monetary policy was not sufficiently tight, residents could switch their liquid assets denominated in national currency into ECUs. The influence of the EMF would be greater, the wider the circulation of ECUs in substitution for national currency. However, national control over monetary decision-taking would not necessarily be less in practice than it is at present, because of the extent to which it is already influenced by decisions taken by the Bundesbank.

Exchange intervention

35. Exchange intervention under the scheme set out in this paper could be divided into two categories:

(i) exchange intervention between members of the ESCB in Community currencies; and

(ii) exchange intervention between the currencies of members of the ESCB and the currencies of third countries (e.g. dollars).

36. Within the EMS, the parity grid consisting of bilateral exchange intervention points would be replaced by intervention margins for each currency in terms of the ECU. At sterling's lower intervention margin, the Bank of England would be obliged to buy the sterling offered by the market in exchange for ECUs. The Bank of England would finance the purchase of sterling by borrowing ECUs from the EMF. The ECU loan by the EMF would be financed by borrowing from the Bank of England the sterling offered by the market. The residual claims of the Bank of England and the EMF on each other would cancel out. At sterling's upper intervention margin, the mechanism would work the other way round. In either case, there would be no net monetary effect. The creation of ECUs by the EMF would be offset by the withdrawal of an equivalent amount of sterling by the Bank of England (or vice versa). An increase in the market's holdings of liquid assets denominated in ECUs would be offset by a reduction in the market's holdings of liquid assets denominated in sterling (or vice versa). The mechanism would be symmetrical, simultaneous and unlimited as to amount.

(i) Purchases of £ from the market at £'s lower intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
ECU liability to EMF	+100	£ claim on EMF	+100
Repayment of ECU liability	-100	Use of £ claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
£ liability to Bank	+100	ECU claim on Bank	+100
Repayment of £ liability	-100	Use of ECU claim	-100

(ii) Sales of £ to the market at £'s upper intervention margin against ECUs

Bank of England

Liabilities	ECUm	Assets	ECUm
£ liability to EMF	+100	ECU claim on EMF	+100
Repayment of £ liability	-100	Use of ECU claim	-100

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
ECU liability to Bank	+100	£ claim on Bank	+100
Repayment of ECU liability	-100	Use of £ claim	-100

37. Outside the EMS, national central banks would continue to intervene in their national currencies against third currencies (e.g. dollars), as at present. But the EMF would become responsible for intervention between the ECU and third currencies (e.g. dollars). If the EMF purchased dollars against ECUs, it would pay for the ECUs that it sold in exchange by issuing ECU securities. Conversely, if the EMF sold dollars against ECUs, it would use the proceeds to redeem ECU securities. As in the case of the EEA, the monetary effects of the EMF's exchange operations in dollars would depend on whether the ECU securities issued (or redeemed) by the EMF were purchased (or sold) by the banking system or by the non-bank private or overseas sectors. If the securities were purchased (or sold) by the non-bank private or overseas sectors, the monetary effect on the Community of the EMF's dollar operations would be sterilised.

38. A separate question that needs to be addressed is who would be responsible for issuing the ECU securities. While in principle the securities could be issued at Community level, in practice the rules of subsidiarity could apply. In that case, the EMF would pay for its net purchases of foreign exchange by increasing its net liabilities in ECUs to national authorities (pro rata). National authorities would then have the task of deciding whether, and if so how, to sterilise the monetary effects, within any guidelines agreed at a Community level. These would need to take account of the Bundesbank's policy of not sterilising the monetary effects of exchange intervention. If the monetary effects of exchange intervention were to be sterilised, this could be achieved by issuing securities to the non-bank private sector in local currency or in ECUs. The net sale of securities at national level would not be additional, because exchange intervention by the EMF in ECUs would substitute for exchange intervention that would otherwise have taken place in the national currency of member countries at national level.

(i)

EMF purchases of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Sale of ECU securities to central banks	+100	Purchase of $ claims	+100

National central banks

Liabilities	ECUm	Assets	ECUm
Increase in money supply	+100	Purchase of ECU securities from EMF	+100
Reduction in money supply	-100	Sale of ECU securities to non-banks	-100

(ii)

EMF sales of $ against ECUs

European Monetary Fund

Liabilities	ECUm	Assets	ECUm
Purchase of ECU securities from central banks	-100	Sale of $ claims	-100

National central banks

Liabilities	ECUm	Assets	ECUm
Reduction in money supply	-100	Sale of ECU securities to EMF	-100
Increase in money supply	+100	Purchase of ECU securities from non-banks	+100

39. In order to enable it to intervene in third currencies, the EMF would take over the assets and liabilities managed by the EMCF. The assets taken over would consist of dollars (and gold), representing 20% of the dollar (and gold) reserves of member countries. The liabilities would consist of the claims of national authorities in ECUs on the EMF, representing the counterpart to the EMF's holdings of dollars (and gold). There would be no monetary effects from the transfer. One option would be for the EMF to take over ownership of the assets. However, national authorities might decide to retain direct ownership of all their dollar (and gold) reserves. In that case, the EMF would manage as agent the initial proportion (say 20% of the total) allocated to it, in the same way as the Bank of England acts as manager of the EEA on behalf of the Treasury. If and when the 20% of reserves initially allocated to the EMF proved no longer sufficient, national authorities would exchange more of their reserves with the EMF for ECUs, on a unanimous vote by Ecofin.

ORGANISATION OF THE EUROPEAN MONETARY FUND

40. The new institution established in Stage 2 would take the form of a European Monetary Fund rather than a European Central Bank because a Monetary Fund is a recognised form of institution in which participants of different sizes can cooperate, but remain accountable at national level. (An EMF of a slightly different kind was originally envisaged as the next stage to monetary union in 1978, when it was originally agreed that the EMS should be established.) The EMF would have some similarities with the IMF in terms of its institutional form, though its role would differ: the primary role of the EMF would be to set a European monetary standard, not to act as a regional IMF providing short term balance of payments support. The EMF would be complementary to the EIB, in broadly the same way as the IMF is complementary to the World Bank.

Need for a Community institution

41. The question arises why an EMF would be needed in Stage 2 to take responsibility for the development of the ECU as a common currency, and why this could not be left to the private market. Of course, the private market can already substitute ECUs for national currency on demand. But there are drawbacks:

(i) The ECU cannot compete on a level playing field with the national currencies of Community countries while it is manufactured in the market rather than being issued with official backing as legal tender, as national currencies are.

(ii) To the extent that the circulation of the ECU does increase in substitution for national currency under the existing ECU definition, this is not necessarily desirable because the current definition represents 'the average' in the Community rather than 'the best'.

(iii) Although a link between the ECU and gold or the Deutsche mark would eliminate the need for a new institution, in the case of gold because no institution would be needed and in the case of the Deutsche mark because the Bundesbank would take overall responsibility at Community level, neither link would necessarily represent 'the best' in the Community, and both would have other disadvantages.

(iv) It would not be feasible to make the ECU a standard of 'the best' in the Community in Stage 2 while linking it permanently with any single Community currency or group of currencies. Consequently, the ECU would need to be independently managed at Community level.

(v) Although the implementation of ECU operations could be delegated to national central banks, a central institution would still be needed with powers to formulate a single monetary policy for the ECU, in the same way as a single monetary policy is formulated for each national currency at the moment.

42. So when Stage 2 began, following the revision in the Treaty, the EMF would be established as a Community institution with decision-making power over the ECU. Whether the EMF that was established would represent a new institution would be more problematic. In one sense, it would not be new, because it would take over the functions of the EMCF. In another sense, the institution would be a new one, because a revision in the Treaty would be required before it could be established. But even then, there would not necessarily be a net increase in the number of international official institutions. Once the secretariat based at the BIS was absorbed by the EMF, it is not clear whether the BIS would have a viable long term future as an independent institution. The BIS might in effect become the EMF's

institutional focus for policy making, though the institution might need to be relocated in a Community capital rather than in Basle, and its chief operating arm would need to be based in a Community financial centre. In that event, the residual functions of the BIS not related to the EMF might be taken over by the IMF.

The constitution of the European Monetary Fund

43. The EMF would be owned by national central banks rather than their governments. The constitutional arrangements relating to the statutory responsibility and accountability of national central banks currently vary from country to country. Insofar as monetary operations denominated in national currency are concerned, the existing constitutional arrangements would not change in Stage 2 in any way unless a particular country wished to change them (e.g. by giving the central bank statutory responsibility to achieve price stability while remaining democratically accountable at national level), in which case it would continue to be free to do so. Insofar as monetary operations denominated in ECUs are concerned, decisions would be taken at Community level through the EMF rather than at national level.

44. The constitution of the EMF might take the following form:

(i) The capital of the EMF would either be subscribed by national central banks in the same proportions as the EIB, or some other measure of economic and currency significance, such as the respective weights in the definition of the ECU basket at the time of the last revision. An adjustment might need to be made for the inclusion of East Germany.

EIB weighted voting and ECU basket weights

	EIB	ECU
Belgium	5	6
Denmark	3	2
Germany	10	23
Greece	5	1
Spain	8	4
France	10	14
Ireland	3	1
Italy	10	8
Luxembourg	2	...
Netherlands	5	7
Portugal	5	1
United Kingdom	10	10
	76	76

(ii) The Council of the EMF would consist of the governors of the national central banks of member countries and EMF Board members. The appointment of national governors to the Council of the EMF would run concurrently with their appointments at national level, and the relationship between national governors and their respective governments would reflect the constitutional arrangements in place in each case. EMF Board members would be appointed by the European Council. Their appointments would run for a fixed and long period of time (e.g. eight years). They could not be removed in normal circumstances.

(iii) Voting procedures would be discussed at the Inter-Governmental Conference and provided for in the Treaty. Decisions might in some cases require unanimity, and in other cases might be made on the basis of qualified

cost, the full range of financial transactions in ECUs: payment and clearing arrangements, and settlement arrangements for banking and securities operations. To the extent that ECU systems are currently based elsewhere, the UK could take the initiative in coordinating them.

48. It is sometimes argued that there is no particular importance to be attached to the decision about whether the chief operating arm is located in London. The argument runs that London has developed as an international financial centre by carrying out financial transactions more cost-effectively than they are carried out in the host country of the currency concerned. One of the reasons for this is that London has advantages over competing financial centres in terms of language, skills and critical mass. But another reason is that London has been subject to a lighter level of regulation and control than most potential alternative centres.

49. This advantage is likely to be removed by the advent of the single financial market within the Community. In these circumstances, if the chief operating arm was based in another financial centre (e.g. Frankfurt, Paris or Luxembourg), the principal money, government debt and foreign exchange markets within the Community would be likely over a period of time to develop there, along with the clearing and settlement systems needed to support them. It would be advantageous for large financial institutions within the Community to build up a significant presence in the market where the chief operating arm was based, and the same considerations would apply to US and Japanese financial institutions requiring a European base. Of course, London would remain a financial centre, but its pre-eminent position in Europe would in due course be lost, and its relative position would over a period be likely to decline.

majority voting. The Bundesbank, the Banque de France and the Bank of England might be granted a blocking vote in certain circumstances, in the same way as the US has a blocking vote in the IMF.

(iv) The Council of the EMF would have as its prime objective the achievement of price stability within the Community. Subject to this overriding objective, it would have an obligation to support the general economic policy set at Community level by the competent bodies.

(v) The Council of the EMF would be democratically accountable for achieving these objectives in four principal ways. First, the EMF would be established following a revision in the Treaty approved by national parliaments. Second, appointments to the Council of the EMF would be made by national governments and by Ecofin. Third, the President of the EMF Council would be required to report on the EMF's policy form time to time to Ecofin and the European Parliament. Fourth, although the EMF Council could not be dismissed en bloc, either by Ecofin or by the European Parliament, the influence of the EMF would effectively be determined by the extent to which citizens within the Community chose to use ECUs in preference to their national currencies.

(vi) The Chairman of Ecofin and the President of the Commission might be invited to participate in the proceedings of the EMF Council without a vote, and the President of the EMF Council might be invited to attend meetings of Ecofin on a similar basis.

Expansion in membership

45. New members could be admitted to the EMF, which would be based on cooperation among its members, with less difficulty than to a European Central Bank, which would be based on central control. One option would be to confine membership to Community member countries. Another option would be to widen it, either at the outset or at a later stage, in anticipation of the expansion of Community membership (e.g. to include member countries from EFTA, and eventually from Eastern Europe). It is worth noting that membership of the BIS does not at present coincide precisely with membership of the Community, and includes Switzerland and Sweden.

Location and infrastructure

46. The policy arm of the EMF would be based, either at the BIS in Basle or in a Community capital. The operations of the EMF would be carried out by the national central banks of member countries on the EMF's behalf, and by the ECU operating arm of the EMF. National central banks would continue to have responsibility for monetary policy denominated in their respective national currencies, including exchange intervention between national currencies and third currencies (e.g. dollars), and would undertake the exchange of national currencies into ECUs on demand on behalf of the EMF. The ECU operating arm of the EMF would be responsible for implementing decisions taken by the EMF relating to open market operations in ECUs and exchange intervention between ECUs and third currencies (e.g. dollars).

47. The UK would be able to put a strong case for locating the ECU operating arm of the EMF at the Bank of England in London. First, London is Europe's most important financial centre, as the survey in the November 1989 issue of the Bank of England Quarterly Bulletin shows. Second, the Bank of England has taken the initiative in promoting the use of the ECU (e.g. through the regular issue of ECU Treasury bills). Third, London would be in the best position to put in place the financial infrastructure necessary to support, at minimum

THE TIMING AND DURATION OF STAGE 2

50. One difference between the scheme set out in this paper and the scheme set out in the Delors Report is that Stage 2 would become a significant set of monetary arrangements in its own right, as Stage 1 has been, and not simply a process of transition to Stage 3, which is the way in which Stage 2 is described in the Delors Report. As Stage 2 would become a significant step, it could take longer to prepare than it would take to prepare Stage 2 on the Delors model. The main questions that would need to be resolved first would be how stable exchange rates between members would need to be, how convergent their monetary policies would need to be, and how nearly price stability would need to be achieved in each member country, before the EMF began to issue ECUs in substitution for national currency. A measure of when the conditions would be right to begin Stage 2 would be when member countries were ready for the EMF to begin issuing ECUs as a dual currency on the European Standard. Until that point, cooperation between central banks within the Community could continue and intensify through existing informal arrangements during and 'beyond' Stage 1. But there would be no need for a new Community institution as such, or a revision in the Treaty.

51. Once Stage 2 had been introduced, the Community might decide to stay on the European Standard rather than moving on to Stage 3, at least for the foreseeable future. It would be likely in any case to take time for the ECU to gain popular acceptance as a Community currency. But unlike the Gold Standard, where the supply of gold was limited, it would be feasible on the European Standard to evolve from the use of the ECU as a standard to its use as the single Community currency. In this respect, the scheme goes further than the Delors Report, by proposing a way of resolving the problem identified in paragraph 57 of the Delors Report. Power would transfer from national level to Community level, but only to the extent that individual and business consumers within the Community decided to use ECUs rather than national currency.

52. An Inter-Governmental Conference would be needed under the proposal set out in this paper to prepare the way for a revision in the Treaty, but the path to monetary union that the Conference would consider would be different from the path set out in the Delors Report. The revision in the Treaty would be roughly equivalent to Stage 2 of the Delors Report. While it would be possible in theory to specify in the Treaty covering Stage 2 that the ECU should become a single (rather than a dual) currency when it represented more than a specified proportion (e.g. 80%) of liquid assets in each member country, in practice an automatic provision of this kind would not take sufficient account of the option available to holders of liquid assets denominated in ECUs to convert them back into national currency if they wished to do so. Consequently, another Treaty would be needed if the European Council were to decide at some future date to abolish national currencies and establish a single Central Bank in place of the EMF. The Inter-Governmental Conference would need to consider the circumstances in which the Treaty should provide for a further Inter-Governmental Conference to be called to consider a further revision in the Treaty to implement Stage 3.

53. The issues to be considered in preparing the Inter-Governmental Conference to revise the Treaty, or by the Committee of Central Bank Governors outside it, would include: (i) membership of the EMF; (ii) its statutes; (iii) the redefinition of the ECU; and, assuming that the ECU was not linked to gold, (iv) the future of any EC gold reserves surplus to requirements. (One option might be to reduce the level of EC gold reserves to the same

proportional level as the US and Japan by transferring surplus gold reserves into a Trust Fund for the benefit of Eastern Europe, or by privatising the surplus over a period of time through the issue of gold coins to European residents, and using the proceeds for development aid and environmental purposes.)

54. It now looks as though the revision in the Treaty relating to monetary union in the Community will be preceded by monetary union in Germany. The question will no doubt arise whether German monetary union should be used as a model for the Community as a whole. German monetary union is similar to monetary union in the Community in the sense that monetary union is likely to precede political union. But the differences outweigh the similarities. The main differences are, first, that German monetary union represents the union of a single divided nation. The Community by contrast, is a group of sovereign nation states which has never been unified. Second, the Ostmark is not a convertible currency, leaving a potential overhang of unspent savings in East Germany. This is not the case in the Community, where all member currencies are fully convertible. Third, one of the main reasons why German monetary union is being proposed now is that the East German economy is near a state of collapse.

CONCLUSION

55. In the event that a decision is taken at the Inter-Governmental Conference to revise the Treaty, a revision in the Treaty along the lines proposed in this paper would meet all the UK's objectives for an evolutionary approach to monetary union:

(i) The principle of subsidiarity would be preserved. National central banks would remain directly accountable at national level under the constitutional arrangements in place in each country, and the EMF would act as a forum for the coordination of national monetary policies by means of cooperation rather than control.

(ii) The prospects for price stability would be enhanced. The European Standard would be based on 'the best' in the Community rather than 'the average'.

(iii) Competition among national monetary policies would be maintained, and a new element of competition between national monetary policies and the monetary policy for the ECU would be added, with the market determining progress towards the common currency. In addition:

(iv) The EMF would be open-ended, so as to be able to accommodate new members (e.g. from EFTA and eventually from Eastern Europe) without disrupting the system.

(v) There would be a strong case for basing the ECU operating arm of the EMF in London.

56. The revision in the Treaty would cover Stage 2. Another Treaty would be needed to implement Stage 3. Stage 2 would become a significant set of monetary arrangements in its own right, and not simply a process of transition to Stage 3. Once Stage 2 was introduced, individual and business consumers within the Community would decide whether to stay on the European Standard, or whether, and if so when and to what extent, to move towards monetary union. This would resolve the fundamental difficulty identified in the Delors Report relating to the circumstances in which decisions about monetary policy should be transferred from national level to Community level.

O.P. Richards
4 March 1990

Foreign and Commonwealth Office

London SW1A 2AH

CONFIDENTIAL

2 March 1990

Dear John,

British Membership of the ERM: Spanish Views

The Foreign Secretary thinks the Chancellor should know that in Madrid on 26 February he was button-holed by the President of the Central Bank of Spain, Sr Mariano Rubio. Sr Rubio said he wished to make a fervent appeal to the UK to join the ERM. Although we appeared from our statements to be worried about German economic dominance of Europe as long as the United Kingdom stayed out of the Exchange Rate Mechanism we were encouraging precisely that.

Sr Rubio said that London could not maintain its claim to be a serious financial centre and stay out of the ERM. The Foreign Secretary explained the conditions which would need to be fulfilled before the UK would join the Exchange Rate Mechanism. He added that the argument about the second stage of the Delors report was a political one on which both main British parties were agreed. Sr Rubio took this as a cue to say that of course EMU was a political issue. But he challenged the view that by agreeing to Delors stages II and III the British Parliament would be abdicating its responsibilities. Had the United Kingdom not been a democracy in the 1920s and 30s, and was the United States not a democracy now, although in both cases monetary control did not lie with central Government?

Sr Rubio said that the Spanish experience of the ERM had been good. In joining the Mechanism the Spaniards had been influenced by the French experience: France had a tendency to inflation which had been curbed by ERM membership.

I am copying this letter to Charles Powell at No.10.

Yours ever,

Richard Gozney

(R H T Gozney)
Private Secretary

John Gieve Esq
PS/Chancellor of the Exchequer

CONFIDENTIAL

EMU(W)(90)10
28 FEBRUARY 1990

HER MAJESTY'S TREASURY

COORDINATING GROUP

ON ECONOMIC AND MONETARY UNION

I attach the final version of the Group's report entitled "Next Steps on EMU: A Report to Ministers".

Wilf White

A E W WHITE
Secretary

ecl.bk/meb/20.7.1

MR WICKS' CO-ORDINATING GROUP ON ECONOMIC AND MONETARY UNION

Members

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*Mr Odling-Smee	)
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Sir David Hannay - UKREP
Mr Bonney - UKREP
Mr J Kerr - Foreign Office
Mr A Crockett - Bank
Mr J Arrowsmith - Bank
*Mr Blythe - Treasury Solicitors

*To receive papers and attend as necessary

Recipients of papers

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PS/Sir Peter Middleton	)
Sir T Burns	)
Mr Scholar	)
Mr Grice	) Treasury
Mr S J Davies	)
Mr Melliss	)
Mr McIntosh	)
Mrs Chaplin	)
Governor	)
Deputy Governor	)
Mr Flemming	)
Mr George	) Bank of England
Mr Coleby	)
Mr Taylor	)
Mr Arthur	FCO

NEXT STEPS ON EMU: A REPORT TO MINISTERS

I INTRODUCTION

1.1. This report, prepared by officials from the Treasury, Cabinet Office, FCO, UKRep Brussels and the Bank of England, is intended to provide Ministers with a basis for deciding HMG's strategy and tactics both in the approach to and during the forthcoming Inter-Governmental Conference (IGC) on economic and monetary union (EMU).

1.2. The UK Government's position on the IGC is that we consider its calling to have been premature but we will play a full and constructive part in its work.

The IGC, Treaty change and EMU

1.3. In considering the issues raised by the Strasbourg decision to call an IGC to "prepare an amendment to the Treaty with a view to the final stages of EMU", it is important to distinguish between:

i) the process of preparing and negotiating treaty provisions in an IGC; and the subsequent ratification and entry into force of these provisions;

ii) actual movement towards EMU, beginning with removal of Italian exchange controls this spring, followed by the 1 July start of Stage 1; and

iii) developments thereafter which, on the Delors Report model, would consist of a move, after an undetermined period, to a Stage 2 and, after a further undetermined period, to a Stage 3.

The IGC process is likely to be relatively rapid, but that does not mean that progress towards EMU need be. In practice it will not be, if EMU is to be attained at the same pace throughout the

Community, ie at the pace that, for example, the Portuguese and Greeks can manage.

1.4. Indeed, in the light of the experience of the Werner Report - which set deadlines which proved nugatory - the Delors report itself came down firmly against any attempt to set fixed dates for the moves from Stage 1 to Stage 2 and from Stage 2 to Stage 3. No-one has so far challenged that, and it is much in our interest that it should be sustained throughout the IGC sequence.

1.5. External events, eg the upheavals in Eastern Europe and above all the move to monetary union in Germany (GMU), will affect the pace of these processes quite differently. Because GMU may lead to some disturbance, and possibly realignments, in the ERM, actual progress towards EMU may be slowed by these external developments, thus giving the dynamic effects of the Single Market more time to work through before a move to Stage 2 can be contemplated. But the treaty drafting process is, perversely, more likely to be accelerated, as the large majority of member states keen on early progress become the more determined to get on with the IGC (and very possibly to bring it to a reasonably rapid conclusion) in order to demonstrate that, at least on paper, development of the Community is continuing. Our report makes no judgement on these various external forces. But we judge that it would be wrong to assume at this stage that the task ahead of us in an IGC will be made easier by the events in Eastern and Central Europe.

1.6. Proceedings in the IGC will also be influenced by the state of the European Monetary System: an ERM in disarray may cast doubt on the whole enterprise of EMU; yet that very disarray may suggest to some member states a reason for pressing ahead all the faster. The UK's current attitude to ERM membership will influence the attitude of other Member States to our negotiating position in the IGC.

1.7. The UK paper on "An Evolutionary Approach to Economic and Monetary Union" published last November has proved a valuable contribution to the debate on EMU. Its emphasis on an approach

which minimises inflationary risk, which devises practical means for moving towards EMU and which works with the grain of the market was welcomed. But the paper failed to command support as a credible alternative to the Delors' definition of full monetary union, partly because of what was seen as the UK's unwillingness to accept the ultimate goal of EMU, and partly because the paper was perceived as giving primacy to the Bundesbank and this was regarded as politically unacceptable. Scepticism has also been expressed about whether the EMS could, even under our evolutionary process, evolve into one of fixed exchange rates, without some institutional underpinning.

1.8. The other 11 Member States appear likely to insist, with varying degrees of enthusiasm, that a new Treaty should enshrine both the Delors definition of EMU - which would include the eventual irrevocable locking of exchange rate parities and perhaps a single currency - and the creation of a new institution which would underpin the process towards and the eventual management of full EMU. Some in the Community, probably the FRG, will argue for a long Stage 1 and an amending Treaty which clearly specifies the conditions for entering the later stages, a short Stage 2 (or perhaps none at all) and a detailed specification of both the objectives of full (Stage 3) EMU and of the institutional mechanics for implementing it, foremost among which will be a European System of Central Banks (ESCB) which will, to the extent possible, mirror the constitution of the Bundesbank. A few, possibly the French, may argue for a long Stage 2 and probably a detailed specification of Stage 3 as well. (Further information on member states' current views is given in Chapter IV).

The form and general content of an amending Treaty

1.9. It is too early to judge the precise form of an amending Treaty for which there might be majority support in an IGC. We have identified four possible options, but they should, on past experience, be regarded at this early stage in the negotiating process more as a spectrum than as clear cut models:

i) **A new Treaty confined only to some interim "Stage 2" arrangements**, merely hinting at further developments beyond that on the route towards EMU, and leaving detailed specification of "Stage 3" institutions for a further Treaty.

ii) **A Treaty mainly concerned with interim institutional arrangements**, but also defining EMU more specifically as a target; but again leaving detailed specification for "Stage 3" institutions for a further Treaty.

Both these options would require subsequent further Treaty changes to implement the final stage. On the face of it, this seems a sensible and pragmatic approach: it allows time to pass, and the changes in the EC and its markets to take place, before the Community will be ready to define and to take the final step to monetary union. But it is clear that most other member states want to go beyond this. Option (i), in particular, looks unnegotiable. Option (ii) looks more credible, particularly if supported by proposals for institutional changes as part of Stage 2 (see chapter II of this paper). But our present assessment is that at the end of the day it would probably not achieve the necessary consensus because the other member states are keen to establish the future path of the Community. The following two possible options seem more likely to get wide support:

iii) **A Treaty giving a full definition of EMU, and the institutions necessary for its final stage** (together with a transitional stage if agreed); but then allowing an "opting in" mechanism for member states, with different member states allowed to join in the new Stage 3 arrangements at their own pace. This may be the Commission's favoured option.

iv) **A comprehensive Treaty**, which similarly sets out the final stage and its institutions in detail; but which specifies stiff conditions that would have to be met before all

member states moved together to full EMU. The Germans may favour an approach like this.

The Delors report (paragraph 44) envisaged that some member states might not participate in all aspects of EMU at the outset and that this would be acceptable provided their influence on the management of the system reflected their degree of participation. Accordingly option (iv) might well include an "opting out" procedure permitting individual member states to delay their participation for justifiable reasons. If so, this option would be closer to, though still distinct from, option (iii).

1.10. We thus seem most likely to be faced with an amending Treaty which takes the form of (iii) or (iv), or some combination of the two. As for the detailed content of an amending Treaty, the models above could conceivably encompass arrangements proposed in the Delors Report or different ones.

1.11. If option (iv) were chosen, the conditions for proceeding from one stage to the next would need to be determined. Such "firebreaks" could be institutional and/or functional. So far as institutional "firebreaks" are concerned, the Delors report (paragraph 63) refers to the moves from Stage 1 to Stage 2 and from Stage 2 to Stage 3 requiring "an appraisal of the situation and a decision by the European Council". We might at least wish to insist that each move should require a unanimous Council decision. (It would of course be possible for any member state to declare that it would not participate on such a decision without the agreement of its Parliament.). A functional firebreak would involve setting out objective conditions, eg levels of achieved economic convergence, or intra-ERM exchange rate stability, which would need to be fulfilled before the moves from Stages 1 to 2 and/or 2 to 3. It is difficult to envisage how either type of firebreak could be a feature of option (iii).

1.12. The choice between options (iii) and (iv), and the nature of the firebreaks if option (iv) were chosen, would be likely to depend on other member states' assessment of the attitude of the UK in particular. Those keen to proceed so full EMU would be

reluctant to agree to a mechanism allowing one member state to thwart the wish of the others if they believed that it would in practice be so used.

1.13. Clearly, if Ministers wish to attempt to shape the product of an IGC in a direction that we could support, they will need to have devised a coherent strategy and the tactics to implement it. The forming of alliances, both before and during the IGC, will be essential if we are to achieve any objective which we set ourselves. This report, however, focuses on the key policy issues which need to be considered before Ministers decide questions of tactics and presentation.

The structure of this Report

1.14. The remainder of our report is divided into the following chapters:

II monetary aspects of EMU, including questions concerning the definition of monetary union and possible institutional arrangements both for Stage 2 and Stage 3;

III the implications of economic union - the question of binding budgetary rules in particular;

IV a summary of the views of other member states on EMU and the IGC, and the approaches they are likely to adopt; and

V a list of the main issues arising which Ministers may want to discuss.

1.15. A list of annexes which are available on request is given at the end of the report.

II MONETARY ASPECTS OF EMU

2.1. In the IGC, and the discussions leading up to it, we are going to have to take a view on:

i) what definition of Monetary Union we can accept.

ii) what kind of institutions in the final stage would be acceptable.

iii) what, if any, interim steps we could support (as useful in their own right, whether or not they led to further development).

2.2. We suggest that our basic position for the objectives of monetary union should be those set out in our November 1989 paper: price and currency stability; lower costs of financial transactions, especially across borders; and equal access to financial instruments and services throughout the Community. We have shown how the market forces at work during Stage 1 will go a long way to meet these objectives. It is important to ensure that any step beyond Stage 1 does not compromise them; and in particular that it does not undermine the objective of price stability.

2.3. This chapter considers (A) the definition of full monetary union, and (B) possible institutional developments.

A. Definition of full Monetary Union

2.4. Although in principle the definition of a monetary union might cover an area within which several currencies freely circulate, in practice monetary union in the Community has always been defined as either:

i) irrevocably fixed parities between national currencies; or

ii) a single Community currency.

2.5. The definition in the Delors Report (paragraph 22), taken from the 1970 Werner Report, sets out "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 Werner Report concluded that: "... 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 ... The replacement of national currencies by a single currency should ... take place as soon as possible after the locking of parities."

2.6. We avoided accepting the Werner/Delors definition in the UK paper through the words in the penultimate sentence ".....the system could evolve into one of fixed exchange rates." But we do not believe we can realistically hope to challenge in an IGC the Werner/Delors definition, which is the one always used by economists and monetary experts. Indeed, to attempt to do so could discredit our case generally.

2.7. So we think that a large majority of member states, indeed probably all the other 11, will be ready to see monetary union defined in a Treaty in either one or a combination of the two alternatives in paragraph 2.4. There will be a strong wish in certain countries for some sort of commitment to an eventual single currency. Either alternative would cause us difficulty, since both require the operation of a common monetary policy, throughout the Community; and both therefore would need some form of Community central monetary decision-taking mechanism.

Acceptance of either alternative definition of monetary union, in paragraph 2.4 above would not prejudice our negotiating position on the procedures for moving towards a monetary union: in any case, no one is pressing for a timetable to be laid down in a Treaty. Though the UK has already subscribed to political texts envisaging the progressive implementation of EMU, we are not committed either to a timetable or to any particular institutional framework. But our acceptance of a definition of monetary union as an objective of the EC would implicitly rule out any opposition in principle to Treaty texts designed to achieve its progressive implementation.

Irrevocable locking of parities

2.8. Of the two options in paragraph 2.4, irrevocable locking of parities looks more like a natural progression from a Stage 1 ERM system of fixed but adjustable parities: indeed, we accepted in the UK paper last November that this was a point that might eventually be reached. But irrevocable locking:-

i) would involve some central procedures (and almost certainly a central institution) for making decisions about the general level of (short-term) interest rates in the Community; and

ii) could well be unstable, likely to lead fairly quickly - assuming member states really are committed to irrevocable locking - to a single currency.

2.9. The reasons for the conclusions at (ii) are as follows. So long as separate currencies remain, market participants may not believe that parity locking really is irrevocable. The system would be likely to go through periods of calm, with more or less identical short-term interest rates in all countries, but with intermittent bouts of market pressure involving widely differing interest rates, and pressure on some central banks to exchange their currency for others. To demonstrate that locking was irrevocable, central banks would have to be ready to exchange their currency for the others without limit, at the fixed parity.

There would thus be no national control of money supply and decisions on the general level of interest rates would have to be taken jointly. To reduce market turbulence there would be great pressure to do more to reassure the market that locking was irreversible. The two obvious steps would be to establish a more powerful central monetary institution; and to move to a single currency. So we suspect that any attempt to operate a system of irrevocably fixed exchange rates could quickly lead to a move to a single currency. It might therefore be difficult for us to argue that we were committed to irrevocably locked currencies, but as a matter of principle could not commit ourselves to a single currency.

2.10. It should also be noted that, when other member states envisage irrevocably fixed parities as a possible definition of EMU, they are not thinking of a procedure under which separate national central banks, and separate national monetary policies, would be maintained. They probably have in mind the version set out in the Delors Report under which there would be a single EC monetary authority and the separate national currencies would only continue to exist for political and presentational reasons.

Interim Stages

2.11. This analysis is predicated on "full" monetary union. Before then, even in an intermediate stage during which exchange rates in the ERM had become much more stable, the possibility of parity changes would leave member states with a degree of freedom of action in setting monetary policy. One way in which an IGC might agree the system should develop is that some countries would opt to go for full union - irrevocable locking with no margin of fluctuation - earlier than others. Those countries that chose to travel outside would then retain freedom to set national monetary policies; those that had opted for full union would not. We would need to consider the advantages and disadvantages of this sort of arrangement.

B. Institutional Developments

2.12. Most of the discussion so far in the Community has been about institutions needed after full monetary union ie in Stage 3. At an IGC we can expect the Commission and other member states to table various schemes, in legislative form, for such institutions, and we need to be ready to respond. Member States' views on Stage 3 will inevitably shape their views on the transitional phase. The next section of the paper therefore discusses these issues.

2.13. But there is also a further issue : are there any interim institutional changes, useful in their own right, that we could support for developments before Stage 3? Insufficient thought has been given to this aspect in the Community so far. We discuss below (paragraphs 2.34-2.41) some possible practical initiatives.

Institutions after full monetary union

2.14. Before the final stage of monetary union, member states would be able to continue operating their own monetary policies, with decisions constrained by the exchange rate commitment against other ERM currencies - the tighter the commitment, the narrower the constraint. The UK paper showed how this, combined with peer pressure and collective surveillance, should lead to low inflation. But as noted above, once the move to irrevocable fixing had been taken, there would have to be machinery for taking decisions about interest rates at Community level. Market pressures would require the creation of a European Central Monetary Institution (ECMI); and, probably, a single currency. At this stage it would become necessary to devise institutional arrangements, to replace the market forces operating in Stage 1 so as to continue to build in a similar bias towards price stability.

2.15. Four key issues are beginning to emerge in discussions of Stage 3 institutions :

i) **The fundamental objective** of a European Central Monetary Institution (ECMI).

ii) The degree of independence, of such an institution;

iii) Democratic (or as we might prefer to put it political) accountability. What does this mean : control by national governments through the Council of Ministers, or a system where the ECMI renders account to national governments and/or parliaments, and to the European Parliament?

iv) Policy responsibilities of the ECMI - presumably it would set interest rates; but where would responsibility for (external) exchange rate policy lie? And what about responsibility for banking supervision?

Current discussions in the Monetary Committee are also focusing on issues concerning the structure of an ECMI (eg one Board of Separate superintending and executive Boards) and voting rights of Board members. This report does not consider these detailed, though important, issues.

(i) Fundamental objective

2.16. We assume that the Treaty itself should specify that the objective of the ECMI would be price stability and that any other terms of reference should be framed in such a way as not to detract from this fundamental aim.

(ii) Independence and control

2.17. The realistic choice is between an ECMI that has a substantial measure of independence, and an ECMI controlled by the Council of Ministers. There would be constant pressure from one member state or another to reduce interest rates and accommodate price increases. We have argued in the UK paper that decisions within an independent bank might still be liable to compromise between national interests (thus leading to decisions which converge on the average rather than the best inflation performance). Decisions in the Council of Ministers taken by majority vote would be even more liable to compromise and avoidance of tough but necessary action. All this suggests that

Finance Ministers as well as Central Bank Governors, as a matter of international economic relations. Indeed probably all other member states would accept that the international exchange rate regime (to take an example from the past, the operation of the Bretton Woods system) is a matter for governments, not central banks.

2.25. There are some further supporting arguments about where responsibility for holding reserves should lie :

i) owning foreign exchange reserves entails financial risk. Even where reserves are owned by central banks, these risks are sometimes underwritten by governments. But if EC governments underwrote the ECMI's reserves they would want a say in their use and investment. Moreover currently national reserves belong in most countries to governments rather than central banks, and have a very uneven distribution between EC countries;

ii) intervention has to be financed, and preferably financed in a non-monetary way. If the Community's gold and dollar reserves were held by the ECMI it might need to borrow from member governments if the reserves were increased by intervention.

2.26. This suggests a case for a different approach to the Delors Report proposal, under which the proposed ECMI is responsible for the "formulation and implementation" of exchange rate policy, with official reserves pooled and managed by it. The alternative arrangements might be on the following lines :

i) exchange rate policy against the dollar and yen to be a responsibility of ECOFIN, after consulting the Central Bank Governors Committee/ECMI;

ii) ECOFIN to nominate one of their number - not necessarily the German Finance Minister as it would be at present - to attend G3 meetings (EC, USA and Japan) if G7 did not continue, together with the Chairman of the ECMI;

iii) guidelines for intervention policy against the dollar and yen to be set by agreement in ECOFIN;

iv) ownership of reserves to remain with national governments/central banks as at present. But intervention against dollar and yen to be carried out, on an agency basis, by ECMI - with reserves contributed and withdrawn in tranches, as necessary, by member states.

2.27. There would inevitably be a tension in such arrangements between Governments and the ECMI : but the same tension already exists on exchange rate policy in many member states - and indeed other countries, such as the US.

2.28. There are signs that the French may favour an approach of this kind, though it is very different from that favoured by the Bundesbank. It could have implications for intermediate institutional developments (see paragraph 2.40 below).

Banking Supervision

2.29. The Delors Report suggests (paragraph 32) that, in addition to its monetary policy functions, the ESCB "would participate in the coordination of banking supervision policies of the supervisory authorities". Banking supervision is, of course, an area where there is already some Community competence: for example, the recently adopted legislation to create a single market in banking imposed minimum standards of capital adequacy on banks in the Community. Within Member States, responsibility for carrying out supervision normally lies with the Central Bank but there are some notable exceptions (Belgium, Denmark and Germany). Arrangements already exist (for example the Banking Advisory Committee (BAC) and the Contact Group) whereby national supervisory experts discuss matters of common interest, advise the Commission, and act as regulatory committee for the purposes of introducing delegated Community legislation.

2.30. Since EMU will not create any fundamentally different banking supervisory problems, there is no particularly strong reason why these arrangement should be changed. On the other hand, the sound functioning of the banking system is a matter of importance to Central Banks and, as part of Stage 1 of EMU, the Committee of EC Governors is already strengthening its arrangements for discussing and dealing with those supervisory matters of common interest to member Central Banks; where the Central Bank does not have legal responsibility for banking supervision, provision is being made for the non-Central Bank supervisory authority to be represented. It would be reasonable for such arrangements to continue in the later stages of EMU and thus sensible for any ECMI which was set up to be consulted on supervisory matters. The ECMI would be likely to want to concentrate on matters of principle, leaving more technical and detailed considerations to the BAC and the Contact Group, ie to national supervisory authorities acting collectively.

"Gold Standard" Options

2.31. It is worth pausing to consider whether there is any alternative approach that requires less centralisation of monetary policy in a "full" monetary union. There is one approach, in theory, that would avoid the creation of a new central institution with significant powers : if separate national currencies (or indeed a single Community currency), were linked to some external standard, preferably one that retained its real value. There would be loss of sovereignty in the sense that national central banks would lose power of discretion, but no transfer of sovereignty from national to Community level.

2.32. Possibilities include a link to gold, or some basket of commodities. A modern variant would be a link to a centrally defined and issued index-linked currency, say an indexed ecu.

2.33. The approach suffers two difficulties. First there is no evidence of any such system being made to work in modern times (and even the gold standard did not always work in practice as the text books said it should). But this is not a fatal drawback,

since we have no evidence of the successful achievement of a monetary union of the kind proposed by Delors either. Second, and more important, we do not think it would be negotiable with our Community partners. To float it at this juncture would be regarded as a wrecking tactic : and we doubt whether it would succeed.

Interim institutional steps in Stage 2

2.34. As noted above, we will also need to decide our attitude to proposals for Treaty change to bring about interim institutional development, before the final stage of monetary union (if it ever happens). The German position is to resist such developments, and to argue for a long Stage 1 (we agree) but a short Stage 2 or none at all. The French on the other hand seem ready to contemplate a form of Stage 2 which incorporates the creation of some new institution, though following a much briefer Stage 1 than the Germans would favour.

2.35. Ministers will wish to consider whether there is a case for supporting interim institutional developments. The more positive we can be in this respect, the greater the weight that some other member states may be willing to give to our views on the final stage. But there can be no certainty that this tactic would succeed, in view of the firm commitment of most other member states to a clear definition of the final stage: indeed the probability is that it would not. Even so in any event there are some institutional developments that might make sense in their own right whether or not the Community ever moves to "full" monetary union. Just as the UK paper suggested an evolutionary approach towards EMU, so it is possible to envisage an evolution of the present institutional structure. This could have the incidental advantage of removing some functions at present carried out by the Commission to a body more closely associated with the Council and Central Bank Governors' Committee.

2.36. The proposal we could make is that as experience is gained with Stage 1, a new Community institution should be created. We have given it the working title of European Monetary Fund (EMF).

This would have a range of functions, some new and some already carried out by others.

Three possible functions for an EMF

2.37. To take the possible new functions first, there is one concrete and practical step, but which could have considerable appeal as a natural development of our evolutionary approach : the creation of a currency board, to issue ecu bank notes (and possibly coin) for general circulation. The board would do this backing the notes and coin, precisely, with the required basket of base money in the 12 national currencies. It would provide ecu notes on demand, in exchange for Community currencies. But when, for example, a bank went to it with drachma and asked for ecu notes, it would have to exchange the excess drachma - other than those needed to back the ecu issued - at the prevailing market rate for the base money in the other 11 currencies it needed as backing.

2.38. We could expect German opposition to such a proposal: the Bundesbank has always been opposed to the use of parallel currencies, in general and the ecu in particular. Nevertheless, there would be several advantages:

i) its symbolic appeal is that it would bring into being an ecu notes (and possibly coin) circulation comparatively quickly. There seems no other mechanism which is likely to stimulate retail usage of ecu currency on the same scale in the near future (though views differ widely about the likely scale of demand for ecu notes);

ii) by contagion, it might also add to the appeal and usage of the private ecu more generally, deposits for example;

iii) it would also break down some of the remaining barriers to the free circulation of currencies within the Community, so speeding up the process of currency competition. Over time, the proportion of ecu notes and coin in circulation

should increase and the proportion of national notes and coin reduce, to some extent.

2.39. There seems no reason why a Currency Board issuing ecu notes would be incompatible with the UK's evolutionary approach to monetary union. Indeed, in some respects it would be neatly complementary. The evolutionary approach argues that in the environment of Stage 1, there will be factors pushing monetary policies towards low inflation policies. Countries which tried to pursue inflationary policies would be punished by suffering damaging devaluations of their currencies.

2.40. The same or another institution could take on a responsibility for co-ordinating intervention against third currencies. The Delors Report included a minority proposal for pooling national reserves in Stage 2. Co-ordination can however take place without reserve pooling, and would logically make sense after all member countries have joined the ERM. The precise function might involve:

i) no pooling or change of ownership of reserves; but

ii) voluntary (ie unanimous) agreement that all Community intervention against the dollar and yen would be channelled through a single agency that would draw and repay tranches of dollars, yen and national currencies as necessary from member states; subject to

iii) intervention guidelines agreed by the Council (after consulting the Central Bank Governors' Committee).

2.41. Finally, an EMF might take over a range of existing functions performed by the Commission and others. These include:

i) managing the ERM : its short-term financing facilities and realignments (work currently largely done by the Monetary Committee, its Secretariat, and central banks);

ii) managing the ecu : both the official ecu, and development of the private ecu including, perhaps, its clearing system (tasks currently carried out by the EMCF, the Commission, and the BIS);

iii) managing Community financing facilities. This would include recommending conditions for Community loans to member states, and monitoring performance - a function largely carried out at present by the Commission;

iv) providing a Secretariat, and research and development facility, for ECOFIN, Central Bank Governors' Committee, and Monetary Committee.

2.42. If Ministers wished to pursue a proposal of this sort, careful thought would have to be given to its presentation. Other member states would be unlikely to take it seriously if they considered that it was being put forward merely as a diversionary or wrecking tactic.

III ECONOMIC ASPECTS OF EMU

3.1. The Delors Report (paragraph 25) defined economic union as consisting of four essential elements:

- a 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 changes and regional development; and

- macro-economic policy coordination, including binding rules for budgetary policies.

3.2. While accepting this broad definition of economic union, the UK paper expressed strong reservations about the Delors Report's proposals in the fourth area, macro-economic policy coordination, particularly in relation to the recommendations for binding budgetary policy rules.

3.3. Before discussing the latter, however, it is worth noting that the Delors Committee envisaged that economic policy coordination would go beyond budgetary policy, and that 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."

3.4. The principle of subsidiarity, however, implies that macro-economic policies and objectives, with the exception (in Stage 3 as defined in the Delors Report) of monetary policy and price stability, are properly the preserve of national governments. While the surveillance process will inevitably involve discussions of macro-economic developments and policies,

it will be essential to avoid any extensions of Community competence in this area. This means avoiding any suggestion of centralised decisions on policies or objectives.

Budgetary policy rules

3.5. The Delors Report (paragraph 30) advocated:

> "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 operating 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."

3.6. In Stage 2, the Report envisaged that such rules would be precisely formulated but would not yet be binding. In Stage 3 they would become binding.

3.7. The UK paper explained that we could not accept the first of the binding rules proposed by the Delors Committee in the passage quoted above. We could accept the third rule to the extent that it precluded monetary financing; but the Delors Report suggested that it might go further than this. And we have reservations about the use of the word "conduct" in the final sentence of the passage quoted above, which seemed to imply a system of centralised decision-making. We also expressed a general reservation about binding EC rules to the extent that "they infringe the principle of subsidiarity and could lead to acute political difficulties within member states". The paper did, however, accept that there was a case for Community rules in the following areas:

i) an explicit understanding that there will be no monetary financing of budget deficits; and

ii) agreements that the Community will not bail out governments which run excessive deficits.

3.8. We also now believe that there is a case for:

iii) imposing in the context of Community mechanisms for lending to a member state, a legally binding budgetary commitment upon that member state as a condition of the loan, if it chose to take up that loan;

and we would be prepared to concede:

iv) establishing, in order to underline the undesirability of excessive budget deficits, binding Community procedures on member states for the surveillance of national budgetary policies - what would be binding would be the procedures and not the outcome of the surveillance exercise.

(These four "binding rules" have already been endorsed by the Chancellor and the Prime Minister: Private Secretary letters of 12 February and 13 February.)

i) Prohibition of monetary financing

3.9. Rules prohibiting monetary financing are envisaged under both the Delors and UK approaches. These rules could be imposed under existing Community legislation - for example, by amending the Convergence Decision or by adopting directives to give effect to a revised Decision. But there seems no reason for the UK to oppose inclusion of such a provision in general terms in the Treaty, even if it is not strictly necessary. Details could be fleshed out by the competent bodies and incorporated in subordinate legislation.

ii) Prohibition of "bail outs" and Community assistance

3.10. We have proposed a no bail out rule in the UK paper. That is, there should be no Community arrangements for providing Member States with budgetary support, either from other Member States or, more important, from the Community budget itself. The prospect of such assistance would blunt the operation of market forces on budgetary policy. If the capital markets assumed that Member States or the Community stood behind each other's debts, the presumption of the ultimate threat of default would be removed. This could encourage borrowing by a Member State which is excessive or underpriced according to normal market criteria.

3.11. While these arguments command general support in Community Finance Ministries, many argue that whatever statements the Community might make about no bailing out, the markets would not believe that they would be honoured in the last resort. There is, of course, no way of proving or disproving such an assertion. But a statement in as firm as possible terms enshrined in a treaty would clearly help to persuade markets. There is also a role for Community surveillance procedures in such persuasion (see paragraphs 3.17-3.21 below).

iii) Attaching conditions to loans to member states

3.12. The case for the no bailing out approach is further complicated by the arrangements for the Community to provide mutual balance of payments support which already exist under the Treaty and which are currently in use in the case of Greece. Their complete abolition is almost certainly non-negotiable.

3.13. We believe that, if such a Community facility is to continue to exist, steps must be taken to ensure that loans are made only on very stringent conditions including, in the context of budgetary policy, requirements that loans are granted only on condition that the Member State concerned agrees to binding restraints on its fiscal policy designed to ensure that necessary adjustments are made. Loans should also be limited in size and be granted for a relatively short term so that the mandatory

budgetary restraints can be made effective. There would be a case for enshrining these rules, perhaps in some detail, in a new Treaty and Council Decision.

3.14. The availability of Community assistance on these terms and on this sort of scale would probably not undermine the operation of market forces to any significant degree. The scale of finance would be too small to prevent bankruptcy in extreme circumstances. Making it conditional on a stringent adjustment programme could even augment the operation of market forces rather than retard them, since countries facing budgetary difficulties would have a clear incentive to bring forward the adjustment process and thereby avoid a stringent Community-enforced adjustment.

3.15. For the system of conditional loans described above to operate effectively, it would be essential that the decision to grant such loans and the monitoring of performance against conditionality were not subject to political direction from the Commission and the Council of Ministers. The success of the IMF has in large part been due to the insulation of its operations from direct political control. There can be little confidence that a Community loan mechanism would be operated with sufficient rigour if it was in the hands of the Commission and the Council. Experience with the current Greek loan - when the Community provided far too much to Greece against criteria that were thereafter badly missed with no penalties being incurred by the recipient - fully bears out this gloomy conclusion.

3.16. In the light of all this it would seem desirable for proposals to grant Community assistance, formulation of the conditions under which it is made available, and the process of monitoring compliance with the agreed conditions, to be undertaken at arm's length from the political process - ie from the Council and the Commission. It might be a role which the proposed European Monetary Fund (EMF), described in paragraphs 2.34-2.40 above, could undertake.

iv) Enhanced arrangements for Community surveillance

3.17. There will be those in the Community who will argue that stipulation against monetary financing, rules against bailing out and strong conditionality on Community support mechanisms, even if they all have the backing of an explicit treaty provision, will provide an insufficient framework for disciplined national budgetary policies in an EMU. While this school of thought is unlikely to argue for explicit quantified upper limits on budgetary deficits, they may propose a treaty power which would enable the Council, where it judges in particular cases that deficits are excessive, to lay down binding limits on their size. This would be unacceptable to us.

3.18. We suggest that we should counter such arguments by proposing a treaty based enhancement of Community arrangements for the surveillance of economic policy.

3.19. The Community has agreed to improve the arrangements for coordinating Member States' economic and monetary policies in Stage 1 of EMU. The Council Decisions on Convergence and on Cooperation between Central Bank Governors have been revised to give effect to this. ECOFIN will regularly review Member States' economic policies through the process of multilateral surveillance, and may make non-binding policy recommendations.

3.20. Both the Delors report and the UK paper envisage that multilateral surveillance will continue beyond Stage 1. The difference is that Delors envisages a more prescriptive approach, including binding rules on budget deficits. The UK believes that in Stages 2 and 3 surveillance should still lead only to non-binding guidelines. The Stage 1 surveillance arrangements could therefore continue to provide an adequate framework for coordinating economic policies in stages 2 and 3.

3.21. However, it would help our case in arguing against binding budgetary rules for the size of deficits if we agreed to some strengthening of the surveillance procedures after Stage 1. This could be done through a further revision of the Convergence

Decision and - possibly - certain amendments to the Treaty. A possible package (for adoption in Stage 2 or Stage 3) could include:

- specifying the range of economic policy and other indicators on which ECOFIN will annually make non-binding recommendations;

- member states would be required to respond formally to the recommendations;

- the Commission (or an alternative body such as the EMF) would be required to monitor member states' performance and report to the Council;

- in some cases, where there are budgetary problems, special consultative procedures and tighter monitoring arrangements would be specified;

- compliance with surveillance procedures would be binding, although Council recommendations would remain non-binding.

Sanctions

3.22. Inclusion in the Treaty of rules on budgetary matters, of the sort supported in this report, or the binding budgetary rules advocated in the Delors Report, raises the issue of sanctions against member states who fail to comply with the new requirements.

3.23. In principle, member states who breach such rules can be taken by the Commission to the European Court of Justice, which can order compliance. But this procedure is both cumbersome and time consuming and there is no effective sanction for non-compliance. Some Member States may therefore argue for introducing specific sanctions when EMU rules are flouted. Withholding Community funds is one obvious option. Others may argue that no specific sanction should be prescribed at the outset, but should be considered as EMU progresses; for this

purpose it would be necessary to incorporate in the Treaty powers to enable the Council to prescribe sanctions.

3.24. We believe that it will be difficult in practice to secure agreement amongst Member States on specific sanctions to back up EMU rules. As far as the UK is concerned, we do not want to encourage unnecessary centralisation of powers in the Community. At the same time, we need to be sure that the rules we favour are actually applied: the Community's readiness to take tough decisions is at present questionable.

3.25. The best approach for the UK may be

- to let others raise the question of sanctions;

- if they do, to point out that a willingness to adopt any binding rules must be accompanied by determination to see that they are applied. That points <u>either</u> to specific sanctions, <u>or</u> to a much tougher political attitude among member states;

- to insist on strict conditionality for Community financial assistance, with the implication that such assistance would be withheld if the member state concerned did not meet the economic conditions set down;

- to accept if necessary that <u>existing</u> sanctions would apply to a no monetary financing rule: ie peer pressure with ultimate recourse to the European Court;

- to argue that rules on budget deficits should not be binding, and should not therefore be backed up by sanctions.

<u>A minimum average maturity rule</u>

3.26. Another possible binding budgetary rule that we might propose is that the Council should have powers to stipulate that new Government debt should be of a minimum average maturity. The rationale for such a rule would be that one sign of excessively

large budget deficits is the inability of budget authorities to finance their debts other than at fairly short maturities. Such a rule would not amount to a direct limitation on Parliamentary authority, and would be consistent with both our domestic funding rule and our support for a non-monetary financing rule in the EC context.

3.27. This proposal might be held in reserve as a possible way of dealing with pressures for binding rules on the size of budget deficits. However, its implementation could raise practical problems even for countries with a strong fiscal position like the UK; and we are considering whether it could be specified in some other form which would avoid these.

The Commission's "Bid and Offer" System

3.28. The Commission are considering this idea, in which each member state would propose a budgetary rule for itself to follow, seeking agreement with the Council on this basis. Rules based on such an approach, which amounts to each country negotiating its own MTFS, may be easier to agree than rules based on absolute criteria of some kind.

3.29. But the fundamental distinction, between rules that are binding and those that are not, applies as much to this system as any other. We could probably accept such a system as a basis for non-binding surveillance. But we could not accept that reaching agreement on a rule should be obligatory, still less that any rule should be binding on the country concerned.

Economic and Social Cohesion

3.30. There will undoubtedly be pressure from some member states - in particular, the southern member states and Ireland - for the inclusion of material on economic and social cohesion in a new Treaty. This will reflect not only a genuine concern about the possibility of adverse effects from EMU on the peripheral regions, but also a need to convince public opinion in

their own countries that there is some prospects of sharing in the gains.

3.31. We might be able to accept some additional material in a Treaty on the desirability of economic and social cohesion. But it will be essential to avoid any specific commitments to particular measures, for example in relation to the size of the structural funds. The emphasis should be on the mechanisms by which the poorer countries will be able to catch up, and measures which will enhance them, rather than on the redistribution of gains from EMU to the poorer countries; redistribution will of itself tend to inhibit adjustment. As regards mechanisms, our approach stresses the need to enhance market forces and flows of private capital, rather than flows of official capital in the form of subsidies which are likely both to be inefficient and to inhibit adjustment.

Subsidiarity

3.32. A key objective for the UK will be to have written into any Treaty provisions on EMU a clear definition of subsidiarity in the economic policy field together with explicit reservation of certain parts to national governments.

IV VIEWS OF OTHER EC MEMBER STATES

4.1. Summary notes on the current views of other Member States on the broad Delors Report and IGC issues are attached at Annex B. Three general themes emerge.

4.2. First, all other Member States advocate progress towards Economic and Monetary Union. For some (eg Italy, FRG, Benelux) it is seen as a necessary and desirable step on the road to political union; for others (eg France, Denmark) as essential if increasing de facto Bundesbank control of Community countries' monetary policies, and the economic dominance of the FRG, is to be diluted. German unification is likely to strengthen both perceived reasons for advocacy of EMU, and early Treaty change.

4.3. Second, all other Member States accept the definitions of EMU set out in the Delors Report and the need for institutional developments. Some aspects of the UK paper have attracted widespread support, including in France and the FRG, but the central thesis that an eventual monetary union need not entail a single monetary policy, or any common institutional framework, has evoked no governmental support.

4.4. Third, all other Member States also accept the Delors Report's thesis that monetary union necessarily entails concomitant economic union, with some binding budgetary rules. But there is no agreement on the precise form of such rules, particularly whether they should place limits on national budget deficits, as recommended in the Delors Report.

4.5. Views on the likely pace at which EMU might in practice come about, using new Treaty provisions, differ widely. Central Banks tend to envisage a slower timetable than do governments, and within governments Finance Ministers tend to be more cautious than Prime Ministers. The implausibility of very rapid progress on a Community basis, ie involving all Twelve countries, is rarely discussed. Those Member States (eg Ireland, Portugal, Greece and perhaps Spain and Italy) whose economies plainly could not in the short/medium term sustain full economic and monetary union with

the FRG retain hopes, fed by the Delors Report, of an expanded EC budget to narrow regional and structural disparities through redistributive resource allocation. (For them a central defect of our "Evolutionary Approach" was that it dashed such hopes, pointing instead to market forces as more efficient in narrowing disparities.) On the other hand, most of those Member States (France, Benelux) who, like the UK, probably could sustain full economic and monetary union with the FRG, share our opposition to a much bigger redistributive budget, but shy away from "uncommunautaire" acknowledgement that full EMU might not be reached by all willing partners simultaneously. They are likely, however, to accept a continued high level of structural fund spending beyond 1993 as the necessary political price for getting the southerners on board.

4.6. More often discussed is the question of whether willing partners could or should wait for an unwilling UK. This issue of course concerns the pace and nature not only of actual progress towards EMU but also, much more imminently, of the IGC. All Member States claim to want the IGC to end with the unanimity necessary to amend the Treaty and most such claims (certainly in the FRG, the Netherlands, Denmark, Luxembourg, Spain and Portugal) probably are genuine. EMU would be weaker if sterling were excluded; and the legal problems of a new Treaty of Eleven, though not insurmountable, would be formidable. But, for the reasons set out at paragraph 4.2, our present assessment is that in the last resort even our closest partners - the Dutch and Danes - if forced to choose between a nugatory IGC or a split IGC, would probably prefer a split, and agreement among Eleven. Their current hope is that the development of positions during the IGC will mean that they do not have to face such a choice. No doubt most statements on this aspect have both an element of the tactical in them (making UK flesh creep) and an element of substance.

V ISSUES FOR CONSIDERATION

5.1. Our report suggests that the following are the main issues on which Ministers will want to focus their attention, in determining their strategy both in the approach to and during the forthcoming IGC.

The IGC and progress towards EMU

- The important distinction between the pace of an IGC and of actual practical movement towards EMU. (Paragraphs 1.3-1.4)

- The implications of recent developments in Eastern Europe and GMU. (Paragraph 1.5)

- The assessment of other member states' views on a new Treaty. (Paragraphs 1.8 and 4.1-4.6)

The form and general content of an amending Treaty

- Our analysis of the four options in paragraphs 1.9 and 1.10.

- The discussion about the importance of "firebreaks". (Paragraphs 1.11-1.12)

Definition of full monetary union

- The difficulties of avoiding the definitions in the Delors Report. (Paragraphs 2.4-2.5)

- The change in the UK position involved in accepting the Delors' Report position. (Paragraph 2.6)

- The acceptability of the ultimate objective of irrevocably linked currencies. (Paragraph 2.7)

- The possibility that irrevocably locked exchange rate parities would be inherently unstable. (Paragraph 2.9)

Institutional developments after full monetary union

- Identification of the four key issues in paragraph 2.15: the fundamental objective of an ECMI; its degree of independence; its democratic accountability and its policy responsibilities.

- The fundamental objective of an ECMI (paragraph 2.16)

- The choice between an independent ECMI and one controlled by the Council of Ministers. (Paragraph 2.17)

- The distinction between political control and democratic accountability. The problem of delivering proper accountability in practice. (Paragraphs 2.18-2.21)

- The question of whether exchange rate policy should rest with an ECMI or with Finance Ministers/Central Bank Governors. Our ideas for alternative arrangements to those proposed in the Delors Report. (Paragraphs 2.22-2.28)

- Questions concerning responsibility for banking supervision under an ECMI. (Paragraphs 2.29-2.30)

- "Gold Standard" options. (Paragraphs 2.31-2.33)

Interim institutional steps in Stage 2

- The arguments for and against proposing interim institutional developments. (Paragraph 2.34-2.36)

- Our ideas concerning the creation of an EMF, and its three possible functions. (Paragraphs 2.37-2.42)

Budgetary policy rules: possible UK initiatives

- Our assessment of the Delors Report recommendations, and some fresh proposals for moving forward. (Paragraphs 3.5-3.8)

- The acceptability/workability of rules prohibiting monetary financing and Community "bail-outs". (Paragraphs 3.9-3.11)

- Our ideas for attaching binding conditionality on EC balance of payments support loans to member states, and whether this could be a role for an EMF. (Paragraphs 3.12-3.16)

- On enhanced arrangements for Community surveillance, the package of ideas outlined in paragraph 3.21.

- On sanctions, the pros and cons of the approach outlined in paragraph 3.25.

- The possibility of a minimum average maturity rate rule. (Paragraphs 3.26-3.27)

- The Commission's ideas for a "bid and offer" system. (Paragraphs 3.28-3.29)

Economic and social cohesion

- The importance of offsetting pressures from southern, etc member states for Treaty language which may create future commitments for increased expenditure on regional support. (Paragraphs 3.30-3.31)

Subsidiarity

- Definition of areas of economic policy to be reserved explicitly to national governments. (Paragraph 3.32).

ANNEX A

Timetable

Key dates in the timetable are:

1990

5/6 March	Foreign Affairs Council will discuss scope of IGC and role of European Parliament in IGC process.
31 March/1 April	Informal ECOFIN will discuss reports on EMU from Commission and Monetary Committee.
April-May	Further preparatory work by ECOFIN (monetary and economic issues) and FAC (initial discussions of institutional aspects probably unavoidable).
24-25 June	Dublin European Council. No indication yet how Irish will play EMU.
July-December	Italian Presidency. Preparatory work for IGC likely to take place in ECOFIN, FAC and possibly special group(s).
December (probably)	IGC formally convened.

1991

January-June	Luxembourg Presidency. Substantive work on IGC will get underway.

Until the IGC meets, and particularly before the European Council in June, there will be opportunity to influence the debate on EMU and feed in further ideas if Ministers wish to do this. The timing and tactics for doing this will need further consideration in the light of Ministers' views on strategy. But if we have ideas, it will be important to seek support for them before the IGC. Once the IGC has opened, the Commission and other Member States are likely to table detailed Treaty amendments, perhaps at an early stage. So the coming months will be crucial.

EMU: VIEWS OF OTHER MEMBER STATES

1. BELGIUM
2. DENMARK
3. FEDERAL REPUBLIC OF GERMANY
4. GREECE
5. SPAIN
6. FRANCE
7. IRELAND
8. ITALY
9. LUXEMBOURG
10. NETHERLANDS
11. PORTUGAL

1. BELGIUM

Belgium continues to be amongst the most ardent supporters of EMU, fully supporting the Delors Report definition of EMU, and criticising the UK paper as no more than Stage 1 plus. The Central Bank and Finance Ministry believe in fully implementing Stage 1 before moving on, and sees no particular hurry. But the Government as a whole would certainly join any pressure from elsewhere for an early end to stage 1.

Formally, there is not yet a government position on the form and substance of an IGC, but the Belgians have never disguised their wish that it should extend widely, increasing the powers of the EP and the Commission, and reducing those of the Council of Ministers. No mention is made in Belgium (even by members of the Parliament) of the question of accountability to national Parliaments.

Both the Central Bank and the Finance Ministry believe that convergence of budgetary policies cannot be left to market forces. Senior Belgian politicians have not yet focused on the implications of Delors' views on binding budgetary restraints, even though the Belgian budget relies on massive annual deficit financing. Nor are there concerns in Belgium about loss of monetary sovereignty. On the contrary, the Belgians believe they would gain a voice, albeit a modest one, through EMU and the ESCB, as opposed to the present situation of Bundesbank domination.

The Central Bank is unlikely to differ from the Government on any EMU issue. The Governor (Verplaetse) was until July 1989 the Prime Minister's key adviser on economic issues, and remains very close to Martens.

2. DENMARK

The Danes do not think Delors provides all the answers for EMU; they have problems on fiscal policy and on the institutional side. Some now question the need for Stage 2 and envisage a long Stage 1. Opinion is cautious about when, how, and whether to move to Stage 3.

The Government are bound by a Folketing Resolution to work for an IGC with a mandate covering economic and exchange rate cooperation, closer cooperation with the EFTANS and Eastern Europe, and qualified majority vote decision-making on environmental and labour market matters. But they could, at the end of the day, accept a narrower remit. The Danes want to see a one-part conference.

Denmark thinks democratic accountability not too difficult to achieve. They think governments should make appointments to the ESCB Council or Board; and Board members should appear as needed before the EP and submit reports to other Community or national institutions, including Parliaments. The Danes foresee operational as well as political difficulties for binding budgetary rules given the difficulty of precise budget deficit and surplus prediction.

~~Yet~~ The Government has broad political support, though the Social Democrats and the Socialist People's Party have some doubts about Stages 2 and 3.

3. FRG

The Germans say that their commitment to EMU remains unaffected by what is happening in Germany and that they will keep to the timetable of an IGC in December but without bringing it forward. Kohl is no doubt sensitive to the risk that the French will accuse him of going back on his commitments. However, it remains to be seen whether once the Germans have fully digested the implications of unification, they will remain as enthusiastic as before for EC political union and for EMU.

Implementing German monetary union is likely to lead to a less stable monetary environment and a German desire for continuing monetary autonomy. Moreover the need for budgetary flexibility to provide help for the GDR may make the Finance Ministry even more wary than they already are of binding budgetary rules. All this could persuade the Germans of the need for an even longer Stage 1 than previously envisaged, though they have not yet thought this through.

The Germans accept the definitions in the Delors Report. Their central concern is to guarantee the stability of the currency, which they see as being best provided for by an independent European Central Bank. They have not yet thought much about the content and length of stages beyond Stage 1. The Finance Ministry, the Economics Ministry and the Bundesbank do not like the prospect of big resource transfers as sketched out in Delors Stage 2 and like to gloss over this phase. Kohl has more than once said that the powers of the European Parliament should be increased. The Germans have not addressed the issue of how to divide the IGC agenda.

Pöhl gave a personal view of how to achieve accountability in his speech in Paris on 16 January. The main German point is to minimise political accountability. He wants an ESCB as independent as the Bundesbank. There is a debate about whether what accountability there is should be primarily to the ECOFIN and Monetary Committee (the view of the Bank) or, and if so to what extent, the European Parliament. The attraction of the Parliament to the proponents of its having a say is that this puts some flesh on Kohl's commitment to increase the powers of that institution.

The Bundesbank want binding fiscal rules. The Finance Ministry are less certain of the need for this and there is a constitutional problem because of the fiscal powers of the Länder. EC rules might require amendment to the constitution, but this could infringe the Basic Law.

4. GREECE

Athens will not focus seriously on EMU issues until after the 8 April elections, and even at official level a theoretical position has not been worked out. Greece broadly accepts the Delors definition of EMU, though some have reservations on the need for fiscal harmonisation. There is general opposition to ideas of reducing the length of Stage 2; experts speak of the need for an "evolutionary" approach which might include more than three stages. The Greeks also argue for a protracted Stage 1, given the difficulty of predicting how long it would take Greece to fulfil its requirements. There is concern that Greece could be left outside EMU if it found it difficult to move from one Stage to another.

There is no agreement on the scope of the IGC. The MFA prefer a wider IGC which under one roof would cover EMU and relevant institutional provisions. The Bank of Greece argue for an EMU-specific IGC. All sides see a need for an enhanced role for the European Parliament. There is no indication that binding budgetary rules could cause constitutional difficulties. Indeed officials think them highly desirable for a budget deficit which reached 22% of GDP last year. But there is no doubt they would cause considerable political difficulties. Greece is likely to be an early and intractable test case of the practicality of fiscal disciplines.

Tactically Greece regards itself as too small a fish to have a decisive vote an EMU. Consequently it is ultimately ready to accept EMU decisions in which it may have little faith but it will a) bargain strongly for more EC structural aid for Greece to ease economic convergence b) seek derogations and c) worry less than more principled partners about obligations that cannot be met.

5. SPAIN

For Spaniards of all shades of political opinion EMU embodies their vision of European union. At this stage the detail does not matter very much, though Spaniards will be quite cautious once discussions on substance begin.

They are unlikely to subscribe to all Delors' prescriptions. Neither the Ministry of Finance nor the Bank of Spain is happy with the idea of binding budgetary rules which might tie the growth of the Spanish economy to that of the FRG - as compared to their favourable experience in the past three years. The Ministry of Finance say that some kind of national control over budgetary regulations would have to remain. Constitutional changes are anticipated.

The Spaniards are unconcerned about the duration of the EMU process; they simply want it to begin and advance step by step. But they are concerned that the German question may knock the whole process off course.

Both the Finance Ministry and the Bank of Spain definitely want the IGC to be EMU-specific and expect the UK to be strict on limiting the areas of reform. They see it remaining in being in some form for a number of years.

Gonzalez has said that an ESCB would have to be answerable to and therefore controlled by national Governments. But others advocate a relatively independent ESCB. Gonzalez has also argued for eventual strengthening of EP powers, and there is imprecise talk of new coordination mechanisms between national Parliaments and the EP.

6. FRANCE

Having obtained a longed for procedural decision on convening an IGC at Strasbourg, the French are less certain what they want to do next. They accept the Delors definition of EMU, but recent events in Germany and Eastern Europe have left their thinking fluid. To some extent this reflects their view that the IGC will itself be the forum for addressing the fundamental questions posed in the report of the Guigou group.

The French appear to expect that Stage One will take around two or three years (overlapping with the IGC itself). Thereafter, Beregovoy and Tresor officials have recently been emphasising that Stage Two will be a "long and decisive" period (Beregovoy) when a balance between Community and national management of economic and monetary policies will have to be struck, and the role and tasks of a Central Bank defined. There is no common line on the timing of the move to Stage Three.

The French believe EMU is an important project straddling the economic and political fields. Mme Guigou has suggested that a revision of the entire decision making system in the Community may be called for once EMU were in place, involving in turn a reappraisal of what decisions were appropriate to be taken at which level within the Community. But the French are only beginning to think about how far these background questions should be approached at the IGC. Mme Guigou has said she does not yet have a view on whether there should be one or two IGCs.

The French have tended to see the exercise of democratic accountability in terms of the relationship to be created between the Council and the ESCB. This gives them some difficulty with the Pöhl vision of a Central Bank. The

French will probably not be enthusiastic about giving the European Parliament a major new role in any new configuration, if only because they would not want to lose any purchase over European monetary policy they gained through EMU, but they could live with a symbolic gesture.

Beregovoy has said that the question of budgetary rules is difficult: the basic powers of National Parliaments have to be respected and pragmatism and the diversity of situations should prevail. He agrees that the financing of deficits by Central Banks should "probably" be forbidden. In general the principle of subsidiarity should apply in budgetary policy. We are not aware of any constitutional difficulties in this area.

There are no serious political constraints at present evident between now and the IGC. One background factor is Delors' positioning for possible reentry into French political life after 1992, but the implications of that are not straightforward.

7. IRELAND

Because they hope to improve their negotiating position in the IGC when resource provisions to ensure Community cohesion are discussed, the overriding Irish concern is to appear as good Europeans both during their Presidency and thereafter. This means that although some officials privately share British concerns about the Delors approach to EMU, they are reluctant to stick their necks out within the Irish administration let alone in public.

The Irish would prefer an EMU-specific IGC but recognise that others may want a wider agenda, and a two part IGC. Ireland's Presidency position is likely to be determined by that of the Commission. Most officials would prefer a long Stage One. But if a majority of member states favour an early move to Stage Two, Ireland will not try to slow this down.

The Irish probably accept some increased accountability at the centre and expect that the European Parliament will be involved in the IGC in some way. The leader of the Irish Labour Party has been a lone voice in expressing the need to safeguard the position of national Parliaments. Amongst officials only the DFA express concern.

There is support for binding budgetary rules as an effective discipline for small countries, though they would probably cause constitutional and legal problems. Any commitments are seen as being given only for the broad economic objectives (eg the Exchequer borrowing requirement as a percentage of GNP). The Irish are also weak on no bail-out provisions; they think that withholding Community support would be inappropriate.

8. ITALY

The Italians strongly support EMU, in part because they are instinctive federalists. They believe that EMU will inject discipline into the running of the Italian economy. And they hope that an ESCB will limit the powers of the Bundesbank.

The Italians support the Delors definition of EMU and strongly dislike the UK's 'alternative approach' which they tend to see as a wrecking manoeuvre and a recipe for instability.

The Italians have given little thought to the respective lengths of Stages 1, 2 and 3 of Delors (only that the overall process should be as short as possible) and are flexible on the structure of the IGC. They envisage an agenda covering the establishment of an ESCB and increased powers for the European Parliament (Italian MPs do not object to the loss of soveignty). The MFA envisage two tables at the IGC: one of 'technicians' to discuss the detail of EMU, and one of 'generalists' to discuss institutional issues. The Banca D'Italia are worried about the prospect of political interference in their area of expertise.

The Italians have some difficulties with binding budgetary rules on practical grounds. The Banca D'Italia think such a regime impossible and envisage instead a system of budgetary guidelines which would, in practice, be self-regulating.

Finally, the Italians, as Presidency, will want an early and high profile IGC.

9. LUXEMBOURG

Given the responsibilities of its Presidency early next year Luxembourg does not want to take up unnecessary positions now which will make an honest broker role more difficult. The Luxembourgers went along reluctantly with the call for an IGC. They regard its aims as now even more uncertain than at Strasbourg. Their main preoccupation is to prevent it spilling over into an attempt to build up the powers of the Commission and the European Parliament.

The Tresor are doubtful about the definition and purpose of Stage Two. They argue that when the Central Bank is set up it should immediately be given the power to create currency. A period of shadow control would only be a dangerous pretext for the Commission and parliament to extend their powers.

Luxembourg is quite clear in wanting the IGC to be EMU-specific, and sees no case for a second instalment.

Problems of democratic accountability do not seem to be much of a worry in an EMU context. Belgo-Luxembourg Economic Union has already taken much policy out of Luxembourg government hands. EMU is seen as a way of ensuring Luxembourg retains at least a say.

Tresor favour all member states being represented on the ESCB governing body, ECOFIN appointing Executive Directors on grounds of competence rather than nationality. Members of the Bank could appear before the European Parliament. They believe that majority voting in the governing body is not a worry if the Bank operated through market-orientated instruments.

The main domestic political constraint arises from the need to ensure adequate defence of Luxembourg's financial centre.

10. NETHERLANDS

The Dutch are fairly flexible about how EMU is defined. They themselves have little problem with the definition in the Delors Report but they attach importance to involving major EC countries, including the UK, fully in the developments towards EMU and will be prepared to agree to look at other wording if this enabled consensus to be reached.

The Dutch are also flexible over whether arrangements leading up to EMU will involve only one, or more stages. They think it more important that participants should be satisfied that key questions have been properly dealt with.

The Ministry of Finance believe that the IGC should be EMU-specific, and that it would be too difficult to look simultaneously at wider institutional issues. However, the MFA view is that the IGC must inevitably consider the role of the European Parliament in the EMU process, and that early decisions will be necessary on how to associate the Parliament with the work of the IGC. This accords with the view of many Dutch parliamentarians who are concerned more generally with the question of the "democratic deficit": and with the inclinitions of Dankert, state secretary for European Affairs, who has said that he could see the arguments building up in favour of extending the remit of the IGC beyond EMU alone.

On democratic accountability, the Dutch continue to dismiss worries about this as unreal. They argue that there need be no major problems if the role of the bank is limited, as the Delors Report suggests, to ensuring price stability. Their proposals envisage that Bank Governors

should be nationally nominated for fixed terms, that the Bank should have requirements to report to the Council of Ministers, and that the Bank mandate should require approval by national legislatures.

On binding budgetary rules, the Dutch have yet to come to a final view. Here, too, there is some difference of outlook between the Finance Ministry and the MFA. The Finance Ministry acknowledge that such rules might contribute to political difficulties rather than overcoming them. The view of the Netherlands Bank had earlier been that an independent Central Bank would not be able to operate without binding rules. However, they and the Ministry of Finance are now considering the possibility of broader disciplinary guidelines rather than binding budgetary rules. The MFA is still open to the idea of binding budgetary rules and indeed see some advantage in them as a means of imposing budgetary discipline on countries such as Greece and Italy.

11. PORTUGAL

A Government reshuffle in early January brought in a new Finance Minister, Miguel Beleza, who has so far made no public statement on EMU. But the Portuguese position is unlikely to have changed much since Strasbourg. Economic and social cohesion are paramount, and to gain acceptance in Portugal any approach to EMU must include redistributive mechanisms. A study commissioned by former Minister Cadilhe is underway in the Ministry of Finance on the technical aspects of EMU, but it will not make political recommendations. The Portuguese have no view on the timing and staging of the EMU process. The general assumption is that a wider conference is inevitable.

They take no position on democratic accountability. Some widening of the powers of the European Parliament would not be unthinkable, and might even be welcomed given the youth of democracy in Portugal. Implementing binding budgetary rules may well give the Portuguese difficulty during the current phase of rapid modernisation. Portuguese advantage would in any case lie in seeking a few years' derogation rather than opposing in principle.

The Portuguese have particular problems with the timing of the escudo's entry into the ERM as part of Stage 1 because of high inflation and the existing policy of crawling-peg devaluation. They also fear the centripetal effects of EMU Stage 1 on capital; capital flights could slow economic development significantly.

The Government and the Central Bank made considerable efforts during 1989 to reach common positions. The appointment of Beleza, himself previously a Director of the Bank, is likely to bring the two even closer. But the Bank is currently so depleted it has not even been sending a representative to the Monetary Committee.

LIST OF ADDITIONAL ANNEXES, AVAILABLE ON REQUEST

1. An Indexed ECU Standard. *(Paragraphs 2.31-2.33)*

2. An ECU Currency Board. *(Paragraphs 2.37-2.39)*

3. Administrative Arrangements for Community Assistance at Different Stages of Monetary Integration. *(Paragraphs 3.12-3.16)*

4. One Variable as the Centre of Budgetary Policy? *(Paragraphs 3.17-3.21)*

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

13 February 1990

Dear John,

EMU

Thank you for your letter of 12 February describing the point reached in the monetary discussions of EMU and setting out the line which our representatives intend to take in discussion on budgetary policy next week. I have shown this to the Prime Minister who is content with the four stipulations we might propose for an amended treaty.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and Sonia Phippard (Cabinet Office).

Yours sincerely,

Charles Powell

Charles Powell

John Gieve Esq
HM Treasury.

CONFIDENTIAL

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CC PC

(1)

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

12 February 1990

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Prime Minister

Agree the line which it is proposed to take?

CDP 13/2

I think these four points are all right. MT

Dear Charles

EMU

The European Council agreed at Strasbourg that the General Affairs Council and the ECOFIN Council should use the period prior to the opening of an Inter-Governmental Conference on EMU, before the end of 1990, to ensure the best possible preparations. It is very much in our interest that as much of this preparatory work as possible is carried out under the auspices of ECOFIN so as to ensure that the technical problems of a move towards EMU are fully recognised. To that end, the Monetary Committee, composed of senior officials from Treasuries and Central Banks, have begun to review what might be involved. The Committee plan to produce a report which ECOFIN would consider, probably at its informal meeting at the end of March. The Chancellor will, of course, discuss his line with the Prime Minister for that meeting, in the light, among other things of the work being carried out by an interdepartmental group of officials which was foreshadowed in my letter to you of 30 November.

In the meantime officials are doing the best to ensure that the Monetary Committee's report is as helpful as possible. While they serve on the Committee in their personal capacities so that their views do not commit the UK, the Prime Minister may wish to be aware of the line that they have in mind to take in the

discussion on budgetary policy next week. As you will recall the Delors Report argued that there should be binding budgetary rules on Member States. There is some support for this in the Committee but also some backing for the UK's view that such rules are neither necessary nor desirable. Our representatives intend to argue that, if there is to be an amending treaty, it could include requirements:

(i) to prevent monetary financing of budgetary deficits;

(ii) to prevent bail-outs of Member States by the Community Budget or other Member States;

(iii) to impose in the context of Community mechanisms for lending to a Member State (if these mechanisms continue), a legally binding budgetary commitment upon that Member State as a condition of the loan. But there would be no such commitment unless the Member State voluntarily accepted the need for a loan and the accompanying conditions;

(iv) to establish, in order to underline the undesirability of excessive budget deficits, binding procedures on Member States for the conduct of economic surveillance, including national budgetary policies, within the Community. The crucial element here is that what would be binding would be the procedure for the surveillance exercise, not its outcome eg in the form of Delors' binding budgetary rules. The procedure might, for example, cover the circumstances in which a special examination of a country's budgetary policy could be initiated, the scope of such an examination, and the roles of the Commission, the Monetary Committee and ECOFIN.

3. The first two stipulations were referred to in the UK's paper, "An Evolutionary Approach to Economic and Monetary Union". The third would in effect incorporate into the Community legal framework the conditionality associated with an IMF loan. But that conditionality could only bind Member States if they voluntarily accepted the need for a loan and the accompanying conditions. The Chancellor thinks that the fourth stipulation above is acceptable provided we are clear that the binding element applies only to the procedure. Such a procedure could provide a useful buttress to the process of multilateral surveillance within the Community, which is an important element in the UK's evolutionary approach.

4. An approach on the lines described above should find some support in the Monetary Committee and it would be most helpful in ECOFIN if it were reflected in their report. But the Chancellor thinks that even if it does not, the approach is clearly the right one and we should continue to press it.

5. I am sending a copy of this letter to Stephen Wall in the FCO and to Sonia Phippard in the Cabinet Office.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

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FRAME ECONOMIC

STERLING AND THE ERM

SUMMARY
1. BEREGOVOY CALLS FOR ENTRY OF STERLING INTO THE ERM AND SAYS THAT WORK ON EMU SHOULD BE ACCELERATED IN THE FACE OF GERMAN UNIFICATION.

DETAIL
2. DURING HIS WEEKLY PRESS CONFERENCE ON 8 FEBRUARY BEREGOVOY (MINISTER OF FINANCE) SAID THAT A POSITIVE ELEMENT IN THE CONTEXT OF GERMAN UNIFICATION WOULD BE THE ENTRY OF STERLING INTO THE EXCHANGE RATE MECHANISM. QUOTE THIS WOULD BE A GOOD WAY OF CONSOLIDATING THE EUROPE OF THE TWELVE, AT A TIME WHEN THE CHANGES IN EASTERN EUROPE DEMAND FROM US IMAGINATION AND NERVE UNQUOTE

3. BEREGOVOY IS QUOTED IN THE FIGARO AS WANTING TO STRENGTHEN THE FRANCO-BRITISH AXIS IN THE LIGHT OF GERMAN UNIFICATION, EVEN THOUGH THE ENTRY OF STERLING INTO THE ERM WOULD NOT BRIDGE THE DIFFERENCES BETWEEN PARIS AND LONDON OVER STAGES TWO AND THREE OF EMU: HE IS ALSO REPORTED AS CALLING FOR WORK ON PREPARATION OF THE IGC TO BEGIN FORTHWITH, ON THE GROUNDS THAT THE PROSPECT OF GERMAN MONETARY UNION DEMANDED FASTER PROGRESS AMONG THE TWELVE.

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

4 February 1990

Dear Stephen,

EMU

Thank you for your letter of 2 February about the likely procedural discussion at tomorrow's Foreign Affairs Council about an IGC. The Prime Minister has noted this.

I am copying this to John Gieve (HM Treasury) and David Hadley (Cabinet Office).

Yours sincerely,

C.D. POWELL

J.S. Wall, Esq.,
Foreign and Commonwealth Office.

RESTRICTED

Foreign and Commonwealth Office

London SW1A 2AH

2 February 1990

Dear Charles,

Prime Minister
There is no point in raising objections
CDP 2/2

EMU

The Foreign Secretary would be grateful if you would let the Prime Minister know of the possibility of some procedural discussion at Monday's Foreign Affairs Council about the formalities consequent on the Strasbourg IGC decision.

Convening an IGC requires consultation with the European Parliament under Article 236 of the Treaty of Rome. Technically, this process has to be triggered by a decision of the Council of Ministers, not the European Council, and the formal Council of Ministers decision has yet to be taken. We understand that the Irish are likely to suggest on Monday that it be taken rather quickly, as happened after the Milan European Council in 1985 in the run-up to the Single European Act IGC.

Given that some in the Community hanker after widening the IGC's scope, it would in fact suit us to dispose of this procedural point quickly, in precisely the terms of the Strasbourg text, which makes it clear that the IGC would be EMU-specific. The Foreign Secretary therefore proposes to agree that this procedural hoop should be gone through quickly, and in the Strasbourg terms, though he would, of course, make it clear that we still think the IGC timing premature.

If the procedure is agreed, the actual decision would then follow without discussion at a subsequent Council. The line to take with the press, then or on Monday, is that this is only a procedural technicality, in line with the 1985 precedent. This is, of course, the plain fact.

I am copying this letter to John Gieve (HMT) and David Hadley (Cabinet Office).

Yours,

Stephen Wall

(J S Wall)
Private Secretary

C D Powell Esq
10 Downing Street

Prime Minister (2)

PRIME MINISTER

2 February 1990

Helpful - but public spending in absolute terms has risen quite sharply & that is projected to continue

CDP 2/2.

MT

RATIO OF GOVERNMENT SPENDING TO GDP: UK/EC COMPARISIONS

The attached article by Tim Congdon in today's Spectator is well worth reading. It turns the table on those who say that Britain will be marginalised unless we embrace EMU in all its most extreme forms.

He shows very clearly that your achievement in cutting the State's role in the UK economy has not been matched elsewhere in Europe. The UK's ratio of 38.8% in 1989 compares with 44.3% for the FRG and 50.5% for France. He thinks the divergence will continue to increase in the early 1990s, not least because the UK is alone in running a budget surplus.

He argues that this has already led to a definite contrast in economic structure between the UK on the one hand, and France, Italy and all of Northern Europe (except perhaps FRG) on the other. This is clear evidence, in his view, of the impossibility of Delors' vision of a fiscally harmonised Europe because UK tax rates do not need to be as high as elsewhere.

Finally, he suggests that continuation of your policies will indeed lead to a twin-track Europe in the 1990s, but with a lowly-taxed, ~~highly~~-regulated and debt-free Britain in the fast lane. [deregulated]

It will be extremely interesting to see how economic commentators in other EC countries react to his analysis.

John Mills

JOHN MILLS

WE'RE DOING BETTER THAN EUROPE

Tim Congdon shows how the reduction of government spending is placing Britain in a virtuous circle of prosperity

ONE of the geopolitical clichés of the 1980s was that the countries of Europe had to 'harmonise' their economies if they were to 'progress' or 'advance' towards greater political integration. The assumptions behind this cliché were not only that political integration was a Good Thing (hence the unthinking use of words like 'progress' and 'advance'), but that the various economies had to have essentially similar fiscal and monetary structures if they were to be truly unified. There was also a view, never far from the surface of debate, that countries pursuing distinctive policies might behave unfairly towards the rest. The phrase 'social dumping', used to describe countries with low levels of social security provision and correspondingly high attractiveness to internationally mobile investment capital, reflected this concern.

How far did the cliché translate into action? Did the countries of Europe became economically and financially similar in the 1980s or less? And how far did Britain conform to the expected pattern? Did Britain become more like the 'typical European country' or not?

These questions are, of course, at the centre of the tensions within the Conservative Party about Britain's attitude towards Europe. Mrs Thatcher has isolated Britain from other European countries by refusing to support the proposed Social Charter, with its recommendations of workers on boards, compulsory holiday months, minimum wages and the like. By so doing she has invited the charge that Britain might itself indulge in a little 'social dumping'. She has also made clear to Conservative members of the European Parliament that, whatever they might think about the matter, she is less than enthusiastic about visions of an early European federal union. For the foreseeable future she clearly wants Britain to retain sovereignty over most social and economic issues, and so to have the option to remain different from the rest of Europe.

There is one yardstick of national differentiation — the ratio of government spending to gross domestic product — which is not only vital in its own right, but also reflects much else of importance, including tax levels and the broader social philosophy of government. It turns out that, on this measure, Britain has been diverging from the rest of Europe, not harmonising towards it. Indeed, Britain now has the lowest ratio of government spending to GDP in the European Community. If recent trends continue, by the mid-1990s the divergence between it and the rest of Europe will be conspicuous.

The key numbers are set out in the accompanying table. In 1980 the four large European countries — West Germany, France, Britain and Italy — were quite close in their ratio of government spending to GDP, all lying between 42 per cent and 48 per cent. This similarity of government shares had prevailed for about 20 years. There had been a tendency for the government share in GDP to rise steadily over time in all four countries, but only marginal changes in relative positions. As far as the smaller countries were concerned, the main feature was a marked contrast between the large welfare states of north European countries like Denmark and the Netherlands, and low levels of government spending in the Mediterranean countries such as Spain, Portugal and Greece.

In the early 1980s the rankings began to change. The tight control over public spending in Britain, due to the Thatcher Governments' policies, had the effect of reducing the state share in GDP from almost 48 per cent in 1981 to a little over 43 per cent in 1987. During the Lawson boom this trend was reinforced by the buoyancy of the economy, which reduced spending on unemployment benefits and other forms of social security, and also caused GDP as a whole to grow faster than spending on education, health and other categories little affected by the business cycle. By 1989 government spending was less than 40 per cent of GDP.

Meanwhile other European countries followed their own paths. West Germany went in the same direction as Britain, but it did not go so far. The share of government spending in GDP fell in the 1980s, but only from about 48 per cent in 1980 to 45 per cent last year. By contrast, France and Italy experienced significant rises in the public-spending share. In France this rise was concentrated in the early years of the Mitterrand government, but has not been reversed by the more pragmatic policies subsequently. In Italy the growth of state expediture has not yet been properly checked and there is a particular problem because of the unsustainable increase in the ratio of public debt (and debt interest) to GDP.

The behaviour of government spending in other European countries was, if anything, even more remarkable. The north European countries which had had high ratios of public spending to GDP in 1980 continued to have high ratios of public spending to GDP in the late 1980s, with little change in the ratios or relative positions. But the Mediterranean countries embarked on a decade of unprecedented fiscal expansionism, with the shares of government spending in GDP rising from about 30 per cent in 1980 to almost 45 per cent today. The rapid growth of public

Government outlays as a proportion of gross domestic product in the European Community (per cent)

	1968	1973	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
UK	39.1	40.4	42.7	44.9	47.7	47.1	46.9	47.5	46.2	45.5	43.2	39.0	38.8
Portugal	20.9	21.3	36.2	25.9	43.9	43.0	47.9	44.4	43.4	43.9	42.8	42.6	41.8
Spain	21.3	23.0	30.5	32.9	35.6	37.5	38.8	39.3	42.1	41.7	43.0	43.0	43.2
Ireland	32.5	39.0	46.8	50.8	52.5	55.3	55.3	53.3	54.5	54.7	49.8	47.1	43.8
W Germany	39.1	41.5	47.6	48.3	49.2	49.4	48.3	48.0	47.5	46.9	46.8	46.2	44.3
Greece	23.5	21.1	29.7	30.5	35.9	37.0	38.2	40.2	43.7	42.1	43.0	43.7	44.8
Belgium	36.3	39.1	49.3	50.7	55.3	55.5	55.4	54.4	54.1	53.5	52.3	49.8	48.0
Luxembourg	37.3	36.1	52.5	54.8	58.5	55.8	55.1	51.8	51.1	51.7	52.3	50.9	50.1
France	40.3	38.3	45.0	46.1	48.7	50.4	51.4	52.1	52.2	51.8	51.8	51.2	50.5
Netherlands	43.9	45.8	55.8	57.5	59.7	61.6	62.2	61.0	59.7	59.4	60.1	58.5	56.9
Denmark	36.3	42.1	53.2	56.2	59.8	61.2	61.6	60.3	59.3	56.0	58.3	58.3	57.2

Sources: Figures until 1987 (or 1986 in Ireland, Luxembourg, Portugal and Spain) are taken from Table R.14 of the Organisation of Economic and Cooperation publication, *Economic Outlook*, December 1989. Figures thereafter are calculated by assuming that the share of government outlays as a share of GDP behaved in the same way as the share of public consumption as a share of GDP and using the data for public consumption and GDP in the December 1989 OECD *Economic Outlook*. The only exception is the UK where the figures for 1988 and 1989 are the ratios of general government expenditure (excluding privatisation receipts) to GDP in the fiscal years 1988/89 and 1989/90, as given in the November 1989 *Autumn Statement*.

spending in these countries is perhaps best interpreted as a move towards north European norms of welfare provision, following the replacement of right-wing military dictatorships by democratic and often left-leaning governments in the late 1980s. Here, exceptionally, was a process of fiscal harmonisation in the Europe of the 1980s.

But it is the British position which is perhaps most extraordinary. It is clear that the Thatcher Governments' ambition to curb the state's role in the economy has already led to a definite contrast in economic structure between Britain on the one hand and France, Italy and all of northern Europe except West Germany on the other Whereas public spending today is above 50 per cent of GDP in all these countries, it is under 40 per cent in Britain. But that is not the end of the matter. Future trends in public spending will differ markedly between Britain and most other European countries and are likely to widen the gap in the public sector burden.

There are at least three reasons for expecting the trends of the mid- and late 1980s to last into the early 1990s and possibly even longer. The first is that the British Government is running a budget surplus, whereas other European governments have budget deficits. As a result Britain is repaying its national debt, the ratio of public debt to GDP is falling and so also is the ratio of debt interest to GDP. Debt interest is somewhat different in character from other items of public expenditure, but it is still public expenditure. Because public-sector finances are in such good shape today, the strain of servicing public sector debt in future will be lighter. A virtuous circle is at work.

In the rest of Europe the persistence of deficits has denied governments this advantage. In West Germany and France public-sector finances are not a very great policy problem, but there is little prospect of achieving the same gains as Britain from a reduction in debt interest costs. Elsewhere in Europe the condition of public-sector finances is more unhealthy, and in one or two countries there is a serious risk that debt interest costs will spiral out of control. Italy faces one of the worst dilemmas. Its national debt is now roughly equal to GDP. With interest rates typically above 10 per cent, debt interest exceeds 10 per cent of GDP.

In fact, public debt is about 30 per cent of GDP in Britain and the ratio has been falling by about 2 or 3 per cent a year since the mid-1980s. If the Italians cannot improve their public sector finances soon, the cost of servicing past debts will prove a long-term fiscal handicap compared to the rest of Europe. Italy will be at a particular disadvantage compared to Britain.

Secondly, Britain has a different system of pension provision from the rest of Europe. In this country over half of pension payments are funded by the private sector through company schemes, personal retirement plans and the like. In the rest of Europe, however, most pensions come from the state and are distributed on a pay-as-you-go basis. (In other words, they are paid not from a fund set aside specifically for the purpose many years before the pension liabilities fall due, but from general government expenditure in the year concerned.)

This difference ought to lead, systematically and permanently, to a lower share of government spending to GDP in Britain. But there is a further consideration which will give Britain a special advantage in the next two decades. Whereas the proportion of the elderly to the total population will be rising steeply in most of Europe, it will be broadly stable in Britain. Because most European countries therefore face a steep increase in pension payments, the mismatch between the low cost of state pension provision in Britain and the high cost elsewhere in Europe will be aggravated.

Finally, Britain spends a higher proportion of its GDP on defence than any other European nation (except Greece), partly as a legacy of its former status as a great power and its retention of the nuclear deterrent. If the present wave of reform in Eastern Europe and the Soviet Union is consolidated, defence spending will be cut across Europe. A country such as Britain with an above average level of defence spending should benefit particularly.

In short, there is a high probability that in the mid-1990s the share of public spending in GDP will have been lowered to almost 35 per cent, and certainly will have remained under 40 per cent, in Britain, while all the rest of Europe is stuck at over 45 per cent and some countries are in the band of 55 per cent to 60 per cent.

Of course, the argument is conditional to some extent on Britain's future political complexion. The change in Britain's position on this measure of economic structure is clearly the work of the Thatcher Governments and is one of their main achievements. But what would happen if a Labour government were elected in 1991 or 1992? Any new left-wing government would be strongly tempted to use Britain's divergence from the European average as a justification for large increases in public expenditure. The difference between Britain and the rest of Europe would soon narrow and perhaps disappear.

This is possible. Much does indeed depend on the outcome of the next general election. However, the success of the Thatcher Government in cutting the public sector down to size has already been a great influence on the debate about Europe's future. M. Delors must be well-

aware that, if current trends are maintained, his vision of a fiscally harmonised and monetarily united Europe just cannot happen. If the share of government spending in GDP is much lower in Britain than in the rest of Europe, it is unrealistic to expect tax rates in this country to be the same as elsewhere in Europe. On the contrary, Britain is likely to favour fiscal competition, knowing that low tax rates will encourage inward investment and the immigration of skilled professional people.

Advocates of full British endorsement of the Delors Report say that, unless Britain is more positive about European monetary union, we run the risk of 'missing the boat'. They warn that there could be a two-speed Europe in the 1990s, with an inner core of countries moving faster towards integration than sceptical slow-coaches on the periphery, including Britain. Several politicians holding this view, notably Lord Jenkins and Mr Michael Heseltine, appear to believe that industry and finance will be increasingly located in the core countries. They fear that Britain will be marginalised by its more dynamic neighbours.

They have not bothered to check the facts. The truth is that Britain has attracted far more inward investment, in both manufacturing industry and financial services, over the last five years than any other European country. Its abstention from the exchange rate mechanism of the European Monetary System does not seem to have worried foreign businessmen at all. But it cannot be denied that, if Mrs Thatcher's policies continue, the 1990s will see a two-speed Europe. A lowly taxed, lightly regulated and debt-free Britain will outpace the highly taxed, heavily regulated and debt-burdened nations of the inner core.

(2)

Prime Minister

An important speech by Karl Otto Pohl.

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"Basic features of a European monetary order"

Karl Otto Pöhl

President, Deutsche Bundesbank

Lecture organised by "Le Monde", Paris

on January 16, 1990

I.

The European Council took a decision in Strasbourg last Decembe which will have far-reaching implications. Before the end of th year an intergovernment conference is to be convened which is t discuss, and to decide on, the future road to European economic and monetary union and its institutional structure. It is to provide the legal basis for the necessary responsibilities whic now rest with the national authorities to be transferred to Community bodies. Monetary policy will be affected most. The ruling EC treaty does not provide for any Community responsibil for monetary policy, which sufficiently explains why institutic steps towards monetary integration require an amendment to the treaty. Article 102 A, which was added to the ruling EC treaty the Single European Act in 1986, expressly reaffirmed this requirement by stating: "In so far as further development in th field of economic and monetary policy necessitates institutionr changes, the provisions of Article 236 shall be applicable." Pursuant to that article, such amendments shall be "ratified by all the member states in accordance with their respective constitutional requirements".

In most other aspects of economic policy there is no comparable requirement to establish new institutions for economic and monetary union and to transfer responsibilities to them. However, better use must be made of the existing instruments and bodies in order to achieve more convergence in economic policy and its results and to establish these permanently. The progress made so far, for example, the liberalisation of the movement of goods and capital, must not be called into question again if economic and monetary union is to last. Additional binding arrangements will therefore be necessary in major sectors which make unilateral action more difficult or impossible for member states and which set a minimum standard of "good conduct" for them, particularly i fiscal policy. This will necessitate the surrender of sovereignt by the individual member states, but this need not mean corresponding gains in Community authority, that is, by the Council and the Commission, provided the subsidiarity principle respected. As is well known, this principle provides for everything which need not be decided on at the higher levels to decided on and implemented at the lower levels. Incidentally, th control functions of the European Parliament are to be strengthened systematically, particularly in relation to the Commission and the Council; this was a condition made by the German Federal Chancellor in Strasbourg.

II.

The most important issue in the menu of questions and problems which the intergovernment conference will face is no doubt the European central bank system (ECBS). Its structure must satisfy the high expectations which a future economic and monetary unic arouses in the member states, namely, in the countries with stable currencies the expectation that monetary stability will not be lost in an economic and monetary union; and in countries where the value of money is being eroded to a greater of lesser degr that an end will be put to this erosion once and for all.

Nor other than Walter Hallstein himself, the first President of the EC Commission, saw monetary policy as the touchstone for the Community. He wrote that "monetary stability is a value of great importance, a fundamental requirement".[1] The fact is that only when those responsible in all member states are prepared to concede monetary stability this priority can the project of an economic and monetary union succeed. Only then will it be possible in the foreseeable future to fix the exchange rates between the national currencies permanently and finally to replace the national currencies by a common currency.

This ambitious goal certainly cannot be achieved in a revolutionary act, in a great leap forward, but only in an evolutionary process which, however, should be determined by the same principles that must apply in the final stage of a European monetary order. This means that the monetary policy of the countries participating in this process must now concentrate on the task of maintaining monetary stability and of preventing inflationary pressures, a task which can be pursued with the greatest chance of success.

III.

The EMS did not stabilise either until major member states accorded monetary stability the importance which was necessary to the satisfactory functioning of the system. There were no fewer than seven realignments by March 1983, which in itself is a sign of instability and divergence in terms of economic development. The decisive turnaround in the stabilisation of the EMS occurred in March 1983 when the French government radically changed its economic policy objectives. It is probably not an exaggeration to say that at that time the existence of the EMS was in the balance

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1 Walter Hallstein, "Die Europäische Gemeinschaft" (The European Community), Düsseldorf, Vienna, 1973, p. 133.

Since then the EMS, or at least its "hard core", has come increasingly closer to the original objective, namely to create a zone of internal and external monetary stability, which is all the more remarkable as the dollar rate was subject to extreme fluctuations in that period. The D-Mark no doubt played an important part in this. It provided the stability standard which every fixed exchange rate system needs. This is a widely held belief today. The Delors Report states, for example: "Moreover, the system has benefited from the role played by the D-Mark as an 'anchor' for participants' monetary and intervention policies."[1]

The D-Mark has increasingly become the most important intervention and reserve currency in the EMS, not because the Bundesbank sought this role but because the D-Mark is regarded by the markets and the central banks as a stable currency which can be used internationally without restriction. Outside the EMS, too, the D-Mark is today the second most important currency after the dollar. About one-fifth of all foreign exchange reserves world-wide are held in D-Mark.

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1 Report on economic and monetary union in the European Community (Delors Report), 1989, section 5.
See also the remark made by the Governor of the Bank of England Leigh-Pemberton before the Treasury and Civil Committee on June 19, 1989: "One has to acknowledge that the Bundesbank does exercise a very strong influence over the ERM at the moment. Quite honestly, we must acknowledge, too, that the successes of the ERM are due to a large measure to what one might call the anchoring role of the D-Mark." Again, Italy's former Central Bank Governor and present Minister of Finance Guido Carli said: "The European Monetary System in its present form centres on the D-Mark and thus on the most stable currency; if one tried to let it break away ..., one would endanger the process of achieving monetary union." (La Repubblica, July 13, 1988).

The D-Mark is becoming more important in several eastern European countries as well, and this importance is likely to increase even more, if anything. In their efforts to make their currencies convertible and to stabilise them, the central and eastern European countries will probably increasingly orientate themselves towards the D-Mark. This applies particularly to the GDR. If, after May 6, a freely elected government decides in favour of the free market economy and creates the necessary preconditions for investment capital from the Federal Republic of Germany and other countries, it could become the target of an enormous inflow of funds. This, together with an appropriate monetary and exchange rate policy, would provide the opportunity to introduce convertibility step by step. It is clear that the D-Mark must be seen as the "anchor" in such a development. In fact, the D-Mark is already a kind of parallel currency in the GDR and other central and eastern European countries.

Particularly during the seventies the Bundesbank actually resisted seeing the D-Mark forced into the function of a reserve currency as the monetary policy implications are not always very convenient. We would therefore welcome it if other currencies were to share this burden with the D-Mark as a result of the "competition of currencies" recommended by our British friends or perhaps it would be better to say: "competition of policies". The pound sterling, which has a long tradition as a reserve currency could perhaps win back something of its old glory if the United Kingdom succeeded in solving its inflation and balance of payments problems. But particularly the French franc has in my opinion the potential of playing a far greater role in Europe and world-wide. The determined policy of the French government and the Banque de France to contain inflation could contribute to this just as much as the elimination of the last controls on capital movements and the development of Paris into one of the most important European financial centres.

[NOT helpful]

On the other hand, I believe that the potential of the ECU in its present form as a basket currency is fairly limited. The private ECU has had a successful career on the financial markets, but basically it has only played a minor role in monetary integration in Europe, and as a numéraire for exchange rates its significance has at best been symbolic. During realignments it is the changes in bilateral central rates which matter, and new ECU central rates are merely derived as a second step from the changes in bilateral exchange rates. Viewed as a whole, the experience of the past ten years confirms the fact that, while an exchange rate system such as the EMS requires an agreed set of rules, its functioning depends primarily on the willingness of the partner countries to satisfy the requirements underlying stable exchange rates. These include above all the safeguarding of domestic monetary stability in all participating countries.

IV.

How can this basic condition of monetary union be ensured if the responsibilities for monetary policy are transferred from nationa institutions to a Community body? Historical experience has shown that this can best be expected of a system which is independent o political interference. This applies to the EC to an even greater extent than to national states because in a confederation such as the EC there is always a tendency to orientate oneself towards averages and compromises, but that is the worst possible compass for monetary policy. Only an independent institution is in a position to resist the ever-recurring wishes of politicians to prescribe monetary policy targets which are often inconsistent with the objective of stability, such as the stabilisation of exchange rates or the promotion of growth and employment or the balancing of regional disequilibria.

If only for practical reasons a modern, efficient central bank system must be independent of the instructions and pressures of national governments and European institutions. Protracted

consultation and concertation processes are not consistent with the requirements of the financial markets which need fast and flexible reactions by the central bank, as was the case, for instance, on the outbreak of the debt crisis in 1982 or after the crash in October 1987.

What is more important, however, is that only an independent central bank is in a position to pursue a monetary policy geared to longer-term requirements.[1] We know that an increase or decrease in the money stock works through to the economy only with a substantial time-lag. Interest rate measures do not affect the money stock for several months, and price movements take even longer to react to the money stock. These delays must be taken into account when monetary policy measures are being drawn up. An independent central bank is in a better position to do so than any government as it is not so much subject to the temptation to neglect the basic requirements of anti-inflationary monetary policy for the sake of short-term effects or election tactics. William McChesney Martin (Fed Chairman 1951-70) expressed this rather vividly when he said: "The Fed's job is to take away the punch-bowl just when the party gets going".

Of course, even an independent central bank cannot alone guarantee monetary stability. The financial behaviour of the public authorities and the behaviour of management and labour must make their contribution. But the decisions of an independent central bank about the width of the "monetary cloak" which it is prepared

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1 Alan Greenspan in a speech before the Subcommittee on Domestic Monetary Policy on October 25, 1989: "... independence enables the central bank to resist short-term inflationary biases that might be inherent in some aspects of the political process. The Federal Reserve must take actions that, while sometimes unpopular in the short run, are in the long run in the best interests of the country."

to provide gives an important signal for a realistic assessment of the available opportunities by all economic agents.

V.

If it is agreed that a future European central bank system (ECBS) must be independent of governments, the Council and the Commission, the question arises of how this independence can be ensured. A corresponding legal regulation which guarantees the ECBS's independence of instructions is only one element of its independence. In addition, it requires the personal and professional independence of the members of the governing bodies of this system, that is, of both the governors of the national central banks and the members of the supreme governing body, that is to say, of the European "central bank council".

The personal independence of the members of the governing bodies can be ensured if the officials nominated by the governments (central bank governors) and the Council (members of the Board) are appointed for a sufficiently long period (14 years in the United States, eight years in the Federal Republic of Germany) and if their appointment cannot be terminated during that period. Moreover, and this goes without saying, they must have excellent expert knowledge to enable them to make independent judgements. The qualities of personal independence naturally include adequate financial arrangements during and after their term of office. This is, after all, what Professor Adolf Weber called "the continuity of responsibility and the continuity of expertise" in the discussion about the new Bundesbank Act at the beginning of the fifties.[1]

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1 Erich Achterberg, Volkmar Muthesius, "Die Bundesbank - Aufbau und Aufgaben" (The Bundesbank - structure and functions) in Schriftenreihe der Zeitschrift für das gesamte Kreditwesen, Frankfurt am Main, 1950, p. 14.

It is important that nationality takes second place to the task with which these officials are entrusted. As there can be only one self-contained monetary policy for the Community as a whole, and not a monetary policy which takes account of the special requests of individual states and regions, the central bank governors and the members of the Board must be committed to the common task and not to the interests of individual countries or regions, and this must be clear when they cast their votes.

VI.

Above all the instrumental independence of the system must be guaranteed, i.e. its ability to fulfil its function of safeguarding monetary stability without restriction by using the necessary instruments. The instrumental independence of the ECBS must be ensured by providing it with a sufficient array of market instruments whose application is not hampered by administrative regulations and measures. These should be instruments which are linked to the markets and which use market processes to achieve their ends instead of eliminating them or falsifying them in an undesired way. It is obvious that interest rates as the price of money and credit must be of central importance. But this set of instruments should also include all the other tools of modern central bank policy, irrespective of whether they are being applied in the individual countries at present or not.

I cannot deal in greater detail with these rather technical questions in this lecture (some proposals are contained in the collection of papers submitted together with the Delors Report), but one thing should be clear: a future ECBS which is to satisfy high expectations must have the weapon which every efficient central bank must have: <u>the monopoly of money creation</u>. Monetary policy is not divisible, not even in a basically federalistic system such as the Fed or the Bundesbank. Without the monopoly of money creation, the ECBS would be a "tiger without teeth".

A system which is used only to "coordinate" monetary policy but leaves the right to decide on the price and the quantity of money in circulation to the national governments and/or central banks would be "half baked", as Alan Walters called the EMS. "Coordination" must not be orientated towards a European inflation average or any exchange rate targets, which would amount to restricting the Bundesbank's room for manoeuvre without providing a convincing alternative. Attempts of this nature have often been made in the last few years, as all those involved know. Such a system would be less efficient for achieving stability than the present regulatory framework of the EMS. It would therefore be unacceptable to us and no doubt to other EC countries as well. This has always been the German position, and a German government which gave it up could not count on the support of the German general public which reacts very sensitively to matters of price stability. This has become very clear in the sometimes most critical reactions to the Delors Report, particularly to the proposals on "stage two", which in fact remained fairly vague and left more questions open than they answered. Not without reason is it said of "stage two" (and I quote): "At this juncture, the Committee does not consider it possible to propose a detailed blueprint for accomplishing this transition",[1] that is, for the transition from stage one to stage two in the monetary sphere. I will revert to this problem later when I describe the work programme of the Committee of EC Central Bank Governors.

With their decision to start negotiating an agreement on a European central bank system as early as the end of this year, the governments undertook to put their cards on the table and to say whether they were in fact prepared to transfer the decision on future monetary policy to an independent Community institution. In my opinion, it would have been better to gain a few years'

[Helpful]

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1 Delors Report, section 57.

experience with "stage one" of economic and monetary union and to implement first what has already been decided on, particularly the single market, the liberalisation of capital movements, the harmonisation of taxes, etc., before envisaging further-reaching institutional steps. But naturally I accept the decision of the Heads of State and Government and I understand the political motivation behind it.

VII.

If a basic consensus on the structures of a European central bank system can be achieved in the way just outlined, a number of other important questions remain to be decided on, and I would like to mention just a few of these.

First of all, what is to happen if not all governments and parliaments agree to an amendment to the treaty because of economic and monetary union as is required under EC legislation? In this case, which cannot be ruled out from the outset, there are two possibilities. One could proceed in the same way as with the EMS, which legally is an agreement between the central banks of the Community. This would give rise to a second treaty, in addition to the EC treaty. I would think this highly questionable for the cohesion of the EC and would prefer an arrangement based on the EC treaty even if it cannot be implemented by all contracting parties at the same time, as was the case with several regulations of the EC treaty some of which have still not been implemented.

Another question which is frequently raised, particularly by the French and the British, seems to me to be easier to solve: the "democratic control" of an ECBS. There is no need to wait for complete political union, a European government and a parliament with real responsibilities before an ECBS is set up even though historical experience would suggest this. Historically, central banks have always been established after the formation of states.

Naturally the integration of Europe cannot be confined to monetary policy. Progress in other fields, such as the German Federal Chancellor demanded for the European Parliament, is necessary. But an independent ECBS would, in my opinion, be conceivable before the completion of political union if the governments want this and if they are prepared to surrender the corresponding sovereignty as they have done in other, albeit less important, fields. The system would have an adequately democratic legal base if it came about by an agreement between democratic governments, if the agreement were ratified by democratically elected parliaments and if the system were provided with a clearly defined mandate. In addition, the members of the Board could be appointed by the ECOFIN Council and the members of the Council by the national governments. The accounting (not the monetary policy!) could be audited by an impartial court of auditors. In my opinion it would be quite consistent with the independence of the system if the president regularly reported to the European Parliament, albeit not as frequently as is the case in the United States, and if the Chairman of the ECOFIN Council and the President of the EC Commission could attend the meetings of the European central bank council (without voting rights) just as, conversely, the chairman of the ECBS would be invited to the relevant ECOFIN meetings. In addition, the general public should be comprehensively informed, as is customary in the United States and the Federal Republic of Germany, for instance. As for the rest, the system would be measured by its success.

It is much more difficult to answer the question of which functions national central banks should retain than to answer the question of "democratic control".[1] Here, too, the subsidiarity

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1 Milton Friedman, "The case for floating rates" in Financial Times, December 18, 1989. "A truly unified European currency would make a great deal of sense. But to achieve it requires eliminating all central banks in Europe ... except one ...".

principle should apply, that is, only those functions should be transferred to the Community body which cannot be satisfactorily fulfilled at the national level unless this affects the requirements of a consistent, self-contained monetary policy. In the first place, these are all decisions on interest rates, liquidity and the money stock, that is, monetary policy in the proper sense. This must necessarily include decisions on purchases and sales of third currencies (mainly dollars) because these have direct effects on liquidity and the money stock. It also involves the difficult problem of a transfer of foreign exchange reserves to Community institutions and the decision on who is to receive the proceeds.

In spite of these far-reaching powers, the ECBS could function with a comparatively small staff, say, a number similar to that of the Board of Governors of the Federal Reserve System, as executive functions could largely be transferred to the well-established systems of the national central banks which would then act on behalf of the Community. The settlement of payments, open market operations with the banks, business on behalf of government institutions and the like could well be taken care of by the national central banks - according to the guidelines and instructions of the ECBS. In addition, the national central banks should, in my opinion, be responsible for bank and stock exchange supervision unless this is already the case as, for example, in the Federal Republic of Germany. This means that the national central banks would play a role similar to that of the Federal Reserve Banks in the United States or the Land Central Banks in the Federal Republic of Germany. However, they (and/or the finance ministers!) would have to give up their right to formulate independent national monetary policies. Particularly for Germany this would have far-reaching implications. The Central Bank Council, which today is the supreme decision-making body in the monetary policy field, would lose its most important function, a consequence which may not have become quite clear to every advocate of an ECBS in the Federal Republic of Germany.

Numerous other questions have to be answered, such as: how the voting rights are to be determined in a European central bank council; where the ECBS is to have its domicile; and how the profits are to be distributed, and so on. In this lecture I cannot deal with these questions in detail. There is one aspect, however, which I would briefly like to highlight.

VIII.

Even a strong and independent central bank can only fulfil its functions if its policy is not counteracted by fiscal policy. The agreement must therefore stipulate that the effective use of central bank instruments is not hindered or influenced undesirably by the nature and scale of public borrowing. Recourse to central bank credit must be ruled out from the outset or reduced to a minimum; in view of modern and free financial markets it is basically no longer up-to-date. Even if government functions are financed through the market within the appropriate limits, both the effects on the use of monetary policy instruments and the overall economic implications must be taken into account. The greater interest rate resistance of the public authorities compared with that of private borrowers must be corrected by an adequate degree of self-discipline if a crowding-out of private financing is to be avoided. And monetary policy must not be condemned to facilitate or ensure the satisfaction of the "inevitable" public borrowing needs, possibly at the expense of its proper function, the safeguarding of monetary stability.

An adequate degree of self-discipline at all government levels could reduce the necessity of binding rules for fiscal policy to minimum or even make it superfluous. As is well known, such binding rules, with limits for the budget deficits of individual member countries, were considered necessary in the Delors Report in order to guarantee "a coherent fiscal/monetary policy mix" in the Community. There are not yet very clear ideas as to where suc binding rules should come into force, how they should be

determined and how they could be implemented. And, as I said before, they should not lead to all powers and control authoritie being concentrated in Brussels in future. Judging by all experience, the idea that fiscal discipline will come about quasi automatically with the aid of market mechanisms appears not to be very realistic, however.

IX.

Experience in Germany has shown for years how important it is the the government at all levels, as well as management and labour, are willing to act responsibly under realistically assessed conditions so that the central bank can fulfil its function without undue frictional loss and safeguard the value of money, both internally and externally. As early as in the first stage of economic and monetary union it will be found out whether this willingness exists in the larger European context. It will depend on this willingness whether and when further steps are possible, including the establishment of a European central bank system. Even without amending the treaty the European Community has already an adequate institutional framework for establishing a convincing common economic and monetary policy. We have among other things the Council of European Finance Ministers and the Council of European Central Bank Governors, as well as the Monetary Committee in which our alternates work. Within this framework progress towards coordinating economic, fiscal and monetary policies is already possible and necessary today, that is, without waiting for the result of the presumably protracted intergovernment conference.

As far as monetary policy is concerned, the Committee of Central Bank Governors agreed at its January meeting on a reorganisation of its work, with respect to both staffing and scope of its deliberations. Its staffing was affected in that the Chairman we elected for three years, instead of one year, thus ensuring greater continuity. Furthermore, to support the Committee, a

research team consisting of competent economists will be set up; this team is to prepare problem-related studies on questions which must be answered for a common assessment of monetary trends within the Community and in relation to third countries. It will also draw up well-researched comments on relevant questions which are to be addressed to the Council or to the governments.

Regarding the content of its work, the Committee will work towards a higher degree of convergence "with a view to achieving domestic price stability, which is at the same time a necessary condition for stable exchange rates".[1] That higher degree of convergence was the aim of the amendment to the Council decision of 1964 on the cooperation between the central banks of the Community. A starting point for this is the closer coordination and convergence of the annual monetary targets of the individual national central banks. So far the most varied aggregates have been used and differing assumptions have been taken as a basis. A common monetary target for the Community will not be the result of these discussions in the foreseeable future, but it should be possible to converge the concepts and to give the Committee of Central Bank Governors the opportunity to use consistent yardsticks when consulting about the basic stance of its monetary policy. This will be of great use even if individual member countries continue to gear their monetary policy, particularly their interest rate policy, essentially to the objective of defending the exchange rate relations agreed upon within the EMS. The significance of monetary targets is thus qualified in individual cases. As a control variable the money stock nevertheless retains its significance as a money stock getting out of hand would have to be interpreted as a sign of unwelcome developments even if the exchange rate of the currency concerned remains stable.

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1 See Council Decision, Doc. 10128/89, of December 4, 1989, p. 1.

The cooperation among the EC central banks has contributed much to the progress towards convergence in the ten years or more which have passed since the EMS was established, and it is this progress which opens up the prospect of an implementation of economic and monetary union. Compared with this, there is a considerable need to catch up in other fields, not least in fiscal policy. The Committee of Central Bank Governors will therefore not hesitate to fulfil its mandate "to express opinions to individual governments and the Council of Ministers on policies which might affect the internal and external monetary situation in the Community and, in particular, the functioning of the European Monetary System."[1]

The Committee will also comment on questions concerning the further progress towards economic and monetary union. In their capacity as members of the Delors Committee the central bank governors have created an important basis for the debate. In the meantime further considerations and ideas have come to light. The final decision naturally rests with the governments and parliaments, but it must be as well-founded as possible. The Committee of Central Bank Governors will contribute its expertise, and I am convinced that we shall thus make an important contribution to achieving European economic and monetary union. There is no way back. The task before us is to set the points correctly so that the European train reaches the destination we all want to arrive at.

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1 See Council Decision, Doc. 10128/89, of December 4, 1989, p. 4.

FILE. ECL

CONFIDENTIAL

bc PLL.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

9 January 1990

Dear John,

ERM: LIRA REALIGNMENT

Thank you for your letter of 8 January which the Prime Minister has seen and noted.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Andy Lebrecht (Ministry of Agriculture, Fisheries and Food) and Paul Tucker (Bank of England).

Yours,
Paul

Paul Gray

John Gieve, Esq.,
H.M. Treasury.

CONFIDENTIAL

KC

chex.jp/jg/6 **CONFIDENTIAL**

cc P.U.

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

8 January 1990

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Prime Minister
Confirmation of the details.
PRC 6
8/1

Dear Paul

ERM : LIRA REALIGNMENT

I told you on Friday afternoon of the proposal for an ERM realignment involving a commitment by the lira to operate in the narrow ERM band. As you know, the Chancellor and Governor participate in ERM realignment proceedings even though sterling is not a member. On this occasion it was possible to reach agreement by telephone, on Friday afternoon and evening, so no weekend meetings were needed. I enclose a copy of the agreed Communique put out by the EC Monetary Committee just before midnight GMT on Friday.

The only change in the ERM is in the value of the lira. Intervention margins and central cross rates between all other member currencies have been left unchanged. For the lira the margins of fluctuation have been narrowed from ±6 per cent to the ±2¼ per cent margins followed by all other member currencies apart from the peseta. The lower limits for the lira have been left unchanged. The central rates have been reduced by around 3¾ per cent, setting them roughly in line with Friday's market rates. As is normal practice at realignments, new notional central rates against the ecu for the non-ERM currencies - sterling, the drachma and the escudo - were set in line with the latest market rates.

The Italians have been largely successful in presenting the move as a shift to the narrow margins arrangement and not as a devaluation. Nevertheless, we know that the move was precipitated

sooner than the Italians wished by market pressures on the lira last week.

It is significant that no other ERM country took the opportunity to devalue against the DM, despite some recent strains in the mechanism. We believe the French welcomed the opportunity to reinforce the message they have been giving to the market that they do not intend to devalue.

In the market this morning the lira strengthened by around ½ per cent against the DM, putting it temporarily at the top of the ERM narrow band.

As with all ERM realignments, there will be consequences for Community agricultural expenditure and green rates. We cannot yet be sure what these will be, but we believe that on this occasion any effect on expenditure will be modest.

I am copying this letter to Stephen Wall (FCO), Andy Lebrecht (MAFF), and to Paul Tucker (Bank of England).

Yours sincerely

JG.

JOHN GIEVE
Principal Private Secretary

MONETARY COMMITTEE OF THE
EUROPEAN COMMUNITY

Brussels, 5 January 1990

C O M M U N I Q U E

Following a decision by the Italian government to reduce the fluctuation margins of the lira in the exchange rate mechanism of the EMS to ± 2.25%, the Ministers and Central Bank Governors have by mutual agreement, in a common procedure involving the Commission and after consultation of the Monetary Committee, decided to fix a new central rate for the lira at approximately its market rate, with the result that its lower intervention limits will remain unchanged.

The Ministers, the Governors and the Commission welcome this as a contribution to strengthening the EMS. It is also an expression of the commitment of the Italian authorities to the implementation of Stage One of Economic and Monetary Union. They encourage the Italian government, in view in particular of the implementation of the 1988 EEC Directive on full capital liberalization, to undertake the necessary measures for further reduction of the fiscal deficit. This will also foster greater economic convergence in the Community.

The new ecu central rates are the following :
(in units of national currency per ecu)

FB	42.1679
Dkr	7.79845
DM	2.04446
FF	6.85684
IrL	0.763159
Lit	1529.70
Flux	42.1679
Hfl	2.30358
Pta	132.889
Dr	187.934
Esc	177.743
UKL	0.728615

The bilateral central rates between all the other currencies participating in the ERM remain unchanged.

The new bilateral central rates and the compulsory intervention rates for the lira will be communicated by the monetary authorities in time for the opening of foreign exchange markets on 8 January 1990.

1(a) RA

PRIME MINISTER

ERM REALIGNMENT

News has come through this evening that a minor ERM realignment is likely to be agreed tomorrow (Saturday).

The Italians are moving from their 6 per cent bands to 2 1/4 per cent bands. The plan now is that they will do this by aligning the bottom of the new narrower bands with the bottom of the existing wider bands, i.e. a modest devaluation for the range. But their present market rate is within the new proposed range, so there should be no immediate impact on market rates.

I have enquired whether there is a possibility of a German revaluation. But I am told this is not being considered and of course there is nothing we can do to affect this.

The one consequence for the UK is that the notional central rate of sterling within the system is always adjusted into line with sterling's current market rate at the time of any realignment. In practice the effect this time is very small; it will involve our notional central rate being reduced by just 1/4 per cent. In other words the net movement in sterling since the time of the last realignment is very small.

The fact that both the Italians and sterling changes are so small means that there will be very little agri-monetary consequence for the CAP.

PAUL GRAY

5 January 1990

C:\economic\ERM (kk)

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Very helpful
MTS

(EUROPEAN POLITICAL)

MEETING WITH ANDREOTTI

SUMMARY
1. PRESIDENT OF THE COUNCIL PUT ON NOTICE THAT THE IGC WILL NEED TO LAST WELL OVER A YEAR. CLAIMS THAT THERE HAS BEEN A MISUNDERSTANDING ABOUT GIVING MORE POWERS TO THE EUROPEAN PARLIAMENT AT THE EXPENSE OF NATIONAL ASSEMBLIES. SAYS IT IS RATHER A QUESTION OF RE-ALLOCATING EXISTING POWERS BETWEEN COMMUNITY INSTITUTIONS. WOULD NOT BE DRAWN ON DELORS' IDEA OF A SECOND IGC. KEEN TO KEEP IN CLOSE TOUCH WITH THE PRIME MINISTER ON THE GERMAN QUESTION.

DETAIL
2. I PAID MY FIRST CALL ON PRESIDENT ANDREOTTI IN THE CHAMBER OF DEPUTIES ON 15 DECEMBER. HIS DIPLOMATIC ADVISER VATTANI (ALSO THE ITALIAN SHERPA) WAS PRESENT. AFTER GREETING ME ANDREOTTI SAID HE HAD TO BE IN THE PARLIAMENT AS HIS BUDGET WAS AT LAST BEING VOTED ON.

3. I BEGAN BY THANKING HIM FOR HIS COURTEOUS RECEPTION AND DEFT HANDLING OF THE FOREIGN AFFAIRS COMMITTEE LAST MONTH (MY TELNO 743). SINCE THEN WE HAD HAD THE GORBACHEV VISIT, WHICH HAD BEEN A CONSIDERABLE SUCCESS FOR ITALIAN DIPLOMACY, AND THEREAFTER THE EUROPEAN COUNCIL, WHICH HAD ENDED IN A SPIRIT OF HARMONY. THOUGH I HAD NO (NO) INSTRUCTIONS, I COULD SAY THAT WE WERE CONTENT THAT THE IGC WOULD BEGIN IN THE LAST MONTHS OF THE ITALIAN PRESIDENCY, THOUGH WE NOTED THAT THE EUROPEAN COUNCIL HAD SET NO (NO) DATE FOR ITS CONCLUSION. IN VIEW OF THE MANY COMPLICATED TECHNICAL ISSUES WHICH THE CONFERENCE WOULD HAVE TO DISCUSS WHILE STAGE 1 OF THE DELORS PLAN WAS BEING IMPLEMENTED FROM NEXT JULY, I HOPED I COULD REPORT THAT ITALIAN MEDIA STORIES QUOTING HIM AND DE MICHELIS AS SAYING THAT THEY WOULD WORK FOR AN END TO THE IGC WITHIN A YEAR OF ITS START WERE INCORRECT. IN OUR VIEW, MUCH LONGER WOULD BE NEEDED, GIVEN THAT ANOTHER SET OF TREATY REVISIONS WOULD BE PROPOSED RELATIVELY SOON AFTER THE SINGLE EUROPEAN ACT. HOW DID HE SEE

DELORS' RECENT PUBLIC STATEMENT FAVOURING TWO IGCS, EITHER IN PARALLEL OR SEQUENTIAL, THE SECOND TO DEAL WITH CONSTITUTIONAL MATTERS (SUCH AS MORE RESPONSIBILITY FOR THE EUROPEAN PARLIAMENT)?

4. ANDREOTTI SAID HE UNDERSTOOD THE NEED FOR A FULL AND WELL-CONSIDERED IGC. HEADS OF DELEGATIONS AT STRASBOURG, INCLUDING ITALY, HAD CONSIDERED DELORS' IDEA OF A SECOND IGC, BUT HAD CONCLUDED THAT IT COULD GIVE RISE TO CONFUSION. SO THEY HAD AGREED TO CONVENE JUST ONE CONFERENCE AND TO REVERT IN DUE COURSE TO CONSIDERATION OF OTHER ISSUES, EG THOSE OF A CONSTITUTIONAL NATURE. HE THOUGHT THAT A MISUNDERSTANDING MIGHT HAVE GROWN UP ABOUT GIVING THE EUROPEAN PARLIAMENT MORE POWERS, FOR EXAMPLE AT THE EXPENSE OF NATIONAL PARLIAMENTS. IT WAS RATHER THE CASE THAT POWERS ALREADY ASSIGNED BY TREATY OR USAGE TO THE COMMUNITY'S INSTITUTIONS NEEDED TO BE REDISTRIBUTED. THE ISSUE OF FINDING A DIFFERENT WAY OF STRUCTURING THE COMMUNITY HAD BEEN TOUCHED UPON AT STRASBOURG, BUT NO DECISIONS THEREON HAD BEEN TAKEN, EVEN IN PRINCIPLE. MEANWHILE THERE WAS NO (NO) NEED FOR NATIONAL PARLIAMENTS TO TAKE FRIGHT. I SAID THAT THE BRITISH PARLIAMENT WAS EXTREMELY JEALOUS OF ITS RIGHTS, ESPECIALLY IN PUBLIC EXPENDITURE AND FISCAL MATTERS, AND WOULD NOT (NOT) TAKE WELL TO LOSING ANY PART OF THEM TO ANY COMMUNITY INSTITUTION. ALL THE BRITISH PARTIES WERE CLOSELY INVOLVED AND FELT THE SAME WAY. ANDREOTTI NODDED.

5. I THEN ASKED IF HE WAS SATISFIED WITH THE STRASBOURG SUMMIT'S DISCUSSION AND DECLARATION ON THE GERMAN QUESTION. ANDREOTTI SAID THAT THE PRIME MINISTER AND HE HAD BEEN 'ON THE SIDE OF THE ANGELS' IN THE RATHER SENSITIVE DISCUSSIONS ON THIS SUBJECT AT STRASBOURG. THE PARAGRAPH IN THE DECLARATION ON CENTRAL AND EASTERN EUROPE ABOUT FREE SELF-DETERMINATION FOR THE GERMAN PEOPLE WENT RATHER FURTHER THAN HE HIMSELF WOULD HAVE WISHED, THOUGH IT WAS LIMITED BY FOUR CLEAR STIPULATIONS. BUT IN ANY CASE HE THOUGHT THAT THE PRESENCE OF TWO ARMIES IN THE GDR OUGHT TO BE ABLE TO SLOW DOWN ANY TOO HASTY MOVES TOWARDS REUNIFICATION. MEANWHILE THE US POSITION ON THE GERMAN QUESTION WAS EVOLVING AND NEEDED TO BE WATCHED. (KISSINGER HAS BEEN HERE RECENTLY AT AN AERITALIA SEMINAR, AND SAID THAT WE WERE ALREADY ON THE ROAD TO GERMAN UNIFICATION.) ANDREOTTI COMMENTED THAT HE NOTICED THAT NEW PHRASEOLOGY WAS CREEPING IN AT NATO GATHERINGS, EG TO THE EFFECT THAT NATO STRUCTURES SHOULD BE REVIEWED, ETC. HE HAD FOUND A WIDE COINCIDENCE OF VIEWS ON THE GERMAN QUESTION WITH THE PRIME MINISTER AT THE ELYSEE DINNER, THE NATO SUMMIT (MY TELNO 764) AND AT STRASBOURG, AND LOOKED FORWARD TO KEEPING CLOSE TOUCH. I SAID I WAS SURE THAT MRS THATCHER WOULD WANT THIS ALSO.

6. ON ANOTHER SUBJECT I SAID I SHOULD REPORT TO ANDREOTTI THAT MR SICA, THE HIGH COMMISSIONER AGAINST THE MAFIA, HAD GIVEN US GLOWING REPORTS OF HIS VISITS TO WHITEHALL DEPARTMENTS, AS WELL AS TO NORTHERN IRELAND, FROM 11 TO 13 DECEMBER. HE WOULD HAVE LEARNED AT FIRST HAND OF THE VASTLY INCREASED DANGERS TO SECURITY DERIVING FROM THE AVAILABILITY TO PIRA OF LARGE QUANTITIES OF LIBYAN-SUPPLIED SEMTEX. ANDREOTTI SAID SICA HAD A DANGEROUS AND UNENVIABLE JOB, AND WAS GLAD THAT WE HAD BEEN ABLE TO GIVE HIM GOOD BRIEFINGS.

7. WHEN I GOT UP TO LEAVE ANDREOTTI SAID HE HOPED I WOULD NOT HESITATE TO ASK TO SEE HIM AS NECESSARY ON ANY FOREIGN AFFAIRS OR OTHER MATTER WHICH SEEMED IMPORTANT. I COULD ALWAYS GET IN TOUCH THROUGH VATTANI OR CAVALCHINI, HIS OTHER ADVISER. I SAID THIS WAS EXTREMELY HELPFUL. (I DID NOT MENTION THAT I AM STILL WAITING FOR A FIRST CALL ON DE MICHELIS, BUT HE MAY KNOW THIS.)

INCIDENTAL
8. I WAS GLAD TO SEE THAT ANDREOTTI LOOKED MUCH RECOVERED SINCE THE LONG STRASBOURG MEETING. VATTANI CONFIRMED THAT HE HAD FOUND IT QUITE EXHAUSTING. BOTH OF THEM WERE NOW GATHERING THEIR STRENGTH FOR A FOUR-DAY HOLIDAY VISIT (SIC) TO THE YEMENS, FOR WHICH ANDREOTTI AND HE WOULD LEAVE SOON AFTER CHRISTMAS. I WARNED VATTANI THAT HIS MASTER WOULD NEED A LONG PURSE IN THOSE TWO AID-HUNGRY COUNTRIES.

EGERTON

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Foreign and Commonwealth Office

London SW1A 2AH

11 December 1989

C D Powell Esq
No.10 Downing Street

CDP
12/12

Dear Charles,

EMU

1. A potentially useful new quote for tomorrow:

> "The British authorities have understood the essential point: monetary integration should proceed along the path from stability to unity, and not that from unity to stability."

(Markus Lusser, Governor of the Swiss National Bank, Zurich, 21 November, speaking about the UK 2 November "Evolutionary Approach" paper.)

2. The most useful of the Pohl quotes in our Strasbourg kit was, I think, this one, also on the "Evolutionary Approach" paper:

> "... a realistic and sensible description of what monetary policy should concentrate on in future years".

(Pohl: Frankfurt, 7 November.)

Yours ever,

John Kerr

J O Kerr

JK2AFT

From: BARONESS SEROTA
Chairman of the Select Committee on the European Communities

PRS

CF

R8/12

COMMITTEE OFFICE
HOUSE OF LORDS
LONDON SW1A 0PW
01-219 3146

7 December 1989

CDP
9/xii

Dear Prime Minister

It was good of you to reply to my letter of 30th November when I sent you a copy of the Select Committee's report on the Delors Committee Report which was published this week and I am sending you a copy of our report on the Social Charter which has also just been published. There is no need to acknowledge this as I know how busy you are.

With every good wish for Christmas and the New Year.

Yours,
Bee Serota.
SEROTA

The Rt Hon Margaret Thatcher, MP,
10 Downing Street,
LONDON, SW1.

EURO POL: EMS pr 6

DAS

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

5 December 1989

Dear Lady Serota

Thank you for sending me an advance of the House of Lords European Communities Select Committee's report on the Delors proposals for Economic and Monetary Union. I much appreciate your thoughtfulness.

Yours sincerely

Margaret Thatcher

Baroness Serota

chex.jp/jgl/51

CDP
Econ

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

4 December 1989

Stephen Wall Esq LVO
Principal Private Secretary
Foreign and Commonwealth Office
Downing Street
SW1A 2AL

Dear Stephen

ECONOMIC AND MONETARY UNION: BEYOND STRASBOURG

I know your posts in Community countries have mounted a very active lobbying campaign in the run up to Strasbourg to highlight the problems of Stage II and III of the Delors proposals and the advantages of our alternative approach. You are no doubt already giving thought to how best to carry forward the argument after Strasbourg. The Chancellor thinks there could well be advantage in a co-ordinated programme of Ministerial speeches, articles, and interviews in at least some of the Community countries over the coming months to alert informed opinion to the issues and to build up support for our arguments. He and other Treasury Ministers would certainly be willing to take part in this and Ministers from other departments - and possibly other respected figures from outside the Government - may also be interested. He would be grateful for your advice and from posts abroad on how best to take this forward.

I am sending copies of this letter to Charles Powell and Neil Thornton.

Yours
JG.

JOHN GIEVE

File KLo
cc Sir PC
Pemberton.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 December 1989

The Prime Minister has asked me to thank you for your letter of 1 December about economic and monetary union. She was most grateful to you for writing before the Strasbourg meeting. She very much shares your view that the Community ought to defer an IGC until it has experience of the changes that Stage 1 will bring. Unfortunately, it seems unlikely that a majority will be prepared to do this.

There will be a chance to talk over all this on Tuesday.

CHARLES POWELL

The Rt. Hon. Robin Leigh-Pemberton.

PRIME MINISTER

Sir Geoffrey Howe has made remarks about British membership of the ERM which will be carried on two separate television programmes this weekend. I attach transcripts. They were apparently recorded some time ago. I have underlined the offensive passages. They are bound to be taken up and exploited by the press in the present circumstances. It is not clear to me why he needs to be giving interviews on these subjects at all in his present post.

CDP

C. D. POWELL

1 December 1989

C:\wpdocs\foreign\howe.pmm

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

1st December, 1989

Dear John,

Please find attached the segments of pre-recorded interviews given by the Lord President on Europe which are to be used in two television programmes being broadcast this weekend.

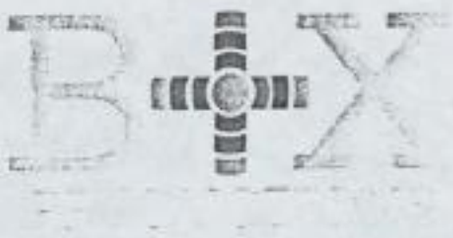
The first is the third edition of "1992 and all that" at 7pm on Channel Four on Saturday. The interview was recorded on 8th November. The segments being broadcast, plus the full text of interview recorded, are attached.

The second is a one-off documentary on Jacques Delors to be broadcast at 8.05pm on BBC2 on Sunday. The interview was recorded on 16th November. The section to be broadcast on the EMS is attached.

Yours
Anthony

ANTHONY TEASDALE
Special Adviser

John Whittingdale Esq



29 November 1989

Mr Anthony Teesdale
Rm 112
Privy Council
68 Whitehall
LONDON SW1

Dear Anthony

I enclose a copy of John Plender's interview with Sir Geoffrey Howe together with the two excerpts we have included in the programme. They both appear in the second half where we deal with the Social Charter and the European Monetary System.

REFERENCE TO THE SOCIAL CHARTER

I think it's very important to try and persuade British commentators like yourself to diminish your obsession with the risk of isolation. (EDIT) If you take the Social Charter, that debate is shifting very substantially all the time. And the discussions that I've had with Jacques Delors and others, one's been able to make a significant impression by saying "look, these nations of Europe, come from tremendously different traditions, they've tremendously different ways of doing things. (EDIT) They must have different approaches to things like the Social Charter.

REFERENCE TO EMS

What I say is that the more closely we are participating in the exchange rate mechanism and in a sense the sooner we are fully engaged in it, the more likely we are to have a substantial influence on what's happening. I don't say that outside it we have no influence. Heavens above, we've - we've exercised a great deal of influence on a lot of the discussions in Europe over the last ten years. But in the monetary field, if the exchange rate mechanism is a part to which others are able to belong, then clearly inside rather than outside is a more influential position to be. Hence I repeat, there is no argument at all about the principle of membership. We've set out very clearly the conditions against which we shall judge when we join the - the institution to which we're committed.

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(Q : Is there any likelihood at all that we might find our way into the exchange rate mechanism before the next election?)

Oh it must be a - real possibility, surely, yes. We have to make our judgement on the fulfilment of the conditions. I can't now tell you when that date will be, but I'm certainly not going to exclude any date from being in that category.

If you have any questions, please do not hesitate to contact me.

Yours sincerely

Sean McPhilemy

Sean McPhilemy
PRODUCER

cc RJ up (2)

PRIME MINISTER

~~Put to bed Next Wednesday~~ ~~soon~~.

mb

ERM AND EMU

You asked Mr. Ridley to prepare a paper on ERM and EMU. He has now done so and I attach it. It is a useful summary but does not - to my mind - have any new insights. I am not quite clear what use you have in mind for it. Perhaps you would like to discuss it with Mr. Ridley at your next bilateral.

- Yes, we must allow sufficient time.

CDP

(C. D. POWELL)
1 December 1989
a:\foreign\ERM.srw

CONFIDENTIAL AND PERSONAL

ERM & EMU

1 This paper describes the various proposals being suggested by the European Commission in the field of European economic policy, and how they would work. It attempts to assess their consequences from a United Kingdom point of view. It concludes by suggesting the policy which would be in the best interests of the United Kingdom.

The necessary definitions are:

EMS - The European Monetary System. This consists of Credit mechanisms together with the ERM.

ERM - The Exchange Rate Mechanism : a scheme which attempts to link the currencies of the member states to give more stable rates of exchange between them. [Currencies may move upward or downwards within "bands", and realignments are allowed when they become necessary].

EMU - Economic and Monetary Union between the 12 member states of the Community - leading to a common currency.

2 The Single Market is to be achieved by 1992. It consists of a Free Trade Area among the 12, but one where the rules are laid down by Directives - so that central control is achieved of standards, regulatory practices, non-tariff barriers to trade, subsidies, and many other matters. This is to ensure fair conditions for competition and for the free movement of labour, capital, goods, and services. It is accepted by all member states as highly desirable to achieve the Single Market in the interests of greater economic opportunities.

The Exchange Rate Mechanism of the European Monetary System

3 The EC established the present European Monetary System (EMS) in 1979. It included the Exchange Rate Mechanism in order to achieve greater convergence of economic policies through greater exchange rate stability. This consists of a set of fixed but adjustable bilateral rates with permission for minor fluctuations within fixed bands around those central rates.

4 The system includes credit mechanisms to help central banks intervene voluntarily to keep market rates within the limits. Central rates may, however, be adjusted from time to time, but only by mutual agreement amongst all participants. It is assumed that its existence will bring pressure to bear upon the participants to order their economic policies, particularly their monetary policies, so that they avoid re-alignments. We are formally members of the EMS but sterling is not in the ERM.

5 The advantages which the ERM seeks to achieve are those of a fixed exchange rate system - where there is reduced exchange rate uncertainty. It also seeks to achieve a firmer discipline upon Governments to pursue policies likely to produce low inflation. The need to adjust exchange rates from time to time to allow for changing economic circumstances is recognised by allowing periodic realignments when necessary.

FLC.

Economic and Monetary Union

6 The focus of debate within the EC has become the Report of the Delors Committee of April 1989. This suggested a three stage process leading to Economic and Monetary Union.

Delors Stage 1

7 Delors Stage 1 involves:

(i) full implementation of Single Market, including

single financial area;

(ii) strengthened competition policy including action against economic aids;

(iii) closer co-ordination of economic and monetary policies by member states;

(iv) inclusion of all the Community currencies in the Exchange Rate Mechanism under the same rules;

(v) The reform and doubling of the structural funds.

Delors Stages Two and Three

8 These two stages involve a move to irrevocably locked exchange rates and the eventual replacement of national currencies by a single Community currency. National budgetary policies and Community structural policies would become subject to binding central rules. The European Central Bank, acting independently, would determine monetary policy, exchange rate policy with non-EC countries, and the management of official reserves. The European Central Bank would be controlled by a Committee of the Central Bank Governers of the Member States. There is also a suggestion that supervision (by some unspecified process) by those with political responsibility in the Community, might be exercised on the European Central Bank.

How the ERM has worked

9 The actual performance of the ERM was poor to start with, but it has been better over recent years. There have had to be eleven currency realignments within the ERM over the 10 years from 1979-1988 but most were in the early years and there have been no realignments since January 1987. Since 1979 the franc has depreciated by 47% against the mark and the

lira by 64%. So the system has not - over the long term - overridden the market. Nor has it remotely produced stability of exchange rates. Sterling has actually fallen less against the DM than either of these two currencies by 25%. Only the Dutch guilder has maintained approximate parity with the mark over the period. Despite the scale of these movements, over ten years there has lately been a reduction in the day to day volatility of exchange rates between ERM currencies. Nor has the reduced volatility of exchange rates been accompanied by more volatile interest rates.

This needs revising.

10 There are a number of reasons for the relatively smooth operation of the ERM. First because the DM is a widely traded international currency, it is affected by movements in the dollar much more than other ERM currencies. When the dollar is weak funds move into DM, making the DM strong, and vice versa. The strength of the dollar between 1981 and 1985 therefore made it easier to keep the DM in line with other currencies within the system.

11 Second, the 1980's has been a period of relative calm in the world economy. The precursor to the ERM the currency "snake" of the 1970's, fell apart partly because of its inability to withstand the differential pressures on exchange rates of extreme turbulence in the foreign exchange markets as a result of the first oil crisis, as well as and divergent economic policies. There were on several occasions exchange rate adjustments beyond those allowed. The less than wholehearted commitment of member countries to stable economic policies and to the goal of monetary union which was the stated object of the 1970 Werner report meant that by 1976 the 'snake' had degenerated into a system involving only Germany and the Benelux countries.

12 In the early years of the EMS several members had extensive controls over the movement of capital. These controls allowed countries to delay but not to avoid adjustments in exchange rates or in domestic economic policies by limiting the ability of capital to move in response to

changes in economic performance and policies. Recently, there has been a marked reduction in exchange controls in the major countries. The main exchange controls in both France and Italy are now on holdings of foreign bank accounts by domestic residents. In both countries the really powerful constraints - those preventing companies from moving money abroad, or from advancing or delaying trade payments, or from borrowing their currency to sell it - have recently largely gone. A major impact of relaxing controls has been to stimulate capital inflows as investors realise that they can withdraw their funds if necessary.

13 There is a remarkably close relationship between relative changes in Exchange Rates within the EMR and relative changes in Unit Labour Costs. Unit Labour Costs are a combination of inflation and productivity. Over the ten year period the Franc has been devalued by 47%, and its ULCs have gone up by 45% more than Germany's. For the Lira the figures are 64% and 71% respectively. For the pound sterling, not a member of the ERM, the figures are 25% and 23% respectively.

14 There appear to be other reasons apart from ULCs why the pound's value changes relative to those of the ERM currencies, as it did particularly around 1981 when sterling was very strong. Sterling is an internationally traded currency, and has not been protected by exchange controls for 9 out of the 10 years. It is also a "petrocurrency" in that about 5% of its GDP was represented by oil production over the period. The waxing and waning of prospects for oil prices and production clearly affected its value, as well as changes in UK Unit Labour Costs.

15 The ERM system is potentially incompatible with a world of high capital mobility. Whenever the need for adjustment becomes apparent fixed but adjustable exchange rates provide market operators with a one way bet. If, say, markets come to expect the franc to be devalued, selling francs yields substantial gains if the franc is devalued but virtually no loss if it is not. The result is likely to be large sales of

francs, perhaps forcing a devaluation, with extreme movements in interest rates to try and defend the currency. These pressures caused the breakdown of the Bretton Woods exchange rate system in the late 1960's early 1970's as capital flows were liberalised and economic policies became more divergent creating pressures for exchange rate changes. In fact the ERM has been so organised that the permitted margins of fluctuation before and after realignments have overlapped, so speculators have not necessarily been given a one way bet. In realignment it has been possible for the exchange rate to rise even though the realignment has been downwards. Clearly this might not apply were world markets to enter a period of great turbulence, and the relative movements of exchange rates become greater as a result.

16 The reason for the apparent success of the ERM in recent years has been the convergence in ULCs between members and in particular the emergence in rates of inflation that were previously so disparate. This has reduced the need for realignments and enabled the mechanism to survive the liberalisation of capital movements which naturally exacerbate speculative pressures. In the early years there was a wide divergence between ULC performance in Germany, France and Italy. In the last three years the growth of unit labour costs in Italy has been similar to Germany and the French performance has been slightly better than the German. Both French and Italian monetary policies have been adjusted in the light of developments in the ERM. The French authorities, in particular have placed great emphasis in recent years on keeping the franc/mark rate unchanged. They have been prepared to keep interest rates 3-4 points above the Germans for this purpose. This has been necessary because the markets still clearly believe French inflation is likely to be higher than German. But it is not the ERM which has produced the stability; it is the determination shown by the Authorities to pursue economic policies likely to result in exchange rate stability.

17 Despite the greater convergence of inflation rates between members of the ERM, strains are re-emerging within the system. The German trade surplus with other members of the ERM continues to increase. A period of renewed dollar weakness would put upward pressure on the DM. The German authorities have indicated a desire for a DM revaluation to help reduce trade imbalances and reduce the German inflation rate. Other ERM members are unwilling to see their currencies devalued against the DM but a realignment cannot be ruled out in the early part of next year. Strains and parity adjustments are by no means a thing of the past.

18 So the conclusion must be that the ERM has worked for its member countries in recent years because there have been no dramatic economic upheavals to put irresistible and differential pressure on currencies within the system and because the countries concerned have committed themselves to sensible domestic economic policies which have kept their currencies within the rate bands. Membership of the system itself may have given the markets greater confidence in the commitment of these countries to continue sensible policies, but the system has not 'beaten' the market and the success is more a result of sensible domestic economic policies. It is thus neither a cause of good economic management, nor a cure for mismanagement. A World economic crisis or the pursuance of an inflationary economic policy by a member state would leave the ERM looking rather less successful.

EMU - Delors Stages II and III

19 Moving to irrevocably fixed exchange rates, as proposed in Stages II and III, would remove the possibility of exchange rate realignments. It inevitably means that there has to be a common currency, managed centrally. The consequences of this are that no country can adjust its parity upwards or downwards if it suffers from high or low productivity growth in relation to its neighbours. The strain has to be taken by a change in relative wages or by Regional

grants from the richer to the poorer countries, or a mixture of both. Delors recognises this by suggesting much larger flows of regional grants than at present. Others would argue that the strain should in fact be taken by wage rates alone. What happens when one country suffers high wage claims which it cannot resist is not wholly clear, but one result is likely to be increased unemployment. A common currency might suggest a common labour market, but such a market is not likely to develop except in the very long term.

20 Whether movement to a common currency would improve upon the financial discipline of the current ERM is doubtful. The anti-inflationary stance of the EMS arises largely from the perception of the need for other countries to follow monetary policies not too different from those of Germany. What would happen in a full monetary union would depend upon whether the monetary policy of the European system of central banks was as restrictive as that currently followed by the Bundesbank. It might well be and could indeed be given a remit to operate this way.

21 Even more fundamental, the UK like other Member States would lose certain national policy instruments. We should not be able to have an independent monetary policy, with the serious loss of political and economic sovereignty this implies. Unaccountable institutions would assume considerable control.

22 Delors also envisages rules on fiscal policy involving restrictions on the size and financing of budget deficits and some degree of co-ordination of fiscal policies between countries. Other member states could be penalised by higher interest rates if they had no control over the scale of a member's borrowing. Excessive borrowing by one member could therefore lead to instability and might shake the union apart. In Delor's scheme binding rules are necessary to prevent such monetary indiscipline. The risk, however, is that they could not be relied on because of difficulties of enforcement ('Brussels fines Government for refusing to close hospitals',

perhaps).

23 The salient feature of all these arrangements is that control over monetary policy, fiscal policy, and interest rates moves to the centre. Delors envisages that the centre would need to control the size of budget deficits. A key element in the freedom of Member States to choose how to finance their budgets will be removed. In enforcing any such rules, Brussels could well be percieved as intervening and dictating the level of spending on specific programmes. Though Delors does not propose to control tax rates, pressures towards the closer federation to which Delors aspires but has not described in detail and pressures towards economic convergence may well lead to Community interference in this area too. This would mean that spending programmes for the unemployed including social security benefit levels, and the provision of roads, hospitals, schools etc. would in effect no longer be the responsibility of the elected representatives of a Member State or its Government. Such a transfer of sovereignty is unthinkable for the United Kingdom to accept. It ends the ability of the UK Parliament to order its own affairs, and to be accountable to the people for its decisions. It would be in effect a fully fledged Federal system.

24 There is an element of the population who may be prepared to join a Federal Europe, to give up the degree of sovereignty envisaged in these proposals. But the Authority to whom these powers are to be given is woefully inadequate. Monetary policy is to be discharged by a Committee of Central Bankers, and major parts of fiscal policy, it seems, by the European Commission. Neither of these bodies is to be elected. There is thus no political accountability proposed at all for the exercise of perhaps the most important functions of Government exist in the economic field.

25 This is not the place to discuss whether a Federal Europe should have a Parliamentary Democracy or a Presidential System, or some other constitution. But some system of

democratic political responsibility is essential if powers of this importance were ever to be exercised at the centre. Since no such system is proposed, even a committed Federalist has to reject Stages II and III. For the UK at least, these proposals must remain unacceptable.

An Evolutionary Approach

26 These difficulties lead the British Government to promote the idea of an evolutionary approach to developments in the Community beyond Delors Stage 1. Delors Stage 1 is essentially about the freeing of markets and the levelling of competition. Stages 2 and 3 are about central control, without any of the necessary political accountability. Encouraging the wider use of whatever currency or currencies offers the least risk of inflation provides a different approach which does not rule out exchange rate adjustment or bring with it unaccountable central control.

27 EMU as proposed by Delors is not and never will be acceptable for Britain for reasons of sovereignty and accountability. The concept of monetary union is not one which offers great advantages in principle and, given the political and structural difficulties, is not likely to happen for a long time to come. Britain has proposed an alternative way forward - competing currencies. This enables each nation to keep control of its fiscal and monetary policy, the essentials of economic sovereignty and political accountability. It leads to something like monetary union - certainly lower transaction costs than now, lower inflation and the greatest degree of exchange rate stability that is practical among sovereign nations.

28 Subjecting Delors' plan for EMU to this degree of scrutiny will doubtless draw accusations of "foot dragging" from the Centralists in Europe. Britain will be accused of a lack of enthusiasm for European integration. But it is not a lack of enthusiasm for European integration which this

analysis produces; it is a total lack of confidence in the method of achievement proposed by Delors.

29 The British Government has always wanted to see Europe progress so that it can exploit the potential economic strength of a single market of 320m people. It has always wanted to see the political unity for Europe to speak with one voice in world affairs. It has always wanted ties to be established which end forever the possibility of conflict in Western Europe. But the Government believes that the wide diversity of the history and culture of the European States can also be preserved by a Europe of cooperating Member States, pooling sovereignty only to the extent necessary to achieve the goals above.

30 The Community will have to rethink Stages II and III. If Britain cannot accept them, then together we must work for an alternative plan. We have been constructive in this respect, by putting forward our plan for free competing currencies. There may be other ways forward. Let us jointly explore them. What is certain is that Britain must remain in the Community, but also the Community's future must be acceptable to Britain.

31 So finally we come back to the question of joining the ERM. The economic arguments are analysed earlier in this paper. The advantages and disadvantages are fairly evenly balanced. It is no substitute for good economic management, nor does it provide exchange rate stability by itself. But it could have a helpful effect in reassuring markets and in providing discipline to achieve good economic management. The case is not proven either way on economic grounds.

32 Nevertheless we have stated our intention of joining the ERM when certain conditions are met. These are, first, that Britain's rate of inflation and trade deficit should be greatly improved. Second, that there is full freedom of capital movements within the Community; that is that the Single Market is complete. Third, that all exchange controls

in the major Member States are abolished. These conditions will take some time yet to be met.

33 Recently, joining the ERM has been seen as a political gesture; a signal that Britain is prepared to travel along the Delors road; a token of our good European intentions. "Good Europeans" though we are, we are not prepared to travel down the path set out in the Delors Report - so we should not hasten to join the ERM for the purpose of giving such a signal.

34 If we are not to follow the Delors path to EMU, where then will the Community go? Surely that question should be answered before we give political signals in any direction? Britain has made clear that we will join the ERM if and when certain conditions are met - that remains the position. We believe that Europe should concentrate on making sure these conditions are met, and at the same time allow the debate to range wide and free as to what should follow Stage I.

35 There are new factors which have to be taken into account. The dramatic changes in Eastern Europe; the difficult question of possible German re-unification, the need for forms of association between the emerging democracies of the East and the Community. Austria, Turkey and Malta are already seeking membership. Perhaps others will do likewise.

36 Thus there are questions of huge importance to be settled about the future of both East and Western Europe. Britain should play its full part in the debates that are to come. We should help chart out the future course of European integration. We must find an alternative to the ~~proposed~~ Delors union of Economic and Monetary Union. Joining the ERM is a relatively minor question, which must depend on the situation where our conditions for entry have been met.

JW1AET

EUROPOL: EMS pr 6

TPM

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

1st December, 1989

Dear John,

Please find attached the segments of pre-recorded interviews given by the Lord President on Europe which are to be used in two television programmes being broadcast this weekend.

The first is the third edition of "1992 and all that" at 7pm on Channel Four on Saturday. The interview was recorded on 8th November. The segments being broadcast, plus the full text of interview recorded, are attached.

The second is a one-off documentary on Jacques Delors to be broadcast at 8.05pm on BBC2 on Sunday. The interview was recorded on 16th November. The section to be broadcast on the EMS is attached.

Yours
Anthony

ANTHONY TEASDALE
Special Adviser

John Whittingdale Esq

29 November 1989

Mr Anthony Teesdale
Rm 112
Privy Council
68 Whitehall
LONDON SW1

Dear Anthony

I enclose a copy of John Plender's interview with Sir Geoffrey Howe together with the two excerpts we have included in the programme. They both appear in the second half where we deal with the Social Charter and the European Monetary System.

REFERENCE TO THE SOCIAL CHARTER

I think it's very important to try and persuade British commentators like yourself to diminish your obsession with the risk of isolation. (EDIT) If you take the Social Charter, that debate is shifting very substantially all the time. And the discussions that I've had with Jacques Delors and others, one's been able to make a significant impression by saying "look, these nations of Europe, come from tremendously different traditions, they've tremendously different ways of doing things. (EDIT) They must have different approaches to things like the Social Charter.

REFERENCE TO EMS

What I say is that the more closely we are participating in the exchange rate mechanism and in a sense the sooner we are fully engaged in it, the more likely we are to have a substantial influence on what's happening. I don't say that outside it we have no influence. Heavens above, we've - we've exercised a great deal of influence on a lot of the discussions in Europe over the last ten years. But in the monetary field, if the exchange rate mechanism is a part to which others are able to belong, then clearly inside rather than outside is a more influential position to be. Hence I repeat, there is no argument at all about the principle of membership. We've set out very clearly the conditions against which we shall judge when we join the - the institution to which we're committed.

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(Q : Is there any likelihood at all that we might find our way into the exchange rate mechanism before the next election?)

Oh it must be a - real possibility, surely, yes. We have to make our judgement on the fulfilment of the conditions. I can't now tell you when that date will be, but I'm certainly not going to exclude any date from being in that category.

If you have any questions, please do not hesitate to contact me.

Yours sincerely

Sean McPhilemy

Sean McPhilemy
PRODUCER

F.

BOX PRODUCTIONS "1992 + all that" Channel 4
EMS Recorded 8-11-89.

I/V GEOFFREY HOWE

Q: Sir Geoffrey, I wonder if you could explain to us the nature of the commitment that Britain undertook at the Madrid summit earlier this year.

A: Oh, it's the commitment to which the whole community er, subscribed. Er, namely that we should get ahead with stage one of the Delors recommendations, and set in hand work and study on the second and third stages.

Q: And what specifically did that entail in relation to the exchange rate mechanism of the EMS?

A: Oh we spelt out the basis on which we could determine when to join the exchange rate mechanism. And enumerated the conditions we'd have to have regard to progress basically on - on the three things. Domestic inflation, er, capital liberalisation, and substantial progress on the internal market.

Q: After the Madrid summit the Prime Minister told the House of Commons that the objective of progressive realisation of economic and monetary union was reaffirmed in Madrid. But she's since said that stages two and stage three are really about trying to get political union and that she firmly disagrees with that. Could you clarify the government's position on that issue?

A: Well, she's talking about the Delors report definition of economic and monetary union. The opposition has always been clear, we have - and on a number of occasions reaffirmed our shared commitment to progress on economic and monetary union. But it's been a concept that nobody's actually defined. And the Delors report, as Madrid acknowledges, offers one definition of that. We're saying that we need to think a great deal more about just how it evolves. I think that the - the - the crucial difference is that our our own approach is essentially evolutionary and pragmatic. When Roy Jenkins first talked about it in 1978, he said you could have what he called the 'long jumpers approach' and leap, as it were, into something defined well in advance. And find out when you got there whether it worked. Which doesn't seem to me to be a very sensible way of doing it. The alternative is to say, well, we know that we want to achieve closer cooperation on economic and monetary matters. And - and just as we're seeking ever closer union among the peoples of Europe under the treaty of Rome, so we proceed practically, er, step by step.

Q: Well, if that is what we want, if we do want to achieve closer cooperation, why has it been necessary for you to reaffirm at various key moments that commitment made at the Madrid summit - summit?

A: Well, because it was a commitment, and when you say, why necessary for - for you to reaffirm, it's a

question you can address to the head of every government in the community. Because it started, "I forget when, 1972 was the first time that we reaffirmed it. I think it began before that. Er, and it's part of the - of the creed, if you like, to which the community subscribes from time to time. Um, but it's quite characteristic of the Community to sign up on very general declarations of that kind, as a declaration of long-run commitment, and then work out over a period of - of decades exactly what it means. It is - it's an enormously long term original, unique, exciting, important exercise. And I think it's terribly important we shouldn't believe that we can define it in blueprints now and leap to that in - in one move.

Q: Could we look specifically at the issue of the exchange rate mechanism of the EMS. And could I ask you what are the costs for Britain of staying out of the exchange rate mechanism?

A: Well, the advantage of - of - of joining that we haven't yet been able to secure is participation in a zone of greater exchange rate stability. That's the crucial thing. Erm, I think that if we are full members then we would enhance our influence in the debates that are going on in the future about the progress towards economic and monetary union. And I think that full membership er, should enable us also to move to a - a period of not just lower inflation but lower interest rates as well.

Q: Well, if - why is it do you think that Spain, for example, which has similar inflation problems and balance of trade problems as Britain, should have taken a decision to go in, whereas we continue to put the day off?

A: Well, we don't continue to put the day off. We reaffirmed that it is not a matter of whether, but when. And at Madrid we spelt out the conditions which help us to determine when. We come from a - a different economic and historical past from Spain. Sterling has played a much larger role in - in - in the world, in the world economy. We are an oil economy, to some extent. Much, much less than we were. Those are the reasons that have er, caused us to take time before joining.

Q: Isn't it a little worrying for the British public that if they are looking for price stability and they believe that it can be obtained from going into the exchange rate mechanism, that the conditions laid down, for example, the single market being completed, are such a - a long term thing? It' s not gonna be completed by 1992, it could go on for an exceedingly long time.

A: Well, well there are two points there. One, it is not necessary to belong to the exchange rate mechanism to achieve price stability. Er, we achieved a very low rate of inflation three or four years back. And there are many economies round the world that have got low

inflation without membership. But it's our belief that the two important objectives, price stability and relative exchange rate stability, the things that the business community wants, are best achieved within the exchange rate mechanism, hence we've made it clear that we're going to join. But your second point, that completion of the internal market is a condition precedent for accession is simply a mistaken presentation of our position. Er, what we need is substantial progress, real progress towards completion of the internal market. And the truth is that although 1992 is a date of crucial importance, because it'll serve to mobilise and energise us in - in working towards these targets by that date, when we get there, as when climbing a mountain, you'll find that there are ridges way beyond. The market will not be complete and will not be single. It'll be a lot completer and a lot singler than it is now, but there's a lot more still to do. That's why it's important not to say completion of the single market is a conditioned precedent, and to say that real progress is one of the things to which we'll pay attention.

Q: Is there any likelihood at all that we might find our way into the exchange rate mechanism before the next election?

A: Oh it must be a - a real possibility, surely, yes. We have to make our judgement on the fulfilment of the conditions. I can't now tell you when that date will be,

Quoted in programme

but I'm certainly not going to exclude any date from being within the category.

Q: And yet in recent pronouncements the Prime Minister appears almost to have expanded the conditions that are required of the continental Europeans to fulfil the commitments made at Madrid.
A: There's been no change in the conditions. The Prime Minister, myself, all of us, the Chancellor of the Exchequer, Foreign Secretary, we've all reaffirmed the Madrid conditions. Which of course contain er, an element of judgement. We list there the conditions against which the decision will have to be judged.

Q: Can I ask you, does the completion of the single market make progressive moves towards economic and monetary union inevitable? Is it inherent in a single market that we are bound to go further down that route?
A: Well, you come back to the point, what do you mean by economic and monetary union. The fact is that the more we develop the habit of working together, the more Finance Ministers are addressing themselves together to the common problems of the Community the more they're likely to evolve common views, or they're likely to learn techniques of - of practical cooperation. I presided over several realignments of the exchange rate mechanism when I was Chancellor, and it was notable that these people coming together

for a rather unusual experience for the first time were - were better at it, er, the second and third time. That's the kind of progress one talks about.

Q: Well, what do you feel more specifically about, for example, the joint central bank for Europe? I mean, is that something which - which has merit as you see it?
A: I think that the concept of the joint central bank opens up all sorts of possibilities. Er, most of which I find - find it difficult to visualise, quite honestly. Because I think that if you take countries which are unitary in a historic sense, although federations like the United States, they don't have a single central bank, they have a federal reserve bank, they have reserve banks in - in - in the other states as well. And that's the position in the country that's - that's been looking to the world like one country for 200 years give or take. Now, in Europe there are 12 nations of different size and scale, whose governors, central bank governors meet, um, who develop in a growing pattern of cooperation, where there's the monetary committee where Finance Ministers meet, and I believe that the progress is likely to be in the direction of additional mechanisms for cooperation, in which in due course, er, there may be a greater sharing of responsibility so that the nature of the structure will change. But I'm sure it's important not to set about the creation of European institutions by doing the drawing first and working out the way to it afterwards.

Q: For all practical purposes though, the Bundesbank has been dictating monetary policy to Europe in recent months and - and years. Would it not be desirable for Britain to find a way of influencing European monetary policy to a greater extent than it is now able to do?

A: Well, that - that's right, yes. The Bundesbank has played a very important er, virtually a dominant role, but it's - it's because people, I think, would like to see the structure of - of European monetary cooperation more broadly based, people outside this country, that they would like to see us join. Er, they believe that our accession would add diversity and strength to the European financial institutions. We believe that if we achieve it successfully it also adds to the attractiveness of the London capital markets and enhances the status of the City of London. So there - there are good reasons for wanting to be in. That's why the question of principle has not for years been in doubt. The question is only when and not whether.

Run in used: "... if Britain's national interest is at stake, why are we staying out?"
Q

Is the question quoted? No.

Q: Well, I'd like to perhaps ask you to clarify to make sure that I've understood you rightly here. Did I understand you right in saying that there is a danger that by staying outside the exchange rate mechanism we're unable to influence those moves towards economic and monetary union?

Quoted

A: What I say is that the more closely we are participating in the exchange rate mechanism and in a

sense the sooner we are fully engaged in it, the more likely we are to have substantial influence on what's happening. I don't say that outside it we have no influence. Heavens above, we've - we've exercised a great deal of influence on a lot of the discussions in Europe over the last ten years. But in the monetary field, if the exchange rate mechanism is a part to which others are able to belong, then clearly inside rather than outside is a more influential position to be. Hence I repeat, there is no argument at all about the principle of membership. We've set out very clearly the conditions against which we shall judge when we join the - the institution to which we're committed.

Q: But the implication there appears to be that by staying out of the exchange rate - rate mechanism, we are failing to pursue effectively British interests at the moment.

A: No, we're balancing a whole range of British interests which have led us so far to conclude that the time for accession to the mechanism has not yet arrived. But that's not because we choose recklessly to disregard British interests. The whole business of policy for - formulation is to judge British interests and we have had British interests foremost in our mind as we formulated these conditions.

Q: Well, one of the things that is going to follow the Strasbourg summit is the intergovernmental

conference next year. Do you feel that there is - there is any risk that if we are not part of the exchange rate me - mechanism, we will be somehow marginalised within the discussion of the issues that that conference considers?

A: Well, you're asking the same question in different ways. The fact is that the conference can be convened, as the Prime Minister's made clear, as a result of a majority decision. It's therefore sensible if the majority so decide, for us to participate in it. Um, our participation in all these discussions will be fully engaged. Er, Britain has not during the time that I've been in government failed to take the most active and energetic and effective part in these discussions and we shall do just that. So I don't think that the difference of membership or not of the ERM would be a decisive factor, but clearly on balance, a full member is likely to have more insight into how it works and therefore more influence on the discussion than someone who is still not participating in the mechanism.

Q: What is Britain seeking to extract from the Strasbourg summit?

A: Well, seeking to extract the right balance of British and European interests on a whole range of matters. We don't go along like a dentist to these summits seeking to extract things in that way. We go along

seeking to come to conclusions which are a sensible reconciliation of all our interests.

Q: So is there any risk, for example, if one looks at the social charter, and also in relation to European monetary and economic union that we could find ourselves isolated in a way which is not helpful to the pursuit of British interests at that summit?

A: I think that it's very important to try and persuade British commentators like yourself to diminish your obsession with the risk of isolation. Of course it's a legitimate factor. Of course Britain, if she is to have her full influence, wants to be playing er, a - an effective part in all the different subjects of discussion. And on some we have a - a great alliance of the majority of the Community with us. On some we start off, if you like, isolated but as pacemakers of change. The whole single market thing, the whole airline fares debate, for example, we were a lone voice. Um, isolated if you like, but pacemaker if you like. And er, on other matters the balance of the argument is different ways. And I think it's terribly important not to be looking all the time for the point on which Britain at that time seems to be fighting a lone rearguard action. If you take the social charter, that debate is shifting very substantially all the time. And the discussions that I've had with - with - with Jacques Delors and others, one's been able to make a significant impression by saying, 'look, these nations of Europe come from tremendously different

traditions, they've tremendously different ways of doing things. We in Britain er, under Harold Wilson's leadership er, if one may put it like that, with Barbara Castle waving the banners, started this tremendous battle to change the structure of our industrial relations market. In Place of Strife wasn't a Tory White Paper, it was a Labour White Paper. So over years we've had to change that balance. Now the French, with a much smaller trade union membership, the Germans with a trade union structure designed by Britain for postwar Germany bore a completely different character. They must have different approaches to - to things like the social charter. And that kind of discussion undertaken time after time after time, gradually erodes the understandable but oversimplified commitment to sign up on this, this and this. And the whole idea of subsidiarity, that - that blessed word, of looking to different structures in different nations, is an idea that's, I - I suspect we began talking about ahead of the others. But again, Jacques Delors is now a principal protagonist of subsidiarity. So the argument changes. The great thing about it is never to believe you're going to lose. Never to conclude you're going to be in a corner on your own. Always to be engaged in the melee of debate, offering propositions, responding to propositions, and in that way I think helping to shape the Europe we all want to see.

Q: Well, could I - we've talked in particular terms about the kind of Europe you - we want to see, could you give me a general statement er, what is it that you want from Europe, what is your vision of Europe?

A: Vision is a short word but a big word. I think that I've said many times that er, Archimedes said, 'give me a place whereon to stand and I can move the world.' And that for Britain Europe is that place. If Britain is not playing central role in Europe then our influence on the world, on the security which our people will enjoy, on the whole East-West debate, will be much less. Er, and that's all the more so as the simplicities of the East-West divide are - are melting away. Europe as a set of nation states will need and will acquire growing influence. That's the political case. Er, the economic case is that if a single market is growing up with increasingly strong and effective institutions prescribing standards for television, standards for electric plugs, standards for automobiles, then I'd rather not be like Sweden or Austria, although they're marvellous countries, sitting outside, accepting the standards set by the 12 who rae inside. I'd rather be there inside setting the standards, helping to shape the market, economically as well as politically.

Q: Is that vision really compatible with an idea of Europe as a loose association of nation states, willing and active cooperation between sovereign states?

A: It's not a loose association. The defined objective is ever closer union of the peoples of Europe. That doesn't in any sense di - diminish the patriotism, the sovereignty which people sense as they continue to belong to their nation states with pride. If you like, it's a method of - of diminishing the adverse impact of nationalism without in any sense reducing the positive dynamic of patriotism. And when we talk about ever closer union, er, the - the idea of closeness implies difference. I've moved away from using the phrase that some use about a pooling of sovereignty. Because pooling implies a degree of anonymity. Um, I think that a partnership in the exercise of sovereignty jointly, strands in a rope of different colours, um, looking clearly different, retaining their difference, but nevertheless because they're woven together for this or that objective, having much more strength than they would be on their own.

Q: But that does sound like, to me, more than the words willing and active cooperation between independent nation states.

A: No, it's that as well. The - the independence of the nation state remains um, unimpaired, because they re - they remain independent. We're not joining the kind of political union that exists between Britain and Scotland, but we're joining a unique exercise, and it's impossible to define where in the long march of history this experiment of the people's of Europe

together will end up. Nobody looking at it 30 years ago would have foreseen that we would be where - where we are now. And it will develop by the continued commitment of - of a common sense of purpose. And the nations will remain European nations and Europe will be all the stronger, because of the strength and independence of - of these nation states.

Segment on EMS being used in BBC2 documentary on Jacques Delors at 8.05pm - 3/12/89.

"LP: For us, our readiness to enter the exchange rate mechanism in principle is not in doubt. We are, ourselves, conducting a discussion as to when the right time should be for doing so. There are many, many of our partners who would regard Europe without Britain as a full participant, as a very incomplete organ. That does not mean we are entitled to insist on our view prevailing at the expense of everyone else."

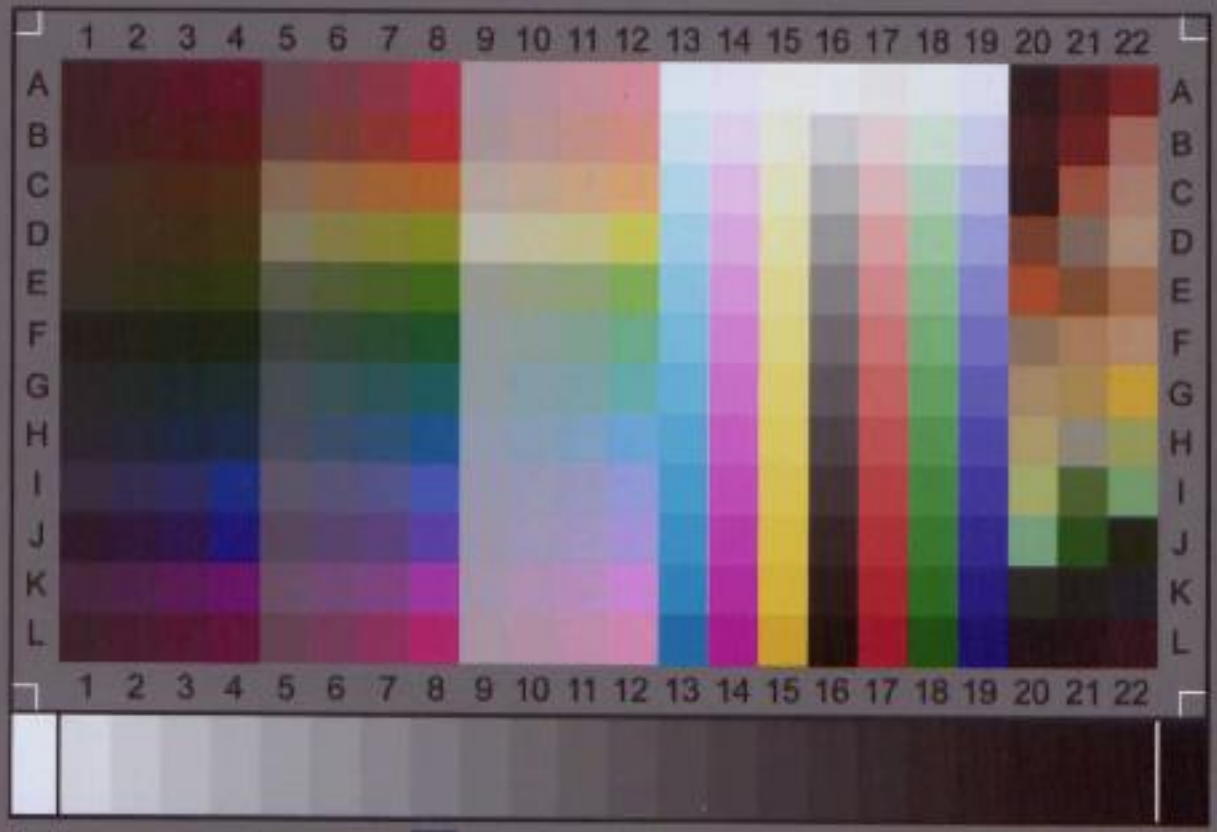
(Recorded 16/11/89)

PART 5 ends:-

BARONESS SEROTA TO PM. 30.11.89

PART 6 begins:-

PCO TO J. WHITTINGDALE 1.12.89



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