

The Governor

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11 October 1989

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Sir T. Burns, Mr Wicks	
Mr H.P. Evans, Mr Odling-Smee	
Mr Scholar, Mr R.L.G. Allan	
Mr Peers, Mr Riley	
Mrs Brown, Mr W. White	
Mrs Chaplin, Mr Tyrice	

Dear Nigel,

While we were in Washington, your office kindly passed me a draft of the paper you are preparing for the November ECOFIN. I felt that in general the paper was developing well as an increasingly credible piece that ECOFIN ought to consider seriously. I know that there have been a number of changes since then, but I would like to raise one point of general principle in case it is still relevant. Andrew Crockett is offering more detailed points to your officials.

The paper has its origin in a commitment to offer an alternative to Stages 2 and 3 of Delors. I think that most of it would be regarded as either an illustration of, or elements in, the fulfilment of Stage 1 of Delors. On this basis, it is a challenge to establish its credibility as a categorical

alternative to Stages 2 and 3 rather than as an argument either (1) that Stage 1 is enough and that its perfection will make the formal and institutional changes of Stages 2 and 3 superfluous or, alternatively, (2) that attention to Stages 2 and 3 is premature before we know fully how Stage 1 has evolved.

In my view, it may not be convincing to put forward the superfluousness of Stages 2 and 3 as an alternative to them. This seems to me to raise the fundamental question of whether it would not be better to promote the very valid arguments that Stage 1 needs to be completed before attention is addressed to Stages 2 and 3, a view which is not totally alien to the Delors Report and for which there is considerable support from other European Ministers, and notably President Pöhl. I had the feeling at Antibes that the extension of these arguments beyond Stage 1 and as an alternative to them was the point at which they began to lose credibility. In particular I think it is important that the paper should be drafted very carefully so as not to jeopardise German support, and in this respect I would be concerned about any suggestion that central bank independence was relatively unimportant or might even be a bad thing. Probably the best performance on inflation since 1979 has been that of the Bundesbank, and the German authorities might therefore react badly to a suggestion, which was certainly in the draft I saw, that the independence of central banks is on its own no guarantee of satisfactory inflation performance.

The validity of the above observations can be tested by asking the following question: what sort of monetary union is likely to be achieved in the absence of institutional and administrative change? The answer probably lies in some sort of soft union as envisaged in the paper which Pöhl put to the Delors Committee early on in our considerations and which, incidentally, received in my opinion rather less attention than it deserved.

The critical test here, however, is one which the Delors Committee considered very carefully; namely, given the pressure of market forces and the inevitable temptations and strains to which democratically elected governments are put, the very existence of twelve different currencies must mean that at any one time one or more may be under market pressure and fluctuate, rightly or wrongly, outside whatever band prevails at the time or even outside the fixed parities once exchange rates are locked. It might be said that the paper deals with this in accepting fluctuations as part of the competition of currencies, but this does not meet the point about the need for stability which is the pre-requisite to union.

It is worth questioning at this stage whether the paper might emphasise that the commitment to ERM in Stage 1 will tend to produce de facto exchange rate fixity (subject only to narrow margins), just as it will tend to produce internal stability. In the world which the paper envisages, parity changes would in practice not happen. In this case, both the benefits and costs of moving to locked parities would be greatly reduced. I wonder if it would help acceptability of the paper if we were prepared to envisage that as a possible ultimate step, though one which could not be decided upon until Stage 1 was completed. Perhaps this is just another way of arguing the merits of "soft union".

Y  
Lorenson,  
Robin