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17 October 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
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Mr. Powell

Essentially the same draft of the paper as you already have with you. But the Prime Minister may want to be aware of this covering letter which has now been copied also to the others attending Wednesday's meeting.

Dear Paul

EMU: CHANCELLOR'S PAPER FOR ECOFIN

... As a basis for the meeting next Wednesday, I attach the latest draft of the Chancellor's paper for ECOFIN on EMU. As you will see there are still some gaps and the Chancellor is still working on the text.

PRCG 20/10

The Chancellor has asked me to draw the following points to your attention.

(i) The paper is long, and in parts quite technical. But he thinks that a substantial piece is necessary if we are to stand any chance of securing support in the Community for our approach.

(ii) Its emphasis has deliberately been cast on competing currencies, and thus competing monetary policies, as the better route, compared to Delors', for securing a low inflation Europe. There is a possibility that if the argument is put this way, it will gain some support from Poehl and the Bundesbank, who may in turn influence Chancellor Kohl. The Chancellor can elaborate further on tactics at the meeting.

(iii) The drafting of the paper requires a decision on whether to distinguish between developments in Stage 1 and later Stages; or whether to elide the whole process into a "super" Stage 1 and to argue that nothing is necessary thereafter. The latter approach would, of course, reflect the most desirable outcome from our point of view. But the Chancellor believes that we should opt for the former approach. The Madrid communique, and most Member States, appear to accept -

and in most cases actively to seek - that there should be some development after Stage 1. For us now to argue that Stage 1 is the end of the process would court the risk of having our paper dismissed from the outset, even by those who have some sympathy for our viewpoint.

(iv) The general presentation of the paper is intended to appeal to its Community audience; hence some of the language.

(v) The Chancellor believes it important for the paper to be circulated to Community Finance Ministers very early the week starting 30 October, so that it can be properly studied before ECOFIN on Monday 13 November and so that it is available in time for the outstanding Scrutiny Committee debate on various Community documents concerning European economic and monetary matters which is expected that week. Directly the paper has been circulated to Community capitals, the Chancellor intends to make it available to the press here though a press conference, and place a copy in the Library of the House.

I am sending copies of this letter to Stephen Wall and Neil Thornton.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

THE MARKET APPROACH TO ECONOMIC AND MONETARY UNION (EMU)

Introduction

The European Council agreed at its meeting in Madrid in June to launch the first Stage of EMU on 1 July 1990. The Council also confirmed the objective of the progressive realisation of EMU but did not specify how that objective was to be realised. By common consent the next steps in economic and monetary integration of the twelve Member States will be crucial to the future economic development of the European Community. That development must be based on firm and durable foundations which reflect both the diversity and the unity of the economic and monetary situation in the Community. This paper suggests how such sound foundations should be laid in a way which avoids the pitfalls of other approaches now under consideration.

2. Whatever the approach to economic and monetary union, be it as in the UK's approach in this paper, or that described elsewhere, eg in the Delors Report, it is important to be clear about objectives. The objectives of economic union are well established and include sustained increases in living standards and more flexible economies. The objectives of monetary union, which are more complex, include:

- price and currency stability;
- lower costs of financial transactions, especially for trade between countries;
- equal access to financial instruments and services by all citizens and other borrowers and lenders within the Community.

3. Stage 1 will lead to substantial progress on each of these objectives. Beyond Stage 1, the UK proposes a gradual,

evolutionary approach that will lead to further steps towards the progressive realisation of economic and monetary union.

Stage 1

4. The starting point for any consideration of future economic and monetary arrangements in the Community has to be the developments identified in the Delors Report as Stage 1 of EMU. It includes the following major steps:

- through completion of the single market programme, to dismantle long-standing barriers to the movement of people, goods and services;
- to strengthen competition policy;
- to liberalise capital movements;
- to strengthen coordination of economic and monetary policies;
- to include all currencies in the ERM on equal terms.

5. Stage 1 will bring about massive changes in the European economy. It will progressively increase freedom of trade in both goods and services, and freedom of movement of capital and labour. The Cecchini Report painted a picture of a Community, following completion of the single market, in which regulations and technical barriers will be drastically reduced; frontier delays will be cut; industries will be restructured to reflect comparative advantage and reap economies of scale; businesses in all sectors will become more efficient as they are exposed to Community-wide competition; and consumers will benefit from lower prices and increased choice. The forces released in Stage 1 will reshape all our economies along new European lines. By any standards it is an unprecedented endeavour whose significance cannot be overstated.

6. In this environment, there will be a powerful stimulus for monetary authorities to adopt policies aimed at low inflation. The main factor is the removal of exchange controls within the context of the ERM and the creation of the single financial area. Any indication that a currency might have to be devalued within the ERM could cause a major outflow of capital against which intervention would not be effective for long. The authorities would have to move quickly to tighten monetary policy and maintain the exchange rate. There are important asymmetries between currencies subject to downward pressure and those subject to upward pressure:

(a) devaluations damage the credibility of national policy, and raise inflationary expectations. There are no equivalent costs to an upward realignment;

(b) foreign currency reserves are finite. Faced with a weak currency, intervention is a less sustainable instrument for buying time than intervention to hold down a strong currency.

These asymmetries, together with the need to act quickly, will provide a powerful stimulus for monetary authorities to aim at an inflation performance in line with the best in the Community.

7. In addition, the changes in Stage 1 will increase the amount of currency substitution. Greater use will be made of low inflation currencies at the expense of high inflation ones in both transactions and deposits, mainly because the value of low inflation currencies is more predictable. Governments do not like to see their currencies displaced by others, if only because of the loss of seigniorage, ie the resources that accrue to the monetary authorities from the creation of currency. National authorities will therefore have an incentive to pursue non-inflationary policies in line with the best in the Community.

8. Finally, increased integration of Member States' economies will increase the mobility of labour and capital. Location decisions will be influenced by the relative stability of prices

in different Member States. Governments will have an incentive to minimise inflation in order to attract economic activity.

9. So these three factors - the removal of exchange controls within the context of the ERM and the creation of the single financial area, the possibility of currency substitution and the influence of prices on capital and labour mobility - will all exercise a powerful stimulus towards stable prices.

10. There is considerable evidence that these mechanisms work in practice:-

- in recent years, we have seen much greater convergence of inflation within the EMS, and fewer realignments;

- in the past, there were big differences between domestic and euro-market interest rates. With the dismantling of controls, these differentials have declined;

11. The integration of member states' economies during Stage 1 will have important implications too for payments arrangements and for the conduct of monetary policies. Greater mobility of people, goods and capital will lead to increased demand for efficient Community-wide payments mechanisms. Moreover, the creation of a single market in banking and other financial services will provide the competitive spur to ensure that improved mechanisms emerge. These may involve some or all of:

- more competitive electronic funds transfer facilities (eg credit cards, debit cards, charge cards);

- improved and lower cost international cheque clearing systems;

- simpler and lower cost currency exchange arrangements.

The result will be a significant diminution over time in the transactions costs and inconvenience of the multi-currency system.

Beyond Stage 1

12. The path on which the Community will be thrust as a result of the changes in Stage 1 is impossible to map with any precision. The competitive forces set free in Stage 1 will lead to a period of increased integration of Member States' economies that will not be complete for many years thereafter. This will be an evolutionary process: it will take many years for the forces to work themselves through - as is evident from the less comprehensive liberalisations already enacted in some individual countries.

13. The history of the Werner report is a warning against seeking to move quickly to a theoretical blueprint of ultimate economic and monetary arrangements, worked out before market realities have had a chance to point the way forward. To try to decide now - even before Stage 1 has begun - precisely how later stages of the progressive realisation of EMU should be carried forward is both hazardous and unnecessary. There is still much to be done to ensure that Stage 1 is effective. For example, half of the 279 single market measures have still to be agreed by Community institutions; and hardly any have been implemented in the legislation of all twelve Member States. Key measures, such as those to bring down barriers in the provision of financial services will not even start to come into effect until January 1993. And it will take much longer for the full economic effects of such measures to be felt. The UK's experience of liberalising its own financial system and of implementing a far-reaching programme of supply-side measures has shown that the process of adjustment is a long and continuing one.

14. Yet despite the uncertainties, it seems clear that during Stage 1, if its objectives are realised, inflationary pressures will have been sharply reduced, and with them the pressure for exchange rate changes between the currencies of Member States. The ERM will have become more stable as a result of a natural

process - and the benefits of further integration in Europe will follow through increased trade and long-term capital flows.

15. It follows that in seeking to identify, on a provisional basis, the further measures to be taken after Stage 1, priority should be given to those which would assist and accelerate the beneficial trends towards economic and financial integration in Europe, created by Stage 1. Two categories of such measures can be identified now.

16. First, the pressures on governments to keep down inflation and enhance the stability of currencies would be increased by the complete removal of all unnecessary restrictions on the use of Community currencies. Even after Stage 1 is complete there will remain many restrictions on the availability of financial services and the use of all currencies throughout the Community. For example, restrictions on the currency and geographical location of the assets of long-term savings institutions exist in many countries, often beyond the limits of what is essential for prudential purposes. And access to financial services throughout the single financial area will be less uniform than it should be because of unnecessary differences in, for example, conduct of business rules, compensation schemes, the regulatory requirements for establishing insurance companies, and the financial techniques and distribution channels which are permitted. All these should be examined with a presumption that changes should be made to enhance the process, already underway in Stage 1, of completing the single financial area.

17. Second, the costs of changing between Community currencies - including the margin between buying and selling prices, and the costs of moving funds between banking systems - could be reduced further by tackling remaining barriers to the use of relatively cheap means of payment and by developing technologies geared to such transactions. [Example or two, possibly relating to credit cards. Work still continuing.] Greater use of the private ECU could also reduce transactions costs, and the ECU itself could be made stronger and more attractive by fixing its currency weights for all time.

18. In practice, transactions costs would be reduced because:

- greater exchange rate stability would mean less need to hedge exchange risks and lower insurance costs;

- greater competition between institutions and currencies would lead to lower margins between bid/offer prices.

- the ability to use financial instruments of other currencies and the ability of banks to trade between countries could lead to the emergence of more international instruments - payments cards, credit cards, euro-cheque clearing. Which was most successful would depend in part on technology and how costs of the service developed. But competition and emergence of larger open market would offer greater returns to scale.

19. Over time, all these measures would strengthen the process of convergence on price and exchange rate stability. Realignments would become rarer, fluctuations within the ERM bands would become smaller, and the EMS could evolve into a system of more or less fixed exchange rates. Concurrently, with minimal exchange rate uncertainty and reduced costs of switching between currencies, all Community currencies would become effectively interchangeable. In this way a practical monetary union would be achieved as the result of a gradual evolutionary process.

20. But a third category of measure may also be needed. Sound monetary policies impose their own constraints on national budgetary policies. Within these, Member States would remain free to set their own budgets, with pressures from the integrated European capital market and multilateral surveillance ensuring that the results do not undermine monetary stability. The discipline of the capital market will be beneficial and the Community should not undermine it by bailing out governments which run excessive deficits. To enhance market credibility it may also be desirable for there to be an explicit understanding that deficits will not be financed by monetary financing.

21. Regional and structural disparities in the Community should be alleviated primarily through the operation of the market. The strengthening of market mechanisms which is central to the achievement of economic union will enable the countries with the lowest per capita GNP to exploit market advantages, such as their low costs, and hence to maximise rates of return and profitable investment opportunities and attract the flows of private capital required to finance them. Indeed this is the way to ensure catching up and the achievement of genuine and sustainable growth. This is the way the United States caught up with and subsequently overtook Europe in the nineteenth century. [It is also the way in which, more recently, the Southern states of the US caught up with and in some cases overtook the Northern industrial states.]

22. The UK Government believes that the Community should move forward, through Stage 1 and beyond, by way of the approach identified in this paper. It has as it basis the following fundamental principles for successful economic and monetary integration:

- Increasing the influence of markets and competition, reflecting the worldwide consensus in favour of working wherever possible with the grain of the market. This is the philosophy behind the 1992 programme. Competitive pressures so released will contribute, over time, to the convergence of economic performance and policies in the Community.

- Respecting the principle of subsidiarity As the Delors Report (paragraph 20) explained, "the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. . All policy functions which could be carried out at national (and regional and local) levels without adverse repercussions on the cohesion and functioning of the economic and monetary union would remain within the competence of the member countries".

- Strengthening the forces tending to bring about stable prices, which must be the overriding objective of monetary policy in the Community.

The Delors Report

23. The approach described above sets out a path to economic and monetary union through an evolutionary process resulting from the operation of the single market. By contrast, the Delors Report envisages moving by administrative fiat and institutional change first to irrevocably fixed exchange rates, then to a single currency. Responsibility for monetary policy would be transferred to a European System of Central Banks (ESCB), independent of both governments and Community authorities. There would be binding rules on the size of national budget deficits. And there would be enhanced governmental resource transfers through the Community Budget.

24. The Delors Committee was charged with "the task of studying and proposing concrete stages leading towards" EMU. The analysis in the Report is a valuable contribution to the debate It sets out a helpful prescription for Stage 1 and its analysis of later stages has thrown up important issues. But there are flaws in the prescription it proposes for those later stages.

25. First, binding Community rules on the size of budget deficits are neither necessary nor desirable. They are unnecessary because deficits of different size and composition in different countries will be perfectly compatible with the sound monetary policies which the ERM and competition will encourage governments to pursue. Fixed exchange rate regimes have in the past operated successfully without such rules, as do the overwhelming majority of federal states today. Market pressures and multilateral surveillance will prevent deficits becoming unsustainable or unneighbourly.

26. Binding Community rules are undesirable because, being unnecessary, they infringe the principle of subsidiarity, and

could lead to acute political difficulties within member countries. Moreover, since there is no agreed view about the role or effects of fiscal policy, centrally devised rules would inevitably be controversial, difficult to monitor, and quite likely to have undesirable effects. They would encourage the development of misleading accounting devices aimed at avoiding the impact of the rules.

27. Second, the Report's structural and regional proposals are defective. There must of course be greater opportunities for the living standards of the less prosperous regions to rise towards those of the more prosperous. But, as paragraph 21 above points out, there is no reason to think that a market route to EMU, would have a negative impact on the less prosperous areas which would require compensatory action by governments. Moreover, recent history provides ample evidence that interventionist policies by governments are likely to create more problems than they solve.

28. Third, there is worldwide acknowledgement that monetary policy is at the heart of macro-economic policy. Countries vary in the degree of independence of their central bank with respect to political controls. There are arrangements in most countries for accountability to national governments or national parliaments and in all countries for co-operation. Where national central banks have a high degree of independence, it is still within a context of careful balance conditioned by historical experience.

29. The proposals in the Delors Report explicitly make no provision for accountability to national governments or national parliaments. So elected governments and parliaments would have no means at their disposal to influence the key area of macro-economic policy in Europe. Nor would there be any effective means of bringing the central banking system to account for major failings - there can be no guarantee that an ESCB would pursue successful anti-inflationary policies whatever Treaties might say. So an ESCB could mean higher inflation for at least some Community countries. Yet the electorate would still hold governments and national authorities responsible for their economic well being.

So the consequence of the Delors Report's proposals would be to create an imbalance of power between the ESCB and the twelve Finance Ministers of the Member States. That imbalance could only be rectified by centralising the power of the Finance Ministers requiring a European Finance Ministry and with it a European Government. There is certainly no agreement among the Member States on their peoples on the desirability of making that fundamental and irreversible constitutional change.

Conclusions

30. In short, there are major political and economic risks in moving to a single currency. The Delors Report was not asked to and did not set out the economic gains from such a move. They are most unlikely to outweigh the political and economic risks. In any event, there is an alternative course available which would provide an evolutionary approach to economic and monetary integration in the Community. This approach builds on the major changes that all governments are committed to in the course of Stage 1.

31. The evolutionary approach maintains national monetary policies within the context of a strengthening ERM, and allows currencies to compete to provide the non-inflationary anchor in the European Monetary System. This approach is centred upon national monetary authorities. It thus minimises problems of political accountability and harnesses the strengths of national monetary traditions to Community objectives. It permits an evolutionary and robust way forward which can develop with the grain of economic and financial integration in Europe.

32. The evolutionary approach to EMU has already been agreed as the basis of Stage 1. It should be allowed to evolve in the period beyond Stage 1 until the Community achieves economic and monetary union. The strength of this form of union is its reliance on many currencies. Deciding now that monetary union has to have a single currency precludes debate and removes any role for the market in favour of a central plan. Moreover, by eliminating both competition and accountability from members'

monetary policies, the Delors Report version of union risks producing a higher inflation rate in Europe - one in which performance approximates more to the average than to the best. The administratively imposed changes that are required would inevitably fail to foresee future developments. And they involve major constitutional and institutional changes which are wholly unnecessary.

33. By contrast, the form of monetary union advocated in this paper would develop naturally towards the commonly agreed objective of stable prices achieved by the alignment, through competitive mechanisms, of the twelve Member States' monetary policies. It is a multi-currency solution with increasingly interchangeable Community currencies. It involves no major constitutional change. As realignments become increasingly rare and exchange rates fluctuate in narrower bands, the system could evolve into one of fixed exchange rates. But that cannot and should not be decided now.

H M Treasury
11 October 1989