chex.dc/jmt2/43 **CONFIDENTIAL**

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

30 October 1989

Charles Powell Esq
Private Secretary to the
 Prime Minister
10 Downing Street
LONDON
SW1A 2AA

~~PC~~ ~~AF~~ to me

CDP 31/x

Dear Charles

ECONOMIC AND MONETARY UNION

... I attach a copy of the paper, which reflects final comments from the Chancellor and others, and is in "publication" form. You will wish to note the inclusion of a new paragraph 5 on the ERM, as requested at the Prime Minister's meeting on 25 October.

The Chancellor now proposes to release the paper to Parliament and the Press at 11.30 am on Thursday 2 November. This will allow MPs somewhat more time before the afternoon's adjournment debate.

I am copying this letter to the Private Secretaries of the Secretary of State for Foreign and Commonwealth Affairs, the Secretary of State for Trade and Industry, the Lord President of the Council and the Leader of the House of Lords.

Yours sincerely

Jonathan Taylor

J M G TAYLOR

AN EVOLUTIONARY APPROACH TO ECONOMIC AND MONETARY UNION

Introduction

The European Council agreed at its meeting in Madrid in June to launch the first Stage of economic and monetary union (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.

Objectives of monetary union

2. Whatever the approach to economic and monetary union, be it 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 market-oriented economies. The objectives of monetary union, which are more complex, include:

- price and currency stability;
- lower costs of financial transactions, especially across borders;
- 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 leading to 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 Stage 1 of EMU described in the Delors Report. It includes the following major steps:

- the dismantling of long-standing barriers to the movement of people, goods and services through completion of the single market programme and completion of the single financial area;

- the strengthening of competition policy;

- the liberalisation of capital movements;

- the strengthening of coordination of economic and monetary policies;

- the inclusion of all currencies in the ERM on equal terms.

~~in conditions which strengthen the ERM itself & provide assurance that an enlarged ERM could be sustained.~~

5. The UK Government reaffirms that it will join the ERM ~~when~~ the level of UK inflation is significantly lower, there is capital liberalisation in the Community and real progress has been made towards completion of the single market, freedom of financial services and strengthened competition policy.

Impact of Stage 1

6. 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 Stage 1 is an unprecedented endeavour whose significance cannot be overstated.

Inflation

7. In this environment, there will be a powerful stimulus for monetary authorities to adopt policies aimed at low inflation. Low inflation in all countries as a result of policy convergence will in turn lead to increased exchange rate stability. There will be a number of factors pushing in the direction of lower inflation and more stable exchange rates in the Community.

Exchange rate asymmetries

8. The main one is the removal of exchange controls within the context of the ERM and the creation of the single financial area. Any expectation 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:

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

- 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 major stimulus for monetary authorities to aim at an inflation performance in line with the best in the Community.

Currency substitution

9. 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. National authorities will therefore have an incentive to pursue non-inflationary policies in line with the best in the Community.

Labour and capital mobility

10. 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.

11. 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 price stability on capital and labour mobility - will together exercise a sure stimulus towards stable prices and exchange rates. The move towards exchange rate stability will reduce uncertainty and lower the costs of the multi-currency system.

Inflation convergence

12. There is considerable evidence that these mechanisms work in practice. There has been greater convergence of inflation within the EMS, and fewer realignments in recent years. In the past, there were big differences between domestic and euro-market interest rates. With the dismantling of controls, these differentials have declined.

Payments arrangements and transactions costs

13. The integration of member states' economies during Stage 1 will also have important implications for payments arrangements and transactions costs. Greater mobility of people, goods and capital will lead to increased demand for efficient Community-wide payments mechanisms. Moreover, the progressive creation of a single market in banking and other financial services will provide the competitive spur to ensure that improved mechanisms emerge. For example, implementation of the Second Banking Co-ordination Directive should help to remove barriers to the cross-border supply of credit card services and other payment facilities.

14. Improved payment mechanisms are likely to involve credit and other cards, cheque clearing and currency exchange

arrangements. In all these areas there is scope for reducing costs and increasing convenience, especially through the greater use of electronic technology. A significant diminution over time in the transactions costs and inconvenience of the multi-currency system can be expected.

15. The third objective of monetary union - equal access to financial instruments and services - will be brought much closer during Stage 1. The abolition of exchange controls, which is the single most important measure of all, will allow people to make greater use of foreign currency instruments than before; and the various single market measures for the financial sector will increase the choice of instruments and services open to them.

Beyond Stage 1

16. 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 experience in implementing even modest liberalisations in some member states has shown.

17. 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. More experience and analysis of the transformation that the Community economy is going to undergo is required before institutional changes should be contemplated.

Progress on Stage 1

18. There is still a great deal to be done to ensure that Stage 1 is effective. For example, more than half of the original 279 single market measures have still to be adopted at Community level; and only seven 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 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.

19. 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.

20. 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.

Restrictions on use of Community currencies

21. 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 cross-border provision of financial services and on 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 where any unnecessary differences remain beyond Stage 1 - for example in the conduct of business rules, compensation schemes, the regulatory requirements for the operation of established 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 still further the integration of the single financial area.

Barriers to use of most efficient means of payment

22. Second, the costs and inconvenience of changing between Community currencies could be reduced further by tackling remaining barriers, including those affecting the development of appropriate technology, to the use of relatively cheap and convenient means of payment. Among the barriers which would need investigating are legal impediments to the simplification of expensive paper-based cheque clearing systems, restrictive licensing of electronic value-added networks, and anti-competitive practices by banks, for example in their charging. 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 composition for all time.

23. 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.

Sound monetary policies

24. But there is a third area of policy which is also relevant. Sound monetary policies impose their own constraints on national budgetary policies. Within these constraints, 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. It would be enhanced by an agreement that the Community will not bail out governments which run excessive deficits. This is not, strictly speaking, essential while realignments remain a possibility, since potential pressures in the exchange market are also likely to impose a discipline against fiscal irresponsibility, but it is clearly desirable. To enhance market credibility it may also be desirable to have an explicit understanding that there will be no monetary financing of Budget deficits.

Regional and structural disparities

25. The Community is committed to the doubling of the Structural Funds by 1992, which is intended to help reduce regional disparities. But regional disparities will 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 how the United States caught up with and subsequently overtook Europe in the nineteenth century. And within the United States, income per head is more equally distributed between states than it is between countries of the Community.

Principles for successful integration

26. 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

27. The approach described above sets out a path to economic and monetary union through an evolutionary process following on from Stage 1. 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.

28. 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.

Budgetary rules

29. 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.

Binding Community rules

30. 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. There is, for example, no agreement about how to take account of the context within which any given deficit occurs, for example the level of private saving, the amount of public sector capital expenditure, or the level of outstanding public debt. Any rule would also be difficult to monitor and enforce, and quite likely to have undesirable effects including the

introduction of a degree of moral hazard. Rules would encourage the development of misleading accounting devices aimed at avoiding the impact of the rules.

Structural and regional proposals

31. 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 25 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. Moreover, recent history provides ample evidence that interventionist policies by governments are likely to create more problems than they solve.

Monetary policy accountability

32. 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.

33. The proposals in the Delors Report make no provision for accountability to national governments or national parliaments. So there would be no 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 a single monetary policy controlled by 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 thus a European Government. There is certainly no agreement among the Member States or their peoples on the desirability of making so fundamental and irreversible a constitutional change.

Conclusions

Evolutionary approach

34. Much of the debate about monetary union has assumed that it must involve 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.

35. 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.

36. 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. It will be built on the twin pillars of the creation of a genuine single market and the fuller development of the EMS. 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.

37. By contrast, the form of monetary union advocated in this paper would develop naturally towards the commonly agreed objective of stable prices and currencies 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 is not mandatory but permissive: everyone would have equal access to all currencies, financial instruments and financial services. 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

November 1989