

R3/11

# Conservative Research Department Brief

ECONOMIC AND MONETARY UNION

Prepared For:

a debate in the House of Commons on  
Thursday 2 November 1989

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## ECONOMIC AND MONETARY UNION

The "Delors Committee" was set up by the Hanover European Council in June 1988 with the task of "studying and proposing concrete stages leading towards economic and monetary union". The members included Messrs Delors and Andriessen from the Commission, the Governors of each EC Central Bank, acting in a personal capacity, and three academics/bankers. This report was published in April 1989. As the Governor of the Bank of England, Mr Robin Leigh Pemberton, made clear in his evidence to the Treasury and Civil Service Select Committee, the Delors Committee devoted themselves "very much to how economic and monetary union might be achieved, rather than whether or when. ... "Whether or when was a matter for political leaders."

The Delors Report proposed three stages leading to economic and monetary union.

The main elements of stage 1 are full implementation of the single market, including a single financial area; strengthened competition policy; closer coordination of economic and monetary policies by member states; the inclusion of all Community currencies in the ERM under the same rules; and the reform and doubling of the structural funds.

In stage 2 member states would begin to work within EEC-wide macro-economic policy guidelines adopted by majority decision. A "European System of Central Banks " would be set up, though without independent powers. The margins of fluctuation within the exchange rate mechanism would be narrowed (see Annex 1).

In stage 3 exchange rates would be irrevocably locked. National currencies would eventually be replaced by a single Community currency. National budgetary policies and Community structural policies would be subject to binding central rules. The ESCB, acting independently, would determine monetary policy, and exchange rate policy with non-EC countries and management of official reserves.



At the Madrid European Council in June the British Government agreed to the first stage of the Delors proposals. (See Annex 1.) But the Government took issue with Delors' prescription for the subsequent stages, for several reasons.

First, the Delors proposals for a single monetary policy, a single currency and a single independent central bank represent a vision of a federal centralist Europe which is unacceptable to the Government.

Secondly, a single centrally run monetary policy could not be guaranteed to reflect the views of those Community countries most wedded to low inflation. Such an approach might result in inflation performance in the Community converging on the average, not the best.

Thirdly, binding Community rules on the size of national budget deficits, as proposed by Delors, are neither necessary nor desirable. They are not necessary because existing monetary unions can and do tolerate diversity of budgetary position in their component regions. Even more importantly, they are not desirable because they would curtail the power of the House of Commons. As the Treasury and Civil Service Select Committee said:

"The power of the House of Commons over the centuries has depended fundamentally on the control of money, both taxation and expenditure. This would be jeopardised by the form of monetary union proposed by the Delors Report which would involve central undemocratic direction from within Europe of domestic budgetary policies."

Fourthly, there is no need for a massive increase in regional and structural aid which the Delors Report proposes. Community structural funds are already to be doubled between 1988 and 1993. Market forces are more likely to bring convergence of regional economic performance than Government intervention.



Today the Government has published a paper describing an alternative and evolutionary approach to achieving economic and monetary union.

The Government believes that monetary and economic policy should remain as far as possible in the hands of national governments. The overriding objective should be price stability and every possible step should be taken to increase the influence of markets and competition.

The paper makes a number of points.

First, the task of completing stage 1 is an enormous one. Less than half of the 279 single market measures have been adopted at Community level. On implementation the UK is ahead of most of our Community partners.

Secondly, completion of stage 1 will bring about massive changes in the European economy, through greater freedom of movement of capital and labour, the reduction in regulations and technical barriers, and the restructuring of industry. These will impose strong incentives on governments to adopt low inflation policies and a strong incentive on them to minimise inflation in order to attract economic activity. With the removal of exchange controls and the creation of a single financial area, the capital markets will react more quickly and directly when they fear that a country is not operating sufficiently sound monetary policies. This will be a powerful discipline. Greater stability of prices will in turn mean greater stability of exchange rates. All this will be achieved through the market, not through centralised regulation and direction.

Thirdly, beyond Stage I the pressures on governments to keep down inflation and enhance the stability of currencies would be increased by removing all unnecessary restrictions on the use of Community currencies. Unnecessary barriers to further reductions in transaction costs between Community currencies should be removed wherever possible.



Over time, all these measures will strengthen the process of convergence on price and exchange rate stability. Realignments should become rarer, fluctuations within the bands of the ERM should become smaller. 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 could be achieved as the result of a gradual evolutionary process.

### Conclusion

There is no basic disagreement between the UK and Community partners on the fundamental objectives of EMU. Everybody wants to move to a stronger and more highly integrated European economy, sustained increases in living standards, and price and currency stability throughout the Community.

The Government believes that its evolutionary approach would be the best way of securing these objectives. It would do so by working with the grain of the market and building on the Community's real achievements so far. Neither Britain's nor the Community's interests would be served by the implementation of a centralist, interventionist blueprint.



**ANNEX 1**

After the Madrid Summit, and in agreeing to Stage I, the Prime Minister made clear that the UK would join the exchange rate mechanism during stage 1 when the level of UK inflation is significantly lower, when there is capital liberalisation within the Community, and when real progress has been made towards completion of the single market, freedom of financial services and strengthened competition policy. This position was reaffirmed in the House of Commons on 31 October by the Chancellor of the Exchequer, Mr John Major.



LABOUR AND THE EXCHANGE RATE MECHANISM

Divisions

Labour are divided on their attitude to full membership of the EMS.

John Smith said:

"We see advantages in the stability that membership of the EMS could provide for the currency in a very volatile world" (BBC Radio 4, 18 May 1989).

Brian Gould appears to disagree. He said:

"For sterling, EMS membership would actually mean a reduced ability to maintain a particular parity against the dollar. Nor is there any evidence that exchange rate stability of itself would necessarily be of great help to our economy. It is relatively easy to hedge against a short-term volatility" (Reported in the Guardian, 15 May 1985).

In the same month Mr Gould also declined to reply to questions on the EMS put to him by the TCSC:

"given my general hostility to the prospect of full membership of the EMS."

The absurdity of Labour's conditions

Labour spokesmen have alluded to at least five conditions which would need to be satisfied before Labour would join the ERM. These are:-

- a strategy for balanced growth in the Community involving the removal of the "deflationary bias" of the system;



- more structural funds;
- higher regional policy spending;
- more swaps;
- an EEC-wide trade policy.

(See for example Mr Neil Kinnock, reported in the Guardian, 24 May 1989; Mr John Smith, Hansard, Tuesday 31 October 1989, Col. 195; and Labour's Policy Review.)

These conditions destroy the raison d'etre of the EMS. Far from being an anti-inflationary mechanism the EMS would become an inflationary one. If the EMS were to operate in such a fashion it would also be inconsistent with the Bundesbank's constitutional duty to secure price stability.

Labour's recipe for higher public spending and inflation on a pan-European scale is therefore not only highly undesirable, it is completely unrealistic. Labour's position on the ERM has clearly been cobbled together to paper over deep divisions on the subject.

#### Current statements by Labour

**John Smith:** 'We have proposed that Britain should join the ERM on certain prudent conditions ... The conditions that the Labour Party attaches, apart from the important question of joining at the effective rate, are that there should be adequate swap arrangements between the central banks, and that there must be a well-organised regional policy within the Community, and that the thrust of the economic policies within the Community should be for growth and not for deflation. (Hansard, Tuesday, 31 October 1989).

#### **'Meet the Challenge Make the Change (Labour's Policy Review):**

'On monetary policy in particular, we see clear advantages in returning to a more stable and predicible system of exchange rates, but we believe that the European Monetary System, as at present constituted, suffers from too great an emphasis on deflationary measures as a means of achieving monetary targets and



that it imposes obligations which are not symmetrical. We oppose moves towards a European Monetary Union which would further impede progress in this area'.

'Substantial changes would therefore be required before the next Labour Government could take sterling into the Exchange Rate Mechanism. There must be less reliance on interest rate adjustment and more on co-operation between central banks. There would have to be an EC-wide trade policy which contributes to balance of payments stability for individual members. There must be a co-ordinated EC-wide growth policy. The pound would have to enter at a rate and on conditions which ensured that British goods became and remained competitive'.



### THE EUROPEAN MONETARY SYSTEM (EMS)

The EMS came into existence on 12 March 1979, following agreement between Heads of Government in the previous December. All countries in the European Community are members of the EMS, with their currencies included in the ecu basket, and depositing reserves with the European Monetary Co-operation Fund (EMCF). All except the UK, Greece and Portugal are members of the Exchange Rate Mechanism (ERM). The system was established by a Council Resolution, and the operating procedures of the ERM are laid out in an agreement between central banks.

#### ECU

The ECU (European Currency Unit) is a central element of the EMS. Its value is calculated as a basket of set amounts of each Community currency.\*

By agreement, these amounts must be reviewed at least every five years. They were last changed in September 1989, when the coverage of the ECU was extended to the Spanish peseta and Portuguese escudo.

#### The Exchange Rate Mechanism (ERM)

Germany, France, Italy, the Netherlands, Denmark, Belgium, Luxembourg, Ireland and Spain all participate in the EMS exchange rate mechanism. Each of these countries has a central exchange rate for its currency against the ECU. These central rates can be "realigned", if necessary, by mutual agreement of the participants. From these ECU central rates, bilateral central rates are calculated for each currency against all the other

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\*One ECU is currently equivalent to the sum of 8.784 UK pence, 0.1976 Danish krone, 62.42 German pfennigs, 1.44 Greek drachmas, 3.301 Belgian and 1.332 French francs, 0.2198 Dutch guilder, 0.8552 Irish penny, 0.13 Luxembourg franc, 151.8 Italian lire, 6.885 Spanish pesetas and 1.393 Portuguese escudos.



participating currencies. Margins of  $\pm 2.25$  per cent ( $\pm 6$  per cent for the lira and peseta) are used to set "floor" and "ceiling" rates around the bilateral central rates and these are the limits within which central banks are obliged to maintain the value of their currency.

Unless there is a realignment, central banks have an unlimited obligation to intervene in the foreign exchange markets when their currencies reach the margins. The central banks participating in the ERM open to each other unlimited credit lines in their own currencies for this purpose, but any drawings must be repaid after a short period. Other longer-term but limited financial support facilities are also available.

The UK, Greece and Portugal do not participate in the ERM.

#### UK position on sterling's participation in the ERM

Following the Madrid Summit in June 1989, the Prime Minister reaffirmed to Parliament the UK Government's commitment to join the ERM when the level of UK inflation was significantly lower, there was capital liberalisation in the Community, and real progress had been made towards completion of the Single Market, freedom of financial services and strengthened competition policy.

#### European Monetary Co-operation Fund (EMCF)

The EMCF administers the exchange rate mechanism and intervention mechanism of the EMS. It issues ECU to the EMS central banks, including the Bank of England, in exchange for deposits by them (renewed every three months) of 20 per cent of their gold and dollar reserves. (These exchanges are purely notional: gold and dollars do not change hands and the central banks continue to earn interest on their dollar deposits.) These official ECU can then be used within agreed limits for settling the debts incurred between central banks in the operation of the EMS, but they are not marketable and cannot be used for other purposes.