FILE

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

PERSONAL

19 July 1990

Thank you for your letter of 17 July and its enclosure. Your prediction as to the likely reactions to paragraph 2(b) were absolutely correct. It is incompatible with the majority view of the House of Commons.

Incidentally, Poehl did not take the line in paragraph 4 of your letter when he came here.

C. D. POWELL

Sir Michael Butler, G.C.M.G.

(2)

HAMBROS BANK LIMITED

41 Tower Hill London EC3N 4HA Telephone: 071-480 5000 S.W.I.F.T.: HAMB GB 2L Telex: 883851

This is not uncooperative of Michael - especially as we have endorsed so many of his proposals. Whether he is proposing it fiddly contributing to the House of Commons approval will go well with the Italians

Prime Minister
You will not like 2(b), but the rest seems all right.
CDP 18/7.

17th July 1990

Charles Powell Esq
No 10 Downing Street
London SW1

Dear Charles,

As I told you on the telephone, I have been invited to talk to Sarcinelli (Italian Treasury) and Padoa Schioppa (Bank of Italy) on Friday before the Ecofin Council next Monday. They wish, in particular, to discuss the way in which our Stage 2 proposals could be given institutional effect.

2. I have therefore prepared the attached short paper. I know that the Government has not yet taken a position on this question and I shall make it abundantly clear that the paper does not have its approval. It merely illustrates the way in which our proposals for a hard ecu managed by an EMF could be put into effect by agreement in the IGC. On the other hand my aim has of course been to devise arrangements which would in the last resort be acceptable to the Government.

3. I know that para 2(b) may cause difficulties for the Prime Minister. But as I told her in April, I am sure that we cannot get agreement without going at least that far. To rally to our side the Italians, Spaniards and others who do not like the Pöhl approach, we need to accept that the aim of EMU is to move one day to permanently fixed parities or more probably a single currency. As you will see, the attraction of my proposal is that it only lays down the Charter of the EMF for Stage 2 and leaves for unanimous decision later the possibility of amendment for any move to Stage 3.

4. The Pöhl approach is doubly unattractive. He made it clear to me that he expected the IGC to create his European Central Bank in full charge of EC monetary policy in Stage 3 and lay down that national central banks shall become wholly independent of national governments and Parliaments. Stage 2 would then disappear and Stage 3 would begin with those countries able and willing to form a D-mark zone. He uses the analogy of the EMS of which we were founder-members while staying out of the ERM. To allow this to happen would be disastrous for the

Not what he said to me

City. The Central Banks of participating countries, mainly of course the Bundesbank and the Bank of France, would act as the operating arms of what he calls the European Central Bank System (ECBS), not European System of Central Banks (ESCB) which I have taken from Delors and used in my paper in a rather different sense. So the Bank of England would be cut out and open market operations on ecu interest rates and exchange intervention to maintain the ecu parity would take place in Frankfurt, Paris and Amsterdam. In my view, there would be a massive movement of business out of the London market, both as a direct result of these arrangements and as a consequence of international banks and other companies becoming convinced that London could not remain the principal financial centre in the European time zone outside EMU.

5. I do not believe that the Chancellor and the Governor of the Bank of England will be able to persuade their colleagues to rally to our plan unless they can soon explain what our alternative proposals are for the institutional arrangements. So I hope the Prime Minister may agree to set work on this in hand. As I said when I saw her I think that it is vital to have a properly coordinated campaign, so that all concerned know what they have to do and speak with one voice. I remain at the Prime Minister's disposal if she would like to use me in any way for this purpose.

6. I have sent copies of the enclosed paper to officials but am not copying this letter elsewhere.

7. I should much welcome an opportunity for another discussion with the Prime Minister before the summer holidays.

Yours ever

Michael

Sir Michael Butler

MDB/JSD

EMU

Proposed institutional arrangements for Stage 2

1. The objective would be to create a system for Stage 2 under which only those things which need to be decided centrally are put under the control of the European Monetary Fund (EMF).

2. (a) The Treaty would create a European System of Central Banks (ESCB) consisting of the twelve national Central Banks and a European Monetary Fund owned and run by the Central Banks, to be operational from day one of Stage 2.

X (b) It would also lay down the aim of permanently fixed parities or more probably a single currency in Stage 3. ??

(c) The aim of price stability would be in the Treaty and in the Charter of the EMF.

(d) The Charter of the EMF would be annexed to the Treaty which would provide that it could be changed by unanimous agreement as necessary.

(e) The Treaty would provide that National authorities (Central Banks, Governments or Parliaments) would not seek to influence EMF policy contrary to its Charter.

3. In addition to the aim of price stability, the Charter of the EMF would provide that in Stage 2 the ESCB shall co-ordinate national monetary policies and the EMF shall control ecu monetary policy. It would create the hard ecu and provide that it should be managed so as to be always as strong as the strongest currency. It would contain the two

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golden rules - no monetary financing of budget deficits and no money creation to replace national currency converted into ecus. It would provide for convertibility of national currencies into and out of ecus and for the EMF to be a lender of last resort in ecus. It would lay down that the exchange risk on national currencies converted into ecus would rest with the National Central Banks and would provide for the sanctions in my statement to the Schmidt/Giscard Committee.

4. The Chairman of the EMF Council would report to the European Parliament and to Ecofin annually in writing and be available to them in person to answer questions when required.

5. Arrangements for Stage 3 would no doubt require amendments to the EMF Charter but not necessarily to the Treaty. It would be wise at this stage only to create the ESCB as required for Stage 2. No-one can fully foresee at present what will be required for Stage 3.

6. National Central Bank Governors could retain their existing relationships with national Parliaments and Governments and could report to national Parliaments if so desired (provided always that 2 (e) above was respected).

MDB/MML

2nd July, 1990