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~~copy~~ GAP The care for
lettering to PM with
this seems to me very
~~the~~ thin! But I leave
it to your discretion.

MR. P. R. GRAY
10 DOWNING STREET,
LONDON
SW1

Your reference

Our reference

Date

21 JUNE 1989

RLE6
u/6

Dear Mr. Gray,

EUROPEAN MONETARY COOPERATION.

Mr. Alex Allan has asked me to send you a copy of the attached copy letter from Jenkinson (bonn) to Turner (fco) which covers an english translated transcript of Loehls speech in Cologne on 8 June. Loehl handed a copy of the speech to Sir Peter Lebrue (Adviser to the Governor) when he was in Frankfurt on 13/14 June. Loehl suggested that the sidelined extracts should be seen by the Prime Minister.

Yours Sincerely

Jan Polin

I. POLIN (MGI
DIVISION)

P.S. Please excuse the manuscript - severe lack of typing facilities today!



BRITISH EMBASSY

Friedrich-Ebert-Allee 77 5300 Bonn 1

Telex 88 68 87 Telephone (0228) 23 40 61

R L Turner Esq
ECD(I)
FCO

Your reference

Our reference

Date

15 June 1989

Dear Hugh

EUROPEAN MONETARY COOPERATION

1. Sir Peter Petrie, the newly appointed Adviser to the Governor of the Bank of England, visited Frankfurt and Bonn on 13 and 14 June. Among other appointments he was able to see the President of the Bundesbank. The discussion with Pöhl turned mostly around the Delors Report, I understand.

2. Pöhl gave Sir Peter the text in German of a speech he had made in Cologne on 8 June to a meeting of German savings bankers. Pöhl said that he was disappointed that press reports of his speech had omitted any reference to remarks he had made about EMU. He side-lined the relevant section for Sir Peter and underlined two pieces in particular. He asked Sir Peter to ensure that his remarks were read in London (I have also faxed it to PS/Governor of the Bank of England at Sir Peter's request) and he suggested that the Prime Minister would find them interesting.

3. I have had that section of Pöhl's speech translated and I attach a copy. I have underlined the words which Pöhl himself thought important.

Yours

[Signature]

E Jenkinson

*Mr. Wides
Mr. Peretz
Miss. O'Mara
Mr. Symes
Mr. H.P. Williams.*

*To see and
Please note X in
particular.*

Ian Polin

19/6/89.

cc: I Polin Esq
HM Treasury

I Tower Esq
Bank of England

Translation

Extract from a speech delivered by the President of the German Bundesbank, Karl Otto Pöhl, to the German Savings Banks' Congress in Cologne on 8 June 1989

The stability of the Deutschmark is also an important pre-requisite for the further development of the European Monetary System on the path to European Monetary Union with the corresponding institutional framework, as described in the report by the so-called Delors Committee. My favourite sentence in the report was: "Moreover, the system has benefitted from the role played by the Deutschmark as an "anchor" for participants' monetary and intervention policies."

I cannot deny feeling a certain sense of satisfaction that this statement was unanimously accepted by all the members of the committee, especially the EC Central Bank Governors. Criticism that the policies of the Bundesbank give the EMS a deflationary bias and prevent other countries from fulfilling their full growth potential can therefore be considered unfounded. We have always rejected these arguments. In reality, the success of the EMS is due to the fact that those countries which form the hard core of the EMS have meanwhile achieved a very high degree of convergence in their economic policies. The inflation rate in France and Belgium is about the same as that in the Federal Republic. In Holland, the figure is even lower. Italy continues to have a higher inflation rate and this explains why Italy still requires broader margins of fluctuation ten years after the founding of the EMS. Without agreement on economic policy objectives and without an efficient common policy to achieve these objectives, progress towards an Economic and Monetary Union is therefore inconceivable. Without these basic pre-requisites, institutional changes would automatically lead to disappointment and eventually prove a failure.

European Economic and Monetary Union is no longer a utopian vision. We are already engaged in a dynamic process in this direction which I believe is irreversible.

Market forces and economic necessities will ensure that restrictions on the free movement of goods and services, the freedom of establishment and finally also on the money and capital markets have to be removed to an increasing extent. It is no longer a question of "whether", but "how" and "when" an Economic and Monetary Union is established. The British criticism therefore misses the point. In this respect, the so-called Delors Report sounds promising since it emphasises principles which the Federal Republic stressed in the Werner Report and on several other occasions, namely parallel integration of economic and financial policy on the one hand and monetary policy on the other, the opening of markets not only within the EC but also vis-a-vis third countries, and the need to give price stability priority over all other objectives in a future European Central Bank constitution and to ensure the independence of a European Central Bank System. But of course there is still a long way to go. The British Government is not the only one which has difficulties in accepting the transfer of sovereign rights to supra-national institutions. That goes for the Federal Republic too. For example, the creation of a European Central Bank System equipped with real monetary policy powers to take decisions affecting interest rates and liquidity, would require far-reaching changes to the Bundesbank Act and I do not know whether there would be broad agreement for such changes in the Federal Republic in the foreseeable future. But that certainly applies to other countries in Europe as well. It is therefore difficult to imagine that countries like Italy or Spain, which make the loudest calls for Economic and Monetary Union but do not even observe the rules of the European Monetary System, could subject themselves to the much stricter discipline of an Economic and Monetary Union.

Institutional changes based on an amendment to the Treaty of Rome may be necessary one day. But in my opinion, it would be a serious mistake to begin inter-governmental negotiations on this at an early stage as some people have suggested. There is an implicit danger here of a serious breach within the European Community as well as the danger of such negotiations ending in failure and disappointment as we have experienced on several previous occasions. I need only remind you of the fate of the Werner Report. So if we advise caution, this does not mean that we are against Economic and Monetary Union, but that we assess the chances realistically.

More important than amendments to the EC Treaty and the creation of new institutions is the need to expand existing developments towards an Economic and Monetary Union and to implement those decisions which have already been taken. This applies primarily to the creation of a Single European Market. There are difficult decisions, e.g. on harmonisation of indirect taxes, still to be taken in this area. I believe one should not strive for too much perfectionism. A certain degree of harmonisation of framework conditions in a common market is certainly necessary, but this leaves a great deal of room for competition between the legal systems. In the final analysis, this is of greater benefit to the people than harmonisation at any price which could only lead to over-bureaucracy and perfectionism. This also applies to the "taxation of investment income" which I do not consider a pre-requisite for an Economic and Monetary Union.

Just as important as the removal of trade barriers and other restrictions on the trade in goods and services is the liberalisation of the capital market which was agreed last summer under the chairmanship of the then Federal Finance Minister, Gerhard Stoltenberg. To my mind, the Directive on the liberalisation of the capital market is one of the most important decisions taken in the EC for a long time. The

liberalisation of the capital market is by no means a concession for which one could expect reciprocal gestures, as one hears from some of our neighbours on the other side of the Rhine. The commitment is already set out in the Treaty of Rome. Moreover, we cannot expect progress towards Monetary Union unless restrictions on the capital market are lifted at the same time. The free movement of capital is one of the two pre-requisites for Monetary Union. Anyone who wants Monetary Union must liberalise the capital market. This does not have to produce uncontrollable movements of capital by any means. Experience shows rather that the opposite is true. Those countries which have gradually or, like the Federal Republic, long since liberalised their capital movements have registered an influx rather than an outflow of capital. Of course, a free capital market requires a corresponding financial and monetary policy which receives the confidence of investors but, in my opinion, it does not require the harmonisation of taxation on capital gains or the possibility of recourse to controls if a currency comes under pressure. Investors must be convinced that the liberalisation of the capital market is irreversible. Then countries which lift restrictions on their capital market can expect an inflow of capital and a strengthening of their currency.

The other element of Monetary Union besides a liberalisation of capital markets is the final fixing of exchange rates. We are of course a long way from being able to fix the exchange rates irreversibly in the EMS as envisaged for a Monetary Union in the Werner Report. A common European currency would only be possible after we have achieved this position. Exchange rates would then lose their function as an important instrument of adjustment and monetary policy would bear the main burden. But since the French Government radically altered its economic policy in 1983, changes in exchange rates have been rather the exception among the hard

core of the EMS. The state of fixed but still flexible exchange rates has therefore already been achieved in part of Europe. However, it is more than just a blemish that some EC Member States are either unwilling or unable to accept the rules of the system. This applies not only to Great Britain, but also to Spain, which has declared its intention to join in the next 12 months, and to a certain extent Italy, which still requires special conditions 10 years after the founding of the EMS. The first step towards European Monetary Union therefore ought to be for those countries, which either do not participate in the exchange rate mechanism of the EMS or only with special conditions, to create the domestic pre-requisites for full participation. This means above all reducing their inflation rate and keeping their interest rates at the necessary levels to enable them to participate in a system of fixed exchange rates in Europe.

As long as the anchor function of the Deutschmark in the EMS is guaranteed, I see good chances for further progress on integration. We must therefore ensure that this anchor does not become a drag anchor. The institutional pre-requisites for closer economic, financial and monetary cooperation among EC Member States already exist (ECOFIN, Monetary Committee, Committee of EC Central Bank Governors, EMS Treaty). No new Treaty and no new institutions are required for the time being. The existing room for manoeuvre should first be fully exploited before far-reaching institutional changes are considered.

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Pöhl doubts need for EC bank

By David Marsh and Andrew Fisher in Frankfurt

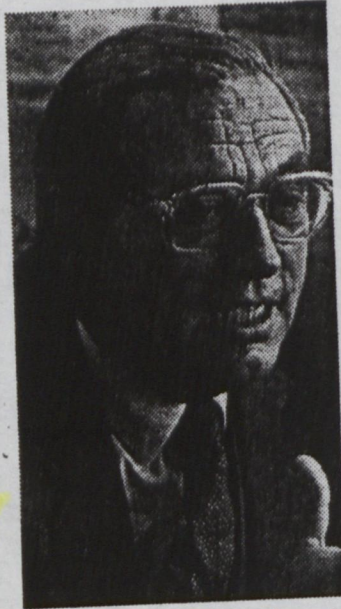
MR KARL OTTO Pöhl, president of the West German Bundesbank, has cast doubt on whether the Bonn parliament would agree to transfer sovereignty over monetary policy abroad - a necessary step to establish a European central bank.

His remarks, in an interview with the Financial Times, showed clearly the differences among the West German authorities on monetary union.

Mr Helmut Kohl, the Chancellor, this week spoke in favour of a European central bank, modelled on the Bundesbank's independence and commitment to price stability.

Mr Pöhl believes the West German Government is underplaying the difficulties of establishing such an institution. Echoing the arguments of Mrs Margaret Thatcher, the British Prime Minister, the Bundesbank chief claimed the Government has not fully spelled out the implications of loss of monetary sovereignty.

Mr Pöhl said creation of a joint central bank was "not necessary" to move towards European monetary union. On limiting the monetary policy powers of the autonomous Bundesbank - as part of a



Mr Pöhl: central bank not a condition for union

move to create a European bank - he said: "I have considerable doubts whether there would really be a majority for this in Germany."

The Bundesbank president is trying to counter the impetus for the European central bank proposals that has been built

up in West Germany above all by Mr Hans-Dietrich Genscher, the Foreign Minister.

Mr Pöhl said it would be possible to achieve monetary union without either a European central bank or a common currency. It would be necessary for member states to liberalise capital controls and fix their exchange rates permanently. He said it would take "many years" for the economic convergence of the present low-inflation EC countries to spread throughout the Community.

He pointed to the difficulty of deciding where a central bank should be sited - a question of "absolute importance" - as an indication of the political problems involved in setting up such an institution.

Mr Pöhl said a joint central bank might eventually prove "useful" in a global process of European integration.

He said he did not fear a resurgence of revaluation pressure on the D-Mark. "On the contrary I would welcome it." The devaluation of the D-Mark over the past 18 months against the dollar and European currencies was not desirable, he said.

Man in the news, Page 7

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MAN IN THE NEWS

Mr Karl Otto Pöhl, president of the Bundesbank, has, unlike Mrs Margaret Thatcher, no difficulty in establishing his credentials as a supporter of European monetary integration.

Mr Pöhl, 59, has a contract running to the end of 1995 at the top of Europe's most powerful central bank. As guardian of the D-Mark, the Bundesbank controls the pivotal currency in the European Monetary System (EMS). It also enjoys statutory independence from government and is seen by many as a model for a possible future European central bank. In his post since 1980, Mr Pöhl has played a vital part in making the EMS work. For all these reasons, Mr Pöhl's qualms about the European Community's path towards monetary union, outlined this week at the Madrid summit, must be taken seriously.

In an interview on Tuesday at the Bundesbank's headquarters in Frankfurt, Mr Pöhl made clear that, in intellectual terms at least, he shares considerable common ground with Mrs Thatcher. However, Britain – outside the exchange rate mechanism of the EMS, and with an inflation rate well above the Community average – is arguing from a position of weakness. Mr Pöhl has the strength and anti-inflationary record of the Bundesbank behind him.

He points out that the fundamental decisions on monetary union are political, to be taken by governments, not central banks. He favours extending co-operation built up in the EMS, and in several recent speeches has called the move towards monetary union "irreversible." But he also affirms: "The Bundesbank can live very well with the status quo."

Mr Pöhl says monetary union needs neither a central bank nor a common currency. The definition of monetary union is that it requires European countries to fix exchange rates permanently and to dismantle all barriers to capital movements. A European central bank is "not necessary at all" in the process of monetary convergence. Such an institution could well be "useful," but only as part of an overall policy – following the goals originally laid down in the Treaty of Rome – towards political and not simply economic union.

Mr Pöhl does not want the Bundesbank to give up jurisdiction over German monetary policy to a future European central bank unless it can be guaranteed that a supranational institution would do an equivalent or better job of

Karl Otto Pöhl Sceptical champion of EC monetary integration

By David Marsh and
Andrew Fisher

maintaining price stability. He also thinks this condition will be insisted on by the West German electorate and parliament.

He believes the basic issue over the European central bank proposals – the transfer of monetary sovereignty away from the present national institutions – has been grasped by relatively few people, one of whom is Mrs Thatcher. There is some doubt whether this has been understood by Chancellor Helmut Kohl. "If the idea spread and the (German) population understood what it is about – namely that it centres on their money, and that decisions on it would be taken not by the Bundesbank but by a new institution – then I would imagine that considerable resistance might arise," Mr Pöhl says.

He is a breezy, cosmopolitan man who combines surprising sensitivity with a taste for irreverent quips and bright retorts. He sits at the head of what is arguably his country's most-respected post-war institution, but can sometimes appear impatient at the Germanic stiffness of the central banker's life.

The Bundesbank chief has been a member of the Social Democratic Party since 1948, but no longer plays any role in the party. He is clearly out of sympathy with the present SPD leadership's economic thinking. He lives with his second wife and two children in the hills outside Frankfurt and

keeps his home life thoroughly private.

Despite some brushes between the two men in 1987-88, he praises as "very constructive" his 6½ years of co-operation with Mr Gerhard Stoltenberg, the former Christian Democrat Finance Minister, who left office in April to take over as Defence Minister. Like Mr Stoltenberg, Mr Pöhl is somewhat suspicious of the impetus given to the European central bank theme by Mr Hans-Dietrich Genscher, the Foreign Minister.

Mr Genscher is seen as having a much better idea than Mr Kohl of the issues involved, as well as possessing the political skills to mount a convincing campaign towards attaining them. The new Finance Minister, Mr Theo Waigel, certainly has a sense of humour – an asset in Mr Pöhl's eyes – but appears preoccupied with affairs in the Bavarian Christian Social Union, of which he is chairman. Moreover, Mr Pöhl has not forgotten that Mr Waigel spoke out against him when his first eight-year term of office came up for renewal in 1987.

A former economic journalist, Mr Pöhl was a protégé of Chancellor Helmut Schmidt, serving as state secretary at the Finance Ministry in Bonn during the 1970s before moving to the Bundesbank as vice president in 1977. His long period on the international financial circuit since the

breakdown of fixed exchange rates in 1971-73 has taught him to distinguish between the desirable and the attainable in world monetary affairs. It has also given him a fine understanding of power-play.

The Bundesbank's autonomy under the 1957 law setting it up inevitably exposes it to unpopularity. "At least the Government (in Bonn) is used to the central bank putting up interest rates when it does not suit them," Mr Pöhl remarked, half-mischievously, on Tuesday. Two days later the Bundesbank was at it again, raising its discount and Lombard rates by half a percentage point to rein in the money supply and strengthen the D-Mark.

Mr Pöhl calls for great care in preparing an inter-governmental conference to lay down stages towards European economic and monetary union. This would include the questions of changing the Treaty of Rome and setting up a European system of central banks. "A treaty which provided for renunciation of sovereignty would have to be ratified by all European parliaments – a very ambitious project," he says. "I think one should not start on such a venture unless there is a good chance of finishing the process."

"If the danger of failure was judged relatively great – and it is my view that it is relatively great, to start with at least – then it would be better to wait. Failure of negotiations

on such a treaty would be the worst possible outcome. It would bring a great setback to the whole process, because then such a thing would not be discussed again for several years."

Mr Pöhl emphasises the need first for the creation of the EC's planned single market, for the abolition of all capital controls, and for all Community members (including Britain) to participate fully in the EMS. He also stresses that convergent policies are much more important than new institutions. "It is much more sensible to implement what has already been decided."

He says it will be "many years" before the EC as a whole attains the economic convergence seen in the countries which now all have inflation rates of about 3 per cent – Germany, the Netherlands, France and Belgium. He confesses himself "somewhat surprised" by the views of countries like Italy or Spain. They are the most enthusiastic about setting up a common central bank. But, benefiting from a wider band of allowed EMS fluctuations, they also have the greatest difficulties in subjecting themselves to the discipline of the present system. "I ask if they realise that, in a monetary union, they would have to adapt their policies to much further-reaching discipline."

Mr Pöhl says he is "very sad" that Britain has not joined the EMS fully, but rules out membership as long as the UK inflation rate is so high. Britain's participation would add to "the intellectual level of discussion" on EMS problems, he says, and would also back up West Germany's fundamentally liberal ideas on the Community's economic development.

Looking back on nearly 10 years as Bundesbank president, Mr Pöhl is pleased above all at German success in bringing down inflation virtually every year since he took over. He also finds it gratifying that he was given his post by an SPD government and then reappointed under the conservatives. He admits, with a smile, that, if the SPD had still been in power in 1987, it might have chosen someone else.

Looking to the future, Mr Pöhl says: "A European central bank system which would be independent and geared to price stability would be a great success. If the Bundesbank were to be replaced by such a system, on a satisfactory basis, then I would depart with greater ease. But, during my period of office, I am not quite certain whether that will be the case."

