

FROM: Sir C Tickell

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PS/PUS

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## EMS AND ECU

1. As requested in Mr Jay's minute of 19 January, I submit papers prepared with ECD(I) and ESID on the related themes of the European Monetary System (EMS) and the private use of the European Currency Unit (ECU) for consideration by DUSs at their meeting on 24 February. It would, I think, be right for DUSs to consider these questions at the same time.

## EMS

2. The purpose of the EMS paper is to bring out the arguments for and against our joining the Exchange Rate Mechanism (ERM) of the EMS. Personally I believe that it may slightly understate the damage which instability in the currency markets has done to Western economies since the break-up of the Bretton Woods system in 1971. Uncertainty is the enemy of investment.

3. The fundamental political argument for full British membership of the EMS with participation in the ERM is similar to that which caused us to join the European Community itself: in short that it profoundly affects us; that it is better to have a guiding hand from within rather than try to influence it from without; and that we should play a full part in an institution whose future could determine the growth of the Community as a whole. At present we are in a kind of half-way house. Already now, and more in the future when the Community is again enlarged, there is a tendency for members to form operational groups for functional purposes. In such circumstances we would not want to find ourselves anywhere but in the central group - in effect the Germans and the French - on the key questions comprised in the development of the EMS, which could eventually evolve towards some form of economic and monetary union.

4. It will not be easy to choose the right moment to join the EMS if Ministers so decide. As we found when we eventually joined the Community itself, moving buses are hazardous to catch. Once we had failed to join the EMS at the beginning, there were always arguments to suggest that the time had not come. Sometimes sterling has been too strong, sometimes it has been too weak. We now confront the likelihood, discussed in the paper, that the Deutschmark will appreciate against sterling as well as the US dollar, and that if we were to join tomorrow, we might all too soon have to change whatever

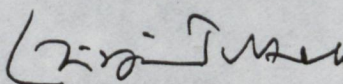
peg we chose for sterling and anyway introduce instability into the system. This is something which will obviously need very careful discussion. At all events we want to be ready to move forward if and when the time looks right. I suspect that whatever the circumstances we shall have to accept some measure of risk.

5. At the DUSs's meeting we shall need to consider how next to proceed. I think myself that once we agree on the two papers, they should be submitted to the Secretary of State with a recommendation that he should talk to the Chancellor of the Exchequer as soon as possible after the Budget. You will recall that FCO Ministers meeting at Chevening in December agreed that this would be desirable. My own discussions with Treasury officials suggest that the Chancellor is keenly interested in the whole problem. There is also plenty of interest in Brussels and elsewhere. The Commission is already in touch with the Treasury on the subject. The annex to the paper on EMS suggests some of the points which require further study. The main burden of such studies would of course fall on the Treasury and the Bank of England, but I hope that the FCO could be involved.

ECU

6. The Secretary of State has asked about the advantages and disadvantages of our pursuing a more positive line than that encapsulated in the nihil obstat which describes the present position of the Bank of England. The second paper brings out the arguments clearly. The fact is that there are no obstacles to the use of the ECU for private transactions in Britain where there are no exchange controls. Were there similar freedom in other member states, the use of the ECU would probably grow faster than it already has. If the market has developed in a more leisurely way in London than in one or two other Community capitals, this mainly reflects special factors (for example exchange control in France and Italy) and the judgement of the market in London. Little can be done about this. Here you will wish to see the conclusions of the paper.

13 February 1984

  
Crispin Tickell

## THE EUROPEAN MONETARY SYSTEM

Introduction

1. The purpose of this paper is first to examine the advantages and disadvantages of possible British membership of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in the light of recent developments; and secondly to consider the implications for future British policy.

Historical Background

2. The EMS was set up in March 1979 with the aim of creating a "zone of monetary stability in Europe". The essential components of the EMS are:

- (a) a European currency unit (ECU);
- (b) an Exchange Rate and Intervention Mechanism;
- (c) a credit mechanism
- (d) measures designed to strengthen the economies of the less prosperous States in the EMS.

3. EMS was envisaged as the first step towards European Economic and Monetary Union (EMU). But the pre-conditions for EMU - the total elimination of internal barriers against trade and services, mobility of capital and labour, a Community-wide system of taxes, harmonisation on a Community basis of aids to industry etc - do not exist and are not likely to do so in the foreseeable future, and the move to the second stage of EMS - the consolidation of the system through the establishment of a European Monetary Fund and the development of the ECU as a reserve asset - which was to have taken place two years after its setting up, has been indefinitely deferred.

4. The numeraire (denominator) of the existing system is the ECU, a composite monetary unit containing fixed quantities of each EC currency (except the drachma). Each currency participating in the ERM has a central rate against the ECU and, deriving from it, against other currencies. Central banks are obliged to intervene to keep their currencies within 2.25% (6% for Italy) of their

central rate against the ECU and against the other ERM currencies. The system implies fixed exchange rates but periodic adjustments have been made. The latest of these was on 21 March 1983 when the French franc was devalued and the DM revalued. These readjustments have been agreed by Finance Ministers meeting in a format similar to that of an ECOFIN Council; ie, under the Chairmanship of the Minister whose country holds the Presidency at that time.

5. HMG is formally a member of the EMS but decided in 1979 not to participate in the ERM. The change of government which took place soon afterwards did not affect this decision. The new government opposed full participation in the exchange and intervention mechanism on the grounds that it would have kept the pound sterling at an artificially high rate, hindering economic activity and requiring intervention at a rate that conflicted with the tight monetary policy being pursued by the British Government.

6. Nevertheless, the United Kingdom does play a part in the EMS. Sterling is assigned a notional central rate and this is adjusted to reflect its value at every realignment of the EMS. If of significant size, this adjustment can affect the central rates of all other ECU currencies. On occasions, due to sterling's wide fluctuations since 1979, the impact has been considerable. However, since sterling's central rate remains unchanged between realignments, these fluctuations have no implications for the intervention obligations of ERM members.

7. Sterling's detachment from the system has enabled the Chancellor to play an important role at realignment meetings. For example, Sir Geoffrey Howe presided over the meeting on 21 February 1982 during the Belgian Presidency when the Belgians were seeking a large devaluation of the FB and there was a need for impartial chairmanship.

8. The Government has kept the question of sterling's participation in the ERM under review and has stated publicly that

it would join when the time was right, both for Britain and for the system as a whole.

#### Recent Developments

9. There have been a number of developments relevant to the debate about British membership of the ERM since the subject was considered at a special meeting chaired by the Prime Minister's meeting on 22 January 1982 and at which the Chancellor, the Secretary of State and the Governor of the Bank of England participated. The EMS has demonstrated its durability and flexibility. Sterling is less obviously over-valued in relation to other EMS currencies than in previous years. Oil prices (to which sterling has been sensitive) are relatively stable. The British inflation rate has fallen below the Community average and to within two percentage points of the FRG's. The potential incompatibility of our monetary objectives with adherence to an exchange rate target within an essentially DM-denominated system is consequently less than hitherto. Indeed, in his Mansion House speech in November 1983, the Chancellor confirmed that the exchange rate had a role as an indicator of monetary conditions. It may be that full membership of the EMS could now begin to have attractions as a possible anti-inflationary discipline.

10. The House of Lords Select Committee on the EMS chaired by Lord O'Brien which reported in July 1983 concluded that the balance of advantage lay in early, though not necessarily immediate, British participation in the ERM. Professor Jim Ball of the London Business School also came down in favour of British membership in his recent report (with Michael Albert) to the European Parliament on economic recovery in the 1980s. Also in September 1983 a Commission paper on the Other Policies chapter of the post-Stuttgart negotiation (COM(83)578 Final) recommended that steps should be taken to promote the role of the ECU and that the ERM should be extended to all Member States. During his visit to London in November, M Ortolini raised the issue briefly and said that he would wish to come back to it with the Chancellor in 1984. A senior Commission official visited the Treasury in late January

1984 to follow up and discussions are now engaged.

11. The rise in the value of the dollar in recent months and the widespread expectation that this movement will sooner or later be reversed has led to growing interest in a co-ordinated European response. It is relevant to observe that the two major steps by which the EMS reached its present stage of development occurred at times of considerable turbulence in international markets. The seminal Werner Report was published in 1970 following the early signs of disintegration of the Bretton Woods system. The Jenkins/Schmidt initiative in 1977-8 which led to the establishment of EMS as we know it was in response to the international recession associated with the first oil price shock; to the growing belief that more monetary stability was desirable; and the feeling that the Community should take steps to ensure that Member States' economies were not adversely affected by a world monetary system dominated by a currency, the dollar, over whose management we had no control. A new bout of currency instability resulting from a rapid fall in the value of the dollar could conceivably lead to calls for the enhancement of the role of the EMS.

#### The Political Case for Joining the ERM

12. The main political factors in favour of joining are:

(a) The United Kingdom ought to be party to all activities regarding the development of the Community. We should never repeat our mistakes which led to our self-exclusion from the process which led to the signature of the Treaty of Rome. Other things being equal it is desirable that we should participate fully in the EMS. This would give us the chance to steer it in a direction consistent with British interests.

(b) So long as we are not in the ERM we strengthen the argument that we are not committed members of the Community. To join would be a telling demonstration of that commitment. This would have particular value in the post-Stuttgart negotiations which are designed to set the Community on a new

course.

(c) Our line that we shall join when the time is right is less and less convincing to our partners. The longer we absent ourselves, the more difficult it will be to join as habits harden in other moulds.

13. But the political case cannot be assumed to be beyond question. Our entry could cause problems for the other members, and if the system were subsequently to collapse, whether or not as a result, we might attract the blame. More significant is the possible domestic political impact: if, as is quite possible, maintaining an EMS rate involved unpopular policy measures such as higher interest rates, this would scarcely enhance enthusiasm for Community membership. Indeed, its present unpopularity might reduce the effectiveness of a constraint expressed as a European obligation (by contrast with France, where the need to maintain the EMS parity is seen as reinforcing the case for tough measures).

14. On balance however, the political arguments in favour of British participation are persuasive. As economic circumstances become more favourable to our joining the political considerations could assume greater importance.

The economic case for joining the ERM

15. This can usefully be evaluated in terms of the effects on:-

- (a) British economic policy;
- (b) European integration
- (c) external constraints on European economies; and
- (d) development of the international monetary and exchange system.

These aspects are, of course, closely related. The policy debate in Whitehall has hitherto concentrated on various aspects of (a),

but points (b) - (d) are also important, both in their own right and also because they impinge on (a).

British Economic Policy

16. The case in terms of British economic policy for joining boils down to the following:-

(a) provided we enter at a reasonably competitive rate, stability with regard to our main trading partners is desirable in its own right, primarily in reducing business uncertainty;

(b) large fluctuations ('overshooting') might be reduced by affecting expectations (because there is a presumption of action by the authorities both in Britain and in other EMS countries to limit them) and because of the practical provisions of the system (additional intervention resources etc);

(c) the link with what is, in effect, a DM zone reinforces anti-inflation policy;

(d) while there remains a possibility of conflict between monetary and ERM objectives, the danger is much less than previously because British performance is now closer to that of the FRG. In practice monetary and ERM objectives may be mutually reinforcing; if conflict persists, there is always the option of realignment.

(e) joining the ERM at an early stage might complement the tighter domestic policies which would be necessary to combat the inflationary effect of any depreciation in the value of sterling consequent upon a realignment of the dollar.

17. At a technical level the issue would be how to reconcile a new exchange rate priority with our existing priority on monetary aggregation.



European Integration

18. Even if the theoretical importance of joining the ERM as a step which would lead towards EMU can be ignored (there is for the time being no impetus to move even towards stage two of the EMS), the more modest reality of the ERM could be helpful in promoting mutually profitable integration. The habit of consultation required inter alia by realignments has grown, and may help to promote consistency of policies. The operation of the CAP, and agreement on price restraint, might be easier if exchange rates were more stable. Inter-Community trade problems are more likely to be manageable in such circumstances.

External Constraints

19. One of the most pressing bones of international contention is the effect of US interest rates on the rest of the world. European governments complain that high US interest rates (generally attributed to the size and apparent persistence of the US Government's budget deficit) face them with the choice between keeping up their own interest rates to avoid currency depreciation and allowing their exchange rates to fall as the price of more acceptable real interest rates. The former inhibits recovery, while the latter increases inflationary pressures.

20. The latter course might be less damaging, and the dilemma less acute, if all the European currencies moved together. The increasing interdependence of EC trade (including Britain's) means that externally generated price pressures for any individual country would then be less significant, and recovery might be hastened at less inflationary cost. Moreover, the pressures on the US to put its house in order might be increased (although there is the hazard that it could be resolved by increased trade protection).

The International Monetary and Exchange Rate System

21. The recent strength of the dollar is but the latest of a series of sharp fluctuations in exchange rates since floating began in 1971. It is widely agreed that there have been severe

damaging misalignments ("overshooting"), and that efforts should be made to reduce them. There is also little dispute that the main ingredients for reducing these problems are policy consistency among countries and convergence of economic performance. This is not, however, inconsistent with measures aimed explicitly at exchange rates. These can take the form both of arrangements for intervention and on margins such as the ERM and of more general commitments by Governments to align policies in such a way as to keep exchange rates within broad target zones.

Expectations in the market can be influenced by measures of the latter type, although the effects are likely to be stronger if they are complemented by relevant practical measures.

22. These questions, as well as wider issues of development of the international monetary system, are likely to be a major item on the agenda of the London economic summit. US reluctance to contemplate interference in the exchange markets may limit progress, although there have been signs that attitudes are changing. The point may be approaching at which these matters will at last be seriously examined; the influence of the European voice in such discussion will depend largely upon the coherence of the European monetary authorities and of their positions. This might be stronger after a period of British membership to the ERM. Moreover, our part in determining European positions may also be stronger in such circumstances.

#### Economic arguments against Membership

23. A reversal of the recent strength of the dollar is widely perceived as likely, if not imminent. Were this to happen the DM would almost certainly strengthen against sterling. The size and strength of the German economy would make it the major refuge for funds coming out of the dollar, driving the DM up also against EMS currencies and sterling. Because the mechanisms of the ERM would tend to dampen the former movement, sterling would probably fall relatively further. If this were the case it could be argued that HMG should wait to join the ERM until at least some of this realignment had recurred. If sterling were to join earlier and

then be forced to devalue, this would be damaging for public opinion in Britain and perhaps for the system itself.

24. A second reason for caution is sterling's petro-currency role; although oil prices are unlikely to show as much instability as in the 1979-83 period, prospects remain uncertain. It is also worth asking whether membership of the ERM might not change expectations and hence the degree of coincidence between oil price movements and the sterling parity.

25. There are also domestic economic arguments against joining:  
(a) although precautions can be taken to minimize the danger of inconsistency, there will always be the possibility of conflict between monetary and exchange rate targets, particularly in the face of unforeseen shocks. Manifestly, those most closely involved judge that we should give priority to monetary objectives in such circumstances. Committed membership of the ERM would require interest rate policy to be linked to exchange rate objectives with the possibility that monetary aggregates could be relegated to secondary importance.

(b) Understandably, those who would have to execute a policy which contained the possibility of inconsistency do not relish the idea of blame for failing on one count or the other: hitting one target is difficult enough.

(c) The possibility of holding a fixed exchange rate in the face of powerful market movements is questioned. Taking the strain partly on the exchange rate and only partly through intervention has long been preferred.

(d) There is a strong aversion among some of those most closely involved to fixed rates, the EMS, and to interference in markets.

26. To these arguments might be added suspicion of proposals which involve sharing with outsiders decisions affecting management of the British economy.

Conclusions

27. A decision on Britain's adherence to the ERM must continue to rest primarily on the economic arguments. Although in recent months the economic arguments for an against membership have become more balanced; the expectation of a significant fall in the value of the Dollar remains a powerful argument to suggest that the time is still not right. Considerations of competitiveness and the difficult of managing entry when exchange rate relativities are changing rapidly mean that the arguments for joining would be stronger once this expected readjustment (which seems likely to involve the relative parities of DM and sterling) had taken place. On the other hand those who give primacy to price stability could argue that entry ahead of any thoroughgoing realignment would assist in maintaining the current policy stance.

28. The interest of the Foreign and Commonwealth Office is to ensure that the political case for joining, and particularly the need to ensure that we are not left out of important EC developments, is never lost to view. We also need to guard against the possibility that we might miss a chance to join at a propitious moment because the essential preparatory work had not been done. This is an argument for a study of the technical issues both within Whitehall and with the Commission. (The annex to this paper suggests some points for study.) This could lead to a more open debate on the fundamental issues and might convince our partners of our sincerity when we say, as we are bound to go on doing if we are not to be thought to be going backwards, that we will join when the time is right. These studies could also lead us to adopt a more collaborative and European approach to the problems of establishing a greater degree of exchange rate stability which could be threatened in the not too distant future by the fate of the dollar.

Annex

POSSIBLE PREPARATORY STUDIES ON UK MEMBERSHIP OF THE ERM

1. We need to consider the implications for the ERM of British adherence. Strains could rapidly reappear within the system if sentiment turned against the dollar and capital flowed towards the DM. Could the ERM cope with a DM and a £ which tended to diverge?
2. If this were to happen, the burden of adjustment would not fall upon the United Kingdom alone. We need to consider the consequences for both the United Kingdom and the Federal Republic of a serious effort to hold their rates together.
3. In the longer term we need to have a clearer picture of what we are trying to achieve. Do we wish to see target zones for exchange rates? Do we wish to see practical measure to introduce 'viscosity' into exchange rate movements? Do we regard decoupling Europe from the influence of US interest rates as a desirable or practical
4. The issue of how best to bring about permanent parity changes. A "market-determined crawling peg" in which central rates change gradually and mechanically in response to past divergences from the central rate is a possible alternative to large step changes.
5. A separate though related question concerns the role of the ecu. We need to consider whether there is anything which can legitimately be done without interference in the market to influence or encourage the use of the ecu, which is increasing of its own volition.  
(See separate paper)

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THE PRIVATE USE OF THE ECU

1. The growing private use of the European Currency Unit (ECU) is perhaps one of the surprises of the European Monetary System (EMS) experience. In terms of an eventual Economic and Monetary Union (EMU) the development of a parallel European currency is a long term goal. But the European Commission has always been keen to encourage private use of the ECU in the meantime, and originally believed that such would follow from greater official use of the ECU. Instead private use now seems to be ahead of official use, involving a number of non Community agents and in spite of capital and currency controls across the Community.

2. These developments have taken the form of accelerating growth of Eurocurrency markets based on the ECU. In the main these have been bond markets but during 1983 bank and official medium term credits began to catch up. During the first ten months of 1983 total bonds and credits issued amounted to 3.3bECU which compared with 2.1bECU in 1982, 500mECU in 1981 and 20mECU in 1980. The main countries involved in these markets are Italy and France, but Ireland, Denmark, Greece, Belgium and the United Kingdom (via an issue by Rank Xerox) have also been the source of smaller issues. Outside the Community, American, Canadian, Japanese, Spanish and Scandinavian institutions have also issued bonds or credits. Nonetheless the ECU market share remains small, amounting to only 4% of total Euro bond markets.

3. There is also evidence that the ECU is being increasingly used to invoice foreign trade within the Community and by some traders outside it.

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4. The underlying reason for lenders, borrowers and traders using the ECU or any currency bundle is risk avoidance. Any transaction must offer both sides some advantage in terms of expected stability of value or level of interest rate over dealing in domestic currency or other foreign currencies (including the constituents of the ECU basket).

5. The relative fixity of exchange rates of the currencies within the ERM gives the ECU some of its attraction but in principle the same considerations apply to the individual currencies as well as the basket. Another advantage at least for citizens of member states is that their domestic currency forms some proportion of the basket and hence bears no exchange risk; but again in principle the difference in interest rates obtainable on domestic and ECU instruments ought to compensate for any expected change in exchange rates. The reality is that exchange rate changes can be sudden and particularly in high inflation countries interest rate differentials may be difficult to interpret and fears of a sudden collapse of the currency greater than reflected in foreign exchange markets. It is certainly suggestive that the main growth in the market has been in high inflation, weak currency countries, Italy and France in particular.

6. There may also be specific institutional reasons. Italian firms felt themselves over exposed to dollar risks and hence began to borrow in ECU. Italian investors, because of a relaxation of currency laws in favour of the ECU, had the opportunity to lend in ECU, thus hedging against Italian inflation. Both sides were in effect setting up a domestic bond market which did not previously exist. Non-EC institutions probably raised money in ECU simply to diversify the exchange risk on their debt, or to allow themselves to borrow currencies such as French Francs which they were otherwise not allowed to hold.

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The private use of the ECU in Britain

7. The United Kingdom has taken a relatively small part in the market, with only one bond issue originating here. Lloyds Bank International is one of the major European banks taking deposits in ECUs, which are second only to their US dollar holdings. Nonetheless, and in spite of rapid growth, by the end of September 1983 British Bank ECU liabilities were only one quarter of one percent of British dollar claims, and 2% of British deutschmark liabilities.

8. There have been, subsequent to the abolition of exchange controls in 1979, no obstacles to British citizens or institutions holding ECU or carrying out any transactions they wish in ECU. This is the basis of the Bank of England declared policy of Nihil Obstat. It needs to be recognised that the absence of exchange controls by itself is a more positive policy than in other member states where exchange controls or, in Germany's case, domestic currency laws may prevent nationals holding ECUs. It is also worth noting that the Treasury is willing to accept loans from the EIB denominated in ECU.

9. So why has development been slow in Britain? Ignorance must certainly be a factor. But the underlying reasons are probably in the current balance of payments/exchange rate position.

10. First, the strong balance of payments has meant that Britain has been a net capital exporter in recent years; a feature emphasised by the portfolio adjustment which took place after the abolition of exchange controls. Second, the decline in both inflation and the public sector borrowing account may have increased demand for sterling assets while reducing supply. Thus there has been no need of official financing in ECU or indeed other foreign currencies, as there

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was for instance in the late 1970s when the budget deficit and the balance of payments deficit were both large.

11. British absence from the Exchange Rate Mechanism (ERM) of the EMS has meant that potentially the ECU rate fluctuates more against sterling than against other member currencies, thus negating some of the apparent advantages to traders of invoicing in ECU. In any case for private individuals and firms, the strength of sterling against European currencies in recent years has probably argued against the ECU as a currency hedge of any importance in trade.

#### Outlook for future use of the ECU

12. In general, a bout of dollar weakness might prove helpful to the future development of ECU based Euromarkets but the main structural improvements would come from a general dismantling of barriers to capital movements within the Community, and in particular a change in attitude by the German central bank towards the ECU. Currently it prevents German citizens holding ECUs. Against these, the possible entry of Greece, Spain and Portugal will reduce the attractiveness of the currency basket to traders in particular.

13. There is also need for a general clearing mechanism for ECUs. Currently banks with small deposits are forced to split them up into constituent currencies at the end of each trading day. Such a mechanism is under active consideration.

14. In Britain a shift from a surplus on the current balance to a deficit would increase demand for loans in foreign currencies. The fact that around 14% of the ECU is in sterling and that there are weak as well as strong currencies in the basket would reduce the exchange risk on ECU denominated borrowings and hence make them more attractive. A weakening of sterling might also increase the demand by exporters to

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Britain for ECU invoicing and hence for ECU accounts.

15. The Commission is currently looking for three positive steps to improve the use of the ECU - none of which provide any substantive difficulty for Britain:-

- a) that all member states recognise the ECU as a foreign currency. Effectively this is aimed at the Federal Republic;
- b) that the ECU is officially defined and copyrighted;
- c) that ECU issues are open to EC citizens wherever they reside, thus giving ECU an advantage particularly where exchange controls operate.

(a) and (c) are already operational in Britain, and (b) is dependant on (a) happening in other member states.

A more positive British policy

16. British membership of the ERM might encourage the use of ECU in Britain particularly if sterling were expected to be among the weaker members. Short of membership of ERM there are a number of possible policy initiatives HMG could undertake to increase use of the ECU:-

- a) instruct the Bank of England to use the ECU among its reserve assets and to intervene in the market for it;
- b) issue Government borrowing instruments in ECUs;
- c) encourage local authorities and nationalised industries to make foreign borrowing in ECUs, particularly loans protected by the Public Sector Exchange Cover Scheme;

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d) publicise the ECU as a monetary asset for trade and investment purposes to raise consciousness of the ECU in Britain.

17. On (a), at present the market would probably be very thin and such a facility would do little good by itself. In any case in circumstances where there was the possibility of differential movements against EMS currencies (eg the DM and the French Franc) it would probably be more efficient to trade direct. Only the Italian Central Bank is currently doing this, against a background of 10% of trade invoiced in ECU and a substantial domestic credit market denominated in ECU. Starting with the Central Bank hardly seems sensible for the United Kingdom.

18. On (b) the issue of government borrowing instruments in ECU would probably be strongly resisted by the Treasury and the Bank of England. There is currently no problem in funding Government borrowing on the Gilt Edged market and some sterling bonds are bought by foreigners. Nor is there any need to finance a balance of payments deficit. Hence the issue of a foreign currency bond could be interpreted as HMG signalling a wish or an expectation that sterling should fall.

19. On (c) there might be less resistance to other Public Sector bodies, who are in any case borrowing overseas, directing their borrowing to ECU. This would give an extra hedge to the Exchequer for those loans insured against exchange rate movements under the Public Sector Exchange Cover Scheme. But even this route would not be very attractive unless there is a substantial risk that sterling would depreciate less against the ECU than - say - the US dollar.

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20. On (d) it would hardly be for HMG directly to undertake publicity to promote the private use of the ECU, although it might let it be known that it had a benevolent attitude towards it. The Eurocurrency markets are largely based in London and the operators on them are sophisticated. It is unlikely that there is anything that HMG could tell them that they do not already know. With private individuals, government advice to hold ECUs might be seen as encouragement to speculate against the currency or at least an indication that British inflation was likely to rise above the EC average. It is possible that the Commission might wish to undertake a Community-wide publicity campaign, aimed at traders in particular but also perhaps covering private individuals, to encourage the use of the ECU. As HMG has no exchange controls this would do no more than recommend what is already allowed. Any campaign would probably founder on German opposition.

21. The European Parliament has suggested the issue of a one ECU coin as publicity and to give substance to the ECU. Given that no prices are set in ECU (beyond the CAP) and that Banks are reluctant to accept even high value coins in foreign exchange dealings, this would look like a gimmick and in the short term could be counter productive. Any commercial initiative to issue ECU travellers cheques is much more realistic. It is possible that such papers as the Economist may be launching campaigns of their own to propagate the use of the ECU as something the City might exploit in order to develop its role as the main European financial centre.

#### Conclusion

22. HMG has placed no barriers against the private use of the ECU, and has preferred to leave its development to market forces. It would be hard actually to promote it without raising doubts about the governments intentions, but in

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certain circumstances HMG might look favourably on ECU denominated borrowings under the Public Sector Exchange Cover Scheme. Publicity from whatever quarter might alert dealers and traders to the opportunities for greater use of the ECU, but the responsibility for such use and the advantages it might bring to the City must be for the judgment of those concerned.

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