Approaches to EMU

*The **Governor** discusses[1] some of the considerations that will be central to the debate on the later stages of European monetary union, highlighting four broad principles that any future arrangements, whatever their form, will have to respect if they are to provide the flexibility that will be needed. These principles are:*

- *that monetary policy must be dedicated to the achievement and maintenance of price stability: and that, therefore, those responsible for its implementation must be given a mandate to pursue stability and the instruments to make that mandate effective, and must have the operational autonomy to employ those instruments for the desired end;*
- *that the techniques by which price stability is pursued should work with the grain of market forces, not against it;*
- *that the monetary authorities must be accountable for the fulfillment of their mandate; and*
- *that the relative roles of the centre and the national central banks in any new monetary arrangements should be determined by reference to the principle of subsidiarity—ie powers should be exercised centrally only where it is essential for the effective pursuit of common objectives.*

It may seem a little out of tune with the theme of this conference that I should be speaking today about developments in Western Europe—and perhaps equally odd to be discussing major questions concerning the future of the European Community while in Salzburg. But historically and again today Austria has been a key bridge between East and West. And surely everyone agrees that the success of the reforms being implemented in Eastern Europe will depend in some degree on the continued unity and prosperity of Western Europe, as well as on assistance from individual Western European countries.

Later today, we shall be discussing the '1992' project, which I believe has the potential to have major effects on economic relations and trade in the Community.

But possible future developments in the Community's monetary arrangements could have even more profound implications—certainly for central bankers! I am therefore going to highlight a series of considerations which I believe *must* be borne in mind during the EMU debate if Western Europe is going to develop successfully in the period ahead.

On the whole, the EMU debate has so far followed the Delors Committee's suggestion that the path to full EMU could be seen as being divided into three stages. In a formal sense Stage 1 of the process is set to start on 1 July this year, but in fact it is already underway since it involves implementation of the 1992 programme, the lifting of exchange controls and closer consultation on economic policies, as well as all member states being members of the ERM.

By contrast, the form to be taken by the later stages of monetary union is still a matter of debate and controversy. Intensive discussions are going on in the Monetary Committee, the EC Central Banks Governors' Committee and ECOFIN. An intergovernmental conference will begin in December 1990 to discuss steps that might be taken, including the possibility of Treaty change.

As you will probably know, we in the United Kingdom would have preferred to see discussions focus on concrete and practical next steps towards monetary and economic integration. It remains our view that the best way forward would be to harness existing institutions and market structures in such a way as to bring about a common convergence to price stability and, as a result, to more stable exchange rates. The process of monetary integration could then proceed in an evolutionary manner, with each step taken in the light of concrete experience and without commitment to a detailed end-objective.

(1) In a speech at a conference organised by Salomon Brothers, in Salzburg, on 11 May.

It is clear, however, that many of our Community partners would prefer to try to define an ultimate goal, and to use that vision to determine the path by which it is approached.

This makes the debate on the later stages of monetary union more important. If that is the approach that is adopted, it would make the process harder. And it would make mistakes more likely. A good deal of the current discussion is focusing on the institutional structure that might underpin monetary union. I do not propose to enter into that debate today. Nor do I propose to discuss transitional issues—how we might get from Stage 1 to the next step on the road to closer economic and monetary union. This is an extremely important issue, to which we *must* soon turn our minds, but it would take me too far from my main theme today. The difficulties of transition do, however, point up the need for flexibility in our approach to the design of any new arrangements.

And I therefore want to focus on how this necessary flexibility could be provided and on the broad principles which future arrangements, whatever their precise form, will need to respect.

A good starting point, it seems to me, are four principles that I believe are widely accepted by all parties. The first is that monetary policy and therefore any new monetary arrangements must be dedicated to the achievement and maintenance of price stability. This objective must underlie the design of whatever decision-making arrangements are put in place.

The second principle is respect for market forces. The techniques by which price stability is achieved, if they are to be effective and sustainable, will have to work with the grain of market forces, and not against it.

The third principle is that of accountability. Monetary authorities cannot be permitted to be impervious to the consequences of their actions. Means must be found which ensure an appropriate degree of responsiveness to the will of elected representatives.

The fourth principle is that of subsidiarity. Any form of monetary union would naturally entail that certain powers previously exercised by national authorities in individual member countries would have to be exercised collectively. But the essence of subsidiarity is that powers should be exercised centrally only in those areas where it is essential for the effective pursuit of common objectives.

How can we design arrangements that meet the objectives of price stability, respect for market forces, accountability and subsidiarity?

Price stability

Let me deal first with the requirements of price stability and respect for market forces. Whether there is a single monetary policy for Europe or a collection of co-ordinated national policies, those responsible for implementation must be given a *mandate* to pursue price stability, the *instruments* to make that mandate effective, and must have the *operational autonomy* to employ those tools for the desired end.

As far as the *mandate* is concerned, I consider it essential that the objective of price stability be clearly set out as the basic purpose and philosophy of any body charged with setting and implementing monetary policy. It might be desirable to go further than this, and to attempt a definition of price stability. In New Zealand, for example, the contract entered into between the Governor of the Reserve Bank and the Government specifies that the Reserve Bank of New Zealand must bring down inflation to under 2% per annum by a given date. (Then, of course, it becomes necessary to specify the index used to measure inflation for this purpose—no easy task. In Europe, consumer price indices are the most familiar measure of inflation, but they differ in important respects between countries, and are anyway not necessarily the best indicator of the strength of inflationary pressures.)

I do see certain advantages in a transparent definition of a price stability objective. Nevertheless, too precise an objective could be counter-productive, limiting the operational flexibility of monetary policy. Some, therefore, might prefer to leave the precise nature of a price stability objective more general, perhaps employing the formula suggested by Chairman Alan Greenspan of the US Federal Reserve Board—a level of inflation where inflation expectations cease materially to enter into business and household financial decisions.

Others might prefer even less precision, leaving the objective undefined, and relying on the integrity and good sense of the decision-making body to interpret 'price stability' as seems most appropriate in the circumstances.

I do not want to express a firm view on this today, but I am clear that the specification of a price stability objective is an important issue that we shall *have to* address as we move to closer monetary co-operation in the Community.

Concerning the *instruments* of policy, monetary authorities must have the power to influence the volume and the price of credit in such a way as effectively to achieve their ultimate objective—ie to maintain a stable level of prices. Over the years, central banks have used a wide variety of techniques to influence the price and quantity of credit. With experience, however, I believe most central banks have come to the conclusion that market-based instruments, as opposed to direct controls, are to be preferred because they achieve their effect with less distortion. I therefore believe that we should establish a clear presumption that the instruments to implement monetary policy would have to be market based. That is to say, they should operate through central banks' operations in the major financial markets, rather than through placing direct constraints on financial intermediaries.

At this juncture I want to address a subject which a number of commentators have argued lies at the heart of monetary management; namely, whether central banks should set the objectives for their market operations in terms of a quantity or a price, in other words a rate of interest. Some argue that there is a fundamental distinction between those two approaches on the grounds that they lead to totally different processes through which monetary influences are transmitted into the real economy. I believe this to be a misconception. Price and quantity are two sides of the same coin. In an efficient market with no distortions, any restriction in the quantity of credit available will result in an increase in its price (ie, the interest rate) to the point where the demand for credit falls back to equilibrium with the availability of credit. Precisely the same result could be obtained by raising the price of credit so that the quantity demanded falls. I do not believe that financial markets in most EC countries are so far removed from the abstract of 'efficiency' as to justify a different conclusion; and the growing influence of the single European market will help to remove inefficiencies where they exist.

There nevertheless remains an important question about how far, and how precisely, the conduct of monetary policy is to be guided by quantitative norms. The inflationary problems of the 1970s led to universal recognition of the importance of basing monetary management on the behaviour of nominal magnitudes if inflation was to be successfully overcome. However, our own experience in the United Kingdom in applying that approach made us uncomfortably aware of the pitfalls of tying policy too *mechanically* to the performance of monetary aggregates, at a time when rapid changes were taking place in the financial system. It seems to me certain that some of the changes experienced in the United Kingdom in the past decade will affect other parts of the Community as the single market becomes established.

So I think the path of wisdom will be to seek to use nominal indicators not as a mechanical formula for guiding the course of Community monetary policy, but rather as part of a broader assessment of monetary and economic developments. In practice, all major central banks operate in roughly the same way, taking guidance from whatever indicators they have adopted in order to arrive at an immediate operational objective for short-term interest rates. They use their short-term market operations to create an incipient shortage of liquidity, which they then relieve by purchases of short-term assets at prices of their choosing. In this way they control the level of short-term interest rates and thus, eventually, the level of demand for credit.

What does this mean for the design of instruments in an economically integrated Community? Even if in time interest rates come to be similar—or the same— in all Community countries, that does *not* mean that the same short-term market techniques would have to be employed in each major financial centre.

Some countries use reserve ratios as a fulcrum for their short-term market operations; others do not. Some countries use repurchase operations to influence short-term interest rates while others rely mainly on outright purchases of securities. All of these variations in technique have grown up in response to specific market conditions, traditions and institutional structures. There does not seem to me to be any reason why we should force the operating techniques of the individual national central banks into a common mould. However close we come to a common framework of Community monetary policy, I therefore envisage flexibility in the instruments employed in individual centres. Eventually, of course, the instruments used in each centre might converge to a similar pattern. This would be normal, and indeed healthy, provided it were in response to market forces, and not imposed *ex ante*.

Let me turn now to the issue of the *operational autonomy* which is required for a successful stability-oriented monetary policy. If it is accepted, as I think it is, that monetary arrangements must be dedicated to price stability, certain inevitable consequences follow. Most obviously, monetary authorities must be free of potentially conflicting constraints on their actions. Other objectives of policy—for example supporting other general economic objectives —must be subordinate to the goal of price stability. Moreover, those responsible for the conduct of policy must be in a position where they can undertake actions that may be unpopular in the short-term but are needed for the longer-term health of the economy.

Two aspects of operational autonomy deserve more attention. The first concerns the inter-relationship between internal monetary policy and foreign exchange policy—as European monetary integration proceeds this would of course mainly mean policy towards non-EC currencies, and particularly the dollar and yen. According to one argument, a monetary authority must be responsible for foreign exchange intervention policy if it is not to allow an important channel of liquidity creation to pass out of its control. According to another argument, governments have always been responsible for exchange rates, and in many cases governments own foreign exchange reserves. Both arguments have a measure of validity. What the debate points up is the fact that one *cannot* have independent domestic and external policies without the potential for conflict. If price stability is the paramount objective, foreign exchange policy must be consistent with this. Whether this consistency is achieved by making the central banks responsible for exchange rate policy, or by providing for close consultation between government and the central banks, is a practical rather than a fundamental matter.

The second aspect of operational autonomy that I want to discuss concerns a central bank's responsibility for the health of the financial system. Some feel that this responsibility should not be entrusted to a central bank, on the grounds that concern for the health of the financial system can get in the way of the primary objective of price stability. I do not agree. Since their inception, central banks have been responsible for the health of the financial and payments system. We have learned, I hope, to distinguish between the overall needs of the system for liquidity, and the needs of individual institutions for support. I believe that an institution that is intimately involved in the financial markets is best placed to supervise banks, regulate the payments system and, if the need arises, provide liquidity support. The extent to which such a function should be provided at Community level rather than by national monetary authorities is another matter. But I have no doubt that the exercise of regulatory and prudential responsibilities is quite consistent with operational autonomy in the field of monetary policy.

Accountability

I should now turn to another of the major principles that must underlie any arrangements, that of accountability. Whenever a body is entrusted with important powers, the issue of accountability is bound to arise; and indeed it should.

There can be no question of any monetary arrangements being created outside a properly constituted legal structure. The powers of monetary authorities must be granted by law, limited by law, and revocable by law.

As I have already indicated, any arrangements devised will require a well-defined mandate for price stability. This could be done in a number of ways. It could be prescribed in a Treaty or granted by the political authorities and made subject to revocation. Other routes would be possible but, whatever the method, the autonomy granted for the pursuit of monetary policy objectives would have to be the *limited* autonomy to pursue that prescribed mandate.

Accountability also embraces the requirement to explain and defend policies to public opinion, and to its elected representatives. The United States provides a constructive example in this regard. The Chairman and other members of the Board of Governors of the Federal Reserve System regularly present testimony to Congressional committees. They are closely questioned by members of Congress on the reasons for, and the implications of, the Federal Reserve's actions. Most observers believe that this process has an important effect in sensitising the Federal Reserve system to public opinion and, in many cases, influencing the direction of Federal Reserve policy. Without wishing to endorse the precise details of the American procedure, I believe that something along these lines would have to be a characteristic of the accountability of future European arrangements.

Subsidiarity

This leaves the question of subsidiarity. 'Subsidiarity' is one of those ugly jargon words that is perfectly familiar to anyone who is a regular visitor to Brussels, but probably incomprehensible to most of the rest of the world. It is the principle that powers should be transferred to the centre only when it is not possible to exercise such powers effectively at the regional level.

While the general principle itself is accepted, rather little thought has yet been given to the question of how it should be put into practice. At the most general level, the question has to be asked: what should be the relative roles of the centre and the national central banks in new arrangements for monetary policy-making in Europe? My answer to this is clear: the expertise, standing and traditions of the national central banks are an important resource. Any future arrangements must seek to harness these resources, and not seek to supplant them with a separate and independent construct.

What does this mean in practice? And is it compatible with the needed independence of the monetary policy-making authority? Let me answer these questions by considering several of the key functions that have to be performed, whatever the arrangements. First, the formation of monetary policy. There can be only one monetary policy in a monetary union, which implies a single source of ultimate decision-taking. But even if that came about, this need not, and should not, jeopardise the role and contribution of the national central banks. Community monetary policy will emerge from the collective deliberation of the national central bank Governors, whose position in any new arrangements will be pivotal. I would therefore envisage a decision-making body composed largely of the Governors of the national central banks. They would need to have the operational freedom to take decisions in the best interests of the Community, and they would bring with them the insights and perspectives of their respective institutions. While they would doubtless have a central research staff (indeed one is in the process of being established for the existing EC Central Bank Governors' Committee), that need not and should not displace national central banks' expertise and knowledge of local markets.

Beyond policy-making, of course, lies policy implementation. Europe has—and will continue for the foreseeable future to have—a number of *large* financial centres. This differentiates it from the individual national economies that comprise the Community, where in general one centre is dominant. It also differentiates it from the United States, where New York is the pre-eminent financial centre. Policy implementation means operating in major markets, and successful market operations require a familiarity with local institutions and techniques. It would be foolish to try to second-guess the expertise of the national central banks. Whatever the arrangements, it would be possible to concert closely the market operations of particular national central banks, while delegating to them the specifics of their operating techniques.

Consider next the function of banking supervision, and the regulation of the payments mechanisms. Most (though not all) EC central banks have statutory responsibilities in the field of banking supervision. The discharge of these functions requires close contact with, and intimate knowledge of, the operations of the commercial banks that are supervised. For some time to come, this familiarity is likely to be much more available to national central banks than to a newly-created, and perhaps distant, European institution. As banking markets become increasingly integrated, an intensification of co-operation among banking supervisors in the Community will inevitably occur. In due course, this may call for certain powers to be exercised at the European level. But there is no reason to displace national arrangements that have so far worked well.

Lastly, I want to touch on the question of reserve pooling. Clearly, in a monetary union there would have to be a single foreign exchange intervention policy. And even short of such full union, a considerable convergence of intervention policy will be required. This would—and does—*not,* however, necessitate pooled ownership of reserves. It is perfectly possible to pursue a common exchange rate policy, with jointly agreed intervention, while limiting reserve pooling to operational balances. (Indeed, one could even envisage no reserve pooling at all, but with a mechanism to share out the profits and losses arising from individual central banks' operations.)

The EMU debate is entering a critical stage. Stage 1 is, in substance, already underway and accepted by all as bringing major benefits. Minds are turning to beyond Stage 1—and, in particular, to what any new institutional arrangements should look like. For myself, an evolutionary and gradualist approach is attractive, but the debate on Stage 3 institutions is already underway. Whatever the framework that emerges from that debate, it is vital that it respects the principles I set out at the beginning of my remarks—the principles of price stability, market-orientation, accountability and subsidiarity. Respect for these principles seems to me much more important than the precise form of whatever arrangements evolve within the Community.