Approaches to monetary integration in Europe

*The **Governor** highlights*[1] *a number of difficulties that will be encountered in any approach to economic and monetary union in Europe. He argues that the United Kingdom's 'Hard Ecu' proposals would offer a coherent way of addressing these difficulties, without prejudging the eventual destination of the process. They provide for institutional development but avoid the risks of premature locking of parities; they would promote greater economic convergence, which is an essential condition for monetary union; and they allow the establishment of a common Community currency which could become a single currency for Europe if in due course that was the wish of peoples and governments.*

It is a very great pleasure to be here today for a number of reasons. This is my first visit to Germany since unification, and what could be a more appropriate venue than Berlin? It is my first major public speaking engagement in another Community country since the United Kingdom joined the exchange rate mechanism. And, although it is hardly the first time I have shared a platform with Karl Otto Pöhl, it is a pleasure to do so again; central bankers see a good deal of each other but rarely get the chance to share thoughts in a public forum.

Sterling's entry into the ERM just over two weeks ago was hardly as momentous as German unification—but perhaps a little more so than my being here with Karl Otto and was certainly an extremely important step in the United Kingdom's economic life. It was something we had been committed to for a very long time. That commitment was, I am very well aware, widely doubted. Those doubts could only be put to rest by the actual act of joining, and yet the commitment was qualified—and had to be qualified—by prudence. It was absolutely essential—for the United Kingdom and for the existing members of the system—that we waited until the inflationary pressures in our economy were abating—as I am confident they now are.

We joined only when we judged that we could make a success of membership. And for similar reasons we have joined the wide band rather than the narrow band because our present economic circumstances require us to maintain substantially higher short-term interest rates than the narrow band countries. But we will move to the narrow band when that too can be done with confidence of success. So far, the reaction in the markets has been positive, and we have successfully negotiated the transition from the initial and welcome euphoria to a more stable and perfectly suitable trading range.

Given some of the recent speculation about our motives for joining, I should perhaps make it clear that we wanted to be part of the Community's anti-inflation club. Joining therefore has two elements: it signals our determination to defeat inflation in the United Kingdom and also to participate fully in a key Community institution. This commitment is also seen in our whole-hearted support for the single market, which is based on the principles of open markets and free trade that have traditionally been at the heart of UK economic policy.

But while we are strongly committed to the 1992 project and the disciplines of the ERM, it is hardly a secret that the United Kingdom has doubts about the approach of many countries to economic and monetary union.

Even so, there are here many more points of agreement than are perhaps appreciated. All of us, for example, are agreed that greater convergence of economic performance in the Community must be an objective. Without it, we cannot have a true single market, in which business decisions can be taken on a rational and long-term basis. Without it, we will certainly not see the sustainable non-inflationary growth across the Community which the German authorities have so successfully sought over the years and for which we in Britain are equally keen.

I think it is also common ground—at least between President Pöhl and myself—that convergence is still far off in the Community, although much has been done, particularly among the narrow band ERM members. For example, in the year to July (the latest period for which full information is available), there were three countries in the Community with three or more times the rate of consumer price inflation ruling in Germany. Even among the members of the narrow band, over the same period retail price inflation ranged from 2.3% in the Netherlands to 5.7% in Italy.

(1) In a speech at the Deutsche Bank/ECU Banking Association Conference in Berlin, on 25 October.

If you look at other key economic indicators, the same lack of convergence is evident. In the last full fiscal year, the public sector's financial position ranged from a surplus (as a percentage of GDP) of about 1.8% in the United Kingdom to a deficit of 10.4% in Italy, and as much as 20.9% in Greece. Current account positions also vary widely, though here it is harder to be sure what is appropriate and sustainable.

We have to recognise that all the countries of the Community may well not complete this convergence within the time-scale that some have proposed—that is to say, by 1993 or 1994. This appears to me to be a reality that we need to recognise. But equally it should not cause distress. Indeed, we have perhaps become a little dismissive of just how much is being attempted in the single market programme and of just how much is involved in the commitment for all EC members to join the exchange rate mechanism with narrow margins.

More generally, it is clearly possible to hold widely different views about EMU. Frankly, I am surprised that so many people can hold such precise views at this early stage as to the exact nature of the union they wish to see and the route they wish to take. Of course we need to think ahead about ways in which we *might* move forward and to establish the consequences of particular institutional and other steps. And it is in that very spirit that I have taken an active part in the discussions of the Central Bank Governors on possible future central banking structures in the Community.

But it would be unnecessary, and highly undesirable, to rush into premature commitments which would deny us the flexibility that unknown future developments will undoubtedly require. Further changes must be soundly based in economic reality and have the widest political support. If not, those who wish to make the most haste may in the end undermine their own cause. The Community is not subject to the political or economic imperatives which lay behind German economic and political unification.

In particular, I am concerned that proposals for a quick move towards a single currency would involve giving up a tried and trusted system—that of the exchange rate mechanism based on the anchor of the deutschemark—for an untried system—that of a new European System of Central Banks. The ERM, with its deutschemark anchor, has been instrumental in bringing about the remarkable anti-inflationary convergence that has been achieved so far in some countries (though, as I suggested earlier, there is still a long way to go in others). Monetary stability is so absolutely important to our economic prosperity that we need to be sure that any new institutional mechanism is strong enough to deliver it before we abandon the existing arrangements.

It may be asked—perhaps, if I may say so, particularly here in Germany—why the Community cannot simply establish a new institution in the mould of the Bundesbank and allow it to operate as the Bundesbank has done, with effective political and operational autonomy. There would be two problems with this approach. First, it is not at all clear that such a high degree of autonomy would be politically acceptable in the Community as a whole. Secondly, it would fall into the trap of assuming that if we simply created an independent central bank, with a mandate to pursue price stability, we would necessarily achieve our objective. This seems to me to be unduly simplistic. However independent a central bank is in principle, it cannot be impervious to the pressures of public opinion or indifferent to public support. It must rely for its legitimacy on the public's aversion to inflation, and to the public's trust that potentially unpopular short-term measures of restraint will be justified by longer-term benefits. The aversion of the German people to inflation—an aversion born of historical experience—has been augmented by a realisation that price stability provides the best basis for sustained and stable economic growth. But the Bundesbank has acquired its reputation as an inflation fighter after a long period of skilful monetary management, and it is this that gives the Bundesbank its credibility and legitimacy.

A new institution would begin with no such inherited credibility or legitimacy. If, in addition, it began its life in circumstances where there were significant divergences among member countries in inflation performance and budget deficits, as well as in underlying living standards, it could be faced by very great pressures. There is a point beyond which a central bank, however independent in formal terms, cannot ignore such pressures if it is to retain its political acceptability. It would be unfortunate (at best) and disastrous (at worst) if a new Community central banking institution was required from its inception to play a critical role in the Community, without having established counterinflationary credentials.

The British proposals, based on a Hard Ecu managed by a European Monetary Fund, are designed to address some of these difficulties. They would enhance economic convergence in the Community without prejudging the final goal. But equally the Hard Ecu could eventually lead to a single currency if that was what governments, peoples and markets wanted.

The proposals are intended to achieve a number of objectives. *First*, they acknowledge the desire of many Community countries to maintain the momentum of institutional development by establishing, at a relatively early date, a Community monetary institution with meaningful powers. *Secondly,* they seek to avoid the risks that would flow from a premature locking of parities before adequate convergence in economic performance. But at the same time, *thirdly,* they are designed to promote further convergence in economic performance beyond Stage 1. *Fourth,* they allow the establishment of a new *common* Community currency which could eventually become a single currency for Europe if market developments made that economically feasible and desirable *and* if such a thing emerged as the wish of people throughout the Community. *Finally,* this way of going forward would give the Community an opportunity to gain invaluable experience in joint management of a common money, without abandoning the tested system of the ERM, and without confusing, in the process, the responsibilities of national and Community monetary authorities.

But over and above all of these advantages is the fact that the Hard Ecu would have firm anti-inflationary credentials. The United Kingdom's overriding concern in proposing the scheme was that it should not fall foul of the criticisms levelled at previously-mooted parallel or thirteenth currencies. I can understand that, before a careful examination of our proposals had been undertaken, they might have been felt to suffer the same pitfalls—pitfalls which would, I totally agree, make the Hard Ecu a non-starter. But it avoids those pitfalls. And if I may say so, I would not be here arguing for it if the Bank of England were not totally persuaded of that point. The Hard Ecu would be a sound currency.

Obviously, I cannot just assert that, however, so I shall explain some of the proposal's details. First, the Hard Ecu is defined so that its central rate *vis-à-vis* other Community currencies could never go down. In other words, in any realignment of exchange rates within the ERM, its value would match that of the strongest currency.

Furthermore, the European Monetary Fund, the institution established to manage the new currency, would be given a mandate to pursue and attain price stability and would therefore plainly need to enjoy the necessary operational autonomy to fulfil that mandate. The EMF would be empowered to issue ECU liabilities, on demand, when holdings of national currencies were surrendered to it. Intervention techniques for the EMF would be devised to ensure that Hard Ecu were created as a substitute for, and not in addition to, national currency assets.

Initially, the main role for the Hard Ecu would be as a monetary standard. One can view it as playing a role not dissimilar to gold under the gold exchange standard, or that which the deutschemark has played within the ERM. The Hard Ecu might well not immediately enter into ordinary retail transactions on a large scale; indeed its development in this role is likely to be gradual. But, from the outset, it could exert an important influence on monetary policies throughout the Community. This is because, in order to ensure that the introduction of the Hard Ecu did not lead to excess money creation, the EMF would have the right to sell any national currency it had acquired back to the issuing central bank in exchange for hard currency. A rise in Hard Ecu interest rates would tend to attract balances out of national currencies—initially, one would expect, from those countries at the bottom of the ERM band—into Hard Ecu. And, if the EMF then exercised its right to present national currencies back to the issuing central bank, the issuing central bank would experience reserve losses, and would therefore need to take policy action to remedy the situation.

The reserve loss mechanism under the Hard Ecu proposal would be broadly similar to the way the discipline of the ERM is transmitted into national monetary policies. However, there are certain features of the Hard Ecu mechanism which, in my view, would make it preferable to the existing arrangements. First, the anchor role for Community monetary policy would—and I think should—be played by a Community monetary instrument, and not by a national currency. That would increase its acceptability in the Community as a whole. It would also avoid the risk of the anchor currency central bank's policy being inappropriate for the Community as a whole. In that sense, there would be an extra safeguard against inflationary pressure.

A question that is often asked about the Hard Ecu proposals is whether they are consistent with eventual moves to full monetary union as described in the Delors report. A subsidiary question is whether, even if they are so consistent, they would slow down the process towards progressive union. I hope the answers to these questions are now clear. The Hard Ecu proposals are not only consistent with phased progress toward a single monetary policy and a single currency if in due course that was the wish of peoples and governments. But by promoting greater economic convergence, they would actively help to create the conditions that are essential for a monetary union. They do not, on the other hand, in themselves mandate a single currency or carry any implications as to its timing.

Concerning the effects of the Hard Ecu on the speed of progress toward monetary union, it is of course true that the proposal holds little attraction for those who believe that one could move directly towards a single currency within the space of a few years. For those who believe that more time will be required, and that care will be needed to ensure that the foundation of progress are solid, the proposals should hold more attractions. You will, by now, be in no doubt where my own sympathies lie.

Conclusion

Let me conclude by emphasising one point. The Hard Ecu proposals address a number of genuine difficulties that will be encountered if the Community attempts to force the pace towards full monetary union and a single currency and monetary policy; difficulties that cannot be wished away. I believe, though, that the UK proposals offer a consistent and coherent way of addressing these issues. Indeed, we have yet to hear objections which strike at the heart of the technical aspects of the proposal.

It would be unrealistic, however, to claim that, in their detail, the Hard Ecu proposals are the only possible way of approaching the problems of convergence and transition. UK representatives in international meetings have consistently emphasised that the proposals should not be regarded as 'cast in stone'. And we therefore look forward to a continuing dialogue with our Community partners designed to find a way forward which is equitable across the Community and soundly based.