Central banking in Europe

*Discussing the role of central banks in the future of Europe's monetary arrangements, the **Governor** argues*[1] *for a cautious and evolutionary approach to greater monetary integration. He stresses the importance to Stage 1 of the process of a shared commitment to internal price stability and currency stability: and suggests that the question of what comes after Stage 1, including the possibility of institutional change, be left until the issues can be addressed in the light of experience.*

It is a special privilege for me to come to Florence during a period when the future of our European monetary arrangements, and even the possibility of a European central bank, is being debated.

It would be quite wrong to pretend that the debate is entirely cordial or easy. There is no denying that it has *rightly* stirred strong feelings because it raises issues, not only of considerable economic significance, but also of major political importance. In a way that few could have foreseen, the possibility of Economic and Monetary Union has become a central element in any discussion of the European Community's objectives and long-term strategy; and has brought to the fore profound questions about national sovereignty, the relationship of the Community with its individual nation state members, and the relationship between its members.

The timing of Charles Goodhart's book is therefore well chosen—one might almost say perfect, were it not for the risk that I would be suspected of speaking as an ex-colleague rather than as an impartial observer. It is characteristic that he should ask now whether central banks are in fact really necessary at all. While he poses that question academically in a national context, it arises as a pressing practical matter at the European level.

Through his recital of central banking history, Charles shows that it would be a mistake to think that a central bank's functions need be fixed for all time. The experience of my own institution—the Bank of England—is of constant evolution; and in this the Bank has been greatly assisted by its flexible charter and governing legislation. I want to suggest today that it has some useful lessons for the future of Europe's monetary arrangements.

As is, I hope, now well known, the Delors Group concluded that the final stage of a process of increasing monetary integration might be *full*—or *hard*—monetary union. Plainly some people are strongly committed to obtaining *full* EMU at the earliest possible date, and to that end would adopt an activist strategy to bring it about, involving the creation as soon as possible of new institutions with pre-ordained functions. Others have serious reservations about the later stages of the Delors outline and about any commitment *now* to goals whose desirability and feasibility *cannot* yet be demonstrated.

Stage 1 of the process towards monetary integration

Much has been made of these differences, but I am bound to say that this has been at the cost of distracting us from what should be our immediate goals, which the protagonists *do* agree should be closer monetary cooperation and ensuring the success of the 1992 programme.

The establishment of a free internal market will bring major changes to the basis of trade throughout the Community—maybe even as great as those instituted by the Florentine bankers. Perhaps most importantly in this context, it will help to create the integrated and flexible markets necessary for closer monetary integration. But the results will take time to show through, and the precise nature and scale of the effects cannot be predicted. Nor can the benefits be expected to come automatically. We cannot relax and assume the remaining elements of the programme—of which there are very many—will simply fall into place. We must be unrelenting in our efforts to agree the measures that will remove both the barriers to free trade and the subsidies which distort open competition.

The other key ingredients of Stage 1 will be increased co-operation between the Community's monetary authorities and the strengthening of the exchange rate mechanism of the EMS. Both will be critical to ensuring that the internal market develops within a framework of financial stability and discipline.

I hesitate to say this in Italy, but some commentators doubt that the Exchange Rate Mechanism (or ERM) is capable of bringing benefits to the United Kingdom. I do not agree with them, and believe that the United Kingdom will gain from sterling's participation once the conditions for entry are satisfied. Equally, however, it would be quite wrong to believe that ERM membership is some sort of magic wand. What matters fundamentally at present—and will continue to matter—is that the member

(1) In a speech at the CARIPLO presentation ceremony for Professor Charles Goodhart's book, *The evolution of central banks*, in Florence, on 13 December.

countries should share price stability as an unequivocal objective, and direct their policies towards that goal.

I would suggest therefore that the enhanced cooperation between monetary authorities during Stage 1 must be based on each aiming at *internal* price stability. This would be quite consistent with leaving each country free to decide the means by which it achieves that objective, acting of course within the constraints and discipline of the ERM itself.

For those Community members with small open economies, which are heavily reliant on tradable goods subject to international arbitrage, the exchange rate may be an adequate—and perhaps also the easiest—guide for a monetary policy designed to achieve price stability. The same *cannot* be said for the larger economies, and this goes for all the large Community countries and not just for the country whose currency provides what many regard as the anchor in the ERM.

The financial positions of the larger economies can have a decisive effect on each other and therefore on the stability of the system as a whole. Thus, in the absence of a commitment to internal price stability, and even more importantly the determination to carry it out, there would be a danger that the maintenance of exchange rate stability through the ERM could occasionally create tensions, of an economic and possibly even political kind.

Sterling and the ERM

This has a bearing on the question of the timing of sterling's entry into the ERM, which will be one of the major events of Stage 1—and not just for the United Kingdom. I am conscious that some argue for early sterling participation on broad political grounds, not least of which is the possibility of increasing the United Kingdom's influence in the Community and specifically in the debate on EMU. Whatever the merits of these arguments, as a central banker I should caution that there would be quite considerable economic risks—both for the United Kingdom and for existing ERM members—in sterling joining before a better balance is restored to our economy; which means before UK inflation and interest rates are more in line with those prevailing elsewhere in the Community.

From a narrow UK perspective, therefore, premature entry could complicate the task of putting our own house in order. But equally, as I have suggested, it could be disruptive to the existing ERM members, and it is therefore in the interests of the Community as a whole for sterling to enter at the right moment.

Beyond Stage 1?

As I said earlier, the 1992 programme is a major undertaking and it is clear that a commitment to internal price stability within the framework of the ERM is the essence of greater monetary co-ordination during Stage 1.

This does not mean that we cannot begin to address how the system might develop. But, by the same token, I hope that there will be growing agreement that we should avoid pre-judging what comes after Stage 1.

If Stage 1 is a success, it will, almost by definition, bring us much greater exchange rate stability—which is to say that ERM realignments will become less and less frequent and will increasingly be disregarded by the markets as a possible policy response to prospective imbalances. In those circumstances, the locking of parities would not be the leap in the dark which it appears at this distance, but rather the natural and relatively small step of moving from *de facto* stability to *de jure* immutability.

There is, however, a *long* way to go before we can realistically look forward to that point. Our approach towards it will depend on the success of each country in achieving appropriately defined price stability and also on the Community becoming more closely integrated. This last point is particularly important.

It is widely accepted that the key requirement of a single currency area is a very high degree of economic—and also cultural—integration. The enhanced mobility of both labour and capital brought about by the 1992 programme will certainly increase the pace of economic integration in the Community, but we are still plainly less integrated than a successful industrialised single currency area such as the United States. For the foreseeable future, the appropriate stance of monetary policy will therefore need to vary from one part of Europe to another, and thus, while we can—and should—all share the goal of price stability, we will need different measures to obtain it.

In contrast to this evolutionist approach to greater monetary integration, some have proposed that we should seek to force the pace to full EMU by establishing new institutions at an early stage. While I recognise the potential benefits that we might one day enjoy from monetary union, I think we should recognise that there are dangers—possibly great dangers—in moving too quickly. Specifically, I believe that it would be liable to exacerbate regional disparities, and that the fundamental problems this created could not be alleviated—and could possibly be aggravated—by regional transfers or any other centrally administered policy.

We thus need to be cautious about any tendency instinctively to tackle our problems by the creation of new institutions. In particular, if institutions were set up before a clear need for them was established, there would be a danger in the not unnatural tendency to find things for them to do. Thus, just as I suggest that in Stage 1 we would be wise to concentrate on a shared commitment to internal price stability and currency stability, with greater co-operation and openness about individual countries' policies, so I also believe that, even in some hypothetical full monetary union, it should still be possible for implementation of a centrally agreed policy to be left to national authorities.

The profound structural differences in the institutional arrangements in our various markets may even require separate implementation of a common policy in separate centres, using different techniques.

In suggesting that we should examine carefully—and critically—the need for new institutions and ensure that they do only what is genuinely necessary, I believe that I am merely expressing, in a central banker's terms, the importance of the principle of *subsidiarity*; namely, of doing at a Community level only what can be done more effectively there than by national governments and authorities. It is essential that we should not lose sight of this throughout the discussions that lie ahead of us.

A second issue of principle is *accountability*. This is generally addressed in terms of the degree of independence that should be enjoyed by a central bank, whether a central Community institution or individual national monetary authorities. I have to say that I believe the term 'independent' is misleading and obscures the key issues. No-one could sensibly suggest that in liberal democracies any central monetary institution should be unaccountable.

What *is* for debate however—and especially in the context of Charles Goodhart's book on the history and functions of central banks—is whether central banks should be given an explicit statutory responsibility for ensuring price stability. The issue is *not* whether central banks are likely to be better at running monetary policy than elected politicians. Rather the question is whether an obligation to ensure price stability—to secure, as it were, the soundness of the currency—can separate monetary policy from wider economic policy-making in a way that protects against damaging trade-offs. I believe as a central banker—and I concede therefore possibly as a biased judge—that an institution placed under such an overriding obligation would, over the long run, be better at obtaining and sustaining price stability; and that democratic accountability could provide sufficient protection against incompetence or a misuse of powers. However, whether such arrangements should be put in place is of course a matter for politicians.

Conclusion

In discussing the role of central banks in the future of Europe's monetary arrangements, I have stressed three principles. First, the importance of market forces and the need to work with the grain of the market. Second, the principle of subsidiarity. And third, the overriding objective of price stability.

I believe we should be gradually working towards greater monetary co-operation and integration, while remaining agnostic about the final resting place. The possibility of institutional change—or amendments to the Treaty—should, I suggest, be left until we have proper experience of Stage 1 which allows us to address our future in an informed manner. Given the scale and importance of the issues involved, it is right that we should examine the options very carefully before making critical strategic decisions.

This approach *is* based on a vision. But it is *not* activist. Quite the opposite—it is cautious, because lack of caution in such an important area could have very damaging consequences.

Which takes me back to the question raised by Charles Goodhart. He concludes—I am sure correctly—that national central banks are desirable and necessary. But as to whether an ESCB might one day be necessary, that remains an open question—and one on which we should avoid occupying hard positions while there are so many more pressing questions facing us.