The single market and its implications for Europe's monetary arrangements

In a further speech[1] discussing the implications of the single market for Europe's monetary arrangements, the ***Governor*** *comments in more detail on some of the factors that account for the emphasis the UK authorities place on the importance of an evolutionary approach to monetary union. He argues in particular—in part in the light of the United Kingdom's own experience of adjustment to structural change and financial deregulation—for the need to give due weight to the complexity of the forces that may be unleashed by so major a change as a single financial market: and the need to take a pragmatic approach to essentially practical issues.*

Mr Chairman, it was a great honour to have been invited to address you today, and it is a pleasure to be here.

The Federal Republic's savings bank movement is not only at the centre of your banking system, it is also the largest such movement in the European Community and includes some of the largest banks of any kind in Europe. You are therefore likely to be profoundly affected by current developments in the Community. In particular, in common with the rest of the financial services industry, your members are considering how to respond to an intensification of competition as Europe's markets become more integrated.

These Community developments may seem rather prosaic in comparison with the dramas of the past few months in Eastern and Central Europe, especially as experienced here in West Germany. But the longer-term effects of the current Community initiatives could also change the face of Europe.

1992 is not only a matter of interest for those of us concerned with industry and commerce. Economic integration of the type fostered by the Single European Act holds the prospect of substantial economic gains and will therefore benefit individuals throughout the Community. And, in addition, as it progresses, it will strengthen the case for closer monetary ties. That is what I have come to talk about today: the Single Market and its implications for the Community's monetary arrangements.

I should say at the outset that for my part I have no reservations about the desirability of greater economic and monetary integration, or eventually even union. The benefits could obviously be great. Greater exchange rate stability within the Community would reduce the risks and the costs faced by a producer wishing to supply its European customers from a single location; and also reduce the costs to consumers wishing to shop around the Community for goods or services.

I also recognise the symbolic significance of the Single Market and the adoption of EMU as a goal. In other words, I share the vision, the importance of which has been highlighted so vividly by recent events in Eastern Europe. Nevertheless, symbols are ultimately less important than solid achievements, and we must therefore take care not to become blinded by the symbolic element of our undertakings.

Nor should we be led into thinking that national distinctions and barriers are about to melt away. Important social and cultural differences will persist, and these will undoubtedly continue to limit the success of some businesses in competing outside their home countries. Huge questions, which are not for a central banker, also remain concerning taxation and frontier arrangements. But not all barriers need to be eliminated for major opportunities to be created, and in fact I *do* believe that the effects of establishing a free market in Europe are likely to be extremely powerful.

The effects are, however, unpredictable and will take time to show through. The response of businesses and consumers is what will ultimately matter as the single market programme can only remove barriers, it cannot *make* things happen.

It is therefore essential that due weight is given to the complexity of the forces which may be unleashed and of the interaction between real and monetary mechanisms.

So far as the monetary sphere is concerned, I believe that the process we have embarked on confronts us with some quite pressing issues; pressing, not because there is an immediate need for massive change but because mistakes now could cost us dearly later. Premature action designed to force the pace of convergence of our economies and currencies could all too easily have quite the opposite effect, and produce economic and political tensions between member states that perversely could actually delay rather than accelerate what we are seeking to achieve.

(1) To the West German Savings Banks and Giro Association at La Redoute, Bad Godesberg, Bonn, on 16 January.

We should work with the grain of the market, and we could jeopardise our goals if we do not. A pragmatic approach—'learning by doing'—will be sounder and safer than rigidity in our strategy.

Harnessing competitive forces: creating a single European Market

Whatever some critics of a more activist frame of mind may say about this evolutionary approach, it is emphatically *not* a formula for obstructive delay. I believe the United Kingdom's record in implementing directives in the Single Market programme is evidence of this, and that it stands comparison with that of any other member state. This should not come as a surprise. Through its aim of creating a free market throughout the Community in goods and services, capital and labour, the Single Market project shares the liberal pro-market bias which has formed the basis of the UK Government's domestic policies over the past decade. We are accordingly committed to pressing ahead with the 1992 programme in order to enlarge the scope for market forces to operate within the Community, which we see as the surest way of integrating our economies.

When such market-based policies were first mooted in Britain, some of their proponents drew inspiration from the Soziale Marktwirtschaft model pioneered by Ludwig Erhard and the academic economist and later Economics Ministry official, Alfred Müller-Armack. It was therefore something of a surprise to find that in the Federal Republic itself the establishment and maintenance of that model was not completed in a number of fields, including transport and the labour market. It is also striking that subsidies in the Federal Republic represent a higher proportion of GNP than in a number of other major industrialised nations.

I know from the United Kingdom's own experience that reducing subsidies and removing regulatory restrictions can involve painful adjustment and political costs before the longer-term benefits come through. There is little doubt, however, that the pain is worth bearing. We therefore welcome—and can understand the reasons for—the many recent notable initiatives, such as deregulation of postal services and telecommunications, tax reform and the sale of state interests in industrial and financial concerns.

So far as the direct concerns of a central banker are concerned, the moves towards creating a free European market in financial services are of special importance. Major steps have already been taken. Some have been at the macro level, and in this regard I particularly welcome the action of the French Government in abolishing its remaining exchange control restrictions.

In the *micro* field, we have all recently—and *both* the United Kingdom and the Federal Republic were involved—made important compromises to secure the successful passage of the Second Banking Co-ordination Directive and the Solvency Directive. This will allow us to give a specifically Community dimension to the groundbreaking work of the G10 countries over the past ten years in the supervisory field. Equally, much remains to be done; critical work is already underway in the insurance and investment services field.

We in the United Kingdom have therefore been following the deregulation in the West German financial sector with close interest. The universal banking tradition and the policy of progressive deregulation have served financial markets here well, leaving them among the strongest and most open in the world. This has been bolstered in the past year by some particularly significant developments, including the legislation making way for the opening later this month of the new futures and options exchange, the Deutsche Terminbörse; the decision to abolish Stock Exchange Turnover Tax from next year; and the recently announced liberalisation of the arrangements for domestic bond issues denominated in foreign currencies, including ECUs.

Against this background, the views expressed by Karl Otto Pöhl last summer in Frankfurt were heartening. As you will know, he called for more to be done to enhance the efficiency of the Federal Republic's domestic financial markets through the removal of impediments to market forces remaining in, for example, the authorisation procedures for corporate bond issues and through reform of government debt management techniques and Stock Exchange trading procedures.

Measures along these lines in other countries have worked to the benefit of the economy as a whole. So too has deregulation of retail financial services business, placing the emphasis on greater competition between suppliers as well as on the protection of consumers.

Notwithstanding the long-run benefits of allowing market forces to work more flexibly and effectively, it has to be recognised that such deregulation and liberalisation—in the financial area particularly—can have implications for the conduct of monetary policy. Indeed, as I shall illustrate later, it can at times make policy more difficult to operate. The changes in the Community likely to be brought about by the Single Market programme therefore need to be taken into account as the course towards Monetary Union is mapped out.

Stage 1 of the process to Monetary Union

It is first worth considering, however, what a commitment to exchange rate stability through ERM membership can deliver to individual nations in terms of domestic price stability, which is—and must remain—the overriding concern of national monetary authorities.

(a) The ERM

The ERM framework is often seen as one in which the Federal Republic, through the disciplines exerted by the Bundesbank, provides the anchor against inflation, with other member countries pursuing domestic price stability essentially by maintaining a stable exchange rate against the deutschemark. This is not without its risks. By pegging their currencies to the deutschemark, other, more inflationary economies are likely initially to lose competitiveness against the Federal Republic. This in turn will tend to have a disinflationary effect upon the partner country—as its trade balance and the level of domestic activity decline with a moderating effect on prices and wages in that country. This indeed is seen by many as the essential nature of the discipline which the ERM is intended to provide. The problem is that the same mechanism has an opposite, expansionary or inflationary, effect on the Federal Republic itself.

The overall outcome in terms of inflation in the EEC as a whole is uncertain. It will depend in part upon the relative sizes of the economies in question; in part on the relative responsiveness of prices and wages in the relevant economies; and in part on the respective policy responses. What is important is that the West German anchor should hold firm, and that the Federal Republic's partners in the EC should address those characteristics of their own economies that make them inflation prone. In that way, convergence toward lower inflation throughout the Community can be promoted most effectively.

Over the past four years, prices and wages in the FRG have reacted more slowly in response to the increase in your competitiveness than have those in many other member states to their loss of competitiveness. The disciplined behaviour of prices and wages in the FRG contributes to the reduction of inflation within the whole ERM area; but any absence of similar discipline in other countries would tend to lead to fairly persistent imbalances in trade. There is, in consequence, an apparently structural current account surplus in the Federal Republic, which has recently been enlarged by the world-wide investment boom, further stimulating demand for German capital goods for export.

How does the United Kingdom fit into this? We believe that, when the circumstances are right, ERM membership will bring us considerable benefits and strengthen our counter-inflationary strategy. But it is unlikely that UK adherence to the ERM—to which the UK Government is firmly committed—would be helpful in the present context. We start with an excess of domestic demand in our economy, which is still in the process of correction. Premature entry to the ERM before that process is closer to completion, and our inflation rate accordingly more closely approximates to that of the other member countries, including your own, would place stresses on the British economy during a critical period of adjustment and add to those in the ERM itself. This, I believe, is now accepted in the United Kingdom and elsewhere in Europe, even by those who regret that sterling participation has been so long postponed.

It is impossible to predict when the circumstances will be right for entry, precisely because, as I have said, this must depend on our bringing the economy back into better balance. We will take all the relevant factors into account, including primarily the level of inflation, but also its trend. Conditions may arise—but equally they may not—where, if inflation were declining, membership might help to reinforce the trend through the effect on expectations in the real economy and perceptions in financial markets and through the exercise of external discipline.

We are often asked to be more precise. This is not possible; it is a question of practical judgment and the combination of circumstances prevailing in the economy and markets.

(b) Strengthening the EC Governors' Committee

The tensions which are bound to arise occasionally in the ERM should over time be alleviated by greater convergence in the economic performance of the member states. This process will in turn be assisted by the recent measures taken to strengthen economic co-operation and co-ordination in the Community.

In the monetary sphere, the proposed modifications to the work of the EC Central Bank Governors' Committee will, I am sure, increase the value of the consultations that have regularly taken place since the committee first met in 1964. A number of changes are being made, but there is no intention of replacing the current practical and flexible forum with a rigid institutional framework and heavy bureaucracy. As you may know, we are establishing a new research team of monetary experts, largely seconded from central banks, to assist us, but it has been kept small, and deliberately so.

The main function of the committee will continue to be the discussion of domestic and external monetary developments. The mutual surveillance which is to be a key element of enhanced monetary co-operation is likely to involve more sharply focused and possibly more forceful critiques of each other's policies, but we have not sought—nor could we have—any collective control over individual national authorities.

This does not mean that the committee will be a mere talking shop; it has never been that. It is proposed that our views should be voiced in the Council of Economic and Finance Ministers whenever they undertake mutual economic policy surveillance under their own new arrangements for Stage 1. In this way, I believe a constructive dialogue between the Governors' Committee and the ECOFIN Council can develop which will help to bring about an appropriate, non-inflationary balance between members' policies.

And perhaps at this point I might say how much I welcomed the election of Karl Otto Pöhl as our first chairman, and thus as the committee's spokesman at the regular ECOFIN meetings.

(c) The role of national central banks

It is natural—and necessary—that we should ask how all these changes will affect the position and role of national central banks, and this seems particularly pertinent here in West Germany, where the Bundesbank so obviously provides a model of success. It has not only provided Germany with a relatively stable currency but has also facilitated the spread of price stability through much of the Community. This has been achieved through the strength of the Bundesbank's commitment to sound money, backed—and I think this is critical—by strong support from the German people and successive governments.

As we move towards closer monetary integration in the Community, a situation in which the Bundesbank concerns itself only with West German prices and other central banks only with the exchange rates of their currencies against the deutschemark—which admittedly is a caricature of the present situation—will inevitably have to be replaced by something more symmetrical. This need not, however, involve any weakening of the influence of the West German model. On the contrary, as implied earlier, what is required is that monetary authorities throughout the Community should share the same unequivocal commitment to internal price stability and have the means—which may, in some cases, mean the degree of autonomy—for that commitment to be made effective in their respective societies.

A shared commitment to internal price stability is consistent with different monetary authorities, even among the members of the ERM, adopting different operational techniques and intermediate objectives. Clearly this would need to change if a common currency were eventually introduced since monetary policy would then lose its distinctive national features. That point is, however, still some considerable way off. As we embark on the task of bringing about greater economic and monetary integration, the question therefore arises as to whether we should expect—or even encourage—a rapid convergence of intermediate objectives and techniques.

(d) The role of intermediate monetary targets in Stage 1

The British experience can be instructive in this respect. We have been through a period of radical financial innovation that may well prove to be of direct relevance in the 1990s for others as yet relatively untouched by those powerful forces, but who would be unwise to assume they will be immune as financial structures converge and the competitive forces of the Single Market take effect. One particular lesson has been the uncertain role of monetary targeting when there is structural change in the economy and particularly in the financial sector.

When we in the United Kingdom started monetary targeting in the latter half of the 1970s, the monetary aggregate used was M3. M3 then included residents' foreign currency deposits which in principle should have been, but for practical reasons was not, replaced by foreign holdings of sterling.

M3 was controlled partly by a system, known as the 'corset', that penalised individual banks if their deposit liabilities grew too quickly. The system was rendered ineffective by the abolition of exchange controls in 1979, and was abandoned within a few months. Removal of limits on the growth of banks' liabilities left them free to compete for mortgage business with building societies (whose deposits were not included in M3), so that the growth of M3 was affected by the success or otherwise of banks in gaining share in this market. This naturally directed attention to broader aggregates embracing bank *and* building society deposits, but also inspired attempts to construct a narrower 'retail transactions' aggregate since a significant proportion of the broadest aggregates was held by financial institutions as 'investment' money rather than 'transactions' money.

In this search it was natural to look at interest and maturity terms to draw lines between different classes of account. Unfortunately for the use of monetary aggregates—although fortunately for consumers—competition between banks and building societies, which was intensified by some tax changes designed to make the competition fairer, led to large sums moving into the narrower aggregates on account of the introduction of new kinds of accounts which combined immediate availability for the settlement of transactions with the payment of interest at near-market rates.

In the United Kingdom's circumstances, the relationship between broad money aggregates and nominal income became too variable for monetary targets to be used as viable intermediate objectives for securing the end objectives of steady growth and low inflation. We therefore decided to move towards targeting narrow money; eventually in the form of M0 since this is the aggregate perhaps least erratically disturbed by the structural changes of recent years, though our attempts to identify a stable relationship between M0 and the ultimate objectives of policy have also not met with unqualified success. (I might add as an aside that it is noteworthy that, in the Federal Republic by contrast, you have found it appropriate to move in the opposite direction: from targeting Central Bank Money to broad money.)

Returning to the United Kingdom, as many of you will perhaps know, the changes in economic relationships brought by deregulation and structural reform have driven us to adopt an essentially pragmatic approach to policy. But I should stress that, while we are not in a position to use monetary *targets* as a direct guide to policy, we do place considerable emphasis on the monetary statistics as an important input to our assessment of current and prospective developments in the economy—although the interpretation of our monetary statistics has been made difficult by the same changes that caused us to abandon targeting. We also look at all the economic data concerning the real economy. Policy making in the United Kingdom is therefore a complex, judgemental process, with no simple guiding rule.

I have dwelt on the development of the United Kingdom's approach to monetary policy at some length. The events I describe occurred independently of technology, Big Bang or the Great Crash, each of which has also affected financial behaviour. Thus my catalogue is by no means complete. Indeed, my selection is based in part on the existence of comparable situations in, or between, ERM countries. The Federal Republic has problems with residents' deutschemark deposits held in Luxembourg but excluded from M3; the Netherlands has recently introduced a device fairly similar to the 'corset' we abandoned in 1980; France has recently completed the removal of its exchange controls and Italy is in the process of dismantling its remaining restrictions, which could effect private sector financial behaviour. Increased competition in the domestic and 'off-shore' markets, especially as the Single European Market becomes a reality, will also distort national aggregates, as will any fiscal and reserve ratio consequences of the ending of exchange controls.

The conclusion I draw about the path to EMU is that we will not find a monetary aggregate that could be used as a target for all our Community economies. This is not a question of principle, but a severely practical problem. Some countries, including the Federal Republic, will perhaps be able to continue to use targeting, whereas others will use aggregates only as indicators of monetary conditions. And even then, we may not be able to find an aggregate that is a useful indicator of monetary conditions in all our countries. Indeed, no single *indicator* is likely to prove reliable for any one country through the phases of competition, innovation and continuing reform that will confront us all in the years ahead.

I believe the same goes for operational techniques. The present diversity of institutional arrangements and the changes each will undergo on the road to greater monetary integration make it very unlikely that any one operational formula would be appropriate to all members now or to any one member throughout the journey.

(e) Inflation convergence and progressive exchange rate stabilisation

The implication is that throughout Stage 1 we should concentrate on the ultimate objective of internal price stability in each of the member countries, accepting that each will need to pursue it in its own way. This too, however, may be difficult to monitor in the process of eliminating exchange rate variations as we approach monetary union. The problem is that as national price indices are currently constructed, uniform movement in the indices would not necessarily be compatible with fixed exchange rates. This is because they give considerable weight to non-traded items such as housing, bus rides and hair-cuts which, unlike most manufactured goods, are not subject to arbitrage through the international trading process.

It is for this reason that regional price indices in the United States and the United Kingdom—and I suspect also in the Federal Republic—do not all grow at the same rate. This is not a problem in such single currency areas since the commitment to price stability is defined in terms of a single index that, in effect, averages the regional indices. The same could in principle eventually be true of Europe if it one day moved to a single currency and central bank, though it would probably be better to choose to define the objective of price stability in broader terms such as those recently used by Alan Greenspan (and cited by Karl Otto Pöhl): 'a state of affairs in which inflation expectations are not a significant factor in economic decision-making.'

An evolutionary approach to Monetary Union

I have sketched out some of the factors which account for the stress which the UK authorities place on the importance of an evolutionary—or gradualist—approach to Monetary Union.

There are other *fundamental* arguments for proceeding cautiously, relating to the circumstances in which the economic welfare of countries is likely to be enhanced by their sharing a common currency. The key conditions for such an optimal currency area are that, within the area, there should be considerable similarities in the pattern of output and consumption, together with extensive trade and great mobility of labour and capital. There can be no doubt that the Community is moving towards the fulfilment of these conditions, but it is equally clear that in several respects—notably labour mobility—Europe still falls well short of other large single currency areas, such as the United States.

A great deal could therefore go wrong if a single currency and central monetary institutions were imposed too soon as part of an activist initiative to force the pace towards monetary union. For example, economic shocks or domestic policy mistakes might cause competitiveness to get out of line from time to time. If exchange rate realignments were ruled out (as by definition they would be once a common currency were introduced), other means of adjustment would have to take the burden.

This could result in persistent—or even cumulative—deflationary or inflationary pressures if for some reason—such as language barriers—labour mobility did not occur spontaneously. Any stickiness in nominal wages would tend to translate into unemployment or excess demand. In the former case, this would raise public expenditure while reducing revenues, which would increase present or future taxes on those in employment or reduce prospective public services, thus making the area a less attractive place in which to work and possibly leading to a further erosion of the tax base. Similar—but opposite—difficulties would arise in conditions of excess demand.

With this sort of scenario in mind, some have argued that other means of assisting, or easing the burden of, economic adjustment should be put in place if exchange rates became fixed. Most notably, resort to fiscal transfers has been canvassed. I believe, however, that this would be both politically difficult and far from secure in its economic effects. But because it has attracted attention, it is worth just touching on some of the detailed problems that would need to be overcome.

For example, transfers between countries could *in principle* be effected by amending the Community's budget formula. In order to measure the impact of the shock that the transfers would be designed to ameliorate, it would be necessary to define some normal or trend level of each country's GDP, as well as accurately and promptly to measure deviations from the trend. Our statistics do not meet these requirements.

A second theoretical possibility would be Community-wide 'built-in stabilisation' through central social security and, more particularly, unemployment insurance arrangements. This would face similar problems, though not so much in the field of measurement. Such a scheme would have to offer benefits in each country (or region) that were proportional to productivity levels there. A uniform benefit level throughout the Community would make work in many areas unattractive even if the unemployed in the most prosperous regions were harshly treated by present standards. It is far from clear that an appropriately discriminatory central scheme could be established, not least because of the practical political difficulty of determining who should agree and revise its parameters.

It might be argued that mobility of private capital could make up for the immobility of labour or the absence of intergovernmental transfers on the grounds that the adversely affected region would be a more attractive location for investment as a result of the pool of unemployed workers. I think this is unlikely, however, because as a market it would have suffered and at a given wage and exchange rate it would not have become a more competitive place from which to export. (It is doubtless for these reasons that private capital does not lead to the mopping up of regional pools of unemployment in either the United Kingdom or the Federal Republic.)

Against this background I believe that, while exchange rate changes are neutral in their long-run impact on a country's economic performance, there is a case for preserving the realignment option but only as a last resort for easing the costs of economic adjustment. In other words, the ERM should be retained—and we should not lock our exchange rates irrevocably—until our economies are much more homogeneous.

Gradualism and market forces

The UK approach to the economic future of the European Community is founded on a belief in primacy of market forces as a mechanism for the satisfaction of man's material needs, as well as of their virtues as an outlet for individual freedom. It is for this reason that we so strongly support the creation of an internal market, the removal of distorting subsidies and the strengthening of competition policy, while recognising that structural reform can bring unexpected—and unpredictable—changes in the preferences and behaviour of economic agents, which can disturb economic relationships and thus make life harder for policy makers.

This belief in market forces is of course shared throughout the Community, and increasingly in the rest of the world also. Thus, although my remarks this evening have not been directed towards the historic events of recent months, it would be wrong to come to West Germany without taking a moment to dwell on the significance to the EMU debate of developments in Central and Eastern Europe.

It is to be hoped that convergence in economic structures, and eventually economic performance, will not be confined to Western Europe. Though starting from a depressingly low level, the potential for trade with Eastern and Central Europe is considerable. There remain, however, major uncertainties as to the speed with which economic progress can occur, and also about the shape it will take. This is bound to be a further complicating factor in the process towards greater monetary integration in the Community, and tends to support the evolutionary approach that I have argued for.

In summary, then, I believe the Community should work gradually towards greater monetary integration and should keep an open mind about the final resting place. More specifically, we should avoid rushing into the creation of new central monetary institutions, but should pursue our shared goal through a common commitment to internal price stability both as an end in itself and as the means of achieving exchange rate stability. In Stage 1, this will leave discretion to national authorities as to how they pursue that goal within the framework of the ERM and buttressed by closer co-operation and co-ordination. In time, new institutions may be appropriate, but the time should be proportionate to the speed with which the real economies converge in structure and performance.

Those impatient for EMU should concentrate on promoting the real economic and social conditions that must exist if it is to enhance general welfare. This is not a recipe for procrastination but for prudent advance. Due caution is an essential element of the vision of progressive monetary and economic integration.

A central bank colleague outside the Community said recently, 'monetary integration in Europe should proceed along the path from stability to unity, and not from unity to stability'. I wish I could have put it so crisply, because that is the British message.