The United Kingdom's proposals for economic and monetary union

*In a speech to European parliamentarians,[1] the **Governor** argues the case for a gradualist approach to European monetary union, pointing up some of the essential characteristics and consequences of full union—particularly for interest rates and exchange rates—and warning of the problems that could arise should the Community press ahead to full monetary union before a much greater degree of economic convergence has been achieved.*

*The **Governor** then goes on to explain the United Kingdom's proposals for measures that might form the basis of the next stage of the process towards monetary union—the establishment of a European Monetary Fund and the issue of a new common currency, the Hard Ecu. These proposals, he argues, would offer an evolutionary, market-based approach to greater monetary integration; would avoid jeopardising the ultimate goal of monetary union by pressing for it prematurely; and would be a way forward beyond Stage 1 for all Community members.*

It is a very great honour to be here today. There can rarely have been a time when European parliamentarians had a greater interest in the activities and, dare I say it, the views of central bankers. Needless to say, this heightened interest is a direct result of the debate on European Economic and Monetary Union.

I do not think I am alone in having been surprised by the pace of developments since the publication of the Delors Committee's report fifteen months ago. EMU appeared to many of us to be something that could be desirable in the European Community's *longer-term* future, but which raised many difficult technical and political questions. In fact, EMU has captured the imagination, in some parts of the Community, in a way that few would have predicted. An inter-governmental conference is due to open on 13 December and a great deal of preparatory work is underway. I have just come from a meeting with my central bank governor colleagues in Basle, where we considered possible statutes for a monetary institution.

The Delors Committee, on which I served, avoided the vexed questions of whether EMU should happen, and when. Those are matters for politicians. What we did do was articulate a definition of full Monetary Union, and what would be required in the way of pre-conditions.

We stated that the minimum pre-conditions for locking exchange rate parities would be total and irreversible currency convertibility, complete liberalisation of capital movements and *de facto* elimination of exchange rate fluctuations.

Personally, I seriously doubt whether locked parities among continuing separate national currencies could ever be totally credible to the markets, given that parity changes would still be technically feasible. And in my view therefore, if or when exchange rate parities were locked, there would have to be a relatively quick move to a single currency. This would, inevitably, have its emotive side.

But in fact a *far more* important consequence of full Monetary Union as defined in the Delors Report would be that monetary policy—in particular, interest rates—would be set for the Community as a whole by a new, central institution. The reality of Monetary Union would be that the main monetary policy decisions would no longer be in the hands of national authorities, and that interest rates would be the same in every part of the single currency area. Karl Otto Pöhl pointed out in a speech in London last week that these essential characteristics of Economic and Monetary Union may not be widely appreciated. They need to be.

We should be clear how far away we are from identical rates at the moment. There is a wide disparity in interest rate levels in the Community; 3-month money-market interest rates vary from just over 8% in the Netherlands and Germany, through 10% in France, to 13% in Portugal, 15% in the United Kingdom and Spain, and to 26% in Greece.

This is not because the countries of the Community have different monetary policy objectives; on the contrary, everyone agrees that monetary policy should be directed towards achieving price stability. Rather, it is because differing conditions— and in particular differing levels of

(1) At a meeting with the European Currency Inter-Group of the European Parliament and the European Parliamentarians and Industrialists Council, in Strasbourg, on 11 July.

inflation—in our countries *require* different interest rate levels. This is not going to change in the short, or even in the medium term.

These differences between our economies are not just conjunctural. There are also very considerable *structural* and behavioural differences, and these must not be forgotten when one considers the steps that could *safely* be taken towards Monetary Union.

One of the basic consequences of Monetary Union is the loss of nominal exchange rate variations as a means of bringing about or smoothing economic adjustment. This would not be so painful if the single currency area enjoyed a high degree of economic convergence and structural similarity, with considerable labour mobility and flexibility in wages. But these conditions do not yet exist in the EC.

I hope and expect that economic integration in the Community can be increased through a combination of the effects of the Single Market ushered in by the 1992 programme, together with increasingly co-ordinated national monetary policies aimed at the common objective of price stability. But this process will take time to complete. Several key directives have still to be adopted, and a number of member states are falling behind in implementing Community legislation. And even when formal barriers to the movement of goods, services, capital and labour have been removed, it could be some time before integration is actually established on the ground. We are thus still some way from genuinely free, open and integrated markets.

If the Community moved to full Monetary Union before economic convergence was considerably greater, long-term structural problems could be aggravated and some areas could be quite severely disadvantaged. This could be politically as well as economically divisive.[1]

In addition, too early a move to Monetary Union—and identical interest rates—would *not* offer a smooth path to price stability. For the time being, it is better to retain the flexibility that allows different interest rates in our different countries.

Perhaps at this point therefore, I should stress that, whatever its potential long-term benefits, Monetary Union would not be something to undertake lightly. It could *not* be a temporary measure. It would have to be designed to last for as long as one could reasonably envisage. The task that falls to our generation is to do everything that we can to create the conditions for increasing prosperity in Europe, including price stability, and this might at some point involve a single currency. We do not *have to* put a single currency in place ourselves. And indeed we should *not* do so unless we are convinced that it would help to secure our objectives and, in particular, that there would not be a material risk of the new arrangements breaking down.

None of this is to deny that Monetary Union *could*, in the right circumstances, bring real benefits to the Community; for example, through lower transaction costs and a more stable environment for business planning on account of the end of exchange rate uncertainty amongst ERM currencies.

But there are, crudely speaking, two approaches to EMU, activist and gradualist. Political opinion on which of these is the better is, of course, divided throughout the Community, but I have to say to you that, whatever the political arguments, economic realities are not to be ignored.

What I have been saying is, in essence, the economic case for a gradualist approach to Monetary Union. It is a view which finds expression in the Delors Report in the jargon 'parallelism', which is to say progress towards monetary union should parallel progress towards economic union.

I am of course aware that there are areas of the Community where the degree of economic convergence is further advanced than elsewhere and which might therefore be in a position to form a more limited single currency bloc. This raises some extremely difficult questions, not least in the already complex area of accountability, which I do not wish to go into in any detail today. But I will just say that one has to be very careful when talking of a two-*speed* Europe that it is not really short-hand for a *two-tier* Europe, and very careful that progress over a more limited front does not in fact hinder progress by the Community as a whole.

For the *Community* as a whole, the immediate challenge is Stage 1. But we should all be asking ourselves *now* what steps could be taken *beyond Stage 1* that would be sensible in themselves and at the same time help create the conditions necessary for successful monetary union. The essential condition is closer convergence of economic performance, especially in relation to the achievement of the common goal of price stability.

I think it is generally recognised that perhaps the main weakness of the Delors Report was that it did not address Stage 2 in any depth or detail. We need to consider this as a matter of priority so that, when the time comes, we are in a position to move beyond Stage 1 in a constructive and substantive and prudent way.

I think it *is* possible to devise useful measures for Stage 2. The United Kingdom's recent proposal is one such option. There may be others that we should look at.

The Hard Ecu

As you will know, our idea is that the heart of Stage 2 should be the establishment of a European Monetary Fund and the issue of a new common currency, the Hard Ecu.

(1) These arguments were set out more fully in two earlier speeches by the Governor; the first was his IEA Lecture on 26 July 1989, reprinted in the August 1989 *Bulletin*, pages 368–74; the second was given to the West German Savings Banks and Giro Association at Bad Godesberg on 16 January 1990 and was reprinted in the February 1990 *Bulletin*, pages 62–7.

The Hard Ecu would be quite different from the current Basket Ecu, which is a composite currency unit that performs exactly as well as the average of its constituent national currencies. The Hard Ecu would, by contrast, be an independent currency—the thirteenth currency in the ERM— whose value in relation to the other, national currencies would be guaranteed by the national central bank owners of the EMF.

The special feature of the Hard Ecu would be that its ERM parity could never be devalued against any other ERM currency. This would mean that, subject to the ERM's margins of fluctuation, it would be as strong as the strongest currency in the Community.

Because of this certainty in its value, the Hard Ecu would be an attractive currency to hold, increasingly so over time as market instruments developed.

Without safeguards, substitution into Ecu would leave the EMF with considerable risks since it would incur Hard Ecu liabilities while accumulating holdings of potentially weaker national currencies. A key element in our proposal is accordingly that each participating central bank would accept an obligation both to maintain the Ecu value of any EMF holdings of its currency, and to repurchase its currency at the request of the EMF in exchange for Hard Ecus or possibly some other strong currency.

As well as protecting the EMF against loss, this provision would ensure that the EMF did not validate any excessive liquidity creation by individual national central banks. The EMF's absolute right to require the repurchase of national currency by the issuing central bank means that the United Kingdom's Hard Ecu proposal does not—I repeat, does *not*—fall foul of the criticisms of a conventional parallel currency which we set out in the Delors Report, and which I totally supported and would still support. They are not relevant here.

But over and above this, the Hard Ecu could potentially have a very powerful unifying effect on monetary policy in the Community as a whole, increasing over time as Hard Ecu holdings built up. The EMF would be able to manage Hard Ecu interest rates just like any central bank—by creating a liquidity shortage which it could relieve at an interest rate of its own choosing—and would be required to manage the Ecu in such a way as to bring downward pressure to bear on inflation. Thus, if the Board of the EMF believed that monetary conditions in the Community as a whole needed to be tighter, it could increase Hard Ecu interest rates. By doing so, it would stimulate flows out of national currencies, particularly weaker national currencies, into Hard Ecus, and the obligation of national central banks to redeem their currencies with Hard Ecu would put pressure on them to raise interest rates in their respective countries—the extent of the pressure depending on their currency's position in the ERM band and the country's reluctance to realign downwards relative to the Hard Ecu.

In short, as the circulation of the Hard Ecu rose in relation to national currencies, the EMF would have an increasingly powerful technique for the application of a collectively agreed, non-inflationary monetary policy among member states.

But while the EMF could have an important influence, exercised through the market place, on monetary policy in the member states, short of moving to a single currency, it would *not* directly control monetary policy in the member states; it would influence but not control. National authorities would continue to set interest rates on the basis of their domestic policy objectives—and in particular internal price stability—subject to the constraints imposed by the ERM bands and subject to the influence exercised through the market by the EMF.

The UK proposals do, to my mind, satisfy the principles, widely accepted throughout the Community, which any future monetary arrangements in Europe *must* respect.[1]

Taking *price stability* for example—which must be the most important test—during Stage 1 national authorities will pursue their own policies, directed towards internal price stability, within the constraints imposed by the ERM and peer pressure exerted through the Committee of EC Central Bank Governors. This will be an intensification of the current position, rather than something genuinely new. The UK proposals for Stage 2 would add an extra discipline and impetus towards counter inflationary policy in member states, through the mechanisms I have described earlier.

In consequence, the EMF would have to be given a clear counter-inflationary mandate and be adequately accountable for the exercise of that mandate.

Any Stage 2 arrangements must also respect *market forces*. One key characteristic of our proposal is that its effectiveness would increase to the extent that the public developed a natural demand for the Hard Ecu. This, I believe, is one of the scheme's strongest features since it would ensure that the Community's *common* currency, the Hard Ecu, displaced national currencies only to the extent that the people of Europe found it attractive. This would go a very long way to avoiding the risks that would be run by imposing a *single* currency on the Community before our economies are sufficiently integrated.

All this would be achieved consistently with the extremely important principle of *subsidiarity*. As national central banks would remain responsible for setting and implementing their own domestic monetary policy, the EMF would undertake *only* those functions which really did need to be undertaken at the centre *during Stage 2*.

(1) These principles were discussed in the Governor's speech at Salomon Brothers' Conference, 'Post 1992 and Perestroika' in Salzburg on 11 May 1990 and reprinted on pages 347–51.

Subsidiarity, incidentally, is related to the so-called indivisibility of monetary policy—in other words, that there can be no mixing of responsibility for monetary policy—which has been stressed recently, particularly by President Pöhl. I believe our proposal meets this criterion too. Each national bank would be responsible for its own monetary policy; while there would be collective responsibility, through the EMF, for maintaining the value of the Hard Ecu. There would, thus, be no ambiguity about the responsibilities of either national central banks or the EMF.

A market approach

So what, in summary, would the EMF and the Hard Ecu bring to the process of European Community monetary integration that could not be achieved simply by relying on a long Stage 1 to take us to Stage 3? In my view four things:

(1) first and foremost, it would add an extra counter-inflationary discipline to monetary policy decisions in individual member states;

(2) building on the hoped-for achievements of Stage 1, it would significantly strengthen the forces leading to convergence of economic conditions in the Community;

(3) it would pave the way for a move away from the current position where the ERM anchor is a single country's currency, and would bring an element of collective decision-making to the ERM;

(4) it would provide a common currency that could be used throughout the Community, enabling consumers and producers to get used to using a real, new currency.

As I have said, the Hard Ecu could in time develop into a dominant common currency, creating conditions where a move to a single currency was feasible. But that would *not* be preordained; it would be a consequence of market developments and political reaction.

Establishing a European Monetary Fund to issue the Hard Ecu would therefore be an evolutionary, market-based approach to greater monetary integration in the Community. It would be a desirable step beyond Stage 1. It would reinforce the anti-inflationary characteristics of the ERM. It would avoid putting the ultimate goal of Monetary Union in jeopardy by pushing for it too soon. And it would also be a way forward beyond Stage 1 for *all* members of the Community.

I therefore believe that the UK proposal is one which addresses seriously and constructively the major policy questions concerning Monetary Union, and I believe it deserves close study and careful consideration by those taking part in the historic debate which is now in progress.