European monetary arrangements: convergence and other issues

In the Paolo Baffi Lecture,[1] *the* ***Governor*** *discusses the future of Europe's monetary arrangements over the longer term and examines some of the conditions that would need to be met before moves to economic union could safely be contemplated. He stresses in particular the need for underlying economic convergence, based on a firm commitment to economic self-discipline and above all to price stability. He goes on to review the economic convergence conditions under discussion at the Intergovernmental Conference, arguing that these criteria are likely to be subject to problems of measurement and interpretation: they cannot be mechanically applied but should be reinforced by other considerations, particularly supply-side flexibility, in the overall economic judgement of a country's readiness for monetary union.*

I am delighted to be back in Milan. And it is a great privilege to visit Bocconi, whose name commands such high respect among academics and businessmen. Your university can, if I may say so, be extremely proud of its contribution to Italian—and indeed European—education in economics and business administration. You can take special pride in the leading role which many of your graduates, some still quite young, have begun to play in European economics.

The dominant theme of European economics today is, of course, Economic Monetary Union; and so there could hardly be a better place or time for me to discuss the future of Europe's monetary arrangements. With the twin Intergovernmental Conferences perhaps only weeks away from conclusion at Maastricht, it would be imprudent just now to forecast the outcome. Yet you would not expect me to avoid the subject altogether. Let me therefore say a word or two about the EMU conference, while standing back a little from the actual negotiations, in which Finance Ministers rather than central bankers play the dominant role.

My overall impression is one of immense goodwill among all the participants. This has enabled a lot of serious and fairly technical work to be done in a constructive atmosphere. Yet even as we enter the last phase before the Heads of Government are due to meet, there are still important differences of view on a wide range of important issues. I hope they can be resolved in time, although no one can be absolutely confident. In any case it is more important to resolve the issues wisely than to meet a specific deadline. We are after all dealing with our *long-term* future.

Lessons from the past and from the ERM

In seeking to mould the future, we would do well to observe the past. One important if fairly obvious pointer from the Community's past is that hastily conceived proposals for monetary union unmatched by underlying economic convergence are bound to fail. That was the fate of the Werner plan of 1970, which never really got off the ground. And an associated lesson is that EMU is unlikely to succeed unless there is a strong political commitment behind it. This means not only commitment by political leaders, but also acceptance by parliaments and public opinion in the member states.

Of course, the Werner proposals were by no means the first effort at monetary union by European countries. Several such unions were actually created on a smaller scale in various parts of Europe in the last century: you will be particularly conscious of the Latin union formed in 1865 between France, Belgium, Switzerland and Italy. That neither this nor any of the other major attempts survived can be put down in part to the absence of both a sufficient community of interest and a sufficiently integrated economic structure, as well as insuffucient monetary discipline. It reminds us that monetary unions do not of themselves solve basic problems of economic convergence; and that they can be dissolved as well as created, although this is undoubtedly costly, in economic and political terms.

A second—and, I am glad to say, rather more positive—set of lessons can be drawn from our experience of the EMS over the past decade or so. It is now, I think, widely accepted that the EMS has been a success. But it took time to become so; indeed the early years were not at all encouraging. The lessons I would draw are as follows.

In the first place, the EMS is no panacea. There is nothing automatic about it. It provides no miracle cure for inadequate economic performance. The system has eventually succeeded in creating a zone of price and exchange rate stability because participants have been prepared to accept the necessary self-discipline, even though it has meant, for some, adopting temporarily painful adjustment policies. This was manifestly not true of the European currency 'Snake', which preceded the EMS and which by 1978 retained only 5 members.

My second point is, therefore, that the essential feature distinguishing the EMS in recent years is the credibility which comes from firm and explicit national commitments to

(1) At Bocconi University, Milan, on 22 October.

price and exchange rate stability. The absence of such commitment can greatly damage the credibility of the whole system.

And my third and, to my mind, most important point is that the pursuit of exchange rate stability depends on the scheme having a strong anti-inflationary bias. And it is this which does not come automatically, as can be seen from the early years of the EMS, when it was felt that the onus for corrective action should lie equally between those with weak and strong currencies. In recent years it has become accepted, if only tacitly, that participants should aim to match the performance of the strongest member currency, which has of course at most times been the deutschemark. We need to think about what this means. It has become commonplace to describe the deutschemark as the EMS's anti-inflation anchor; and I think this is not an exaggeration of the past few years. But we cannot blindly rely on Germany always playing this anchor role. That it has done so comes from the Bundesbank's unswerving commitment to price stability. It is *this* commitment which must be matched and maintained by the other member countries.

There is another feature of the EMS that I see as a virtue, although perhaps not everyone would agree in all respects, which is the ability it has demonstrated to both 'deepen' and 'widen'. Deepening has taken place through the decreasing frequency of general realignments, and widening through the incorporation of new members into the ERM, Spain and the United Kingdom. Moreover, it has been possible for non-EC members to gain from ERM stability by unilaterally linking their currencies to it; Norway is a recent example, while Austria has maintained a link for some time. And the ERM provides a monetary standard to which others in Europe might be glad to attach themselves, including perhaps eventually some of the newly-liberated economies following the historic upheavals in Eastern Europe.

The way ahead: the single market and convergence

I have talked of 'self-discipline' and of 'convergence'; I see these as vital to the process of closer economic and monetary integration. We have to be clear that, although much has been achieved, there is still much to do before our economies could seriously contemplate entering into what is being called the third and final stage of monetary union.

The size of the task is illustrated by the key convergence conditions under discussion at the IGC. The current view is that, over a reasonable qualifying period, eligible member states would need to have achieved:

(a) a high degree of price stability;

(b) a sustainable government budgetary position;

(c) successful participation in the narrow band of the ERM; and

(d) close approximation of comparable interest rates relative to those of member States with the best price stability performance.

The details of these conditions and the way in which they would be applied have still to be decided, but it is plain enough that they would be demanding tests. For example, the budget deficit test is being thought of in terms of a deficit of no more than 3%–4% of national income (including debt interest); and also a stock of debt no more than around 60% of national income.

By my reckoning no more than about three member states meet them all at the moment—not even Germany, whose general government deficit is likely to reach nearly 5% of GDP this year. Certainly, neither your country nor mine would qualify at present, even on a generous interpretation.

For our part in the United Kingdom, we are determined to subdue inflation and have been pursuing a tough counterinflationary policy to that end; there is no doubt that our inflation performance must improve, and that improvement must be maintained year-in year-out. Although we have been spurred on by the prospect of 1992 and by the ERM commitments we took on just over a year ago, we would certainly have been striving to achieve price stability anyway, for the simple but compelling reason that we are convinced that we shall not otherwise enjoy sustainable growth. After our experiences of the past twenty years, there are no responsible people in Britain who believe that one can safely ignore inflation, much less that one should attempt to inflate oneself out of recession. Indeed, the fact that sterling has not encountered pressure in the ERM while we have succeeded in bringing down interest rates by $4\frac{1}{2}$ percentage points owes a great deal to our having adopted the necessary policies some time *before* joining; and it also reflects the strength of the United Kingdom's continuing counterinflationary commitment. ERM membership has of course greatly reinforced the credibility of that commitment, in the eyes of financial markets, of companies and individuals and, I trust, of our Community partners. Our twelve-month rate of inflation as measured by the headline retail price index is now down to just over 4%. On the budgetary side, the Government's accounts have, until recently, been in approximate balance or better for some years. The recession is now, inevitably, pushing us into deficit for a while, but the Government has made clear its objective of balancing the books over the medium term.

I am therefore hopeful that the United Kingdom is set on a course which will meet the economic convergence conditions in a very few years' time.

Of course, you too in Italy have had inflation problems, and equally you too have made progress in overcoming them. But, if you will permit me the licence of saying so, your government clearly has important structural and budgetary problems to cope with as well. Strong efforts will be needed to overcome them. Success in reducing inflation further should help by reducing the burden of debt interest, which is currently a large element in the Italian deficit. Even so, it could take some years to reduce the debt/income ratio to the proportions required for EMU.

Admittedly, no set of bare numerical criteria is going to tell the whole story. Other things will have to be weighed heavily in the assessment of readiness for monetary union. We in the United Kingdom attach considerable importance to completion of the Single Market as a condition for moving beyond Stage 1, as was agreed by the Rome European Council in October last year, and we would like to see that reaffirmed. And we believe that the first benefits of this process in terms of greater competition and market flexibility need to be secured before there can be serious contemplation of Stage 3. Otherwise there would be risks that monetary union would run into severe problems before its benefits, which are essentially long term in nature, could come through.

Ideally, therefore, we would like to see the convergence criteria include tests of supply-side flexibility, so that the costs of union will be bearable and so that the union will be able to cope with future economic shocks which affect its members differently. If devising such tests is technically too difficult, we believe that supply-side considerations should nevertheless be taken into account in the *judgements* eventually made on convergence.

And it is important to emphasise that assessing the viability of a move to monetary union will, necessarily, be a matter of judgement. This is not merely because of the need, as I have argued, to weigh real economy factors. It is also because even the apparently straightforward criteria concerning nominal magnitudes, such as inflation, are bound to prove complex.

In particular, they are likely to be subject to problems of measurement and interpretation, and should certainly not be applied mechanically. For example, there is the question of what is meant by price stability. Should we literally mean zero inflation, according to published indices of consumer prices? It is well known that many goods and services undergo a continuing process of quality improvement and that although statisticians try to adjust for these changes, they probably do so only partially. If so, consumer price indices may overstate true inflation by an unknown though probably small percentage. Should we therefore aim at measured inflation of 1%–2% per annum? Not necessarily. Most manufactured goods experience productivity improvement and there is no reason in principle why their prices should not *fall*; indeed the money prices of some goods do actually fall through time, as anyone who has bought ballpoint pens, televisions, gramophone records or, more recently, computers over the years knows from personal experience. In fact, since very few goods and services suffer persistently *declining* productivity, it might even be argued that our aim should be modest negative inflation. Gone then would be the need for 'automatic' annual wage increases!

So there are many complications, and that fortifies me in my view that the criteria cannot be mechanistic; there will be an element of judgement. And on that basis, I would suggest that overall consumer price stability, simply stated, may be the best way of expressing the objective. The important thing is that expected changes in the general level of prices should not enter significantly into economic decision-making; that is into the spending and saving choices of firms and individuals.

Price indices are subject to other complications as well, for various reasons. It is well known for example that the prices of many services, especially those sold in so-called 'sheltered' markets, typically rise faster than prices of manufactured goods, because productivity tends to rise faster on average in manufacturing and manufacturing is usually more exposed to international competition. It may therefore be the case that, for structural reasons, overall inflation tends to be rather higher in less-industrialised regions of the Community than in the industrial centres. Should different regions nevertheless aim at exactly the same price stability objective? This, again, calls for judgement, taking account of particular cases; although I have to say that, on conventional figuring, such factors seem unlikely to warrant persistent national inflation differences of more than a very modest amount.

Inflation rates are not alone in having complications; some of the other proposed criteria are not straightforward either. Interest differentials may require careful interpretation; for instance because rates in small, less-liquid money and bond markets will never be quite as low as those in large, highly-developed markets. And measures of budget deficits are notoriously dependent on such matters as scope and the state of the economic cycle.

In fact, I should, I think, say something about the need to include measures of the overall fiscal position among the criteria for convergence. I do not think their need is disputed. Large and persistent budget deficits are a potential source of inflation through the temptation they offer for government to indulge in excessive monetary creation; and since there is no presumption that they will be accompanied by commensurate investment in productive assets, they threaten to generate excessive consumption, likely to show up eventually as either inflation or unsustainable balance of payments deficits. For that reason some argue for the so-called 'golden rule': that public sector deficits should not exceed public investment. Unfortunately this too is subject to serious measurement problems, such as the difficulty in identifying the true economic depreciation of public sector assets, and the ambiguity in dividing some kinds of public expenditure between consumption and investment. (For example, how should one classify spending on the salaries of teachers engaged in vocational training?)

The inclusion of public sector debt-to-national income ratios as a further convergence criteria perhaps needs slightly more explanation. I think there is broad agreement, however, that a large debt overhang is likely to create serious problems when there are positive real interest rates, because of the heavy implied tax burden; and, of course, positive real interest rates are necessary to bear down on inflation. The difficulty comes in judging what level of public debt service is sustainable; there can be no absolute answer. In my own view, a debt-to-GDP ratio of much more than around 60% is distinctly within the danger area of potential unsustainability, unless governments are persistently achieving the budget surpluses needed to reduce it.

Need for an economic judgement

I have commented at some length on convergence criteria lest I be thought guilty of oversimplification in insisting that we have to be sure of achieving genuine, sustainable convergence before taking irrevocable steps towards monetary union. Judgement will certainly be needed in assessing which countries are ready to move to Stage 3. But the criteria must be *economic, not political*. There is agreement that no member state should be *obliged* to move to Stage 3, and the United Kingdom values this; and that none should be *arbitrarily* prevented from doing so, which also seems right. But, in addition, it is plainly important that countries should *not* be able to join a currency union unless they are economically ready to do so. That is the importance of the convergence criteria. And it means that the *economic* hurdles to be surmounted for entry to Stage 3 therefore need to be *clearly* stated and their significance widely understood as soon as possible.

This may, I am conscious, sound a little hard-edged, but it really is a crucial point. The economic stakes for all member states will be very high. The dangers from countries joining prematurely would be enormous, both for themselves *and* for others. I know that there are contrary views on this, and that some believe that union can—even should—precede convergence on the basis that it would promote convergence. But the history of previous attempts at monetary integration seems to me to cast very serious doubt on that view. And, in addition, this is hardly something where risks could sensibly be taken.

There are two particular dangers that I want to mention. One is that, absent adequate economic convergence and supply-side flexibility, successful regions within a monetary union could all too easily find themselves being called to assist, with money transfers, those areas which had not adjusted sufficiently before joining. This is, of course, happening within Germany at the present time. But, as a single country rather than a union of separate countries, Germany has in place mechanisms, such as a social security system, for transferring resources from rich to poor regions; and, critically, these mechanisms enjoy political legitimacy. Broad political support for transfers on a large scale among Community countries would, I suspect, be absent, so that problems brought on by a premature move to EMU could generate political tensions in the Community. But that is for politicians.

As a central banker, I have another concern. A key danger as I see it is that inadequate convergence on low inflation *before* setting up a currency union could lead to subsequent pressure for relaxation of monetary policy, and hence a dilution or even sacrifice of the objective of price stability. Such an outcome could be near disastrous for the Community; a monetary union which is not based on price stability could very easily unravel and would certainly be in nobody's long-term interests. And that is why central bankers attach so much importance to the proposed European System of Central Banks having the clear and untrammelled objective of price stability; and to its being given the independence necessary to pursue that objective.

This is all by way of explanation of the stress which the Bank of England and the United Kingdom place on convergence criteria, both for the Community as a whole and for individual member states aiming to join a Stage 3 monetary union. But I should make it clear that the United Kingdom also places great emphasis on the Community moving *together* as far as possible, so that any countries which were not ready for Stage 3 or which did not wish to join when the time comes should not be left permanently behind, or excluded, if they later wished to proceed. This seems to point to a need for patience and caution in setting the timetable; it would surely not be sensible to start Stage 3 before a clear majority of member states were both economically ready and politically willing to join. It also points to the need for a framework for continuing monetary co-operation between participants and non-participants in Stage 3, including new Community arrivals, a number of whom must be expected over time. It may well be that, if EMU is established, the ERM (or something like it) should continue to be available for non-participants. These are all issues needing further consideration in the weeks before Maastricht.

Accountability of the ESCB

I spoke earlier of political acceptance, which I stressed was an important condition for a successful monetary union. The UK Government has insisted that the final decision on whether to join Stage 3 must lie with the British people, expressing their view through Parliament. At times, this attitude has seemed to meet with a degree of incomprehension—even irritation—among Community colleagues. I hope you will agree with me that this is unwarranted. Moving to a monetary union would be a very major step—for individual member states and for the Community as a whole—and each country must therefore take the critical decisions in a way which secures the necessary political legitimacy. In fact, it has surprised me a little that other States have not taken a similar line to ours.

If Maastricht agrees Treaty changes which fall to be ratified by national parliaments, one may be sure that commentators will put the small print under the microscope. There will be a realisation that, even though the final decisions to move to currency union still lie some way off, any arrangements agreed by the IGC will be hard to change. Among them, the institutional arrangements provided for the proposed European Central Bank and participating national central banks will rightly be seen as key points. As I have indicated, central bankers firmly believe that the ECB must enjoy sufficient independence to pursue price stability. I hope that in time that view will be shared by ordinary citizens across the Community.

Of course, in a democracy such independence could not be absolute: there would have to be adequate accountability, 'properly embedded in the democratic process', as the Delors Report put it, which I mention because I would not want it to be thought that the Central Bank Governors overlooked this need for accountability. In a Community with twelve national parliaments as well as the European Parliament this would be no straightforward matter. It would be important not only to get the balance between independence and accountability right but also to give national parliaments a clear and important role. I suspect that there are one or two tricky issues here that need more attention between now and Maastricht.

The EMI

I have talked mainly about possible arrangements for the longer term, but I would finally like just to touch on the more immediate question of Stage 2. Throughout the EMU discussions the United Kingdom has felt that the immediate developments beyond Stage 1 need careful thought. Our original proposal for a new Community institution, the European Monetary Fund, with a key role in managing a new common currency, the Hard Ecu, has not I regret to say won majority support in all its details. But elements of the proposal have been developed by the twelve—in particular the need to harden the Ecu as the Community's monetary standard. And it has focused attention on the importance of addressing life beyond Stage 1 but before Stage 3. There has, since we launched the Hard Ecu scheme, been an active debate on this, and I am glad that there now seems to be a good deal of agreement in this area.

The new institution which is now emerging for Stage 2 has an equally inelegant name (in my language, if not in yours!) —the 'European Monetary Institute'. The EMI will not be an embryo European Central Bank; rather, it will build on the *existing* Committee of EC Central Bank Governors, taking over the running of the EMS and preparing the institutional and technical arrangements for Stage 3, as well as having a role in relation to the hardened Ecu. An important feature for all of us is that it will have only an advisory role in policy; it will not have policy decision-making powers, so there will be no confusion of national and collective policy responsibility in Stage 2.

An EMI along these lines may not sound like a terribly bold move. But it would strengthen the existing arrangements for consultation and co-operation among the Community's Central Banks. As I have said *responsibility* would remain unambiguously with national authorities, but the EMI would provide a useful means through which peer group pressure could work to ensure that all member states maintained an appropriate monetary policy and pursued price stability. Indeed we might even have to envisage a Governor returning home with a message from his fellow Governors that policy in his country needed adjustment. I do therefore think that the EMI could offer a sensible, sustainable and adaptable framework in the tradition of the EMS, with potential to reinforce convergence if the national will exists to exert self-discipline.

Summing up then, I think that, from a basis of goodwill and co-operation, great progress is being made in the negotiations leading up to Maastricht. There are, of course, issues left to resolve and I have today identified a few of these which strike me as among the most important, including the independence and accountability of the ECB; the monetary arrangements for any countries which did not initially participate in a Stage 3 Monetary Union; and above all, the degree of economic convergence needed before moves to Monetary Union could be contemplated. And in my view, as will be clear by now, convergence, based on a commitment to economic self-discipline and above all to price stability, is the *only* foundation on which progress towards EMU can be securely built.