The world economy and Europe—1991

Reviewing[1] *some of the challenges and uncertainties facing the world economy, the* ***Governor*** *stresses the importance of ensuring that the GATT trade talks should not be allowed to fail, and comments also on the need for fiscal restraint in Germany in the face of the dilemmas posed by the mounting costs of unification. Against the background of current difficulties, he spells out the risks of moving to monetary union in Europe before there has been a much greater degree of economic convergence and sufficient structural integration to ensure the social and political costs of union would be manageable and acceptable.*

There are, however, useful ways in which further progress can be made that do not involve unnecessary risks, and the ***Governor*** *goes on to argue in detail the advantages of the UK proposal for a European Monetary Fund and a Hard Ecu: in particular, it would help to familiarise the Community with the concept of a common currency; it would address the question of how transition to a single currency and a European central bank could be managed and the essential credibility acquired; and, most important of all, it would have powerful anti-inflationary characteristics, so that it could, over time, become the anchor currency.*

It is not only with great pleasure but also with a sense of appropriateness that I find myself in Hamburg addressing you this evening. Like my own country, 'the Free and Hanseatic City of Hamburg' developed and prospered through international trade over many centuries. As modem Europe started to emerge five centuries ago, you were one of its commercial leaders; and Hamburg's merchants, along with those from other Hansa towns, played an important part in the development of the City of London. Your trade ultimately extended beyond Europe to reach the Americas, Africa and the Far East, so that you were truly 'Germany's gateway to the world'. An achievement that lives on to this day.

I should like to think that this shared reliance on international trade has also given us shared values. We both value pragmatism. And we are both, I believe, cosmopolitan—or, in the modem idiom, internationalist—in outlook. This has encouraged me to share with you this evening some thoughts on the current world economic situation and on the debate on European monetary union.

The importance of free-trade and the GATT

The peoples of Hamburg and London both know that the great leaps in prosperity—the standard of living improvements enjoyed by our people—have flowed from the growth of world trade over the centuries. Thankfully, global trade is not a zero-sum game. Countries and cities pursue their economic ends most successfully when their trading partners also benefit. We tend to do better when we collectively pursue policies that lead to a bigger cake than when, out of short-sighted self-interest, we seek solely to increase our share of the cake. Or in other words, *enlightened* self-interest actually requires co-operation and recognising the objectives that we share with our partners.

Nothing could be clearer to those from trading cities such as Hamburg and London. And taking this to be self-evident, you might well ask why I labour the point. It is because I believe that, sadly, there is in fact a pressing need to remind ourselves of these truths at the current time.

Nowhere is this recognition more urgently needed than in the GATT talks, and yet it seems to be absent. The Uruguay Round has rarely grabbed the headlines; it is too easy to think of it as bureaucratic behind-the-scenes work of only marginal importance. But we now have to face the risks of the talks failing. They should have been completed last month in Brussels. But agreement could not be reached, largely because the United States and the European Community differed on the degree of liberalisation needed in the agricultural sector.

The issue is now urgent. If the talks fail, the consequences, far from being the minor set-back that some appear implicitly to assume, would be far-reaching, with serious implications for the world economy. There would be a real risk that parochial, and misconceived, self-interest would lead to a series of protectionist measures that, over time and cumulatively, would do great harm to world trade and prosperity.

(1) In a speech to Members of the Übersee Club, Hamburg, on 22 January.

Trade conflicts between the major industrial nations would be especially damaging as we address the problems of a slowing world economy and the task of reconstructing eastern Europe. But the consequences for the developing world would be even more disastrous. For all these reasons, I hope that the governments participating in the GATT talks will display the statesmanship that the situation demands.

The world economic situation

The risk of a failure of the trade talks is only one of the many uncertainties facing the world economy. Another is the Gulf situation. The invasion of Kuwait five months ago led to an inflationary rise in oil prices and a sharp increase in uncertainty. And since fighting began, markets—in currencies, bonds, gold and, most strikingly, in oil—have been reassessing the economic implications of military action, as expectations vary as to how long the war will last and as to its longer-run effects on oil production. So far markets have coped well, without severe disruptions to trading mechanisms or settlement processes. It is important in my view—and very much in the London tradition—that markets should do their utmost to remain open at all times in the period ahead.

It is I think fairly clear that the Gulf events have reinforced the slowing in the world economy that has now been apparent for some time. Some countries—notably North America and the United Kingdom—are clearly in recession. Most other industrial countries, with the notable exceptions of Germany and Japan, seem set for a period of only moderate growth; in Europe, growth projections for 1991 have been scaled down in Italy, Spain and, to a lesser extent, France.

This is, to a degree, an inevitable response to the measures introduced to combat inflation. Speaking for the United Kingdom, I acknowledge that, with the benefit of hindsight, policy was insufficiently restrictive in 1987 and 1988. In part this was because we misjudged the underlying strength of demand, and overestimated the extent to which it would be adversely affected by the stock market crash in October 1987. Once it became apparent that domestic demand was growing too rapidly, tough domestic policies were applied. Our decision to join the ERM last October should be seen as a strong reinforcement of our anti-inflationary policy. And perhaps I can take this opportunity to stress to a German audience that we are absolutely determined to stay within our ERM bands and to subdue inflation. This may, I am afraid, entail some initial loss of output depending on how quickly the economy adjusts, but we are prepared to accept that for the longer-run benefits of a credible and lasting reduction in inflation. Only then can durable growth be sustained.

Although the United Kingdom and a number of other countries are now in recession, I do not expect there to be a particularly deep or lengthy retrenchment in the world economy. For one thing, economic activity in Germany and Japan promises to remain robust. In addition, we do not face the kind of stock overhang that increased the severity of previous downturns. And although concerns have been expressed about the health of the financial system, there are risks of exaggeration. Comfort can be drawn from the fact that the world banking system entered the current slowdown with stronger capital ratios than in similar periods in the past.

Once the uncertainties engendered by the Gulf war are past therefore, I think there is a good chance that prospects for the world economy will brighten.

The ERM; a policy dilemma in Germany

There are, however, other factors at work in Europe, and perhaps I could now move on to say a few words about prospects in the ERM countries. The ERM's success does, of course, rely heavily on the discipline of the deutschemark anchor. In consequence, the policy decisions taken here in Germany are of great significance to your ERM partners.

Demand had begun to turn up even ahead of unification, but unification has obviously been a further powerful impetus. Last year's GNP growth of over 4½% was, of course, the strongest for almost fifteen years, and it seems likely to be rapid again this year.

This presents a complex set of economic policy issues. On the one hand, robust German demand is welcome to Germany's trading partners in the European Community and beyond. Together with continuing growth in Japan, rapid growth in German imports will underpin economic activity, moderating the slowdown elsewhere and helping to reduce external imbalances.

But rising demand pressures have led to fears that inflation may accelerate. The German budget deficit has increased sharply as a result of the expenses of unification. The official projection for the deficit this year is already around 5% of German GDP, compared with 0.9% in the final year before unification. And even this projection for 1991 seems to be based on a number of possibly optimistic assumptions. In particular, it assumes that the costs of unification, primarily the costs of supporting, then rebuilding, the economy of eastern Germany, have been correctly estimated. Furthermore, although the Federal Government has now published details of how it intends to keep its own deficit to DM 70 billion, the financial position of the Länder Governments, for which no plan has yet been laid out, will be equally important in keeping the overall deficit down to the proposed DM 140 billion or, as some are now saying, DM 160 billion. There also appears to be strong pressure from eastern Germany to increase the contribution of the Unity Fund. Finally, the current estimates make no allowance for further expenditure in the Gulf or elsewhere in Eastern Europe.

As you know, there is a widespread concern that these fiscal developments may mean that monetary policy will have to bear too much of the burden of keeping inflation down, and that higher German domestic interest rates will create tensions in the ERM that could be avoided by fiscal restraint.

What is the right response to this? There is no simple or complete answer. Nevertheless, I would venture to put forward two principles. First, there must be no compromise in the fight against inflation. We have all benefited too much, directly and indirectly, from Germany's low inflation to want to give up the advantages of a strong deutschemark. Second, monetary policy is more effective, and less disruptive, if it receives adequate support from fiscal policy. We recognise of course that unification is a unique event which requires and justifies exceptional measures. But the risks must also be recognised.

Monetary union in Europe

These observations will, I hope, help to illuminate some of the important underlying issues in the debate on economic and monetary union. At first sight, it might seem just slightly ironic that I should be calling for fiscal restraint in Germany, when it is Germany that has been the keenest advocate of binding rules on budget deficits in a monetary union, whereas the United Kingdom has been resolutely opposed to this. I say 'at first sight', because the approach we have recommended by no means neglects the importance of budgetary restraint. It is indeed something the UK Government believes in very firmly and is enshrined in its policy of aiming at a balanced budget over the medium term. We believe, however, that budgetary restraint would best be encouraged through peer-group persuasion and market pressures; partly because, in our view, binding rules would be excessively mechanical. It would be disingenuous to pretend that Germany has not been subject to peer-group pressure in recent months.

Much more importantly, I think the current situation helps highlight the importance of the Economic Union (or 'EU') part of EMU, which it has been all too easy to neglect as we have debated the pros and cons of various routes to greater *monetary* integration.

The economies of the European Community are not nearly so converged or integrated as some appear to think. This is apparent whether one looks at inflation, fiscal deficits, or unemployment rates; and applies to the narrow band countries as well as to the Community as a whole.

A Community monetary union imposed in these conditions—and more generally before much more convergence was achieved—would be a fragile entity. Monetary union would not only prevent exchange rate changes between Community currencies, it would entail a single official interest rate for the whole of the Community.

No-one should therefore be in any doubt that a move to Stage 3 would have major implications, and would furthermore have to be envisaged as a permanent, irreversible step. There could be no going back without a massive disruption to our Continent's monetary system. To my mind, the risks of moving to a single currency too early far outweigh the costs of delaying monetary union until EU is much further advanced.

This view is, as I am sure you are aware, shared by the President of the Bundesbank. Indeed, his and my repeated insistence on the importance of *convergence* has at times risked overshadowing an equally important economic pre-condition for successful monetary union. It would be quite wrong to think that conditions for monetary union would be ripe just as soon as key indicators such as inflation rates, interest rates, budget balances and cyclical portions were, on some measure, sufficiently close. First, *conjunctural* convergence must be *durable*, and not just a temporary coincidence. And second, it must be accompanied by a high degree of *structural integration* of our economies. By this, I mean a high level of trade and investment between the countries of the Community and high mobility of capital and labour across frontiers.

Why should this be so? In short, because of the way the regions of the Community would be able to respond to economic shocks.

If the economies in a monetary union were structurally different, they would tend to be affected in different ways by external shocks. The desirable policy responses would therefore also vary from region to region, but the options would be constrained by the lack of exchange rate flexibility and there being one Community-wide interest rate. In these circumstances, a region would adjust more easily if the prices of capital and labour were flexible and labour was mobile. And in the absence of these characteristics, the response would tend to come through a change in the level of activity, with badly hit areas suffering a loss of activity and employment. In circumstances where there is lack of an adequate degree of structural integration and where the prices of capital and labour are inflexible and labour is immobile, there is therefore value in retaining the discretion to set different interest rates in different parts of the Community.

In national economies, these problems are reduced by tax and social security provisions that help spread the burden of adjustment across countries and regions. In Hamburg, you are, I am sure, very conscious of the role of the financial equalisation mechanism that operates between the Länder. But the Community does not have—and is very unlikely to have—such mechanisms. That being so, a premature monetary union would be quite likely to lead to calls for special regional transfers on a large scale; indeed on a scale that would very likely prove unacceptable politically in the 'contributor' member states, and would lead to tensions within the Community. And furthermore, such transfers could actually stand in the way of fundamental adjustment.

So there is more—much more—to setting up a monetary union than agreeing the constitution of a central bank and the tools of monetary management. Monetary policy affects the lives of citizens—their welfare and prosperity; indeed that is what it is for—and it therefore has inescapable social and political implications on a day-to-day basis. This is not to say that monetary union would need to be accompanied by political union or that it would over time inexorably lead to it. But it is most definitely to say that the economies of the participating countries would need to be sufficiently integrated for the social and political costs to be manageable and acceptable to the people.

I conclude that there is a real risk that those who wish to press ahead fastest with monetary union for political reasons are overlooking the economic obstacles that stand in their way; obstacles that, when hit, could create political discontent as well. The difficulty is that this would become apparent only once the mistake of a premature monetary union had been made. We should not for a moment allow ourselves to think—or hope—that economic realities would not assert themselves.

The wisest course, in my view, would be to await the greater economic integration that will inevitably result over time, from the implementation of the 1992 programme. As we achieve better convergence in underlying economic performance and as our economies become more closely linked through greater mobility of factors of production, as well as through trade integration, we shall be better placed to decide on both the means and timing of further steps in the process of monetary integration.

These changes will not be complete on 1 January 1993. Cultural and linguistic considerations suggest that it will take some years for the legislative programme for 1992 to have its full effect on economic behaviour. The economic impact of German unification is a further useful reminder that unexpected country-specific disturbances can occur, and take time to address.

Beyond Stage 1

But this caution does not necessarily point to a totally passive approach, with *any* moves on the monetary side needing to be delayed until much greater convergence and integration is achieved. On the contrary, it should be possible to adopt an approach based on *parallelism*, which was emphasised by the Delors Committee. This would involve taking steps towards greater monetary integration when that was economically feasible and in the belief that they would foster *further* economic convergence and integration, so making possible yet more steps on the monetary side.

In general terms, I can see three possible approaches to moves beyond Stage 1 that seem worth considering. One would be an intensification of co-ordination and co-operation among central banks, based on the EC Governors Committee. A second would be somehow to strengthen the mechanism of the ERM, and the various proposals for hardening the Ecu can be seen as examples of this approach. And a third would be to set up an institution with real operational functions and with the prospect that it might, in time, be the basis of an ESCB for Stage 3.

The UK proposal

These approaches need not be mutually exclusive and, in fact, I believe that the United Kingdom's own favoured approach—to set up a European Monetary Fund to issue and manage a new common currency, a Hard Ecu—would combine the best features of all three. I will confine myself to addressing its chief characteristics; and I will save until last the point about counter inflationary performance, which I know is of most interest here and which I agree is by far the most important test of the proposal.

(a) Familiarising the Community with a common currency; allowing businesses and consumers to choose

First, the introduction of a new common currency would help familiarise businesses and individuals with the concept of supranational money. They would be able to express their support for such an innovation in the most practical way possible—by using it.

The circulation of a common currency would therefore give businesses and consumers a real choice. Their behaviour would provide a more reliable guide to whether the people of the Community genuinely want a single currency than *a priori* reasoning and political rhetoric. As we saw the speed and pattern by which its use grew, we would be better able to judge the timing and nature of further institutional change.

The proposal therefore has the virtue of being evolutionary and market-based. I am conscious that those may be thought to be characteristics particularly appealing to Anglo-Saxon countries. But I frankly challenge that. The 1992 programme and the creation of the Single Market, which will be the Community's greatest achievement to date, is plainly based on market principles. The view that markets provide the most efficient way of enhancing our prosperity is widely shared. And I would therefore suggest that an argument that progress beyond Stage 1 should be market-based is a powerful one.

(b) Transition to Stage 3

Second, the UK proposal addresses the difficult question of how transition to Stage 3, if that were ever the wish of peoples and governments, could be successfully managed. There are very obvious difficulties with an abrupt leap from twelve currencies to a new single currency, and a sudden transfer of responsibility from twelve national central banks to a new European Central Bank. This problem would not, in my view, be eased greatly by setting up an institution in Stage 2 unless it had some genuine operational role. It would not be enough simply to call such a new Stage 2 institution 'the ESCB'; continuity of function is more important than continuity of name.

This difficulty of transition is particularly acute given the paramount importance to central banks of credibility and legitimacy. The price of achieving credibility is a willingness to accept that interest rates have to be at whatever level is necessary to maintain price stability; lack of credibility could mean higher interest rates. So how to ensure a Community central bank enjoys credibility has a real bearing on levels of economic activity in the Community.

It would be a mistake to think that any new European Central Bank would automatically have the credibility of the Bundesbank. In the first place, it would not be the Bundesbank; it would plainly be a new institution, under different control. And credibility would not be bestowed merely by the ESCB having a similar constitution to the Bundesbank, which is something that the EC Governors have recommended and which I broadly support. Credibility has to be earned.

A further advantage of the UK proposal is therefore that the EMF could build up credibility through its management of the Hard Ecu, and it would have this credibility behind it if the Hard Ecu ever became the single currency of the Community.

(c) The anti-inflation characteristics of the Hard Ecu

The EMF could achieve this credibility only if the Hard Ecu was a non-inflationary currency. This and the effect of the Hard Ecu on Europe's inflation performance generally is, I am perfectly well aware, an important concern here in Germany. It is, in fact, a question I pressed myself as the proposal was developed, and I strongly believe it meets the test. Indeed, our intention is that the Hard Ecu should reinforce the anti-inflation discipline presently exerted by the Bundesbank.

The Hard Ecu would not be victim to the pitfalls of other parallel currency schemes because it would be defined so that it could never be devalued against other ERM currencies in a realignment. That is to say, its value would match that of the strongest currency and therefore the EMF's policy for the Hard Ecu would need to be at least as counter inflationary as that of the strongest currency's central bank. In concrete terms, the EMF would need to be just as resolute as the Bundesbank. The Hard Ecu would therefore become a standard of the best inflation performance, rather than the average—the problem with the present Basket Ecu.

Moreover, the EMF would be empowered to ensure that Hard Ecus were created only as a substitute for, and not an addition to, national currencies. And it would be able to exert a strong influence on the monetary policies of central banks throughout the Community, by setting Hard Ecu interest rates at a level of its own choosing and by having the right to sell any national currency it had acquired back to the issuing central bank in exchange for hard currency.

Since some observers maintain that the Hard Ecu would risk undermining anti-inflationary discipline, I hope you will allow me to take just a little time to explain how these mechanisms would work in practice.

A rise in Hard Ecu interest rates would encourage holders of weak national currencies—weak because of lax policies—to exchange them for Hard Ecus. The EMF would be able to present this national currency back to the relevant national central bank, which would therefore suffer a loss of reserves and would be placed under pressure to tighten its domestic policy so as to increase confidence in its currency and thus stem the flow from its currency into Hard Ecus. This would tend to depress national currency creation, and thereby restore the appropriate Community-wide stance of monetary policy.

Perhaps at this point I should briefly address the claim, made by some critics of the Hard Ecu proposal, that its primary objective would be exchange rate stability rather than price stability, and that this could lead to wrong policy prescriptions. Although this criticism has gained some support, it is neither the intention nor the expected outcome. The premise of the proposal is that any arrangements for moving beyond Stage 1 should ensure, to the maximum degree possible, anti-inflationary pressure and convergence towards stable prices. It is of the essence that the operations of the EMF could only subtract from inflationary pressure and never add to it.

The Hard Ecu system would therefore operate in roughly the same way as the gold standard during the years of its success, and it is also similar to the way the ERM has worked, with the deutschemark as the anchor. From a German perspective therefore the UK plan can properly be regarded as substituting the Hard Ecu for the deutschemark as the ERM anchor. I can quite imagine that you might ask why this is necessary, and many of you might be opposed to it. And certainly in the absence of moves towards monetary union, it would not be necessary. But *if* the Community is going to move towards monetary union, then the deutschemark is going to cease being the anchor currency; it could only continue in that role if the deutschemark itself became the single currency, and that would not be politically feasible.

The issue therefore is how to develop a currency that would be an adequate substitute for the deutschemark. The Hard Ecu would be at least as strong as the deutschemark for the reasons I have described and would therefore not involve any weakening of counter inflationary policy in the Community. But, furthermore, because its introduction would not involve a leap to a single currency, the Bundesbank would continue to operate to the inestimable benefit of the Community while the EMF established credibility. The Hard Ecu would therefore have an opportunity to prove that it was a worthy successor to the deutschemark.

(d) The European Monetary Fund

These essential features—and in our eyes virtues—of the Hard Ecu proposal have been familiar since John Major announced the Hard Ecu plan last year when he was Chancellor of the Exchequer. I know, however, that a number of observers here in Germany have questioned whether the EMF would be a strong enough institution to perform for the Community the job the Bundesbank has done for Germany. They are right to stress this point, and we have been careful to ensure that the EMF would meet the test. This, I hope, was demonstrated when, less than a month ago, the UK Government published draft statutes for the EMF.

This exercise has obviously paralleled the work in the EC Governors Committee on draft ESCB statutes. And, indeed, there are a number of important similarities between the EMF and the ESCB as described in the two documents. First and foremost, both make *price stability* the overriding aim. Support for other objectives—such as the general economic policies of the Community—would, rightly in my view, be subsidiary. We have all learned only too well—none perhaps better than a German audience—that in the long run low inflation is an absolutely necessary condition for stable growth and a strong economy. This is manifestly not an optional extra, as the relative performance of the economies of Europe amply demonstrates—and demonstrates to your advantage.

Beyond sharing that primary aim, the EMF would, like the ESCB proposed by the EC Governors, have a two-tier management structure based on a Governing Council and an Executive Board; and indeed the membership structure we have proposed for the EMF board is the same as the proposed ESCB board.

Then there is the complex—and vexed—question of the balance to be struck between autonomy and public accountability. This was not resolved in the draft ESCB statutes. And the British Government has put forward two options for discussion in the EMF statutes. One of these would make the EMF completely independent of all other national and Community bodies. The second option is that the creation of the EMF should not prejudice existing relationships between Member State governments and national central banks, which would be the members of the EMF. I think it is fair to say that the inclusion by the UK Government of these options has been widely seen as a signal of just how seriously and constructively it is approaching this debate.

The proposed EMF statutes also provide for its role to be increased over time, by agreement within the Council of Ministers. It would therefore be possible for the EMF's role to be developed and broadened as it built up a track record, provided it commanded the support of the political authorities. This feature of the statutes is therefore one illustration of the way that a leap into the dark can be avoided.

The draft EMF statutes also make clear that its role would be to manage the Hard Ecu and that existing national central banks would, during Stage 2, retain responsibility for managing their currencies. There would thus be no muddying of responsibility or violation of the principle of the indivisibility of monetary policy, which I support and which has been stressed so often by the Bundesbank President. By contrast, there must be a real danger that a Stage 2 based on an ESCB with co-ordinating powers would either have no substance or would actually muddy responsibility for the conduct of monetary policy.

Conclusion

To summarise, I believe it is plain enough that the world economy currently faces a number of serious challenges. The most obvious of these—the Gulf conflict—is largely outside the province of economic policy-makers. Our role must be to ensure that monetary policy does not accommodate any inflationary consequences. That was one of the most important lessons of the 1970s.

Economic policy-makers—in a broad sense—can, however, help to ensure that world trade is not severely damaged by a failure of the GATT talks. This is an important priority.

These special factors aside—if I may put it like that—I am not unduly pessimistic about the world economy, partly because of continuing growth in Japan and Germany. But the German situation is complex, and has created the prospect of tensions in the ERM.

The issues can, I am confident, be resolved, but they should I suggest help to put in perspective the debate about economic and monetary union. I have described the dangers of a premature move. These have been set out before, but I make no apology for doing so again. They are too important for that.

We can, however, find useful ways of moving beyond Stage 1. You will not have been surprised to hear me advocate the UK proposal for doing so in such strong terms. I firmly believe that the proposal deserves to be debated seriously in the Community, and I am glad to see the interest it has created. But I believe even more firmly that we must all debate carefully and openly how to progress beyond Stage 1 in a way that benefits the Community and does not involve unnecessary risks. In that way, we can proceed in a measured way to greater prosperity, which as I opened by saying, is best achieved by co-ordination and co-operation.