Europe in the 1990s: the economic perspective

Mervyn King,[1] an Executive Director of the Bank, discusses some of the economic issues facing Europe in the 1990s. Concerns over the present conjunctural position—in particular slow growth and high real interest rates—should not, he argues, disrupt medium-term policies to raise economic growth and to ensure price stability. The current constraints on monetary policy, for which Germany is usually blamed, are the result of a collective, self-imposed attempt to enhance the credibility of Europe's commitment to price stability. This has had some success. At the same time, there is no reason to suppose that deutschmark interest rates necessarily represent the floor for short-term rates within a fully credible ERM. Furthermore, high short-term interest rates may not be as depressing a factor in investment as sometimes supposed; while long-term rates (which, unlike short-term rates, are at similar levels in the United States, Japan and Europe) reflect less the stance of monetary policy than the fundamental factors of investment opportunities and saving in the world economy. Mr King concludes by looking at some of the policies that will be necessary for growth and stability over the longer term, stressing first, the need for the EC to open its markets to developed and developing nations; and second, the importance of placing monetary policy in the hands of an independent central bank.

The middle of 1992 is a good time to take stock of the achievements of the European Community. By the end of this year the single market is supposed to be in place. And the Treaty agreed at Maastricht—though there is obviously now uncertainty about its ratification—laid down a timetable for economic and monetary union. But what comes next? On 1 July the United Kingdom takes over the presidency of the Community. As well as providing momentum to the completion of the single market, it is natural that our thoughts turn to the agenda for Europe after 1992. I would like tonight to share with you some thoughts on what such an agenda might be.

The last few years have seen extraordinary events—the collapse of Communism, the entry of 15 former Soviet republics into the principal international financial institutions, German unification, and the signing of a treaty intended to bring monetary union to western Europe. The market economy has triumphed over rival economic systems. And there has been a consistent move away from the post-war enthusiasm for planning and controls. There is a new economic consensus. Indeed, Fukayama has described these events as 'the end of history'. There is to be no more ideological debate; economic policy can safely be left to technocrats. Or, in the more vivid language of Maynard Keynes:

> '. . do not let us overestimate the importance of the economic problem, or sacrifice to its supposed necessities other matters of greater and more permanent significance. It should be a matter for specialists—like dentistry. If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!'[2]

But the collapse of the intellectual enemy has not produced rejoicing in the camps of the victors. Instead, we see in Europe a widespread concern over our economic prospects, and, following the collective betrothal at Maastricht, signs of nerves about walking down the aisle to formalise the union. There is slow economic growth in western Europe, no growth in much of eastern Europe, and the bulwark of recent monetary stability, Germany, is discovering that, even in the most successful market economies, there is no such thing as a free lunch.

Nor are worries about the future confined to Europe. In the United States, a country abundantly endowed with natural resources, real wages per man-hour are no higher today than they were 25 years ago. Its financial system has experienced the worst crisis since the 1930s. In Japan the sharp falls in the Tokyo stock market—of more than 50% since the peak at the end of 1989—have uncovered scandals in market practices and made it more difficult for Japanese banks to meet the target capital ratios required under the Basle agreement. On the global stage, international policy co-ordination has played a much less prominent role than in the mid-1980s, with the G7 Communiqués becoming ever more bland. And to reach a successful conclusion to the Uruguay Round of the GATT it may be necessary to stop not only the clock but also the calendar.

There is little doubt that the enormous changes in the world economic scene have created uncertainties about the future. But these uncertainties represent great opportunities,

(1) In a lecture organised jointly by the British Council and the London School of Economics Alumni Association in Rome on 9 June 1992.
(2) Keynes 1930 page 332.

particularly for Europe. Nevertheless, it is as well to understand the causes of our present discontent. They stem, I think, from two sources.

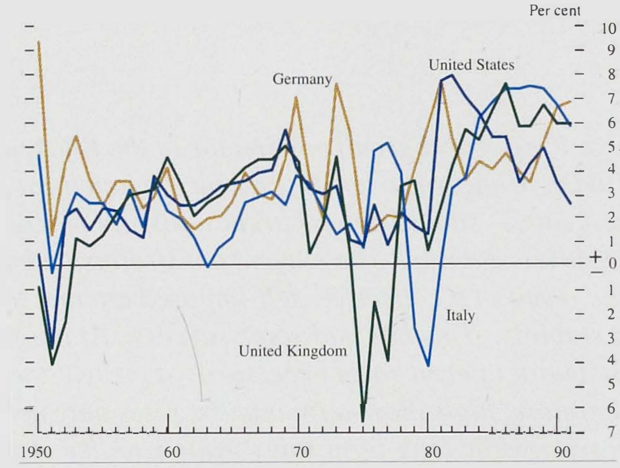
The first is the current economic situation in Europe—and, in particular, the high level of real interest rates. A rapid economic recovery, it is argued, is unlikely with real interest rates at their present level, and the critics point to the United States and Japan, both of which have taken action to lower interest rates to stimulate recovery. Indeed, the most vocal critics of European monetary arrangements have offered visions of a slump of 1930s proportions unless we escape the vice-like grip of the Bundesbank's monetary discipline.

The second is a belated realisation that underlying economic performance can be improved only slowly. Supply-side reforms—vital to the improvement of economic performance in the long run—cannot work miracles overnight. It will take many years before the newly liberalised economies of Central and Eastern Europe and, especially, the former Soviet republics, catch up to the living standards of the west to which they aspire. This is not an argument for delaying reforms—the opposite in fact—but a recognition that economic convergence inevitably will be slow. The historical experience of the United States, where the South took almost a century to catch up the North, of the slow reduction in productivity differences among regions in European countries, not least in Italy, suggests that there is no short cut to economic development. Some economists have estimated that on average the gap in levels of output per head between rich and poor regions disappears at a rate of about 2% a year.(1) Such estimates cannot be precise, and countries such as the Asian 'tigers' are clearly exceptions. They do illustrate, however, the size of the task facing those countries that have embraced market economics. But they also suggest that if these countries are both patient and persistent there will be profitable investment opportunities in the years ahead in parts of the world hitherto denied access to private capital markets.

The hors d'oeuvres to my talk was a description of the problems of the world economy; the main course will be a demonstration that these two issues—high real interest rates and the prospect of structural change in the world economy—are inextricably linked. Anticipation of structural changes and reforms raises investment and lowers current saving. It is these forces, not monetary policy, which determine the level of long-term real interest rates, not only in Europe but in the world as a whole. Let us start the main course by focusing on the question of why interest rates in Europe are so high.

It is important to tackle this issue head-on for two reasons. First, there are more misunderstandings about the role of interest rates than almost any other aspect of economic policy. Second, interest rates are now the primary tool of short-term macroeconomic management and will, when

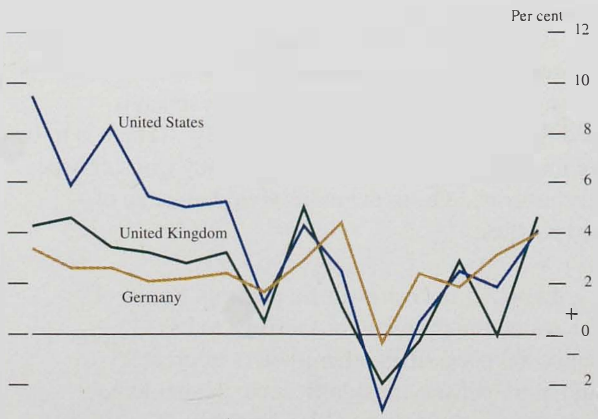
Chart 1
Short real interest rates 1950–1991



Economic and Monetary Union occurs, be under the control of the European Central Bank.

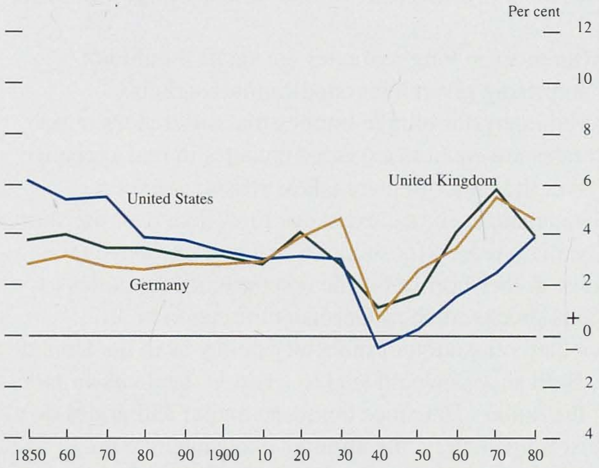
It is undeniable that real interest rates are high by historical standards. Real interest rates—the nominal rate minus the expected inflation rate—are notoriously hard to measure. They depend upon unobservable expectations of future inflation and the nominal rate at which households and firms can borrow. Nevertheless, it is useful to examine some approximate estimates of real rates in Europe and the United States in recent decades. Chart 1 shows such estimates for short-term real interest rates—defined as a horizon of one year—over the period 1950–91 for the United States, the United Kingdom, Germany and Italy. Not surprisingly, short rates are volatile and often vary across countries. There is at present a particularly large gap between short rates in the US (and Japan) and in Europe. Charts 2 and 3 put these numbers into historical perspective by showing estimated short and long real interest rates from 1830 to the present. Differences in long rates—defined over a ten-year horizon—are smaller than in short rates, despite significant variation over time. Clearly, these estimates are even less

Chart 2
Real short-term interest rates (10-year averages)



(1) In particular the work of Barro and Sala-i-Martin (1991).

Chart 3
Real long-term interest rates (10-year averages)



precise than those for the post-war period. But they do show that the level of real rates that we have seen since the 1980s is not at all uncommon. Indeed, one might be tempted to say that the real puzzle is why real rates were so low during much of the post-war period, especially the 1970s. And calculating interest rates on a post-tax basis, as they really should be, would lower the estimated level of real rates.

These data, albeit imperfect, do, I think, prompt two questions. First, why are long-term real interest rates at their highest level for some decades? Second, why do we see the unusual phenomenon of large differences in short-term real interest rates between Europe, on the one hand, and the United States and Japan, on the other?

Before trying to answer these questions, I would like to describe what I shall call the 'conventional wisdom' in terms of *three* propositions. Let me stress that I do not ascribe these to anyone in this room, but they form, I think, a useful starting point for discussion. The three propositions are:

(i) Long-term interest rates are high because the response of Germany to the economic shock of unification has been to adopt an unbalanced policy mix—with an excessively tight monetary policy required to offset an excessively loose fiscal policy. The prospect of large deficits of the public sector—in its broadest sense—is keeping long-term rates high.

(ii) Short-term rates are high because of tight German monetary policy. And since Germany sets the floor to short-term interest rates in the ERM, interest rates are high throughout Europe.

(iii) These high short-term rates are preventing economic recovery.

I want to disagree, at least in part, with each of these propositions. My reasons for doing so will, I hope, provide tentative answers to the questions that I raised concerning the behaviour of interest rates.

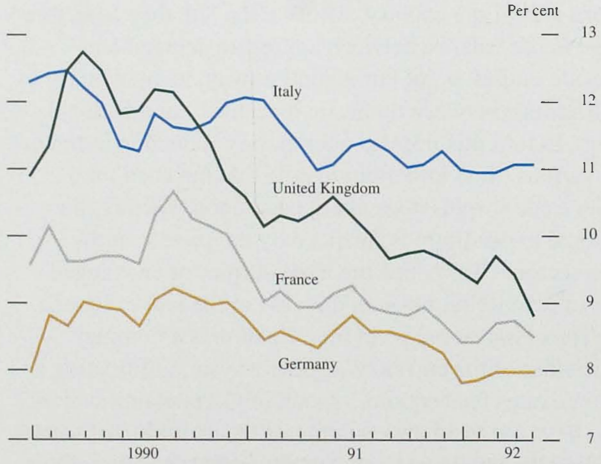
Let me turn to the first proposition which I described as the conventional wisdom—namely, it is all Germany's fault. I think it is mistaken to blame Germany in general, and the Bundesbank in particular, for the current stance of European monetary policy. Why is this the case? The economic impact of Germany unification had two components. First, an increase in consumption and investment in the new eastern Länder which required, in the short run, a reduction in Germany's net trade surplus. Second, higher expenditure by the public sector. Many commentators have focused on the second of these effects, and on the size of current and prospective budget deficits. It is true that, in retrospect, it might have been better to have raised taxes earlier because of the medium and long-term nature of some of the spending commitments. But, without a real appreciation of the deutschmark, it would have been difficult to avoid higher interest rates because of the first effect—namely the need to lower the net trade balance to meet the increased demand resulting from unification.

The impact of unification was to raise demand—for both consumption and investment—in the eastern Länder without any corresponding immediate increase in output. Much of this increased demand was for goods produced in the western part of the country. Unification led, therefore, to a change in the balance between aggregate demand and aggregate output, or, to put it another way, to an increase in the difference between domestic investment and national saving. In turn this implied a temporary reduction in the net trade surplus. It is important to note that the need for a smaller trade surplus does *not* depend upon whether the additional expenditure is financed by the private or the public sectors. To reduce the trade surplus at unchanged levels of activity requires an increase in the real exchange rate. The classical recipe in this situation is a nominal appreciation of the currency. Under a system of floating exchange rates the economic shock of German unification would have led to an appreciation of the deutschmark—thus providing the incentive to switch demand from Germany to its trading partners. And there was a short-lived rise in the deutschmark real exchange rate against non-ERM currencies in 1990. A more sustained rise would have helped to limit inflationary pressures, and some of the current difficulties might have been avoided.

But in the ERM changes in parities have costs in the form of reduced credibility in the new parities, and the member countries of the ERM decided that even the German-specific shock of unification did not justify a change in exchange rates. In any case, that is now water under the bridge. The result was that capacity utilisation in the western Länder rose, and tighter monetary policy came to bear the burden of the adjustment. The resulting increase in interest rates in Germany, and by implication in the rest of the ERM, followed inevitably. Some real appreciation of the deutschmark can take place if inflation in the rest of the ERM is lower than in Germany. To state that condition is to see why it has been difficult to achieve. Inflationary pressure in Germany derives from a real economic shock specific to Germany, and can not be attributed to a weakening of counterinflationary resolve. Long-term nominal interest rates are still lower in Germany than elsewhere in Europe. It is wrong to think that the anchor role of the deutschmark is threatened by the current rate of inflation. In the short run lower inflation elsewhere will accelerate the adjustments that are necessary. But in the long run it is a track record of the willingness to take the measures required to achieve the goal of price stability which provides the credibility that defines the anchor.

Other members of the ERM decided to maintain unchanged parities against the deutschmark. Monetary constraints on countries other than Germany have, therefore, largely been self-imposed in order to increase credibility in the long-term commitment of ERM member countries to price stability. In this objective policy has been broadly successful—at least as far as market expectations embodied in long-term interest rates are concerned. Chart 4 shows interest rates on 10-year Government bonds in the United Kingdom, Germany, France and Italy. The level of rates has fallen and there has been some convergence.

Chart 4
Long bond yields



The greater credibility in the current parities of the ERM means that short-term deutschmark interest rates do not *necessarily* represent a floor to short-term rates elsewhere. Even within the narrow band of the ERM, *provided* that there is credibility in the band itself, there is room for differentials among short-term interest rates to reflect differences in the cyclical positions of member countries. And the theoretical proposition that deutschmark rates do not have to be the floor in the ERM will be tested empirically over the next year. Whether other countries' rates will be able to fall below deutschmark rates is not a question of high theory but of practice and market expectations.

This leads me to the final part of the conventional wisdom —do the high short-term real interest rates pose a threat to economic recovery in Europe? And here I want to strike a cautiously optimistic note by pointing to the difference between short and long-term rates. As I showed earlier, the interesting feature of the pattern of interest rates is the difference between high short real rates in Europe and low short real rates in the United Sates and Japan. Long-term real rates, in contrast, appear similar in many large countries.

That differences in long real rates are small should not appear surprising given integrated capital markets. Uncovered interest arbitrage implies that differences in real interest rates are equal to expected changes in real exchange rates. Over the long run there is less reason to expect systematic changes in real exchange rates than over the short run. The main reason for thinking that real exchange rates may move in the short run is the response of economies to exogenous shocks, such as German unification or an unanticipated relaxation of monetary policy as in the United States. Both shocks would lead to a rise in the deutschmark against the dollar. But since domestic output and prices do not adjust immediately, the nominal exchange rate may 'overshoot', to use the jargon, in the short run before slowly returning to the new level. In turn, the real exchange rate overshoots, and the expectation that it will, over time, return to its long run level leads to a difference between domestic and foreign short-term real interest rates. Hence there can be large differences in short real rates which are offset by expected changes in exchange rates.

The final step in the argument is to claim that much of investment and some of consumption depend at least as much on long real interest rates as on short rates. This is for two reasons. First, an expected appreciation of the dollar and the yen relative to European currencies, which is required to make consistent the observed difference in short rates, will dampen the enthusiasm of US and Japanese exporters for investing in new capital because their temporary competitive advantage may not justify the set-up costs that are involved in the sales and production facilities for export markets. Second, adjustment costs in the process of capital formation mean that there is a degree of irreversibility in many investment projects. For both reasons, long interest rates will matter more than short rates. It follows that the difference in short real rates exaggerates the deflationary impact of monetary policy in Europe and overstates the impetus to activity from monetary policy in the US and Japan.

So high short rates may not have the impact on the level of activity that some commentators have claimed. Nevertheless, they are a restraining impact on consumption and create especial difficulties for countries suffering high burdens of debt inherited from the expansion of the 1980s. Continental Europe did not experience the sharp rise in household and corporate debt that occurred in the United Kingdom, the United States and several other countries. Such differences in debt burdens mean that differences in monetary conditions among member countries may be appropriate.

The remaining question concerns the determination of long-term real interest rates. In the long run real interest rates will, in an integrated world capital market (for either financial or direct investment) reflect the balance between the anticipated future returns on current investment and average national saving rates. In the 1980s supply-side reforms in a number of countries raised the profitability of investment and, because of expectations of higher future incomes, led to higher consumption and lower saving. Both effects would be expected to raise real interest rates, and that is what happened. In these circumstances higher real interest rates are a symptom of good news, not bad news, about the world economy. The supply-side reforms that took place in many developed countries in the 1980s are likely to be matched by structural changes in the newly liberalising economies in the 1990s. And net national saving rates fell sharply in the 1980s in all of the G7 countries, as can be seen from the Table. There is no reason to suppose that rapid economic growth is incompatible with high long-term real interest rates.

Net national savings ratios

As a percentage of net national product

	60–70	71–80	81–90	90
United States	10.7	9.1	3.7	2.5
Japan	25.6	24.6	21.3	23.9
Germany	19.9	14.2	11.6	14.5
France	19.4	16.3	8.6	9.7
Italy	20.0	15.9	10.4	8.4
United Kingdom	11.2	7.6	5.5	5.0
Canada	11.1	13.0	8.9	6.7
Major 7 average(a)	15.9	13.6	9.0	9.2

Source: OECD National Accounts.
(a) 1897 GDP weights.

What, then, are we to make of the conventional wisdom? First, the constraints on monetary policy in Europe are self-imposed in order to enhance the credibility of the commitment to price stability. In this they have had some success. Second, there is no reason to suppose that deutschmark interest rates necessarily represent the floor for short-term interest rates within a fully credible ERM. Third, high short-term interest rates may not be as depressing a factor on investment as is sometimes supposed. And long-term real rates reflect less the stance of monetary policy than the fundamental factors of investment opportunities and saving in the world economy.

I conclude from this that the tensions in monetary policy in Europe derive not from high short rates as such, but from the observation that member countries of the ERM continue to experience country-specific shocks, of which German unification is only the most extreme, and that these shocks might require different monetary policy responses.

The strains that we see are the result of a collective decision to use similar, if not yet common, monetary policies to respond to very different economic shocks in different member countries of the ERM. Those strains will continue not only up to, but after, monetary union. It is the ability to find alternative ways of dealing with these shocks that will determine the success of the move to a single monetary policy.

What does all this tell us about the agenda for Europe after 1992? The main lesson is that we must not become obsessed with the current conjunctural position to the detriment of medium-term policies to raise economic growth, on the one hand, and ensure price stability, on the other. To be fully credible such policies must be embodied in clear agreements among countries. That is why the economic aspects of the Maastricht treaty are so important. The Treaty contains provisions that might almost be described as an 'economic constitution' for the next phase of Europe's development. I would identify two parts to this constitution:

(i) competition and market access within the Community. We should go further. Europe needs to open up access to EC markets to countries in Eastern Europe, the Far East, Latin America, and, eventually, Africa. The association agreements signed with Czechoslovakia, Hungary and Poland in December of last year are a start, but only a start. Those countries to whom we preach the benefits of a market economy are entitled to expect that we should hold out practical opportunities for them to participate in a liberal trading environment. This is especially true for those Eastern Europe countries and former Soviet republics which, before their conversion to central planning, were successful exporters of agricultural commodities and raw materials.

Post-war growth in western Europe was based on the expansion of trade in manufactured goods. Trade liberalisation increases not only the efficiency with which resources are used, but also the growth rate of output. Recent studies of so-called endogenous growth models have revealed the impact that opening up of markets has on raising growth rates, both through the transfer of knowledge and new ideas and from the ability to exploit economies of scale in research and development that flow from a larger market.[1] Foreign direct investment too can transfer new technology and management skills. In the old Surrey Docks in London, there is an iron tablet which recalls the trade that used to fill the wharves which have now been converted into modern apartments—jute and spices from Calcutta, hardwood from Calabar, grain from New Orleans, wheat from Montreal, whale products from Cape Farewell in Greenland, woodpulp from Kotka, softwood from Leningrad, tar oil and tallow from Gdansk, and only general cargoes from Hamburg. Old trading relationships must be re-established. Trade is the best aid that the Community can offer the newly liberalising countries of the world.

(ii) placing monetary policy in the hands of an independent central bank. Academic monetary experts generally agree that the most effective way to achieve price stability is to delegate discretionary control over monetary policy to an independent central bank. There is a growing volume of evidence that inflation is lower the greater is the degree of independence of the central bank.[2] And the desire of governments to make a public

(1) There has been a significant expansion in the literature on the relationship between growth and trade in the context of endogeneous growth models. See, for example, Romer (1990), Grossman and Helpman (1991), Rivera-Batiz and Romer (1991), Young (1991), and Blackman and Hung (1992).
(2) See, for example, Alesina (1988, 1989), Alesina and Summers (1990), Bade and Parkin (1987), Capie, Mills and Wood (1992), and Masciandaro and Tabellini (1988).

pre-commitment to the goal of price stability lies behind the enshrinement of independence of the European Central Bank in the Maastricht treaty. But why should we suppose that a European Central Bank would be any more successful in controlling inflation than have been the countries that will participate in the monetary union? What are the incentives for a central bank to pursue price stability? As Professor David Laidler has argued persuasively in a recent paper,

> 'price stability will not just happen; it has to be engineered by some public body; and we must devise a framework which not only confers discretionary powers on that body, but also gives it the incentives to use them in a desirable fashion. When we put it this way, it becomes clear that we are discussing not some new issue, but an old one, namely the governance of the central bank'.(1)

Two features of European monetary union are important in this respect. First, the Maastricht Treaty embodies statutes for the new institution that set the pursuit of price stability as its overriding objective. Second, admission to the monetary union will be conditional upon meeting a set of convergence criteria designed to test that a country is committed to price stability *before* entry into the union. But a statutory mandate to pursue price stability will not be sufficient in itself to ensure that the goal is attained. There must also be clear public support for that goal. The lesson of the post-Maastricht hiccup in some countries—of which the Danish referendum result is the most dramatic illustration—is that an open and public debate is vital in order to provide legitimacy for the new order. And the same lesson applies to the European Central Bank. If and when it is established, its affairs must not be shrouded in secrecy. There must be a well informed and public debate over the conduct of monetary policy. And thought will need to be given to the appropriate methodology for the construction of price indices that will enable the European Central Bank to decide for itself, and to be judged by others, on the extent to which it has been successful in achieving the goal of price stability.

Conclusions

In 1492 Europeans made history by leaving these shores to open up a new continent. In 1992 American economists are returning in droves to write about the new Europe—both east and west. Let us try to rekindle some of that earlier spirit, a Europe open to the world, a single market of many peoples. The lesson of trade theory is that diversity can enrich us all through the exploitation of comparative advantage within an open trading system. Protectionist measures will lower our living standards in the long run—and raise the spectre of unwanted migration. Feeding lame ducks in western Europe will starve the healthy ducklings of eastern Europe. This is *not* a question of widening rather than deepening the Community. It is a matter of offering the rest of the world an economic and trading partnership from which all can benefit. That is not the end of history, but a 'new Enlightenment'.

Economic growth and price stability require the basis of a competitive market economy. The battle for market-based solutions will never end. As Adam Smith taught us over two hundred years ago those businessmen and politicians who—collectively—have the most to gain from the adoption of market principles are often the first—individually—to try to suppress competition. The interests of European consumers must be articulated. I like to think that economists and central bankers have a role to play in that process.

(1) Laidler (1991).

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