# Monetary aspects of European integration

*The* **Governor** [1] *argues that economic and monetary union has been made conceivable, and the Maastricht agreement possible, by the emergence over the last decade of a consensus within Western Europe on the overriding importance of price stability. Among other things, the determined pursuit of anti-inflationary policies will be essential if monetary union is to be viable; but, although the convergence criteria are achievable, they will by no means be easy or straightforward. The eventual shape of monetary union will depend on a number of issues which remain to be resolved, including the detailed institutional structure, the mechanisms for formulating monetary policy and the techniques used. In particular, the* **Governor** *raises a number of questions about the likely suitability of monetary targets. He goes on to stress that, once achieved, monetary union will live up to the hopes placed in it by EC leaders only if the peoples and politicians of all member states accept the importance of price stability and set fiscal and exchange rate policies which are consistent with this.*

It was a very great honour to be asked to round off this year's series of Green College Lectures, although one I have to say which I approach with a certain amount of trepidation: it is a challenge indeed to follow three such distinguished and authoritative speakers as Roy Jenkins, Ralf Dahrendorf and Michael Butler, and a testament to your famed skills of persuasion that I should have to.

Each of them, in different roles, has been intimately involved in the development of the European Community over the past twenty years or so, and also in our developing attitudes to the Community. Looking at the extent and scope of their contribution, I have to say that the monetary issues which pre-occupy my own institution might seem rather specialist, but in a way the development of the Community's monetary arrangements has become central to the Community's future as a whole. The issues raised by Economic Monetary Union for Europe, for the United Kingdom, and the Bank of England are enormous. So is the need to get the answers right.

## EMU and the consensus on economic policy

Personally, I think we are more likely to get the answers right if we keep very firmly in mind the circumstances in which the EMU debate has taken place—indeed, in which it has been feasible. The key has been a shift in consensus on the ends and means of economic policy; a shift which has been pronounced; which has been widespread—extending internationally and nationally across the political spectrum; but which has been insufficiently remarked upon. Twenty or thirty years ago, policy proceeded on the presumption—which was held equally internationally—that there were a number of policy objectives: growth, full employment, price stability and balance of payments equilibrium, which were potentially in conflict and which the authorities had to try to reconcile as best they could using all the levers available to them. The results were a manifest failure, and since the inflationary traumas of the 1970s, a new consensus has emerged. This gives primacy to price stability as a policy objective, not only for its own sake but also because it is a necessary condition for achieving *sustainable* growth and lasting prosperity. At the same time, monetary policy has become the principal tool for achieving price stability and providing a stable nominal framework for economic activity.

Over much the same period, broad agreement has emerged on the importance of free and open markets—of a freely-functioning market economy. In the Community, this became the basis of the drive to complete the Internal Market which is now approaching realisation, a huge achievement which should get close at last to making a reality of the Common Market talked of by the Community's founders.

As a result of that drive, we are confronted more visibly by something that has been going on in the background for some time—the emergence of the EC as a regional economy to rival the United States and Japan. The Community has become more confident in its thinking about economic policies, reflecting in part its success in recent years in coping with inflation within the framework of the ERM. That growing confidence, together with the political developments in Eastern Europe and the Soviet Union, has strengthened ambitions both to deepen the Community, as was the intention from its foundation, and to widen it.

Recent moves towards Economic and Monetary Union have to be seen in the context of these developing interests and ambitions; but they would not have been possible even to contemplate without the newly-established consensus on policy which I described earlier. With the benefit of hindsight, we can see that early efforts at monetary

(1) In the fourth 1992 Green College lecture at Oxford on 13 February 1992.

integration in the late sixties and early seventies—most obviously the 1970 Werner plan—could not reach fruition because the necessary policy consensus was lacking; the European currency 'snake' did not withstand the inflationary tensions of the mid-seventies as individual members reacted in different ways, and too often in the belief that inflation could somehow be accommodated and yet growth and exchange rate stability sustained at the same time. The experience with the snake showed graphically that a mere mechanism, even if brilliantly designed, cannot of itself automatically deliver currency stability, internally or externally. The same lesson was clear enough from the early years of the snake's successor—the EMS, set up in 1979—as it took well over five years before it could be said to be approaching a zone of monetary stability in the Community. And the key change here was a re-orientation of the objectives of economic—and especially monetary—policies in several important member states towards price stability.

If I dwell on this point, it is because, both tonight in my remarks and more importantly in the real world of a monetary union, the pursuit of price stability has to take the central role.

## The Maastricht agreement

And these issues are not academic—indeed there is little doubt that they are central—because progress towards monetary union does seem to be taking place, most obviously in the Maastricht agreement.

Maastricht was plainly a watershed, but it was also the culmination of a fairly extended process of preparation, and I naturally have to admit to a share of responsibility for this, together with my fellow central bank governors. We were members of the Delors Committee, which in its 1989 Report set out what was essentially a description of monetary union and an outline procedure for getting there. And more recently we drew up the statute for the European System of Central Banks, which was submitted to the EMU IGC in November 1990—and has changed remarkably little since then. That we were able to reach agreement in two such complex and far-reaching exercises, to say nothing of the European Monetary Institute Statute which followed, says a lot for the spirit of co-operation amongst us. In fact the whole EMU enterprise, culminating in last December's agreement, was a remarkable collaborative effort by heads of government, ministers, officials and central bankers of the member states, whatever reservations one may have about the hectic pace of the discussions and the timetable set for Monetary Union. But effort alone would not have been enough: the backbone of the agreement is the broad consensus on economic policy that I have tried to describe.

I would not, however, want to give you an unduly rosy impression of Monetary Union—either of the end-point or the ease with which we can approach it. It raises genuinely difficult questions for all potential participants, as the changes proposed are both big and, probably, irreversible—or at least would be very costly to reverse. We are contemplating a single currency for the Community, with a single monetary policy formulated and managed by a single institution, the European Central bank, at the head of a System which will embrace the existing national central banks.

That is quite an agenda. And on the face of it, a pressing one, as the Maastricht Treaty provides that Stage 3 could begin as early as 1997, if a majority of member states are judged ready for it—which is to say, if they were judged to meet the fairly strict convergence tests. Failing that, the Treaty asserts that a move to monetary union will happen by 1999 at the latest, with all countries passing the convergence tests being able to join. Between now and then, there is to be a transitional phase—the so-called Stage 2—one of the most important elements of which will be the reformation of the current Committee of EC central bank Governors into the European Monetary Institute. This will make the technical preparations for full Monetary Union and will build up further the Governors' existing consultative role, while—and this is a critical point—leaving ultimate policy responsibility unambiguously in the hands of national monetary authorities.

Two countries, Denmark and the United Kingdom, did not make a commitment now to move automatically to Stage 3. The UK government, as everyone knows, agreed to the Treaty amendments on the basis that the decision on whether or not to join is one for the government and Parliament of the day to make nearer the time. We shall of course, however, be committed to joining Stage 2 on 1 January 1994 if the Treaty amendments are approved by Parliament when they come before it later this year, probably during the UK Presidency. And it is perhaps important to stress that there is no reason at all why the United Kingdom's reserve on Stage 3 should not put us in the same position as the other eleven in the run-up to full monetary union. The United Kingdom should and can—and I hope will—meet the convergence tests, and indeed it is very much in our interests to do so. Quite apart from their relevance to Monetary Union, since for our own domestic reasons we naturally want to achieve the low inflation, correspondingly low interest rates and strong budgetary position which the tests imply.

Other countries will also be pursing the convergence standards but it is far from clear that they are better placed to achieve them than we—that is, to converge sufficiently for Germany, say, to be prepared to transfer responsibility for its currency from the Bundesbank to a new EC central bank and for a move to a single, Community-wide monetary policy to be in everyone's interests. I am not saying this will not happen—I don't doubt it can; but I am saying that the United Kingdom is in as good a position to hit that target as anyone else and therefore to have a genuine option to participate.

But perhaps I should now turn to the three issues which seem to me to be of fundamental importance following Maastricht: will Monetary Union *actually* happen and what will be needed to make it happen; what will Monetary

Union and the new monetary institutions be like; and, briefly, what might Monetary Union imply for the longer-term development of the Community?

## Will Monetary Union actually happen?

First, will Monetary Union actually happen, as foreseen in the Treaty, before the turn of the century? There are sceptics whose answer would be—probably not. They point to the economic stresses and strains in the Community at the moment; the pressures associated with GEMU; the turbulence being encountered within the ERM, the toughness of the convergence criteria; and what some—including Sir Michael Butler I believe, when he spoke earlier in this series—consider to be the 'emptiness' of Stage 2.

I think there is force in *some* of those arguments. There have certainly been economic stresses in the Community recently, reflecting the special situation in Germany following unification and the local inflationary pressures which this has generated; the general sluggishness of the world economy; and recession in a number of member states, the United Kingdom included. The combination of tight monetary policy in Germany and policy relaxation in the United States has at time put upward pressures on the deutschmark, with implications for other ERM currencies, including sterling. But the ERM has weathered other episodes of tension in the past few years, and will be able to do so again *if the right policies are followed*. That surely is the key to ERM stability. If the monetary authorities and governments of member states are genuinely committed to sustainable non-inflationary policies, and can convince the markets of their determination and ability to keep to them despite economic disturbances and periods of political pressure, market speculation will tend to reinforce exchange rate stability, not upset it. This has been our experience in the sixteen months since we joined the ERM. And furthermore, the steady application of such policies within the ERM framework is the best means of approaching the *de facto* exchange rate stability which would make the *de jure* fixing involved in a move to Monetary Union more natural and less controversial.

Determined pursuit of anti-inflationary policies is therefore the key to whether any move to full-scale monetary union would be economically viable. If the economic conditions for monetary union are met, progress towards it would depend upon the political climate in the Community at the time and on whether something had happened to cause the Treaty to be called in question. Major economic or political disruptions in the Community, not at the moment foreseen but not entirely inconceivable in the eventful times we are passing through, could admittedly upset the prospect.

But assuming no really major disruptions, the relevant questions is perhaps not *whether* Stage 3 will start in this century, but *how many* countries it will involve, and which they will be. Those are obviously impossible questions to answer with confidence now because the convergence criteria are rightly demanding; because a number of candidates do not meet them at the moment; and because the time for judgment is still quite a long way off. No country can be *sure* at this stage that it will either meet, or fail, the convergence tests. There is time for countries currently falling well short of the criteria to get their economies to a position where they can pass the tests securely, if they adopt the appropriate policies *now*. This seems so even in relation to the fiscal tests, which at present look formidable for those States with alarmingly high fiscal deficits or government debt in the area of 100% of GDP; it *is* possible to get control of an apparently intractable fiscal deficit in the space of a few years, as the United Kingdom has found, but only if the appropriate policies are followed.

So convergence *is* achievable, but it will by no means be easy or straightforward. Satisfactory progress will be far from automatic for some countries; some need to redouble their policy efforts now, and apply them persistently.

In short, the convergence criteria are set to take centre stage over the next few years. Certainly they will be a pre-occupation for the Governors' Committee in its preparatory work and in its consultations on the path of policy as we transform ourselves into the European Monetary Institute. This will, I think, provide an extra focus and dimension to our discussions. We will, I expect, have to step up our analysis of economic and monetary trends in each others' economies, to give our assessments greater depth and precision. And in fact, this is already beginning to happen, through our Secretariat and our Monetary Policy Sub-committee which meets regularly in Basle, but it will develop over time; and perhaps take a while to get used to, given the established policy-making patters under the ERM. In the same way, I would expect that there will be more of a Community dimension to our assessments and consultations; this will mean trying to identify more clearly the feedbacks between our economies, so that we can foresee better the consequences of national policies both for other EC economies and for the Community as a whole.

During this period, however, responsibility for monetary policy will remain firmly and unequivocally in the hands of national authorities. It might be though that there is room for tension here, but in fact I am hopeful that the extra element in the Governors' discussions will actually help national policy-making by providing a potentially important extra input from that source to the discussions which we shall continue to conduct here on the course of domestic policy.

## What will Monetary Union be like?

What I have been describing is of course the lead up to Monetary Union, and I think it is fair to say that, while a lot of behind the scenes work will be under way, the world will not have actually changed very much. With Monetary Union, the world becomes fundamentally different.

The *exact* shape of the Monetary Union world is, for very good reasons, not yet fully resolved. Although there is now

wider understanding about its main features, and much thought has gone into the objectives and functions of the ESCB and the ECB, there is a lot of detail still to fill in before Stage 3 can begin. In the draft Treaty amendments, the EMI is given, among other tasks, the job of making the technical preparations for the introduction of a single currency and monetary policy. There will be no shortage of technical issues to discuss. I will not detain you by enlarging on them all now, but perhaps I could say a few words on some of the most significant since there is bound to be debate on the use of monetary targets as guides to policy and on the choice of instruments and procedures for monetary control.

The United Kingdom adopted monetary targets in the mid-1970s, but had concluded by the mid-1980s that it should move away from *targeting* (with the exception of M0) as the main aggregates had been found to give distorted and misleading signals in a period of great financial change; they continued to be a very useful source of information but could not be usefully deployed as the primary benchmark for policy decisions. A number of Continental countries do still practice monetary targeting, however, and they may press for its adoption by the ECB, perhaps citing suggestions in the technical literature that monetary relationships should be more stable at a Community level than at individual country level. But on the other hand it will have to be remembered that important changes are under way in the financial structure of many member states, associated with the creation of the Single Financial Area, as well as resulting from the more general forces of competition in financial markets as liberalisation spreads more widely. It remains to be seen whether monetary aggregates elsewhere in the Community will continue to give as reliable signals to policy-makers as they may be thought to do now, and therefore what kind of indicator role they may be able to play in EMU. This would be particularly so given the inevitable problems of constructing a Community-wide monetary aggregate usable as a *target* before economic behaviour and relationships have adjusted to the introduction of a single currency. Nevertheless, monetary aggregates would be an important indicator.

But all this lies ahead of us. As does a debate about methods of monetary control, which will inevitably involve questions about the techniques and instruments for market intervention given the differences in arrangements and practices existing in the major centres across the Community at present. No doubt another issue will be whether there should be minimum reserve requirements for banks which, although discarded some time ago in this country, are retained in some form in most other member states and which have implications for the competitiveness of financial centres—not only within the Community but also as against New York and Tokyo. It will be extremely important to bear this in mind.

One of the EMI's most challenging tasks will be planning the mechanics of any transition to a single currency. Most of you will remember the decimalisation of our currency twenty-one years ago, but few I imagine will be aware of the time and effort which went into that exercise behind the scenes. It may surprise you to know that the lead time for decimalisation was about four years, and that the cost of producing new coins and converting machinery has been estimated at between 600 and 900 million pounds at today's prices. A switch to the Ecu would be a far more complex exercise, because all notes as well as coin would eventually need to be replaced and because none of the national currency units would convert on a one-for-one basis into Ecu. Equally careful thought will have to be given to the improvement of cross-border payments systems if the full benefits of a single currency were to be secured. So far, relatively little detailed attention has been given to these developments in an EMU context.

Choices about the formulation and execution of monetary policy in Stage 3 will, although technical, be enormously important as they could greatly influence the effectiveness of policy and the efficiency of the Community's financial markets, including London. They will also help to determine the structure and organisation of the monetary institutions themselves; for example, the extent to which the monetary operations of the ESCB are concentrated in one centre, or distributed between several centres, or spread among most or all of the national central banks. These issues have yet to be debated in detail, and no doubt there will be an important and difficult task there for the EMI in due course. We in the Bank look forward to playing a full part in those discussions, and we shall be pointing out to colleagues elsewhere in the Community that it will be very much in the interests of the Community as a whole for the ECB—and first the EMI—to be located in London. A single European currency would be one of the world's three major currencies, and would obviously be actively traded in centres around the world. The formulation and operation of monetary policy will necessarily have to be deeply sensitive to market development and perceptions. London is one of the three major world financial centres, perhaps the only truly *international* centre and certainly the *pre-eminent* international centre in Europe, with a depth, variety and liquidity in its money and capital markets—which very much now embrace and are developing the Ecu—that will be vital to an effective single monetary policy.

This is one of the most important outstanding issues. There are others which it will not really be possible to resolve until the Stage 3 institutions actually started to function, however much preparation there is beforehand. I will touch on just a few of them.

One is the leap of faith involved in detaching responsibility for monetary policy from that for other aspects of economic policy, and giving it exclusively to a central bank, and a new one at that. The tradition in this and many other countries has been for governments to have ultimate responsibility for the key decisions on all the main levers of economic policy, and for them to be able to use those levers relatively flexibly. EMU represents an important step away from this tradition. As envisaged in the Delors Report and after, it

means instead that monetary policy will be decided and conducted away from the political arena, on grounds somewhat similar to those underlying the administration of law by independent Courts; a tradition exemplified in the monetary model adopted in post-war Germany.

The fact that all the main political parties in this country appear to contemplate, albeit with varying degrees of reservation, such a shift of policy responsibility says a lot for the dissatisfaction of British politicians—and British opinion generally—with the United Kingdom's inflationary record since the War. A similar sense of disappointment is behind the willingness in Europe to find a better approach, and I have to say that as a central banker I would view the prospect of an independent ESCB, should it materialise in time, with lively anticipation tinged with appropriate realism.

In contemplating their responsibilities in a full monetary union, potential participants on the ECB Governing Council will be bound to ask themselves how much support they will receive from the governments who appoint them. The ECB's task could obviously be made much more difficult, if not impossible, if governments reverted to policies conflicting with price stability. Two areas are likely to be particularly important—fiscal policy and exchange rate policy. In drawing up their ideas for a full-scale monetary union, the Delors Committee put emphasis on the need for limits on fiscal deficits, and quite a lot of this thinking has survived in the Treaty. But no politically acceptable arrangements for fiscal surveillance and sanction can guarantee fiscal probity and nor, I fear, can the enhanced free market discipline foreseen in EMU, even re-inforced as it will be by the 'no bailout' rule in the Treaty, which I welcome. The acid test will be whether all the governments admitted to Monetary Union fully accept the implications for fiscal and other policies of a monetary policy dedicated to price stability. Only time can ultimately tell, although it will be one of the many questions which the government and Parliament of the day will need to address in considering how the United Kingdom should exercise its option on Stage 3.

There are corresponding questions in the field of exchange rate policy. In most western countries the tradition has been that governments determine exchange rate policy, especially the negotiation of exchange rate agreements but also, in a formal regime, the choice of central rates for the national currency. This is essentially accepted in the Treaty, subject to the provisions that in reaching a formal agreement the Council must consult beforehand with the ECB 'in an endeavour to reach a consensus consistent with the objective of price stability'; and that any 'general orientations' on exchange rate policy formulated by the Council must be after consultation with the ECB and also be 'without prejudice to the primary objective of the ESCB to maintain price stability'.

However, the Council will not be bound to accept the ECB's advice. For its part, the ECB Council will not be bound to adjust their policy instruments to conform to the Ministers' exchange rate regime or guidelines, and its members could not be dismissed or disciplined if they set their duty of pursuing price stability, as they saw it, above the wishes of Ministers. On the face of it, these arrangements leave scope for conflict, since monetary policy and exchange rate policy have to be consistent if damaging economic tensions are to be avoided. And if tensions were to emerge between the ECB and the Finance Ministers' Council, in this or any other area, it would be damaging to monetary union, highly dependent as it will be on the maintenance of confidence in the ESCB and its policies.

The inescapable conclusion is that monetary union can live up to the hopes that Community leaders have placed in it only if the peoples and the politicians of all participating member states understand and accept the implications of the ESCB's price stability objective, so that to policy-makers it becomes virtually a way of life. There is reason to think that governments already accept this; indeed, the price stability objective has, of course, been enshrined in the Treaty by governments. It will mean among other things that all the separate national fiscal policies, and the exchange rate policy adopted for the single currency, will have to be set with the achievement of price stability in mind. The convergence criteria for admittance alone cannot ensure this; neither can the various safeguards built into the Treaty. Nor could a period of 'practice' for the ESCB before Stage 3 begins, as some have advocated. And it is hardly plausible that participation in the disciplines of Stage 3 would quickly produce a widespread change in attitudes if such were necessary, as others have argued.

Those on the verge of joining EMU will therefore surely need to be confident that the key objective of price stability allied to open, flexible and competitive markets is thoroughly accepted by *all* participants before joining. The pressures and temptations to relax on inflation are never far below the surface. So the European policy consensus of the past decade or so, which I have argued was an essential precondition for moves to monetary union, needs continuing consolidation before the final irrevocable steps can be taken.

## Longer-term issues

Perhaps I could conclude though with some comments on one or two longer-term questions which EMU will raise if it does go ahead. First, a crucial but delicate issue. There are those who see monetary union inevitably giving a powerful boost to federation in Europe. The argument, I think, is that, having pooled responsibility for monetary policy and adopted a single currency, one cannot stop there. The elimination of the scope for member states to adopt different monetary policies and for exchange rate adjustments, it is argued, puts a heavy onus on fiscal transfers as the only remaining means of preventing heavy unemployment emerging in less productive regions, given the likely continuation of rigidities in labour markets. Whereas *national* fiscal systems can, and typically do, provide transfer systems to cushion problems of inadequate incomes and unemployment within countries, there is not a

Community budget on a scale anything like comparable with, say, the federal budget in Canada or the United States. This is said to mean that there could well be pressure in due course for major *ad hoc* fiscal transfers between member states in a monetary union, and that would be politically very difficult. The solution, on this view, would have to be a sizable Community budget, but this would require a European Parliament with powers of taxation, and the development of more and larger spending departments in Brussels, etc; in short, federalism.

I have to say that I do not accept this line of argument. In the first place, it seems to ignore the benefits—indeed in an EMU context, the purpose—of the convergence and integration which are underway, and which are critical tests for a move to monetary union: it is precisely with these sorts of concerns in mind that we and other countries, including Germany, insisted on rigorous convergence criteria. The argument also seems to me to take too pessimistic a view of the benefits which monetary union, allied to the Single Market, could bring to the less developed member states, if they pursue the right domestic policies. Even allowing for social security, their levels of labour remuneration tend to be lower than in the more industrialised states, and they should be capable of attracting very sizable inward investment to take advantage of this, given also the advantage of relatively low interest rates stemming from credible ESCB policies and access to the Single Market. The less-industrialised states will, however, need to create a receptive local environment for new enterprise and to take on board the price stability objectives, with accompanying wage moderation, required by monetary union. In that case the poorer countries would have as much to gain from EMU as the richer ones, and there should not be inexorable economic pressures making for a federal budget.

The agreement on monetary union will doubtless be seen in the wider Europe as a notable reinforcement of the Single Market developments, making it if anything even more important that peripheral countries should not be excluded from the Community market. With a single currency, trade with the Community will be made easier, and direct investment more attractive. This will almost certainly mean that the Community becomes even more of a magnet for new members and associates seeking free entry to its markets. A number of the EFTA countries have either already applied for EC membership or are seriously contemplating doing so. And it is likely to feature increasingly in the thinking of the reforming eastern European countries as they seek the huge market access and the monetary stability which the Community will, if all goes well, be increasingly seen to represent. For its part, the Community will have to consider very carefully its policy on such matters.

Finally, monetary union will in due course create a currency area at least equal in terms of output, trade and investment to the dollar and yen blocs. Whether there will be broader, 'global', benefits is very hard to day. Some commentators look forward to an improvement in the quality of international economic co-operation resulting from the emergence of an Ecu bloc, associated with fewer major players and the possibility of better policy co-ordination at the level of, say, G7 meetings. Personally, I would be inclined to be a little hesitant about such optimistic claims. Judging from the difficulty of progress in the GATT negotiations, the Community still has a lot to do to convince itself as well as its global partners that its heart is in free trade; in macroeconomic policy it will have much to do to convince the rest of the world that it can evolve in time a degree of willing co-ordination of national fiscal and other policies to set alongside the centralisation of monetary policy contemplated in monetary union. But at least the possibility of doing so will provide a fascinating challenge for policy-makers over the next decade.