The need for economic co-operation in the 1990s

The **Governor** [1] *argues the case for international economic co-operation if countries are to prosper. He warns against protectionist pressures and highlights the need to resolve the negotiations on the Uruguay Round of the GATT. In doing so, he draws some comparisons with the 1930s. The* **Governor** *also examines the particular importance of economic co-operation in Europe. He concludes that the European economies need to continue to strive for greater economic convergence, which will only occur if each nation successfully pursues the key macroeconomic objective of price stability.*

Introduction

It is Bristol's long connection with international trade that has prompted the theme I would like to address this evening. Namely the need for economic co-operation if countries are to prosper. This need applies both to the policies of closely integrated national economies, such as those of the European Community, and more generally to all nations with significant involvement in international trade.

I should therefore like to examine the need to stand firm against protectionist pressures and to resolve the negotiations on the Uruguay Round of the GATT. I will draw some comparisons with the 1930s. I shall then consider the need for economic co-operation in Europe and conclude that European economies need to continue to strive for greater economic convergence. That will only come about if each nation achieves the key macroeconomic objective of stability.

Protectionism

The successful conclusion of the Uruguay Round is of central importance if we are to achieve a further liberalisation of global trade and the associated benefits for growth. A successful outcome promises, for example, to bring important areas such as trade in services into the remit of the GATT. It would also bring agriculture more fully within the GATT arrangements and secure further tariff reductions. It has been estimated conservatively that a successful outcome could add up to 1% to the combined GDP of the seven major economies after six years. Conversely, there is a real danger that, if the Round is not successfully concluded, the world trading environment could take several steps backward. That possibility is still present. Protectionist forces are never far below the surface, particularly during downturns in activity. The recent disputes between the European Community and the United States on trade in steel and procurement for federal contracts, and the strong reactions to one company's decision to move production of electrical goods from France to Scotland, are a disturbing illustration of this.

The 1930s taught us a great deal about the dangers of protectionism. The United States led the way in this with the introduction in 1930 of tariffs on a wide range of products. This step may well have been decisive in starting a round of protectionist measures throughout the world economy. Other countries followed suit—although not right away. Similar measures were introduced in the United Kingdom at the end of 1931 and the beginning of 1932. A basic import tariff on manufactured goods of 10% was introduced in April 1932 with higher rates on some other products—notably steel. The system of imperial preference was introduced at the same time.

It is fairly clear that protectionism as such did not precipitate the depression of the 1930s—it was a reaction to it. But there can be little doubt that it was a significant factor in prolonging the downturn. Protectionist measures provoked retaliation, which led to a misallocation of resources and discouraged investment. The experience of the 1930s also shows us that, once governments give in to pressures to impose protectionist measures, it is very difficult to reverse these. Once recovery began later in the 1930s the pressure for further protectionist measures seems to have subsided but no attempts were made to reduce the barriers to trade which had been erected earlier.

The founders of the international economic institutions established in the post-war period had witnessed the corrosive events of the 1930s. They sought to prevent recurrence of this negative sum game. The Articles of Agreement of the IMF for example state that two of its purposes are: 'to facilitate the expansion and balanced growth of international trade' and 'to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation'. And much progress has been made since 1945.

There can be no question that the increasingly liberal world trading environment in the post-war years has served the global economy well. The establishment of GATT in 1947 provided a framework for multilateral tariff negotiations

(1) In a speech to the Bristol Society on 1 March.

and, as such, marked a new era in world trade. In just four years tariff reductions had been negotiated with 33 countries, prompting a period of reconstruction and economic growth. The emergence of the EC in the late 1950s provided fresh impetus to international trade. It is no coincidence that the following two decades were the most remarkable period of economic growth in modern history. Freer trade allowed more efficient exploitation of technology to improve industrial production, and hence global welfare. The annual volume of world exports almost quadrupled between 1960 and 1980. The Gross Domestic Product of the industrial world more than doubled. The growth in both trade and industrial production significantly outperformed earlier expectations of the effects of freeing trade. World export volume grew by a further 50% between 1980 and 1990. By contrast world trade contracted in the protectionist period between 1929 and 1938 and industrial production grew by an average of 2% during those years.

But even now we hear the siren song of the protectionists. More disturbingly, as I noted a moment ago, there are increasing signs of a creeping form of this self-destructive behaviour.

The superficial appeal of such measures is easy to see. There is a sense, not only in this country, that the world economy is once again in the doldrums. Activity in the United Kingdom has certainly been disappointingly weak. The United States experienced a recession in 1991 followed by a period of lacklustre growth. Only now is the upturn in that country looking more secure, but the baton of economic slowdown has meanwhile been passed to continental Europe and Japan. There is, in fact, no global slump: the major industrial countries *as a group* grew modestly last year and are expected to do so again this year. But the protracted slowdown as it affects countries in turn is clearly contributing to a profound sense of economic malaise—particularly when comparisons are made with the buoyancy and optimism of the 1980s.

World trade grew by 4% or so last year and a similar rate of increase can be expected in the coming year. But most of this growth is accounted for by developing economies—notably the Newly Industrialising Economies of the Far East. This makes a negligible contribution to growth in the major economies. Meanwhile, notwithstanding the welcome upturn in the United States, domestic demand in many industrial countries particularly in Europe and Japan is likely to remain subdued for much of this year. This is a sombre prospect. It is not surprising in these circumstances that calls should be heard for governments to create an external stimulus through restricting imports or artificially promoting exports.

It is not easy, of course, to quantify the detrimental effects of succumbing to such pressures. This would involve making judgments about the extent of retaliation and comparisons with what would happen were protectionist measures not in place. It is also impossible to take full account of factors which are not measurable such as the willingness of business to invest and adopt an international perspective. These are, nevertheless, as important as they are immeasurable.

The trend to greater liberalisation of trade has been under way for forty years. It is my firm belief that a reversal now would be myopic and represent a loss of nerve which we can ill afford. Once begun it would be difficult to contain and harder still to reverse. There would also be a peculiar irony in becoming more isolationist just as many countries—notably those in Eastern Europe and the former Soviet Union—are being encouraged to seek the benefits of trade.

In fact, extensive progress has been made in reaching shared positions in the complex and often emotive issues involved in the negotiations of the Uruguay Round negotiations. Fundamental issues of levels of state intervention and support are involved and vested interests of many different groups are threatened. It is little wonder therefore that the process is not straightforward. Over a year ago the Director General of the GATT issued the text of an agreement which commands wide support. Outstanding areas of disagreement are few, particularly when set against those on which there is consensus. It is in the interests of all to build upon the progress made so far and make a final push for overall agreement. The new US administration has recognised the difficulty of the issues involved by proposing an extension of the deadline under the 'fast track' procedure. This sensibly allows more time to reach agreement while maintaining the discipline which a deadline provides. But a proliferation of *ad hoc* protectionist measures in the meantime will make it more difficult to secure overall agreement and is a dangerous game to play.

European co-operation

Closer to home, within the European Community, we have seen concrete progress in the field of economic co-operation. The European single market came into effect formally at the beginning of this year. Like the GATT, however, it is a continuing process and further liberalisation of European markets will be desirable. But the achievement to date is very considerable and a tribute to what can be achieved when nations see their common interest in enhancing the opportunities for trade.

It is perhaps inevitable, however, that progress towards greater co-operation between the members of the Community will take place in spurts rather than at a slower but steady pace. There will therefore be disappointments along the way for those of us who believe in moving further in this direction. But I believe that these setbacks will prove temporary.

A year ago it seemed that the European Community was set for a smooth progression to economic and monetary union before the end of this decade. The exchange rate mechanism had acquired increasing stability over the previous five years and had increasingly been seen as the mechanism by which economic convergence could be achieved. Three countries' currencies entered the mechanism in that period, including the United Kingdom. Italy also moved from the broad to the narrow band. Now, the vision of a smooth path to monetary union looks highly questionable in the light of the market tensions of the second half of 1992. But what those events highlighted, is the distance still to be travelled in achieving the necessary degree of convergence within Europe for EMU to be a realistic possibility. We now need to reflect on the lessons of last year at both the technical and policy level. And I shall argue that at the policy level the conclusion must be that we need more rather than less co-operation.

The triggering event for the monetary turmoil of the second half of 1992 was undoubtedly the Danish Referendum last June. This was the first occasion on which financial markets had their attention drawn to the serious risks to the Maastricht treaty and the timetable contained in it. That raised doubts as to whether the existing parities of the ERM were likely to be those that applied in Stage 3 of EMU.

This shock was exacerbated by the decision to hold a referendum in France as well. It gradually became apparent that the vote was likely to be much closer than originally expected and a negative vote was widely thought to be likely to undermine the whole Maastricht process. The markets began to consider whether the ERM could survive that eventuality.

These events were the triggers for the severe exchange rate pressures in the autumn of 1992. But the underlying cause was the divergence in domestic conditions among the member states.

In particular the domestic needs of the German economy were different from those of many other European countries, including the United Kingdom. The consequences of German unification were much greater than had been foreseen even a short time earlier. German interest rates were naturally kept high to contain inflationary pressures in Germany. It became increasingly apparent in the course of 1992, and in particular in the summer, that these rates were too high for the domestic conditions in the United Kingdom. I should emphasise in these remarks that I do not wish to suggest that the German authorities should in any sense be blamed for this choice. Unification is by far the greatest political event in the history of the German Federal Republic. It was correct that the authorities should wish to strive to contain the inflationary risks of this process. This political event produced an economic shock whose magnitude was virtually impossible to forecast; it proved to be far greater than the adjustment mechanism available through fiscal policies.

What I think these events have illustrated is that monetary union should not be established until there is greater convergence between the countries of the Community. The economic divergences between member states which were reflected in the exchange market turmoil last year are real. If there had been a single currency they would have been reflected in other ways. But I do believe that there can be important gains from monetary union if economies are highly integrated. These gains come from the elimination of transactions costs in using different currencies and from greater certainty about the future real prices at which cross-border transactions can be undertaken. The decision to move to monetary union would, in my view, clearly not be right now. It is a decision we should leave for a later date. Monetary union should be the final step of a process of increasing economic integration. First we must address the rigidities both within our individual economies, and between European economies, which inhibit effective trade. Developments such as the single European market, however, are important steps along that road, and can contribute considerable benefits in their own right.

With the benefit of hindsight, it is possible to see that the ERM in its later years had become too rigid. The degree of exchange rate fixity exceeded that which could be justified by the degree of convergence that had been achieved. Perhaps monetary authorities overestimated both the ability of fixed parities to promote convergence and the ability of the system to withstand external shocks. Certainly markets demonstrated their ability to force changes in parities that were no longer viewed as credible. This power increased substantially during the 1980s as exchange controls were dismantled and developments in financial technology facilitated cross-border transfers of funds.

Following the special European Summit meeting in Birmingham in October of last year, a number of studies are under way on the causes of recent financial turbulence in the ERM. It would not be appropriate for me to anticipate the outcome of these studies but I should like to outline some of the broad principles that must underlie the successful working of the mechanism.

First it must be recognised that a central purpose of exchange rate co-operation is to facilitate common convergence to low inflation. As long as inflationary pressures persist, participants in the mechanism must accept a disinflationary tendency in the implementation of policy. It would clearly be wrong to force stronger countries to absorb the inflationary pressures of their weaker colleagues. Nevertheless, all countries should have an obligation to pursue a policy mix that does not cause fluctuations in monetary conditions.

Second, exchange rate arrangements must be compatible with free market principles and thereby support the single market. It would not be desirable to achieve an improvement in exchange rate stability by interfering with legitimate market forces.

Third, greater care must be taken to ensure that the pattern of parities within the ERM is seen to be credible. This means that the sustainability of exchange rates within the system must be reviewed regularly. Realignments should be undertaken promptly when exchange rates are inconsistent with fundamentals. This, of course, raises many questions because it is difficult to establish what exchange rate is required by fundamentals. But it is important that members of the ERM should be frank with each other about their assessment of parities and the outlook for individual economies. This involves co-operation on an analytical framework and frank and confidential discussions between the monetary authorities about exchange rate relationships.

The need for co-operation in Europe has been heightened not diminished by recent events. In the long run it may well be that a single currency will be an effective way of binding the economies together but until we have reached a much closer level of economic convergence than is now the case, such a move would impose very severe adjustment costs. The focus therefore has to be on convergence. This in turn will help to generate exchange rate stability. And I should like to conclude by discussing how we have set out to keep our own house in order in this respect.

Domestic monetary policy

The focus of economic policy has to be on the achievement of sustained non-inflationary growth. Monetary policy instruments in particular need to be used to achieve price stability. I hope that it is now widely accepted that there is no long run trade-off between inflation and growth. We pay for misguided attempts to generate a little more growth now through having greater inflation in the future. That in turn eventually requires policies to contain inflation which damage growth in the short term. The stop-go policies of the post-war era are witness to the unsustainability of such an approach. They raise the average level and variability of inflation. And they reduce the level of investment, raise long-term real interest rates and undermine the prosperity of the country. Britain's post-war inflationary experiences have made it more difficult for our counterinflationary policies to be accepted as credible. Monetary policy therefore needs not only to be consistent with the objectives of stability but to be accepted as consistent. Moreover, the markets must believe that policy will remain consistent with stability.

The decision to join the exchange rate mechanism in 1990 enabled the United Kingdom to demonstrate its commitment to reducing its inflation rate to the levels of the best in Europe. That policy was successful with inflation falling from 12% to below 4% during the two years that the United Kingdom remained in the ERM. I have already described the circumstances of our departure from that mechanism. The departure from the ERM, however, has made no change in the underlying objective. But, it has required a change in the means by which the objective is achieved.

The Government's commitment to defeating inflation has never been more explicit. The Government has published an inflation target of 1% to 4% with the intention that inflation should be within the lower half of that range by the end of the current Parliament. In addition, the Government has committed itself to greater openness in explaining the information that is used in considering the appropriate stance of monetary policy to meet that target and in explaining the reasons for any changes in that stance.

It will, of course, take time to establish the credibility of this policy. But the Chancellor has asked the Bank to produce a report on inflationary pressures and the prospects for inflation every quarter. The first of those reports was produced a couple of weeks ago and I commend it to you. I hope you would agree that it is independent, thorough and objective. It shows that the immediate outlook for inflation is encouraging with underlying inflation likely to remain within the target. But there are possible risks of a resurgence of inflationary pressures, and we must always be alert to them.

The improved performance on inflation has justified the easing of domestic monetary policy which has taken place since last September. I would not have supported these moves if they had not been consistent with the counterinflationary objective. Since then, there has been a substantial fall in the value of sterling. This was not a deliberate object of policy; indeed continued success in pursuing our inflation objective could be impaired if the exchange rate were to fall too far. I must emphasise that we are in no way indifferent to the behaviour of the exchange rate. We have most certainly not been seeking to secure a competitive advantage through depreciation, as has been suggested in one or two places. Depreciation brings only short-term gains in competitiveness. The exchange rate, however, has reacted to lower interest rates which were, in turn, justifiable by the more favourable outlook for inflation. To the extent that UK demand grows more rapidly as a result of this monetary easing the benefits will feed through to our European partners.

We will need to monitor very carefully the impact of the exchange rate on inflation and to respond with tighter monetary policies if we believe the inflation target to be threatened. The depreciation of sterling has been in large part a consequence of the relatively tight monetary policies pursued by other European countries. Were they to relax their monetary stance in response to developments in their own economies, sterling would be expected to appreciate. In such circumstances there would be no question of the United Kingdom seeking to hold the exchange rate down to maintain a competitive advantage. Indeed, the appreciation of the exchange rate which would result from easier policies elsewhere would greatly assist the achievement of the Government's target for reducing inflation.

Conclusions

I said at the beginning that my theme was the need for economic co-operation. We live in an increasingly interdependent world and that has brought great economic and social benefits. It has, however, also limited our scope for independent action.

Co-operation requires openness—both of markets and of relationships. In that respect I am encouraged by the discussions during the informal meeting of G7 economic leaders in London over the weekend. We need to continue to oil the wheels of international dialogue and to reiterate fundamental principles: free trade and economic stability are in all our interests.