The economics of EMU

The **Governor** *argues*(1) *that the need for a careful and dispassionate assessment of the economic case for and against Economic and Monetary Union (EMU) should not be overlooked amid the broader political debate about the future of Europe.*

The heart of the economic justification for EMU—the irrevocable locking of parities—is that the permanent elimination of exchange rate fluctuations would promote prosperity by deepening the benefits from competition and free trade. EMU would be likely to be useful in helping to convince the business community that intra-European monetary stability would be maintained over the medium and longer term.

The case against, in essence, is that there could be significant continuing intra-EU economic differences causing tensions between Member States which would be difficult to relieve without the possibility of exchange rate adjustment. Real and sustainable economic convergence among the states participating in EMU needs to be achieved to avoid the risk of long-term stagnation in some parts of the Union.

It is a very great honour to have been invited to deliver this 21st Churchill Memorial Lecture to such a distinguished audience here in Luxembourg—a city which is familiar to me from my days as a Director of the European Investment Bank, and a city which is familiar to me also as a European financial centre with so many interests in common with our own City of London.

I am delighted to be here—delighted but also, frankly, somewhat nervous. I am nervous because deep in the consciousness of the Bank of England is an awareness that it was one of my predecessors as Governor, Montagu Norman, who in 1925 advised Winston Churchill to return to the gold standard. That was—I hasten to point out—well before I was born! But our experience of fixing sterling's exchange rate parity, in the conditions of that time, was deeply unfortunate. And shortly before we were forced off gold again in 1931, Winston Churchill wrote to Edward Marsh, his Private Secretary:

> 'Everybody I meet seems vaguely alarmed that something terrible is going to happen financially. I hope we shall hang the Governor of the Bank of England if it does. I will certainly turn King's Evidence against him!'

You see now why I am nervous—especially since I shall be talking about the fixing of exchange rate parities within monetary union this evening!

The title of my lecture is 'The *economics* of Economic and Monetary Union'. I realise of course that 'Europe' is about much more than economics. The inspiration that lay behind the concept of 'Europe'—after the two wars—was, above all, the need to ensure that Europe could never be devastated by war again. And this meant achieving political harmony within Europe itself, as well as ensuring that Europe's legitimate interests were effectively represented and protected at the broader international level in a world of superpowers.

I am only too well aware that the question of what this objective means—in terms of the future political organisation of Europe, and for the nature of the relationship between European institutions and their powers on the one hand and those of the individual Member States of the European Union on the other—is a matter of sometimes passionate political debate, and not just, I think, in the United Kingdom. At one extreme, there are some across Europe who are persuaded that only the creation of a single European state will be enough. At the other extreme, there are some who distrust even the most modest steps towards collective decision-making. But I suppose that most people are essentially somewhere in between, having in mind some point on a spectrum of possible forms of political organisation within Europe, involving more or less close co-operation between sovereign states; and they tend to react somewhat instinctively to particular proposals for collective action in this or that field, depending on where they position themselves along that spectrum.

But there is also an economic dimension to 'Europe'. There are, potentially, very considerable economic benefits to be achieved through economic and monetary co-operation within Europe—through the Single Market, through the collective promotion of free and fair trading relationships with the rest of the world, and through the achievement of economic and monetary stability in the region as a whole. But there are equally economic risks in seeking to go too far or too fast. My concern is that steps towards Economic and

(1) In the Churchill Memorial Lecture given at the Fondation J P Pescatore in Luxembourg on 21 February.

Monetary Union within Europe (EMU) should be debated on their economic merits, and that the economic issues should not be lost sight of in the heat of the broader political debate.

There are dangers on either side. The potential benefits of economic integration would be denied to us if the member countries took a narrowly protective political view. But on the other side, there would be dangers if political aspiration were to run ahead of the economic realities. So whatever one's political starting-point, the political judgments that have to be made—and they are of course inherently political judgments—need to be informed by an assessment of the possible economic costs and benefits of further steps towards EMU; the economic issues cannot be simply brushed aside.

The Single Market

The heart of the economic justification for EMU is the familiar argument about the economic advantages of competition and free trade.

Now I appreciate that in saying this I run the risk of appearing to confirm the widespread suspicion that the United Kingdom is only interested in belonging to a large free-trade area or customs union and nothing more. This is simply not true on the evidence. It is an example of the way in which much of the debate about Europe tends to be conducted in terms of assertion and slogan. The fact is that the European Union has already moved well beyond just a free-trade area in establishing the Single Market—which involves not just the free movement of goods and services within the European Union. It involves also the free movement of both labour and capital, as well as supporting European legislation to avoid market distortions from, for example, state aids and government procurement, or restrictive practices within the private sector. And the Single Market was created with—and still enjoys—the enthusiastic support of the British Government and a large majority of the British people. But that is by the way.

More generally, if—in economic terms—EMU is not fundamentally about achieving the potential benefits of competition and free trade within Europe, then I cannot imagine what it is about. The basic argument is certainly well known to you and I do not propose to take up a lot of time this evening spelling it out in detail. Put very simply, it is an argument in favour of increased competition and free trade throughout the European Union in order to ensure that productive resources are efficiently deployed to satisfy consumer demands more effectively and to increase aggregate economic welfare in Europe.

Now none of this is immediately obvious at the 'microeconomic' level. Existing activity is likely to feel threatened by competition, and there is a natural temptation—to employees, their employers and their national governments—to seek to defend existing activity through protective action in one form or another, inviting retaliation from others in what would rapidly degenerate into a negative-sum game. The benefits of greater competition and the removal of unnecessary barriers or distortions to free trade, on the other hand, lie essentially in the future activity that is likely to be created—so that the benefits are less tangible or immediately self-evident. Nor, in the short term anyway, do the benefits necessarily accrue evenly across the Single Market area or between different groups in the member countries. Even though it can be shown in principle that future aggregate benefits do indeed exist, and even though we have seen in practice that competition and free trade represent a powerful positive-sum game, there are bound to be visible—and vocal—losers. And this is bound to provoke outbursts of resistance. It is hardly surprising that establishing the Single Market should have been a slow and difficult process. But it is a very remarkable achievement which it is crucially important to preserve.

The Single Market is still not complete and there is a constant danger of backsliding. A number of the relevant directives have yet to come into effect. Restrictions and distortions remain, even in areas that are already in principle governed by European legislation, and there is work to be done to uncover and remove unjustifiable distortions. The European Commission, whose task this is, can hardly expect universal popularity!

But a huge amount has been achieved and the framework is in place for reaping a large part at least of the benefits of free trade within Europe. The question is whether we should attempt to do more to even out remaining bumps in the competitive playing-field through European legislation, or can things now be left quite happily to national discretion? Given how far we have already come, it is not at all clear that —in terms of the economic benefits—we need to go further with collective decisions. But would it be nevertheless desirable in principle to do so, and would it be possible in practice?

There is no clear-cut answer. We already have collective rules, and the means of enforcing them, in the more obvious areas. As a general principle, I suppose that one might argue incrementally that the more even the playing-field the greater the benefits of the Single Market. And I suppose that there is a presumption that removing restrictions and distortions, and reducing as far as possible the burdens on business, would be more likely to increase competitive efficiency than the introduction of new regulations. But while we clearly need some collective rules, it is equally clear that it would not be desirable—or feasible—to eliminate all competitive differences between the Member States. No-one has seriously suggested, for example, that wage rates should be harmonised across Europe!

That leaves a large grey area in between, relating perhaps more to matters of social policy than specifically economic policy, where there are deep-seated differences of view—both within the Member States of Europe and between them—on the appropriate policy choices. Policy action in these areas—whether collective action or action by individual Member States—may well involve economic costs. That does not necessarily mean of course that the policy action should not be undertaken. But it does mean that we need to be clear about the motivation and aware of the economic implications, including, for example, the impact on overall fiscal policy or on employment incentives, as well as the impact on competitive efficiency. And we need to recognise too that decisions in these areas are necessarily constrained by the differences that inevitably exist between the Member States of the European Union and competing countries in the rest of the world.

There is every reason, it seems to me, for proceeding cautiously and pragmatically in these areas. There is a danger that we would put at risk what has already been achieved in establishing the Single Market if we were to proceed simply on the basis of harmonisation for its own sake, or for the sake of advancing political integration.

Monetary union

A similar calculus applies to the question of European monetary union. If we ask why we should be contemplating a move to monetary union, the economic—as distinct from the possible political—answer would have to be that the permanent elimination of exchange rate fluctuations between the Member States would promote economic prosperity within Europe by increasing further the benefits to be derived from the single European market. That is the case that I want to consider in the rest of my lecture this evening.

But let me first define more precisely what I mean by monetary union in this context. Most people think immediately of monetary union and a single currency in terms of the replacement of their familiar national banknotes and coinage by common European banknotes and coins. They think of familiar national currency prices of goods and services being redenominated in an unfamiliar European currency unit. This is understandable; but it seems to me to be unfortunate because, like so many aspects of the European debate, it immediately arouses political and popular sensitivities that tend to obscure the more fundamental economic issues. As someone said recently, the change from fahrenheit to centigrade may not have changed the temperature in the room, but it certainly raised the temperature of the debate!

From the economic perspective, monetary union requires the irrevocable locking together of exchange rates and a single monetary policy (that is effectively uniform short-term interest rates) independently pursued by a single monetary authority, the European central bank.

There is an important question about whether people would ever be totally persuaded that exchange rates really had been irrevocably fixed—even though this would have been enshrined in both European and national legislation—so long as national currencies had not in fact been withdrawn in favour of a single European currency. But, in principle at least, this is not a necessary condition for monetary union. As my colleague, Dr Duisenberg, President of the Nederlandsche Bank, has pointed out recently, it would be possible for national currencies to continue to be used alongside or instead of the European currency unit for a generation—even in principle indefinitely. And in practice, there is bound to be a relatively long transitional period during which this occurs anyway, because in the nature of things it will take time, for example, for new notes and coins to be produced, and for financial institutions and retailers to prepare—which can only seriously begin once decisions have been taken on when monetary union will start and which countries will participate.

Perhaps this is a point which I do not need to labour here in Luxembourg. You still retain your own currency despite having been in monetary union with Belgium for decades. But it is a point which is less well understood elsewhere. Once exchange rates are irrevocably fixed, Deutsche Marks or francs or pounds, for example, would become simply different—albeit broken-amount—denominations of the European money, immediately convertible into each other or into the European currency unit through the introduction of the appropriate constants into banks' accounting systems.

Now the practicalities of all this certainly need to be properly explored. It may be that, as a matter of convenience, people would choose to switch from their national currencies to a common currency quite rapidly—especially for larger financial transactions. But it is important that the debate about monetary union does not become bogged down in the technicalities of a single currency, at the expense of the more fundamental issue of whether irrevocably to fix exchange rates in the first place. It would be a classic case of the tail wagging the dog!

So what, then, are the potential benefits and the possible risks of monetary union in this more fundamental sense? I start with the potential advantages.

I certainly would not question the view that sustained monetary and exchange rate stability within the European Union is wholly desirable and would substantially increase the benefits of the Single Market by improving the efficiency of resource allocation within Europe. Monetary stability is desirable in itself—whether regionally or nationally—as a necessary condition for sustainable growth and to reduce the risks of long-term investment. And it contributes to real exchange rate stability, encouraging investment to be located where, within the European Union, it is most productive.

Now, how far monetary union would contribute to this is a matter of degree. Countries individually have a strong national interest in pursuing monetary stability quite independently of the European dimension. I doubt whether we would be contemplating monetary union at all if it were not for the strength of the consensus that has emerged over the past decade and more—within Europe, but also much more widely—on the crucial importance of monetary stability to economic prosperity. And if we were all individually successful in pursuing domestic monetary stability, then that would help to produce some measure of exchange rate stability. In other words, some of the undoubted advantage of monetary and exchange rate stability could be achieved, in principle, without formal monetary union.

The economic argument for monetary union is that it would deliver greater union-wide stability in practice and, importantly, that it would carry greater conviction with investors that intra-European stability would be maintained into the medium and longer term. Given past experience of both domestic and exchange rate instability within the countries of Europe, I am inclined to agree that there is substance in this.

The single monetary policy would anyway be beyond the reach of national governments if they were tempted to seek a short-run increase in output at the expense of higher inflation. And the Maastricht Treaty logically imposes continuing constraints on excessive overall fiscal deficits, although within those constraints overall fiscal policy, as well as decisions on taxation and expenditure separately, are matters for national governments. Given this, and given that monetary union removes the safety valve of exchange rate realignment within Europe so that this escape route would no longer be available, persistent relative inflationary pressures in one part of the monetary union would tend to be punished by falling economic activity and rising unemployment. That realisation ought to make inflationary price or wage behaviour in the private sector too less likely than hitherto.

Even so, monetary stability within Europe would not be guaranteed. It would depend upon how successfully the independent European Central Bank pursued its mandate to maintain price stability within the monetary union as a whole. But there is no reason to suppose that it would be less successful than European countries generally have been in the past in pursuing price stability through independent national policies—rather the reverse.

Some people argue that even if, as a matter of degree, monetary union did make for greater monetary stability within Europe than would otherwise be achieved, national acceptance of such a strong external discipline would be a high price to pay. That, of course, is intrinsically a political judgment. But it would be a mistake to imagine that the discipline of monetary stability could be avoided without monetary union. If anything, that discipline would be more important for countries that did not participate, because they would have to demonstrate that remaining outside monetary union was not simply seen as a soft option. Otherwise they would be likely to suffer in terms of both financial and physical investment, and their economies would remain vulnerable to disruptive intra-European capital flows.

While European monetary stability can in principle be achieved without monetary union, and while this could deliver *de facto* relative exchange rate stability, this would not provide the business community with certainty about intra-European exchange rates over the medium and long term. That would be a unique advantage of monetary union. Opinions nevertheless differ on just how great an advantage it would be, given that market mechanisms for eliminating the exchange risks are available—at a price.

Similarly, monetary union—even without a single currency—would yield some benefits in terms of intra-area transaction costs. But while this is undoubtedly a factor on the plus side, it is certainly not significant enough on its own to be decisive.

What, then, is the economic case on the other side? Essentially, the argument is that there are, and could continue to be, significant economic differences between the member countries of the European Union that could cause tensions between them that would be difficult to relieve without the continuing possibility of exchange rate adjustment between the member currencies. In that case, in monetary union the monetary policy appropriate in some countries would be inappropriate in others, leaving the European Central Bank in a dilemma as to what (single) monetary policy to pursue.

People point to the problems that arose within the ERM, as a result of the economic ‘shock’ of reunification, as an example of the sort of tensions that could arise. It is certainly true that that did produce a situation in which the appropriate monetary policy in Germany was excessively tight for the conditions prevailing elsewhere in Europe—and while the circumstances in that case were, of course, quite exceptional, it is possible to envisage other shocks which could have similar asymmetrical effects.

The possibility of inadequate convergence is explicitly recognised in the Maastricht Treaty, which lays down more or less precise criteria designed to ensure that conjunctural convergence, at least, is achieved before any move to the irrevocable locking of exchange rates. Those criteria relate to relative rates of inflation, to exchange rate stability and to relative long-term interest rates—all observed over a qualifying period—as well as to fiscal deficits and public debt ratios. The Treaty also, as I noted earlier, contains on-going provisions to prevent the subsequent emergence of excessive national fiscal deficits.

There is a concern that the Maastricht convergence criteria are not in themselves sufficient. The worry is that it may be possible for a country to meet the Maastricht criteria—which relate to nominal values—at a particular point in time, but with no assurance that such convergence could be sustained into the medium and longer term. What matters fundamentally for the successful functioning of monetary union is that economic convergence is capable of being sustained.

This concern has increased with the growing recognition of serious disequilibrium in the European economy reflected in the very high levels of unemployment almost everywhere, but differing substantially from one country to another. Among the larger countries, the rate of unemployment in December 1994, as measured by Eurostat, ranges from 6% in the western part of Germany through 9% in the United

Kingdom, 11½% in France, 12% in Italy, to 23% in Spain. The problem of unemployment is now acknowledged almost everywhere as much the most urgent problem currently facing Europe. Some part of the problem is certainly cyclical, though we do not know just how much of it is cyclical in any particular case. That in itself makes the Maastricht convergence criteria more difficult to interpret.

But to differing degrees in different countries much of the present unemployment is more fundamental, and is unlikely to be eroded by the present cyclical expansion. This longer-term problem of unemployment reflects, at least in part, structural features of the European labour market, which also differ from one country to another—for example in the degree of flexibility in wages and other conditions of employment, or in the degree of non-wage, social costs of employment. It is being addressed, variously, through structural policies nationally and through measures such as those that are being explored by the European Commission and debated by the European Council. But it will not easily go away. And it could, in fact, become more difficult to resolve within monetary union as a result of on-going differences between member countries, for example as a result of differences in rates of productivity growth or unrelated differences in earnings growth, or as a result of divergent demographic trends and associated differences in dependency ratios.

Now I do not pretend to know—I do not think anyone can really know—how all of this will evolve over the next few years. It is possible that we will see clearer evidence of real convergence, between some countries anyway, that would reduce the risk of tensions arising between them in monetary union. But we cannot—at this stage, at least—rely on that. It is precisely because this is so uncertain that it is difficult to know whether nominal convergence in the Maastricht sense really would be sustainable, even if the Maastricht criteria are rigorously applied—as they clearly must be. Given the uncertainty, it cannot be excluded that resolution of the problem of wide differences in structural unemployment levels will ultimately require adjustments in relative real wages—whatever the present differentials. And given the real-world inflexibility of nominal wages, it cannot be ruled out that there will be a continuing need for exchange rate adjustment to help to bring that about.

I do not suggest that the Maastricht criteria should be changed to take account of all this. I am concerned with the substance rather than the form. The important thing is that we should be confident that convergence is real and that it is sustainable, before moving forward. It is in no-one’s interest for that decision to be fudged.

If it were to be fudged, the costs could be substantial. The European Central Bank is, quite rightly, required by its statute to set the single monetary policy so as to maintain price stability in the monetary union as a whole. In that case—and if inadequate sustainable convergence were not to result in long-term stagnation and unemployment in some parts of the union—there really are only two possible adjustment mechanisms, neither of which on present evidence looks likely to be particularly effective.

First, there is the possibility of migration from areas of high unemployment to areas of lower unemployment. This possibility already exists in principle under the Single Market provisions for the free movement of labour. But in practice, actual labour mobility within the European Union remains limited. In 1992, less than 5% of the total resident population in EU member countries was foreign, and only one third of them originated from other EU countries. Monetary union in the United States, for example, relies upon much greater labour mobility than this implies.

Secondly, there could be pressure for larger fiscal transfers from countries with lower unemployment to countries where unemployment was higher. In fact, the size of the EU budget currently amounts to less than 1¼% of EU GDP (compared with an average of about half of GDP accounted for by national government spending in EU countries). Fiscal transfers from the western to the eastern part of Germany amount to 4% of all-German GDP.

Neither of these possibilities is particularly attractive. Either long-term stagnation in some countries or the rapid expansion of these adjustment mechanisms could become a source of political, as well as economic, disharmony within Europe, rather than monetary union acting as something that brings us closer together.

My purpose this evening, Mr Chairman, has been to identify the issues, not to point to conclusions. I have no doubt at all that the Single Market brings huge economic benefits to Europe as a whole and to its individual Member States. There may be advantages in extending it into other policy areas—though proposals in this sense need to be examined very carefully on their economic merits and not pursued simply for their own sake. The same applies to monetary union. There are potential economic advantages in monetary union to the extent that it would increase economic and monetary stability within Europe and make the Single Market more effective. But there are also potential economic risks in moving ahead before sustainable convergence is assured. It would be an enormous step. A decision to take that step is, quite rightly of course, a decision that has to be taken through the political process. But it must be in the interests of the European Union as a whole that that decision is informed by a careful and dispassionate assessment of the economic arguments.

It is not a decision that can, or should, be taken now. We all have our work cut out to achieve economic and monetary stability, and to address the problem of structural unemployment within Europe, through our independent national efforts and through European co-operation. And we have a great deal still to do in continuing to explore both the economic and technical conditions that would need to be met before any decision could be made. The important thing at this point, Mr Chairman—or so it seems to me—is that we all carry forward this work patiently and with an open mind.