EMU—a British perspective

*The **Governor** of the Bank, Eddie George, discusses*(1) *the potential economic benefits and risks of greater monetary integration. He argues that the economic case for greater integration within Europe is an application of the wider argument for free trade. The **Governor** notes that, while monetary integration within Europe is not a requirement in order to derive the substantial benefits of the single market, it is important to consider how far it can increase the benefits of the single market, and at what cost. It is beyond doubt that the single market would work better in an environment of reasonably stable intra-European real exchange rates, but the issue is how best to bring that about. The **Governor** considers this issue in relation to both the ERM and monetary union, noting that the latter would represent a much more powerful discipline on the participating economies, but also involve greater risks if they had not converged at the outset or if they subsequently became subject to serious country-specific economic shocks.*

I am very honoured to be here at Bocconi University and to participate in this series of lectures organised by the Paolo Baffi Centre for Monetary and Financial Economics.

I have, perhaps inevitably at the present time, chosen to speak about Economic and Monetary Union (EMU) from a British perspective. Specifically, I will try to explain both the potential economic benefits and the economic risks, as I see them, of greater monetary integration, in the context of the progress we have already made towards economic integration through the European single market.

But I begin by recognising that EMU is not just about economics, it is fundamentally about politics. The relevant decisions will, of course, quite rightly, be taken by elected politicians in the light of their perceptions as to how best to promote long-term political harmony and stability within Europe. And the spectrum of political opinion remains very wide, ranging from pragmatic, case by case, co-operation between sovereign states, on the one hand, to a vision of a federal Europe, with varying degrees of supra-national authority centred in Brussels, on the other. As a central bank governor, I take no position on the politics, though I would make two observations.

The first is that, if the objective of collective arrangements of whatever kind is lasting political harmony within Europe, then those arrangements have to be freely entered into by the member governments with the support of their peoples. I do not see that the cause of lasting harmony between countries would be advanced by coercion or majority insistence, provided of course that minorities do not behave in a disruptive way; on the other hand, I recognise, too, that minority views should not be allowed to obstruct collective steps that other member states choose to take, provided that their legitimate rights are protected. Those principles were essentially accepted at Maastricht; they have wide application, it seems to me, extending even to elaboration of apparently technical arrangements.

Secondly, although EMU is not *just* about economics, it is nevertheless *also* about economics, and the economics can go either way. If the economics go wrong—as they could—then that could equally blow back on the politics of Europe and give rise to tensions. But it is on the economics of Europe that I want to concentrate in the rest of my lecture.

Economic integration

The economic case for economic integration within Europe is essentially an application sub-case of the wider international argument for competition and free trade.

The argument is certainly familiar to you. The removal of barriers to international trade increases the scope for competition between producers of tradable goods and services. Increased competition increases aggregate economic welfare within the free trade area through benefits to consumers and as productive resources are redeployed to take advantage of comparative efficiencies and economies of scale. Additional income generated in this way in one part of the area is then available to be spent on goods and services produced at a comparative advantage elsewhere, making the elimination of trade barriers—internationally, and, consistently with that, at the regional, European level, a potentially powerful positive sum game.

Of course the benefits of free trade are aggregate benefits. It does not guarantee that everyone in the free trade area is an immediate winner. In particular, pre-existing producers—individual businesses, their employees, and the

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national governments representing them—may well see increased international competition as a threat rather than an opportunity. Those who stand to benefit—consumers and producers with the potential to take advantage of the new market opportunities—are less easy to identify, so there is an important asymmetry in public perception. Not surprisingly, therefore, there is an undertow of sometimes vocal opposition to free trade from potential short-term losers. And such latent opposition inevitably increases at times of weak overall economic activity and high unemployment, so that there is a continuing danger of retreat into protective nationalism, with the risk of the destructive spiral of retaliation that would be likely to follow.

Generally speaking, world trade arrangements have proved to be remarkably resilient against pressures of this sort—indeed there have been some remarkable achievements, including the successful conclusion of the Uruguay Round of trade negotiations in very unpromising circumstances. Nevertheless, the threat of backsliding is continuously present, and it is a more potent threat when those who feel threatened are able to point to aspects of partner country economies which appear to give those partners an ‘unfair’ competitive advantage.

The difficulty is that we do not have a precise, objective definition of what should be regarded as ‘unfair’ in this context. International trade arrangements, now within the framework of the World Trade Organisation (WTO), already seek to preclude gross discrimination and distortion of competitive markets. And some people would like to see the definition of what is ‘unfair’ extended, on the general principle that the benefits of free trade are likely to be greater—in terms of efficient resource allocation—the more level the playing field. But there are no absolutes in any of this—only questions of degree. Few people would argue that the benefits of free trade depend on a perfectly level playing field or that perfection would be a realistic objective in practice. And some suggestions that market access should be made to depend, for example, upon labour market or social standards or even on action against corruption or in support of human rights, can appear as defensive or to go beyond questions of economic efficiency to much wider political concerns.

These considerations apply *mutatis mutandis*, at the regional level, just as much to the European Union. The fact is, of course, that we have already moved well beyond just free trade within Europe in creating the European single market. That involves not just free trade in goods and services but also the free movement of both labour and capital. It further involves supporting European legislation to avoid market distortions—through rules relating to state aids or public procurement policies, for example, or to restrictive practices within the private sector. And it involves, too, the setting of minimum standards in a number of areas, not least in my own field of financial services. Creation of the single market has necessarily involved much more than the removal of trade barriers; it has involved a limited measure of pooling of national sovereignty, by unanimous agreement, including the agreement of the British government. There is much that remains to be done in terms of implementation and enforcement of what has already been agreed in relation to the single market, but a great deal has been accomplished. The effects are not easy to measure, but from the United Kingdom’s perspective it is clear that our trade with the rest of the EU has grown consistently faster than our trade with the rest of the world since we joined the common market. Last year the share of UK trade with EU countries as a proportion of our total trade was some 57½%, compared with just over 44% 20 years before. And there is little doubt that our involvement in the single market has been an important factor, though one factor among many, in attracting overseas investment to the United Kingdom. British business, as best I can tell from my own contacts and those of the Bank of England, remains enthusiastically committed to the single market, and so I would suppose does a large majority of the British people.

There is perhaps more hesitation about the justification for extending the principles underlying the single market legislation into other areas. Europe has, as I say, already come a long way and is already (or at least prospectively in some cases) enjoying most of the more obvious economic benefits that the single market can offer. It is not at all clear that we *need*, in any absolute sense, to go further in terms of harmonisation or the setting of common or minimum standards in other fields, or that there would be significant incremental benefit from doing so. There cannot, I think, be any general presumption in that sense; the argument would need to be made case by case.

Some of the suggested extensions would affect sensitive areas of social policy and taxation, which can have important implications for economic structural flexibility, and where there are substantial political divisions, both within EU member states as well as between them, as to the appropriate policy choices. The issues would be far more complex than simply abolishing obstacles to trade where the economic rationale is much more immediately obvious. And they would need to be examined in the wider international context. It is not just Europe that is confronted with the problems of rapidly changing technology and global competition. In order to succeed in increasing levels of activity and employment in this environment, Europe as a whole and its individual member states will need to be able to respond flexibly, taking account of the policy responses elsewhere. That flexibility could be reduced if we tried to agree upon too much at the European level.

Whatever hesitations there may be about extending European economic integration into new areas, that does not in any way diminish the importance of holding on to the benefits we have already achieved through the European single market—not in any sense at the expense of our economic relations with the rest of the world, but over and above the benefits from those outside relations. Our immediate priority in this area, therefore, should be to keep the single market intact.

Monetary integration

The economic—as distinct from the political—debate about European *monetary* integration is somewhat similar to the debate about further economic integration. You do not actually *need* monetary integration within Europe to derive substantial benefits from the single market any more than you need monetary integration with third countries to derive substantial benefits from free trade with them. The question is how far monetary integration can *increase* the benefits of the single market, and at what cost; and whether, in particular, there would be advantage in collective arrangements designed to stabilise intra-European exchange rates—the ERM or the single currency.

Now I do not think that anyone seriously questions the proposition that the single market would indeed work better in an environment of reasonably stable intra-European real exchange rates. The issue is how best to bring that about.

In discussing that issue it is important to recognise first of all that there is a very remarkable consensus throughout the European Union at the present time on the need for macroeconomic stability—involving disciplined fiscal policies to limit the burdens placed on the wealth-creating private sector as well as monetary policies directed to maintaining permanent price stability—in each country's long-term national economic interest as well as in our collective regional interest. The idea that there is a meaningful long-run trade-off between growth and stability which can be exploited through short-term demand management policies—whether at the national or the European level—has largely gone.

Against that background, it might be argued that if each EU member state individually pursued the consensus macroeconomic policies successfully, producing sustained domestic stability, then that would be likely also to produce substantial *de facto* real—and indeed nominal—exchange rate stability between them. Certainly you are unlikely to achieve exchange rate stability without domestic stability in the member states. In that case, it might further be argued that a collective exchange rate arrangement would in fact add very little—though, by the same token, it would cost very little either in economic terms or in terms of the perceived costs of surrendering national policy discretion.

But, the argument then goes on, one cannot rely upon consistently prudent macroeconomic behaviour—certainly on past performance—so that a collective exchange rate arrangement *is* needed as a helpful discipline to ensure that the EU member states do in fact remain on the path of macroeconomic virtue, and incidentally, are not tempted to seek 'unfair' advantage within the single market through competitive depreciation.

Up to this point the argument would seem to depend upon how far one can in fact rely upon member states pursuing appropriate policies as a matter of their perceived national self interest, and, if not, upon whether a collective exchange rate arrangement would be effective as an external discipline. That clearly depends in part upon its form. A very loose collective arrangement is unlikely to make much difference. A tight collective exchange rate arrangement can clearly be a tougher external discipline—but it could equally impose more substantial costs. With the best will in the world, individual EU member states are vulnerable to country-specific economic shocks of various kinds, which may mean that the macroeconomic policies they need to pursue to maintain domestic stability are not necessarily the same as those required in their partner countries. A tight exchange rate relationship might then involve substantial sacrifice in terms of domestic stability which might exceed the incremental benefits from the more effective functioning of the single market that the collective exchange rate arrangement was intended to deliver.

Let me illustrate these arguments by reference to the ERM and monetary union in turn.

The ERM

There is no doubt that for a number of countries—including even some larger EU countries—the ERM, particularly in its narrow-band form, did serve as a very valuable external anchor for domestic policy. It had some potential disadvantages. Specifically:

(i) it was a *nominal* exchange rate arrangement so that countries with relatively high domestic inflation tended to experience *real* exchange rate appreciation, creating persistent price distortions within the single market; and

(ii) partly as a result but more generally, it invited market speculation against existing parities; and although in principle this might have been kept within bounds by timely parity adjustment, that proved to be extraordinarily difficult to achieve in practice.

In fact for most of the period from 1987 to 1992 the arrangements worked well, without serious tensions. What caused it to collapse in the end was more than anything the economic shock of German reunification, which meant that Germany's legitimate domestic policy needs came to conflict with those of other countries.

A number of countries were, as you know, driven out of the mechanism in 1992, including both Italy and the United Kingdom; and the fluctuation margin was increased very substantially to 15% for those countries remaining in the mechanism in 1993. In its wide-margin form the ERM is clearly less prone to market speculation against the parity. But it also represents less of an external discipline on member countries' policies, and so contributes less potentially additional exchange rate stability within the single market, compared with simple reliance on national policy discipline without a collective exchange rate arrangement.

A variant on the wide-margin ERM is, of course, being discussed now as a framework for the relationship between the single currency and currencies of countries that initially remain outside the single currency area. And while it is accepted that participation in this framework cannot be mandatory, there is some suggestion that it should be a precondition for eventual membership of the single currency itself. I am bound to say that from my perspective what we *should* be concerned with, in this context, but also as a matter in its own right so far as the functioning of the single market is affected, is not the technical form of belonging to the wide-margin ERM but the substance of economic stability—including exchange rate stability within a substantially narrower range than the wide-margin ERM would allow. What people need to recognise is that the ERM—even in its earlier form—was not synonymous with exchange rate stability, and it could certainly not ensure such stability in the absence of appropriate macroeconomic policies. It would be far more meaningful, in my view, to exercise collective surveillance over member countries' macroeconomic policies as a whole than to focus narrowly on the nominal exchange rate.

Monetary union

The issues in relation to monetary union are much more fundamental. Monetary union involves the once-for-all, irrevocable, locking of exchange rates and subsequent replacement of participating currencies by the euro as the single currency. That would have unique advantages beyond any that can be conferred by the ERM.

Monetary union would represent a very much more powerful discipline on the participating economies. A single monetary policy in the euro area would, by statute, be directed to price stability in the area as a whole. National fiscal policies—in the sense of overall public sector deficits—would need to be tightly constrained. This might be done through something akin to Germany's proposed stability pact, which met with considerable support, in substance if not necessarily in precise form, from other finance ministers at the recent meeting in Verona. They supported it because they recognised that a self-denying ordinance would serve their own interests by simultaneously constraining the behaviour of others, who could otherwise impose monetary policy burdens on the whole of the euro area. And there would be no possible escape route through exchange rate depreciation from undisciplined wage or price behaviour, which would then tend to result directly in falling activity and rising unemployment in those parts of the euro area in which it occurred. To this extent monetary union would provide greater assurance of macroeconomic stability, as well as removing permanently uncertainty about nominal intra-European exchange rates as a factor in investment decisions by the financial and business communities.

But monetary union would also involve greater risks if the economies of the participating countries had not sufficiently converged at the outset or if they subsequently became subject to serious country-specific economic shocks.

The Maastricht Treaty itself, of course, recognises these risks and seeks to limit them through the convergence criteria, which provide important benchmarks against which initial convergence can be measured. It is important that those criteria should be strictly applied. But it is equally important, and this too is reflected in the Treaty, that convergence should not simply be achieved at a particular point in time, but that there is a realistic prospect of it being sustained into the future.

Now it is not clear that any of the major countries will in fact succeed in meeting the convergence criteria to the present timetable—though the political determination to do so in both Germany and France especially is unmistakable. My own concern is as much about how—in conditions of extraordinarily high, and very different, levels of unemployment around Europe—we could be confident that convergence would be sustained even if the convergence criteria are initially met.

Unemployment is much the most important and urgent economic, and social, issue confronting us in Europe. I accept—with most other commentators—that it is not primarily to do with the economic conjuncture, although the present weakness of economic activity in the major continental countries is certainly not helping. So I agree that conventional macroeconomic policy, and exchange rate adjustment, cannot, certainly on their own, provide a solution. More and more of the EU member states identify the cause as structural features of their economies and are looking for remedies through deregulation, greater labour market flexibility, lower non-wage employment costs, and cutting back in particularly generous areas of social provision, for example. (This incidentally is a particular reason for being cautious about extending principles underlying the single market into some of these areas.) My concern is that no matter how the unemployment issue is addressed in individual countries, its resolution is bound to have substantial consequences on the whole of the rest of their economies. And, although we cannot know for sure, such changes could well have important implications for the sustainable pattern of real wages and exchange rates within the prospective euro area.

In these circumstances some national flexibility of fiscal and monetary policy, and some capacity to adjust real exchange rates, may well be helpful in rebalancing the different national economies when one can see the likely impact of their respective structural changes. Without that, in the context of a single currency, real adjustment would need to come about through changes in nominal wages, which would be extraordinarily difficult to achieve. It is not difficult in those circumstances to envisage tensions arising for the single monetary policy, or in the form of unwelcome migration or demands for increased transfers through the EU budget, or in the form of national pressure for protection against other countries whether they are within the euro area or outside, within the rest of Europe or more widely. It is in this sense that one can envisage political disharmony if the economics of Europe go wrong.

There are still some two years to go before the extent of these risks have to be assessed and the political decisions have to be taken. In the meantime, as far as the United Kingdom is concerned, we remain intensively—and I hope constructively—involved in the technical preparation for the single currency, and we continue in our national economic interest to pursue domestic macroeconomic policies directed to stability—sustained growth with low inflation—which are taking us towards meeting the Maastricht criteria. Notwithstanding the recent fiscal slippage, I am still hopeful that we will have a genuine choice as to British participation in monetary union when the time comes.

In that case I would expect that the government and parliament would examine the arguments very carefully. Our economic interests are the same as those of our European partners, that is to say that monetary union should only go ahead if there is reasonable confidence that it will be successful. That is much the most important consideration for British membership. Without that confidence it is not clear that we should wish to join if it went ahead anyway. But there is no conceivable circumstance in which it could be in our interests for it to be unsuccessful.

The other main consideration will be whether we can afford to stand aside if others do go ahead. There are potential risks in doing so. We might be penalised by financial markets which would require an interest rate premium to protect themselves against the exchange risk of holding sterling rather than the euro. We might become subject to discrimination in some form if the euro area were to see a need to protect itself against perceived predatory behaviour by non-participants within the single market. We might find that the United Kingdom became a less attractive location for overseas foreign investment—including investment in the financial services industry in the City of London. But there is no inevitability about any of this. The remedy lies largely in our own hands. There is no reason that I can see why we should be significantly damaged in these ways so long as we persist in responsible macroeconomic policies directed to stability. But we could be damaged economically if remaining outside the euro area were to be seen as a soft option, allowing the United Kingdom to revert to the sort of opportunistic short termism that has sadly characterised our macroeconomic policies on occasion in the past.

Conclusion

Mr Chairman, I recognise that in concentrating on the economics of Europe I run the risk of appearing to confirm the perception of many here on the continent that the United Kingdom is only interested in Europe as a free trade area. I do not think that is true—as I say we have already gone well beyond just free trade in constructing the European single market, with enthusiastic British involvement. The fact is, however, that the *economics* of Europe *is* essentially about maximising the potential benefits of free—and fair—trade within the region. That is more obviously true in relation to single market issues; but it is equally true of our common interest in macroeconomic stability throughout the region, and the contribution that collective exchange rate arrangements, including a single currency, might make to that.

Of course I understand that the single currency project in particular has been identified as a convenient lead ship in the convoy by those wishing to drive forward the political integration of Europe. I would only caution that even on this course, unless we are confident that the economic conditions are favourable the convoy could be led into rough water.