EMU—considerations for British membership

*The **Governor** of the Bank, Eddie George, discusses(1) the economic aspects of the debate on European Monetary Union. He explains that while there are potential benefits from EMU undertaken in the right conditions, there are economic risks which could, if EMU goes wrong, become a serious source of political discord. The **Governor** notes that what matters fundamentally is not that convergence is achieved by a particular date, but that it is expected to be sustainable over the longer term. He questions the wisdom of moving ahead with EMU until there is more evidence of how unemployment is being addressed in different potential members. The **Governor** suggests that fears of competitive devaluation by the 'outs' are overstated. Looked at another way, opting out of EMU would not be a soft option.*

You have invited me to speak specifically about British membership of EMU—and I will. But it is impossible to divorce that question from the question of EMU in relation to Europe more widely, so I will begin with some more general remarks.

The first is to recognise that EMU is about much more than economics. For some it is above all a convenient motor to drive to political union. Some of you may think this is to put the cart before the horse—but I couldn't possibly comment. It is in any event intrinsically a political issue because it necessarily involves some deliberate pooling of national sovereignty over important aspects of public policy, monetary and overall fiscal policy, just as the single market involved the pooling of sovereignty over aspects of trade policy for example. Decisions on whether EMU goes ahead, and on whether the United Kingdom participates if it does, will, quite rightly be taken by politicians, who will have to carry their electorates with them.

Now, as you would expect of a central banker, I have nothing to say about the political debate—nothing that is except that it does sometimes seem to be conducted, here and on the Continent, in fairly extreme language. This language shows no sign of moderating as the Maastricht timetable shortens.

But EMU *is* also, of course, about economics, and my main concern is that the political debate should not lose touch with the economic realities. There are certainly potential economic benefits from EMU in the right conditions. But there are also clearly economic risks, and if EMU goes wrong it could become a serious source of political discord within Europe rather than contributing to political harmony.

The economic debate about EMU, too, arouses great passions. Yet there is, I believe, a good deal of common ground. It is common ground, I would think, that the single European market has already made an important contribution to economic prosperity within Europe, and that its further potential will be more fully realised in a macroeconomic environment of stability—including real exchange rate stability between all EU member states. There is, too, a remarkable consensus across the European Union—and even more broadly—on the policies necessary to pursue macroeconomic stability, in each country's national interest as well as the regional economic interest, that is to say responsible overall fiscal policies and monetary policy directed to achieve permanently low inflation. The economic debate about EMU really narrows down to whether, and in what conditions, the irrevocable locking of *nominal* exchange rates—which is what monetary union involves—would help to bring about and maintain macroeconomic stability and to realise the benefits of the single market more fully.

Some very strong assertions have been made in this context recently—that monetary union is absolutely essential to the completion of the single market, and that any delay in introducing it could produce a 'dynamic of disintegration' and threaten the single market's very survival.

I find it difficult to see the issue in such black and white terms. There are no absolutes in any of this—the questions we need to resolve are questions of degree.

The more modest argument made in favour of monetary union is that it could *help* to bring about sustained stability within the European region, and to maximise the benefits from the single market and reduced transaction costs, thereby improving resource allocation. I am inclined to agree that, in the right conditions, there is some substance in that.

It is true in principle that if member states of the European Union were all, individually, consistently successful in maintaining domestic stability, we could achieve much the same outcome without going to monetary union in any formal sense. But our collective past experience is not all that encouraging.

(1) In a speech given at the Royal Institute of International Affairs on Wednesday, 13 March 1996.

If one assumes that the ECB would be more successful than national authorities acting individually in maintaining price stability within the euro area, which is its statutory purpose, then that would certainly represent a powerful discipline in member countries. With no safety valve, in the form of exchange rate adjustment, persistent cost pressures in one part of the union relative to the rest would tend to result more directly in falling activity and rising unemployment in that part of the union. Recognition of that ought to encourage more disciplined wage and price behaviour (though the initial effect could go the other way, if, irrationally, attempts were made to equalise wages across the euro area without regard to differences in labour productivity). In any event, formal monetary union would make a unique direct contribution to the more effective working of the single market by removing permanently uncertainty about intra-European nominal exchange rates as a factor in investment decisions by the business and financial communities. So monetary union could have economic advantages—in the right conditions.

The question then is what *are* those conditions, and what are the risks if they are not met?

Again there is a fair degree of consensus on the need for economic convergence among the potential participants before moving ahead. The convergence criteria in the Maastricht Treaty provide important benchmarks against which convergence should be measured. But, what matters fundamentally—and this is also reflected in the Treaty—is that convergence is not simply achieved at, or by, a particular date, but that it is realistically expected to be sustainable over the longer term. Monetary union is intended to be forever. And I am concerned that the Treaty timetable is producing a sort of sprint to the line by the end of next year, which is not necessarily helpful in terms of its immediate economic effects, and raises a question as to whether the effort can be maintained.

Even without the latest developments, it was always going to be difficult to assess the sustainability of convergence in conditions of high levels of unemployment throughout the European Union and very different levels of unemployment from one member state to another. Most commentators, of course, argue that these labour market conditions reflect structural features of the various European economies, and more and more countries are seeking solutions through deregulation, greater flexibility of labour markets, lower non-wage costs of employment and so on. And I do not for a moment believe that you could hope to resolve the problem of high and differing levels of unemployment within Europe simply through macroeconomic management and exchange rate adjustment. That is not the point. The point is that unless you assume that the unemployment problem is allowed to persist—which I certainly don't—then, however it is addressed by individual countries, there are likely to be substantial economic consequences—affecting both real and nominal economic variables—which will differ from one country to another. Such structural changes could have a significant impact on the sustainable pattern of real wages and of real exchange rates within Europe. And in these circumstances some independence of monetary policy, and some nominal exchange rate flexibility, could be useful in rebalancing the different national economies. It would certainly be more difficult to achieve through adjustment of relative *nominal* wages in the context of a single monetary policy directed to price stability across the euro area. It is in that context particularly that I foresee potential pressures—in the form of unwelcome migration in search of employment or increased demands for fiscal transfers. In addition there will be a continuing risk of tension because of the possibility of asymmetric shocks of various kinds in the future.

I have to say that recent developments cause me to be more, rather than less, doubtful about the wisdom of moving ahead until we see more clearly just how the unemployment problem is being addressed in the different potential members of the monetary union and what the consequences are likely to be. I understand that failure to go ahead on the basis of the timetable could mean a loss of momentum and a weakening of current efforts to achieve sustainable stability in some countries. But to go ahead—on the basis of an arbitrary calendar—before we were reasonably confident that adequate sustainable convergence had been achieved would also involve risks; and as others have observed, once you go ahead you do not have a second chance to put it right. To put it at its lowest, the interpretation of the convergence criteria in the Treaty 'Maast-be-strict'.

Our economic interest is the same as that of our European partners, that is to say that monetary union should go ahead only if we are sufficiently confident that it will be successful. That is far and away the most important economic consideration for British membership. If we had serious doubts about that at the appropriate time, and it went ahead anyway, then I am not at all convinced that it is a club we should wish to join—but it is certainly not in our interests that it should fail.

In saying this I am assuming, of course, that we would be eligible for membership—and it is enormously important that we should be. The timetable for meeting the Maastricht criteria is, for the United Kingdom, wholly consistent with the policies that we need to pursue in our national economic interest. We would—rightly—be far more severely punished, both by financial markets and in terms of business investment, if we gave up on those polices, than if we persisted in them but still chose to stand aside from EMU. In fact we are as likely to meet the criteria—on the public deficit and debt ratio and on inflation and interest rates—as our major partners, though no-one can be sure at this stage that *any* of us will meet them by 1997. There is a question about the interpretation of the criterion on exchange rate stability, but I would expect this to be assessed in terms of its substance rather than its technical form given that the ERM has changed fundamentally since the Treaty was agreed. So I would hope that we will have a genuine choice over British participation when the time comes.

There will be a number of other issues that will need to be considered—including whether possible future changes in the world economy are likely to have significantly different effects on the United Kingdom from other members of the union and whether the transmission of monetary policy in this country is substantially different from elsewhere. Differences of this kind might mean that we would be adversely affected by tying our monetary policy to that of our partners. Our present work in the Bank suggests that the differences may be less than some have suggested, but they are certainly important issues to be carefully explored.

The other main consideration will be whether this country can afford to stand aside if others go ahead. This is another area of the debate where emotions run high—with warnings of potentially dire consequences for the United Kingdom if we decide not to take part or are otherwise excluded. The warnings are given in the context both of the debate about the relationship between the 'ins' and the 'outs', and of the continuing attraction of the United Kingdom as a location for business activity, including particularly financial activity. Let me comment briefly on these two aspects in turn.

There is a perhaps understandable fear, on the part of some EU countries that see themselves as strong candidates to join the monetary union from the outset, that countries on the outside will somehow use their policy freedom to steal a competitive march. There is a lot of talk in particular about the potential for 'competitive devaluation', with the implication that such behaviour would lead to defensive measures by the 'ins' and the erosion of the single market. In my view this fear overstates the risks of such predatory behaviour, which most countries nowadays would not see as in their own long-term interest. This applies in particular to 'competitive devaluation'. I don't believe that you can explain any recent falls in exchange rates as 'competitive devaluation'. People are far too well aware that any short-term advantage is likely to be rapidly eliminated by higher domestic inflation and would damage financial market credibility. But there is no doubt that all EU member countries—with or without monetary union and whether 'ins' or 'outs'—have a collective interest in ensuring that they all pursue policies directed to economic, monetary and exchange rate stability. Provided that they do, then, in the case of monetary union, the 'ins' would have no reason—and certainly no right under any European legislation—to seek to disadvantage the 'outs' or vice versa. I can well see that *all* sides nevertheless have an interest in mutual policy surveillance and co-ordination, which could take a variety of forms, not necessarily or exclusively through a collective exchange rate arrangement. I see no difficulty with that. Indeed it would be eminently sensible and entirely normal for all EU countries to be involved in such arrangements whether or not monetary union goes ahead. In short, given rational economic behaviour, there is no reason to suppose that relationships between 'ins' and 'outs' will necessarily be a problem; we would be shooting ourselves in our collective foot if we allowed it to become one.

I take a somewhat similar view in relation to the location of economic and financial activity. I can well see that businesses might feel it safer to operate elsewhere within Europe if they thought that the British authorities would behave erratically outside monetary union, generating instability and inviting defensive action by the 'ins'. But there would be no reason for them to do so assuming that they expected us to continue to behave responsibly. There are a host of reasons why businesses choose to locate in one country rather than another—and while the prospect of a wildly fluctuating exchange rate may be a significant factor for some types of business, the difference between reasonable stability outside monetary union and precise nominal stability inside seems unlikely to me to be decisive. So the answer here too is essentially in our own hands. What we clearly need to do in any event is to equip ourselves with the technical capacity to trade at the wholesale level in the euro, as we trade at present in all major currencies; and that we are in the process of doing.

Let me conclude.

I do not underestimate the political determination on the Continent to move ahead to monetary union. I can only hope—as I have said often before—that this political aspiration does not run ahead of the economic realities. We in this country, when the time comes, will need to make up our own minds whether the necessary condition of *sustainable* convergence has been met by those who plan to move ahead. If we conclude that it has then I hope we will seriously consider our own participation. But if we have serious doubts about the chances of success of the monetary union without significant tensions, and this country decides to stand aside, we will need to continue to pursue responsible macroeconomic polices, both in our economic self-interest, as well as in the interests of preserving and increasing the economic benefits that we and the rest of Europe derive from our involvement in the single market. Opting out would not be a soft option for the United Kingdom, and if we fail to recognise that then I suspect we would be in for a hard landing. But with that proviso there is no particular reason in my view to suppose that the British economy would be damaged by exercising that option.