Prospects for monetary stability and the economics of EMU

*The **Governor** reviews[1] the recent performance of the British economy and argues that the encouraging record can be maintained, and even improved upon, providing a firm grip is kept on inflation, fiscal policy is prudent and sustainable, and supply-side policies promote flexibility and market competition, including an emphasis on free trade. The **Governor** welcomes the modest rise in interest rates in October, but notes that some further rise in rates may become necessary in due course. He comments that economic forecasters agree on an outlook combining continuing growth with low inflation over the next two years.*

*The **Governor** argues that Britain's interest lies unambiguously in a stable and prosperous Europe. He reviews the economic arguments for and against EMU, noting that the risks are greater if EMU starts from a position in which there is substantial divergence in the economic situations of the various member countries. Thus, it is vitally important for all to pursue macroeconomic discipline and structural flexibility. Finally, the **Governor** notes that Britain must be prepared for the proposed EMU starting date of 1 January 1999 whether or not EMU will happen, and whether or not Britain is in or out.*

Mr President, the British economy is now well into its fifth consecutive year—our nineteenth successive quarter—of expansion, at an annual average rate of 2.6%, and that expansion has been at an unusually steady pace. Unemployment has fallen, month by month, almost without exception, for most of that time, by almost a million, to a rate of below 7½% of the workforce. That is still wastefully high. But it is the lowest rate of any major country in Europe. Our external current account is in near balance, despite weak demand in our major trading partners in the EU. And—just in case you thought I hadn't noticed, or perhaps forgotten—retail price inflation (RPIX) has averaged 2¾% over the past 4 years, compared, unbelievably, with over 10% in the preceding 20 years.

But what you want to know is can we keep up—or even improve upon—this recent performance. My answer is a cautious yes—but it comes with conditions.

A first condition is that we keep a firm grip on inflation, in line with the Government's inflation target of 2½% or less for the indefinite future.

The point is that inflation is essentially a symptom of an emerging imbalance between demand and supply in the economy. We have learned that you cannot secure economic growth in anything other than the short term simply by pumping up demand without regard to the underlying capacity to meet it. So what we are really trying to do by aiming for permanent *price* stability is to achieve lasting *economic* stability in a much broader sense—a sustainable balance between demand and supply growth.

You have all seen the consequences when we have failed in the past, and the boom—however pleasant while it lasted—had to be stopped in its tracks. That kind of experience has created uncertainty and scepticism about the seriousness of our ongoing commitment to stability even today. That uncertainty distorts economic decision-making and is immensely damaging to our long-run ability to generate wealth and thereby to meet our wider social goals. So it is not enough just to aim for 'reasonably low inflation' as is sometimes suggested by our critics, but which might come to mean anything. If we are to convince you and others outside that we really will provide a stable environment in which, for example, both industrial and commercial and financial businesses can reliably plan and invest for the longer term, without building a fat inflation risk premium into their calculations, then we have to do what we say we are going to do and actually deliver effective price stability as reflected in the inflation target.

We now have a monetary policy framework for doing this: an unambiguous objective—the inflation target; uniquely transparent analysis directly related to that objective, which is open to public scrutiny and comment; and public accountability for both the Bank of England's advice and for the Chancellor's decisions.

That still doesn't make the task easy.

We are currently seeing an almost textbook, domestically driven, economic upswing. It started with monetary acceleration through last year. It fed through into final domestic demand, particularly consumer demand, in the first half of this year. And it has come through more recently into domestic production, which had previously been held back by a stock overhang.

(1) At the Confederation of British Industry National Conference, Harrogate on Tuesday, 12 November 1996.

We take the view that, while there is still no doubt some degree of spare capacity in the economy, the accelerating upswing will need to moderate if it is not to put the inflation target at risk further ahead. That is why we welcomed the recent modest rise in interest rates. It may well be that some further rise will become necessary in due course—and that was the conclusion in our latest *Inflation Report*. But by acting promptly to begin gradually easing back, the Chancellor has helped to limit the extent of the rise that may ultimately become necessary, and improved the prospect of lasting expansion.

The position is complicated by the erratically sharp appreciation of sterling through the autumn, which probably has as much to do with developments abroad as in this country. It is suggested that this made the rise in interest rates unnecessary. The problem with this is that the stronger exchange rate does nothing directly to restrain the domestically driven upswing in demand. It may affect our net trade position—if indeed sterling persists at the recent level, which is uncertain—and we certainly recognise that concern; and it should help to dampen inflation at least in the short term. We take account of these influences, of course, in our inflation forecast and in our policy advice. But there cannot be any automatic offset against interest rates—certainly no simple rule of thumb. Nor can the exchange rate become an excuse for overriding the inflation target. We have been down this road before—in 1987 for example. The objective of monetary policy can then become unmanageably blurred.

So much then for a tight grip on inflation as a necessary condition for keeping up our recent, better, economic performance. On its own it is clearly not enough. There are two further critical conditions. It needs to be accompanied by prudent and sustainable fiscal policy. And it needs to be accompanied, too, by structural, supply-side, flexibility, including free trade and market competition. That does not, and of course cannot, deny a very important role for government regulation—even dare I say, EU regulation. What it means is that all such regulation needs to be kept under constant review and justified against the economic costs it may involve.

If these three conditions are satisfied, then the rate at which the supply capacity of the economy grows is determined essentially by your efforts—in co-operation with your employees. As it is I don't know of any serious forecaster who does not expect continuing growth with low inflation over at least the next two years.

Now all three of these conditions—stability-oriented monetary policy, fiscal prudence and sustainability and structural flexibility—apply in our national economic interest, whatever the outcome of the present merger talks relating to EU monetary policy and EU central banks. They are in fact today's received wisdom throughout the European Union.

Fundamentally of course EMU is a political matter which arouses strong passions on either side. But there is nothing obvious or self-evident about the economics—where the answer, as so often, is 'it all depends'. It depends essentially upon whether, in Monetary Union, the different member countries would find that the single monetary policy—the single interest rate—was, consistently, at least broadly compatible with their national economic situation.

If it worked well in this respect, then there would be real advantage, in terms of intra-regional exchange rate *certainty* in a single currency, as well as lower transactions costs. But if domestic policy needs were likely to diverge in a major way, so that the single policy was too expansionary in some countries but too deflationary in others, that could give rise to serious tensions, including possibly persistently higher unemployment in some areas and pressure for protection. In that case it would be better for *everyone* if we all continued to pursue stability-oriented macroeconomic policies and structural flexibility independently, outside Monetary Union. If we did, successfully—and it is, of course, a big 'if'—then that should deliver reasonable *de facto* exchange rate stability within the EU area over time, though not the certainty that only comes with the single currency.

So the economic issue is whether the benefit of intra-regional exchange rate certainty, as against 'reasonable' *de facto* stability is worth the risk of intra—and possibly extra—euro-area tensions. It is a difficult judgment and the people to steer clear of are those who claim at this stage to *know* the answer. I'm not at all surprised that CBI opinion appears divided. But it is reasonable to suppose that the risk is greater if we start from a position in which there is substantial divergence in the economic situation in the various member countries. It was precisely to try to reduce the risks that the famous 'convergence criteria' were built in to the Maastricht Treaty. They were intended to ensure that at least a minimum degree of genuine, sustainable, convergence has been achieved before Monetary Union goes ahead. I doubt whether the architects of the Treaty envisaged the present hectic dash for the line—the chosen calendar deadline; and I doubt whether they envisaged either that some of the runners might be tempted to take artificial stimulants in order to get there! The decision when the time comes will be for Europe's politicians. I can only hope that they weigh the economic risks seriously. If they disregard them, there can be no assurance that Monetary Union will lead to the political cohesion that they have in mind.

But, however that turns out, what is vitally important is that we all do—whether in or out—continue to pursue macroeconomic discipline and structural flexibility based on free trade and open markets—in our own national interests but also to preserve the collective benefits of the single market. In that case, there would be no cause—it seems to me, for the outcome on Monetary Union—whatever it is—to lead to antagonism or hostility.

In the meantime, Mr President, we in this country must be prepared for 1 January 1999 whatever the outcome. That means, in the first instance, that the wholesale financial markets of the City must be ready to transact business in euro whether as our own developing national currency or as a foreign currency alongside the dollar and yen. We at the Bank are working closely with them to ensure that they will be. That will enable the City to offer euro facilities to those international industrial and commercial businesses that need them from the start. Many other businesses, including retail-oriented businesses, have more time. They will not be much affected, even if the UK participates in Monetary Union, until euro notes and coin, become available in 2002, and personal banking facilities generally convert to the euro denomination. I recognise that many of you are concerned about what Monetary Union will mean for you. I therefore welcome the initiative taken by the CBI and the British Chambers of Commerce in conjunction with ourselves at the Bank to arrange a series of workshops around the country to discuss the practical issues.

Mr President, let me sum up. This country's interest lies unambiguously in a stable and prosperous Europe. Fundamentally, that requires that all EU member states pursue policies directed to monetary stability, fiscal sustainability, and structural, supply-side, flexibility including free trade and market competition. And that remains true whether or not there is an early move to Monetary Union. In pursing these same policies, the British economy is in better shape than it has been for years both to contribute to, and take advantage of the opportunities that will be presented by, that stable and prosperous Europe. And that remains true whether or not the United Kingdom is part of a Monetary Union. We do not need to be apprehensive about the euro in either case, but we do need to be prepared.