UK monetary framework and preparations for EMU

In his opening remarks,[1] the ***Governor*** *briefly outlines recent changes at the Bank of England and new procedures for operating monetary policy. He then considers the UK position on EMU, noting that uncertainty about whether the United Kingdom would participate at the start was helpfully dispelled by the Chancellor's statement on 27 October. This statement provides greater clarity, if not absolute certainty, about the timescale and conditions in which to make preparations for EMU, and together with the Government's commitment to both fiscal and monetary stability, on lines that run parallel to the macroeconomic discipline of EMU, it provides a solid foundation for a positive and constructive relationship between the United Kingdom and the initial members of EMU. The* ***Governor*** *concludes with a description of the Bank's contribution to EMU preparations.*

I am delighted to have this opportunity to meet the European Parliament's Monetary Policy Sub-Committee. It is a critical time for the evolution of monetary affairs within Europe, and you will be playing an important part at the beginning of May next year in the process of deciding which members of the European Union are to be initial participants in EMU.

At the same time, and particularly during the past seven months, the Bank of England has been experiencing changes to its structures and responsibilities as great as any it has known since 1946, and possibly in all the 303 years of its existence.

In these introductory remarks, I shall try briefly to describe these changes and the role that the Bank is playing in the preparations for the single currency.

Changes at the Bank

On 6 May 1997, four days after the new Labour Government took office, the Chancellor announced a new monetary policy framework, giving the Bank operational responsibility for setting short-term interest rates to achieve an inflation target to be set by the Government in Parliament. Without prejudice to this objective of price stability, monetary policy will 'support the Government's economic policy, including its objectives for growth and employment'.

A fortnight later, the Chancellor announced his intention to transfer responsibility for banking supervision to a single Financial Services Authority, which will become responsible for the authorisation and regulation of all kinds of financial institutions in the United Kingdom. The Bank will, however, remain responsible for the overall stability of the financial system. There are advantages in separating the central bank's responsibility for the overall stability of the financial system as a whole—which is an intrinsic central banking function everywhere—from the supervision of individual banking institutions, where the public policy interest has increasingly focused on consumer protection, in this case the protection of depositors. That is not a natural habitat for a central bank, and it may produce a conflict of interest if it causes the central bank to become over-protective of individual institutions, giving rise to moral hazard in the system as a whole.

In giving the Bank operational responsibility for the conduct of monetary policy, the Chancellor's primary objective has been to ensure the credibility of monetary stability in the United Kingdom, as an essential basis for sustainable economic growth. In certain respects, notably the setting of targets, the Bank of England Bill falls short of the independence criteria required by the Maastricht Treaty and would have to be extended before we joined. But it is clearly a significant step in the direction of independence, and in other respects, such as accountability to Parliament, it could be said to go beyond what is currently envisaged for the European Central Bank. A very high degree of transparency has been introduced into our monetary policy-making: the details of the analysis and deliberations of the Monetary Policy Committee are both published, together with the individual votes of the members participating in interest rate decisions; and I and other members of the Committee regularly appear before the Treasury Select Committee of the House of Commons to report and be questioned on our work.

Perhaps it would be helpful if I were to explain in a little more detail how our new procedures for operating monetary policy are working. In discussion with parliamentarians in the United Kingdom, I find that a great deal of interest, and indeed anxiety, focuses on the extent to which we take into account developments in the real economy and the effects of our monetary policy decisions on the lives of ordinary people. I can assure you, as I do them, that we are extremely conscious of both of these concerns.

(1) At a meeting of the European Parliamentary Monetary Policy Sub-Committee in Brussels on Monday, 24 November 1997.

We are not just inflation nutters or even only number crunchers!

The objective we are currently set by the Government is an inflation target of 2.5%. This is different from the previous objective, before the change in the arrangements, which was a target of 2.5% or less. In betting terms, we ought to have moved from an odds-on to an evens chance of hitting 2.5%. In other words, in the new regime we have as much incentive to avoid going below as we have to going above 2.5%.

Our procedures are briefly as follows. In the week before our monthly decision-making meeting, the nine members of our Monetary Policy Committee (five professional members of the Bank, and four outside appointees of high economic expertise and distinction—including two non-nationals, which I think is unique among monetary policy-making bodies) sit down with the Bank's economists to analyse all the latest relevant data. This includes data from statistical sources, comparison of the work of other outside analysts or institutions, and the input from our twelve regional Agents, who are in regular contact with all sectors of economic activity in their regions. At this stage, we confine ourselves to evaluating the information, and in a two-day meeting in the next week the Committee draws the necessary conclusions from it. The result—ie whether there is or is not to be a change in the short-term interest rate—is announced at midday on the Thursday of that week. The minutes of the two-day meeting at which that decision is made, together with a summary of the information presented by the staff, are published in the week after the following meeting. Those minutes also record the individual votes of each member of the Committee.

Beyond this, we publish a regular assessment of monetary policy, including a forecast of inflation over the two-year period that we believe is relevant, given the lags between policy actions and inflation outturns, in the Bank's quarterly *Inflation Report*. And the Treasury Select Committee of the House of Commons regularly summons me and other members of the Monetary Policy Committee to give evidence on the basis of these reports.

Finally, the Government has made it a requirement that, if we miss the target of 2.5% by 1% or more in either direction, the Committee must write an open (ie public) letter to the Chancellor, explaining why and what we intend to do about it.

These arrangements taken together provide a framework of transparency and accountability quite unlike any that applies anywhere else in the world.

Preparations for EMU

Let me now say a few words about the UK position on EMU. The uncertainty about whether the United Kingdom would participate in the start of monetary union was helpfully dispelled by the Chancellor's statement on 27 October.

He made it clear first of all that the United Kingdom will exercise its opt-out, and not participate in EMU in the first wave. That, I believe, should come as a considerable relief to many of our European partners, because UK participation at a time of substantial cyclical divergence would certainly have increased the economic risks of the project in its early stages. It will leave the United Kingdom free to concentrate on ensuring an orderly decision-making process during the crucial period of our EU Presidency in the first half of next year. But the Chancellor also made it clear that the Government is not opposed to membership of EMU as a matter of principle, but will make the decision in the light of a pragmatic assessment of the potential economic benefits and risks, which in turn depend upon the achievement of genuine and sustainable convergence. He recognised that it is very unlikely that it would be realistically possible to reach such a conclusion before the end of the present Parliament, which could run until May 2002, but he has put in hand arrangements to ensure that the United Kingdom is prepared both for the advent of the euro and for our participation when the necessary economic conditions are in fact satisfied.

This is the clearest statement on its attitude to EMU made by a British Government for a very long time. It implies that the United Kingdom is to be regarded effectively as a 'pre-in'. Taken together with the Government's commitment to both fiscal and monetary stability, on lines that run parallel to the macroeconomic discipline of EMU, this in my view provides a solid foundation for a positive and constructive relationship between the United Kingdom and those EU member countries that do participate in monetary union in the first wave. I very much welcome this. It is clearly very much in our mutual interest to build such a constructive relationship. And it provides a realistic basis on which we can all now plan for the future.

The position, therefore, is that we now have greater clarity, if not absolute certainty, about the timescale and conditions in which to make our preparations for EMU.

The Bank's contribution has hitherto been in two main directions. In the context of the EMI and the Monetary Committee, we have been fully participating in the elaboration of and preparations for monetary union. We have taken as our planning assumption the likelihood that EMU will begin on 1 January 1999. As Europe's leading financial centre, London would be significantly affected whether or not the United Kingdom is a first-wave member. We have therefore taken the lead in the past two years in preparing the financial sector. Thus we:

- co-ordinate preparations where necessary;
- serve as a catalyst to stimulate preparations of the necessary infrastructure;

- plug gaps where we identify them;
- promote consensus where we believe a harmonised approach makes sense, including at the European level; and
- communicate as widely as possible the state of the developing preparations (our *Practical Issues* series has a circulation of up to 40,000, including 4,000 overseas).

We are confident that the City will in fact be ready for 1 January 1999 and will retain its pre-eminent position among the financial centres of Europe. But I want to emphasise that a successful City should be seen as a resource for the whole of Europe, not just for the United Kingdom. All can benefit from the efficient intermediation of savings and capital flows, in the real economy just as much as in the financial sector narrowly conceived. Nor should the financial activity that will be generated by the introduction of the euro be seen as a zero-sum game: London's success need not be at the expense of the main continental financial centres.

We have also sought collaboration with private sector bodies such as the CBI and Chambers of Commerce, to encourage other sectors of the British economy to understand the practical issues that would arise from the introduction of the euro. With the changed approach of the new Government, this part of our activity has moved under the aegis of the Treasury.

It has also moved into a higher gear. The Chancellor has set up a standing committee on which I serve, together with the Presidents of the Board of Trade and the CBI and the Association of the British Chambers of Commerce, to help with the practical preparations that business as well as the Government will have to make before a decision to join a successful single currency can be taken. We shall be studying the lessons from decimalisation in 1971, the preparations for 1999 in other countries, what the United Kingdom needs to do for 1999, and the timetable and critical path for preparations for the United Kingdom to join. We shall receive reports from business advisory group working parties, and early next year we shall initiate a programme of conferences and seminars.

As for the UK economy more generally outside EMU, what matters above all is the continued pursuit of stable, non-inflationary policies. These will parallel those to be followed in the euro zone, governed by the Treaty obligation on the European Central Bank to achieve price stability, together with the Stability and Growth Pact obligation on governments to maintain prudent fiscal policies. Against that background, there is every chance that the day will be brought forward when the Government is able to conclude that the economic tests that it has set for entering EMU have been met.