BANK OF ENGLAND

Speech

Britain in Europe

Speech given by
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It's a great pleasure to be here in the beautiful City of Bruges, and I am honoured to have this opportunity to address the Financial Forum here in West Flanders.

Mr Chairman, in just 50 business days' time - on 1st January next year - eleven European countries will take the long-awaited, truly historic, step of merging their national currencies into a single "euro". The United Kingdom will not be among them, but we have a vital interest in the euro's success. I should like to explain to you this evening Britain's attitude to the euro, and then say something about the prospects for the new single currency as an element of stability in today's turbulent global financial and economic environment.

Let me make clear at the outset that, of course, I recognise that monetary union is fundamentally a political issue. It necessarily involves some deliberate further pooling of national sovereignty over important issues of public policy - monetary policy and overall fiscal policy - just as the single market involved the pooling of sovereignty over aspects of trade and competition policy and so on.

As a central banker I have nothing to say about the politics of monetary union. But it is also, of course, about economics, and the economics of monetary union could go either way. I can see that if it goes well it will contribute to a broader cohesion within Europe; but equally if the economics were to go wrong, then that could blow back on the politics of Europe and give rise to tensions. I shall concentrate my remarks this evening on the economics of monetary union.

The economic pros and cons have in fact been exhaustively debated in the United Kingdom and the arguments are now reasonably well defined, even though different opinions inevitably attach different weights to them.

On the positive side, the crucial and unique economic advantage of monetary union is nominal exchange rate certainty within the euro area - not just the reasonable de facto stability that might result from each EU member state individually pursuing disciplined macro-economic policies in parallel - but nominal exchange rate certainty for the indefinite future. And that is a very real economic advantage as any UK exporter who has suffered from the exaggerated strength of sterling over the past two years or so will readily tell you! One can argue that such exchange rate certainty is not an essential complement to the European single market - any more than exchange rate fixity is essential to achieving benefits from free trade more generally. But it brings very material benefits - through increased competition as a result of greater transparency of prices and lower transactions costs, through broader and more liquid financial markets, and through the associated improvement in economic resource allocation. And there is no doubt that intra-European exchange rate certainty in particular will enhance the benefits to be derived from the European single market. Whether or not it is essential, therefore, most people would, I think, agree that, other things equal, the nominal exchange rate certainty that comes with the move to the single European currency is very desirable in this context.

What then are the economic arguments against it? Essentially they can be summarised as the risk that the single monetary policy - the single, one-size-fits-all, short-term interest rate within the euro area, which is a necessary corollary of the single currency - will not in the event prove to be appropriate to the domestic needs of each of the euro-member countries. There is no doubt that such risk exists. It may result from cyclical divergence within the euro area, with some participating countries needing to stimulate domestic demand while others are already operating close to capacity. It may arise from differences in fiscal positions even though these are to be constrained through the Stability and Growth Pact. Or it may result from economic shocks of some sort that have a bigger impact on some countries than on others. The rise in oil prices in the early 1970's or German reunification are classic examples.

So the risk of divergent monetary policy needs within the euro area is real. And if there were a material divergence of monetary policy needs, that could lead to serious tensions, because alternative adjustment mechanisms, such as labour migration or fiscal redistribution, that exist within individual countries, and which help to alleviate familiar regional disparities when they arise at the national level, are simply not well-developed at the pan-European level.

The Maastricht Treaty, of course, recognised this risk. The famous convergence criteria were specifically designed as a means of reducing the risk to manageable proportions by requiring that, before joining the euro club, countries should have achieved at least a minimum degree of macro-economic convergence - thereby demonstrating their commitment to macro-economic discipline both through fiscal consolidation, and through monetary policy consistently directed at effective price, and exchange rate, stability. And all member countries of the European Union have certainly made great progress towards macro-economic stability over the past few years.

This has, of course, been a matter of national economic self interest. But there is no doubt that the goal of monetary union, and the Maastricht criteria, provided a very powerful external incentive for many countries - indeed it is barely conceivable that anything like so much progress would have been achieved across the Continent without this incentive. It is a remarkable demonstration of political commitment that the eleven participating countries - against all the odds as seen only a couple of years ago - could reasonably have been judged to have met the criteria, enabling the Heads of Government to agree to the launch of a broadly based monetary union at their meeting in Brussels in May.

But the risk of divergent domestic policy needs - or of potential regional tensions within the single currency area - did not simply disappear during that momentous weekend in Brussels.

Remaining cyclical differences are reflected in the persistence of interest rate differentials among the first eleven, which will, of course, have to be eliminated by the end of the year. It may then prove necessary in some countries for fiscal policy to be tighter than would otherwise be necessary in order to offset the easing of monetary policy as a result of the move to a single interest rate.

Even without that, a number of Euroland countries enter monetary union with very high ratios of public debt to gdp. And virtually all - to varying degrees - face the prospective burden on their public finances of ageing populations. All of this means that there will be a continuing need for rigorous fiscal discipline throughout the area well into the future - as was very clearly recognised in the EMI's Convergence Report. That indeed is very much the purpose of the Stability and Growth Pact.

And the potential for external shocks, with asymmetrical effects on different Euroland countries, of course remains.

A particular worry is that macro-economic stability - vitally necessary though it is - will not, on its own, be sufficient to prevent the persistence of unacceptably high levels of unemployment in a number of the major Continental European economies. Unemployment has been for some considerable time, and remains, much the most urgent and important economic issue confronting us in Europe. I do not suggest for a moment that the right answer would be to abandon macro-economic discipline and revert to old-fashioned demand management policies. In anything other than the very short term that would be likely to make matters worse. I share the broad consensus view that Europe's unemployment problems originate essentially in rigidities on the supply-side of the economy. The point is that unless we are all more successful in bringing down this structural unemployment, through micro-economic policies designed to improve structural, supply-side flexibility, then some countries could find it difficult to continue to live with a common macro-economic discipline without significant tensions. The nagging doubt is whether the necessary commitment to fiscal discipline, alongside monetary stability, will prove - in the terms of the Maastricht Treaty - to be sustainable.

Some people who basically recognise this concern are inclined to argue that if a euro-participating country were to find itself in this situation - and given that it would have no macro-economic way out, for example, through exchange rate adjustment, or monetary relaxation, or fiscal stimulus beyond the limits of the Stability and Growth Pact - then it would have an overwhelming incentive to take the sort of supply-side measures which have proved so difficult to implement hitherto. As one of my colleagues once put it to me "when we have exhausted all other possible policy options, we will finally be forced to do what we know to be the right thing!" And the populations in those countries would it is true have a similar incentive to accept structural change. I am not sure how far one can rely upon that. But it does in any event serve to emphasise that supply-side flexibility will be more crucially important than ever in the context of monetary union.

I should emphasise at this point, Mr Chairman, that I am not predicting that there will necessarily be serious tensions within the single currency area. There will no doubt be policy challenges - there always are, with or without monetary union. But it is difficult for anyone to predict how serious the problems will in fact turn out to be. I am simply describing the sort of economic risks which might occur, and which have been identified in the debate about monetary union in the UK as the potential downside to be set against the potential benefits of nominal exchange rate certainty which I touched upon earlier. You here in Belgium may think that these risks are sometimes exaggerated - you have after all been effectively in de facto monetary union with

Germany for some considerable time. But I don't think one can reasonably argue, certainly in the case of a larger country, that the risks can be ignored.

It was against the background of this kind of economic debate that the Chancellor of the Exchequer announced a year ago that the UK would exercise its opt-out and not participate in the first wave of euro membership. That was a disappointment to some of our European partners. But it was a considerable relief to others, because UK participation from the outset would undoubtedly have complicated the project - not least because of the substantial cyclical divergence between ourselves and the major countries on the Continent.

But the Chancellor also made it clear that the present British Government is not opposed to euro membership as a matter of principle; it will make its decision on pragmatic grounds - the test being whether membership would be in our economic interests; and it would submit that decision to Parliament and to the British people in a referendum. The Chancellor recognised that - barring some fundamental and unforeseen change in economic circumstances - it was unrealistic to think that a decision could be made during the lifetime of the present Parliament - and that could extend to May 2002. But he stressed that in the meantime the United Kingdom should prepare - both for the euro's introduction on the Continent on 1 January 1999 and for our own eventual participation.

This statement was the first by a British Government to accept the principle of monetary union. It implied that the United Kingdom is to be regarded effectively as a "Pre-In". It recognised that the single currency will affect us whether we are in or out of it, and that it is clearly in our national interest to do all that we can to help ensure that the euro is successful.

This, in my view, provides a solid foundation for a continuing, positive and constructive relationship between the United Kingdom and other EU member states, including those participating in the first wave of the euro. And that must be in the interest of both sides: just as we benefit from a stable and prosperous Europe, so too the Continental European interest lies in a stable and prosperous Britain - and that mutual interest above all is the thing we must all hold on to. To allow the euro to become a divisive factor in the broader relationship between European Union member states would be to cut off our collective nose to spite our collective face!

What then can the United Kingdom bring, initially as an 'out', or 'pre-in', to the European party, in terms of contributing to the euro's success?

There are, I think, two things in particular.

First, we can continue to pursue macro-economic - both monetary and fiscal - discipline alongside the euro-area countries. The Government is committed to that course as a matter of national economic self-interest, but it reflects the same philosophy as that which underlies the Maastrict Treaty.

One of its very first acts in Government, for example, was to give operational independence for the conduct of monetary policy to the Bank of England, and we have been set the objective of delivering, consistently, underlying retail price inflation of 2 ½ %. That objective appears to be compatible with the ECB's target for the European Harmonised Index of Consumer Prices of less than 2% - in fact while we are, on the most recent data, precisely on track in terms of our own target measure, our inflation rate in terms of the harmonised index is down to 1.3%. And on the fiscal side the Government has committed itself both to maintaining the debt to gdp ratio at a stable and prudent level over the economic cycle and to the "golden rule" (under which public sector borrowing is limited to the financing of investment). These fiscal rules, too, are broadly consistent with those established for euro-member countries under the Stability and Growth Pact, and will ensure that we continue to comply with the Maastricht Treaty fiscal criteria.

These macro-economic policies - together with continuing structural reforms to improve supply-side flexibility - are calculated to make the UK a more prosperous trading partner and to ensure that we do not disrupt the policies and the economy of the rest of Europe. More than that they are calculated to encourage sustainable economic convergence with the rest of Europe as a necessary precursor to our eventual adherence of the euro club.

Secondly, Mr Chairman, the UK can contribute directly to the development of the euro through the City of London's financial markets. To take its place alongside the dollar, the euro needs well developed, pan-European, financial markets. And providing liquid, transparent, competitive and innovative, but well-regulated, financial markets is one of the things that the City of London does particularly well.

The City's strength derives from being a uniquely international financial centre, in which the strongest financial businesses from all parts of the world - including from all parts of the European Union - are represented. There are more banks in the City incorporated abroad, for example, than domestic banks. And more than half the total deposit base (over £1 trillion equivalent) of the UK banking system is denominated in foreign currencies. And while the current global financial turbulence is taking its toll on employment in some financial services activities in London as elsewhere, the longer-term trend is for the foreign presence - including that from European partner countries - to continue to increase.

The Bank of England has been working intensively with the City for the past few years to ensure that it is as thoroughly prepared for the start of the euro next year as the financial centres in any of the participating countries. We will be ready to provide financial services denominated in euro to all those that want them from day one. And we are already taking the initiative with our European partners in creating regional market structures, as you see, for example, in the talks between the London Stock Exchange and the Deustche Borse, which are designed to lay the foundations for an inclusive, pan-European, equity market. You will be able to account, trade and settle in euro-denominated assets in London just as you can now in Deutsche Mark or French francs or Dollars or Yen. The financial markets of the City are our wedding present to the euro marriage partners. They are not just a national - but a European - asset.

There are, of course, some here on the Continent who regard this role of the City as something of a mixed blessing - perhaps even a threat rather than a promise. There is a view that the euro should somehow 'belong' exclusively to the participating countries and that its introduction should be used as an opportunity to confer competitive advantage on national financial centres within the euro area. If that view were to prevail the main effect would be to inhibit the development of the euro as an international trading and portfolio currency, reducing one of the single currency's major benefits to both investors and borrowers within the euro area itself.

In practice in today's world of globally integrated markets and liberalised capital flows there is very little prospect of being able to impose artificial constraints on the international use of the euro. There will inevitably be active euro markets in all the major financial centres, including London. And it is in the interest of financial activity right across Europe that there should be. Like trade in goods, trade in financial services is a positive sum game, so that London's success is not a threat to other European financial centres. As a major interface between Europe and the rest of the world I have little doubt that euro-activity in London will mean more rather than less euro activity in other European financial centres like Frankfurt, Paris, Milan, Amsterdam or Brussels. And conversely I have little doubt either that what is good for those centres will be good too for the City.

I hope, Mr Chairman, that I have said enough to persuade at least some of you that British hesitations about participating in the euro from the outset are not just plain obstinacy! Out of the first wave we may be - indeed we are - but we remain very much an active and, I would hope, a constructive partner in the process of European monetary integration in a wider sense, and we clearly want the euro to succeed. That is why I prefer to think of Britain in Europe which I took as the title for my talk.

Let me conclude, Mr Chairman, with just a few remarks on the prospects for the euro in the current climate of global financial turmoil.

For much of the past two years or so financial markets have shown a degree of scepticism about the future character of the euro. The sense, from about the autumn of 1996, appeared to be that the process was being driven by the politics of Europe with less emphasis on the importance of economic convergence; expectations therefore increasingly focussed upon the prospect of a broadly-based rather than a narrower euro; and the inference was drawn that this would mean a weaker rather than a strong euro. Together with comparatively subdued economic activity on the Continent, this perception - or misperception - meant that the core European currencies were for a time relatively weak against the dollar, and against sterling.

That situation has more recently begun to change. Market scepticism has diminished with the growing realisation that the ECB will in fact be rigorous in pursuit of its mandate of maintaining effective price stability throughout the euro area as a whole - that the euro will in fact be soundly managed. And at the same time domestic demand growth and economic activity have started to pick up in the core European countries, causing the euro-currencies collectively to strengthen in the foreign exchange market and helpfully easing some of the cyclical tensions that might otherwise have complicated the move to a single monetary policy.

All this is now overlaid by the successive financial shocks to the global economy from Asia, from Russia, and most recently from the need to rescue LTCM.

In practice the euro currencies have been remarkably stable in relation to each other in the face of these shocks - demonstrating the market's total conviction, in the words of one market participant recently that "the euro is a done deal". The euro area has in fact been a zone of stability in turbulent currency markets - and that performance puts in proper perspective earlier excited talk about spectators waiting to rip the euro apart. That never was in my view a serious issue, given the political commitment to the process - the economic issue has, as I say, been about the sort of regional tensions that might subsequently emerge.

The big questions now - for all of us, not just for the euro countries - are, first, and most immediately whether we can avoid new financial shocks; and, secondly, how we should manage the economic fall out from the financial shocks that have already occurred.

Developments since the IMF/IBRD meetings in Washington have in my view been quite encouraging. The Japanese financial package is reassuring, and the strengthening of the Yen has brought welcome relief to much of the rest of Asia. United States Congressional approval of the IMF quota increase and of the New Arrangements to Borrow (NAB) has paved the way to a vitally necessary increase in IMF resources. Brazil - which has been widely seen as the next potential emerging market domino - is clearly committed to taking strong corrective domestic policy action, which would command broad international support. And while there evidently has been a sharp contraction of wholesale market lending, within the financial sector in particular, in the US, and suggestions there of a possible wider credit crunch, no new problems on anything like the scale of LTCM have in fact been uncovered. We are certainly not yet out of the wood, but the financial situation looks rather better than might have been expected two or three weeks ago.

If we can avoid a new financial shock - and I am hopeful that we will - we still have to manage the global economic slowdown already underway. In that context there has been a good deal of talk about concerted interest rate cuts in Europe and the US to stimulate domestic demand and offset the effects of recession elsewhere. And it is true that those effects - both lower world commodity prices and falling external demand - do mean that interest rates in the industrial countries generally can be lower than they would otherwise be, which in turn will help to sustain global demand. But we do not all start from the same point. Rates have in fact been cut in the US and the UK, where underlying domestic demand growth also shows signs of slowing. In Continental Europe, on the other hand, domestic demand growth has, as I say, been picking up. But even here interest rates have already come down in some of the smaller countries and are likely to be generally lower than they would have been in the absence of the global slowdown. Markets are, in fact, now expecting rates to converge by the end of the year on German rates, where only a couple of months ago, they expected convergence at significantly higher rates.

None of this, Mr Chairman, it seems to me need affect the prospect for the euro - if anything it may reinforce the more recent firmer tone of the euro currencies. It would only add to potential tensions within the euro area if the global economic weakness had a disproportionate impact on some member countries as against others. Although, therefore, the present international climate is less than ideal for the euro's introduction, that does not alter my conclusion that the new currency will indeed prove to be a stable element in an uncertain world, and that continuing growth of the European economy will help to ensure that the present slowdown does not develop into global recession. And that is clearly in everyone's interest.