BANK OF ENGLAND

Speech

Britain in Europe

Speech given by
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I am delighted to be here this morning, and to have this opportunity to meet with the Danish financial community.

I would like to use this opportunity to explain to you something of the British attitude to Europe - as I see it - and in particular our attitude to monetary union. I am well aware that we British have something of a reputation for stubbornness about Europe. I should like to try to persuade you this morning that while we do have some - not wholly irrational - misgivings, we are nevertheless as anxious as anyone to see the project succeed. We have to be - it is clearly in our national interest that it should.

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 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. Decisions about monetary union will quite rightly be taken by elected politicians, according to their perception of its long-term political impact on the future of Europe, as well as its impact on the future prosperity of their countries, and they will have to carry their electorates with them.

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; if it goes well, that certainly could yield political benefits, but 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 morning on the economics of EMU.

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 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 actual exchange rate certainty. And that is a very real economic advantage as UK exporters presently suffering from the strengthening of sterling over the past eighteen months will readily tell you! One can argue that 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 there is no doubt that intra-European exchange rate certainty would - through the increased competition resulting from greater transparency of prices and lower transactions costs, through broader and deeper capital markets, and through the associated improvement in economic resource allocation - enhance the benefits derived from the single market. Whether or not it is essential, therefore, most people would, I think, agree that, other things equal, exchange rate certainty would be very desirable in this context.

The potential disadvantage of monetary union can equally be simply stated, though it is perhaps more difficult to assess. Essentially there is a 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 - where for example would we be in the UK now, confronted as we are with relatively strong domestic demand growth, if we were obliged to have German- level interest rates? Or where would Germany and France be as they struggle to sustain domestic demand if they were constrained to have interest rates at the UK level? The risk may arise from differences in fiscal positions even though these are to be constrained through the Stability 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 the damage it could cause if serious tensions between member countries were to emerge is substantial, because alternative adjustment mechanisms, such as labour migration or fiscal redistribution, that exist within individual countries, and which help to alleviate the similar regional tensions that arise at the national level, are not well-developed at the pan-European level.

The Maastricht Treaty, of course, recognised this risk, and the famous convergence criteria were designed precisely as a means of reducing the risk to manageable proportions by requiring that, before they join the euro club, countries should have achieved at least a minimum degree of macro-economic convergence - demonstrating their commitment to macro-economic discipline through both fiscal consolidation and monetary policy directed at effective price, and exchange rate, stability. And there is no doubt that all European Union member states have made huge progress towards macro-economic stability over the past few years. The betting in financial markets is therefore that when, in early May, the Heads of State come to make their decision, a broadly based euro will indeed go ahead.

The nagging concern is whether this determined pursuit of macro-economic stability will be maintained - whether in fact the degree of macro-economic convergence that has been achieved is likely - in the terms of the Treaty - to be "sustainable".

A particular worry is that macro-economic stability, on its own, is not enough. It has not been enough to prevent the progressive emergence of very high, and very different, levels of unemployment in a number of the major Continental European economies. Unemployment has been for some considerable time, and it 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.

Some people here on the Continent who share 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 Pact - it would then have an overwhelming incentive to take the sort of supply-side measures which have proved so difficult to implement hitherto. I am not sure that you can necessarily rely upon that making life very much easier. But what I think this discussion points up, is the broader conclusion that if the euro is to go ahead in current conditions, as I assume that it will, then supply-side flexibility will become more crucially important that ever across the whole euro area.

The Chancellor of the Exchequer announced last October that the United Kingdom 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 certainly 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 British Government is not opposed to euro membership as a matter of principle; it will make its decision on pragmatic, economic, grounds, and 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 - which 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 declare for the principle of monetary union. It implies 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 play a full part in ensuring 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 those EU member states that do participate 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 collectively to cut off our nose to spite our face!

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

There are, I think three things in particular.

Most immediately the Government has undertaken to use its current term as President of the European Union Council of Ministers to promote an orderly decision-making process during the crucial next few months. Not being part of the first wave leaves us free to concentrate on that, and while there are issues - such as the vexed question of the Presidency of the European Central Bank - which only others can resolve, the UK’s role is to give them every opportunity to reach timely decisions.

We can, secondly, contribute positively and directly to the success of the euro through the City of London’s financial markets.

The potential benefits of the euro derive importantly, as I have said, from the exchange rate certainty which it will provide across the euro area. But the potential benefits will derive importantly, too, from the greater transparency and liquidity of unified financial markets in the euro-denominated instruments rather than the fragmented markets denominated in the various national currencies that we have now. Providing transparent and liquid, competitive, innovative and well-regulated financial markets is one of the things which the City does particularly well. There will be a vigorous Euro-euro market in London, just as there are vigorous markets in Euro-DM, Euro-francs, Eurodollars and so on now. If not our dowry exactly, since we will not participate in the first wave, it will be our wedding present.

The wholesale financial markets in the UK derive their strength from London’s position as a uniquely international, rather than simply a national or regional European, financial centre. This reflects the critical mass of markets and financial services in commercial and investment banking available in London including the strongest financial businesses from all around the world, and including leading Danish institutions. For instance, there are more banks operating in the City which are incorporated abroad than there are domestic banks, and more than half the total deposit base (over £1 trillion) of the UK banking system is denominated in foreign currencies. And, the fact that so many foreign-owned institutions - including very many from our European partner countries - continue to build their presence in London, suggests that they share this perception.

The City in this capacity is, I know, seen as something of a mixed blessing by some people on the Continent. There is a view that the euro should in some sense ‘belong’ to the participating countries and to them alone. If that view were to prevail it would point in the direction of one form of bureaucratic regulation or another - no doubt with a nod in the direction of monetary policy considerations as justification - which would damage the euro at least as much as it would harm the financial markets of the City. At the same time some of these same people argue for a successful, strong and widely-used euro that will take its proper place alongside the dollar and the yen as an international trading and portfolio currency, and in that context they positively welcome the active participation of London.

In the end I do not think there is very much choice. In a world of increasingly integrated capital markets and liberalised capital movements it is inconceivable that the international use of the euro could be unnaturally constrained. There will be active euro markets in the major financial centres of the world, including in London, which will be ready to trade in the whole range of euro wholesale financial products from day one.

And that will be in the interest of financial activity right across Europe. 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 Copenhagen. And I have little doubt either that what is good for those centres will be good too for the City.

Thirdly, and perhaps most fundamentally, the United Kingdom, even while it does not participate in the euro, can contribute to its success by continuing to pursue macro-economic, both fiscal and monetary, discipline in parallel with the euro-area countries. The Government is committed to this course as a matter of national economic self-interest - one of its very first acts in Government for example was to hand operational independence for the conduct of monetary policy to the Bank of England. But these same policies are calculated, too, to make us a more prosperous and active trading partner for Europe as a whole, and to ensure that we do not have any avoidable disruptive effect on the policies or on the economy of the euro participants. More than this they are calculated to foster sustainable economic convergence as the necessary precursor to our eventual adherence to the euro club.

And in the meantime the British Government will continue to pursue, and to advocate in the councils of Europe the supply-side flexibility that will be vital to its success.

Madam Governor, I hope that I may have persuaded some of you at least that British reservations about monetary union are not just plain obstinacy! Out of the first wave of the euro we may be, but we remain very much an active and, I hope, constructive partner in the process of European monetary integration in a wider sense - which is why I prefer to think of Britain in Europe - which I took as the title for my talk.