The Rt Hon Sir Edward George GBE: The progress of the euro

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, at the Cercle de L'Union Interalliée in Paris on 24 October 2000.

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Thank you, Mr Chairman. I am grateful to the French Section of the Franco-British Council for giving me this opportunity to address this distinguished audience here in Paris, and I am delighted to share this public platform with my dear colleague, Jean-Claude Trichet.

You have invited us to speak about the progress of the euro. I am very happy to do so from my British perspective - at least for the time being - as a keenly interested observer. My perspective you might expect would be very different from that of Jean-Claude, who was, and is, one of the principal architects of and a major driving force behind the process of European monetary union - one of the true founding fathers. In fact you will find that our analysis and assessment of the euro's progress so far is very similar. I hope that will not come as too great a disappointment to you!

We would certainly, I think, agree that the preparations for and introduction of the euro at the beginning of last year were a technical triumph. The euro-payments infrastructure is generally working well and has underpinned the integration of the euro money market which is an essential precondition for the effective implementation of Eurozone monetary policy. And there has from the beginning been clear evidence of the anticipated broadening and deepening of euro financial markets more generally, reflected, for example, in increasing issuance of euro-denominated commercial paper, corporate bonds and equities. (If you would like chapter and verse on all this I commend to you the Bank of England's half-yearly publication, "Practical issues arising from the euro" - available free from our public information department.)

I am happy to say that the City of London has played a positive role in this process of euro market integration: it is in fact the greatest contribution that we can make to the success of the project from outside the Eurozone. And it runs in parallel with the distinct, but closely related, pressure for broader international integration of financial markets which is currently reflected in a whole series of market initiatives to unify trading platforms and both clearing and settlement systems, in which both London and Paris are, of course, very much involved. I have no doubt that increased financial market efficiency has an important part to play in improving overall economic efficiency - the question is how best we can bring it about.

Jean-Claude and I would also agree, I suspect, that the introduction of the euro has contributed to the increasingly positive macro-economic performance of the Eurozone economy, taken as a whole, over the past couple of years. The need to satisfy the Maastricht criteria for entry to the euro served as a strong incentive to a number of the present member countries to pursue disciplined, stability-oriented, macro-economic policies in the run-up to monetary union; and - despite the dampening after-shock of the global financial crisis of two or three years ago - that macro-economic stability has provided the platform for the Eurozone's subsequent strong macro-economic performance. Looked at in its own terms that performance is impressive - with relatively strong growth, currently and prospectively; falling unemployment, albeit from a painfully high level; and a broad balance between overall demand and underlying supply growth reflected in both broad balance in the Eurozone's current account and low and stable core consumer price inflation.

By any conventional standards that is a pretty good performance. I must confess that, measured against that performance, I find some of the popular criticism I read in the media - of lack of political coherence at the Eurozone level, of lack of co-ordination between fiscal and monetary policy, and of shortcomings in the conduct and presentation of policy - greatly exaggerated if not wholly misplaced.

The problem, of course, has been the weakening of the exchange rate of the euro since its introduction - particularly against the dollar. This was not at all what most people had predicted - given the earlier widespread fears of an overheating US economy and the progressive widening of the US current account deficit - and most conventional analysis has for some considerable time now suggested that, on “the fundamentals”, the euro has become increasingly undervalued. I share that view.

Why then has the euro weakness persisted? Frankly I’m not at all sure that anyone really knows the answer to that question.

What I think we were all somewhat slow to recognise was the impact of the remarkable acceleration of productivity growth in the US economy - not just faster productivity growth but accelerating productivity growth on the latest data up to the second quarter of this year. This has allowed the US economy to continue to grow faster than before without generating inflationary pressures - though there is clearly a limit to how far that can go. But accelerating productivity growth has also increased prospective returns on investment in the US which has contributed to a huge net inflow of capital - in the form of both direct and portfolio investment - which has much more than financed the US current account deficit.

The numbers are truly massive. In the 18 months since 1 January 1999 when the euro was introduced the US current account deficit was something over \$500bn compared with net long-term capital inflows of nearly \$750bn. Meanwhile the Eurozone was in small current account surplus but saw net direct investment and portfolio outflows of some \$275bn. The conventional “fundamentals” - which one would still expect to reassert themselves in due course - have been overridden for the time being by these massive international capital flows.

To the extent that the capital flows have indeed been driven by an improvement in prospective rates of return in the US associated with the productivity “shock” - and I freely acknowledge that this explanation may be oversimplistic - one would expect that at some point it would be discounted through a change in relative asset values, including the change in the exchange rate. The problem is that we simply do not know how close we are to that point - or indeed whether we have already passed it. Putting that question to the market was, for me, the real point of the recent G7 intervention. We all need to understand much more about the nature of the capital flows and in particular about what motivates the market participants who initiate them. My immediate point, however, is that on the basis of what we do know it seems unlikely that the euro’s weakness in the foreign exchange market is pushed by any obvious macro-economic failure in the Eurozone. It is much more likely that it reflects the magnetic attraction of the US at present as a destination for long-term investment. And while that may partly reflect relatively greater flexibility on the supply-side of the US economy, it does not have much to do, as far as I can see, with the introduction of the euro.

Of course, whatever the cause, the euro’s weakness complicates the task of monetary policy within the Eurozone. It adds to inflation in itself and amplifies the inflationary effect of the rise in oil prices. The ECB is rightly concerned to ensure that these effects do not feed through into an increase in the rate of core inflation.

Given the importance of the Eurozone as far and away our major trading partner, the weakness of the euro, in this case more specifically its weakness against sterling, also, of course, complicates our own monetary policy task in the UK.

Looking at the aggregate economic data the UK has had a rather good run now for the past seven or eight years. We have grown fairly steadily quarter by quarter at an average annual rate over that period of some 2¾%, which is well above our longer term trend rate - usually estimated at around 2¼%. Employment has risen steadily so that the number of people employed is the highest on record. And the rate of unemployment is as low as it has been for about twenty years. Meanwhile inflation on our inflation target measure has also averaged some 2¾% over the past seven or eight years. Helped by the dampening effect on UK inflation of the weakness of the euro against sterling, we have been below the 2½% target now for the past year and a half, and currently - on the standard HICP measure - we have the lowest rate of inflation in Europe at around 1%.

Our problem in the UK is the imbalance within the overall economy between those sectors that are competing with producers in the Eurozone, who are under considerable pressure, and the rest of the economy, which is doing relatively well. Believe me, we are very conscious of the desirability of exchange rate stability with our partners in the single market - even though we recognise that membership of the euro provides only nominal, rather than real, exchange rate certainty, and is, of course, limited to the Eurozone.

Why then do we hesitate? The answer - in terms of the economics of the euro - it seems to me - and here I differ from Jean-Claude - is quite straightforward - not a bit paradoxical or bizarre! It is because to join the euro we would have to live with the single monetary policy. It may be that in time we could expect to do so relatively comfortably. But had we joined at the outset the presumption must be that over the past two years we would have lived with both a lower exchange rate and lower interest rates during a period when we have in any case been operating close to productive capacity and growing at above trend. The likelihood therefore is that we would then have experienced something of an inflationary boom - as they have, for example, in Ireland though I am not sure one can generalise from the Irish experience.

The subsequent weakening of the euro since the beginning of last year has not made things any easier for us. Just as, I suggested earlier, the euro is substantially undervalued in terms of the medium-term "fundamentals", so in the same terms sterling is on most calculations substantially overvalued against the euro. To lower sterling to a more sustainable level in present conditions would again require an easing of monetary policy which would destabilise our overall domestic economy; and this in turn would tend to set in train a process that would lock in a subsequent real UK exchange rate appreciation within the Eurozone (albeit from an initially less uncompetitive level). That might help reduce sectoral imbalances in the short term, only for them to re-emerge. And in the meantime the whole of the economy would have been exposed to accelerating inflation, which we would be powerless to address through national monetary policy. Frankly it is not clear to me that this is a risk which it would be in the interests of either the UK or the Eurozone to take in today's conditions.

For the time being our best bet, it seems to me, is for both the Eurozone and the UK to continue to pursue macro-economic - both fiscal and monetary - stability in parallel, and to hope that the euro recovers, as I continue to expect that it will. That strikes me as a more reliable path to the sustainable convergence which the British Government has set as the essential economic criterion on which its decision to move ahead to a referendum on UK entry to the euro will be based.