Mr. Davies gives his personal view of EMU Speech by the Deputy Governor of the Bank of England, Mr. Howard Davies, at the EFMA Conference on the Single Currency in Brussels on 16/12/96.

Like many British men of my generation, I spent a good part of my spare time as a boy involved with the Scouting movement, first as a Wolf Cub, then as a Boy Scout.

I have to confess that I have forgotten many of the useful things I learned in the Boy Scouts. I can no longer light a camp-fire using only two sticks. I can no longer tie a clove hitch. But I can remember the Boy Scout's motto - 'Be Prepared'. And that motto strikes me as a useful injunction to bear in mind, as we approach the D-Day for Economic and Monetary Union of 1 January 1999. It applies, I think, just as much to those who may, for one reason or another, find themselves outside the first group of EMU countries, as it does to those who firmly intend to surf on the first wave. The preparations, though, may be slightly different in each case.

Now some of you may think, if you read the British press, or hear echoes of the British political debate on EMU through the media elsewhere in Europe, that in present circumstances one of the other pieces of advice which Lord Baden-Powell handed down to Boy Scouts who followed him would be more appropriate. I am thinking particularly of the injunction to smile and whistle through all difficulties. Certainly I am sometimes tempted, when asked to explain the state of opinion in London, to take refuge in a cheery smile, and to begin to whistle a mournful tune (not easy to do at the same time, you will find).

Fortunately, it is not my responsibility to discuss the politics of EMU in the United Kingdom. Another good reason for me not to do so is that I would like to keep my job. As a humble central banker, a mere technician, it is more appropriate for me to focus on the economic dimension of EMU and to say something, also, about the financial market implications which concern us, particularly given the Bank of England's position at the heart of the City of London.

In both these areas - economic and financial - the Boy Scout motto is particularly apposite today. Let me explain why.

At the Bank of England we have always held the view that Economic and Monetary Union is a momentous enterprise, with huge consequences for European economies. The act of irrevocably fixing exchange rates, between economies which have in many cases been managed separately for centuries, is not a step to be undertaken lightly. It is an exciting venture, almost too exciting for some, perhaps.

Those who have operated for decades with a regime of low inflation, interest rates set by a strong independent central bank, and a strong and appreciating currency, may rightly think they have little to fear from the disciplines implied by EMU. Others will find EMU more bracing, particularly those whose inflation record has been poor, whose currency has undergone successive devaluations, and whose fiscal position is less than robust. For those countries, the EMU mission is potentially dangerous.

Joining EMU would for them be to embark on a stiff mountain ascent, in weather which might be colder and less forgiving than one is used to. In those circumstances, the Boy Scout ensures that he is well prepared. He equips himself with waterproofs in the event of rain, with thick pullovers for the cold, with stout boots and, probably, a Swiss army knife in case it should prove necessary, at some point on the journey, to extract a stone from a horse's hoof. He would also, I think, wish to ensure that he was fit, and had undertaken some strenuous rambles in the foothills before making an assault on the mountain range.

At this point you may be tired of hearing about Boy Scouts, and be ready to accuse me of the typical British trick of hiding behind down-home metaphors, and reducing topics of high seriousness to wry jokes. So let me be entirely clear about what I mean.

We fully appreciate the great potential advantages of EMU for Europe's economies. The Chancellor of the Exchequer, Kenneth Clarke, described them in the House of Commons on Wednesday of last week. As he said then "if EMU can be made to work it would eradicate exchange rate movements which can disrupt trade and have disrupted trade in our recent history. EMU would also reduce transaction costs, making it easier for smaller businesses to enter into and compete in the European market. The members of a strong euro zone could also expect to enjoy lower interest rates . . . countries with a history of devaluation or bursts of inflation pay a lasting premium in terms of higher interest rates, as we in Britain know only too well!" And in his response to the debate Gordon Brown, the Shadow Chancellor, said that he was in principle in favour of a single currency for the United Kingdom.

So the attractions of EMU are well understood in Britain. They were in the minds of the architects of the Maastricht Treaty five years ago. But those architects also knew that the advantages would only be accessible to those countries whose economies were equipped to accept the disciplines which go alongside. If that were not true, then the EU would have discovered the economic equivalent of alchemy.

We are convinced that if a single currency is to be a success, then all the participants must be satisfied that they can survive within the EMU disciplines in the long term, as well as the short. This applies to the 1997 convergence criteria themselves, of course. It also applies to performance against those criteria in later years. And, in our view, perhaps more controversially, it applies to other aspects of the real economies of applicant countries, particularly to the structures of their labour markets.

In the case of the convergence criteria, our attitude is straightforward. They must be rigorously respected. And that applies to the substance, as well as the form. So it would be unwise for a country to seek to qualify in 1998 by massaging down its 1997 public sector deficit through artificial, unrepeatable devices, even if those devices are not technically disallowed.

It would be unwise, because the deficit limit is not a one-off requirement. Continued discipline on individual member states' budget positions is a crucial element of EMU in the future. Friday's agreement at Dublin provides for such discipline, albeit with an element of political judgement over the way that discipline will be exercised in certain circumstances.

But the general conclusion is clear. Member states will need to live with continued fiscal discipline. In our view, unless a country can show that its fiscal position is structurally sound - in other words that in mid-cycle, with the economy growing at trend on its potential growth path, the budget of the government would tend to be close to balance - then it may find the fiscal discipline of EMU difficult to sustain. That is both a long-term point, and one relevant to the transition period. It would be potentially destabilising of the whole project if countries found themselves obliged to take extremely difficult political decisions in the early years because their fiscal positions had not been properly corrected beforehand.

Of course it goes without saying that if a country's outstanding debt burden is well above the Maastricht guideline it will be much more difficult to achieve a sustainable deficit position, since it will be necessary to run sizeable primary surpluses at high points in the cycle. It is worth recalling that when the Treaty set a figure of 60 per cent of GDP the EU average was 55 per cent. This year it will be over 73 per cent, and only Luxembourg, France and the UK will be below 60 per cent.

Any country with a very large outstanding debt to GDP ratio will find the going particularly tough. As far as the UK is concerned, our debt to GDP ratio is relatively low at 56 per cent, but while we have made considerable progress towards fiscal consolidation in recent years, our deficit remains above the Maastricht guideline, even after almost five years of growth. A UK government of any political colour, as it comes to make a decision on our readiness for EMU membership next year, will be bound to take that into consideration. The latest government forecast, after the recent Budget, shows us achieving a figure of a touch below 3 per cent in calendar 1997.

I could make similar points about the exchange rate criterion where, once again, we believe it is important to focus on the substance rather than on the form. Has a country shown that its anti-inflation discipline, over a lengthy period, has allowed its currency to hold its own without generating significant current account imbalances? For some applicant countries, the answer is evidently yes; for others, no. Once again, that is an issue which we will have to consider carefully as we assess the position of the United Kingdom next year.

I imagine that these points would be very widely accepted across the EU, certainly by my central banking colleagues. But our view of the optimal state of preparedness for EMU is rather broader than this. And, here - as I said earlier - we may be less obviously in the mainstream of European opinion. Because we have concerns about the sustainability of an Economic and Monetary Union in which there is too little flexibility in product and labour markets, particularly the latter. Is the monetary union being designed one which retains sufficient flexibility to cope with the kind of differential shocks which may affect different countries within it? This point is, I think, not the same as asking whether the EU is an optimal currency area. I suspect the answer to that question would be no. But one might well give the same answer in relation to the United States, or even to the United Kingdom itself. The question is whether there is sufficient flexibility within the proposed currency union to cope with asymmetric shocks.

We know that, in the United States, there is considerable fiscal flexibility, some through automatic stabilisers, like federally-funded welfare benefits, and some through direct transfer payments from prosperous to less prosperous states. We also know that there is considerable labour mobility in the United States, and that wages vary widely from region to region.

In Europe, the central EU budget is very small, less than 1.5 per cent of European GDP, and there is no strong current of opinion in favour of expanding it significantly. It is also the case that labour mobility is low, for linguistic and cultural reasons, which cannot easily be overcome by government fiat.

Now I would certainly not argue that an EMU could not be attempted without a huge central EU budget, or without teaching everyone commercial German. But we need to make sure that labour markets are as prepared as they can be for the future, a future in which there will be no possibility of the use of the exchange rate to cope with changes in competitiveness, from country to country, whether driven by supply-side shocks or by differential rates of productivity growth. Our concern is that, unless EMU is accompanied by measures to free up Europe's labour markets, existing high rates of unemployment in disfavoured regions will be ossified, with unpredictable and possibly unpleasant social consequences in the long term.

Looking at Europe's regional economies, it is striking that relativities between them have remained so stubbornly large for so long, even within individual member states. Indeed only in the UK have there been some recent signs that relative unemployment rates, from prosperous to less prosperous regions, have begun to converge. That appears to be related in changes in relative wages which have come about as a result of the dismantling of centralised pay bargaining, and of other labour market restrictions, in the 1980s. Elsewhere in Europe those changes have not been made; without them we would have to enter a reserve on the preparedness of some European economies for the rigours of a single currency. That is another point which, I am sure, any British government will wish to take into account in making its final decision. And we would feel more comfortable about the likely success of EMU as a whole - and I emphasise that the success of EMU is strongly in the British national interest, whether we are in or out - were we to see faster progress towards greater labour market flexibility elsewhere in Europe.

It may be argued that EMU itself will act as a stimulus to reforms needed in fiscal policy, and in labour markets; indeed that the prospect of EMU is already doing so. We - cautious, pragmatic, non-visionary people that we are - would like to see the needed reforms implemented first.

These preparations, both in the financial and the real economies, are the preparations which prospective 'ins' need to make, in particular. But there are of course preparations in financial markets which apply to everyone. We are in no doubt that the introduction of the euro in 1999, if the current timetable is maintained, will have profound consequences for financial markets, initially for wholesale markets, and later for the retail financial sector too. It is incumbent on all central banks to seek to ensure that the financial markets in which they sit are as well prepared as they can be for this momentous change. We must also ensure that the central banks themselves are well prepared.

At the Bank of England we now have a steering group, which I chair, focused on preparing the Bank itself. We have made a clear decision that the Bank will be ready for UK membership of EMU in January 1999, if a future government decides that that is the right course for the country. But our more important work in the short term is focused on preparing the City of London and on preparing the financial infrastructure which the City will need to maintain its position as the most innovative and dynamic financial market in Europe.

I should emphasise that we see the City as a financial market for the whole of Europe, not just for the United Kingdom. That explains why we are always ready to welcome overseas financial institutions to London, why we rigorously avoid discrimination on grounds of nationality in our financial market dealings, and why we have greatly welcomed the decisions by German, French and Swiss banks in particular to concentrate many of their wholesale market activities in London in recent years. Europe needs a broad and deep market like London to rival those in Tokyo and New York.

I would not wish, today, to talk at length about the preparations being made in the City for EMU. Partly because this afternoon, in London, we shall be releasing our latest quarterly report on Practical Issues Arising from the Introduction of the Euro, which sets out in some detail the progress that has been made over the last three months, and how we propose to take things forward. In short, we are confident that London will be as well prepared for EMU as any market, when the time comes.

As we say in that paper, we are fully involved in preparing the wholesale financial sector of the economy for the euro and, of course, in the extensive work being undertaken at the European Monetary Institute. For the most part that work is proceeding successfully and we are happy with the decisions made. Some are, inevitably, compromises. But that is what building Europe is all about, and we are always ready to seek compromise solutions. We understand that to build one European wholesale financial market will require a staple diet of solid Bundesbank fare, seasoned with a soupçon of Banque de France, a ración of Banco de España, and so on, as well as a couple of pints of Bank of England pragmatism.

There is one important area, I think, in which it has not so far been possible to reach an agreed solution, and one on which I might just conclude with one or two observations. That is the question of TARGET, the inter-linking of real time gross settlement systems across Europe. There are two issues of interest, here. First, pricing policy. We have argued that the pricing of the national element of cross-border payments should relate to national costs, rather than being set uniformly. So far we have not prevailed on that point and, as long as the competition authorities approve, it is likely that there will be a common price within the TARGET system for cross-border transactions. Unfortunately, some of our colleagues do not believe this is an area in which competition should intrude.

The second important question relates to the terms on which 'out' central banks might link to TARGET in the future. We can see no reason why out central banks should not be able to link to TARGET on the same terms as those which apply to the ins. We accept, of course, the need in both in and out countries for rigorous policing to prevent unintended spill-over of intra-day credit into the overnight market. That policing can be achieved through penal interest rates. But we can see no monetary policy issue in relation to intra-day credit. The extension of sterling intra-day liquidity in our present domestic RTGS system is of no interest to, and never considered in the context of, monetary policy decisions. The same holds for all other countries.

Indeed we could go further and say that denying even-handed access to TARGET through out central banks will negate one of the main purposes of the whole exercise, to reduce the risk inherent in systems in which banks are exposed to each other for a period of hours. Banks would find other ways round the restriction which would be more risky. So central banks across Europe will have scored an own goal.

We shall need to look carefully at this issue as we move towards 1999. If restrictions were to be applied to out central banks which made TARGET unattractive to banks in London, thereby encouraging them to use less secure cross-border mechanisms for euro payments, then we shall need to think about the other options we could adopt. One possible option might be to develop our own euro RTGS arrangements to allow quick, efficient and safe euro payments within the UK which would not rely on access to intra-day credit from the euro area.

We would prefer a pan-European solution which, we strongly believe, would be in the interests of the EU as a whole in the long run. But one thing is clear. Safe, efficient and competitive payment and settlement systems must be available in our own marketplace, and they will be.

London has huge advantages as a strong and competitive financial centre in or out of EMU. We are confident that those advantages will remain. The fact that more and more banks are centring their foreign exchange, corporate finance and investment business in London suggests that they share our confidence in the future of London. In these matters it always seems to me to be best to take one's cue from 'revealed preferences' - where financial institutions choose to base themselves, taking account of all the uncertainties. Those revealed preferences remain strongly in London's favour.

The preparations for EMU are now hotting up. All over Europe, Boy Scouts are packing their rucksacks with the kit they will need for this determined assault on what, in deference to its German roots, we should perhaps call the Magic Mountain, with apologies to Thomas Mann. The Magic Mountain is perhaps a more tactful title to choose than The Confessions of Felix Krull, Confidence Man, or Death in Venice, as some others in London might suggest. I hope that this morning I have given you some insights into what we think should be in the central banker's rucksack, and how the United Kingdom will assess its own preparedness next year, when the time comes.