Mr. George weighs up the pros and cons of European Monetary Union

Speech given by the Governor of the Bank of England, Mr. E.A.J. George, at the Bankers Club Annual Banquet held in London on 3/2/97.

I've been a follower of Jim Wolfensohn for the past 20 years, and it is a great pleasure to follow him again this evening.

I first came across him when he was an extraordinary investment banker - reputedly flying the world with his cello strapped securely in the adjacent seat. His eventual appointment to the Presidency of the World Bank was inspired. He brings to it an outstanding professionalism. But - as you have heard this evening - he brings to it also a broad humanitarian vision and total commitment to the World Bank's task of improving the lives of people in those parts of the world that still need outside official help with their reconstruction and development.

President Wolfensohn's canvas tonight has been global. My own focus will be on Europe, and in particular on European monetary union - though it's fair to say that EMU could well have significant consequences for the global economy.

This country is widely regarded elsewhere in Europe as being bloody-minded and even obstructive about monetary union, largely because there is indeed an intense, and often impassioned, debate going on here about the pros and cons. And so there should be. It's a momentous enterprise, with potentially enormous implications for Europe's political and economic future. The simple fact is that there are real risks as well as real potential benefits in monetary union; and it would be foolhardy just to assume that the enterprise, if it is embarked upon, will inevitably bring about the political harmony and economic prosperity across Europe that anyone in their right mind wants to see. It is hugely important to all of us that Europe's political leaders stand back and weigh the risks as well as the potential benefits, dispassionately, before any irrevocable step is taken. If the debate in this country encourages open debate elsewhere then we will be doing a service to Europe as a whole.

It is something of a fashion these days to describe economic conditions in terms of fairy stories. I have heard the steady expansion in the United States, and more recently in this country, described as the "Goldilocks" condition - with the economic temperature not too hot, not too cold, but just right.

In the same vein I might describe European monetary union as Beauty and the Beast. The Beauty of it lies in intra-European exchange rate certainty. And if you don't find that instantly seductive I suggest you speak, as I have, to some of Britain's exporters. They have seen, over the past six months or so, an erratically sharp appreciation of sterling, against the core European currencies in particular, which can't be adequately explained in terms of economic fundamentals.

But Beauty comes in a package along with the Beast, and the Beast in this case is the single monetary policy - the single, one-size-fits-all, interest rate. The trouble is that it may not in the event suit the domestic monetary policy needs of the different individual Euro-area countries. And if you don't find that instantly repulsive I suggest you ask yourself how, at this particular juncture, we could keep the economic porridge - if I may mix my fairy stories - at just the right temperature if we were obliged now to have German-level interest rates.

Now you can't just hope the Beast will never appear. I don't know of any serious analysis that doesn't acknowledge that tensions could arise between the domestic policy needs of the different member countries - as a result of different cyclical positions, or different fiscal policies, or as a result of external shocks which affect some member countries more than others, or as a result of structural changes in one member country as against another. The risks, like the potential benefits, are, as I say, real.

You might more reasonably hope that Beauty's Beast will turn into Prince Charming - and that all their problems turn out to be little ones. But I have to tell you that it was always at this point in the story that I began to wonder if my mother was making it all up! In any event, you need to be rather confident that the potential tensions are indeed likely to be minor, or at least short-lived, because, if they do turn out to be serious, then you could be stuck either with a weak Euro - and more rather than less inflation, higher rather than lower interest rates over the medium-term, and exchange rate instability against outside currencies - or, if the European central bank is allowed to do its job in accordance with its statutes, you could be stuck with persistent stagnation and unemployment across the economically weaker parts of the Euro-area. It's not enough, it seems to me, to shrug one's shoulders and say "well, that's what happens now anyway within individual countries"; at least within individual countries there are alternative adjustment mechanisms, in the form of labour mobility and fiscal redistribution, to moderate the tensions, which will be much less effective within the Euro-area.

The architects of the Maastricht Treaty clearly knew all about the Beast, and they evidently shared my scepticism about it turning naturally into Prince Charming. The famous convergence criteria are there precisely in order to reduce the risks of tensions emerging after the start of the Euro. One can argue about how far they do in fact reduce the risks. But it would be a reckless gamble to charge ahead if even those criteria were not met - sustainably, and in substance rather than just in form.

So there needs to be a serious debate. But it would be disappointing if that debate degenerates into recrimination and antagonism. That would be to obscure the remarkable consensus that now exists - throughout the European Union and indeed more widely, and across a broad spectrum of political opinion within the countries of Europe, including this country, on the broad approach to macro-economic management. This unforced consensus extends to monetary policy directed to price stability, and it extends to budgetary policy directed to medium and longer-term fiscal sustainability. There is growing recognition, too, across the continent, of the importance of structural policy directed to supply-side flexibility. This strengthening consensus is fundamentally important - more fundamentally important, in terms of the economics of it at least, than whether these common objectives are pursued inside or outside the framework of monetary union.

Pulling these thoughts together, it would be a mistake in my view for monetary union to go ahead without reasonable confidence of genuine, sustainable, convergence between its members; and it would be a mistake for any individual country to seek to join, or to be permitted to join, unless it had achieved genuine, sustainable, convergence. If there are serious doubts - generally or in any particular case - it would be in no-one's interest to proceed.

But it would be just as big a mistake, if monetary union does not go ahead, or for countries on the outside, if individual governments saw that as an opportunity to seek to take short-term advantage of the apparent macro-economic freedom that that gave. It would be against their longer-term national economic interest; and countries behaving in this way should not be at all surprised if other European Union countries sought to protect themselves against disruptive behaviour. With or without monetary union, within it or outside, it is of overriding importance that we all continue to pursue stability-orientated macro-economic policies. On that basis I can see no reason, and certainly no right under the Treaty of Rome, for distinctions to be made among the member states of the European Union whatever the outcome on monetary union. Indeed we would all suffer if they were, because it would reduce the potential benefits of the single market to Europe as a whole. Whatever the surrounding noise, we must surely be smart enough to avoid cutting off our nose to spite our face in that way. Our national and collective economic interests are too closely aligned for that to be allowed to happen.

So I am not particularly impressed either by the fears sometimes expressed about the economic penalties that will be visited on countries outside monetary union, or by the occasional rattling of the cage to try to bully them into it. Unless we are convinced, as I say, in general or in any particular case, that Beauty will in fact end up with Prince Charming, and not be condemned to long-term cohabitation with the Beast, then it would be better for Europe as a whole to delay until we were more confident of a happy ending.

Investment will continue to flow to this country so long as we succeed in maintaining an environment offering attractive returns, and our macro-economic and supply-side policies are a much bigger factor in that than the exchange rate.

Similarly the City will continue to flourish as Europe’s international financial capital so long as the strongest financial firms from all around the world continue to find it attractive to conduct their business here. I see no signs of that changing: indeed the international business of the City continues to increase; and that has very little to do with our national currency, or with an expectation that we will be among the first to merge it into the Euro.

So long as we are properly prepared, as we will be, and so long as we have in place efficient infra-structure, including for payments and settlements, as I assure you we will have - in or out, then the Euro, if it comes, will be more of an opportunity than a threat to the City. There are those who sometimes give the impression that they think the Euro could - by regulation or restrictions - be confined to within the territory of the Euro area, and that this would be “a good thing”. That I have to say is not our experience. In practice unnecessary or ineffective domestic regulations or restrictions have often been the cause of financial activity growing up elsewhere. In any event we live in a global financial world and the Euro is bound to become a widely-used and actively-traded currency internationally. Its liquidity is likely to be a key attraction to domestic and foreign users alike. The City of London both contributes to, and thrives upon, liquid markets, and the Euro-market, or the euro-Euro-market if we are an “out”, will be no exception. That can only be good for the development of financial activity - the provision of competitive financial services - across Europe as a whole, because we are not talking here about a zero-sum game. Euro-activity in London is likely to stimulate financial activity in other centres and vice versa; and much of that activity will be undertaken by branches or affiliates of the same major financial firms. The first ecu-Euro bond raised last week by a European borrower and managed from London by a Swiss/British and a French bank and by another French bank in Paris, is a good example not just of London’s international role as it is today, but of how it is likely to continue. In this area, too, therefore I see our national interests coinciding rather than conflicting with the collective European interest. That is why the Bank of England, at all levels, is playing a full, active, and constructive, part in both the preparatory work of the EMI, and in the technical preparation of London’s great financial markets. If monetary union goes ahead, with or without the UK, we have a vital interest in its success, and we will do all that we can to ensure that outcome.

Mr President, I am delighted to see so many bankers from around the world here again this evening - and generally looking so prosperous. And, come what may in relation to EMU, I confidently look forward to seeing you all at this great banquet again next year, and for many years to come - looking just as prosperous. It is in that context that I ask you to rise and join me in a toast to the Bankers Club - coupled with the name of its President, Sir William Purves.