Mr. George looks at the prospects for the UK economy and developments towards European Monetary Union Speech by the Governor of the Bank of England, Mr. E.A.J. George, at the Liverpool and District Bankers' Institute Bi-Annual Dinner in Liverpool on 12/3/97.

It is a very enjoyable - and vital - part of our job at the Bank of England to keep in touch with what is going on around the country. And we work quite hard at it - through visits like this one; through our non-executive directors who have business interests in the regions and through our network of regional agents.

Now the purpose of these contacts is to help us understand the reality behind our precious monetary and economic statistics, and to help us understand what is pre-occupying you.

The economic reality I would say is not at all bad. Looking back over the longer term, I detect an important change in attitudes in this country: where before people - both employers and employees - tended to look inwards and backwards, seeking to protect what they had had, now, it seems to me, they are increasingly looking outwards and forwards to new opportunities. It is a fundamental change. And over the past four years or so it has been complemented by a more stable macro-economic environment than most of us can remember in our professional life time. Putting these together has brought us consistently low inflation; steady and sustained growth; and gradually falling unemployment. And interest rates have been lower and less volatile over this period than they have been for more than thirty years.

Some people, it's true, still say to me that all this has not had much effect on them - it's not like it was in the boom times! And I recognise, of course, that economic conditions do vary across regions and sectors and between individual companies. More than ever before it's a tough competitive world.

But what most people say to me these days is that steady growth and low inflation is exactly what they want so that they can make rational, long-term, decisions in their own businesses, which is what enables them to face the global competition. The major preoccupations that I hear are about whether our recent, more stable, economic environment will continue, and about the implications - good or bad - for that environment of a move to a single European currency.

Let me say a word first about our domestic economic prospects before turning to Europe.

In fact, Mr. Chairman, we set out the Bank's views on the domestic economy at some length in our quarterly Inflation Report only last month. But in summary we have seen a gradual pick-up in the pace of activity over the past year, driven by domestic demand - notably consumer spending - so that the money supply and both demand and output are now growing at above-trend rates. Other things equal we would expect that to continue.

The picture is, however, complicated by the exaggerated strengthening of sterling since last summer - particularly against the European currencies - which probably reflects uncertainties affecting the Continental countries at least as much as developments in our own economy. This strength of sterling poses, for the time being, a genuine monetary policy dilemma. It will lead to a fall in inflation in the short run - over the rest of this year - as import prices fall. And it makes life very difficult for UK manufacturers exposed to international competition, so that our external trade position is likely to deteriorate - and that may have a longer-lasting effect on inflation. But these effects may not be enough to offset the gradual emergence of inflationary pressure looking forward to next year, stemming from continuing above-trend growth of domestic demand.

On that basis we advocated a moderate tightening of policy in order to slow the domestic expansion to a pace that can be sustained in the medium and longer term.

Let me be quite clear, for those who insist on over-dramatising these things, we were not calling in the Inflation Report for "an immediate interest rate hike to bring an incipient boom to a juddering halt!" I should like to think that in the present more stable environment that kind of language is anachronistic. What we in fact expected over the next couple of years is continuing growth somewhat above trend with inflation picking up towards 3%, though rising - which by our own past standards is a relatively benign outlook. What we are seeking to do is to moderate the pace of expansion before inflationary pressures begin to build in order to ensure that the outlook remains benign next year, and a year after, and well into the future. And that, Mr. Chairman, is precisely what most business people - whether in industry or commerce or financial businesses - tell us they would want us to do. It is also the purpose of the Government's Inflation Target.

Let me then turn to Europe and the question of monetary union.

I do not think anyone questions that economic prosperity in Europe is crucial to economic prosperity in this country. Our fundamental interests are the same. And not many people question that the effective functioning of the European single market can make a major contribution to our collective prosperity - it is a positive sum game in our mutual interest. It is clear I think too that the single market in Europe will function more effectively if each member country pursues disciplined macro-economic policies in a context of structural, supply-side, flexibility - again as a matter of national as well as collective interest. So much it seems to me is common ground in all 15 EU member countries - and indeed beyond. Whatever happens in relation to monetary union it is vital, it seems to me, that we hold on to this fundamentally important consensus.

Moving on from there to the narrower question of monetary union, the potential economic benefits and risks have now become much clearer, and are rather well illustrated by our own present monetary policy dilemma. On the one hand, any manufacturer will tell you - after his experience since last summer - about the great advantage of intra-European exchange rate certainty. On the other hand, with the single currency comes the single monetary policy - the single, one-size-fits-all interest rate throughout the euro-area. The risk very simply is that the single interest rate may not in the event suit the domestic monetary policy needs of all the euromember countries - just as the present level of German interest rates of around 3%, reflecting the disappointing weakness of the German economy, would not at this point suit the UK - where, as I have said, we need to moderate the pace of our economic expansion.

The potential economic risks, as well as the potential benefits, were recognised when the Maastricht Treaty was signed - and the famous "convergence criteria" were put into the Treaty precisely in order to limit the risks. Looked at from an economic perspective it would be a considerable mistake 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 apply to join - or to be allowed to join - unless it had achieved genuine, sustainable, convergence. But at the end of the day it is a political process - and no-one should underestimate the political determination on the Continent to proceed according to the Treaty timetable. I only hope that those who will make the decision really appreciate that if the economics of monetary union were to turn out badly - resulting in policy tension between the euro-member states - then it is unlikely to have its intended effect of advancing political harmony either.

I would not at this stage care to put much money on the outcome - central bankers are a naturally cautious breed. But the prudent planning assumption is that monetary union probably will go ahead on time - at least among a limited group of countries. The question then is what would that mean for you.

Let me start with the timetable. A final decision on whether to go ahead, and who should participate, will need to be taken next spring. That would open the way to the immediate setting up of the European Central Bank so that it could complete its preparations for the irrevocable fixing of exchange rates with effect from 1st January 1999.

It is important to be clear what the irrevocable fixing of exchange rates means. It does not mean that the participating national currencies would instantly disappear. They would continue to exist initially as separate denominations, or sub-units, of the euro, which would have become a currency in its own right. The DM or French franc or whatever would in effect relate to the euro just as pence relate to the pound - except that the fixed conversion rate would be a great deal more complicated, extending to six significant figures!

There would be no euro banknotes or coins at that stage, only book entries in euro-denominated bank accounts for those who wished to use them. No-one would be compelled to use the euro; but equally no-one would be prohibited from using it or offering euro-denominated facilities. The European Central Bank and the National Central Bank members of the European System of Central Banks would denominate their transactions in financial markets in euro, although euro-denominated amounts would be convertible into national currency denominated amounts and vice versa through the payments system for those that wished. To provide added impetus, national governments will denominate new debt issues in euros, and some at least may also convert their outstanding debt to the euro-denomination.

Our working assumption is that banks and others active in the wholesale financial markets will in fact choose to transact most of their wholesale business in the euro-denomination more or less from the start. And we assume that they will wish to offer euro-denominated facilities to major business customers that wished to use them. So, for example, non-financial companies, including large retailing companies, with an active business in other euro-area countries may wish to be able to quote prices or undertake transactions in euros from an early stage, although they would certainly still need to transact most of their local business in national currencies for some considerable period.

On the other hand, we would not expect there to be much demand for banking facilities denominated in euros either for individuals or for the vast majority of smaller local businesses much before euro banknotes and coins become available in late 2001 or early 2002. At that point, the conversion of retail facilities into euros might proceed quite rapidly during the subsequent six-month period when national currency notes and coin are to be withdrawn - but again the principle of no compulsion and no prohibition would apply. Retail conversion is of course a massive undertaking. But the timetable does at least provide some 4-5 years from now for people to prepare.

The bottom line in all this is that if EMU goes ahead on time and whether the UK is in or out, the impact on your business will depend very much upon the nature of the business you are in.

Up to now, we at the Bank have concentrated mainly on ensuring that the banking system and the wholesale financial markets will be ready to operate in euros from Day 1, because they will be affected first, and they will be affected whether or not the UK is a part of the "first wave". But we are conscious of the developing thirst for information from the rest of the business community. With this in mind, we have co-operated with the CBI and the British Chambers of Commerce in organising regional workshops - including one to be held here in Liverpool on 23 April. We are participating too in seminars organised by the Forum of Private Business - and I am sure that if you are interested you will be able to prevail upon Stan Mendham, who I am delighted to see here this evening, to organise such a seminar here too! If you are really lucky, 007 might even provide you with a short Bank of England guide: "Introduction of the Euro - what does it mean for business?" which, for reasons that I can't quite understand, in this case comes absolutely free.

The picture is rather different if the UK were to opt out of monetary union - at least for the time being. In that case the euro will be a foreign currency in the UK, and businesses, where appropriate, will need to cope with it from the 1 January 1999 just as they cope now with transactions and contracts denominated in deutschemarks, dollars, yen and the like. But the huge difference between the 'in' and the 'out' scenario will be that notes and coins would not be introduced in this country if we are an 'out', so that for most of us life would go on very much as normal.

Mr. Chairman, I have dwelt on the practical side of monetary union very briefly this evening, because I fear that the practicalities may be overlooked in the passion of the debate about the principle. But in my youth - which seems a very long time ago now - I was a boy scout, brought up with the motto "Be Prepared". It is vital in this context that we are indeed prepared, whatever the outcome, and the Bank is determined to do all that we can to ensure that we are.

And provided we have properly prepared ourselves I do not believe that monetary union need hold great terrors for this country whichever way the decision goes when the time comes. If it is decided that EMU is a safe club for the UK to join then I think this country is as well placed as any to live with its disciplines. If on the other hand, we remain on the outside but continue to behave responsibly - in our national interest, but also as a member of the EU - then I think the fears for inward investment, or for the future of the financial services industry in this country, will prove to be exaggerated. The economic reality is that businesses - whether financial or non-financial - will expand their activities in this country so long as it is profitable for them to do so. They would be answerable to their shareholders if they behaved in any other way.

The key to economic prosperity in this country, Mr. Chairman, lies in continued macro-economic discipline in a context of structural, supply-side, flexibility, and that is true regardless of monetary union. Provided - in or out - we persist in that, then we can continue to deliver a business climate of steady growth with low inflation for as far ahead as we can see. That is the best possible prospect for the bankers here this evening - and the best possible prospect for their customers.