The Rt Hon Sir Edward George GBE: Britain and Europe

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, at The British Swiss Chamber of Commerce Lunch, held in Zürich, on 12 September 2000.

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I agreed to talk briefly about Britain and Europe - and then respond to questions. I will in fact talk more specifically about Britain and the euro from my perspective at the Bank of England. But let me make clear, from the outset, that monetary union is fundamentally a political rather than an economic issue. It necessarily involves the deliberate pooling of national sovereignty over important aspects of public policy, in the interest not just of collective economic advantage, but of a perceived wider political harmony within Europe.

As a central banker, I have nothing to say about the politics of monetary union - that's for elected politicians and clearly political opinion is divided - not just in the UK - about how far and certainly how fast to go in the sensitive matter of pooling national sovereignty. But monetary union is also an economic issue and that is my concern.

So what are the economic pros and cons?

The arguments on either side are in fact now reasonably well defined in the UK where there has already been an intense and protracted debate - though different opinions inevitably attach different weights to them.

On the plus side, the crucial and unique economic advantage of monetary union is nominal exchange rate certainty within the Eurozone - which takes over half UK exports. I'm not talking just about reasonable exchange rate stability - which might result over time from each country pursuing disciplined macro-economic policies in parallel. I'm talking about nominal exchange rate certainty for the indefinite future.

That very real economic advantage is well understood in the UK. It is particularly well understood by those businesses in the UK that export to, or compete with, businesses in the Eurozone, especially given the euro's unexpected - and puzzlingly persistent - weakness since its inception at the beginning of last year. On that ground alone many of them, who are under intense competitive pressure as a result of sterling's excessive strength against the euro, though not against other major currencies, would see our joining the single currency as an advantage - provided, of course, the exchange rate at which we joined was fixed at an appropriate level, which most of them - and indeed most analysts looking at the economic fundamentals - think should be substantially lower than at present.

At a broader macro-economic level the potential benefit of joining - as a result of greater transparency of costs and prices and lower transaction costs - leading to greater competition and more efficient economic resource allocation is well understood.

Exchange rate certainty within Europe - even though only within Europe, and even though it is nominal exchange rate certainty rather than real exchange rate certainty, which is what matters in terms of competitiveness - would potentially enhance the benefits to be derived from the European Single Market.

The euro's second very powerful advantage is the possibility it opens up for much broader and more liquid financial markets. It will mean a progressive narrowing of spreads between borrowers and lenders, which is good news for the users of those markets - and that will be good news too for financial intermediaries as a group, because it will lead to higher volumes of financial activity. Not every individual intermediary will benefit, of course, in the more competitive environment, but those who survive will thrive!

The City of London is already making an important contribution to this process of euro financial market integration. It is in fact the greatest contribution that the UK can make to the success of the euro while we remain outside. (It runs alongside the conceptually distinct, but closely related, pressure for broader international integration of financial markets, currently reflected in a spate of initiatives to unify trading platforms, and both clearing mechanisms and settlement systems, in which London, of course, is also very much involved.)

These then - nominal exchange rate certainty throughout the Eurozone and integrated euro financial markets - are potentially powerful economic arguments in favour of UK membership. What then are the risks - the possible arguments against our joining the euro?

Essentially the potential downside can be summed up as the risk that the single monetary policy - the "one-size-fits-all" short term interest rate within the Eurozone, which is the inevitable consequence of a single currency - will not in the event prove to be appropriate to the domestic monetary policy needs of all the participating countries.

Countries may have divergent cyclical positions. They may face divergent fiscal positions, which would affect their appropriate fiscal/monetary policy mix in different directions - though this should be contained by the Growth and Stability Pact. Or their domestic policy needs may diverge as a result of economic shocks of some sort - a classic, but unique, example was German re-unification, but the more recent global economic disturbance was perhaps another example.

The risks of divergent monetary policy needs within a monetary union are certainly real. They were recognised in the Maastricht Treaty, which established the famous "convergence criteria" precisely in order to try to limit the risks before the euro-project went ahead.

They are essentially similar to the risks of sectoral or regional divergence within a national currency area - which we in the UK certainly know something about - it is in fact a major monetary policy headache for us at the present time. But in the case of the Eurozone the risks are of divergent monetary policy needs between the different member countries - they apply at the national level. And if they materialised to any very significant extent, the resulting tensions could be serious, because alternative mechanisms - such as labour migration or fiscal redistribution through a central budget - which help to mitigate sectoral or regional disparities in the national context - are less developed at the Eurozone level. Some commentators point to the present inflationary pressures in Ireland as an example of the problems that could arise where the single monetary policy is easier than the national situation might require - though I am not sure how far one can sensibly generalise from the Irish experience. It is equally possible to envisage circumstances in which the single monetary policy is too restrictive for some countries.

The fact that the UK did not join in the first wave of EMU was a disappointment to some people, including to some of our European partners - but it was also a considerable relief to them - we would certainly have complicated the task of the ECB in setting its single monetary policy. And from our own perspective, if we had joined EMU from the start - and had Eurozone interest rates over the past eighteen months or so, it is very difficult to envisage how we would have avoided an inflationary boom in the UK. It is true that, to the extent that the present imbalance within our economy reflects sterling's appreciation against the euro, we would have been protected against that. But, with accelerating inflation in the economy as a whole, the effect would have been tantamount to real exchange rate appreciation, which would in any event have damaged their competitive position and so provided at best only short-term relief even to them. And it would not in that case be possible to reverse that effect through exchange rate adjustment. The fact is that there are no easy answers or ideal solutions to the one-size-fits-all problem at the Eurozone level, without substantial - and sustainable - convergence between our economies, although coping with such tensions as may emerge within the Eurozone - with or without the UK - is likely to be easier in a context of structural, supply-side, flexibility and adaptability in labour and product markets.

Now, many people in the Eurozone acknowledge these concerns. But they are inclined to argue that if a country participating in the monetary union were to find itself in an unsustainable situation, and given that it would have no macro-economic way out - through exchange rate adjustment, or independent monetary policy action, or fiscal stimulus beyond the limits of the Growth and Stability Pact - and given limited labour migration or fiscal redistribution at the pan-European level - then it would have an overwhelming incentive to undertake the supply-side reforms which have proved so difficult to introduce up until now. One of my ECB colleagues in fact once put it to me that - "when we have closed off every other policy option, we will finally be forced to do the things we know that we should have been doing all along!"

There are those, I know, who find our hesitation about the euro - in an economic context - hard to understand. That's true particularly of those who have been in effective de facto monetary union with the Deutsche Mark for a long time already. But it is not just stubbornness or obstinacy on our part - though we British can of course be pretty stubborn at times. In the macro-economic context it reflects a real debate about the risks and potential costs of divergence between our own monetary policy needs and those of the members of the Eurozone - which in turn depend upon the extent to which our economies really have achieved sustainable convergence, and the extent to which we are able to respond flexibly on the supply side to economic shocks or tensions between our domestic monetary policy needs and those of our European partners.

As you know, the Chancellor of the Exchequer announced some three years ago that we would not join the euro in the first wave. He made it clear that the present British Government is not opposed to Euro membership as a matter of principle. It will make a decision on pragmatic grounds, based upon five economic tests. These are: whether the UK economy has achieved sustainable convergence with the economies of the single currency; whether there is sufficient flexibility in the UK economy to adapt to change and other unexpected economic events; whether joining the single currency would create better conditions for businesses to make long-term decisions to invest in the UK; the impact membership would have on the UK financial services industry; and ultimately whether joining the single currency would be good for employment. It would then submit a favourable decision to Parliament, and the British people in a referendum.

The Chancellor recognised that it was unrealistic to think that a decision could be reached during the lifetime of the present Parliament, which runs to May 2002 at the latest. But he stressed that in the meantime the UK should nevertheless prepare - not only for introduction of the euro on the Continent on 1 January 1999 - which we of course did very effectively - but also for our own eventual participation.

The Chancellor's statement was the first by a British Government to accept the principle of monetary union. It recognised that the single currency will affect us whether we are in fact in or out - and that it is clearly in our own national interest to do all that we can to ensure that the euro is successful.

This policy of "prepare and decide" has subsequently been confirmed by the publication of a National Changeover Plan, which sets out the key steps that would be involved in the transition following a positive decision on UK entry. This remains the Government's policy.

In the meantime, we continue to pursue macro-economic - both fiscal and monetary - stability and supply-side flexibility alongside our European partners, in our own national economic interest, which will also help to bring about closer convergence between our economies.

Over the past seven years or so we have in the UK achieved the longest period of sustained low inflation we've known for a generation. Retail price inflation - on the Government's target measure - has averaged 2.6% since the beginning of 1993 and is currently running at 2.2%, or only 1% on the European harmonised index of consumer prices.

But alongside low inflation we've had the lowest nominal interest rates that most of us can remember. Short-term rates have averaged some 6¼% since the MPC's first decision in June 1997 compared with some 9.25% over the preceding decade. And 10 year government bond yields have fallen, with inflationary expectations, to around 5¼%, which apart from a brief period last year is the lowest they've been for nearly 40 years.

Much more fundamentally we've enjoyed the longest period of uninterrupted, quarter by quarter, economic growth since records began some 45 years ago - with annual growth since Q3 1992 averaging 2.8% - between ¼ and ½% above most estimates of our underlying trend rate. The number of people in employment is the highest on record. And unemployment has fallen from its most recent peak of 10½% on a claimant count basis at the turn of 1992/93 to the present rate of 3.7%. That is the lowest for 25 years in the UK as a whole, and just about the lowest in nearly every region.

This is not just past history. Having come through the global economic slowdown a year or two ago, the economy as a whole is now again growing at well above trend, with inflation a bit below target; and the broad prospect for the next couple of years - on most forecasts, is for continuing relatively strong growth with relatively high employment and relatively low inflation.

Our economic progress - and the common approach to economic management that underlies it and which we share with our European partners - provides, in my view, a firm foundation for a continuing positive and constructive relationship between the UK and other members of the European Union, whether or not they are members of the Eurozone. That of course is in the economic interest of all sides. Just as we benefit from a stable and prosperous Europe, so too the Continental European interest lies in a stable and prosperous UK. And that mutual self-interest above all is the thing we all need to hold on to.