Mr. George speaks on the advent of the euro, and its possible impact on Europe and the Mediterranean region Speech by the Governor of the Bank of England, Mr. E.A.J. George, at the FT Euro-Mediterranean Capital Markets Conference in London on 26/3/98.

I'm delighted to take part in this conference which has been organised by the British Government during its term of Presidency of the European Union to promote and strengthen financial and economic ties within the partnership between the European Union and its Mediterranean neighbours.

It is a very happy accident of fate - to me as a central banker at least - that this country should hold the EU Presidency at this particular time, as Europe prepares to take the definitive step to monetary union. Earlier this week in Frankfurt the Council of the European Monetary Institute finalised its "convergence report", which we published yesterday, at the same time as the parallel report by the European Commission. The Commission also published its recommendation to EU Finance Ministers and Heads of Government that 11 EU member states should move to monetary union, in a first - tidal - wave, from January 1st next year. Without seeking to anticipate the decision to be taken by the Heads of Government under Prime Minister Tony Blair's Presidency in Brussels during the first weekend of May, the odds are that monetary union will go ahead on that basis. It is an historic moment.

The irony, of course, is that this country itself will not be a part of that first wave. That is a disappointment to some, but a relief to others - a point I'll come back to - but, whatever view one takes about that, no-one, I think, can fail to recognise the huge achievement of all those who have laboured, with such determination, for so long, and against formidable difficulties, to bring the venture to this point, and I take my hat off to them.

In the circumstances, Mr Chairman, I could hardly choose to speak about anything else this morning. The advent of the euro, on this broad basis, will, of course, have profound effects on financial activity, and on both providers and consumers of financial services, all around the world - including in our Mediterranean partner countries. And I should like to take this momentous development, in the broader context of the evolution of the European Union, as my theme.

I recognise at the outset that the EU is, fundamentally, about politics, inspired by the need to ensure that Europe is never again devastated by war. I am only too happy to leave the debate about what that implies for the political organisation of Europe - including the relationship between European institutions and the individual member states - to the politicians. My interest is in the economic dimension of Europe - though I realise of course that economics and politics can't in practice be separated quite as neatly as this distinction suggests.

The "economics" of Europe starts from familiar arguments in favour of free trade and competition as the most effective means of ensuring that productive resources are efficiently deployed, promoting specialisation in areas of comparative advantage - and thereby satisfying consumer demands more effectively and increasing aggregate, macro-economic, welfare. These arguments apply, in principle quite generally - as much to international trade and competition as to regional trade and competition or indeed to trade and competition within individual national markets.

The macro-economic benefits are less immediately obvious at the micro-economic level. Existing activity is threatened by greater competition, and there is a natural temptation - to employees, their employers and their national governments - to seek to defend their established activity through protective action in one form or another. The benefits of greater competition, and of the removal of barriers or distortions to free trade, on the other hand, flow essentially from the future activity that is likely to result - so that they are much less tangible. And the benefits - anyway in the short-term - do not necessarily accrue evenly across the free trade area - they accrue to those that are flexible and adaptable enough to take advantage of the new opportunities that free trade offers. So that although we know that in principle at the macro-economic level free trade and competition are a powerful positive sum game - and although we have seen it clearly enough in practice - there are always likely to be visible - and vocal - losers. And that is bound to provoke outbursts of popular resistance. Against that background establishing and maintaining free trade to the extent that that has been achieved in the EU is in itself a remarkable achievement.

But the EU has already in many areas gone well beyond just free trade, in establishing the single market. That involves more than the free movement of goods and services within Europe. It involves also the free movement of both labour and capital, as well as supporting European legislation to avoid market distortions from, for example, state aids, or government procurement, or restrictive practices within the private sector. This further pooling of sovereignty has essentially the same purpose - it is designed to reinforce the macro-economic benefits from free trade and competition and act as a stimulus to growth and employment by allocating resources still more effectively based on comparative advantage, enabling savings to flow to where they can be most productively invested and production to be located where it can be most effectively carried on to satisfy consumer demand.

The advent of the euro represents a massive new step in the same direction.

The crucial and unique advantage of monetary union is the exchange rate certainty it will bring throughout the euro area - not just the reasonable de facto stability that can result from each EU member state individually pursuing disciplined macro-economic policies in parallel, and which has in practice been achieved within much of Europe for quite long periods within the framework of the Exchange Rate Mechanism - but actual, and in principle permanent, exchange rate certainty. There is no doubt that this is a very real advantage. One can argue that exchange rate certainty is not an essential complement to the European single market - any more than exchange rate fixity is essential to achieving the benefits of free trade more generally. But there is no doubt that intra-European exchange rate certainty will - through the intensified competition resulting from greater transparency of prices and lower transaction costs, through broader and deeper capital markets, and through the associated improvement in economic resource allocation - substantially enhance the macro-economic benefits to be derived from the single market. Whether or not it is essential, therefore, exchange rate certainty is very desirable from this perspective.

The potential drawback of monetary union can also be simply stated, though it is more difficult to assess. Essentially there is a risk that the single monetary policy - the single, one-size-fits-all, short-term interest rate - within the euro area, which is a necessary corollary of the single currency, will not in the event prove to be appropriate to the domestic needs of each of the euro-member countries. There is no doubt that such risks exists. They may result from cyclical divergence. They may arise from differences in fiscal positions even though these are to be constrained through the Stability Pact. Or they may result from economic shocks of some sort that have a bigger impact on some countries than on others. The rise in oil prices in the early 1970’s or German reunification are classic examples.

So the risk of divergent monetary policy needs within the euro area is real. And the damage it could cause if serious tensions between member countries were to emerge is substantial, because alternative adjustment mechanisms, such as labour migration or fiscal redistribution, that exist within individual countries, and which help to alleviate the similar regional tensions that arise at the national level, are simply not well-developed at the pan-European level.

The Maastricht Treaty, of course, recognised this risk, and the famous convergence criteria were designed precisely as a means of reducing the risk to manageable proportions by requiring that, before they join the euro club, countries should have achieved at least a minimum degree of macro-economic convergence - demonstrating their commitment to macro-economic discipline through both fiscal consolidation and monetary policy directed at effective price, and exchange rate, stability. And there is no doubt that all European Union member states have made huge progress towards macro-economic stability over the past few years, which you will find documented in the two “convergence reports”. Although the EMI in particular emphasises the ongoing need in a number of countries to persist in determined fiscal consolidation, it is this progress towards nominal convergence that underlies the European Commission recommendation.

The nagging doubt is whether this pursuit of macro-economic stability will in fact be maintained - whether the convergence that has certainly been achieved will, in the terms of the Treaty, prove to be sustainable.

A particular worry is that macro-economic stability, on its own, has not been enough to prevent the emergence of very high, and very different, levels of unemployment in a number of the major Continental European economies. Unemployment has been for some considerable time, and it remains, much the most urgent and important economic issue confronting us in Europe. I don’t suggest for a moment that the right answer would be to abandon macro-economic discipline and revert to old-fashioned demand management policies. In anything other than the very short term that would be likely to make matters worse. I share the broad consensus view that Europe’s unemployment problems originate essentially in rigidities on the supply-side of the economy. The point is that unless we are all more successful in bringing down this structural unemployment, through micro-economic policies designed to improve structural, supply-side flexibility, then some countries could find it difficult to continue to live with a common macro-economic discipline without significant tensions.

Some people on the Continent who basically share this concern are inclined to argue that if the government of a euro-participating country were to find itself in this situation - and given that it would have no macro-economic way out, for example, through exchange rate adjustment, or monetary relaxation, or fiscal stimulus beyond the limits of the Stability Pact - then it would have an overwhelming incentive to take the sort of supply-side measures which have proved so difficult to implement hitherto. And the people in those countries would similarly have the incentive to accept structural change. I am not wholly persuaded that you can necessarily rely upon that making life very much easier. But what I think this discussion leads to the broader conclusion, given that the euro is to go ahead, that structural reform - in labour markets and welfare systems and in broadening and deepening the single market for goods and services, but also capital markets - in order to improve supply-side flexibility - becomes more crucially important than ever. The need for greater supply-side flexibility was the subject of much of the discussion at the informal meeting of European Finance Ministers and Central Bank Governors in York last weekend, and I was greatly encouraged by the degree of consensus around the table on this point.

The United Kingdom of course will not participate in the first wave of monetary union. That decision, taken last October, was - as I noted earlier - a disappointment to some of our EU partners; but it was a considerable relief to others because UK participation from the outset would certainly have complicated the project - not least because of the substantial cyclical divergence between ourselves and the major countries on the Continent.

But in making its announcement the British Government made it clear that it is not opposed to euro membership as a matter of principle. When the time comes - and that will almost certainly not be during the lifetime of the present Parliament - it will make its decision - and submit it to Parliament, and the people in a referendum - on pragmatic, economic, grounds. In the meantime the United Kingdom will prepare both for the introduction of the euro on the Continent from next January and for our own eventual participation.

The fact is that monetary union will have a major effect on this country whether or not we are a part of it, and it is clearly in our national interest as well as the interest of the participating countries, that it should be successful. We benefit in macro-economic terms from a stable and prosperous Europe just as Continental Europe benefits from a stable and prosperous United Kingdom - and the same mutual interest, of course, applies between Europe and its Mediterranean neighbours.

We can contribute to that success in at least three ways. Most immediately the Government has undertaken to use its current term as President of the European Union Council of Ministers to promote an orderly decision-making process during the crucial next few months. Not being part of the first wave leaves us free to concentrate on that, and while there are issues - such as the vexed question of the Presidency of the European Central Bank - which only others can resolve, the UK's role is to give them every opportunity to reach timely decisions.

More fundamentally, we can contribute to the success of the euro, even from outside by continuing to pursue policies directed towards macro-economic stability and supply-side flexibility in parallel with those persuaded within the euro area. The Government is committed to this course as a matter of national economic self interest. But these same policies are calculated, too, to make us a more prosperous and active trading partner for Europe as a whole, and to ensure that we do not have any avoidable disruptive effect on the policies or on the economy of the euro participants. More than this they are calculated to foster sustainable economic convergence as the necessary precursor to our eventual adherence to the euro club.

But thirdly - and of particular relevance to this conference - we can contribute, directly and positively, to the strength of the euro through the City of London's financial markets.

The potential benefits to Europe of the euro derive importantly, as I have said, from the exchange rate certainty which it will provide across the euro area; they derive importantly, too, from the greater transparency and liquidity and competition of unified financial markets in the euro-denominated instruments rather than the fragmented markets denominated in the various national currencies that we have now. Providing transparent and liquid, competitive, innovative and well-regulated financial markets is one of the things which the City of London does particularly well. Provided the City is properly prepared - as it will be - and here I commend to you the Bank of England's quarterly reports on the practical, preparations we have been making in London for the introduction of the euro from 1st January next year - available, amazingly, at no charge from the Bank - then there will be a vigorous Euro-euro market in London, from Day 1, just as there are vigorous markets in Euro-DM and Euro-francs as well as Euro-DM and Euro-Yen now. If not our dowry exactly - since we are not entering into the marriage at this stage - it will be our wedding present.

The wholesale financial markets in the UK derive their strength from London's position as a uniquely international, rather than simply a national or regional European, financial centre. This reflects the critical mass of markets and financial services in commercial and investment banking available in London including the strongest financial businesses from all around the world. For instance, there are more banks operating in the City which are incorporated abroad than there are domestic banks, and more than half the total deposit base (over £1 trillion) of the UK banking system is denominated in foreign currencies. And, the fact that so many foreign-owned institutions - including very many from our European partner countries - continue to build their presence in London, suggests that they share this perception.

The City in this capacity is, I know, seen as something of a mixed blessing by some people on the Continent. There is a view that the euro should in some sense 'belong' to the participating countries and to them alone. If that view were to prevail it would point in the direction of one form of bureaucratic regulation or another - no doubt with a nod in the direction of monetary policy considerations as justification - which would damage the euro at least as much as it would harm the financial markets of the City. At the same time some of these same people argue for a successful, strong and widely-used euro that will take its proper place alongside the dollar and the yen as an international trading and portfolio currency, and in that context they positively welcome the active participation of London. In the end I do not think there is very much choice. In a world of increasingly integrated capital markets and liberalised capital movements it is inconceivable that the international use of the euro could be unnaturally constrained.

And that will be in the interest of the users of financial markets - whether as borrowers or lenders - within Europe itself and across the world, including the Mediterranean region. It will be in the interest, too, of the providers of financial services by promoting the volume of financial activity throughout the European Union. Like trade in goods and other services, trade in financial services is very much a positive sum game. As the major interface between Europe and the rest of the world, London's success is not a threat to other European financial centres. I have little doubt that euro activity in London will mean more rather than less euro activity in other European financial centres like Frankfurt, Paris, Milan or Amsterdam. And, conversely, I have little doubt either that what is good for those centres will be good too for the City.

Mr. Chairman, I make no apology for concentrating my remarks today on the advent of the euro. It is an historic step; and it will affect the lives of all of us - throughout Europe, throughout the Mediterranean region, and across the world. It can be a powerful force for good through its impact on free trade and competition, and on economic prosperity. But it is not without its dangers. What matters now is that we should all do all that we can to maximise the potential benefits and minimise the risks.