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The European Debate

Monetary Union

the issues and the impact

Sir Leon Brittan

CENTRE FOR POLICY STUDIES

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The author

Sir Leon was appointed Vice-President of the European Commission in 1989 with the responsibility for Competition Policy and financial institutions. He entered Parliament as Member for Cleveland and Whitby (which became Richmond in 1983, following boundary changes), holding various shadow posts. Following the general election of 1979, Sir Leon was appointed Minister of State at the Home Office. In 1981, he joined the Cabinet as Chief Secretary to the Treasury, became Home Secretary in 1983 and Secretary for Trade and Industry in 1985. He was knighted at the beginning of 1989.

The Centre for Policy Studies never expresses a corporate view in any of its publications. Contributions are chosen for their independence of thought and cogency of argument.

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Preface

Europe's businesses need the healthiest possible financial climate if they are to survive; and such a climate is one which will encourage them to compete, both within and without the boundaries of the common market. So much is beyond contention; but when Sir Leon argues that this in turn demands a common currency and an independent Central Bank, he enters into a thicket of controversy, in which by no means all of the directors and donors of the Centre for Policy Studies will emerge on the same side. That, however, is in the nature of the debate about the future of Europe, which still shows no sign of dwindling in intensity – even within a few weeks of starting the three-stage process towards full monetary union which was agreed at the Strasbourg summit.

The Centre for Policy Studies will continue to provide a platform for the contenders; is indeed now encouraging distinguished exponents of views very different from Sir Leon's to enter the lists. No one pamphlet can be taken to represent the views of all at the CPS; which endorses its authors only so far as it thinks their opinions are well worth listening to, and are expressed with vigour and authority. Those who oppose Sir Leon's arguments will not deny him that endorsement.

Thomas of Swynnerton

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Introduction

LET ME ACKNOWLEDGE THAT THERE ARE MANY QUESTIONS WHICH need to be answered by those who, like me, favour moves towards a common currency for Europe. In my speech to the Federal Trust Conference on monetary union in London in May (which, with certain revisions and additions, now appears within the covers of a Centre for Policy Studies paper) I discussed some of the central issues which it is necessary to resolve if we are to turn EMU from a perhaps somewhat threadbare catchphrase, into a tangible reality for all of the Community's 325 million citizens. In particular, I emphasised that we need to bear in mind the paramount objective of the Community's move towards EMU: that is, to provide concrete benefits to Europe's businesses – large and small – who need to compete to survive. They deserve the best possible financial system. If war is too important a matter to leave to generals, money is certainly too delicate an issue to be left to economists.

1
Background to the current debate

The governments of the Community have been committed to economic and monetary union (EMU) as a formal objective for over 20 years.

The 1970s bequeathed to us the European Monetary System, which, let it be remembered, was due to develop into a more advanced form of monetary integration within two years of its 1979 launch.

The most recent initiative picks up the commitment made by all twelve Member States in the 1986 Single European Act Treaty when they confirmed the objective of the progressive realisation of economic and monetary union. In Hanover in 1988 the European Council of Heads of Government set up the Delors Committee including all twelve central bank governors to propose concrete stages towards this union. The Delors Report was produced last year and has formed the basis of the Community's approach to EMU. Stage One of its three-stage process towards full monetary union was approved unanimously by Member States at the December 1989 Strasbourg summit and is due to begin on 1 July of this year.

It is no coincidence that the accelerated tempo of moves towards EMU have followed from the impetus given to the Community by the 1992 single market programme. A single market without a single money is seen as an increasingly expensive anachronism. But we need to stand back and ask ourselves what we want from an economic and monetary union. What real benefits will it provide to Europe's 325 million citizens? Is the game worth the candle?

I believe that it is, and its benefits can be summed up very succinctly: EMU strengthens Europe's competitiveness. In so doing it safeguards millions of jobs and creates many others. It ensures that in the increasingly competitive markets of the twenty-first century the Community will be a leading player. And it offers a base for the expansion of our firms throughout the world.

2
Economic Union: characteristics and objectives

How will this increased competitiveness be achieved? Let us look first at the economic characteristics of EMU.

A genuine economic union must be founded on a genuine internal market, with legal and administrative structures which encourage businesses to take advantage of its opportunities. We have made historic progress in the Community through the 1992 programme, and for that, both Lord Cockfield as its presiding genius and the British Government as a consistently enthusiastic supporter deserve much credit.

Equally, there can be no illusions about how much there is still to do, both in terms of agreeing proposals in Brussels and then in implementing them effectively throughout all twelve Member States.

This process will go on beyond 1992 into the next century. Indeed there will always be room for improvement. Even the United States, after over 200 years of economic union, has yet to provide a genuine internal market in a market as important as insurance. The insurance sector falls within my portfolio, and I intend to ensure that, as already agreed in the banking sector, the Community removes its barriers first, and reaps the competitive benefits accordingly.

Second, economic union implies a more effective Community-wide competition policy. In the short term, the move to a common currency, by taking away devaluation as a seemingly easy short term means of increasing exports and reducing imports will tempt some governments to increase their direct state subsidies to favoured firms. If unchecked, such a trend could undermine the benefits of intensified competition on the Community structure of production. So greater vigilance will be required by the Commission in using its Treaty powers to limit state aids once these become the only means of bending the rules through national subsidy on fair competition.

This is also important for regional policy reasons. The Commission has an irreplaceable role in protecting the weaker, poorer and often peripheral regions of the Community from having their economies undercut through subsidies provided by stronger Member States to their own industries – and we shall carry out these responsibilities to the full.

Thirdly, economic union will be effective only if we can ensure that there are open markets in the rest of the world to reap the benefits of our improved competitiveness. Here we are succeeding. Comments in the United States have moved 180 degrees, from alarm about the phantom threats of a fortress Europe to concern about the much more real threat posed by a more competitive Europe with a unified home market of 325 million people.

One of my jobs is to make sure that such a threat becomes reality, and that the Community succeeds through fair competition in open markets. That is why we are working so hard for a satisfactory outcome in the current GATT Uruguay Round.

Overall, therefore, the economic component of EMU is designed to provide a genuinely free market for goods, services, labour and capital across Europe. Its effects reach far beyond the foreign exchange desks.

3
Monetary Union: characteristics and objectives

Let us turn now to the idea of a single money in the Community. Here, too, we need to ask: what are the basic functions which we require a currency to fulfil? And how will monetary union help to achieve them more effectively?

Clearly we need to maintain a broadly stable price level so that individual savers and investors will have confidence that one pound or franc or deutschmark today is worth what it was yesterday or last year. This criterion of price stability could be taken for granted in most (though by no means all) countries until the Second World War, thanks in part to the gold standard. Since then we all know that some have been more successful at maintaining the value of their currency than others.

Money is more than simply a store of value. It must also be an effective means of making transactions: the oil in the wheels of trade. It is no coincidence that one of the key elements for economic recovery after the Second World War in Europe is also one which is being pursued by the newly liberalising economies of Eastern Europe now: the full convertibility of currencies.

Otherwise money cannot do its job of linking producers, consumers and traders through a transparent and reliable price mechanism. Barter – or countertrade as it has euphemistically become known – springs up only when currencies are so distorted that they can no longer be used in the marketplace.

But we also need to ask what money cannot do. It is absolutely central to the debate on monetary union to understand that inflation of a country's money supply does not increase the amount of real wealth available to its citizens – indeed the reverse can be true. In Britain, governments of both political persuasions have gone in for rather thorough and repeated tests of this proposition over the last forty years.

Fortunately, few politicians now show any desire to repeat the experiment; although once inflation has entered the system it can be a slow and painful procedure to squeeze it out. So giving up the freedom to run a higher and more fluctuating rate of inflation than one's economic competitors is not a loss of sovereignty, since it can gain nothing; rather it is the removal of a handicap.

Price stability then must be the primary objective of any monetary union; and the precondition of achieving its other advantages – cost savings, efficiency and certainty in trade between both companies and individuals.

The move to a single money is *the* most important step for smaller firms in providing them with the full benefits of the internal market. It will bring an end to the letters we continually receive from small businessmen, complaining that cross-border sales can lead to exchange rate and transaction costs ten times higher than their profit margins.

Finally (and again very important for the man in the street), the Commission is not suggesting that there must be a bonfire of national banknotes or that the head of Wellington on the five pound note should give way to that of the Brussels bureaucrat rampant. Once again the British have shown the way. Following the Scottish and English union of 1707 – and a very far-reaching one that was too – banknotes in Scotland continued to show their value both in pounds Sterling and in Scottish pounds for another century or so, one English pound being worth twelve Scottish pounds. So monetary union can and should take place in such a manner that the common currency continues to be denominated in traditional ways within each country.

In other words, so long as the value of the pound is permanently fixed in terms of ECUS there is no reason why pounds should not continue to be used domestically, with a clear indication of their EC value printed on all banknotes. A genuine economic and monetary union on these lines will make our economies work better and will make our firms more competitive.

Our objective therefore is a monetary union which respects legitimate national diversity, and provides low and stable inflation as a basis for sustainable economic growth.

We also have to ask what we do not want from a monetary union.

To be in favour of monetary union does *not* mean agreeing to excessive centralisation of fiscal or budgetary powers in Brussels. EMU is not about empire building, whether by the mythical hordes of Brussels bureaucrats or anyone else. And centralised fiscal control is not a feature of other successful monetary unions such as exist in Canada or the United States.

No doubt fiscal cooperation between Member States will develop in any case because of its mutual advantages; but so long as no Member State is allowed to finance a budget deficit by simply printing money, nor to borrow on the credit of the tax payers of other Member States, then, given a sensible framework for debate about economic policy priorities in the Council of Ministers, we should not need any more binding rules.

4
Necessity of a flexible Central Bank structure

So how do we achieve these objectives of price stability and market efficiency, without the drawbacks of excessive centralisation and bureaucracy? In essence, the answer which the Commission has chosen is very simple. It is to set up an independent central bank with the agreed objective of achieving price stability within the Community. This should be set out in direct and simple terms in the Treaty amendments setting up the new Federal Central Bank structure. People are more likely to do what you want them to do, if you tell them clearly what they are supposed to do in advance; and here the goal of the new central bank must be the maintenance of price stability.

We must therefore resist pressure to seek to make the central bank responsible for other economic objectives. A central bank cannot by its own decisions about monetary policy guarantee full employment, though it can make full employment harder to achieve by taking the wrong decisions; nor is it the means of transferring income between one group and another.

To seek to add these as equally valid objectives would be to trespass on the terrain of Member States and of finance ministers at Community level, while making it very much harder for the Central Bank to achieve its purpose of maintaining a broadly stable price level in the Community through control of the money supply. The Commission has resisted this temptation. We must now look to the Member States to do the same during the negotiations ahead.

Having clearly set out our objective of price stability in the Treaty we must provide an institutional structure which ensures that we can in fact achieve it.

The European Central Bank System, 'EuroFed', or whatever one likes to call it, must have the institutional cohesion to take difficult decisions on interest rates etc. rapidly. So its governing body must look as little like the Council of Ministers as possible. The Directors should consist of the central bank governors, *ex officio*, and four or five independent experts.

To be effective, decisions on European monetary policy cannot be the result of intergovernmental haggling or political compromise. They must be the informed judgement of a separate institution with its own objectives and independent power of action. The Commission's proposal is therefore particularly firm on the need to preserve this independence. I hope that ultimately a collegiate decision-making structure similar to that used in the Commission, based on the principle of one man one vote, will be agreed to buttress this in practice.

Together with clear objectives and operational independence embodied in a satisfactory decision-taking structure goes the need for democratic accountability. The 'EuroFed' will have a constant role of education and information about what it is doing in order to maintain its legitimacy in the Member States.

So it is not merely helpful but necessary that there should be regular reporting by the President of the 'EuroFed' to the European Parliament and to the Council of Ministers. By being open on the justification for its broad policy approach the 'EuroFed' will be much better able to oppose attempts to question its day-to-day autonomy.

And it is heartening to note that there is a very wide degree of consensus that the operation of a European monetary policy can only be the responsibility of the 'EuroFed' – no second guessing can be allowed.

This approach, based on clear objectives and independence of operation, reflects the solid experience of forty years of the German Bundesbank, the Dutch central bank and others who have shown that a rigorous approach to monetary policy is possible, does work and does produce better results in terms of growth and employment for the wider economy. So Member States are not being asked to buy a pig in a poke, but a tried and tested recipe for price stability.

5
Objections and alternative approaches

There are two main alternatives to this approach. One is to carry on as we are at the moment with monetary policy essentially laid down by the dominant central bank within an exchange rate system; in Europe's case by the Bundesbank. But this is politically difficult for both the countries that have to follow the lead and also for the leading country itself which finds itself saddled with a reserve currency role which it may not be willing or able to undertake effectively.

The *de facto* domination of one money is not a sustainable route to monetary union even in economic terms; and it is certainly not a sufficiently stable basis on which to build the political acceptability needed for a genuine monetary union.

Monetary union will not be achieved through hegemony, but through common institutions building on forty years of Community experience in this area. And it is significant that the Bundesbank itself is fully committed to following this route.

A second option would be to set up a parallel currency as the route to monetary union.

There are two main problems with a parallel currency. Most fundamentally, a parallel currency by definition means that there cannot be a single money with a fixed value in circulation. So the benefits for the man in the street and the small businessman trading between countries can never be fully achieved. There will always be transaction costs between the European parallel currency and national currencies. There can never be certainty about exchange rates, adding a further risk for investors and savers. All of this means a greater handicap for European firms compared with our competitors in other countries.

It is worth noting in this context that even those countries keenest to use market mechanisms have never gone so far as to sanction the operation of several central banks with the power to issue their own money within one Member State. Clearly the notion of competing currencies has its limits.

Second, and also perhaps why the central bank governors on the Delors Committee unanimously rejected this approach, it is a potentially anarchic way to lessen the role of national currencies. To avoid increasing inflation central banks would have to give up their own money creation powers step by step as their currencies were transferred into ECU by the foreign exchange markets, who would naturally judge the most advantageous moment for such a changeover.

A Member State might conceivably face the prospect of losing control of 10% or more of its domestic money supply through transfers to a parallel currency in an afternoon's trading if market sentiment moved against it – and we all know the fragile nature of market sentiment.

Moreover, a parallel currency approach does not provide any greater genuine policy flexibility for national monetary authorities. It merely gives them the illusion of continued control of what is likely to be a progressively shrinking monetary base. If we are to make the move to a single money, it is better to do it with our eyes open through deliberate political decision than with our eyes closed through a parallel currency route.

A further rather strange objection to monetary union which has surfaced recently is postulated on its success in achieving price stability. If it does so, runs the argument, those who have taken out debt at high interest rates expecting continued inflation to erode its real value will find themselves in greater difficulties. It has even been suggested that all contracts will somehow have to be changed.

This is simply not the case. Just as the change from fixed to floating exchange rates had no direct effect on contracts, so the move back to irrevocably fixed exchange rates and then to a common currency need not interfere in any way with existing contractual obligations.

The more sophisticated version of this argument, however, is an argument against any attempt to reduce inflation at all. Of course those who take out high fixed interest obligations are aware of the risk that governments will succeed in doing what they are constantly telling people is their objective and reduce inflation to low and stable levels. Indeed, if more people believed that this would happen, then inflation would subside more easily. In fact, price stability removes the arbitrary and unfair redistributive effects of inflation. It will mean lower interest rates and greater transparency for savers and investors: the end of the arbitrary and unfair redistribution of resources between debtors and savers which is a feature both of unforeseen increases and of reductions in inflation. That is in everyone's interest.

Nor is it plausible to argue that in the type of monetary union we are aiming for ECU interest rates need be higher than Deutschmark rates. We are aiming for the best not the average. Governments now know that the apparent benefit of a reduction in government debt through inflation is brought at too high a price through the distortions created in the rest of the economy.

Then there are the objections of those who subscribe to the parachute school of competitiveness. They argue that if a country's real unit costs are rising more rapidly than its competitors, then it should pull the rip-cord of devaluation, depreciation, call it what you will, and at least make a soft landing by achieving a short term improvement in competitiveness through exchange rate changes. Whatever the economic models may say, experience by a wide variety of countries over the last forty years shows that such an approach is doubly dangerous. First, it leads to greater inflationary pressures as imported goods become more expensive, and the transient gains in price competitiveness are offset by a further increase in domestic costs: the inflationary spiral. Expectations of further currency depreciation to compensate become rapidly self-fulfilling and can end in a total collapse of confidence, as Britain discovered in 1976. Only recourse to the IMF stabilised that situation.

Second (and more insidiously) depreciation, as the apparently soft option, diverts attention from the real need for structural change. What are the requirements for training, for infrastructure, for research, for regional policy needed to improve *competitiveness?* These, unlike the value of a currency, are not susceptible to a 10% change overnight. But they are the real issues, and again experience shows that countries which have focused on them have performed consistently better than those who have sought a way out through the quick fix of devaluation.

It is perhaps a sign of the maturity of economic policy makers in Western Europe that governments are now prepared to put such pseudo-solutions behind them in exchange for the genuine benefits of a single currency.

6
EMS and the transition to EMU

Granted that economic and monetary union, with the characteristics outlined above, is a worthwhile objective, how do we get there from here? The transition from high and fluctuating inflation levels to low and stable inflation is a difficult one, since government, companies, trade unions and individuals all have to change their behaviour if the necessary disinflationary process is to take place at minimal cost in output and jobs lost.

That is why it is right to build on the existing exchange rate mechanism of the European Monetary System. The EMS is clear proof that a structured approach to monetary stability produces more effective results than unbridled competition. A comparison between the inflation performance of France, Ireland and the United Kingdom over the last decade is informative in this respect.

Since joining the EMS and taking its discipline seriously, French inflation has fallen to an average of 2.9% over the last five years compared with 10.5% in the five years up to 1980. France has become a low inflation economy. This was not done by magic but by a combination of the correct domestic policies combined with the credibility of adherence to the narrow bands of the EMS. After a period of adjustment in the mid-1980s we can now see the rewards in levels of growth over 3%.

Over this period British inflation has also fallen from 13.9% to 5.2% but, as we know, has stubbornly failed to fall below this for any length of time. The attempt to rely on monetary targets alone to reduce inflation has not worked well for various reasons, not least the difficulty in finding a satisfactory monetary aggregate to follow. A credible exchange rate link with low inflation economies will work. During the initial transition interest rates in Britain will naturally reflect a risk premium and so stay relatively high; and that too will help to squeeze inflation out of the system. The process will not always be smooth; but at least we have ten years of evidence showing that low and stable inflation is attainable through the EMS exchange rate mechanism.

Ireland is a further interesting example because until the start of the EMS in 1979 the monetary union with sterling meant that

Irish inflation was always exactly the same as that in Britain. It is now 3.0%. Irish growth this year will be 4.6%.

These results were achieved through acceptance of the disciplines of the EMS. The countries that have gained them through considerable sacrifice have no desire to give them up. On the contrary, they wish to set up an institutional structure designed to perpetuate price stability.

That in itself is one of the strongest arguments why it is not the United Kingdom which need be worried about inflationary pressures from other Member States, but rather other countries which might be understandably cautious in accepting a member whose inflationary record is not as good as their own.

When should Britain join the EMS exchange rate mechanism? Many of us would answer that question by saying: 'Some time ago' It is not my aim to seek to read the tea-leaves of government economic policy. But it is clear that the only real constraint remaining is the inflation differential between Britain and full EMS members. Joining the exchange rate mechanism is a heaven-sent opportunity to provide the needed jolt to inflationary expectations in Britain.

It would therefore be doubly unfortunate if Britain were to join the EMS only in the 6% band (now abandoned by Italy), on the basis that, if things came to a crisis, sterling could always be devalued. The benefits of the mechanism come from the hard-won anti-inflation credibility of countries within the narrow 2% exchange rate band. A decision to join it must be whole-hearted.

Joining the EMS is not the same as making a commitment to full monetary union, although it is a necessary part of the Delors process. But there can be no question of imposing a common currency: monetary union will only take place by agreement. Equally, *not* taking part in a monetary union cannot prevent other Member States from deciding to go ahead with it, if necessary without the United Kingdom.

Some British pragmatism needs to be applied to the issue of effective monetary independence. The last time German interest rates went up United Kingdom interest rates followed about 30 minutes later, even though we have theoretically retained full monetary sovereignty outside the EMS exchange rate mechanism.

Does anyone in this country believe that when there is a common currency for much of Europe, British interest rate decisions will not be even more tightly constrained than at present?

Let us be generous. Let us assume that if there is a European ECU and sterling is not part of this monetary union, that we would still have 15 minutes in which to decide whether to follow interest rate decisions of the 'EuroFed', before the markets took the decision for us by selling sterling and precipitating a crisis of confidence – a situation with which too many British Chancellors have become familiar, and one which would leave any government in a most unheroic posture. Is that extra quarter of an hour of crisis really so precious an addition to sovereignty that it is worth putting British industry at a permanent competitive disadvantage, when it comes to doing business in the Community, by excluding it from the benefits of a common currency for a single market? Because that is the alternative before us.

Fortunately, the evidence that we have suggests that those in the private sector who must make a living through routine financial transactions have clear views in favour of greater monetary stability. The CBI supports moves towards a single European currency. And an interesting recent survey of corporate treasurers showed that 60% favoured moves towards a single currency and monetary policy in Europe, while over 80% wanted sterling to join the exchange rate mechanism of the EMS.

There is a further empirical argument. Apart from the European Community, there are two other major economic forces in the world economy: the United States and Japan. They both enjoy the benefits of a single currency. In the case of the United States this single currency covers a whole series of economic regions with completely different structural problems. There is no doubt that California, or indeed New York, *could* operate its own currency. There is no doubt to that the adjustment problems faced in regions such as the North East, with industries in structural decline, are completely different from those of the oil-producing areas of the South and West. In practice no one, so far as I know, not even an economist, suggests that the United States should move to a system of competing currencies.

The problems of differential regional development are, however, independent of whether one or many currencies are being used. Indeed, a planned policy to assist regional development is more effective in a single currency area. The last thing a disadvantaged region needs is a second-class currency; and the gains of lower wage costs and other cost advantages are much clearer to investors, and so work better, when they can be directly compared with costs elsewhere without the complication of exchange rate costs and uncertainties.

The benefits to every American citizen in terms of efficiency, convenience and lower cost of having a single currency throughout the fifty one states of the Union are plain for all to see. In the same way, when we have had one currency in Europe for a few years people will ask why it took us so long to get there; *that* will be the only interesting question.

We are not there yet. But we will be soon. I hope that the United Kingdom will play a leading role in this achievement. Monetary union will make markets work better in Europe. And to return to my starting point, a more competitive Europe is one which can offer faster growth, more jobs and a higher standard of living to its citizens in the years ahead. These must be common objectives for us all.

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