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THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM

... I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train - principally but not exclusively in the Committee formed under President Delors - about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on "concrete stages" is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market - "1992" for short - and the exchange rate mechanism of the EMS.

- one, that 1992 will destroy exchange rate stability by removing one of the major defences of the ERM - namely exchange controls; and

- the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much greater degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate - and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants - Germany and the Netherlands - had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; whilst in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years - a period which has encompassed considerable external

turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be coordinated. A fair degree of coordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case - there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that coordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgment, is "no". The purpose of the internal market programme is to remove barriers and distortions to trade - in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price - that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies - something that is not always the case at the moment in the Community with,

for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency - provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer term decisions - including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur within countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; between member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences - often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even promote currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of

convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union, as a premature obsession with that process that is likely to be an impediment to the internal market.

The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the economic challenges that will have to be faced. It is also worth spelling out what monetary union - a single currency - would involve in political terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy; and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur between countries, in the same way as today they exist within countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes - means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the long term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal - topical though it may be to investigate the details of a European currency or a European central bank - but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

The decision is a difficult one. I would not deny that the existing participants have on the whole been happy with their choice; but it has to be said that many small, open economies started from a position of enjoying little effective policy freedom, or saw benefits in the discipline of alignment with the counter-inflationary deutschemark. This latter factor was perhaps particularly important in the early years of the ERM's life, when inflation was high. Now that inflation is less of a problem, one can see emerging, in the debate about the symmetry or otherwise of adjustment under the mechanism, some of the concerns that have influenced the United Kingdom over the years.

I have to say that it is still not obvious that the conditions are yet right for United Kingdom participation in the ERM. As you well know, our domestic monetary policy is at present responding to the excessive growth of domestic demand during the course of this year, and to the inflationary pressures that accompanied

it. The main objective of policy is to exert steady downward pressure on inflation. Interest rates play an important part in this process and we while we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation.

From the viewpoint of the ERM itself I think it still also true to say that the involvement of sterling in the mechanism at this stage would introduce a new element of complexity into its operation.

What then are the practical steps open to us? I suggest that we should concentrate first on promoting the real economic integration of the Community. The success of the single market programme will [illegible] must expect to see further steps towards integration, and the markets will need time to take full advantage of the opportunities created. In many if not all member states there are instances of structural imperfections and rigidities which make markets work less than perfectly and which can hinder adjustment to changing circumstances; this tends to be true of labour markets in particular. If the Community is to work smoothly as a single market, such structural problems will need to be dealt with.

Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy coordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

There are a number of further practical steps that could be considered. For example, there might be greater use of EMS currencies in intervention within the Community. The ECU might have a useful role to play here, as markets in it develop; the impact of a country's intervention in ECUs upon relative exchange rates in the rest of the EMS will be muted by the wide spread of currencies in the ECU basket. But such issues can be controversial, and it cannot be denied that, even now, there are differences between ERM participants on the appropriate course of monetary and exchange rate policies. These are genuinely held differences which will not easily be resolved. One should perhaps not be too surprised that it is proving difficult to agree the precise terms of a common policy in regard to the ERM; and it

underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an "exogenous shock" for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major pre-occupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and [illegible] and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

Tonight is not the occasion to speculate where the Plaza-Louvre process of policy co-ordination and exchange rate management is leading. Some siren voices regard it as wholly misconceived. Others hanker after a return to a Bretton Woods type system, and are encouraged by the successes of the ERM to hope that this is no longer so fanciful an idea as it may have seemed only a few years ago. Still others believe we are heading for a tripolar currency system based on a US dollar zone, a Japanese Yen zone and the EMS.

What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short-term

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.

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