

TSB Group plc

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November 1990



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Following the Government announcement, on 5th October, to include Sterling within the Exchange Rate Mechanism of the European Monetary System the subject of economic and monetary union has risen to the top of the political agenda.

By coincidence, TSB Group organised a Forum on the subject of Economic and Monetary Union on the same day that the Government announcement was made. Our speaker was Sir Leon Brittan and his lecture is re-printed in the enclosed booklet.

Sir Leon's lecture was well received by his audience and was followed by a lively discussion. I thought you would be interested to read what he had to say.

*Nicholas Goodison*

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TSB FORUM  
'EUROPEAN MONETARY UNION'

Guest Speaker: The Rt Hon Sir Leon Brittan, QC

Vice President of the Commission  
of the European Communities

Sir Nicholas Goodison in the Chair



TSB Group plc

Other lectures in this series include:

'Inward Investment'

The Rt Hon The Lord Young of Graffham  
(November 1989)

'Competition Policy'

Professor John Kay  
Director - Centre for Business Strategy  
London Business School  
(April 1990)

'Education for Wealth Creation'

David Sainsbury  
Deputy Chairman, J Sainsbury plc  
(June 1990)

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PREFACE

The objective of the TSB Forum is to stimulate serious debate about a range of business, economic and social issues of national and international dimension. Industry and commerce are the lifeblood of our nation and opportunities to debate the issues which confront them can greatly assist their progress.

The fourth in this series of Forums was held in Birmingham and was addressed by Sir Leon Brittan. His speech and the Chairman's introduction are reprinted here. It is hoped that these and additional Forums planned for 1990 and beyond will make a significant contribution to the development of corporate awareness on crucial issues.

The views expressed by the participants are personal and do not necessarily reflect the policies of TSB Group.

5th October 1990

INTRODUCTION

SIR NICHOLAS GOODISON

This is the fourth in a series of TSB Forums which we are holding in a number of important centres throughout the United Kingdom.

Our objective is to stimulate serious debate about a range of business, economic and social issues of both national and international dimension.

I am very pleased to welcome as our lecturer today Sir Leon Brittan, Vice President of the Commission of the European Communities. Sir Leon is specifically in charge of competition and financial institutions. His subject is "Economic and Monetary Union".

The convergence of economic policy and monetary union within the European Communities will have far reaching effects on every citizen, and every industrial and commercial company. The removal of restrictions – and the use of many different currencies is undoubtedly a restriction – creates both competitive threats and great opportunities. The topic is thus of enormous importance. It is also very pressing. By the end of the decade, if not earlier, a single European currency and a single central banking authority could be in sight, if not in place.

I am delighted that Sir Leon Brittan is with us today and I very much look forward to hearing his thoughts on this important subject.

EUROPEAN MONETARY UNION  
"WHAT MONEY FOR EUROPE?"

SIR LEON BRITTAN

Much of the work of the European Community is not calculated to set the world on fire: the co-ordination of detailed foreign trade negotiations, measures to protect the environment, technical working groups on everything from nuts and bolts to bananas.

Yet all of these form part of the constant day-to-day care and maintenance needed to ensure that the single market for goods, services, labour and capital is a reality across 12 countries and – with the welcome reunification of Germany – 340 million European citizens. The effectiveness of the internal market is built upon the success of literally thousands of such highly specialised agreements.

The monetary organisation of our economies is different. We all know about money. We all use it. Most of us would like rather more of it. The internal workings of the august central banks that supervise the currencies in each member state are not always entirely transparent; but they affect directly every single man and woman in Europe.

It is natural that when the Community starts to talk about developing its monetary structure in the same way that we have been successfully developing our

internal market in recent years, there should be considerable interest and even emotion generated on all sides.

So let me start by making my own views clear. There is nothing mystical about national currencies – or international ones for that matter. I am in favour of those arrangements which make our economy work better and so provide more prosperity and more jobs; and against any changes which do not make economic sense. If, therefore, Britain is better off with its own currency, not all the tea in China, or even all the Directives in Brussels, would convince me that it would be right to give up that currency.

For at the end of the day our monetary system is a tool at the service of our economy. And that in turn is designed to produce the goods; not to be the servant of any economist, bureaucrat, academic or politician in Brussels, London or anywhere else. People in Birmingham, who work for their living in the private sector, will not need to be told this twice; some other audiences further from the market place might take a little longer to understand it.

So we should judge proposals for changing Europe's monetary structures in this very concrete and practical way: do they help to improve our competitiveness, benefit our industry, create new jobs and generally make the market work more efficiently? And a useful starting point, rather than

any theory, is to consider what our competitors do. If we look around the world it is clear that there are three major economic blocks which together produce 70% of world output and are responsible for 61% of world trade. One block, the European Community, has nearly as many people as the other two put together. Two of the blocks, the United States and Japan, have a single currency: the dollar and the yen respectively. Europe has eleven: the Deutschmark, the pound sterling, the French franc, the Italian lira, the Spanish peseta, the Portuguese escudo, the Irish punt, the Dutch guilder, the Danish kroner, and the Belgian and Luxembourg franc (they share a currency).

A company based in New York can open a factory 3,000 miles away in California to take advantage of new markets or cheaper raw materials without the slightest need to be concerned about any more exchange rate costs or uncertainty than if the factory was being planned for across the road. The result is a stronger economy and therefore more jobs.

Individual American or Japanese citizens know that throughout their home markets – and even beyond – they can buy and sell in their national currency, without suffering the cost and inconveniences of a dozen different foreign exchange rates. A single currency is the cement that binds their economies together.

If you or I travel from Birmingham to Coventry for the day, to Blackpool or Scarborough for the weekend or Cornwall or Scotland for a longer holiday, it goes without saying that our money is worth just as much there as it is here. There is no question of the Manchester pound being worth more next week than the Birmingham pound, nor of anyone being forced to pay up to 10 pence in the pound for the privilege of using different coloured banknotes in Scotland when these are of course worth exactly the same as those used here in England. That is what monetary union means in practice.

And of course for businessmen it means that it does not matter whether a buyer lives in Lands End, John O'Groats or Edgbaston. They pay the same price in the same money today or next week, subject only to different transport or distribution costs.

Birmingham is, in fact, considerably closer to Calais than to Glasgow. But even when the internal market is fully in place, selling from Birmingham to Calais is going to be more complicated, slower and more expensive than selling to Scotland, simply because, although we have a single market, we do not yet enjoy the benefits of a single currency.

These points are obvious. So obvious that they do not receive the attention they deserve. Because here in Britain we have been brought up to accept that

crossing the Channel inevitably means that we must lose some of the value of our money as soon as we have to change it into different coloured banknotes. Indeed, the European consumers' organisation estimated that if we were silly enough to transfer £100 through all of the European currencies – without spending a penny (or an ECU) – we would be lucky to come back with half of what we started with. These are some of the real costs of a multi-currency economy in the Community.

The real winners from a single currency are not the international financiers. They are all of us who every day – for business or private purposes – want to use money. It stands to reason that the wider the economic area in which one money is used, the greater the savings in cost and convenience, the greater the economic liberty, for everyone living there.

Ask any American. California is over 3,000 miles from New York, and five hours of time difference. The Californian economy is at least as big as that of Spain. It could easily run its own currency. But Americans know that the advantages of a single money across a vast economic market like the USA are so great that there is no need to waste time on alternative monetary systems.

There are wider economic benefits to belonging to a major currency bloc. In our economically



interdependent world every country needs to attract outside investors to help create new jobs and output at home. Anyone seeking to invest in America or Japan knows that wherever he does so, he will have only one currency to work with, one currency to pay wages in, and one currency in which to receive his dividends. Europe cannot offer the same advantages without a single currency.

The USA has a considerable advantage in world trade and finance because its currency is widely used by other trading countries and is held in foreign governments' reserves. 60% of the world's foreign exchange reserves are held in dollars, a dominant but now diminishing proportion. The USA benefits from this through the so-called seignorage effect, or rent, which accrues to the central bank issuing an international currency. Less than a quarter of the world's reserves are held in Deutschmark or sterling. How many would be held in a European currency? Certainly a lot more.

American industry benefits directly from the dollar's international role. US firms can purchase many of the commodities and other primary products needed for manufacturing in dollars, removing a major exchange rate risk from their businesses.

And it does not end there. In world economic affairs – in the GATT trade negotiations for example – the United States, Europe and Japan meet and negotiate

as equals. In world financial affairs on the other hand there is the United States, Japan and an empty chair. The Deutschmark is the strongest and most reliable European currency in international eyes but it is not and never can be a truly European currency.

So Europe's voice is simply not heard as it should be. Decisions which affect our economic and financial environment are taken without our interests being properly expressed – not because of a plot against us but because the lack of monetary union in Europe means that many of the real decisions pass us by. That is where the real big absence of sovereignty lies, if you define sovereignty, as I think you should, as the ability to control the world in which we live. And the solution lies in our own hands.

Of course you cannot even think of having a single currency without a single market. And in Europe, over the past six years, we have been constructing with great labour, some sacrifice and unprecedented political imagination, an internal single market which will be Europe's economic dynamo in the decade ahead. In many ways – especially in the financial sector where we will have the world's largest banking and insurance markets – Europe's single market will be more unified than the one which the Americans enjoy. But our companies, and especially our small firms, will not get the full benefits from the thousands of hours spent agreeing hundreds of detailed measures, all the planning and preparation

put in by the private sector, without a single currency to complete the internal market.

The EMS is a step towards giving Europe what our competitors enjoy; but only monetary union will remove the currency tax which is still paid by exporters and importers across the European Community. So why can't we now go on to enjoy the benefits of a common currency? The answer is we can!

Of course these external benefits, including the ability to ensure that events in the world go as we want them and that we are not simply left to follow others, should not be bought at the cost of weakening our national economy. And they are not compatible with a floating exchange rate. But is a floating pound such an economic advantage?

How have Britain's European partners – the French, the Germans, the Italians – chosen to manage their currencies? For the last 11 years they have used the exchange rate mechanism of the European Monetary System to provide an important measure of currency stability for their businesses, and also to focus the fight against inflation. What real benefits has it brought them?

Take the case of two engineering firms, one in Birmingham, one in Lyons. Both export competing products to the German market – which is as you

know the single most important export market for both the United Kingdom and France. Both are concerned to know what return they will get for their products which must of course be sold for Deutschmarks. The exchange rate is therefore a key factor in determining whether output can be sold at a useful profit or an unsustainable loss.

What has actually happened in the market place? During the month of September the £ to DM rate varied from a high of DM 2.972 to a low of DM 2.914, a shift of six pfennigs – 2% – in just 20 working days. The French franc to DM rate remained stable at DM 0.298. Three months ago the sterling rate was DM 2.91, the French franc rate the same at DM 0.298. Six months ago the sterling rate was DM 2.76, the French franc rate was DM 0.297. Twelve months ago the sterling rate was DM 3.03, the French franc rate was DM 0.295. Over the year the pound fluctuated 11.7% against the mark, the franc only 2.1%. Which company has the greatest certainty in its pricing policy, the French or the British? Which will be best able to sign up to fixed price contracts and reach medium-term agreements with customers and suppliers? Which will be more competitive? The answer is clear.

The answer is equally clear if both firms are considering an investment in Germany which must pay for itself over three to five years. Three years ago the sterling to Deutschmark rate was DM 2.99, the

French franc to Deutschmark rate was DM 0.30. Five years ago the sterling to Deutschmark rate was DM 3.76, the French franc to Deutschmark rate was DM 0.33. Which investment is the more certain? Which is more likely to go ahead?

That is why everyone is now agreed that Britain should join the EMS exchange rate mechanism. The Government is to be commended for having taken that decision. Joining the EMS will be a major step towards removing such an unfair handicap on British firms – because British business pays the price in lost orders and jobs for the lack of comparative exchange rate stability our European competitors enjoy. Of course the Government must take day to day factors into account in deciding the precise moment of entry; but the sooner we join the better for British companies, and for British jobs.\*

But those countries which have been full members of the EMS for 11 years and have experienced its benefits first hand want to go further. They now want to move on to a single currency, or a common currency – I don't think there is any real difference between the two. The French firm in Lyons, exporting to Munich, may be able to rely on broad stability in the franc to Deutschmark rate. But it

\*Later that afternoon (5th October), the Government announced its intention to place sterling into the Exchange Rate Mechanism.

must still pay additional bank charges to remit its profits. It must pay higher interest rates, and may also need to insure by hedging against the risk of future currency fluctuations because the EMS still permits changes from time to time. Although the frequency and extent of such realignments has steadily diminished, the possibility of such change still brings in its wake a degree of uncertainty, and with it increased costs.

A New York based competitor investing in Texas does not have these problems because the value of the dollar is always the same everywhere in the US. The result is greater competitiveness for them, less competitiveness for us. More new jobs for them, less new jobs for us; and a less efficient and so less prosperous world economy for everyone.

That is why the debate about monetary union – that further step beyond EMS – is not simply a question to be left to bickering economists nor to theological arguments about national sovereignty. It is a question of jobs, of prosperity, and of economic security for our families today and in the future. Again it is easier for those who must live by maintaining their competitive efforts in the world market place to accept these realities.

Money is the oil in the wheels of Europe's economy. In particular the move to a common currency would be the single most important step for smaller firms in

providing them with the full benefits of the internal market. It would ensure an end to the letters we currently receive in the Commission from small businessmen who find that cross-border sales can still lead to exchange rate and transaction costs which are 10 times higher than their profit margins.

So there are concrete benefits to be gained by joining a Europe-wide monetary union. But our currency is also something that each of us uses every day of our lives and with which we are familiar. I myself and many other people in Britain are understandably attached to the use of the pound sterling. Will we have to give it up if we go down the road that I have sketched? The answer, perhaps surprisingly, but undoubtedly, is: no.

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 12 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 ECU value printed as well on all banknotes.

We can have the benefits of a monetary union without disrupting the convenience and the sentimental attractions of our present currency. We can do away with the tyranny of the exchange rate booth, so that the smallest businesses can trade with our European partners to their mutual advantage without paying an unnecessary foreign exchange levy. For if the pound is always worth the same number of ECUs or DM or francs, changing from one into the other will be exactly like changing a £5 note into coins. There will be no justification or need for any charge for doing so.

What about the claim that moving to a single currency and low inflation throughout Europe would penalise weaker regions? If that were true it would be a strong argument for not going ahead. But it is not true.

Poorer regions benefit from being part of a single currency area because they can sell their goods more easily. They are more attractive for investment and their lower costs of production are clearer. A British firm investing in Portugal now, to take advantage of

low Portuguese labour costs, has to take a view about the future rate of the escudo against sterling. How fast will it devalue? What will Portuguese inflation be like? This uncertainty is a considerable disincentive to any investment. If Portugal and the United Kingdom shared the same currency this problem would disappear.

The real costs of a single money in Europe will not be to those poorer regions which are within the monetary zone. It will be to those regions that stay outside it. A Japanese investor choosing between South Wales and Catalonia in Spain or Flanders in Belgium to build the factory which will sell its products throughout the single European market, is going to pay a lot of attention to the monetary stability offered by one region over the other. Which side of the line do we want to be on? Where does Britain's national interest lie? It is ultimately for you to say.

There is an even more insidious argument against a monetary union which is seldom unveiled in its full guise but which runs as follows. Some countries, it is implied – Britain for example – cannot survive without constantly depreciating their currency so as to provide a short term cost advantage in other markets. To join a monetary union would be to give up this vital economic tool.

What happens in the reality of the market place? The negative effects of the continual series of devaluations which the United Kingdom undertook from the 1940s to the 1970s – under governments of differing political colours – on the strength of our economy are undisputed. A suggestion that more of the same kind of devaluation is a remedy to whatever structural weaknesses there may still be in the British economy is not merely nonsense; it is economic sabotage.

We all know that a business may receive a brief cost advantage from a depreciation as imports become more expensive and exports cheaper in a foreign currency. A brief advantage – because the depreciated pound raises import prices of the raw materials needed to make goods. But employees are perfectly well aware that depreciation is a thinly disguised way of cutting living standards and so they rapidly respond with higher wage demands, facing governments with the grim choice between accepting recession and higher unemployment or pumping more money into the economy, giving a further twist to the inflationary spiral. Neither is good news for the real productive economy – nor for the weakest regions of the country.

And to the extent that it does have any effects, devaluation encourages firms to produce less sophisticated products which sell on price, while other countries – the Japanese are the most obvious

example – seek to develop products which outclass the competition on reliability, innovation and service, and which are usually at the high price, high profit end of the spectrum. You cannot devalue your way to the top of the market.

In a system of floating exchange rates, Sterling may depreciate by 10% tomorrow. But who is to say that next week it will not rise by 5% or 15%? How are you supposed to plan, produce and market on that basis? A yoyo exchange rate produces a yoyo economy. Devaluations may have had a role when we were a more independent economy with less overseas trade. Today our markets lie overseas, above all in Europe. To exploit them effectively we need currency stability.

Moreover, removing the depreciation temptation is a good way of forcing those directly involved in economic management to face up to their responsibilities. How often in the past have short term sterling crises distracted us from the need to improve our economic fundamentals: the training of our work force, our economic infrastructure, our regional policies? In a monetary union it is these issues which have to be considered. Are they more fundamental to the health of our economy than fiddling with the exchange rate? I have little doubt that that is the case.

These arguments in favour of a common currency for the concrete benefits it can bring have long been widely accepted. Indeed, the European Community has officially had monetary union as an objective for the last 20 years. The difference is that now attention is focussing on the practical steps needed to achieve that goal.

Two years ago the European Council, the 12 heads of government of the Community countries, agreed on their objective of a progressive realisation of economic and monetary union. They set up a Committee of Central Bank Governors and other experts to propose “concrete stages leading towards this union.” In 1989 this committee agreed unanimously on a three-stage plan leading to a common currency. Stage one of that plan, which includes completion of the internal market, removal of the last remaining barriers to free capital movements and a convergence of inflation rates, started on 1st July of this year. An Inter-Governmental Conference has been called for December 1990 to decide on the Treaty amendments needed to achieve a monetary union in the Community.

The first and vital step has been agreement on our objectives: what we want from monetary union. Because it is important that the new monetary institution is set up with the independence and authority needed to take the right decisions. The

Commission has set out very clearly that the new European Central Bank should be given the task of keeping prices stable and inflation very low. Its governors must be independent and have a longish tenure of office to secure that.

The European Central Bank would not become involved in member states' fiscal policies or the size of their budget deficits. But high-spending countries could no longer be able to print money to cover an excessive deficit; nor could they expect to be bailed out by others. These principles are vital to the success of a monetary union. Their implementation will mean low inflation, lower interest rates and – in the UK – much cheaper mortgage rates.

So we are now well on the way to a common currency for Europe. Discussion and debate are focussing on finding the most efficient and least disruptive way to move from many exchange rates based on national monetary policies to a single monetary policy and a common currency.

The Commission's proposals envisage a strengthening of the exchange rate mechanism and convergence of member states' inflation rates during stage one, followed by the setting up of a European Central Bank structure in a second stage. The final transition would see the European Central Bank take over responsibility for monetary policy throughout the Community.

The United Kingdom has put forward, in John Major's plan, its own proposals for moving on towards monetary union. These involve setting up a parallel currency – the so called hard ECU – to circulate alongside all the existing national currencies.

A parallel currency approach has the difficulty that it means more not less currencies circulating in Europe and so cannot offer all the advantages of full currency stability. But the British emphasis on the goal of stable prices and the importance of the ECU as a currency in the transitional phase have been rightly recognised by other countries as a significant contribution to the debate.

And in accepting explicitly the idea of a supra-national monetary authority which would be independent and have responsibility for managing the hard ECU to achieve price stability, the Government has taken the decisive step of principle towards a monetary union by accepting the need for a new Community monetary institution and amendment of the Treaty of Rome. As that concept has been accepted, the Rubicon has been crossed, though few people have noticed it. For the Government has put forward a proposal involving a high degree of loss of monetary sovereignty. It is to be applauded for doing so. But it follows that the question of whether this scheme or the alternative one should be adopted is no longer a question of

fundamental political principle. As the Government has taken the decisive step away from monetary sovereignty, the question now is simply: which plan provides the more practical and acceptable route forward? But the logic of all this has not yet been followed through to its inevitable conclusion.

Having made proposals based on the logic of a single currency and including the creation of a powerful supranational agency in the European Monetary Fund, I hope that the British Government will now be ready to come out explicitly in support of the objective of a single currency. Rather than saying that a single currency is something that *could* flow from the plan we should say that it is something that it believes *will* flow from that plan. And the reason for saying that such a change would be of great significance is because it is a change which would ensure that the ideas put forward by the British Government really do receive the attention they deserve.

The question of timing – when the next stage of monetary union should take effect – is very sensitive in all member states, not just Britain. The next move must not come too soon, before governments, businesses and individuals are properly prepared. But it must not be too late either, because European firms competing in the world marketplace are handicapped by its absence. The 12 EC governments must now find the right blend of realism and imagination to take monetary union forward successfully.

The European Community is often accused of talking very much and doing very little; and that accusation is not always as unjustified as it should be. But as with the internal market the move towards monetary union may well prove to be rapid. Decisions on what type of monetary union, how a central bank should be structured, and – very important for the City of London – where its market operations should be carried out, are already being prepared. The Inter-Governmental Conference could finish as early as June 1991.

Of course there is still much to discuss. But our partners are concerned about when and how to achieve a single currency; no longer about whether to go there at all. At the end of the negotiations there will be no arm-twisting. The United Kingdom will not be dragged reluctantly down the route of monetary union against the wishes of its Government or Parliament. But neither will there be a British veto on others going ahead without us. It would be a tragic error to be under any such illusion, because of the short term vicissitudes that are always a feature of any international debate or negotiation.

British interests and British financial expertise need to be involved now to ensure that these historic questions are decided in the right way. For the European Monetary Union will only be created once. And just as in the 1950s, when we sat on the sidelines



and failed to influence the foundation of the European Community, if we do not exert that influence at the start we cannot expect a second chance. What possible gain can there be for our own economy in allowing a monetary system which might not fully reflect our interests to be set up now, to dominate our trade to the advantage of our competitors, and then to have to join it later on less satisfactory terms – an experience with which we are sadly familiar?

The questions raised by monetary issues in Europe are in some senses complex but in my view basically straightforward. But they are also of fundamental importance. If you share the view that money is a tool not a totem and that our objective must be to preserve and strengthen the wealth-producing ability of the British economy, then the case in favour of a European monetary union is clear.

The process of getting there over the months ahead will require imagination. But it also requires a hard-headed assessment of what is really the best way to forward British interests in Europe. You must make your voices heard in that debate. If you do I am confident that Britain will play a leading role in the development of the right sort of low inflation monetary union to the benefit of all Europe's citizens. And in a few years time a single currency for Europe will seem as self-evidently sensible as a single European market does today.