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Dear Prime Minister,

Following our discussions of EMU issues earlier this year you may perhaps be interested to see the attached article I have written on problems posed by convergence. This is likely to appear shortly in the British press.

Best wishes.

Yours,
Leon

Rt Hon John Major MP
Prime Minister
10 Downing Street
London

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COMING TOGETHER FOR A SINGLE CURRENCY

After a spectacular Italian opening in Rome last December the EMU show has retreated behind the closed doors of the inter-governmental conference procedure. Some time over the months ahead the curtain is due to rise on an agreed EMU Treaty setting out the structure of monetary union, and above all how we go from Stage 2 to Stage 3.

One of the major issues to be decided is how far the different Member States' economies have to come together for a single currency to make sense. How far do different inflation levels, interest rates, growth rates and public sector deficits risk holding back monetary union? Is convergence - the jargon term - a precondition for EMU or the result; the starting block or the finishing line?

Convergence is rather like money. Everyone wants more rather than less. But for discussion of convergence to be useful we need to be clear exactly what sort of convergence we are talking about, whether it is really important to our economies in a monetary union, and if so how much convergence we need to make a monetary union effective.

What exactly is it that should converge? The differences between economies divide into two areas. On the one hand there are different rates of inflation, interest rates, public sector deficits: the financial side of the economy. On the other side there are the economic differences in growth, unemployment, output and so on.

The two need not always go together. Thanks to respect of the disciplines of the EMS exchange rate mechanism Ireland and Germany - two very different economies - now both have low and stable inflation rates around 3%. The fact that German income per head is nearly 40% above Irish income per head has not prevented this financial convergence. Nor has this gap been seen as preventing more rapid, sustainable economic growth. Most people in Ireland, and in other countries too, see achieving that low and stable inflation rate as a precondition for such growth.

Is financial convergence important at all? Any government can implement a currency reform overnight, as we saw last year when the Deutschmark was extended into Eastern Germany. Equally, several countries can decide to move to a single currency with one central bank and money supply. But the effect could be rather like tying together two cars travelling at different speeds. At least one of the drivers will have to change gear pretty quickly to avoid a very bumpy ride.

If businesses in one country used to high inflation and interest rates wake up to find themselves in a monetary union with low inflation and stable prices, very rapid adjustment will be required. If the high inflation country goes on thinking that nothing has changed, the result will either be a major economic squeeze as its own industries become less competitive, leading to sharp increases in unemployment and falls in output, or great political pressure on the central bank to compromise its strict monetary policy to make the situation of the less competitive firms rather easier. Public spending levels which had been financed by inflation will also be

suddenly squeezed downwards. So there is at least a risk that the low inflation goals of a monetary union would come under great pressure, certainly if there was too big an initial difference in inflation between the major countries joining a single currency area.

If on the other hand different countries achieve broadly the same levels of inflation and interest rates before a single currency is introduced, then the shift to a single monetary policy should be as smooth as changing gear in a Rolls Royce or a Mercedes. How close the speeds need to be has to be a matter of judgement for the drivers. There can be no mathematically precise correct answer. But clearly those EC Member States which since about 1983 have treated the EMS 2¼% fluctuation bands as a real discipline on their monetary policies have already joined this limousine class by achieving a high degree of financial convergence between themselves.

Since Stage 2 of EMU is not due to begin until 1994 and the final move to Stage 3 may not be until after 1997 there is plenty of time for this financial convergence process to go further. Already five year UK government interest rates are only 1% above similar rates in France, 1½% above German levels and lower than in Italy. So the currency markets are giving a positive answer to the question of whether there will be more financial convergence within Europe. It is reasonable to expect that the ERM itself will further increase the degree of convergence between its member currencies well before Stage 3 begins - indeed that is one of the major objectives of Stage 1 of EMU which began last July.

But what would then happen once we were all inside a monetary union? On one level, financial convergence would be complete. Just as the same interest rates are available to investors throughout England and Scotland,

and there is one inflation rate, so throughout the Community there would a single unified structure of interest rates and inevitably, over time, of inflation rates. Present levels of interest rates in the UK would certainly come down as the uncertainty premium over the future behaviour of sterling disappears and rates converge towards a low inflation level. If one government or company was required to pay more to borrow funds, that would reflect market judgements on its credit, not views about whether its currency would rise or fall.

But what about the differences between rich and poor? How much economic convergence is needed before we can start a monetary union?

Since money is a tool of trade it forms part of every economy. Indeed, in some of the poorest countries in the world the dollar is the de facto currency because no other is accepted as a reliable medium of exchange. It is vital for poorer regions just like poorer countries to have access to a viable money, as a way of improving their own economic prospects. So not only is there no minimum prosperity level needed to join a currency zone; joining such a zone can help to achieve economic development. Differences in income are certainly no barrier at all to the introduction of a common currency.

While a monetary union does not affect the real economy one way or another as it comes into existence - countries remain just as rich or poor at the start of Stage 3 as they were at the end of Stage 2 - there are many who fear that over time a monetary union would mean an inevitable widening of regional economic disparities. And this is perhaps the crux of the argument. A monetary union may be good for London, Paris and Frankfurt. But what is in it for Cardiff, Newcastle or Barcelona?

A single currency benefits everyone by removing transaction costs and uncertainty for investors and businesses throughout the Community. Building on the capital liberalisation we have already achieved in Europe, this should benefit those less well off regions with lower costs by making their relative cost advantages more transparent and more certain. So a German or a Japanese investor thinking of building a factory in Wales will no longer have to build into his calculations the risk that a change in the sterling exchange rate over the life of an investment could reduce the value of its profits, and complicate sales into the rest of the EC internal market.

So long as there is effective free movement of capital, and poorer regions maintain a lower wage and cost structure, there is no need for a monetary union to mean a mass migration of Portuguese workers to Frankfurt or Stuttgart - the jobs will tend to move to the workers and their families rather than vice versa. Indeed, historically, labour mobility has proved a very inefficient form of economic adjustment. Schools, hospitals, housing and other forms of infrastructure cannot be moved along with the workers. The same result can be better achieved through capital mobility seeking out new investment opportunities in less developed regions.

Are there any automatic costs of convergence? The costs are the mirror image of the advantages. A poorer region with excessive labour costs will not be an attractive area for new investment. The moral is clear: don't oppose monetary union, but fight for the right of less prosperous regions of the Community to retain the advantages of a lower cost structure. This battle can most certainly be won, for the countries concerned are themselves increasingly seeing the importance of retaining these advantages.

The only certain drawback of a single currency in Europe will be to those regions which are not part of it. They will be competing against other locations which can offer that all important certainty of costs and prices to investors operating in the Community's single market. The investment successes of areas such as Wales, the north east of England, Silicon Glen in Scotland, have been won in part by the prospect of easy access to the Community's 340 million consumers. In the increasingly tough fight for new investment we in Britain cannot allow our European competitors to offer potential investors the advantage of a single currency zone across most of the internal market which we ourselves are not part of.

Returning to the economic fundamentals, a monetary union does mean giving up the ability to devalue as a shortterm way of seeking to improve competitiveness. But does devaluation work?

All the evidence suggests that it does not. Inflationary pressures are increased as the prices of imports rise. When inflation has got a grip once again the demand for a further dose of the devaluation drug becomes irresistible. And so the vicious cycle continues. This is exactly what happened in Britain for much of the post-war period. It led to Britain becoming the economic sick man of Europe, until the bankruptcy of this policy was accepted by all.

The simple fact is that in the UK devaluation has not worked as a way of purchasing improved competitiveness. Labour costs respond to higher prices, companies are encouraged to compete on price rather than quality and innovation; and the real problems of the economy get lost in a welter of short term crisis measures. The road to increased competitiveness is not easy without devaluation. But it is no coincidence that the most successful economies in Europe see currency stability not as a constraint but as a positive contribution to better economic performance. Giving up the devaluation option, for any country, is like giving up hard drugs. Extremely uncomfortable in the short term, but essential for long-term survival.

But convergence can also be used to mean the coming together of living standards throughout Europe. This is a legitimate and praiseworthy political objective. But it is logically unrelated to the type of convergence required for monetary union to work. Convergence of living standards is one objective of the Treaty of Rome - and the unanimous agreement of all Member States in 1988 to double the resources devoted to the European Community's structural funds showed the extent of the political commitment to help improve economic performance in weaker regions.

Does the move to EMU provide an argument for going further in this direction? If, as I have been arguing, a single currency will itself help and not hinder poorer regions, the answer must be a resounding No. The Commission has always made clear that there are no economic reasons why EMU should be accompanied by greater budget transfers. The case for a single currency stands or falls on its own merits. No Member State will be forced to join - but equally no one should expect to be bribed into joining.

Of course regional transfers between richer and poorer parts of each Member State will continue and it is right that they should do so. But that has nothing to do with EMU. For EMU is not about more spending, nor does it depend on the size of the EC budget. It is an opportunity for all of Europe's regions to gain greater benefits from the internal market programme of the last five years and in this way to increase the resources available for everyone.

So a single currency does require a substantial, though unquantifiable, degree of convergence of inflation and interest rates - but not of income levels - before it is introduced. That is achievable within the timescale proposed. Once introduced, a single currency can help to reduce divergence between the real economies of the different Member States. It does not offer any additional reason for increased subsidies from richer to poorer areas. The challenges posed by convergence should therefore present neither a political nor an economic obstacle to full British participation in EMU.

Leon Brittan