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Comments on Sir Edward George, "Comparing Financial Systems: How Much Convergence?"

Sir Edward George has given a very good summary of the role of the financial system. I would not disagree with anything he has said. Clearly, European Monetary Union (EMU) is one among a number of factors in determining the effectiveness of financial systems.

I would emphasize things somewhat differently, however. His comments on EMU were concerned primarily with positive aspects:

- first, with providing a more competitive market for financial services and,
- second, with increased efficiency due to the absence of exchange rate uncertainty.

An important issue obviously is what, if any, are the negative aspects of EMU?

As somebody who lives in the United States, one of the things that has surprised me most about EMU is the lack of an academic debate at a theoretical level on this issue. The decision to create a European monetary union is clearly one that is susceptible to economic analysis. The theoretical papers that are quoted are often from many years ago. Mundell (1961), for example, comes to mind.

So what are the potential negative aspects of EMU?

– Inflation is one issue that is often focused on. Given that the European Central Bank is modeled on the Bundesbank, I do not think that this is much of a concern.

– A more important issue is that of financial stability.

Today, I think, many regard the primary role of central banks as preventing inflation with a secondary emphasis on maintaining economic growth. This has not always been so. When the Bank of England was founded in 1694 its primary purpose was to raise money to fight the French. Some historians have argued that it was the superior financing ability of the British that allowed them to continually defeat the French throughout the 18th century despite the fact that the population of France was three times that of Britain.

By the 19th century the focus of central banks shifted more to financial stability and their role increasingly came to be to eliminate crises. The Bank of England was particularly important in this respect. The last

the Overend and Gurney crisis of 1866. Skilful manipulation of the discount rate allowed avoidance of many severe crises. For example, in May of 1873 there was a severe stock market crash in Vienna that triggered a major international crisis. It spread to many countries, but the U.K. avoided the worst of it. The techniques the Bank of England developed spread to other European countries, and crises became relatively rare in Europe.

The experience of the U.S. at this stage was quite different. In a report on the Second Bank of the United States, John Quincy Adams wrote: "Power for good is power for evil even in the hands of omnipotence." (Studenski and Krooss, 1963, p. 254). This quotation sums up the American distrust of centralized power of any kind. From 1836 until 1914 the U.S. did not have a central bank. It had many financial crises. On average, about every ten years there was a crisis.

In 1907 there was a particularly severe one that originated in the U.S. and then spread to many other countries. A French banker is reported to have commented: "The U.S. is a great financial nuisance." (Timberlake, 1978, p. 39).

The undertone is, of course, that "We sophisticated Europeans have solved the problem of crises. If only you unsophisticated Americans could get your act together we would all be much better off." The severity of the 1907 crisis reignited the debate on whether the U.S. should have a central bank. The outcome of this debate was the foundation of the Federal Reserve System (Fed).

The distrust of centralized power that John Quincy Adams' statement illustrates persisted and as a result the Federal Reserve System was very decentralized. This together with a

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Fed was unable to prevent the banking crises of the early 1930s. Many economists argue that it was the Fed's failure that led to the severity of the Great Depression. The Banking Crisis of 1933 resulted in a significant reform of the Federal Reserve System and power became much more centralized. Since then there have been no systemic crises in the U.S.

The U.S. experience with the Fed early in its history raises the important issue of whether the division of responsibility between the regulatory authorities, the national central banks and the European Central Bank is the correct one. I don't think we will be able to judge the success of EMU until this important aspect has been tested during a downturn. My own view is that a more centralized structure is desirable. The speed with which many crises develop is such that coordination between different entities becomes difficult. This could make dealing with the crisis problematic. Taking a long run perspective, the role of central banks in preventing crises is their most important job. It is, for example, much more important than whether the inflation rate is 1% or 3%.

The other major issue facing EMU that Sir Edward was only able to hint at is the question of whether the U.K. should join. My own view is that it should. I think the positive aspects of EMU that Sir Edward emphasized outweigh the negative aspects in the long run.

For the U.K. there is a particularly important additional factor. This is the contribution that the financial services industry and in particular the City of London makes to the U.K. economy. In the short run it is difficult to believe that London will cease to be a major financial center. In the long run, if the U.K. does not join EMU, it is quite possible. ❧

References

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