THE DAVID HUME INSTITUTE

A COOL LOOK AT THE EURO

Samuel Brittan

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FOREWORD

In the three chapters of this *Hume Occasional Paper*, Sir Samuel Brittan examines the prospects for European Monetary Union (EMU). In the first chapter, Sir Samuel places the EMU project in perspective, and produces a generally positive evaluation. The advantage of short-term exchange rate adjustments in dealing with shocks to the economy is questioned. In a similar fashion, the importance of the members of a monetary union converging in real terms is shown to be illusory. It is argued that flexibility in labour markets will assume a key importance—an area where Britain claims a lead in Europe.

Sir Samuel makes a particular point of highlighting the danger that europhobes can pose when they extend their arguments beyond merely keeping Britain out of EMU to trying to destabilise the entire project by attempts to destabilise the *Franc fort* policy in France. This is because a devaluation by the French is unlikely to be allowed to pass without some retaliation from the German government. But one is left with the impression that Sir Samuel expects no long delay in the launch of EMU—at least among a core of members.

In his second chapter, Sir Samuel examines a rather overlooked aspect of EMU, namely, what problems are likely to emerge in the early days of an operational EMU? While minimising discussion of technical detail, the belief that the system would quickly become destabilised by a movement into D marks is discussed. The key role of the European Central Bank is emphasised here.

Other "running in" considerations dealt with in this chapter include the difficulty of maintaining fiscal discipline among EMU members who might be experiencing a slump in business conditions. Here Sir Samuel recommends a generally tolerant attitude to large variations in the budget balance of individual countries over the business cycle. There is also a discussion in this chapter of the scapegoat effect whereby EMU will attract blame for any and all negative macroeconomic effects that befall member economies following the start of EMU, and may be used to underpin special pleading for fiscal transfers at the EU level. In terms of convergence, the main issue is seen to be one of establishing suitable final parity rates among EMU partners and, thereafter, establishing an appropriate rate at which the euro should trade relative to the rest of the world. It is this last to which Sir Samuel suggests more attention might be paid. The final message in this chapter is that there might be an advantage to giving some consideration to a fallback strategy to be

pursued by participants in the event that EMU founders. An analogy is drawn with the new policy framework for UK monetary policy that was quickly announced following withdrawal from the ERM in 1992.

In the third and final chapter in this collection, Sir Samuel offers some observations on the stance of Britain with respect to EMU entry. His view is that under Labour Britain would not be in the first wave of EMU entrants. On the other hand Sir Samuel suggests that Labour might be more "pre-in" than the Conservatives if short of the "pre-in" stance of some of EMU's more enthusiastic proponents among other EU states. In an insightful final comment, Sir Samuel suggests that one possible expediter of Britain's entry might be an increasingly strong pound.

Following its recent publication of an issue of *Hume Papers on Public Policy* edited by Professor Gavin McCrone entitled *European Monetary Union and Regional Development*, The David Hume Institute is happy to be able to publish a further contribution to discussion on this important policy issue. The David Hume Institute is particularly grateful to its president, Sir Samuel Brittan, for allowing us to publish his recent writings on EMU in this *Hume Occasional Paper*. As always, it is necessary to point out that the Institute itself holds no collective opinion on the issues raised here. But we feel sure that we can express our satisfaction at being able to publish this important and topical contribution to the public policy debate on European Monetary Union.

Hector L MacQueen and Brian G M Main
Directors
April 1997

INTRODUCTION

The papers reprinted here are not a complete survey of the issue of European Monetary Union. They are just a few thoughts about areas where discussion seems to me to have gone off the rails.

The first paper was originally given to a House of Lords Committee for whose co-operation I am grateful. It deals with some fundamentals. Readers new to the issues might prefer to start with the second and third chapters originally given to various national and international audiences. They deal with more immediate difficulties and are inevitably more likely to date. But they make an easier read.

I would vote "Yes" in a referendum on joining EMU. But the *economic* issue is less important than many think. If the labour markets of the participating countries became more "flexible" (code for lower labour costs) the euro will work fairly well. If they do not, it matters little what the currency regime is.

Samuel Brittan
March 1997

Chapter 1
EMU IN PERSPECTIVE

Background

The EMU question is one instance of the perennial argument over floating versus fixed exchange rates. This is an argument in which I have been associated with both sides. In the 1960s I was a strong proponent of devaluation, preferably to a floating exchange rate, for sterling. In the 1980s I became a convinced advocate of Britain accepting an exchange rate peg via the European Monetary System. Thus some people have come almost to associate me with the exchange rate question.

In fact it has never been my main interest, even inside economics. In the 1960s, when I was still a pretty unreconstructed Keynesian, I did think that throwing off the exchange rate constraint would enable the UK to achieve faster growth. In the 1980s, when I no longer believed that we could spend ourselves into target rates of employment and activity, I regarded the exchange rate question as a second order one: in other words it was a question of the best framework for monetary stability without profound implications for the real economy.

But my attitude on the two occasions did have a feature in common, which lay quite outside political economy. This was my ingrained hostility to one human being trying to impose his or her views by fiat over others. It is particularly strong when that power is exercised by a British Prime Minister, who is sycophantically obeyed by most of the Whitehall machine and who does not have to overcome, as in other countries, alternative contending sources of power.

In the mid-1960s, Harold Wilson tried to use his office to make all discussion of devaluation unmentionable. Indeed he made the sterling parity his flagship and his test of loyalty. In the 1980s, Margaret Thatcher tried to do the same thing with all mention of the opposite course of abandoning the floating exchange rate and moving into the ERM. She was determined to have her way at all costs and only gave in when the best time to enter had long passed,

but she felt cornered politically. It was the obstinate authoritarianism from Number 10 which I could not stomach on either occasion, and which does not seem any more attractive in retrospect.

A lack of frankness

It so happens that I am mildly in favour both of EMU as a project and of British membership. But I do not support it with anything like the fervour that many of the opponents oppose it. This is not just a personal matter. The most sensible economic supporters of EMU believe it might do a moderate amount of good eventually, but they do not suppose that it will have a decisive effect on the European unemployment problem or any of our other main concerns. On the other hand—leaving aside those who agonise most about national sovereignty—the purely economic opponents of EMU sincerely worry that it will check economic growth, worsen unemployment and be a force for social disharmony in many countries including Britain.

The most important single thing to say about EMU is that its motivation is primarily political. It would be absurd to suppose that the German Chancellor, Helmut Kohl, has spent many hours weighing up the benefits or a single currency against the costs of abandoning the exchange rate weapon. His motive is to bind Germany more closely to its European neighbours and in particular to France.

There is nothing wrong with that motive. What however has been misguided has been the attempt to use EMU, like other technical arrangements, as an indirect step to political union. Kohl is not guilty here, as he is crystal clear about his motives. But I have the impression that some enthusiasts for European Union thought that governments would sign up to a single currency in the belief that it was something technical that they did not understand and then find themselves part of a larger political unit.

This game well and truly ended with the anti-Maastricht vote in the first Danish referendum of 1992 and the wafer-thin majority for Maastricht in the French vote of that year. If anything, public debate now attributes more political content to Monetary Union than it is likely to have.

This lack of frankness about EMU is part of a larger attempt by many politicians to deceive the public and sometimes themselves about the wider implications first of the European Community and more recently of the European Union. The original Rome Treaty of 1957, and the Coal and Steel Community which went before it, were quite conscious attempts to link the states of Western Europe, and particularly France and Germany, so closely together that war between them would be unthinkable. The Macmillan memoirs and many other documents make clear that the British government's objective in seeking membership in the 1960s was primarily political. Macmillan's fear, in particular, was the historical one of Britain being isolated against a combined continental bloc. The French motive was and is to harness German energies to a greater European design. The motives of the German political classes have been the mirror image of this: to achieve respectability by establishing a "European Germany" rather than a "German Europe".

The Rome Treaty already spoke of the goal of "an ever-closer union". And there were even tentative references to monetary union. The first project for European Monetary Union was the Werner Plan of 1970, which came to grief with the oil price explosion at the time of the Yom Kippur war of 1973. But the idea lived on in embryonic form in the European Monetary System, even though the latter became in practice a D mark zone; and there was a more explicit commitment to Monetary Union in the Single Market Treaty of 1985, which the British government chose to pretend did not exist.

A little while ago the political goals could have been dismissed as obsolete. No-one believes that another Franco-German war threatens mankind. With the fall of the Iron Curtain, the threat from the eastern half of the continent also seemed to have vanished. We cannot be as sanguine today. The war in former Yugoslavia brought armed hostilities to within 100 miles of the border of Italy, a founding member of the Community. The Albanian crisis brought it closer still. Nor can anyone, looking at political developments in Russia, be sure that there will never again be a threat from that country.

One can hardly claim that EMU is the most important need from a wider foreign policy point of view. Far more important here is the enlargement of the European Union to include some of the former

Communist countries. Even among existing members the development or a more impressive common approach to foreign policy and defence, by whatever method, would achieve more than a single currency on its own.

Where these sceptics go wrong is to suppose that EMU is incompatible either with enlargement or with the development of a common foreign or defence policy. Any general knows that you can advance on more than one front at the same time. If five, six or seven countries embark on EMU in 1999 or 2000 why on earth should this stop the Visigrad countries from participating in the wider union? A community of 30 countries is bound to go forward at different speeds and with different degrees of integration. We shall just have to live with this prospect—although I will offer a prize to anyone who can think of a name less hideous than "variable geometry".

Value of the exchange rate weapon

By far the most important economic argument against Monetary Union is that its existence deprives member countries of the use of the exchange rate weapon. If countries are not allowed to devalue, it is said, the alternative is likely to be stagnation, unemployment and even depression.

The response to this argument depends critically on whether or not one believes that there is a long term trade-off between unemployment and inflation. For devaluation is only a backdoor way of reducing a country's prices and costs relative to its trading partners. The front door method of reducing domestic inflation would have the same effect in increasing the competitiveness of a country or region that is finding difficulty in paying its way in the world.

The traditional belief was encapsulated in the Phillips Curve. This said that if a country wanted low inflation a price had to be paid in higher unemployment. If it wanted low unemployment, a price had to be paid in higher inflation. This view should not be caricatured. It could not be rebutted simply by saying that Latin American countries with double or treble digit inflation have no better an employment performance than Germany or Japan. Inflation could be high, it was said, for historical, institutional or structural reasons and

could not be reduced without moving to permanently higher unemployment. In other words each country might have its own distinct Phillips Curve.[1] Some such assumption must be behind Peter Jay's advocacy of the smallest feasible size for a currency area.

His criterion for the smallest feasible currency area is one in which pay and prices are fixed "without automatic or continuous comparison back to external reference standards". This may not be as small an area as he supposes. It is difficult to imagine that pay and prices in an independent Scotland would be set without reference to England. (The issue is open to empirical investigation, for instance by examining Latin American countries with diverse currency regimes.)

The Jay case is at its strongest if bouts of uncompetitiveness last only a few years and alternate with periods of over-competitiveness when market forces drive the currency up. It is then possible for countries to have at times real interest rates lower than the going international rate because of market expectations that the exchange rate will recover.

The Jay case is at its weakest when the competitiveness trend (at given exchange rates) is downwards because of domestic inflation. Then wage bargainers add on an implicit devaluation premium to the settlements they make. The USA South might have been given a kick-start if it could have devalued after the Civil War, as might the Mezzogiorno in Italy after unification in 1859. But it is difficult to believe that a century-long depreciation of their currencies would have made much difference to real wages or employment in either the American or the Italian south.

It is a serious question whether nominal rigidities are just facts of life or whether they depend on the exchange rate regime in operation. Are not they made much worse when everyone knows that the government can always devalue? The slide of Sterling from DM 12 in the early 1950s to DM 2-3 is surely relevant.

The Phillips Curve approach has been superseded by the view that there is no long term trade-off between unemployment and inflation. (There might even be a trade-off the other way, but there is no need to go into this controversial territory.) The revisionist case was

formulated in the doctrine of the Natural Rate of Unemployment. A better but clumsier name is the Non-Accelerating Inflation Rate of Unemployment (NAIRU). This second name emphasised that there was nothing natural or incurable about high unemployment, but that it could not be tackled by governments trying to spend their way into target rates of employment or growth.

There are, as always, some sceptics. But I must for the purpose of this paper treat the near vertical long run Phillips Curve as established. The problem with the old style Phillips Curve is that it assumed that workers and employers could be indefinitely fooled by inflation into accepting lower pay and prices than the state of the market really allowed. It came to grief in the simultaneous explosion of inflation and unemployment in the 1970s.[2]

Most mainstream economists believe—and I would not dispute it—that there is still a short-term Phillips trade-off. That is, a temporary unemployment cost in reducing the rate of inflation, which may be quite severe. It would, thus be mad to enter a currency area at a conversion rate which rendered whole swathes of national industry uncompetitive, as was the case with east Germany in 1990 and to a lesser extent with Britain when it rejoined the gold standard at the pre-war parity after both the Napoleonic and the First World Wars. But the recessionary cost does not persist once lower inflation is attained and expected.

If this were all to the argument, the costs of joining EMU would be basically transitional ones for countries running relatively high inflation rates. There would be no reason why low inflation states, such as France, Benelux, Austria and Sweden, as well as the UK, should not join with Germany in establishing EMU tomorrow.

It is, therefore, tempting to argue that EMU and its logical culmination of a single currency do no harm provided that the member countries have converged to common low inflation rates. But will it bring any benefit?

On the face of it, money is a public good and the wider the area in which it circulates and in which people can be spared the costs and uncertainties of conversion to other currencies the better. (Money, it is said, confers "network externalities", the size of which depends on

how many people use it.) But a problem that EMU supporters have is the lack of feel of economists, or anyone else, for the size of the advantages from using one money. The half per cent savings in transaction costs estimated by the Brussels Commission is not on a scale sufficient to justify a large venture into the political and economic unknown. In any case, a large portion of these gains could ultimately be reaped by improvements in the bank transmission mechanism. The main gains would come from escaping the volatility and unpredictability of separate national exchange rates.

What, then, is the drawback? Is it, as opponents say, that of giving up the exchange rate weapon? I have already noted that a long-term, continuing currency depreciation is associated with a more rapid inflation in the prices of traded products than that experienced by partner countries; and I have already argued that this brings no advantages. The economic argument of the Eurosceptics must then boil down to saying that there are advantages in *temporary* periods of depreciation and appreciation. A purely temporary depreciation, later offset by temporary appreciation, need not do much damage to the financial stability of the UK or even an independent Scotland. It is then, indeed, possible for such countries to have real interest rates temporarily different from the going international rate, because of market expectations that the exchange rate will recover.

An Optimal Currency Area can be defined as one where the advantages of single currency just outweigh the disadvantages of not being able to make temporary adjustments in exchange rates, and of not being able to engage in a monetary policy which is *temporarily* different from the international norm. The case for a single currency is supposed to be strongest when prices and wages are flexible, when there is a high degree of openness to trade and, if possible, some mobility of labour.

Most examinations, according to such yardsticks, show an inner core of France, Germany, the Benelux countries and Austria, which enjoy a degree of integration comparable to that of the USA and a periphery of countries, such as Finland and Greece, which move in a very different way. In between come countries, such as Italy, Spain and the UK.

In practice, the biggest costs of a large currency area come not from differences in trading structure but from the occurrence of *asymmetric shocks*. These are events like German unification, oil price explosions or the discovery of North Sea oil, which have a different impact on the various members of the European Union. (German unification was financed by an increase in the German budget deficit and offset by a tightening of monetary policy, which was not required in neighbouring countries.) Also important are differences in financial structure which affect the transmission mechanism of monetary policy. The impact of interest rate variations differs between countries such as the UK, where home borrowing is typically made at short-term variable rates, and continental countries, where most of such borrowing is on a medium or long-term basis.

Absence of fiscal federalism

Arguments about differential shocks are often coupled with references to the absence of a large EU budget, comparable to the USA Federal Budget, to act as a shock absorber. Suppose that there is a fall in the price of oil in the USA. The shock to Texas is partly absorbed by a reduction of tax payments to Washington and partly by an increase of federal transfers to that state. It used to be said that some 40 per cent of the income loss was absorbed in this way. More recent estimates have put the proportion at more like 20 or even 14 per cent (Daniel Gros (1996). In any case such automatic cushioning will never occur with an EU budget of only one per cent of the area's GDP.

I suspect however that the actual sums involved in USA federal cushioning are much less than often supposed. There is a confusion between transfers from rich to poor states and differential payments to states—rich or poor—which are hit by localised shocks. Such payments are likely to be quite modest in relation to overall GDP both in the USA and in the EU.

In many years EU states will have much the same conjunctural experience and there will be no case for transfers. Moreover a country that is on the receiving end in one year is likely to be a net payer another year. (If it is not, then it is not receiving a cushion but extracting a permanent subsidy.) All that is required on an EU basis is an insurance arrangement for temporary net transfers

automatically related to differential changes in unemployment of GDP. Some prototype insurance schemes involve payment of a fraction of one per cent of GDP. (See, for instance, Christopher Taylor (1995), pp.63-4.)

Purists will say that sums of this magnitude could be raised readily by the countries affected on the capital markets (thus justifying a temporary abrogation of the deficit criteria). But a formal insurance arrangement would be a small price to pay to meet a debating objection which turns up not only in the political context but in almost every economic gathering.

Real convergence: a red herring

Another set of debating points relate to so-called real convergence. The Maastricht criteria cover nominal indicators such as inflation rates, interest rates, exchange rates and budget deficits. Sceptics argue that this is not enough and that they should also cover real performance in matters such as output, employment and productivity. This line of argument surfaces from time to time from the Labour Party. John Major uses it; and even Kenneth Clarke, who is sympathetic to EMU, has paid lip service to it. But its most articulate proponent has been the Governor of the Bank of England, Eddie George (eg, *Churchill Memorial Lecture*, Feb, 1995).

But however eminent the proponent, the argument remains a howler. Areas with very different output levels, growth rates, real wages and unemployment rates have long benefited from trading with each other, both at flexible and at fixed exchange rates and within and across national frontiers. The expression "level playing field" may be a natural cliché for a British spokesman, but it is in danger of ruling out all the conditions under which international, or even inter-regional, trade is possible. Fortunately there is not the slightest chance of revising the Maastricht Treaty to add such "real criteria".

For what it is worth, the financial firm of Goldman Sachs set out in its April 1995 Economics Analyst four possible real convergence criteria, including a growth rate within one per cent of the EU average, unemployment no more than two per cent above it, a current account deficit no greater than two per cent of GDP, and

trade competitiveness against Germany within 10 per cent of the 1987 level.

Not surprisingly, it found that the countries nearest to qualifying on the nominal Maastricht criteria qualified on most of the real criteria as well. Only Finland and Ireland looked as if they might meet the nominal but not the real ones because of high unemployment. Countries which were on the borderline on one set were on the borderline on the other.

There is indeed something very peculiar about British demands for convergence of unemployment rates. The old argument, formerly very popular on the left, was that Britain would be unable to use devaluation to mitigate its unemployment problems in a Monetary Union. Now that British labour markets are more flexible and unemployment is well below the EU average, the argument has been stood on its head. Britain, it is implied, should hesitate to join EMU because of inflexible labour markets in other countries. But if anything Britain gains relative to its partners from labour markets that can adapt more quickly to real and monetary shocks.

Transfers to poor countries

Another dubious anti-EMU argument relates to the picture of huge transfers to poor or high unemployment countries which an EMU is supposed to make necessary. Transfers to poorer regions may be a good or bad idea. Attitudes will depend on the extent of pan-European solidarity and on the quality of the likely transfers. The experience of regional policies within EU countries is not too encouraging, *vide* the "cathedrals in the desert", as some of the heavy industry ventures in southern Italy have been called.

Extra regional transfers are no part of Maastricht and would have to be agreed separately and unanimously by governments. The point at issue is: will Monetary Union increase the pressure for such transfers by further depressing the relative position of areas such as Spain, Portugal or southern Italy? (I assume that Greece will not meet the membership criteria for the foreseeable future).

There is a school of thought that holds that increased economic integration will benefit the prosperous core areas at the expense of

the weaker peripheral ones. This argument relates, when examined, to the establishment of the Single Market itself. It is for such reasons that increased "Structural Funds" within the EU were approved by a summit attended by Lady Thatcher. Such transfers can easily get out of hand, but this is a battle that will have to be fought in any case, EMU or no EMU.

Why should the institution of a single currency add to the pressures on the weaker countries, assuming that they have come in at a realistic exchange rate and with low inflation, and have converged, with the core members as laid down in the Maastricht treaty? If anything, the ending of the downward exchange risk may be an encouragement to investment in such countries, as Gavin McCrone points out in his recent Hume Paper.

Should the Mediterranean countries receive extra transfers simply because of the loss of the right to devalue? Devaluation does not bring a single euro of extra resources; so there is no obvious loss requiring compensation. It is far from obvious that the "losses" from being deprived of the right to devalue are greater for the poorer or peripheral countries than for others, once the former have well and truly met the convergence conditions. Countries that want to join the Monetary Union must consider the advantages of lower transactions costs, the ending of exchange rate uncertainty and the added counter-inflationary credibility greater than any disadvantage from not being able to follow an "independent" monetary and exchange rate policy. Otherwise why should they wish to join?

The fear seems to be that peripheral countries with excessive underlying rates of inflation will somehow get into EMU by stretching the Maastricht criteria or by some form of political deal. The implication is that the German government, for instance, will agree to stretching the rules to allow in countries which are in no fit condition to participate; and, having done so, vote them huge sums at the expense of the German taxpayer.

This is difficult to credit from everything that is known of German public and political opinion. In any case the way to meet this fear is by strict insistence on the spirit of the Maastricht criteria, which is quite compatible with flexibility in their year to year interpretation.

Inflation policy decisive

If it were only a matter of balancing the gains from using one money against the costs of losing some temporary flexibility in national policy it would be tempting to conclude that it is a question of half-a-dozen of one and six of the other. To my mind, the decisive consideration for countries like Britain and France, which have lacked a tradition of stable prices, lie in the potential benefits of EMU for counter-inflation in the longer term. In principle, they could be gained by pegging sterling (or the French franc) to the mark. But after everything that has happened a mere exchange rate peg would lack credibility when the going became hard, and would be highly vulnerable to speculative attack. If one is looking for an anchor for price stability, the best bet is a European currency based on a European central bank modelled on the Bundesbank and constitutionally insulated from national pressures.

The losses from giving up the national exchange rate weapon should be assessed not against some ideal vision of how a floating currency ought to behave, but on actual market experience. From the time Italy was forced out of the ERM in 1992 to the end of 1995, the lira depreciated by about 35 per cent against the mark, far more than any deterioration in relative cost levels. And it was little over a decade ago that the dollar first doubled and then halved against the German currency. This is not to speak of the over-shooting of the yen from which the Japanese economy took so long to recover. Of course, a European currency would not insulate member countries from world gyrations, but it would create an area of stability comprising well over half their trade.

Outside EMU, it would be all too easy for one temporary depreciation to be succeeded by another and become part of a long-term downward drift in sterling. Such a drift would be associated with faster inflation and would not, after the transition was over, promote growth or jobs. An independent national policy would then simply permit a higher rate of inflation, which it is hardly worth fighting to preserve. (I have tried to illustrate the difference between these two kinds of exchange rate fluctuation in Brittan (1995, pp.172–5 1995).

Milton Friedman once compared the case for floating exchange rates with the case for daylight saving time in summer. The argument is that it is more convenient than asking everyone to get up an hour earlier. But the same argument tells against the wrong sort of depreciating exchange rate—which would be like a continuing adjustment of the clock in one direction without any reversal at the onset of winter. This would surely be seen through and lead more and more people to disregard the official time in favour of making their own arrangements for rising and retiring.

In the British case, independent national monetary policy has brought faster rates of inflation than in partner countries without any benefits to employment. The experience of the period since departing from the ERM in September 1992 was the exception that proves the rule. The UK was able to devalue without the usual knock-on effect on inflation because of the depth of the recession at the time when the country left the ERM. It is too short and untypical period on which to base a refutation of long-established experience.

The right balance is struck in my view by Christopher Taylor. He is impressed by the fragility of the purely domestic post-1992 UK framework for holding inflation down. This "depends heavily on the will and priorities of the government of the day as well as on the personalities of the Chancellor and the Bank Governor ... The new policy approach has not yet been put to a severe test." These points are made with the tact appropriate to a former Bank of England adviser. I would buy these arguments even though they do not make as much noise as the dire warnings of EMU's opponents.

Interest rate differentials

The lack of credibility attaching to sterling outside the EMU is not a matter of conjecture. It is already being paid for in the pattern of interest rates. UK rates have been higher than those of any of the Group of Five leading industrial countries for all maturities and about one and a half percentage points above Germany's for long-term bonds at the time of going to press.

The UK premium at the very least shows that sterling's trend against the mark (and its euro successor) is expected to be downwards. In view of the high level of the mark relative to German costs, the

differential is more likely to reflect inflation-related fears than a belief in a further real devaluation of sterling relative to the mark.

Some of the other differentials are also enlightening, particularly the one to two percentage points by which German bond yields at times exceed Swiss ones. This is often said to reflect the fears, especially of German investors, that the euro will not be as good as the mark and the consequent desire to find a refuge in Switzerland. Thus, Germany has higher rates than Switzerland because of the suspicion of the euro; and the UK has higher rates still because of a fear that sterling will not even be as good as the still-to-be-proven euro.

What is in it for Germany?

The monetary stability arguments I have given apply to more inflation-prone potential members of EMU. But EMU will not happen without Germany. Until recently Germany's likely gain from EMU was purely political. Nobody expected the "euro" to be more stable than the mark; a risk was being run for a broader European objective. Now, however, an economic case is emerging for German participation. This results from the perceived uncompetitiveness of the German traded goods sector both in Europe and in the wider world.

Eurosceptics might answer that in that case the Bundesbank should simply loosen monetary policy enough to cause the mark to depreciate. Bernard Connolly (1995) makes the interesting point that there is nothing wrong with competitive devaluation, as it simply causes countries to loosen monetary policy in the face of a deflationary threat. This might be true in a 1930s type depression. But in today's conditions unco-ordinated national policies aimed at depreciation might well create too much money worldwide and renew the inflationary danger.

Moreover, it is unlikely that retaliatory actions, taken by countries who fear that their competitors are undercutting them unfairly by currency depreciation, would stop on the monetary side. Currency wars have usually been an aspect of trade wars, in which restrictions on trade and capital movements have been imposed through the front door or back entrances.

If German industry fears competitive depreciation its safest course would be to join the largest attainable "zone of monetary stability". Italy and Spain are unlikely to meet the fundamental stability conditions by 1999. But if EMU is postponed too long, the momentum could be lost to such a degree that there would be nothing for them to join later.

The UK outside EMU

Quite a lot of admittedly inconclusive academic work has been done on the consequences of establishing EMU and even on the countries most likely to benefit from joining. But almost nothing has been done on the consequences for the countries which stay outside if EMU goes ahead. Nor is it easy to see how one could do research into the question.

It would be quite wrong to try to make people's flesh creep with the consequences of being left outside. Before the event there were numerous prophecies of the doom that would result if countries moved onto floating exchange rates. Yet after the collapse of Bretton Woods in 1973 world trade continued to flourish and a truly international system of finance and investment was established for the first time since World War One. Admittedly growth in the western industrial countries slowed down and unemployment exploded. But it would be hazardous to attribute these adverse developments to the end of Bretton Woods. It is more likely that the same underlying forces which destroyed Bretton Woods also destroyed the painless approach to full employment which prevailed after World War Two.

But without being alarmist, some dangers can be spotted. It is difficult to believe that the existence of a single money in a core region—where guesses do not have to be made about exchange rates nor complicated hedging arrangements entered into—will not affect some location decisions at the margin. The division between EMU and non-EMU members is likely to mark a wider division between core and peripheral EU countries; and the core is likely to attract some business which might otherwise have come to the periphery.

It is often pointed out that the members of the North Atlantic Free Trade Area do not envisage any currency link and that the most

successful Far Eastern economic "tigers" do not belong to any currency bloc. But these facts can be interpreted in different ways. A Japanese investor in the Far East or North America does not have the option of investing in a single currency area (apart of course from the United States). But he will have the choice of serving European markets from outside or inside such a bloc. It would be foolhardy to suppose that the English language and the presence of numerous golf courses will always be decisive for Japanese inward investment.

The effect on the City of London's business is one of the biggest unknowns. It does not help very much to ask one's City friends, as the response they give is usually predictable from their political and economic attitudes. The most detailed analysis I have seen is by Christopher Taylor (1995). He makes a distinction between relatively short term institutions such as banks and security houses and long term ones such as insurance companies and pension funds. The latter would be likely to gain from EMU membership because the international integration of capital markets would be boosted if exchange rate risks were eliminated. The pressures on pension funds and insurance companies to match assets and liabilities in particular countries would diminish and continental investors might feel less inhibited about taking advantage of British expertise.

On the other hand the case may be less strong and perhaps negative for short term institutions, such as foreign exchange dealers and those dealing in futures and options. It is however unlikely that large financial institutions such as banks would move to Frankfurt just to be near the European Central Bank (ECB). They do not move to Washington to hear the thoughts of chairman Greenspan, who has been known to travel in other parts of the USA. It has already been made clear that although there will be a single monetary policy the ECB's money market operations will be decentralised through the national central banks.

Exchange rate arrangements between core and periphery

It is a myth to suppose that there is some wonderful new exchange rate arrangement between EMU and non-EMU members waiting to be found. The options are very few and are very well known. Those who propose high level international study of the subject are open to the suspicion of a desire to delay the start of EMU.

A clear distinction should be made between countries that eventually aspire to join EMU but who do not yet fulfil the criteria, and countries that already qualify, but have decided to opt out.

Aspirant members will naturally want to minimise exchange rate fluctuations against the euro, especially downward ones. They will be expected to formalise these arrangements in something like an Exchange Rate Mechanism. But they cannot expect, so long as they are outside, unlimited help if there is a run on their currency. Some of the most advanced of the aspirant members might be able to fix their currencies *de facto* against the euro, as Austria and Belgium already do against the mark. Daniel Gros (1996) has suggested recognising the achievements of such countries by giving them associate status in which they will be able to participate in all EMU activities but not have any vote in the decisions which are made.

For countries that have opted out of membership in principle, there seems little point in going for ERM status. For this would bring all the constraints of a currency link without any say in how the arrangement is to be run. And as there would be no currency merger, there could always be a confidence crisis of the kind Britain experienced in 1992 and France in 1993.

It would, however be a legitimate option to "shadow" the euro. By this I mean that the Bank of England would run a monetary policy designed to prevent any massive depreciation or appreciation against the European unit. In any case the idea that the behaviour of sterling could be ignored either by an ultra-free market government or one of the ultra-left is just a pipe dream. The trend of sterling is a partial indication of how inflationary pressures are moving in Britain, relative to those elsewhere. And governments will not be able to prevent their economic advisers from taking a squint at the sterling charts, whether they admit it or not.

In addition, the movement of sterling is one of the transmission channels by which an inflationary or deflationary domestic monetary policy affects the British price level. Some of us may have exaggerated the strength of these linkages in the short term in a depressed economy. But the depreciation of sterling in 1992-95 went as far as it could without inflationary implications; and if very low

inflation is really here to stay much of the more recent recovery in the pound must be accepted

This however is crystal gazing. *What can be said much more firmly is that any impression of deliberately engineering a sterling depreciation to steal a competitive march on European partners must be avoided like the plague*. For if this were suspected there really would be a threat of discrimination against British goods and therefore a threat to the Single Market.

Admittedly a sovereign country must have the right to relax its monetary policy and take an inflationary risk if it so wishes. The distinction is between a general relaxation all round, which aims to stimulate home consumer and investment demand and which may also stimulate exports along with imports, and a deliberate beggar-my-neighbour policy aimed primarily at increasing British export penetration. The distinction might not be easy to make in mutual surveillance exercises. But there would not be much inclination to give the UK the benefit of the doubt, if it also exhibited a generalised hostility to the EMU and other EU institutions.

Fiscal criteria

As every schoolboy knows, the main economic problem facing the establishment of EMU in 1999 lies in the fiscal criteria. According to the Maastricht Treat (Article 104C) two criteria have to be fulfilled:

- the government deficit to GDP ratio must either be close to the reference value (established in a protocol as three per cent) or the excess must be "only exceptional and temporary" and still "close to the reference value".
- The debt to GDP ratio must not exceed a reference value (60 per cent); or if it does must be diminishing towards it at a satisfactory pace.

Strictly speaking, a Monetary Union does not need fiscal criteria. The no bail-out rule and the desire of governments to avoid a risk premium on their bonds should be sufficient to avoid excessive deficits. The world's most successful monetary union was known as the gold standard and had no fiscal criteria or common institutions

whatever. Indeed gold standard countries were sometimes at war with each other. It must be admitted however that nineteenth century governments believed in the balanced budget, as they did in gold, as an unquestioned dogma, whereas today they have to discover the cost of fiscal excess from hard experience. Maybe, without some treaty commitments, fiscal policy would be too loose and would put too heavy a burden on interest rates, as occurred in the UK in the early 1980s.

There is however no need to adjudicate. Fiscal criteria are the German price for EMU. The justification goes beyond monetary technicalities. Without fiscal criteria, some countries, especially in southern Europe, may be tempted to run deficits, which they will, however wrongly, blame on EMU, and in practice expect Germany to finance.

The criteria have been much criticised by economists, some of whom seek unobtainable perfection. The second debt ratio criterion is indeed a mess. Most EU countries have debt ratios above 60 per cent. But as Daniel Gros (1996) points out, if members concentrate on reducing their budget deficit below three per cent—which will have favourable effects on confidence and nominal interest rates—there will be an automatic reduction of debt ratios. The main requirement is some formula to indicate the minimum normal speed of reduction.

Thus in practice the first criterion, the budget deficit ratio, is the crucial one. As is all too well known, not only is France having to struggle to reach that level by 1997 (after which a decision on membership will be made) but even Germany exceeded the target deficit in 1995 and 1996. Everything depends in practice on the meanings attached to "exceptional and temporary" and how close to the reference value of three per cent is "close".

The main criticism of economists of the deficit limit ratio is that it does not explicitly allow for the business cycle. It would indeed be absurd to go ahead with EMU if France and Germany can achieve deficit ratios of 2.9 per cent, but postpone the project if, because of a disappointing cyclical upturn, they come to 3.1 per cent. Even hardline German officials are aware of the business cycle. But they are understandably afraid that if they start talking about flexibility now that this could lead to the complete erosion of the criteria. They

are also suspicious of the realism of the cyclical adjustments to deficit figures and believe that most European unemployment is structural. In fact German attention has now moved to the post-entry Stability Pact to ensure that fiscal stability is not forgotten once EMU has come into force.

It should surely be possible to do a deal by which the normal aim is a Budget deficit of well below three per cent of GDP, but more explicit allowance is made for the cyclical factor. (The British Treasury estimates that the swing from recession to boom can cause a swing of up to five percentage points in the deficit ratio.)

German officials are well aware that a judgment will be required on whether an apparently excess deficit needs censure or might be justified by exceptional economic circumstances or by remedial measures that have been put in train. The supranational element will come through majority voting by European finance ministers.

Would a postponement help?

It is sensible to expect the core EMU countries to tackle the structural elements, such as the social security imbalances, in their budgets. But it would be folly to expect them to go all out for a headline budget figure of three per cent if slack business conditions persist. My own advice to European governments would be to concentrate on the stability pact and really mean it rather than endanger recovery by making short-term cuts in the face of depressed business conditions.

A postponement of the January 1999 deadlines is highly probable for technical reasons alone. This is not important so long as it is of, say months rather than several years. For example, EU government heads may need to wait longer than the beginning of 1998 for worthwhile figures on which to rationalise a decision on which countries qualify for EMU. Moreover there will have to be a trial run of machinery such as the interbank settlement system on which snags are possible the first time round. The European Monetary System did not start at the beginning of 1979 as planned, but was delayed into the spring of that year. A longer postponement would be a much bigger blow. Momentum would be lost, recriminations would occur and—most important—the political leaders most keen on the project will have departed from the scene.

The danger from the europhobes

Those opponents of EMU who merely wish Britain to stay outside may be misguided but do little harm in the wider world. They become however, a positive menace when they try to put a spanner in the whole project. Some of them are trying to do so by undermining the *franc fort* policy in France. They assert that if only the French Government would stop shadowing the D mark and encourage a depreciation of the French franc, the country would experience an economic renaissance which might spread to the rest of Europe.

This is wishful thinking. For it presupposes that the French franc is overvalued against the mark, for which there is little real evidence. French inflation has been below German for much of the 1990s. More recently the inflation rates in the two countries have been fluctuating around a common rate of 1½ to 2 per cent.

France has been running a current payments surplus for several years, while reunited Germany has been running a moderate deficit. Much more important: French unit labour costs have increased by less than German unit costs over the last 10 years. The small remaining interest rate premium on the franc reflects not the realities of recent cost performance, but a fear that a French government will be panicked into a "dash for growth" of a kind which really would put the French back into the high inflation league.

If, as a result of the Paris Government accepting eurosceptic advice, the German currency also became heavily overvalued in relation to France and its other northern European trading partners, something would be liable to snap. For it would then be extremely difficult for a German government to hold the line against demands for retaliation or countervailing action of some kind. So far from having a White Wednesday France would find itself threatened with retaliation; and it is doubtful whether it would be allowed to get away with an uncontrolled downward float of the franc.

Conclusion

The most tempting conclusion is that EMU could go ahead as near to 1999 as possible, but that Britain should not join immediately. The

reason why this is tempting is the climate of extreme hostility to all European financial arrangements, not merely among the tabloids but among vociferous English language analysts and journalists in the City of London and other financial centres—not to speak of Backbench MPs. The first law of economics is known as Murphy's Law and says that if anything can go wrong it will. So it is likely that all the troubles and disappointments which are probable early in the next century (as in every other period) will be blamed on EMU and an extremely nasty atmosphere kindled by the xenophobes whom we always have with us.

The temptation is therefore to say: let EMU start and let Britain apply to join a few years later, as it has done with almost every other European venture. But it would be cowardly for me to cast my vote—if I am to have one—for such a course, both because I think that EMU would bring modest benefits and even more because of the antics of the more vociferous eurosceptics which do not deserve to prevail.

Chapter 2
PITFALLS IN THE EMU ROAD

Keep any delay short

If European Monetary Union is to be successfully launched, even among a small group of countries, it is important that the deadline of January 1999 is not missed by too long a period.

A short postponement is a different matter. Indeed it is likely for technical reasons alone (see previous chapter, page 22).

Indeed it will not be important if EMU is delayed for several months. But several years would be a very different proposition. Momentum would be lost, recriminations would occur and—most important of all—the political leaders most keen on the project would have departed from the scene. There are also some of us who would find a continuation of present arguments about the desirability of a single currency pretty unbearable.

The running-in period

I am not going to discuss the many technical problems involved in replacing several existing currencies by a new one, where the conversion ratios are extremely awkward to handle. But I must say something on one aspect.

The transition of up to three and a half years between the planned start of Monetary Union and the substitution of a single currency for national ones will be the most critical and vulnerable period. At the beginning exchange rates are to be permanently frozen and monetary policy will be decided at a European level by the new European Central Bank. But national currencies will still circulate.

The hope is that a movement from one currency to another will become a simple conversion operation and that there will be no more such a thing as a foreign exchange market among the individual currencies.

The ideal is a transitional system in which the different European currencies are simply different names for the same underlying money. A comparison would be say Scottish pound notes, which are convertible one-for-one into English pound notes. Another comparison might be the Luxembourg franc which is interchangeable into Belgian francs on a similar basis. Indeed visitors to Luxembourg often do not even bother to see if they are given change in the Belgian or Luxembourg version of the currency.

Even a large run into the German mark from another currency should not in these circumstances be inherently inflationary. For the Bundesbank will simply issue more marks and withdraw French francs from circulation; so the net impact on the European money supply should be zero.

That is the theory. But market operators believe that the system will soon be tested. By that they mean that at some point there will be large conversions from say French francs into D marks. It will be seen if the Bundesbank really is prepared to issue unlimited amounts of marks to finance the switching.

We hardly need reminding that the Bundesbank has refused to do this in the past—not only when there was a run on sterling in 1992, but even when there was a run on the franc in 1993, despite the close relations between France and Germany. Bundesbank reluctance was understandable on these occasions because it did not wish to hold an unlimited number of weaker currencies. The difference after 1999 should be, first the currencies should be truly regarded as interchangeable and secondly that the decisions will now be taken not by the Bundesbank but by the ECB. Indeed the Bundesbank will now bear the same relation to the ECB that a district Federal Board in the United States bears to the Board in Washington.

But I cannot blame people for not taking these changes on trust until they have been tested by events. Important national central banks will find it difficult to cast off all their autonomy; and markets will take time to accept that the different currencies are really equivalent. This is a moment when courage and faith will indeed be needed. For I cannot think of a similar operation in recent European history. The Germany currency unification was simply the takeover of a small

weak currency by a large strong one and was not in the least comparable.

Scapegoat effect

Even if these teething troubles can be overcome, the test of performance will still lie ahead. There is one inescapable difficulty. This is that every single setback to the economy either of a particular country, or the core western European economy will be blamed on EMU. There are enough opponents in all the major countries to see that that is so. The current campaign to blame French unemployment on the *franc fort* is only a foretaste of what is to come. If unemployment is too high in one country it will be blamed on EMU. If inflation is above target in another that too will be blamed on EMU.

The sum of unemployment and inflation has often been called the misery index. If that is regarded as too high, this single currency will take the blame. There is no way of avoiding this scapegoat role even if policy is perfect. Policymakers will just have to grin and bear it. If they are not prepared to sit through such a period of unpopularity they might as well not begin on the venture.

Fiscal guidelines

The big fear about Monetary Union in orthodox circles is that it will not be accompanied by appropriate budget discipline. As a result monetary policy will have to bear too large a share of the burden of securing price stability. This will mean that interest rates will be higher than would be otherwise necessary. It could also bring a period of unwelcome appreciation of the euro against other currencies, thereby making the continent uncompetitive. But in any case a combination of high interest rates and large and unforeseeable budget deficits will not make for a harmonious movement of exchange rates with other currency areas.

There is also a more down to earth German fear. This is that countries, especially in the Mediterranean, will blame their budget deficits on EMU and demand compensating transfers through the structural funds and other Brussels mechanisms. Far better to

prevent these arguments from arising by firm commitments to budgetary stability.

But let us not forget that there are other critics with almost opposite worries. They fear that the untried European central bank will operate tight monetary policies to show that it is as committed to price stability as the Bundesbank was. These critics also worry that the combined efforts of governments to eliminate or reduce their budget deficits will exert a contractionary effect on output and employment. In this way Monetary Union may be discredited and the descredit may spread to the wider European venture.

Is there any way of squaring the circle and tackling the concerns both of those who fear that policy will be too inflationary and those who fear that it will have a bias towards deflation and recession?

Long run fiscal stability is not the same thing as raising taxes and cutting government spending in a slump—policies which are likely to make matters worse. In exchange for the principle of the Stability Pact, the German government needs to accept that large variations in the budget balance are likely and even healthy over the course of business cycle. (It may find this easier to accept after its own recent experiences.) A total swing of at least five per cent is probably necessary. The implication is that there should also be a large surplus in time of boom.[3]

We are still too much influenced by the short and mild business cycles which prevailed in the early post war decades. We have now entered a period which is characterised, not by slumps of a 1930s kind, but by quite long periods of depressed activity: what the Americans call growth recession. These are periods when output is rising but by not enough to offset the increase in productivity and provide jobs for the natural increase in the labour force. This means that the elimination of excess budget deficits could be a long process. So long as the structure of the public finances is improving a great deal of patience will be required with the remaining red ink.

Convergence and equilibrium

Many people doubt whether an area as varied as the European Union can ever form a successful currency union.

Not long ago I took an opposite view in evidence to a British parliamentary committee when I said: "Areas with very different output levels, growth rates, real wages and unemployment rates have long benefited from trading with each other, both as flexible and at fixed exchange rates and within and across national frontiers." (Chapter 1 above, page 11). For a long time I could not understand why this simple factual statement was rejected by so many eminent authorities, including some sympathetic to Monetary Union. It then dawned on me that, like so many disputes, this was about words.

The real worry is not about convergence but equilibrium. There is absolutely no need for the productivity of a Portuguese peasant to be the same as that of a worker in a glittering modern Finnish paper mill. But it is necessary that—taking into account wage rates in both countries—the starting exchange rate should be at a level which enables both of them to trade profitably.

A fear is often put in terms of France. That country needs to reduce its real wage levels to restore employment. It will be easier to do it, it is said, with the aid of a franc devaluation than just by pressing down on the money wages received by French workers.

The problem with this argument is that, by nearly all fundamental measures the French franc is not overvalued against the German mark. There are likely to be all sorts of alarms and upheavals on the currency markets between now and the establishment of a single currency. But I cannot see the final parity franc-mark before monetary union as being very different from the one obtaining in early 1997.

The real problem is that the German mark itself may still be overvalued against the non-European world including the dollar, despite its decline at the end of 1996 . If the franc is overvalued it is because it has been pulled up by the mark.

Euro exchange rate policy

The important issue will not be the exchange rates between the core currencies when the euro is brought in, but the exchange rate movement of the euro against the rest of the world. Policy will be

made more difficult because both governments and the ECB have overlapping responsibilities in this area.

There may indeed be a case for a once-for-all devaluation of the euro against the dollar at the start of the whole operation. But the problem is that when we are talking about currencies as large as the euro, the dollar and the yen, we are talking about very big players indeed. It will not be helpful if European leaders want a depreciation of the euro, but American leaders oppose an appreciation of the dollar. So without aiming for unrealistic mechanical currency schemes, it will be important for the leaders of the main blocks to talk to each other on currency issues and try to avoid both competitive appreciation and depreciation.

In the end however, the main influence on employment in a large continental area like Europe will not be the exchange rate but the internal cost of employing workers. If we are to provide more jobs in Europe real labour costs will have to be more flexible, in many cases come down. This can be done for instance by cutting payroll taxes, relaxing restrictions on hiring and firing, making it more attractive to be in work than on the dole, or, shifting from national unionised wage bargaining to market-based settlements reflecting local supply and demand.

There are innumerable routes and they all face deeply entrenched and emotional resistance. Monetary union is not responsible for the sclerotic state of European labour markets; nor is it a cure for it. But if they are not tackled Monetary Union will be discredited along with many other aspects of the European venture.

A non-federalist note

How does the Federal Reserve manage to operate a single monetary policy in the United States? After all economic conditions in Texas, which is highly dependent on oil, can be very different from those in the north western states, much more dependent on military spending.

The standard answer is that the United States has three different means of cushioning the shock affecting one part of a country. In the first place there is much more mobility of labour than we are likely to

see in Europe. Secondly, the price of labour is much more flexible in the United States. This makes it easier for a part of a country hit by an economic shock to adjust pay and prices downwards as a substitute for a formal devaluation. Thirdly, the automatic effects of the Federal Budget is to reduce revenue collections from states which are suffering economic trouble and boost expenditure in them. This acts as a powerful shock absorber.

The doubts from the absence of these conditions are at their greatest when contemplating the eventual inclusion of the Mediterranean countries. But they are sometimes expressed even about the five, six or seven countries likely to be in the first wave of monetary union in 1999 or soon after.

Our main hope must be that there are not going to be economic shocks which hit different parts of Europe in wildly different ways. The two such shocks in living memory are the oil price explosion of the 1970s and German unification. The last is something that has happened once in several generations, while future oil price movements are likely to have both smaller and more uniform effects throughout the continent.

It should not be beyond the wit of human beings to design some insurance scheme to help countries which do suffer an adverse shock. These need not be nearly as extensive as the fiscal transfers in the United States. The vast majority of these transfers have nothing to do with economic stabilisation, but reflect at best long term structural transfers or at worst log-rolling by particular states for favoured projects. A net subsidy to Texas payable only after a large drop in the oil price and phased out quickly would not be an enormous burden on citizens in the rest of the United States. The resources for such transfers can be provided by modest insurance policies amounting to one per cent of GDP or less in either the USA or Europe. Many such schemes already exist on the files in Brussels but they have been gathering dust because of a lack of interest of European leaders. They will need to be taken out of storage.

A fallback strategy

Whatever our own personal degree of optimism or pessimism about the success of the euro, it cannot be taken for granted. There is a

finite chance that, either it will never get off the ground, or that it will falter in the early stages before the single currency has replaced the existing ones.

Such a setback would certainly be a profound shock. But the consequences will be less bad if there is a strategy on which to fall back. I do not say that governments or international bodies should announce such a strategy now. This will hardly help to build up confidence in the launching of the euro. But most of us would be happier if we thought that such a strategy existed, even behind closed doors.

If I might take an example from my own country: the British departure from the Exchange Rate Mechanism in 1992 was followed within a period of weeks by the launch of a new framework based on direct targets for inflation and greater openness by the Bank of England about its own analysis and advice. So far this framework has helped to hold inflation below three per cent per annum while allowing economic recovery to take place.

There are here the elements of a European strategy should EMU fail. This could involve national inflation targets—or better still combined targets for both inflation and sustainable real growth, which could be combined together as objectives for nominal demand. Exchange rate stability could be an objective, but it will have to be expressed in qualitative terms. The fiscal guidelines need not disappear. They could continue in a normal EU framework and the Brussels Commission could continue to report on national divergences from appropriate targets.

The prospect would not in my personal view be as good as EMU itself, but it might prevent the worst catastrophies. In any case, if you prepare for the worst it may never happen.

Chapter 3
THE BRITISH POSITION

Both main British parties are committed to holding a referendum, if and only if the Government recommends membership in the Parliament elected in 1997.

Tory scepticism about EMU hardly needs emphasising. But it is overwhelmingly unlikely that a Labour Government led by Tony Blair would be in the first wave of countries joining EMU:-

1. Labour is also split on the issue

2. Legislation to join—including associated measures to make the Bank of England independent - would dominate the first year and a half of the next parliament. The first Labour Government for 18 years would have its hands full with domestic legislation, including constitutional measures for Scottish devolution and House of Lords reform. It would not be keen to become involved in a bitterly divisive European argument.

3. Previous bitter experience—including the short-lived membership of the Exchange Rate Mechanism in 1990-92—have made many Labour leaders see EMU as a high risk venture; and they would like to see how it works before making a decision.

Labour's agenda

Nevertheless a change of government would make some difference.

1. A Labour Government would try to adopt a friendlier tone. It would keep the door open for later entry a little wider than the Conservatives would. Would it go so far as to declare Britain, in common with the Mediterranean countries, as "pre-in" rather than an out? I doubt it, although some Labour ministers including Gordon Brown, might push that direction.

2. A Labour Government would not be keen to take European integration and majority voting further in the political sphere. But it would make the gesture of signing the European Social Charter. It might be more tolerant of other countries going ahead on their own and even support a *slight* extension of majority voting for all.

3. There is a chance that the UK under Labour would join other peripheral countries in a European Exchange Rate Mechanism, so long as margins remain wide—say 10 to 15 per cent. There is not the slightest chance of a Conservative Government doing that.

Pressures from sterling

One should always be ready for surprise disturbances to the prospects as they seem at any one time. What could turn policy in a more pro-EMU direction? The most likely pressure would come from an embarrassingly strong—not weak—pound. There might well be a business lobby for a stable currency to prevent British products becoming uncompetitive.

But there are no miracles here. Just as in the early 1990s Britain needed lower interest rates than Germany for domestic reasons, it might now need higher interest rates. A single currency does not abolish the conflict between the needs of different regions—it does not do so in the USA. But if the euro is managed on non-inflationary lines there would be less long term risk in accepting interest rates determined in Frankfurt on the basis of average European conditions.

Appendix on UK Base Rates

At present short term interest rate changes are the only real weapon that policymakers have against undesired movements in sterling in either direction. Although some economists hanker for a larger role for fiscal policy this is much too cumbersome and slow acting; even the direction of its influence on the exchange rate is intellectually uncertain.

The one apparent alternative to large and jerky movements in either exchange rates or interest rates, or both, would seem to be the absorption of sterling into a single European currency—assuming that option continues to exist. It was the stratospheric rise of sterling in the early 1980s which started the business lobby in favour of the ERM; and similar pressures now could spark off a movement in favour of EMU.

There are however no free lunches. The economic price to be paid for the abolition of runs into and runs out of a currency would be the establishment of a single structure of interest rates throughout Europe. Such a structure would have to be based on some average of European conditions. This would mean that interest rates would be too high when judged by some countries' inflation rates and too low when judged by others.

If, outside the EMU, the Bank of England were to reduce base rates towards the German level of 3 per cent to contain sterling, at a time when it was itself warning about double-digit growth rates for British broad money supply, financial markets would certainly suspect that the government had conveniently forgotten about any inflation targets; and there would be no assurance that they were wrong.

But suppose that instead short term interest rates were reduced towards 3 per cent by a European Central Bank. What difference would that make in the UK? The difference would show itself in long-term rates. If the Bank of England reduced short term rates unilaterally, British long bond rates would probably stay way above German rates; and the differential might even increase. In a credible

and "hard" monetary union there would be unified long-term, as well as short-term rate rates, substantially below the UK level.

Thus the same UK base rate would have very different implications if it arose from the policy of an independent central bank with a price stability mandate to those it would have if it arose from British policymakers panicking in the face of a rising pound. The difference lies in the all-important realm of expectations.

There is something to be said for stating the stability case for the euro properly, without either dismissing it out of hand or presenting as a sort of black magic which would make real problems go away.

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Endnotes

[1] For instance, Scotland qualifies and the north-east of England only just fails to do so, Jay (1995). This is not easy to reconcile with Jay's earlier acceptance of the NAIRU in other publications (eg Jay (1985).

[2] The extraordinary thing is that many of the economists who pioneered the idea that there was no lasting trade-off between unemployment and

inflation are among the strongest opponents of Monetary Union. This includes Milton Friedman himself and followers such as Alan Walters.

On the political side the contradiction is quite shameless. You hear British politicians in one and the same speech thumping the table and saying that excessive labour costs, tight regulations and other rigidities are responsible for high continental unemployment. Yet they can go on to say that the *Franc fort* is preventing the French government from expanding the economy and would do the same for Britain. But my theme now is not the intellectual bankruptcy of the Conservative Right; and I must go on to ask why serious economists of a free market and classical bent are such strong opponents of EMU. They do not always make it very clear.

[3] The EU agreement reached in Dublin in December, 1996, on a "growth and stability pact" provides for a normal budget deficit of one per cent of GDP, which could rise to three per cent in periods of recessions or other difficulties. There are exceptional circumstances in which even three per cent could be exceeded — for instance if there is a recession in which output falls by 0.75 per cent per annum or more.

This is much more severe than it may look at first sight. For normal growth for most countries has been around two to three per cent or more. Unemployment increases if growth is appreciably less.. Negative growth is very rare and hardly ever persists for long.

If the argument in the text is correct, the safety valve is insufficient. But the Dublin agreement has still to be converted into a formal treaty. Even then, statesmen can find ways round guidelines if they turn out to be strait-jackets instead.

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