Pamphlet published by the British Section of the European Movement on the single European currency (1996)

Caption: In 1996, the British Section of the European Movement publishes an information pamphlet which welcomes the effects of Economic and Monetary Union (EMU) on the United Kingdom's economy and rejects the arguments of those opposed to the single currency.

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Britain and the Euro

This document is the European Movement's contribution to rebalancing the British debate on economic and monetary union (EMU). *The Other Side of the Coin* will seek to refute all of the objections which have been raised against British participation in EMU. The European Movement believes that the British people deserve to hear the full case for and against British participation in the European single currency. We would challenge those who are against a single currency to take up the points raised in this document and open up the debate.

The countries of the European Union are about to move towards a decisive stage in their economic and political development with the formation of a single currency in January 1999. Britain will have to bite the bullet and make a decision about whether we wish to join economic and monetary union (EMU).

EMU will have a major effect on the British economy, on our jobs, investment and living standards, whether we are on the inside or on the outside. If we are inside monetary union, then we will have a chance to benefit from the competitive advantages which a single currency will bring. If we are outside EMU, then we could face a number of significant economic and financial costs and a steady decline in our influence in economic decision making.

A single currency offers major advantages to British business. Our interest rates are still higher than those countries which are likely to form the core of a monetary union. The current negotiations on the fiscal stability pact have provided further reassurance that the monetary policy of the European Central Bank will inherit the Bundesbank's credibility. EMU is likely to offer greater monetary policy credibility than Britain has enjoyed since the Second World War. We could therefore reasonably expect EMU to lead to lower UK interest rates. Christopher Johnson, advisor to the House of Commons Treasury Select Committee, has estimated that lower interest rates could add up to half a percentage point to economic growth rates.

EMU would also eliminate exchange rate uncertainties and transaction costs for businesses exporting to the countries inside the Euro area. The countries inside the Euro area could expect to be quite attractive to inward investors, because of their lower interest rates, stable exchange rates and lower costs.

EMU would also be a major contribution to the completion of the single market and ensure that it lasts. The Euro could become a major currency in world bond markets. The Euro would also be used widely as an invoicing currency for trade. This will greatly enhance Europe's competitiveness vis-à-vis Asia and North America.

The Euro will herald a shift to a more tripolar global monetary system, where economic policy is driven by the dollar-yen-euro axis. If Britain was outside such a regime, then our influence in international economic policymaking would be severely limited.

The Euro is an opportunity for the City of London to consolidate its leading status. If the UK participates in EMU, then the City should become a major centre for the Euro money market. London would be well placed to be the principal centre for Euro market trading.

Despite the opportunities which monetary union offers both the City of London and the British economy, the debate on EMU in the press has been very one-sided. The disadvantages of EMU have been widely rehearsed, even when many of these objections are superficial and ill-informed. Objections, such as the value placed on the devaluation option and Britain's reliance on fixed rate mortgage finance, have been glibly repeated, without being placed under rigorous scrutiny. This paper gives them a full examination and response.

1. Won't Britain lose its ability to tax and spend independently if we join a single currency?

Britain will still be able to determine its own tax and spending priorities if we join a single currency. However our borrowing policy would be subject to limits. The treaty stipulates that member states should not run "excessive deficits". In practice this constraint is similar to the limits which the financial markets place on Kenneth Clarke's budgetary policy at present. Sustained high budget deficit policies are economically undesirable anyway in mature economies and would lead to high British interest rates with knock-on effects on growth and employment. Ruling out these policies would be a good thing.

EU states have now agreed to a "stability pact" to clarify the Maastricht treaty's sanctions on member states which run high budget deficits. The pact provides for financial penalties on EMU states which breach the 3 % upper limit on borrowing. However, this agreement would allow countries to avoid financial penalties if they could demonstrate that high deficits were due to exceptional circumstances, like a sudden recession. Nevertheless an EMU based upon the Maastricht rules would still leave member states with discretion in public spending and tax priorities subject only to the upper limit on budget deficits.

Germany, for example, can fund its high level of social security payments by raising taxation if necessary. EMU would mean that a member state could have a high spend/high tax economy or a low spend/low tax economy. It could not have a high spend/low tax policy. **EMU would not commit one country's taxpayers to meet the demands of another country inside the single currency zone.**

2. Won't a single currency lead to high unemployment?

No. Unemployment would probably fall. This is because a single currency should lead to lower interest rates for the participating countries. Lower rates should mean stronger growth and should help raise rates of employment throughout the EMU states.

It is likely that the Euro will enjoy lower interest rates once it is successfully established because the new currency would be based on countries with good inflation records and stable currencies. Interest rate levels are closely linked to the financial markets' expectations of the inflation risks present in a particular country. The countries which will form the core of a monetary union have a good inflation track record and consequently have lower interest rates.

Britain's long term interest rates are higher than France or Germany's. This is a direct result of Britain's record of inflationary stop-go policies. Monetary union gives Britain the chance to benefit from the credibility and discipline established by countries with a better inflation and interest rate record than our own. **At the birth of the single currency, its members have inflation credibility built into their money. A 'go it alone' Britain will have to struggle to prove itself.** It is perfectly possible for Britain to bring down these inflationary expectations but this process will take years more of hard and consistent work. It took France more than a decade to establish this credibility.

The only way which we would be able to achieve this credibility would be if we established an independent central bank in Britain committed to price stability. If we adopted these disciplines then we might as well join a single currency where the European Central Bank would also be independent.

Lower interest rates would also bring down the cost of British Government borrowing. At the moment UK Government borrowing costs are £ 5-7 billion higher than Germany's because we have higher long term interest rates. EMU would allow our rates to fall to German levels and at the same time cut the cost of our borrowing. **The savings would mean a cut in income tax amounting to £ 10 a week for the average household.**

An EMU which delivered stable prices and lower interest rates would also provide British businesses with a far more favourable climate within which to invest than they have enjoyed in the past.

3. Will EMU lead to big fiscal transfers from richer to poorer regions of Europe? Won't EMU also hurt poorer European regions?

The plain fact is that no one is prepared to pay for any such transfers. The countries which will form any monetary union are not prepared to pay.

Those who argue that EMU would lead to high fiscal transfers make the assumption that the economy of one member state would be hit by an economic shock which would leave other EMU states unaffected. Opponents of a single currency argue that this member state would be unable to adjust because it didn't have its own currency and would request fiscal transfers from other EU states. The premise behind this argument is wrong. The economies of the European states have a spread of industries and so none of them would be devastated by an economic shock hitting one sector like shipbuilding. We don't have single-industry economies in the European Union.

The real means of economic adjustment inside a single currency is labour market flexibility. The poorer regions will be able to attract inward investment because of their lower costs. Lower costs will be a major consideration in the decisions of inward investors. Britain has more flexible labour markets than some of the other EU countries and therefore we would be in a better position to adjust to the disciplines of a single currency.

4. Didn't devaluation allow Britain to recover from the 1990-92 recession?

Britain's export-led recovery was mainly driven by a recovery amongst our trading partners within the EU. In addition the British economy had already begun to recover before our departure from the exchange rate mechanism. In fact Britain's export performance three and a half years after devaluation has still lagged behind that of other industrialised countries. Devaluation is therefore no panacea.

The conventional view is that devaluation automatically leads to a corresponding fall in relative export prices and therefore a competitive boost to British industry. In fact the 1992 devaluation was followed by a short *increase* in export prices. Six months after the departure of the pound from the ERM, the index of sterling export prices had risen by 10 %. Exporters took the opportunity to increase their prices and profits. As a result devaluation did not yield the results which many economists have traditionally claimed would come about. **Britain's share of world exports actually fell in the three years following the devaluation of sterling (In 1992, the UK's share of world exports was 5.2 %. By 1995, it had fallen to 5.0 %).**

Devaluation is also a response to economic failure. Devaluation is no longer an effective tool of economic management. In the past devaluations took place in the context of a more closed British economy with foreign exchange controls and high levels of state control in the economy. Devaluation was a policy option in an economic world which no longer exists. The real solution to improving the competitiveness of British business is to improve our economic and industrial performance. As Sir Nigel Wicks, Director of International Finance at the Treasury, said to the Common Treasury Select Committee on EMU:

> *The Treasury ..... see no advantage in devaluing currency ..... the whole history of our economic policy for a long time has been to see a decline in the value of the pound against our major trading currencies. I do not think that has benefited the economy.*

5. Doesn't the ERM experience show that EMU would be a disaster?

The ERM experience shows that we need a single currency and a single monetary policy, a half-way house, was not good enough. The ERM meant that monetary policy was increasingly dictated by the needs of Germany as the strongest "hard" currency in the system. So states like Britain had to keep their interest rates high even though they were in recession in the early 1990s. In the early 1990s, Germany's needs sharply diverged from other ERM participants because of the one-off historical event of German unification. The scale of the transfers made by Germany to Eastern Germany show the exceptional nature of the shock that hit the German economy. In 1995 the net transfers to Eastern Germany represented 4.3 % of Germany's total

GDP. A balanced judgement must be made about the likelihood and frequency of such a scale of shock hitting individual EMU members in the future.

Had a single currency been in place at the time of German unification then many of the problems which occurred at the time to the European economy would have been avoided. A European Central Bank would not have raised interest rates as high as the Bundesbank did in the early 1990s and instead Germany would have been obliged to increase taxes further in order to respond to the economic pressures caused by unification.

A European Central Bank would be able to set monetary policy to reflect economic and monetary conditions in all the member states. It would also be a sufficiently strong currency to defy the speculators. The German mark's separate existence even harms Germany's interests. At the moment the mark is quite strong and is forcing up German unemployment, with many German companies transferring their operations outside the country.

Britain also entered the ERM at the wrong rate and at the wrong time, just as we were going into recession. The current reality is that the mark is so dominant in the European currency markets that even a "floating" sterling is profoundly influenced by it. The real choice for Britain is between a single currency run in the interests of all participating states, or a dominant currency run in only Germany's interest.

6. Isn't the convergence process and the 1999 timetable causing too much economic pain in Europe?

Firstly, sound public finance is desirable *in itself, independent of the case for EMU*, if member states are to be able to reduce their interest rates. Secondly, the single currency will only be successful if it is based on countries with strong budgetary credentials. A single currency based on countries with a record of poor economic management would end in failure. The convergence criteria have been designed to ensure that the single currency is well-run and is successful.

Even if there was no single currency commitment, France and other EU countries needed to take strong measures anyway. France has high pension liabilities which could lead to an explosion of its deficit early in the next century. The action which the French Government is now taking would be necessary even if it were not moving towards a single currency.

In addition, the EU's history shows that unless there is a timetable for the achievement of major economic changes, then no progress will come about. The establishment of the single market was given a target date of 1992 to put pressure on the member-states to agree the necessary laws quickly and to implement them effectively.

7. Won't EMU divide Europe? What will be the relationship between the member states who join EMU and those that don't?

If Britain is concerned about the consequences of being outside a single currency, then this is a logical argument for UK participation in EMU.

The reality is that all the other member states likely to be outside the single currency at the start wish to join EMU eventually. It is therefore in their interest to maintain economic disciplines to enable them to participate. Central to these disciplines will be maintaining a stable exchange rate. This would mean that competitive devaluations would not happen.

Britain might, however, be perceived as seeking to gain the benefits of the single market whilst enjoying a competitive advantage because of an ability to devalue. This perception might lead to informal discrimination against Britain within the single market. The Investment Services Directive is one example of European legislation which could facilitate discrimination against the City of London by an EMU grouping. The risk of discrimination is a reason why Britain should join a single currency.

8. Won't a single currency mean the end of the British state?

Britain's monetary policy is already greatly influenced by global financial markets. Our monetary 'sovereignty' is therefore something which has to be judged on pragmatic rather than dogmatic grounds.

History also shows that there is no automatic constitutional relationship between monetary and political unions. Ireland and Britain had a de facto monetary union until 1978 and no one seriously suggested that they were part of a political union. During this period, Ireland and Britain were clearly independent states and pursued markedly different foreign policies. For example Ireland remained neutral and outside NATO. Luxembourg and Belgium also have a currency union but are separate states. A single currency does not mean a single nation. Both Britain and Germany were part of the pre-1914 Gold Standard and were clearly separate states. Fiscal policy and foreign policy are much more at the core of national sovereignty than monetary policy.

Germany's monetary policy is already so dominant in European currency markets that constitutional sovereignty isn't really the issue. The Austrian Schilling has been very clearly tied to the mark since 1972. Dutch short term interest rates have not diverged from German interest rates by more than 0.8 % for eight years. **The real issue is not absolute sovereignty but having the power to make effective policy choices that impact on the British economy.**

9. Are wage levels in Europe sufficiently flexible to allow for a stable monetary union?

Some people have argued that wage levels and the wider labour market structures in the countries likely to form a core currency union, such as France and Germany, will not allow different parts of a Euro zone to be sufficiently competitive. Labour market patterns become more important if devaluation is no longer available as an economic tool. EMU critics see wages as 'sticky' in a number of continental countries, raising the prospect that wage levels will not be an effective mechanism for the correction of regional employment differences.

In fact, unit wage costs have begun to converge significantly already in France, Germany, Italy and the UK. In France and Germany particularly, labour market reforms are being introduced prior to monetary union. Wages are now far less sticky than they were in the 1980s in continental Europe.

In the UK during our membership of the ERM, wage levels showed clear signs of responding to the new monetary discipline, where it was clear that currency depreciation would no longer be able to buy firms greater competitiveness. **If the Euro came into existence there is every reason to expect that companies, wage bargainers and workers would adapt their behaviour to the ruling out of the devaluation option.**

10. Can a European Central Bank run a monetary policy in Britain's interest?

Just like the other EU states, Britain shares common economic interests with other states which are likely to form a single currency. Britain has an interest in having high levels of employment, expanding European export markets and price stability. Unless continental EU states have high levels of demand then British export growth will be curtailed. Britain's economic recovery post-1992 was strongly influenced by a recovery in continental export markets. Britain doesn't have economic characteristics which are fundamentally different to other member states. For example, Britain, France, Germany and Italy all have between 13 % and 15 % of their trade with the EU as a proportion of GDP.

Market economists should also appreciate that economies will converge in response to economic/market pressures. Anti-Europeans seem to believe that the British economy has rigid characteristics but this argument is inconsistent with a liberalised and entrepreneurial economy.

The following features are often mentioned by those who argue that the British economy has fundamentally different economic characteristics from the other EU states:

- *The structure of British mortgage finance*: It has been argued that Britain shouldn't join EMU because our mortgage finance market is driven by floating rates and not fixed rate mortgages. In fact the British mortgage market has moved quite fast towards fixed rate mortgages, much closer to German mortgage finance, since 1992.

In the second quarter of 1994, 59 % of new mortgages were at fixed rates for more than one year (Source: Council of Mortgage Lenders) when UK interest rates fell close to German levels and the UK's deregulated financial system responded rapidly to consumer demand.

Britain has a history of variable rate mortgages, unlike the fixed rates common elsewhere, because we have a high inflation economic environment. If Britain enjoyed stable prices then we could expect that people would be encouraged to borrow longer term. In the 1930s and 1940s many building society loans were at fixed rates and it was only in the 1960s as inflation built up, that variable rate loans became predominant. **This shows that borrowing patterns respond to a low inflation environment.**

Such a low inflation environment under EMU would mean that existing holders of floating rate mortgages would have a lot to gain from a single currency. EMU would offer the prospect of sustainably low interest rates. This would mean that the burden of mortgage repayments for people with variable rate mortgages would remain at a low level rather than ratchet up sharply as it did during the 1980s. This would also enable new homeowners to fix their mortgages at a low interest rate levels.

- *Interest rate sensitivity of the UK economy:* Overall the difference in the structure of British debt between the UK and other EU countries does not provide cause for concern in relation to EMU. The House of Commons Treasury Select Committee report on EMU argued that the evidence showed that there was not a significant difference in the response of the British economy to interest rate changes.

- *The UK's dependence on oil*: This factor has been overplayed by opponents of monetary union. In fact oil does not make a major contribution to the UK economy. Oil and gas production represents a 1.85 % share of Britain's GDP. Britain would also not be alone in having a significant share of its economy contributed to by mineral extraction if it joined EMU. Natural gas makes a similar contribution to Dutch GDP, as oil does to the UK economy.

Any big rise in oil prices would also have a reasonably even impact across the EU and any likely single currency area. A study undertaken by Giavazzi and Giovannini in 1987 showed the effect of a 10 % rise in oil prices across the member states. This study used data from 1980, when the proportionate size of the oil and natural gas sectors in Britain and the Netherlands was larger than it is today. Their analysis showed that the effect on domestic prices in Britain would be 1.7 to 1.9 per cent, compared with a rise in other countries of 1.3 to 1.4 per cent.

Therefore the monetary policy of the "Euro states" would be able to respond to an oil price shock, without adverse effects on any one state, including Britain. European Monetary Institute (EMI) President Alexandre Lamfalussy recently said that difficulties after the oil price shock came largely from the divergences in policy responses in member states in 1972, rather than any differential effects of the shock itself.

11. The North American Free Trade Area (NAFTA) doesn't have a single currency, why do we need one?

NAFTA is only a free trade area, one where trade barriers have been removed. It is not a single market which we are building in Europe - where discriminatory non-tariff barriers to trade are removed as well. NAFTA is not comparable to the EU. Currency changes are not nearly such powerful tools of trade competition in NAFTA.

NAFTA is based on an essentially unbalanced trading and economic relationship. It includes one predominant economy, the US, a developing state, Mexico, and Canada. As a result American economic policy is totally dominant across the NAFTA zone. In contrast, the European Union consists of a core group

of economies of comparable size and economic weight.

12. Switzerland flourishes outside the EU. Why can't Britain adopt the Swiss approach?

The Swiss option is a non-option for the British economy. Switzerland is not a model of economic independence. Swiss monetary policy is devoted to tracking the mark to an extent which should horrify Euro-sceptics. Switzerland had no serious influence over the GATT trade negotiations and its foreign policy weight is minimal. Swiss levels of inward investment have also sharply fallen in recent years. A model which suits 6 million Swiss in central Europe is not suitable for 57 million Britons.

13. Wouldn't the City of London continue to be successful if the UK opts out of the single currency?

Naturally the City would retain the opportunity to expand its already thriving business outside Europe under all circumstances. There are two risks however:

(i) that the US dollar, the currency for most the City's offshore business, would suffer a reduced global role and

(ii) that EMU participants would anchor the new 'Euro' markets in their territory - despite the principles of the Single Market.

If the Euro is successful and goes on to become the currency of most of Europe, then it would become a serious rival to the US dollar. Inevitably the sharing of the global reserve currency role would reduce dollar activity. Can the City offset its shrinking dollar activity by developing Euro business - both within the world's largest trading bloc - the EU - and outside Europe?

In this scenario full access to the European markets would be crucial - in particular to the European Central Bank. When the offshore dollar markets started in the 1960s, the Americans did not care a great deal about the location of the European financial centre. Within existing Single Market legislation, there are clauses that could be used to hinder the City. Moreover, the precise terms of access to key parts of the new financial system are still being negotiated. If the UK is out-manoeuvred, the City could find the playing field decisively tilted against it.

14. What about the costs of the transition to Monetary Union?

The one-off costs of changing over from sterling to the Euro would not be great. The total conversion costs of moving to the Euro would be around £ 2.5 billion. However these would be outweighed by the increase in economic growth brought about by lower interest rates and transaction savings. **The costs of the change-over to a single currency are worthwhile given the benefits on offer.**

The conversion costs for the banks were described by Sir Peter Middleton, Chairman of BZW, as 'not earth-shatteringly large'. These changeover costs should also be compared to the comparative costs incurred through other major transactional changes, such as Phoneday in May 1995. The media made much of Sir Richard Greenbury's estimate that EMU would lead to a £ 100 million bill for his company, Marks and Spencer. However what they did not report was that Sir Richard said that £ 70 million of capital costs would be incurred anyway by Marks and Spencer through replacing infrastructure.

Conclusion

It is now clear that a single currency is very likely to take place in 1999. The bond markets have already taken for granted that EMU will go ahead. There is real political will in other EU states to establish a single currency. British politicians, British business and the City of London have to face up to this reality.

The costs of British exclusion from EMU could be very real. Britain could face higher interest rates outside EMU and businesses outside EMU will lose the benefits of exchange rate stability and lower transaction costs. Britain could also face informal economic and financial discrimination throughout the single market by the EMU core. If Britain intends to opt out of EMU in order to pursue a monetary policy which diverges from the single currency area, then we could pay a high price for this in the financial markets.

If Britain wants to follow a policy which is very close to that of a European Central Bank's monetary policy then we might as well be inside EMU, with a say in interest rate policy. However, Howard Davies, the Deputy Governor of the Bank of England has confirmed that the Bank would like to see Britain effectively shadowing the single currency if the UK opted out of EMU:

"We would not advocate a policy of competitive devaluation, even if such a thing were feasible, which we doubt. Indeed our policy aim as an 'out' would be broadly the same as that of the European Central Bank."

(Speech made by Mr. Davies to German-British Chamber of Industry 11/9/96)

Britain would also face a loss of influence if we opted out of EMU. The core of EMU countries could decide to integrate more closely and form a powerful politico-economic bloc which would wield far greater influence on foreign and economic policy than a 'go-it-alone' Britain. In his evidence to the House of Lords report on EMU, Gavyn Davies, Chief International Economist at Goldman Sachs International, raised concerns about a 'two-tier' economic decision making system developing in the EU as a result of monetary union. There are already moves afoot at the Intergovernmental Conference which would allow some member states to move towards faster integration, whilst leaving others aside. The membership of the single currency has to be seen in that context.

If Britain excludes itself from this project then our influence within the European Union will diminish as a result, as could Britain's economic competitiveness. Is this the side of the coin that we really want for our country?