Aston Centre for Europe, Aston University

Can the Euro save the UK economy?

David Marsh, Chairman, London & Oxford Capital Markets

Author of *The Euro – The Politics of the New Global Currency* [*]

Byng Kendrick Lecture Theatre

Wednesday 4 March 2009

I am not and was not against the creation of European economic and monetary union (EMU) and I am not against Britain joining at some stage in the future. Ruling out such a step for the rest of history, as the Conservative party appears to have done, does not seem sensible. Proponents of EMU membership put forward a variety of arguments. A recent example came with an interesting and thought-provoking booklet [†] produced under the auspices of Peter Sutherland, the chairman of BP, where much of the inspiration came from John Stevens, a former conservative MEP who believes the UK should join EMU to guard against still more devastating economic decline. The booklet contains articles by more than 30 academics, politicians and thinkers and needs to be taken seriously. However I don't think it takes sufficient account of the realities of the present political and economic position, both for Britain and also for its neighbours.

My view is that it is not in that Britain's best interests to join. Nor do I think that will be the case in the next 10 to 15 years. Moreover, I think that for Britain to stay outside EMU over this time is probably also in the best interests of Britain's European partners. Let us not forget that the UK is the most important trading partner of the 16 countries within EMU – well ahead of the US and China. Whether we like it or not, we are vitally affected by whatever happens within EMU. But the rest of Europe is also affected, for better or worse, by what happens in the UK.

Let us look at 10 reasons sometimes put forward why Britain should join, and ask whether these arguments stand up to scrutiny.

The first argument centres on the so-called "safe haven" argument. According to this line of thinking, especially at a time of economic crisis, Britain would be better off inside the EMU area, protected by the confidence generated by the workings of fiscal and monetary policy within a large economic bloc, and that this would be better for jobs, growth and investment. In fact the Euro is far from being a safe haven. It is beset by all

[*] Yale University Press. Published in German as *Der Euro: Die geheime Geschichte der neuen Weltwährung* (Murmann Verlag). http://www.londonandoxford.com/The_Euro/The_Euro.htm

[†] "10 years of the Euro: New Perspectives for Britain", published by John Stevens.edited by Graham Bishop, Willem Buiter, Brendan Donnelly, Will Hutton. www.e4u.org.uk. euroreport@europachannel.net.

sorts of strains, exacerbated by the recession – and these may in fact get worse when the economy eventually recovers. Britain on the outside is incontestably in a mess economically but has the flexibility in fiscal and monetary policy to rally its economy and arguably should surmount the recession quicker than many of those within the Euro. The decline of sterling from its over-valued highs in 2007 is not part of the problem that Britain faces – in fact, by improving British firms' foreign competitiveness, it is generating additional exports, and this is part of the solution. It is also helping to drive more foreign visitors to our shores and therefore, at a difficult time for the economy as a whole, is an important prop for consumer demand.

Second, it is claimed that interest rates would be lower if we were in EMU. It is true that, for the 10 years of EMU up until the Bank of England started full-blown monetary easing last autumn, EMU interest rates were consistently below Britain's. This was not however some act of God – it reflected the higher-growth performance of the UK economy and Britain's consequent higher propensity to inflate. Since the UK has adopted monetary easing far more aggressively than the European Central Bank, interest rates in the UK are now below levels in the Euro area. (This has been one of the main factors behind the sharp fall in sterling). Of course, interest rates in the UK may not remain below those in the Euro area, especially if the Bank starts to raise interest rates rapidly next year as the economy hopefully moves out of recession and policy emphasis again turns to fighting inflation. Whatever happens, the UK has the flexibility to use the collective judgment of the Monetary Policy Committee to react to Britain's own economic circumstances in the best manner possible to meet the Bank of England's overall mandate of price stability. This is, to my mind, a better set of circumstances for running the British economy than would be the case if the UK were constrained by the European Central Bank to follow policies construed as being best for all the other EMU countries but not necessarily for Britain.

Third, proponents of EMU membership argue that fixing exchange rates provides the best way of anchoring inflationary expectations and setting a solid framework for stability and growth. The argument has a certain amount of history behind it – it provides one of the reasons why Britain rejoined the Gold Standard in 1925, why we maintained membership of the Bretton Woods system of fixed currencies after the Second World War and also why we entered the exchange rate mechanism of the European Monetary System in 1990. The problem is that our experience within these fixed currency systems nearly always ended in failure when Britain was eventually forced to come off a fixed peg (either against gold, the dollar or the D-Mark) – and they all resulted in a better UK economic performance after Britain eventually moved to floating. The most crass example was of course the ERM experience that culminated in the UK's forced departure in September 1992. I will not go into all the details of this, as this aspect is covered by my lecture this morning at the Graduate Centre on the history of the EMU project. Suffice it to say that Britain's experience after 1992 was made somewhat more comfortable by German government and Bundesbank mistakes in the handling of our eventual exit. The UK was able to cover up its own blatant policy errors in view of still greater faults and misjudgements by the Germans.

The fourth argument that is often heard is that we can increase trade with our European partners if we are in EMU. This would be an important argument: fuller trade integration would undoubtedly greatly aid the UK (as well as the Continent). However floating exchange rates can, under certain circumstances, promote trade integration as much as fixed rates. Britain's higher economic growth compared with the other larger European economies over most of the past 15 years has represented a source of buoyancy for both imports and exports – offsetting the inconvenience for traders and investors of floating currencies. As a result, Britain's overall trade with EMU countries has in many cases grown more quickly than that of individual EMU members with each other.

A fifth factor sometimes advanced is that the UK joining the Euro would help the European currency strengthen against the dollar and offset what is often seen as harmful dominance of the US in world monetary affairs. In fact, whether the UK joins or not, the dollar is likely to maintain and perhaps enhance further its international monetary position. For all America's undoubted economic problems, this reflects the extraordinary US political and military security and status as still the world's sole superpower. It is arguable whether the Europeans really would wish the Euro to take over one day as the world's No. 1 reserve currency – an idea sometimes entertained by ambitious politicians - as this would bring about an overall revaluation of the Euro against the dollar, and further damp economic growth in EMU members which are already suffering deprivation as a result of uncompetitive fixed exchange rates.

Point No 6 is that membership of EMU would bring the UK the benefit of European largesse that could help overcome our economic difficulties. In fact, such aid is always likely to prove illusory, even for countries that are already within EMU. The no-bail-out clause within the Maastricht treaty prohibits the stronger countries from taking over responsibility for the debts of others. Although some EU solidarity may be forthcoming for harder-hit members suffering from the effects of low growth and burgeoning deficits, such assistance is likely to be small compared with the far larger amounts of credit than can be generated by recourse to the International Monetary Fund at a sensible exchange rate. There is no Euro "pot of gold" available for hard-up EMU members.

A seventh argument is that a move by Britain to join EMU would safeguard the integrity of the single European market, encapsulating the freedom of circulation of goods, capital and labour around Europe - essential components of the outward-going non-protectionist trade and investment policies on which the UK depends. Of course, the rules of the single market are protected by over-arching EU legislation, and will prove durable whether or not Britain is a member of the Euro. It would be a poor state of affairs if these freedoms were so tenuous as to be endangered by the UK's non-membership of EMU – that would certainly be an extremely negative reason for going in. The UK's commitment to free trade has probably thus far been more healthy and vibrant outside EMU than in it, on the grounds that non-membership, at least for the past 10 years, has provided the wherewithal for faster growth than would have been the case had the UK been inside.

Eighth, it is sometimes averred that Britain's adherence to EMU would strengthen the rest of monetary union because we would represent another large and relatively powerful economy in the trading bloc. This has been the case put forward in recent days by Karl Otto Pöhl, the former president of the Bundesbank, on the grounds that some members of the Euro area face genuine payments difficulties and Britain's entry would strengthen the fundamental basis of EMU. There may be something in this argument but, if it were the case, it would be better for the UK to wait for the EMU members to put its structural difficulties behind it before making a decision to join. There is something curious about simultaneously advancing the proposition that we should join because we're in a mess and also that we should join because the rest of Europe is in a mess. One is also tempted to think of the famous Groucho Marx dictum that he wouldn't join a club that would want him as a member.

A ninth issue that often comes up is that within EMU Britain would have more political clout than outside. I myself believed in the early 2000s that the UK should consider joining monetary union as a means of ensuring that, in particular, British and German economic policies were in harmony and that the rules of the ECB would be modified to become more acceptable for Britain (for instance in transparency and accountability of decision-making, some limitations on the ECB's overweening independence and a strengthened dialogue with politicians). Since then, however, the story has moved on. It would be very difficult now for the UK to exercise more influence on EMU from a position within monetary union, either in general or in terms of the detailed rules of the ECB which, after all, have now been set for a decade. Arguably, Britain has more clout as a non-member, for example over attempts to kick-start the international economy or on issues of financial regulation. In recent months, Gordon Brown has hardly had a weekend free in view of the number of times he has been invited by President Sarkozy or Chancellor Merkel to attend trouble-shooting meetings of European leaders – even through Britain is a non-member.

Tenth, the overriding idea is advanced that Britain within EMU would provide crucial support for a liberal open-minded Europe that would prosper on the world stage in competition with the other advanced and emerging industrial countries. We would all like this outcome – but one has to distinguish between means and ends. The political reality is that the only constellation under which the UK would be likely to join EMU in coming years would be one of extreme weakness – and in these circumstances the UK would not be a very amenable or desirable partner. For example, if the UK were prompted to enter EMU to escape a further worsening of the economic crisis, it would do so only at a very low exchange rate to ensure Britain's competitiveness. And this would probably be highly unpalatable to other EMU members who would no doubt conspire to stop it happening. So I am afraid that, for all these reasons, the time has not come for the UK to consider joining EMU. We will continue to stick to the mantra that we will join "when the time is right" – in the full knowledge that this will not be the case for many years.