

Time to choose? Britain and the euro

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The British, by temperament, prefer small and gradual changes. Over time these changes may build up, but there should be nothing too dramatic or revolutionary if we can help it. EMU was therefore everything that British policymakers usually dislike. It was a large, dramatic, discontinuous and radical change. Indeed, it has been the largest change in international monetary arrangements since the Bretton Woods system after the Second World War. It is arguably the largest single change in the framework of economic policy that has ever been made in Europe, including Bretton Woods and the gold standard.

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What is, however, incontrovertible is that monetary union has happened, and it has happened on a much larger scale than most British policymakers, let alone the Eurosceptics, ever believed possible. With eleven founding members joined in 2001 by Greece, the euro area is a currency area of similar size to the United States, with a similar weight on the world economic stage. This fundamentally alters the status quo. Until 1 January 1999, the pound was just another European currency among many. But now it is a comparatively small currency set against a vast one, the movements of which completely dominate the inflationary impact of import prices and the competitiveness

of British exporters. The potential for great volatility in sterling has increased, particularly since the relationship between the euro and the dollar is itself likely to be more volatile as their respective monetary authorities care little about their exchange rates (since they affect only a small part of their now continent-wide economies). Given that international capital flows are also increasing inexorably – a trend that is likely to continue with the growth of private pensions – the potential for the pound to be squeezed between the great tectonic plates of Europe and America has never been greater. It will not be comfortable.

In this context Britain cannot merely opt out and pretend that nothing is happening. If we are to stay out of the euro we must expect an even bumpier ride than we have had over the last twenty-five years of a largely floating exchange rate for sterling. We will need to reinforce the credibility of our monetary institutions, which will otherwise bear unfavourable comparison with those of the United States and the euro area. We will also have to ensure that fiscal policy remains on track, as the cost of market punishment will be greater outside the euro than inside it. Not only can bond yields rise if the markets disapprove of a government's policy, but the exchange rate can fall. Moreover, the exchange rate may well come under strain because of developments in either the United States or euro area and require offsetting fiscal and interest-rate changes to compen-

sate. After all, the Deutschmark/pound exchange rate dropped to just DEM2.2 in 1995 and went into overdrive in 2000 hitting DM3.45, helping to cause more than a third of a million unnecessary job losses among manufacturers.

The balance of costs and benefits points to British entry. The costs are often overstated. The divergences that have in the past occurred among the European economies – the problem that a one-size-fits-all monetary policy is meant to aggravate – have already been experienced in other monetary unions, notably the United States but also existing European countries. An independent monetary policy (both interest rates and exchange rate) is a diminishing asset in a world which is becoming increasingly interdependent. Moreover, it is wrong to assume that the freedoms an independent policy affords are unalloyed benefits.

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Many of the greatest shocks administered to the British economy over the post-war period have been home-grown instances of ill-judged policy, including far greater and more sudden shocks to our trading sectors (such as manufacturing in 1979⁸¹) than are imaginable in EMU. The lack of an independent exchange rate and interest rate will put pressure on the remaining means of adjustment – the labour market – but this is already more flexible than it was, and Britain



is certainly as well able to adjust as other large EMU participants. We have also seen that Britain's economy is not disproportionately affected by short-term interest rates, despite the importance of variable-rate mortgages.

On the benefits side, British adoption of the euro will improve growth and jobs by two principal means: it will increase efficiency and reduce risks. Consumers will have more choice and greater ease in comparing prices. Competitive pressures will increase and so will efficiency. This is perhaps the most fundamental step forward, albeit often underestimated by our macroeconomically obsessed policymakers. The euro is already making a reality of the single European market and providing businesses with opportunities for economies of scale of which they could until recently only dream. The single market is increasing prospective returns on investment, and thereby growth and jobs. There will also be an elimination of the transactions costs in moving from the pound to the euro. Britain can and should participate in these gains.

The second mechanism by which EMU delivers important benefits is through the reduction of risks, particularly exchange-rate uncertainty. This may be expected to boost trade flows, but, even more crucially, it is already boosting investment across borders within EMU and raising the long-run growth rate of the European Union. By creating a monetary area that is a continent-wide economy, EMU has insulated its member economies from external shocks caused either by problems in other economies or by financial flows and misaligned exchange rates. Britain's membership would lift the constraint which British policymakers have often felt: the need to ensure that the bal-

ance of payments (of exports and imports) does not go too far into deficit. Within EMU the balance of payments can no longer have a traumatic effect on the exchange rate of an individual member state, or on its inflation rate.

EMU also reduces the risks of inflation, and hence cuts interest-rate costs in the long run. The credibility of Europe's monetary institutions is already greater than that of its American counterparts. Governments whose countries are participating in the euro area are already able to borrow on better terms over a ten-year period than the American government, owing to the markets' belief that inflation is less likely to erode the value of the debt. If Britain joined, borrowers would also benefit from the reduction in interest costs, which could be £38 a month for the average mortgage payer over the business cycle.

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Most importantly for our longer-term prospects, businesses should find capital more easily and cheaply just as our euro area competitors are doing now. Banks will compete fiercely for new business, and the new capital markets of the euro area are encouraging the growth of risk capital, particularly in the bond market. These interest rates and financial-market effects will help to reduce the cost of capital in Britain, and therefore boost investment. Lastly, the advent of a new world currency will offer all Europeans the advantage of seignorage: the ability to buy other people's exports and offer them printed banknotes in exchange. The euro is likely

to become a major world currency, used as a store of value, a means of exchange and a unit of account much beyond the euro area.

These general advantages are reinforced by two particular features of Britain's situation, which mean that we may disproportionately benefit from the single currency. The first is our ability to attract foreign direct investment (FDI). If we join this will be underpinned. Indeed, we may benefit from the new wave of investment likely in the early years of EMU. The second is the position of the City of London as Europe's incipient financial centre. Within EMU London can be more than just a centre of international finance. It can be the centre of the new, integrated euro capital markets. Outside EMU not only is our share of FDI likely to dwindle, at particular cost to some of our poorer regions, but also the City's role is likely to come under increasing challenge from Paris and Frankfurt.

These unique British factors, the importance of FDI and of the City, are part of the answer to the questions: Why not wait and see how things turn out? Delay always sounds reasonable. EMU has gone ahead with a large membership. The great experiment has begun. If we wait we also increase the risk of losses because foreign investors go elsewhere, and because other centres pick up business from the City. Nor are we likely to settle the issue by waiting. The sorts of things that might go wrong with EMU, as we have seen, are unlikely to happen quickly. They might never happen. They might happen only after twenty years. No one is really suggesting that we can wait that long. Even the "doctrine of unripe time", that famous bureaucratic delaying tactic when arguments of principle fail or prove inexpedient, would not sustain British non-membership for such a





period. The government is rightly worried about the loss of political influence within Europe entailed by Britain's non-membership in such an important European project.

There is another point about delay. If something creates serious strains within EMU the odds are that it will be fixed. The show will go on. This is the experience of the European Union to date, particularly with big projects such as EMU in which so much political capital has been invested. If we are out, we will not have the problems. But we will not be part of the solutions either. This will bring potential economic and political costs as well. Indeed, even a temporary delay could be used against Britain, as the delay in our initial membership of the European Union was used to put in place policies for agriculture and fisheries which were inimical to British interests. There is even a risk that Britain, outside EMU, could be "de Gaulled" again while Paris and Frankfurt benefit at the expense of the City, and the Pas de Calais benefits at the expense of South Wales and the North-west in the race for Japanese and American investment. Far from being at the heart of European affairs, we could become as uncomfortably marginal as we felt in the 1960s. As Professor Willem Buiter, a former member of the Bank of England's Monetary Policy Committee, has said, "Until the United Kingdom is a member of EMU, it will have second fiddle status in the concert of Europe."

If you believe, as most British people seem to believe according to the opinion polls, that British membership of the euro is merely a matter of time, then it is supremely irrational to delay. We will, when we join, have to pay all the upfront costs (such as conversion costs for slot machines) in any case. But with each month that passes

we are delaying the benefits. If an investment is worth undertaking, it is worth undertaking as soon as possible so as to bring the benefits on stream. British membership of EMU is precisely such a case. We will make the investment before long, so it makes no sense to delay the benefits. Nor does it make any sense to risk increasing the costs by prolonging our self-imposed period of political impotence. Time and again Britain has delayed participation in European-wide projects which our partners have deemed to be essential. We continue to pay the price for these delays in both the Common Agricultural Policy and the Common Fisheries Policy. How long must we go on doing so on this occasion?

The Eurosceptics increasingly recognise the power of this logic as they flail to find an alternative vision for Britain and its economy in the twenty-first century. This is one reason Contact Black, the Canadian proprietor of the *Telegraph* newspapers, wrote an interesting article in his own journal, entitled "Britain's final choice: Europe or America?", which rather let the cat out of the bag. Mr Black argued that Britain should leave the European Union and become a member of the North American Free Trade Agreement (NAFTA). "If the United States received a signal from a British government that it wished to avail itself of a North American option, they would respond immediately," he wrote. "If America were jubilant, Canada would be ecstatic." So there is a secret agenda, but is not on the part of the pro-Europeans; it is the secret agenda of the anti-Europeans, which is to leave the European Union.

This is, of course, a rich newspaper proprietor's whim since the Americans have pushed hardest for British membership of the European Union, and take British views seriously in

exact proportion to our influence in Europe. For free traders, there is a good argument for trying to negotiate an Atlantic Free Trade Area (AFTA) including both the EU and NAFTA. But the argument that we should abandon the EU to join NAFTA is extraordinary. The cost of shipping a 40 foot cube container from Canterbury to the nearest port on the European mainland, Calais, is £450 whereas the cost of the same shipment to Boston, the nearest port in the US, is £1,540. Transport costs between Britain and NAFTA are three times as high as transport costs between Britain and the EU, and these costs dwarf tariffs. Inevitably, we will have a much closer trading relationship with our European partners than with the North Americans. Since we export nearly three times as much to the EU as to NAFTA, we would end up paying far more tariffs on EU exports than we would save on NAFTA exports particularly since two thirds of our trade with NAFTA is tariff free in any case. The amount of competition for the consumers' pound would be reduced, and we would give a whole new meaning to "rip off Britain".

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The idea that leaving the European Union would allow us to regain control over our own concerns is also absurd. It completely fails to understand the globalised world in which we live. Norway is outside the EU, but its businesses need to sell in the EU, which is their largest market. As a result, Norway has introduced 3,000 items of EU legislation covering industrial standards, consumer safety requirements and environmental measures needed to ensure that its products comply with EU rules, and can have unfettered access to the single





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market. Yet the Norwegians have no influence over any of these rules in either the Council of Ministers or the European Parliament, because Norwegians are not represented. If that is what our Europhobes mean by national sovereignty, they should think again. We should never exchange the illusion of sovereignty outside the EU for the reality of power within it.

Leaving aside the question of geography, or perhaps oceanography, the problem for most British people with Mr Black's vision is that we have no more desire to become an appendage of the United States than to be subsumed into a European superstate. Yet recently a legal case brought by the US-based Ethyl Corporation under the NAFTA rules caused the Canadian Parliament to repeal a law designed to protect its environment. There are six other similar cases. The European Union, which celebrates its cultural, social and ethnic diversity, suits British interests well. Most people realise that the threat to Britain's cultural identity does not come from Brussels, but from our seductive cousins across the Atlantic with their all-conquering Hollywood dream factory. British social values are more European than American, as is re-

flected in our relatively strong commitment to a welfare state and to relatively high provision of public services. Most British people know that there is no conflict between being British, English and a Yorkshire person. To be European is just another layer of our identity.

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We cannot long stand aside from the central project of the European Union, already adopted by twelve other member states and soon to be adopted as a matter of course by the thirteen candidate members in central and eastern Europe. The euro is a big change, but it has come to seem a much smaller one in the context of present hyperactive international markets. Do we want to live in a world where exchange rates can be so buffeted by speculation that they can move by nearly 10 per cent in one trading session, and where the reasonable expectations of our exporters can be overturned in a week? Lord Keynes warned that the financial system should never allow the bubbles and froth of speculation to undermine the steady efforts of commerce and

industry. He was right. We need to use our sovereignty to provide a stable environment for our businesses, in the same way that we have rightly used our sovereignty to provide a secure defence within NATO. What sort of freedom is it to hike interest rates so high to defend your exchange rate that you drive the economy into recession? What sort of freedom is it to float your exchange rate and price hundreds of thousands out of work? Our present financial system is not sustainable. We can move back to a world where free movement of capital and even of trade come increasingly into question. Or we can ensure the benefits of greater international integration by adopting the euro. In a real world of hard choices, the pound's days are numbered. The euro is our future.

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