WHY BRITAIN SHOULD JOIN THE EURO

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With a foreword by Paul Volcker

Responsibility for the views expressed in this pamphlet rests solely with the authors. Some of the group would be happy to speak and write further on the subject, and can be contacted via Nick Canning on 020 7881 8944 or e-mail nick.canning@britainineurope.org.uk.

Though two of the authors are American, the United Kingdom is often referred to as 'we' for ease of reading.

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FOREWORD

It is for Britain to decide whether or not to join the euro – and I'm American. But it's important to all of us that Britain flourishes. And this American can only admire the strength and clarity of the economic analysis in *Why Britain Should Join the Euro*. The argument is surely right.

Paul Volcker, chairman of the US Federal Reserve Board 1979-1987

INTRODUCTION

The biggest decision now facing Britain is whether or not to join the euro. Many people say they would like more information before making up their minds. And the Government itself, though in favour in principle, has still to decide on when to recommend entry. So the aim of this pamphlet is to clarify the economic issues – to say what really matters and what matters less or not at all.

As in all human decisions, there are pros and cons, and we try to set them out clearly and fairly. But in the end we believe the case for joining is compelling – and for joining soon.

Joining the euro would increase our incomes and thus our standard of living. In 1956 we decided not to join the European Common Market. In the following years our living standards were overtaken by those in France and Germany as they benefited from the extra efficiencies derived from their access to a larger market. Those countries have now achieved the same productivity per hour worked as in the United States, and that is why they can afford hospitals, railways and schools that we can only aspire to. But eventually in 1973 we too joined the European Common Market and soon after that our relative decline stopped. But, despite 20 years of economic reform, we have failed to narrow the productivity gap with France and Germany. And now the countries of Europe have taken one more step towards making a truly unified market, using only one currency. If again we delay joining, we again risk falling further behind.

But of course there are risks of joining. We could no longer set our own interest rates, which means that we would have to rely more on the budget to cushion our economy against economic shocks. As the No campaign put it, "One size interest rates do not fit all". They have set out their case in a lengthy pamphlet and we shall deal seriously with their arguments.[1]

Before turning to the arguments they deploy today, **we cannot refrain from one general comment on the arguments they have used in the past**. At each stage the opponents of the euro have forecast disasters which have in fact never happened and which always looked most unlikely. First, they predicted the euro would never get off the ground.[2] Yet it did. Then they forecast a major exchange rate crisis in the run-up to January 1999 when the euro was due to begin. Yet there was no crisis, despite massive turbulence in other world financial markets in autumn 1998. Then they claimed the euro would rapidly break up,[3] and that there would be chaos and popular revolt when the notes and coins were introduced in January 2002.[4] Yet there was no breakdown and no chaos. And, directly relevant to the current British debate, they forecast disaster in Ireland, Netherlands and Portugal on the grounds that an inappropriate interest rate would produce intolerable overheating. In 2000 for example, Patrick Minford, one of the most prominent economists opposed to the euro, forecast that "in Ireland prices could rise 10% a year for two or three years".[5] Yet in 2001 inflation in Ireland was 4%. In other words the Euro-sceptics constantly underestimated the competence of the Europeans and their ability to organise things properly.

However, poor predictions in the past cannot be the main method of assessing current arguments about the future. We shall therefore proceed carefully through the arguments, beginning with the pros and cons, then considering the issue of “why not wait and see”, and finally looking at the mechanics of entry.

THE CASE FOR JOINING

The argument for British entry into the euro is compelling. It involves the following steps.

- **To improve living standards, Britain needs to belong to a large unified market**, such as exists in the United States. This will enable business to sell more widely and to achieve the massive economies of scale enjoyed in the US. It will also enable families and businesses to buy from a wider, and thus cheaper, range of suppliers. That is why we first joined the Common Market, which eliminated tariffs on trade, and why then under Mrs Thatcher we helped to create the European Single Market, in which other, non-tariff trade barriers are prohibited.

- **Europe is by far our largest market** – taking half our trade, compared to only 16% with the US. But Europe is only now becoming a 'single' unified market such as exists in the US. The European Single Market programme, pushed by Margaret Thatcher, has helped to bring down non-tariff barriers between European countries. But until recently there remained separate currencies, which acted as a major barrier to trade.

- **To have a truly single market there needs to be a single currency**, **as the US has**. At present any British company exporting to the Continent has no idea what the sterling/euro exchange rate will be in the future. So it cannot tell at all accurately what profits or losses might result from expanding its trading activities in Europe. This 'exchange-rate risk' is a major disincentive to trade and invest for the purpose of exporting to the Continent.

- **In this regard Britain is now in a worse situation than it was before 1999**. Up to the launch of the euro any company outside say, Germany, that wanted to sell into Germany faced an exchange rate risk - whether it was located in Britain, France or Italy. Today companies in France and Italy face no exchange rate risk when they trade with Germany; but those in Britain do. So since 1998 companies wanting to sell into the massive continental market have increasingly invested inside the euro-zone because they can thus accrue their costs and revenues in the same currency. Since then trade between countries in the euro-zone has increased 20% faster than GDP, while trade between Britain and the Continent has been stagnant relative to GDP. Britain's best way to avoid this loss of business is to join the euro.

- **Damaging fluctuations in exchange rates may well increase,** as capital becomes easier and easier to transfer between currencies. Britain has already seen the effect of this in the strength of the pound from 1998-2002, which hurt many exporting and import-competing companies. A separate currency will become an increasing disadvantage for a medium-sized country such as Britain, which is too dependent on international trade to be able to neglect its exchange rate in the way the US can. Caught between two large currency blocs, the only predictable thing about sterling is that it is likely to head off in unpredictable directions. Only by joining the euro can Britain protect itself against the dangers of these damaging fluctuations.

- **The issue of influence**. Joining the Euro does not imply tax harmonisation, and will not increase the powers of the European Union to pass laws affecting Britain. Such powers already exist whether or not Britain joins the euro-zone. But Britain will be better able to influence how those powers are used if we are represented at the regular meetings of ministers from the euro-countries. Representation in the European Central Bank will also give Britain more influence over the European business cycle, which is so important to British prosperity and well-being. By joining the euro and so becoming a full member of the European club, Britain's influence outside Europe would also be greater.

Thus for Britain the euro poses both an opportunity and a threat. It is crucial to consider the question of British entry in the "real world" context, where Britain now lives next door to a large and expanding euro-zone bloc. Too much of the debate is devoted to static analysis, or to hankering after an old status quo in which the euro had not been invented. That option is no longer on offer. The euro exists, and Britain has to live inside it or outside it. Either is risky; but the superficially "safer" route of staying outside until the arguments for joining are beyond dispute is the riskier of the two. By joining, Britain can have higher productivity and better living standards. If we stay out, the dangers of falling further behind the core of Europe will steadily increase.

Let us develop these arguments more fully, step by step.

One market requires one money

The central argument for joining the euro is the same as the argument for joining the European Single Market: the benefits of market size. If a country joins a wider market, it benefits in two ways. **First, producers can reach more customers and so they can operate on a larger scale**. This enables them to produce more efficiently. One can see these economies of scale at work in the US, and they are now coming to the euro-countries too. This benefit of scale is contributing to a wave of mergers and of company restructurings, now happening across Europe in response to the Single Market and the single currency.

Second, a large market makes it possible to buy from a wider range of suppliers, some of which will be able to produce more cheaply than domestic suppliers can. This wider choice is good for consumers, and it is good for businesses looking for cheap intermediate products and good locations to outsource. These are the mechanisms which have helped make the US rich, and which made Britain take the lead in pressing for the introduction of the European Single Market in the first place.

But the experience of the Single Market since 1992 has shown that **formal free trade is not enough to create a truly single market**. Prices still vary between countries, with the price of individual goods in supermarkets varying five times as much between countries as it does within countries.[6] This scale of price dispersion does not exist in the United States[7], and the reason is simple: the US common currency.

We can see this from the example of Canada, which shares with the US a common language and culture, free trade and such a long frontier that most of Canada is nearer to the US than to the rest of Canada. But it has a separate currency which floats against the US dollar. Research shows that a given Canadian province trades 20 times more goods and services with another Canadian province than with a US state that is equally distant and has equal income.[8] In consequence prices differ between the US and Canada three times more than they vary within each country[9]. The Canadian market is thus very separate from the US. In part this is doubtless due to nationalistic feeling and different laws. But an important part is due to different currencies. And the cost is considerable. Canada's relative isolation and the resulting small size of its market is one reason why Canada's GDP per head is 20% below that of the US.

Multi-country evidence is obviously yet more convincing. Even before the recent European experience, it was already clear that currency unions have a major effect on trade. The No campaign is critical of the first major article on this,[10] but since then there have been 19 separate studies all of which confirm that currency unions have a large effect on trade.[11] One of these studies concluded that the euro will eventually increase trade between the euro-countries by around 50%.[12]

What has happened in Europe since the euro came in strongly confirms the size of these effects. **Since 1998 trade in goods between euro-zone members is already up 20% relative to GDP** (see Table 1). [13] And this has not been at the expense of trade with the rest of the world. **By contrast Britain's trade with the EU has fallen relative to GDP**. So we are losing out on this trade explosion. This matters because greater trade leads to higher productivity.[14]

Table 1
Trade with other E.U countries (as % of GDP)

	France	Germany	U.K.
1998	28	27	23
2001	32	32	22
Change	+4	+5	-1

Source: Eurostat (Comext); UN (Comtrade). Trade in goods (sum of exports and imports).

There are three reasons why a single currency has such a powerful effect on trade and productivity. The first is the **absence of currency fluctuations**. This encourages the restructuring of industry, which in turn leads to higher productivity. Until the euro was launched, any company with potential revenue streams in several different European countries had a strong incentive to maintain some production in each country as a natural hedge against the corresponding sales revenue in that currency. It could not design its structures on a least-cost pan-European basis (as a company in the US would) without facing exchange rate risk. Now, within the euro-zone, any company can design its business system for maximum efficiency, achieving large productivity improvement.

The figures in Table 1 reflect this. Those for Germany and France reflect the extra trade that occurs when exchange risk is removed. The figures for Britain reflect the opposite. For our **relative** exchange risk has increased (relative to any country in the euro-zone) and our ability to develop our trading links within Europe is thus less than it would have been if the single currency area had not been formed.[15]

The second reason for greater trade and productivity is simply **price transparency**. Until now, major pan-European multi-nationals have charged the highest prices that they could obtain in each national market. But these companies are recognising that, with the single currency, they are likely to have to move towards a single price for the whole euro-zone. If they don't, business customers will increasingly arbitrage pricing discrepancies by buying across borders, and in consumer markets both cross-border shopping and the pressure of public comment and comparison will require response. Euro-zone prices are therefore likely to move towards those seen in the most competitive areas. As a result companies will be subject to more intense competitive pressures, stimulating more rapid productivity growth.

The third reason relates to **capital market integration**. Within the euro-zone the barriers between national capital markets are breaking down. Until recently investors in, say, Germany largely invested in German companies – either in equities or in bonds. Indeed, insurance companies and pension funds were constrained to do so by obligations to hold high proportions of their assets in the same currency as their liabilities. But now capital is free to pursue the highest-return investment opportunities across the whole of the euro-zone, and companies are able to raise capital across all of the euro-countries for high return projects. Thus the pressure on management to perform better is increasing. All this stimulates productivity growth. These effects cannot be achieved without currency union since long-term exchange risk is so difficult to hedge, especially for returns on equity.

Already we can see the effects in reality. The stock of euro-denominated corporate bonds nearly tripled between 1998 and 2001, to 1.2 trillion euros.[16] Associated with this is a major restructuring of business: **within the euro-zone annual cross-border foreign direct investment increased four-fold between 1996-8 and 1999-2000**.[17] If you believe in the power of the market to allocate capital well, you should naturally favour a single currency as well.

The disadvantage of a floating pound

If Britain stays out of the euro then we will lose all three of the advantages described above. The most serious is that our currency will continue to fluctuate against the euro. For business this is a real disadvantage. If any firm produces machines in Britain and sells them in say, Germany then it pays out wages in pounds. If the pound becomes more expensive, the goods become more expensive to the 300 million euro-zone consumers. So the firm cannot sell as much, even if it accepts a somewhat lower profit on each item it sells. The firm's profits fall and it may even go bankrupt.

Thus in a world of separate currencies, profitability fluctuates with the exchange rate. A separate currency increases business risk for any company that exports, or which competes with imports. **Fluctuating currencies discourage trade**.[18]

This risk factor is illustrated by the recent problems of British manufacturing. In the past four years we have had a strong pound, but risk will continue whether potential future movements are up or down – it is the possibility of fluctuation that creates risk. This risk impedes investment, deters medium-sized firms from expanding abroad and diverts management attention towards exchange rate risk management and away from the business fundamentals of higher productivity, lower costs and improved quality.

It is simply not possible for companies to insure themselves effectively against these risks. Using formal foreign-exchange contracts and other financial instruments they can at a cost insure the sterling value of a known amount of foreign exchange revenue from a specific order against a change in the exchange rate over the next year or so. But a company planning to invest to produce goods or services to be sold in several different European countries in uncertain quantities and at uncertain prices over many years into the future cannot hedge that risk - as the workers at plants such as Ford at Dagenham and Rover at Longbridge have found out.

Moreover, British companies wanting to sell in Europe will increasingly have to set their selling prices in euros rather than pounds. This will further add to the risks of selling – whether at home or abroad – so long as Britain retains the pound.

The sheer fact of exchange rate uncertainty is a deterrent to the creation of a unified market and to investment. This would be so even if exchange rates always moved in a rational way. But in fact **exchange rates in the real world are often subject to essentially arbitrary fluctuations**. In the ideal world of oversimplified theory they would move smoothly to reflect differences in national inflation rates and the relative competitiveness of externally traded sectors (as reflected in external current account balances). But in the real world of highly liquid and speculative financial markets, there is overwhelming evidence that this is not the case. Instead exchange rates often massively overshoot the required adjustments, or move, for considerable periods of time, in precisely the opposite direction to that required for smooth economic adjustment.

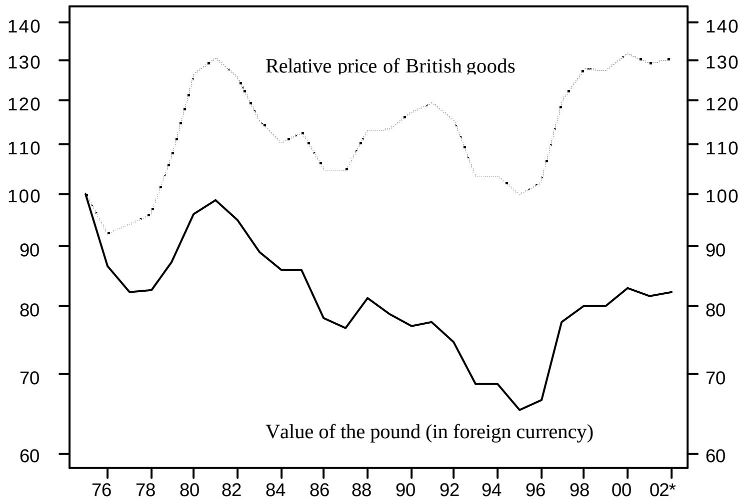
Because of this, **an independent exchange rate can be a source of shocks to an economy rather than a means of offsetting them**. These shocks may be large and potentially very damaging for an economy of Britain's size. The bigger the economy, and the smaller its tradeable sector, the less significant is a prolonged period of over- or under-valuation. That is why the US, with only about 10% of its output traded outside its borders, is able to follow a policy of close to benign neglect towards the external value of its currency, the dollar, without major effects on its own economy. But for a trading nation like Britain, exporting about 28% of GDP, these shocks matter.

These dysfunctional movements of the exchange rate can be seen in Figure 1. The bottom line shows the value of the pound vis-à-vis other currencies.[19] In theory this should move so as to maintain the competitiveness of the British economy and stabilise the price of British goods relative to our competitors. The result should be that the relative price of British goods is fairly constant. But, in fact, as the top line shows, it is highly variable. A major reason for this is the fluctuation in the exchange rate itself. Rather than helping to stabilise our ability to compete, it has on balance destabilised it.

Take, for example, the last six years. Between 1996 and early 2000, the pound rose by 25% at a time when inflation was higher in Britain than in the rest of the G7, and when Britain had no excessive balance of payments surplus on our current account. From 2000 to 2002 it stayed high. The rise in the value of the pound simply made Britain's goods more expensive on the international market, and damaged British competitiveness. The same thing happened in 1979-81. Indeed, the degree of over-valuation in 1998-2001, measured by relative unit labour costs, was similar to that of 1981, a shock that led to a massive fall in manufacturing employment.

Some of these exchange-rate movements were the result of poor monetary policy, others of self-fulfilling shifts in expectations. But they demolish once and for all the idea that a floating exchange rate is an efficient mechanism of adjustment.

Figure 1 Value of the pound (in foreign currency), and relative price of British goods (1975=100)



Note: Indices are trade-weighted to reflect the direction of trade and the sources of competition in each overseas market. The top line uses relative consumer prices. * Jan-May 2002.

The disadvantage of floating may increase

For Britain, a floating exchange rate is already unattractive but it will probably become even more so in the future. As the electronic revolution proceeds, and as world capital markets become more integrated and more liquid, the amount of money that can cross the foreign exchanges will continue to grow. (Already foreign exchange transactions involving the pound are worth £110 billion a day.) **It is therefore likely that floating exchange rates will fluctuate in the medium term even more in future than in the past**. And the more that exchange rates fluctuate in uncontrollable and harmful ways, the greater the arguments for entering a larger currency area.

The size of an optimal currency area reflects the balance between two factors. On the one side is the potential benefit of independent interest rates and exchange rates as a means of economic adjustment: this argues for a smaller currency area. On the other side is the danger that exchange rate flexibility would itself induce shocks upon the economy: this argues for a larger currency area. The latter danger is increasing as global financial markets integrate and become more liquid. The case for entering a large currency area is therefore increasing, as are the dangers of staying out. So for Britain the case for joining the large euro currency block becomes steadily stronger.

The euro is not the same as the ERM

Opponents sometimes claim that joining the euro would be just like joining the Exchange Rate Mechanism (ERM) in 1990, which proved to be a failure. Nothing could be further from the truth. The ERM was a fixed exchange rate system within Europe, rather like the Bretton Woods fixed exchange rate system that operated in the whole world in the

1950s and the 1960s. In that earlier period fixed exchange rates worked quite well – in many ways better than the free floats that followed them. But that was an era before the huge development of liquid global capital markets, a development that has increased the potential for harmful exchange rate movements and made fixed, or managed, exchange rates increasingly untenable.

Britain's exit from the ERM in 1992 was an illustration of the extreme difficulty, at least for a medium-sized economy, of any policy of managed exchange rates.[20] **Joining the euro would not be to repeat the ERM, which tried to link different currencies while retaining national monetary autonomy**. Instead the euro replaces separate currencies with one common currency which all countries share. And one reason why European countries decided on the euro was precisely the difficulties experienced under the ERM.

Thus the choice for Britain now is between a fully floating regime and full currency union, a divide that needs to be better reflected in our public debate. We can go in and get the benefits of currency stability – which the authors of this pamphlet believe outweigh the arguments against. Or we can stay out on the basis of the counter-arguments (given below) but accept that the inevitable consequence will be periodic and uncontrollable exchange rate volatility and misalignment – with the adverse results seen in manufacturing today. But we must not delude ourselves into thinking that there is any way of reducing harmful exchange rate movements - other than through entering the euro.

Why Europe?

But why Europe? We should join our currency to the single currency area with which we do the most trade. That area is the euro-zone. **We do three times more trade with the euro-zone than with our next biggest trading partner, which is the US** (see Table 2). We cannot join our currency to both areas, because their currencies are different. So, if we want to join a large single currency market, the best one for us is undoubtedly the euro-zone. The No campaign reiterate that only half our trade is with Europe, as if half were not much; but that is irrelevant, since the rest is with a whole host of different currency areas.

Table 2
Shares of UK trade, 2000 (%)

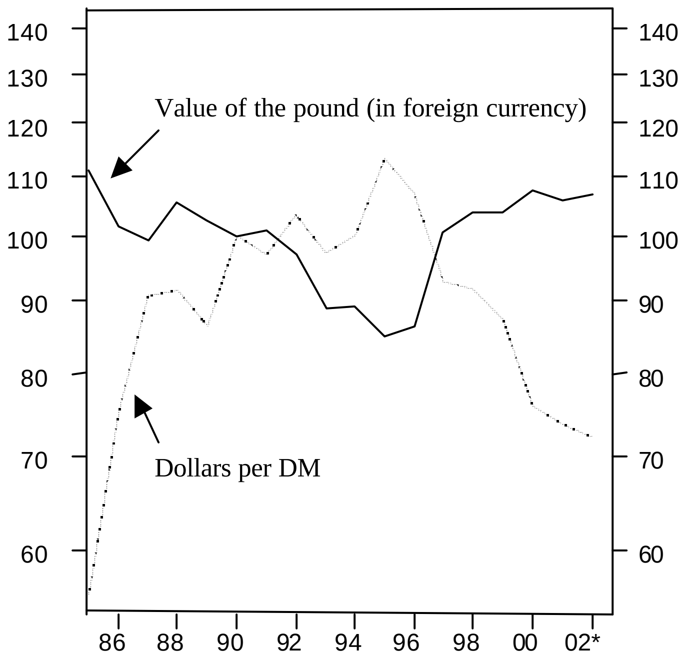
	Exports	Imports	Total
Euro 12	49	48	48
Sweden and Denmark	4	3	3
10 next EU entrants	2	2	2
U.S.A.	18	14	16
Asia	14	18	16
Other	13	15	15
Total	100	100	100

Source: ONS, Pink Book. Goods and services

One possible argument against joining the euro would be if it were a peculiarly unstable currency, so that our terms of trade would become more unstable by joining it than by staying clear. The No campaign argues that we would actually increase our currency risk by joining the euro. They say this is because the euro will still be floating against the dollar and the yen, and previous experience shows that the Deutschmark (DM) often fluctuated quite sharply against the dollar. To make their point, the No campaign compare the fluctuations in our trade-weighted exchange rate (shown in the bottom line in Figure 1) with the fluctuations in the dollar value of the DM. In Figure 2 we reproduce their graph. According to them it "shows very clearly that we have been able to enjoy less volatility in our overall exchange rate by tying to neither of the two big regional currencies".[21]

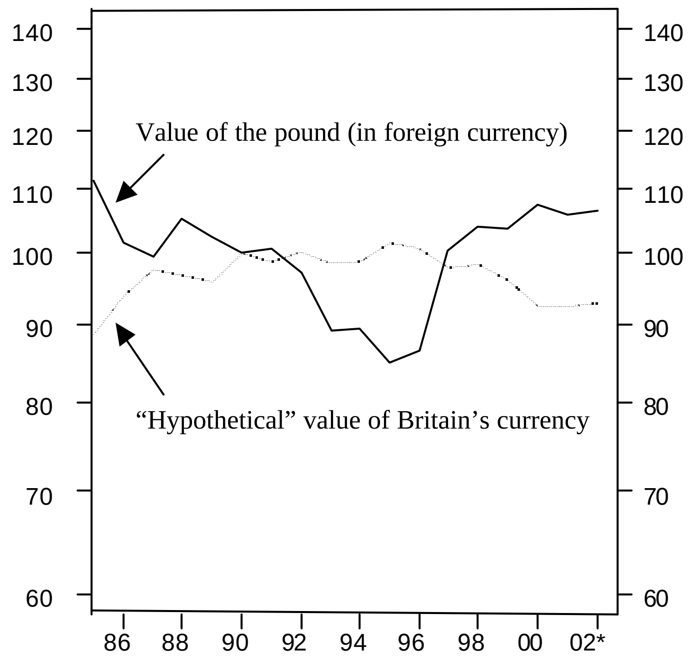
Unfortunately they have made an elementary error. For one half of our trade is with Europe and would not have been subject to **any** currency fluctuations at all if Europe had had the same currency. We can easily find how volatile our **overall** trade-weighted exchange rate would have been in such a case. The answer is given in Figure 3. If all EU countries had used one currency (the DM) since 1985, our trade-weighted exchange rate would have been much less volatile than was in fact the case. Indeed, it would have been half as volatile;[22] the coefficient of variation of its monthly value would have been 4% rather than 8%.

Figure 2 Value of the pound (in foreign currency) and Dollar/DM exchange rate (1990=100)



*Jan. – May 2002. Value of the pound is trade-weighted.
Source: Bank of England.

Figure 3 Value of the pound (in foreign currency) and "hypothetical" value of Britain's currency (1990=100)



*Jan. – May 2002. Indices are trade-weighted.
Source: Bank of England and authors' own calculations using Bank of England data.

The next argument of the No campaign directs our attention to the future. They correctly point out that for many good reasons (such as demographics and catch up) other parts of the world will in future grow faster than Europe. Asia in particular will grow faster then either Europe or the US. It will therefore absorb a rising share of our trade. But so what? Do we conclude that Britain should keep clear of Europe? If so, California should also leave the US single currency, because its Asian market is growing faster than its home market. Both suggestions are absurd. **Britain's best way of exploiting our opportunities in Asia and North America is to capture the economies of scale that can be obtained by integrating our economy more thoroughly with our European partners.** As for the suggestion that Britain should join the North American Free Trade Area in order to secure the benefits of integration with the US, we cannot do that without leaving the European Union completely, with all of the losses that would entail. There is, in short, only one sensible way to reap the gains from integration – by the fullest possible participation in Britain's most important market – which is obtainable only by joining the euro.

Finally, we should deal with three more technical objections from the No campaign. First, they claim that Table 1 exaggerates our interaction with Europe. For it only covers trade in goods and services and not investment income, which comes more from the US. But the right way to measure our involvement with another economy is to look at the amount of goods and services that we trade with them. It is this trade that provides jobs in our export industries and supplies the imports we depend on. If our exchange rate changes, this affects our jobs and our supplies. By contrast, most investments can be quickly transferred between countries, which trade cannot. Trade is the life-blood that we want to protect from exchange rate changes.

But if that is so, shouldn't we, as the No campaign sometimes argues, focus on the currency in which the trade is invoiced rather than the currency of the country where we are selling. Some 44% of our trade is invoiced in sterling, 32% in dollars and only 20% in euros.[23] So, the argument goes, if we want to minimise exchange risk, we should join the dollar. The argument is wrong. It implies for example that if we invoice in sterling there is no exchange risk. But suppose I am selling something in Germany and the price is fixed in sterling. Now the pound rises, and Germans stop buying my goods because they are too expensive. I will suffer. So perhaps I drop the sterling price a bit to keep more of my market. Then I keep sales volume but I lose profit. Either way I lose. The moral is that what matters is not the currency in which the price is expressed but the stability of the domestic currency (in which producers incur most of their costs) in relation to the currencies of their most important customers. As our most important customers are members of the euro-zone, it would thus make most sense to achieve perfect exchange rate stability vis-à-vis the currencies of those customers, by adopting the euro as our own currency.

Finally, the No campaign argues that Britain is more outward-looking than the rest of Europe. This is simply wrong. There are wide variations within Europe, and **six euro-zone countries, including Germany, trade more of their GDP outside the EU than Britain does.**

Loss of investment

If reducing exchange risk vis-à-vis Europe is important for making the most of existing resources, it is also vital for attracting and keeping new investment. Here the reality of the single currency has taken us into a new world, where Britain as a non-participant is much more exposed than before. Until now every European currency was different, and therefore each currency carried an exchange risk against every other currency. When firms considered where to produce, Britain bore no more currency risk than any other location in Europe.

All that has now changed. The 12 euro-countries have created a single currency area with a population of 300 million – a similar economic space to the US, and one likely to grow as more EU members join the euro, and as new countries join the EU and then in turn the euro. **Within the euro-zone there is no currency risk**, and any business located within the area can predict with certainty the value in its own domestic currency (the euro) of income it will receive from selling anywhere within the area. **By contrast a producer located in Britain but selling on the Continent continues to face an uncertain exchange rate**, since its costs are in sterling and its receipts depend on the sterling-euro exchange rate.

The range of uncertainty can be seen from the pound's fall from DM 3.32 in early 1989 to DM 2.22 six years later, and its subsequent rise to its previous level. These kinds of medium-term swing are impossible to hedge against in the forward foreign exchange market, because of the illiquidity of futures markets beyond the short-term, and more fundamentally because of the inherent uncertainty of the foreign currency revenues to be received. The adverse impact of these swings was mitigated when there was exchange rate uncertainty within the 12 euro-countries as well, but we have already begun to see how they now affect investor sentiment, especially among foreign investors in Britain.

Foreign firms investing in Britain do so to serve the whole European market – not just the British market. For many of them, sales in Britain are a small part of their total European sales. With Britain outside the euro-zone, it will be increasingly difficult to attract such firms to Britain because they can avoid exchange-rate risk on the bulk of their European sales by investing instead in one of the 12 euro-countries. This will strongly affect US and Japanese investors who currently invest in Britain as the gateway to Europe, and therefore want Britain to join the euro. Like most Japanese companies based in Britain Nissan and Mitsubishi have made clear they want Britain in, as have 80% of German investors according to a study published by the German-British Chamber of Commerce in March 2000. BMW even cited Britain's decision to stay out as a factor precipitating the sale of Rover (the cost to BMW of the rise in the pound was equivalent to around a third of Rover's annual losses).

The benefits of joining the euro are illustrated in the promotional material of the Irish Industrial Development Agency. It says:

> As the only English-speaking member of the European monetary union, Ireland offers significant advantages to companies operating from there. These include the elimination of exchange rate risks and transaction costs, consistently lower interest rates and a generally more predictable economic environment in which to operate.

These considerations are as important to domestic as to foreign investors and if Britain remains out British firms with large European sales can be expected to move more factories to the Continent. This has already started to happen with Rowntrees, for example, which has begun shifting production of Kit-Kat chocolate bars from York to Hamburg.

These various predictions are already borne out by experience. **Britain's share of the foreign direct investment coming into Europe has fallen by a half (see Table 3). In 2001 the Netherlands received more of this investment than Britain.**

Table 3
Share of total foreign direct investment into the EU coming to the UK

1997 – 1998	52%
1999 – 2001	24%

Source: Commission answer to written question No. E-0033/02 and Eurostat. The figures for the five years are 48, 57, 25, 22, 24.

We should not be complacent. Britain is not the outstanding place to invest that anti-euro propagandists portray. Though we receive more foreign direct investment than other EU countries, we export more foreign direct investment than we import.[24] This is a long-standing phenomenon and implies **a low willingness to invest in Britain.** . Most Britons are surprised when you tell them that total investment in Britain is a substantially lower fraction of GDP than it is in France or Germany. It has in fact been so in each of the last 10 years – the 10-year averages are shown in Table 4.[25] This low investment rate is one reason why we have failed to catch up with our Continental competitors' productivity and cannot therefore deliver the world-class public services that our voters rightly demand.

Table 4
Gross fixed investment as percent of GDP

U.K.	17%
France	19%
Germany	22%

Source: E.C., European Economy, No.72, 2001, p.150

The risk to the City

The investment risk to the economy as a whole may well, though with a longer delay, apply also to the City of London. At present the City is the largest financial centre in Europe. It has the expertise, reputation and critical mass. More people are employed in financial services in London than live in Frankfurt, Europe's next largest centre. Although in a technical sense finance is a footloose industry, it is unlikely that the City could easily lose its dominance in bond issues, mergers and acquisitions, or foreign exchange trading. Indeed, the City enjoys a self-reinforcing cycle of success – attracting skilled people, capital and liquidity in a classic example of an industry-cluster effect – and supporters of the euro would agree that this cycle is unlikely to be broken by any short-term absence from the euro.

In some ways London is indeed benefiting from the advent of the euro. The single currency has created a new pan-European market for investible funds, where formerly, say, German insurers had to invest in DM assets. That new market is denominated in euros and the funds are mainly invested through London.

It would be equally wrong to assume, however, that this favourable outlook would be sustained if Britain stayed outside the euro on a permanent basis, and particularly if Britain became the sole EU member outside the euro-zone. Continental financial centres such as Frankfurt and Paris will try very hard to stimulate the virtuous circle that has taken London to pre-eminence. Minor details of regulation can be used to advantage one centre over another, or to slow the progress of London to the dominance it would be likely to enjoy if financial services were completely liberalised. Continental determination to avoid London's dominance would undoubtedly increase if it became clear that Britain's absence from the euro was permanent. And British exclusion from euro-zone finance ministers' discussions would permit the use of that forum to develop initiatives aimed at enlarging the roles of Continental centres at the expense of London.

It is therefore staying out, rather than entering the euro, which represents a risk to the City. It is a risk of uncertain magnitude, but also an unnecessary risk. For entry into the euro, justified by the other arguments put forward in this paper, would remove the only possible obstacle to London becoming, even more than today, the dominant financial centre of Europe.

Loss of influence

This brings us to the wider issue of Britain's influence in Europe. Britain's economy is profoundly affected by what happens in Europe – at the **macroeconomic** level by the booms and slumps of the European economy, and at the **microeconomic** level by EU policies on competition, the environment, taxes and so on. It is therefore in Britain's national economic interests to influence all this.

At the macroeconomic level, Europe's monetary policy is conducted by the European Central Bank (ECB) in Frankfurt. To influence it, Britain has to become a member, by joining the euro. If we did so, we would be a key player in the Bank's deliberations. We could also play an important part in reforming the procedures of the ECB, including the way in which it formulates its inflation target.

At the microeconomic level, Europe's economic policy is affected by the European Union, based in Brussels, to which Britain already belongs. By a series of treaties signed mostly by Conservative governments, Britain accepts European law on a whole range of economic issues, such as financial services regulations, consumer protection, environmental standards, competition law, workplace safety and some aspects of employment law. The EU directives, regulations and decisions which determine these laws are decided, either on a unanimous or majority basis, by the fifteen members of the European Union, and are applicable to all of them irrespective of whether or not a country is a member of the euro. A dislike of such laws, and a desire to avoid them, can therefore be – for those who doubt the benefits of European Union membership – an argument for Britain to leave the European Union. But it cannot logically be an argument for Britain to stay in the Union but out of the euro, since **these regulations and any new regulations apply to Britain whether or not we join the euro**.

Conversely, however, the fact that this legislation exists and that Britain is governed by it, means that Britain has a national interest in maximising our influence in the development of European policy. That influence will be maximised if Britain joins the euro. If Britain does not join, there is a danger that euro-12 discussions will be used, informally but effectively, to develop policy ideas and initiatives which Britain cannot influence at an early stage – and cannot successfully oppose on our own at a later stage. And there is a danger that Britain's arguments in favour of micro-economic reform (to reap the full benefits of the euro) will be less influential. In legislative areas governed by majority voting (such as all Single Market and some social policy issues) Britain's ability to find allies will be reduced if we are not members of the euro. In areas where there is a veto (like tax policy) Britain can always insist on our position, but a veto can be exercised more easily and with less damage to our international relationships if our commitment to the club is undoubted. Britain would be far more influential within the euro club than in isolation.

Things will become increasingly awkward as time proceeds. First, it is possible that Denmark and Sweden will join the euro over the next few years, leaving Britain as the only EU member that is outside. Second, the EU itself will be enlarged towards the middle of the decade by around ten new members, which in turn may adopt the euro within a few years.

The awkwardness of Britain's position in Europe will become ever more pronounced and our influence will continually be under threat.

If there were some other role for Britain which was in our economic and political interests, then that should of course be considered. The most obvious role might be in some "special relationship" with the US. There is certainly a special affinity between Britain and the US, based on language and culture. And the US government has shown repeatedly that it attaches importance to Britain's influence in the world. But it has also repeatedly looked to Britain to exercise influence within the EU. Britain could have more influence on the evolution and policies of the EU if we were within the euro-zone than if we remained outside. And in this way we could influence what most directly affects us – what happens on the European continent and in the European economy.

Other arguments

These arguments are those that really matter today. But in the past they seemed to figure much less than arguments about **inflation and interest rates**. That is because historically Britain had higher inflation and higher interest rates than Germany. So the idea took root that, by joining a currency union with Germany, Britain could have lower inflation and lower interest rates. Time has made this argument weaker. Britain has found that we can control domestic inflation quite well through domestic monetary policy. The inflation rate is now roughly the same as in the euro-zone[26] and long-term interest rates have completely converged. (Short-term interest rates, though still different, are also much closer than in the past.)

This is an important achievement and it shows that in the current climate Britain does not need the euro to achieve sustained low inflation. This removes one argument for joining. But at the same time it removes one argument for not joining – the argument that Britain needs a floating exchange rate to compensate for higher inflation. And it leaves the problem of external macroeconomic instability, the adverse impact of a fluctuating exchange rate, as pressing as ever.

Another obvious argument for joining is the **saving on transactions costs** of exchanging currency. This is often stressed in the popular debate, but the order of magnitude (under 0.5% of GDP) is small compared to the big issues we have been discussing. Conversely, however, some Euro-sceptics make great play of the **investment costs of the transition to euro notes and coins** – new ATMs, tills, accounting conversion and so on. Some anti campaigners have suggested costs as high as 4% of GDP (£36 billion). But none of the 12 euro-countries have spent more than 0.8% of GDP, and a typical figure is nearer 0.5%.[27] The cost would probably be less in Britain since the appropriate software programmes and equipment now exist and can be bought off the shelf. In many cases, moreover, these costs will simply represent the bringing forward of an existing investment commitment (new generations of ATMs are continually being developed and introduced) rather than a whole new category of spending. And, of course, the investment in the changeover is a one-off cost, while the savings on transactions costs go on year after year. Transaction cost savings, therefore, while not a crucial reason for entering the euro, will represent a good and quick rate of return on the investment involved.[28]

Summary

So we can summarise the arguments for joining quite simply.

- Belonging to a **large single market** will raise living standards, through more intense competition and large economies of scale. It will make possible the improvement in public services we all want.

- **Europe is by far our largest market** – taking half our trade, compared to only 16% with the US.

- Achieving a single market requires much more than the abolition of trade barriers. It requires a single currency, which increases trade and reduces investment risk by **increasing price transparency and eliminating exchange rate fluctuations**.

- Now that the single currency exists among the 12 euro-countries, Britain is in a **new, more exposed**, **position**. Manufacturing activity is beginning to shift to the area of currency stability, and there is some danger that the City's predominance in wholesale financial services could be threatened if Britain was outside the euro in the long-term.

- **Exchange rate fluctuations may increase** as capital washes ever more rapidly around the world. For a medium-sized country like Britain, such fluctuations are extremely damaging.

- Britain can have more economic and political **influence** within the euro-zone than outside it.

THE COUNTER-ARGUMENTS

As always in life, the arguments are not all one way. So we need to set out and comment on the serious arguments made by those opposed to the euro.

One size does not fit all

The main argument against entering is that at any one time different countries need different interest rates, and should therefore be able to set their own rate. But in the euro-zone interest rates are set by the European Central Bank and, since a euro is a euro, the interest rate will necessarily be the same in every member country[29]. The ECB will set this rate to suit Europe as a whole and not to suit Britain in particular.

If Britain were to be hit by a negative shock that does not affect the rest of Europe, Britain should ideally be able to cut its own country-specific interest rate. If it is in the euro, of course, it cannot. This is a substantial issue, but how much does it matter in practice? There are a number of points to be made.

- The most fundamental is that, while your own interest rate can be a useful lever of economic adjustment in the face of shocks, you can only have it if you also have an independent currency which is free to fluctuate - and a **fluctuating currency is itself a potential source of shocks**. Any single currency prevents interest rate flexibility across regions – and that does carry a cost – but the issue is the balance of cost versus benefit. In the US it would have been very useful, at several points in the last 20 years, to be able to vary regional (e.g. Texan) interest rates to offset property booms or to stimulate a regional economy in recession. But the disadvantage of a fluctuating Texan-US exchange rate, able to oscillate unpredictably, would have more than offset the benefit. In the same way, Britain is likely to gain by abandoning its separate currency and using the same currency as the rest of Europe.

  But there will of course be some Britain-specific shocks. How important are they likely to be? In the past few decades **most shocks affecting Britain have stemmed either from domestic policy or from erratic exchange rate behaviour or from shocks that affect all European countries**. Examples of the first two include the excessive value of the pound in 1980-1, the Lawson boom of 1987-9 and the Major recession of 1990-2. But inside the euro, exchange rate shocks are either impossible or common to all the euro-countries, as are shocks stemming from erratic domestic monetary policy.[30] Examples of Europe-wide shocks include the oil and commodity price shocks of 1973/4 and 1979/80. Shocks of this kind require a Europe-wide response.

  There will of course be some exogenous shocks that affect Britain more than the rest of Europe. These will mainly occur when a particular industry slumps (or booms) and when that industry is one in which Britain specialises more than other countries. So how different is Britain from the rest of Europe? The answer is that Britain is no more different in economic structure from the rest of Europe than the typical US region is different from the whole of the US.[31]

Euro-sceptics often argue that Britain's economic cycle is inherently more in line with that of the US than that of Europe. This point, however, is based on a temporary 1990s phenomenon, not on fundamental factors. Since the Second World War there have been some decades when the annual growth rate in Britain has been as highly correlated with the European average, as has the growth rate in France or Germany. That was, for example, the case in the whole period 1966-92.[32] At other times it has been less so. But the important point is that the degree of correlation depends on the degree of integration. The sheer process of joining EMU will make Britain's economy more in tune with the movement of Europe as a whole.

- When Britain-specific shocks do occur, **Britain will still have its own independent budgetary policy** and can use this to offset any shocks both through the automatic stabilisers and discretionary policy changes. The EU's Stability and Growth Pact puts limits to this, requiring balanced budgets over the cycle and a maximum annual deficit of 3% of GDP, except in severe recessions.[33] But this leaves significant scope for positive stimulus in the face of economic downturn.[34]

That is, incidentally, the answer to one of the most widely-held fallacies about the single currency: that it requires a large central budget in Brussels. It does not. It simply requires that when a country suffers a fall in private demand, this can be adequately offset by a net stimulus from that country's public sector.

In Britain, as in every other European country, there are automatic stabilisers built into the budget. If private demand falls, more gets paid out of the budget in unemployment benefits and less is collected in taxes. So the budget deficit increases. By contrast, in the typical US state there is no such mechanism because in most states the budget is required to be in balance every year. Hence the US states rely on automatic stabilisers provided through the federal budget in Washington - which pays out more unemployment benefit and collects lower federal tax receipts in those states which are in recession. Europe does not need a similar centralised mechanism of counter-cyclical payments since the mechanism already exists in the national budgets. What matters is that the necessary injection of demand occurs; the source of the injection makes little difference.

The idea that the single currency requires a large European federal budget is therefore a politically-motivated fallacy. The really important need is for countries to achieve a reasonable balance over the cycle so that they can then safely increase their national deficits during recessions in order to stimulate their economies. European nations will then use their national budgets to help stabilise their economies over the business cycle. So the success of the euro does not require a major increase in the European Union budget, which is currently limited to 1.27% of European GDP in the years up to 2006 and can only be increased by a unanimous vote and subsequent ratification by every national parliament.

One must add that for most of its life the great US single currency existed without any federal transfers from Washington – up to at least the First World War. It worked, as did the world's Gold Standard from 1880 to 1914, though not without some difficulties due to inadequate understanding of the effects of fiscal and monetary policy. More recent examples of successful monetary unions with no common budget are Britain/Ireland (1921-79), Belgium/Luxembourg (1921-99), the Eastern Caribbean Currency Union, and the two Francophone currency unions in West and Central Africa. They were all quite successful.

- **The labour market response to a shock is also important**. The appropriate response to a negative shock is a fall in wages, which creates more jobs, and an out-migration of workers. Although European wages may be as flexible as wages in the US, which means not very flexible,[35] migration is much lower than within the US. The problem in Europe, however, is not only that people do not move greatly between countries, thanks to linguistic and cultural differences, but also that they do not move within countries very much either. This low level of intra-national mobility contributes to high levels of regional unemployment, such as in southern Italy. Yet these are problems with which European nations have lived, however imperfectly, for many years. Moreover, they have generated policy responses, including inter-regional transfers, already allowed for within national and to a degree European budgets, like the "structural funds". The **additional** problems created by limited **inter-country** migration in a single-currency Europe are small compared with those already faced within each country with its own single currency. It would undoubtedly be beneficial if the geographical mobility of labour increased, both within and between countries, but the absence of labour mobility is not a decisive argument for preferring floating exchange rates. In fact, floating exchange rates, when they float in a perverse way, can increase rather than decrease the required degree of labour market flexibility.

- **Britain is Europe's only oil economy**. The No campaign has made much of this point. We are indeed the only net oil exporter in the EU. If oil were a major part of our GDP and there were a **permanent** increase in its price then a real exchange rate appreciation would be useful, and that could best be achieved by a nominal rise in the value of our (separate) currency. But oil and gas output accounts for only 2.1 per cent of our GDP, the same as in the Netherlands, and, more serious, oil prices are highly **volatile**. The last thing we want is a series of temporary shifts in our competitiveness, driven simply by the vagaries of the world oil market. With a floating exchange rate, if oil prices rise this tends to cause a real appreciation that damages our manufacturing sector, cutting capacity which is not recovered when the oil price then comes down. This used to be called the "Dutch disease" but since the early 1980s the Dutch avoided it by de facto linking their currency to the DM. We experienced this same problem in 1980-1 and we do not need to experience it over again. Similarly, a low oil price tends to increase our competitiveness on a temporary basis, encouraging unwise investments. So, with oil prices behaving as they do, a floating exchange rate functions as a source of instability rather than an appropriate adjustment. Therefore, membership of the euro would be useful protection against the perils of an oil economy.

In the end we always return to the fundamental dilemma. If you want to control your own interest rate in order to deal with potential country-specific shocks, then you have to have your own currency. In a world of footloose capital, this means a floating exchange rate. But floating exchange rates are themselves one of the most potent sources of macroeconomic shocks – and a deterrent to long-term investment by British business competing in Europe.

Europe is a failing economy

Euro-sceptics often make much of their claim that joining the euro would link us too closely to a "failing economy" in Europe. This is one of the most extraordinary notions to have taken root in Britain. The main facts are these.[36]

- In France, Germany, Benelux and Northern Italy **productivity per hour worked is 20% higher than in Britain**. This is true now, and it was true 20 years ago. Over that period Britain has failed to catch up with these other European countries, despite all the talk about our superior economic system and the obvious scope for copying what others do better.

- Over most of the past twenty years (though not the last five) **productivity per hour has grown faster in Europe than in the US**, so much so that Northern Europe has now caught up with the US. Even on output per head of population, rather than per hour worked, over the past ten years this has grown as fast in Europe as in the US.

- **Prosperity is more widely shared across the population in Continental Europe than in either Britain or the US.**

The Continental economies therefore compare favourably with the British in terms of prosperity, productivity and growth. We have certainly ended our post-war period of relative decline, but we are certainly not superior to the Continental economies. **The one black spot in many Continental countries is unemployment** – with the average unemployment rate in the euro-countries at 8%, compared with 5% in Britain [37]. This is a major problem which several countries in continental Europe need to address seriously – but it is not a reason for Britain to stay out of the euro. In particular it is important to note that:

- **The problem is not a general European one, but differs between countries**. Germany, France, Italy and Spain each have unemployment rates currently over 8%, but Austria, Denmark, Sweden, Ireland, the Netherlands and Portugal have an average unemployment rate of about 4%, below that in Britain. While the latter countries are smaller, the fact that these countries achieve low unemployment rates, and in several cases high labour-force participation, illustrates that there is no single "European social model" that is inherently incompatible with low unemployment.

- This diversity of result reflects the fact that Europe's unemployment problem is not the result of mistaken European Union-level policies, but instead the product of different national policy failures in different countries. The impact of EU legislation on European labour market structures is very slight indeed, and Britain's labour market strategy would not be affected by membership of the euro.

- The notion that European countries are incapable of reform is also untrue. The problems are national, the solutions are national and several countries have already taken steps to solve their problems, with favourable results. Reforms in the Dutch labour market, for example, have helped raise the employment rate from 58% of the working age population in 1985 to 73% in 2000. Spain, historically one of the most inflexible of European labour markets, began important reforms in the mid-1990s which, along with a general upswing in growth, have helped to create over 3 million net new jobs. While further change is needed in many countries, the idea that the European labour market involves intractable rules into which Britain would be sucked by membership of the euro is simply wrong and mischievous.

- But, most important of all, even if continental Europe continued to have higher unemployment, this would in no way affect our underlying unemployment rate if we joined the euro. **Within any currency union there are some regions that have higher unemployment than others but this does not constrain the regions with lower unemployment.** For example, in England the North-East has for a century had higher unemployment than the South-East. Has this prevented the South-East from experiencing high employment? Far from it. Is it an argument for the South-East having a separate currency? Not at all.

  There is no merit whatsoever in the argument of the No campaign that convergence of unemployment rates between Britain and the euro-zone should be a condition for entry. This idea flies against all economic history and all economic theory, and should be rejected. Just as Belgium and the Netherlands have totally different unemployment rates within the euro, so could Britain and France.

Tax harmonisation

One argument often give high profile by the press against the single currency is that somehow it must lead inexorably to EU tax harmonisation. There is no logic in such claims. Any European initiative on taxation policy can only become law – under the terms of the Treaty of Rome –with the unanimous approval of all EU member-states, regardless of whether or not they have adopted the European single currency. So it is impossible that Britain or any other country could find its taxes put up or altered in any way against its will. And since the present need for unanimity may itself only be altered by a unanimous vote during a revision of the EU treaties, the status quo is highly likely to prevail. Quite simply, if Britain does not want tax harmonisation, it will not happen. In fact, a majority of countries do not want it anyway.[38] Of course, those that do want it would be even more likely to press for it if Britain kept its own currency which at some stage depreciated substantially, thus becoming super-competitive vis-à-vis Europe.

If Britain ever did decide to accept some element of tax harmonisation, it would apply to us whether we were in or out of the euro. **The idea that tax harmonisation and the euro are somehow legally or institutionally linked is simply wrong**.

The rules of the euro-zone involve only two budgetary constraints.[39] First, countries must keep their overall budget deficits to within 3% of GDP (and in a severe recession even this constraint can be relaxed). Second, overall levels of public debt should be below, or declining toward, 60% of GDP. These broad constraints are in place to prevent one country from free-riding (unilaterally pursuing inflationary policies at the expense of the others) and to make sure that countries' structural fiscal positions are sufficiently sound to allow fiscal policy to stimulate the economy in times of recession without the risk that they will enter an unsustainable debt trap.

Subject to these limits, which taxes are raised and spent are up to each country. Governments may pursue high-tax, high-spend policies or seek to prune back the role of the state. As long as the amount of money spent is not much more than the amount of money raised, the euro-zone rules will have been met. In France, for example, government spending accounts for half of GDP, whereas in Ireland it is just a third. The two governments need very different levels of tax revenues in order to balance their books. Yet both have adopted the euro. Were Britain to join, our decision on the size of our state spending would be unaffected. Joining the euro certainly does not mean joining a new federal super-state, the ghost raised by many out-and-out anti-Europeans.[40]

Britain's financial system is different

Opponents of the euro sometimes suggest we should not join because Britain's system of household finance is different from that on the Continent. Britain has mainly floating rate mortgages, while on the Continent most debt is fixed term. In addition, Britain has higher levels of household debt. The argument advanced is that aggregate demand in Britain will be more sensitive to changes in interest rates than on the Continent, making a single interest policy more difficult to live with.

There are, however, three compelling counter-arguments that cast doubt on the seriousness of these obstacles.

- Empirical analysis does not show demand to be more sensitive to interest rates in Britain than elsewhere.[41] This may be partly because a higher (fluctuating) rate not only hurts borrowers but also boosts the incomes of lenders.

- The structure of debt is highly endogenous, and it will be heavily influenced by Britain's entry into the euro. Britain's existing floating rate debt is connected with our past history of high and unstable inflation. As people get used to low and stable inflation, there will be more fixed rate debt. Moreover, if we join the euro, British banks lending at fixed rates will be more able to borrow abroad at fixed rates, thus matching assets to liabilities.

- In any case, British interest rates are likely to fluctuate less if we are inside the euro than if we are out.

Every country has different institutions. But this has not prevented 12 countries getting together. Nor should it be a strong enough reason for Britain to stay out either.

Europe's unfunded pension liabilities

Some antagonists say that by joining the euro, Britain would have to "take responsibility" for the unfunded pension liabilities of Continental countries. Owing to the ageing of the population, these liabilities will on present policies continue rising. In the EU as a whole public pensions are expected to cost an extra 3.2% of GDP at their peak. The worst affected countries are Greece (up 12.2% of GDP) and Spain (up 7.9%). Italy's public finances are not so badly hit – a rise of just 2.1% of GDP.[42] These liabilities will impose a major burden on future public finances unless action is taken; and if action is not taken, member states could become fiscally constrained, limiting their ability to allow the automatic stabilisers to operate. The issue is therefore an important one, but not a strong argument against Britain joining the euro for the following three reasons.

- The problems are not intractable. In particular **the scale of these liabilities is highly sensitive to minor changes in retirement ages, which should and will eventually be raised** as a logical corollary of increasing life expectancy. Entitlements can also be revised downwards. Furthermore, the whole concept of unfunded liabilities is fraught with measurement problems. In all the calculations of these that are presented there are many notional elements that go well beyond contractual government obligations which could not be changed by changes of policy.

- There is no provision in the EU treaties, or in the institutional arrangements for EMU, for the EU as a whole or for any member state to assume responsibility for the liabilities of other member states. Indeed, they are explicitly precluded from doing so.

- The relative position of Britain is not as favourable as first appears. Germany, France and Italy have high potential liabilities because they have made public pension promises that are too generous to be affordable with current retirement age rules. But Britain has the reverse situation, that our very limited future pensions "promise" is unlikely to be sufficient to ensure adequate income, and thus there is a hidden future burden in other social security and health service costs.

All countries have difficult decisions to make but they are nation-specific difficulties and decisions, not shared European ones.[43]

The euro will fail

A completely different argument against the euro is that it will fail and **break up**. This seems most unlikely. There will of course be times when the ECB becomes unpopular in countries in recession and therefore want lower interest rates. And in extremis a country could technically leave EMU.

However, there are very major forces in favour of permanence. A country leaving the euro would not only be giving up all of the benefits set out above but would also face major financial uncertainty. In every one of the 12 euro-countries the government debt has already been converted into euros, in accordance with European law. The denomination of the debt could not be changed back unilaterally. So if a country left the euro-zone and introduced its own currency, its debt would then be denominated in a foreign currency, leaving it confronting uncertainty about the exchange rate it would face when it had to repay the debt. No country would withdraw lightly from the euro, just as no country should enter without a careful assessment of the pros and cons. In extremis a country can exit, but it only makes sense to enter with the intention of staying in permanently. It is on that basis that the 12 have gone ahead.

In fact, the argument that the euro will break up appears to be either scaremongering or wishful thinking by those who wish it harm. Those who now say that the euro-zone will fragment are often the same people who earlier claimed it would never be established in the first place. They also predicted that it would be "blown apart" by the markets during the period of greatest potential danger – the eight months between May 1st 1998 (the setting of the entry parities) and January 1st 1999 (the permanent fixing of exchange rates). Not only was it not "blown apart" but instead it proved totally stable amid some of the greatest global financial instability ever seen.

A different concept of failure used by the Euro-sceptics is that the euro will be a **weak currency**. It is true that the euro fell in 2000 to a lower exchange rate than at any time since 1985 (in equivalent terms).[44] But is this a mark of failure? No. It reflects a mixture of real and financial factors – all of them transitory – combined with the tendency discussed above of exchange rates to overshoot reasonable adjustments and to move periodically in extreme ways.

The recent under-valuation of the euro corresponds to an extraordinary over-valuation of the US dollar. **This has resulted in a US current account deficit of 4% of GDP** – a level unprecedented in any large country in recent times. The situation is unsustainable and already during 2002 the dollar has started to fall and the euro to rise. In the meantime the low exchange value of the euro has posed no threat to the success of the euro project. Its influence on the real economy has been limited by the fact that euro-zone exports or imports account for only 10% of its GDP. In any case, the limited impact has certainly been positive, helping to stimulate euro-zone growth. And there can hardly be any lack of general confidence in the euro as a currency when the interest yield on 10-year government bonds is the same in the euro-zone as in the US.

WHY NOT WAIT AND SEE?

So when to join?

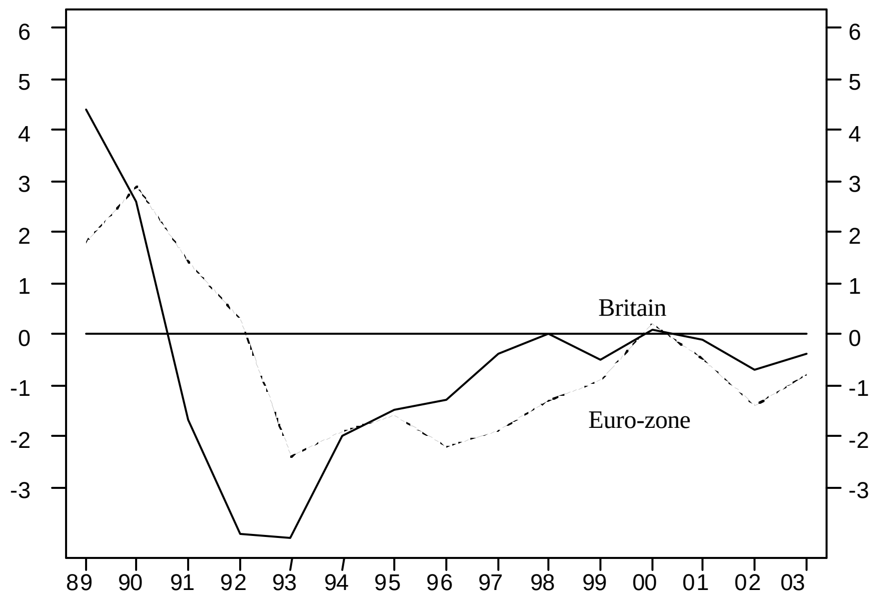
We have given the arguments for and against Britain's membership of the euro and strongly believe that on balance the case for joining is decisive. This is also the view of the Government, which has added that the timing of the decision to recommend entry to the public in a referendum will be determined by an assessment of its five economic tests. These are:

1. Have the British and European cycles sufficiently converged?
2. Is Britain flexible enough to belong?
3. Will it be good for investment?
4. Will it be good for the City?
5. Will it be good for employment and growth?

The Treasury will decide whether it believes the tests have been met and the assessment will be announced before June 2003. The analysis of this paper has revealed our views on the last four of these tests. There remains the crucial question of cyclical convergence.

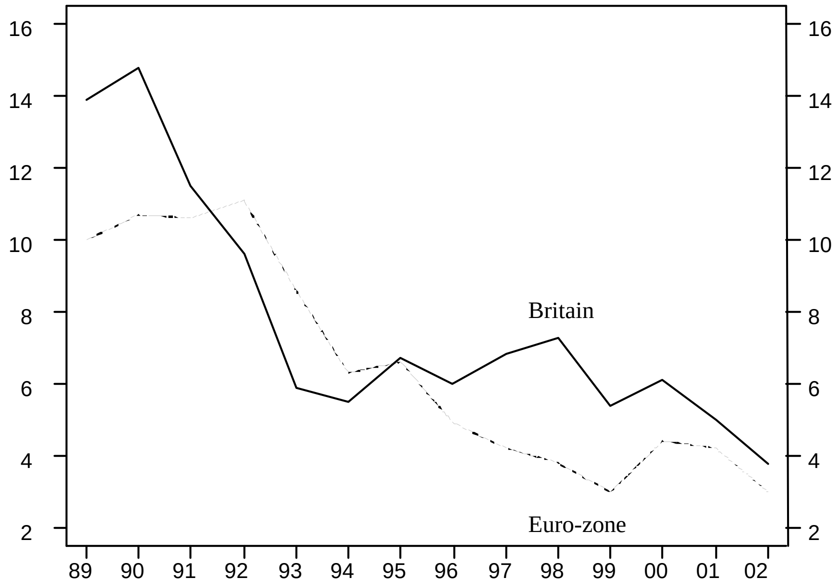
There can of course be no perfect moment for joining. **But it is difficult to imagine a better conjuncture than the present**. As Figure 4 shows, both Britain and the euro-zone are now at similar points in the economic cycle and not far from their sustainable levels of output, relative to trend. Both economies have identical long-term interest rates, consistent with their similar levels of underlying inflation. Though short-term interest rates are higher in Britain (Figure 5), they are closer to euro (or DM) rates than at any time in the past seven years.

Figure 4. Output Gaps (% of GDP)



Source: OECD, *Economic Outlook*, December 2001, Annex Table 11, 2001-3 estimates.

Figure 5. Short-term interest rates (% p.a.)



Source: OECD, *Economic Outlook*, December 2001, Annex Table 36, 2001-2 estimates.

We conclude therefore that we should join soon. So do many of Britain's leading economists. The National Institute Economic Review has just produced a whole issue on the euro, which concludes that the tests have now been met[45]. This is based on its highly respected model. (The model used by the No campaign has a more tarnished reputation – it forecast that British unemployment would rise by ¾ million as a result of the National Minimum Wage.)

Despite the arguments in favour of rapid entry, some people in the popular debate ask, "Why not wait a bit, and see how things go? Wait and see whether single countries suffer unduly from the "one-size-fits-all" interest rate, and indeed whether the euro falls apart".

This sounds like a safe option and would be sensible if waiting gave us much more information. But it would not. For the shocks that cause the problems come very infrequently. Thus we have to rely on our general understanding of how economies work. **There is little informational gain from waiting**.

Moreover, there are major costs to delay. While we stay out, the 12 euro-countries are restructuring their economies. Powerful new commercial groups are emerging and with them, as we have seen, new trade patterns from which we are largely excluded. The longer we stay out the more difficult it will be for us to join these new structures on favourable terms. To stay out now would be to repeat the terrible mistake we made in 1956, when we opted out of the Common Market – a mistake from which we have not yet fully recovered.

The exchange rate issue

But how should we enter? The British government has to

- decide that the Five Tests have been satisfied
- get Parliament to pass the law for holding a referendum, and
- win a referendum

It also has to agree with our EU partners on when we should join and at what exchange rate.

Some people consider the problem of the exchange rate an insuperable obstacle to joining. In recent years the rate has been too high, causing major problems for our manufacturing industry. In consequence we have a balance of payments deficit equal to nearly 2% of GDP. In April 2002 sterling averaged 1.63 euros, a level it had been close to for the previous 12 months. At the end of July it stood at 1.60 euros. The typical view in business is that, if we join, it should be at a rate of between 1.40 and 1.50 euros per pound. (This would correspond to a rate of roughly 2.75 to 2.95 DMs per pound.)[46]

But how can this be achieved? Extraordinary suggestions have been made that the Bank of England should be given a target exchange rate or that we should simply wait until the market rate reaches an appropriate level of its own volition. But this misses the central point: **the entry rate must, according to the Treaty, be decided by the member states. It is a government decision, and the markets know it**.

From that, one can simply work backwards. Once the market knows at what rate Britain is likely to enter, the spot rate will move to close to that level, the exact rate depending on current interest differentials and the likelihood of success in the referendum.

One issue is when the entry rate is to be agreed - and how it is to be made known. An agreed rate could be announced before the referendum. Then voters would know exactly what they were voting about. However, this may be difficult to negotiate, and the government might indeed simply indicate some range within which it expected the rate to be fixed. So in one way or another the exchange rate problem can be managed and the actual rate brought to a satisfactory level well in advance of entry – giving a sufficient period of stability before entry to satisfy Britain's partners.

It is disingenuous for people to imply that the exchange rate on entry is beyond control. The No campaigners have adopted a remarkable position on this point. They have given the over-valued pound as a reason for not joining the Euro. But they have failed to note that the over-valued pound was the direct result of floating. Since they advocate continued floating, they offer no solution to this problem. We do offer a solution – to join the euro at a sensible, politically-agreed rate.

EXECUTIVE SUMMARY

Our aim is to clarify the economic issues as even-handedly as possible. There are of course both pros and cons. But at bottom they are both are quite simple.

Better living standards

If we join, we shall over time achieve higher living standards. This is because we shall be full members of a huge single market, which can achieve the economies of scale and competitive excellence that a single currency has made possible in the US. From our greater wealth we shall be able to pay for the better hospitals, schools, houses and railways that we all aspire to.

The mechanism is quite straightforward. **Separate currencies, fluctuating against each other, are a real barrier to trade and thus to efficient levels of production**. If a company produces output in Britain, it currently pays its workers in pounds. It can then sell its output on the Continent in return for euros. But unless it knows in advance how many pounds it will receive for each euro, it has no idea how profitable it will be to trade in Europe. On past experience the pound can easily and quickly rise or fall by 20% against the euro, with a massive impact on profitability. This 'exchange-rate risk' discourages trade, and thus reduces productivity and living standards.

This very same exchange-rate risk used to exist between countries on the Continent, discouraging trade between them as well. But, since January 1999 when the euro was established, this risk has been eliminated for them. **The result has been a truly remarkable 20% increase in trade between euro-zone countries** (relative to GDP). **By contrast trade between Britain and the Continent has fallen** (relative to GDP). The table tells the tale. In just three years since the euro was launched the average euro-country expanded its involvement in European trade by one-fifth, while we reduced ours.

Trade with other EU countries, as % of GDP

	France	Germany	Britain
1998	28	27	23
2001	32	32	22
Change	+4	+5	-1

As trade patterns change, so do investment patterns. Any business that wants to serve the large euro-zone market will now naturally move its production inside that area, in order to avoid exchange-rate risk. **Since the euro began, Britain's share of the foreign direct investment coming into Europe has fallen from one half to one quarter – an astonishing collapse.** Last year more of this investment went to the Netherlands than to Britain. Meanwhile, inside the euro-zone a massive reorganisation of productive investment is underway. The amount of direct investment flowing between the 12 euro-countries is up by a factor of four.

In this great process of restructuring, we shall be increasingly on the sidelines. **For we are now in a new, more exposed position than before the euro was launched,** since we are now the only large country in Europe where businesses face exchange-rate risk when selling on the Continent. This will have an increasing impact on our trade and thus on our productivity and living standards.

Our productivity per hour worked is currently 20% below the level in France, Germany, the Benelux and Northern Italy. And investment in our economy is also lower relative to GDP. If we want the standard of hospitals, schools and railways that exists on the Continent, we have to join the euro. Otherwise we risk growing more slowly than the rest of Europe, which is precisely what happened when we refused to join the Common Market after the Second World War.

Economic fluctuations

For better standards of living and better public services, we need to join the euro. On the other hand, there is also the issue of economic fluctuations – the extent to which unemployment varies in response to economic shocks. Here there are both pros and cons to joining.

At present the Bank of England tries to cushion shocks to the British economy by raising or lowering interest rates. If we joined the euro that would not be possible, since **there would one interest rate for the whole of Europe**. It would be set by the European Central Bank, on which all countries including ourselves would be represented.

Our view would be one among many. While the European Central Bank should protect us against shocks affecting the whole of Europe, it would not protect us against shocks that were particular to Britain. Since we would have lost our own monetary policy to combat those shocks, it would be more difficult to offset them in the traditional manner.

Yet it would not be impossible, since **we would still be able to use the Budget to offset shocks to our economy**. In this respect Britain would be better off than a US state when it is hit by a shock that does not affect the whole of the United States. For the typical US state is obliged to balance its budget year on year, including during a recession. This means that during a recession it has to raise taxes or cut spending, both of which are positively harmful. This handicap is only partly offset by the automatic stabilisers provided to the state through the Federal US budget. By contrast the US state undoubtedly benefits from greater labour mobility than that between Britain and the Continent. But, all things considered, **there is no reason why a single currency should not work at least as well for Britain as it does for any US state**.

Moreover, **a single currency removes one major source of shocks - the floating exchange rate**. A floating exchange rate is not a smooth mechanism of adjustment; it is more like an unguided missile. In 1980/81 we saw its devastating effect on the British economy. As capital becomes ever more mobile, it is likely that exchange rates will become even more unstable. Good monetary policy can partially offset the effects of an errant exchange rate, as it has recently. But we cannot fully rely on it. Thus joining the euro has two effects on fluctuations: one bad (the loss of our interest rate) but the other good (the loss of our exchange rate).

The overall balance facing voters is a clear gain in living standards versus mixed effects on economic fluctuations. We believe the balance is strongly in favour of joining.

When and how?

There remain the issues of when and how to join? **Now is as good a time to join as any other that is likely to arise**. The cyclical patterns in Britain and the euro-zone are extremely similar – neither of them are far from their sustainable levels of output (relative to trend). Both have identical long-term interest rates. And short-term interest rates and inflation rates are not far apart.

Moreover there is no case in favour of "wait and see". For even if we waited a long time before joining, the next shock might not arise until after we had joined. Meantime, **by waiting we should have missed out on the great restructuring of the European economy and its trading patterns that is already underway**.

To join the euro, the Government has to recommend entry, and the British people have to vote for it in a referendum. In addition, we have to agree with our European partners the date of entry and the rate at which pounds will be converted into euros. **This rate is therefore a political decision.** Once markets know what the entry rate will be, the current market rate will move close to that level – depending on how likely is a successful outcome to the referendum. The exchange rate earlier this year was too high and made Britain less competitive than it needs to be. The typical view in business is that a suitable rate is between 1.40 and 1.50 euros to the pound.

Other issues

This summary covers what we believe to be the main economic considerations that should affect any voter's decision in a referendum. However, many other economic issues have been brought in, which we must touch on.

- **Is Europe the right partner?** Over half our trade is with Europe and only 16% with the US. The rest is spread around the globe. This pattern reflects the realities of geography. If we want to integrate into a large market, the only one available is in Europe. Joining NAFTA would make no sense and would require us to leave the European Union, at massive cost.

- **Is Europe a 'failing' economy?** Critics argue that Europe is a failing economy. This is simply false. Productivity per hour of work is 20% higher in France, Germany and the Benelux than it is in Britain. Over the last 20 years it has grown faster there than in the US, and those Continental countries are now as productive as the US.

France, Germany, Italy and Spain have significantly higher unemployment than Britain. But six other European countries have lower unemployment rates than Britain or the US. So there is no single European problem with unemployment. The differences between countries are caused by different national labour market policies. If we join the euro, this would have no effect on the labour market policies we can choose in Britain.

Nor does linking our currency to that of a high unemployment country like France mean that we ourselves would risk higher unemployment here. The Netherlands has only one third the unemployment of Belgium. And within the single currency area of Britain, the South-East has one half the unemployment of the North-East. The link to the North has not increased unemployment in the South.

High unemployment in some European countries is therefore no argument against joining the euro. And the argument that we should wait for the unemployment rates to converge is like saying that the South-East of England should have its own currency.

- **Won't the Euro require a federal budget?** In the US the states have to have balanced budgets while the federal budget helps a state that is in recession, by automatically collecting lower taxes and paying higher welfare benefits. By contrast, in Europe the automatic stabilisers are built into the national budgets, which can also practise discretionary stabilisation policy. Therefore, no federal budget is needed in Europe to offset shocks.

- **Won't joining mean tax harmonisation?** Tax harmonisation has nothing to do with the euro or the European Central Bank in Frankfurt. Tax issues are dealt with by the Council of Ministers when they meet in Brussels. These issues currently require unanimity, as does any revision of this procedure.

- **What about Europe's 'unfunded pension liabilities?** European governments currently spend more on pensions than Britain and will have to spend even more as populations age – unless they change their policies. However, this poses no threat to Britain because the Treaty explicitly forbids collective support of any country's budget. And, in fact, the countries are likely to change their policies, raising retirement ages and lowering benefits, long before any crisis point is reached.

- **What about our floating-rate mortgages?** In Europe most house-buyers have fixed rate mortgages, while most Britons have floating rates. So it is said that our economy is more affected by changes in interest rates than those in Europe, making a one-size-fits-all interest rate more damaging. But higher interest rates benefit lenders at the same time as they hurt borrowers. The best econometric evidence concludes that the overall effect of interest rate changes on economic activity is similar in Britain and on the Continent.

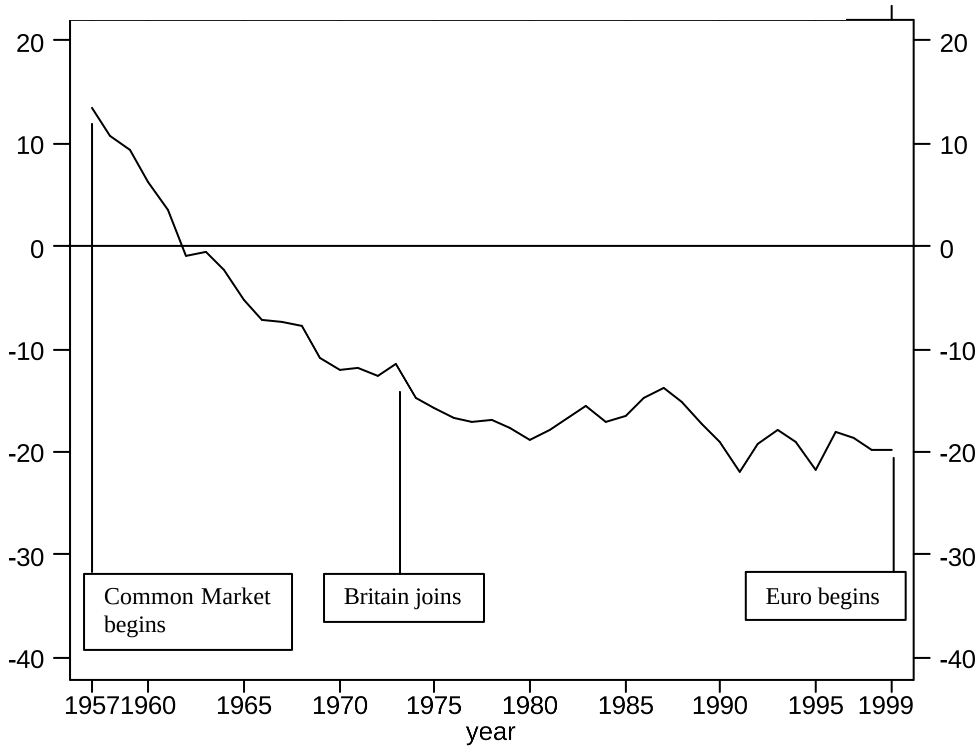
- **Won't joining distract us from improving our social services?** Far from it. The whole purpose of joining is to achieve a higher standard of living. In France, Germany and Benelux, the hospitals, schools and transport systems are far better than our own. We can only achieve such standards if we can improve our efficiency, by becoming a full member of the European market.

Conclusion

In 1957 we were the richest major country in Europe. But we decided to go it alone. In the years that followed, France, Germany and the Benelux overtook us. As the figure shows, we are still trying to close the productivity gap that emerged then. If once again we fail to join the European leaders, we risk falling further behind them.

There are of course pros and cons of joining the euro. We have tried to set them out fairly. But we believe the arguments in favour are much the stronger. And the time to join will soon be upon us.

Real GDP per employed person: gap between Britain and France/Germany (%)



Source: 1957-59: Penn World Tables; 1960-98: US Department of Labor; 1999: E.C. European Economy and OECD Bureau of Economic Analysis.

Note: GDP at PPP. Germany is West Germany.

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End-Notes

[1] *The Economic Case against the Euro*, edited by J. Bush and published by New Europe Research Trust 2001,.http://www.no-euro.com/factsfigures/pdf/ec.pdf
[2] e.g. T. Congdon, Retailing Supermarketing, 8 November 1996; M. Wolf, Financial Times, 25 August 1993.
[3] e.g. D. Healey, Daily Telegraph, 1 March 1999; W. Eltis, International Risk Management, 2 September 1998,
[4] e.g. Daily Mail, 28 December 2001 ("Holidaymakers will face chaos when they go to the Continent as shops and businesses battle to get used to the Euro from January 1st").
[5] P. Minford, Daily Telegraph, 21 August 2000.
[6].European Commission, Internal Market D.G. 'Price differences for supermarket goods in Europe', May 2002.
[7] European Commission, European Economy, Supplement A, Economic trends, No.7, July 2001, chart 4.1.
[8] J. McCallum, 'National borders matter: Canada-US regional trade patterns', American Economic Review, 85, 3, pp.615-623, June 1995.
[9] C. Engel and J.H. Rogers, 'Relative Price Volatility: What Role does the Border Play?' IFDP No.623, Federal Reserve Board, September 1998.
[10] Andrew K Rose, 'One money, one market: the effect of common currencies on trade', Economic Policy, 30, April 2000.
[11] For a summary see A.K. Rose, 'The effect of common currencies on international trade: a meta-analysis', mimeo at http://faculty.haas.berkeley.edu/arose/meta.pdf.
[12] A.K. Rose and E. van Wincoop 'National Money as a Barrier to International Trade: The Real Case for Currency Union', mimeo at http://www/haas.berkeley.edu/~rose/. This study allows for the fact that most earlier currency unions were between small countries and were bilateral rather than multilateral.
[13] See also A. Micco et al. 'The currency union effect on trade: early evidence from the European Union', Inter-American Development Bank, April 2002, email alejandromi@iadb.org ; ernestos@iadb.org ; and guillermoo@iadb.org.
[14] See for example J.A. Frankel and A.K. Rose, 'Estimating the Effects of Currency Union on Trade and Output', CEPR Paper No.2631, December 2000; D. Trefler, 'The Long and Short of the Canada-US Free Trade Agreement', 2001, trefler@chass.utoronto.ca. The first claims that if the export share is higher by 1% of GDP, GDP is 2/3% higher within 20 years. The second claims that NAFTA tariff cuts raised productivity growth by 0.6 per year in Canadian manufacturing.
[15] The figures also reflect the high current value of the pound.
[16] Fitch Ratings.
[17] Commission answer to written question No. E-0033/02.
[18] *The Economic Case against the Euro* quotes earlier negative research on this point but fails to quote the most recent research cited by Rose *op. cit*. which supports this intuitively obvious point.
[19] These are weighted to reflect our trade with the different countries concerned.
[20] Such policies can however work for small economies such as Denmark, pegged against the euro today, whose trade is overwhelmingly with a contiguous much larger currency block and whose currency is not a major trading currency in the global capital markets.
[21] J. Bush ed. *op cit*. p.21.
[22] See also C. Taylor, Sterling Volatility and EMU, NIESR Discussion Paper No 197. Using the period since 1992, he concluded that with the euro our trade-weighted exchange rate volatility would be reduced by two-thirds. (This is the article whose findings have been quoted in exactly the opposite sense by three members of the No campaign.)
[23] Customs and Excise, 2000, goods trade (imports and exports).
[24] This is true whether we focus on transactions with the rest of the world or with non-EU countries only.
[25] For figures excluding housing see OECD Economic Surveys United Kingdom 2001/2 (2002), p.69, Figure 19 top half. For some reason a recent article by Martin Wolf in the Financial Times quoted the bottom half of the table which gives real investment as a % of real GDP - a concept which cannot readily be compared between countries.
[26] In the 12 months to December 2001, the GDP deflator rose by 2.4 per cent in the UK and 2.3 per cent in the euro-zone. In the 12 months to March 2002, retail price inflation was 2.3 per cent in the UK (RPIX) and 2.5 per cent in the euro-zone (HICP). The Euro 12 target (HICP) is 0 – 2% per annum and the UK target (RPIX) is 2.5%. But the targets are really quite similar, since differences in the price indices mean that in the UK RPIX inflation is overstated relative to HICP inflation by around 1 percentage point.
[27] The figure given by Wim Duisenberg to the Economic and Monetary Affairs Committee of the European Parliament, 28 May 2001. His estimate is consistent with later surveys and estimates..
[28] Bannock Consulting, 'An estimate of the one-off transition costs to the UK of joining the Euro', July 2001.

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[29] If they differ, this can only be due to different risks of default.
[30] There can always be country-specific fiscal shocks. But EMU does not affect a country's ability to offset its own fiscal shocks. The biggest country-specific fiscal shock in post-war Europe was the reunification of Germany and Chancellor Kohl's decision to finance it by increasing the German budget deficit. This raised German interest rates. France then chose to follow these rates in order to maintain its exchange rate and suffered a severe recession in consequence. Under EMU a country-specific shock would have less power to generate a Europe-wide recession because the interest rate response would be less.
[31] See T. Bayoumi and E. Prasad, 'Currency unions, economic fluctuations and adjustment: some empirical evidence', CEPR Discussion Paper No 1172, May 1995, Table 2, and K.H. Midelfart-Knarvik et al 'The location of European industry', Centre for Economic Performance mimeo, February 2000, Table 6.4.
[32] A. Fatas, 'EMU: Countries or Regions? Lessons from the EMS experience', European Economic Review, April 1997. In the 1990s British growth has been more decoupled from Continental Europe because Britain entered recession earlier than Continental Europe due to the Lawson boom and the following bust. Europe over expanded later than Britain due to German reunification, but then had its recession, which was prolonged by the need to curb excessive government deficits, both for long-term structural reasons and as a preparation for EMU.
[33] The rules of the Pact apply to all EU countries whether inside the euro or out. But the provision for fining countries with excessive deficits applies only to those inside the euro-zone. For others the maximum penalty is a reprimand.
[34] R. Barrell and K. Dury 'Will the SGP ever be breached?' in *The Stability and Growth Pact: the architecture of fiscal policy in EMU*, edited by Anne Brunila, Marco Buti and Daniele Franco, Palgrave 2001.
[35] See for example R. Layard et al, Unemployment: Macroeconomic Performance and the Labour Market, OUP, 1991, p406, Table 2.
[36] See for example M. O'Mahony, Britain's productivity performance 1950-1996: an international perspective, NIESR, 1999.
[37] All unemployment rates quoted are Eurostat standardised rates – see for example H.M. Treasury, Pocket Databank.
[38] Moreover, full harmonisation would make it difficult for many countries to satisfy the Stability Pact.
[39] The requirement that budgets should be balanced over the cycle applies to all EU members, in or out of the euro.
[40] See E. Troup "A red herring – Tax competition, not tax harmonisation is the future in Europe", Britain in Europe, 2002.
[41] See for example R. Dornbusch et al, "Immediate challenges for the European Central Bank", Economic Policy, 26, April 1998, Table 9. See also OECD Economic Outlook, December 1998, p144, for a summary of a number of studies; and NIESR, April 2002.
[42] EU Economic Policy Committee: "Budgetary challenges posed by ageing population", 24 October 2001.
[43] The 'pension problem' is often expressed in terms of the more general distinction between the UK's (and the Netherlands') funded private pension schemes and the wholly unfunded approach in many continental countries, a distinction which applies to a degree in the private as well as the public sector. It is important, however, to understand that, under all systems, the existing working generation supports the existing retired generation. For the public finances the **essential** differences between countries therefore relate to the generosity of future pension promises and to the choice of public pension retirement age.
[44] There was, of course, no euro in 1985, but it is easy to calculate what its value would have been, using the values of the constituent national currencies.
[45] NIESR, April 2002 No. 180.
[46] Ray Barrell of the NIESR has used their model to derive a sustainable rate of 1.46 to 1.51 euros per pound (FT, 26 July 2002).