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## Britain at a Cross-road : The EMU Question

### **Abstract**

Looking back just the last several years it is easy to find the how the differences in EU economies could cause problems in the future. The problems that were experienced during the curiency crises in Italy and Spain in 1992, where the countries had a dicult time keeping inflation rates on a low German level, and more importantly the British currency crisis of 1993, are just a taste of the problems which will arise as the EMU comes closer to reality (DeGrauwe, 1994).

# Britain at a Cross-road: The EMU Question

John Gutowski

In British politics today there is no more divisive issue than the European Union (EU), and more specifically, whether or not Britain should join the European Monetary Union (EMU). The EMU as put forth in the Maastricht Treaty is a three-stage process with the goal of leading the Member States down the path towards monetary union. To enable the passage of Maastricht through Parliament the British delegation fought for a provision in the treaty that would provide the UK with the ability to "opt-out" if it were decided that it was best for Britain to not join the EMU. The UK must, however, make this decision in 1997. Ever since the passage of Maastricht the issue of whether Britain should join the EMU has divided both major political parties, even to the point where it is threatening to break down the whipping system. The decision of whether or not to join the EMU is of supreme importance that will have ramifications well into the next century regardless of the final outcome. From an economic standpoint the only decision that can logically be made is that Britain must not join the EMU.

There is a long list of economic reasons for why the UK should not join the EMU. The first of these is that the area designated for monetary union, the EU, is not an optimum currency area. An optimum currency area is simply the most efficient physical size for an area to have a common currency. If an area of monetary union is too small then it will not get all the benefits of having a single currency; if it is too large then it will encounter problems that stem from having a common currency (Copeland, 1994). The main problem--which stems from having an area of monetary union that is too large--is that the economy within the common currency area can be so varied that different regions can be experiencing

different economic cycles. Judging by this definition the EU is most definitely too large to be considered an optimum currency area. It is not hard to imagine that the industrial countries of Northern Europe could be experiencing very different economic conditions than the less economically developed countries of Southern Europe.

The criteria to be considered an optimum currency area is admittedly tough, and it could easily be argued that by these standards the US could certainly not be considered one. Many people in favor of the EMU point to the US as an example of a common currency area that, while too large to be considered an optimum currency area, is still thought of as being a success. This is a flawed argument however, because there are economic mechanisms at work in the US that allow it to overcome its size that are not present in the EU.

The first economic mechanism that allows the US to be considered a successful common currency area is that in the US labor is mobile. The high mobility of labor in the US means that if one area of the country is experiencing an economic boom, while another is depressed, people can move from the depressed area to the booming area, thus helping balance out the economy as a whole. In the EU, however, labor tends to be much less mobile than in the US (Heathcoat-Amory, 1996). This is due to a number of factors, including the fact that in most of Europe there tends to be a stronger attachment to the area where one was raised than in the US, the cultural differences between European countries are obviously much greater than those among the American states, many of the EU employment laws and standards are not yet fully harmonized--often making finding a job in another EU country difficult, and finally the

language barrier that exists between the member countries. All of these factors combine to make labor less mobile, and therefore the EU a bad place for a common currency area.

Another factor that the US enjoys that enables it to be a successful common currency area is that in the US large fiscal transfers are available to smooth out differences in its economy. These are made possible because of the strong central government in the US, and they are for the most part automatic. If one part of the economy is booming, then it will naturally produce more revenue for the government in the form of higher tax receipts. At the same time if another part of the economy is depressed, then the government will automatically put money into it through increased social payments (an increase in unemployment, welfare, etc.), and will often provide specific grants and programs to try to help the depressed area. The net effect of the fiscal transfers is that they tend to balance each other out, providing stability for the entire US economy.

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**“The use of monetary policy as the governments’ main economic tool would be lost if the UK joined the EMU.”**

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The EU is set up in such a fashion that its central government, while too strong for many, is not given enough power to tax and make fiscal transfers an effective way to deal with the fact that the EU is too large to be considered an optimum currency area. It has been estimated that for fiscal transfers to be effective the EU would need a minimum budget of 5-7% of Community GDP, compared with the current 1.2% of GDP which it receives today (MacDougall, 1992). An increase in the EU budget by such a degree

is certainly not realistic in the near or even long-term future. Not only must the EU’s budget be increased if the EMU is to succeed, but the central government of the EU, in particular the Council and Commission, must be given more power to tax as well as increased enforcement powers if an EU member is in arrears (DeGrauwe, 1994).

Another important reason why the UK should not join the EMU is that by joining it would lose control over its monetary policy. By its very nature the EMU will require the Member States to give up power over their own monetary policy, with decisions being made by a European Central Bank. The importance of monetary policy as an economic tool for the UK cannot be overstated.

The major benefit of monetary policy that the UK would lose by joining the EMU would be the ability to control its interest rates. Control over interest rates is an important macroeconomic tool that is used by governments as a way to try to smooth out the natural business cycle. If an economy is depressed the government can lower interest rates, which increases the money supply, causes an increase in demand, and hopefully creates an upturn in the economy. The converse is also true. If an economy is booming and inflation is starting to become a concern, a government can increase interest rates to “put the brakes” on an economy. When Margaret Thatcher took power in the late 1970s, she moved away from the traditional Keynesian approach of using government expenditures to smooth out the business cycle, which had been used in Britain from the Second World War onwards. She placed much greater emphasis on the use of monetary policy as the governments’ main economic tool, a tool which would be lost if the UK joined the EMU.

If the UK were to join the EMU, the UK would also lose the benefits which it receives from having a floating exchange rate. The fact that the pound is floating, as opposed to fixed

as it would be if the UK joined the EMU, has several advantages for the UK. If a country has a floating exchange rate, and is experiencing problems in its balance of payments account, the exchange rate will shift naturally to deal with the deficit or surplus that is causing the problem. Floating exchange rates also have the added benefit of changing to keep pace with the changes in interest rates between trading partners.

A final major problem with the EMU, and a reason for Britain to not join it, is perhaps the most obvious. It is simply that the economies of Europe, which the EMU is attempting to bind together, are too diverse for a common currency. Britain's business cycle is just too different from the rest of Europe for a common currency to be in any way in the best interest of the UK. One has only to pick up a current newspaper to read how Britain has one of the most vibrant economies in the EU. The UK is even doing a lot better than many of the large industrialized countries in the EU. So while Britain is at a peak in its business cycle, the rest of EU, while not experiencing a depression, is certainly not at the same point.

Looking back just the last several years it is easy to find the how the differences in EU economies could cause problems in the future. The problems that were experienced during the currency crises in Italy and Spain in 1992, where the countries had a difficult time keeping inflation rates on a low German level, and more importantly the British currency crisis of 1993, are just a taste of the problems which will arise as the EMU comes closer to reality (DeGrauwe, 1994).

The British currency crisis of 1993 provides an ideal example of why the UK should stay out of a common currency. In 1993 the UK was still a member of the exchange rate mechanism (ERM), where member countries tried to keep their exchange rates within a fixed narrow band, and was experiencing a recession. Also at this time the

cost of German unification was causing inflationary pressures in Germany. This meant that the Bundesbank was using its monetary policy to fight inflation, at the same time Britain needed to use its monetary policy to stimulate the UK economy. Eventually the UK was forced to leave the ERM because of the pain caused by having to follow the monetary policy of the Bundesbank (high unemployment and a prolonged recession) was too great (DeGrauwe, 1994). While this is just one example, it shows perfectly how the differences in the EU economies make a pact like the EMU disastrous.

When the EMU was being set out in the Maastricht treaty the authors realized that the differences in the economies of the member countries would be a major problem. Their solution to this problem was to set forth a list of common criteria for the Member States' economies, which all the EU countries had to work towards meeting, so their economies would be close enough for the EMU to be successful. These criteria are known as the "convergence criteria," and according to Maastricht must be met before the EMU is installed. The convergence criteria cover such economic areas as: inflation level, government budget deficit and debt level, and interest rates (Griffen and Pustag, 1996). The idea behind the convergence criteria is a good one. The problem is that as the 1999 deadline for the EMU approaches there is talk of letting countries join even though they don't meet the criteria or countries (such as France) using accounting tricks so they are able to meet the criteria. In both cases it totally defeats the purpose of the criteria, and if the EMU were to go forward without the Member countries meeting the convergence criteria their economies would be too different, creating a union that is destined for failure.

Proponents of the EMU tend to brush aside the economic costs that will be placed on Britain if it joins the EMU and logically focus on the many benefits they see that will be

accrued if Britain were to join the EMU.

The first and most often-cited argument by the Europhile in favor of the EMU is that it will lower transaction costs. While it is true that the EMU will lower transaction costs, these costs are so low that they in no way justify the loss of the benefits which Britain would enjoy by remaining out of the EMU (Heathcoat-Amory, 1996). In fact, as society becomes less dependent upon cash (with the increased use of credit cards and debit cards), these transaction costs will diminish. Another common argument in favor of the EMU is that it will promote price stability. This also is true, but in the UK price stability has not been a problem for over a decade. The best way to promote price stability is through sensible government spending and sound economic management.

The final often-cited economic reason in favor of the EMU is that it would reduce exchange rate uncertainty and risk, thus increasing investment and trade. When examined carefully this reason can also be shown to be unimportant, and in no way justifies the UK joining the EMU. In the UK most major businesses protect themselves from exchange rate risks through open market transactions on the currency market, and with its current system of a floating exchange rate the UK does not have any problem attracting investment, receiving about 40% of the total investment coming into the EU. Another factor which must be taken into account is that half of Britain's trade comes from outside the EU, which means that any help the EMU could give Britain in increasing trade and investment would be less than most other EU states whose economies are centered more on Europe. Overall the economic benefits if Britain were to join the EMU are very small,

when viewed in relation to the costs.

The UK is truly at an economic cross-road. It can decide to join the EMU out of fear of losing trade and influence in Europe, or it can take advantage of its opt-out clause and refuse to join. In the former case the UK would be joining a common currency area which is not optimum and does not have the adjustment mechanisms to make up for this fact, would cause it to lose control over its monetary policy, and whose economic benefits are negligible compared to the costs. In the latter case, Britain could build its future on free trade and avoid a mistake which will bring misery to present and future generations.

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**John Gutowski ('98)** is a Political Science major and Economics minor. After graduation he plans to study international law. John wrote this paper for his British Economy class while in London, where he interned for and was influenced by Sir Teddy Taylor MP, a leading Tory Euroskeptic in the House of Commons.

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