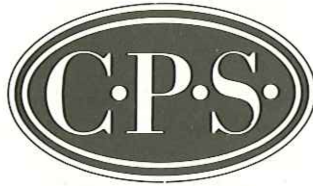
The European debate

EMU *now?*

the leap to European money assessed

Tim Congdon

CENTRE FOR POLICY STUDIES



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The author

Tim Congdon is one of the City's leading economic commentators. As a journalist on *The Times* between 1973 and 1976, and as the economist at L. Messel & Co., the stockbrokers, between 1976 and 1987 (and, briefly, as Chief UK Economist at Shearson Lehman Hutton), he established a reputation for economic research which explored the relationships between financial variables, security prices and the economy. He was a strong supporter of the monetarist policies pursued in the early years of Mrs Thatcher's Government. More recently, he and his colleagues at Messel and Shearson Lehman were uniquely successful in forecasting the boom of 1987 and 1988 and in warning about the consequent rise in inflation. In 1978 the CPS published his first book, *Monetarism: An Essay in Definition.* Tim Congdon is now Managing Director of Lombard Street Research, an economic consultancy he set up last year with the support of Gerrard & National. He is also Economic Adviser to Gerrard & National and Honorary Professor of Economics at Cardiff Business School.

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Preface

This paper is a further publication in the Centre's series which seeks to illuminate the debate on the future of Britain's policy towards the European Community. It may be seen as a reply to the pamphlet which we published in June based on Sir Leon Brittan's lecture to the Federal Trust on 24 May. Nevertheless Tim Congdon, as might be expected from such an old friend of the CPS, has produced a paper which goes a good deal further than a mere response to Sir Leon. It puts cogently and dispassionately the difficulties which would face the nation were we to embrace the full economic and monetary union favoured by some of our partners in the Community.

The Centre, of course, is no more committed as an institution to the views put forward by Tim Congdon than it was by Sir Leon's lecture. Out of a need for internal harmony, I daresay, we insist even more vigorously than ever on our disclaimer: that all we expect from our authors is that they lay out their own recommendations with force and clarity. I would, however, add only one thing – and here I speak for myself – it would be false to represent the Centre as radically split on the European issue. We all of us believe in the idea of a 'Europe of Diversity': or, as the Archbishop of Tarragona put the matter to me last year, we must be 'united but not absorbed'. The path towards this aim is one which does involve some controversy, certainly. But it is an extraordinarily interesting one.

All I can say (I hope I am not being in this matter too 'Balfourian', as it used to be said in the Conservative Party) is that both Sir Leon and Tim Congdon are guides well worth our close attention.

Thomas of Swynnerton

Contents

Foreword		5
1.	The subject defined	6
2.	Some practical difficulties with 'Big Bang'	9
3.	A calculus of economic benefits and costs in the long term	17
4.	No alternative?	23
5.	The political implications	29

Foreword

As with my pamphlet *Monetarism Lost* published last year by the Centre for Policy Studies, this paper was written in great haste in response to topical events. I have not had time to seek extensive comments on it, and mistakes and opinions are very much my own responsibility. It is an expanded version of the July 1990 *Gerrard & National Monthly Economic Review*, which was more exclusively a response to Sir Leon Brittan's important speech to the Federal Trust conference on 24 May. I would like to acknowledge the support and interest I have received from Lord Joseph in my writings on European money this year.

1
The subject defined

Is an abrupt replacement of national currencies by a single European currency desirable?

European Monetary Union, culminating in the introduction of a single European currency, is a venture into the unknown. The political intention behind EMU, to bind the members of the European Community closer together and so promote eventual political union, is clear. But the economic effects are very uncertain. In principle the whole enterprise is based on the three stages set out in the Delors Report, but the Report was vague about the practical problems of implementation and so about the likely consequences. Despite this woolliness, European heads of state will attend an inter-governmental conference in December to discuss the treaty changes needed to make EMU a reality.

The outcome of this conference cannot be forecast at this stage. Karl Otto Pohl, president of the Bundesbank, has mentioned the possibility that France, Germany and the Benelux countries will proceed with a European Central Banking System ahead of other EC members, including Britain. Such a system would presumably manage a single currency, although – as so often with this subject – the precise meaning of words has not been spelt out in the newspaper reports. There is a widely-held view in this country that Britain must not be left out. In his speech to the Federal Trust conference on 24 May, Sir Leon Brittan, vice-president of the European Commission, set out the case for a single European currency before a British audience. The speech was enthusiastic, almost visionary, in tone. In Sir Leon's words:

> 'when we have had one currency in Europe for a few years the only question of interest people will ask is why it took us so long to get there . . . I hope the UK will play a leading role in this achievement'.

This paper will review critically both the economics and politics of EMU. It will conclude that the costs of transition to EMU have been under-estimated, that the long-run economic

advantages of EMU have been over-sold and that EMU would have drastic implications for Britain's political independence. Sir Leon Brittan's speech will come under particularly critical review. There will also be some discussion of a paper 'Towards one money for Europe' by his brother Samuel Brittan of the *Financial Times* in a recently-published pamphlet *Europe Without Currency Barriers*[1].

The debate in recent months has begun to eliminate certain alternatives which were once under active consideration. It is clear, for example, that the Treasury's proposal for competing currencies has made no headway with our EC partners and cannot be taken further. It is also clear that proposals for a parallel currency are being resisted by governments and central banks in other European countries, including the West German Bundesbank. This is more unexpected, since on some interpretations stages two and three of Delors were all about the promotion of a parallel currency which would gradually supplant the existing national currencies. In a speech on 20 June John Major, the Chancellor of the Exchequer, spoke in favour of a parallel-currency scheme (the 'hard ECU' plan) worked out by Paul Richards of Samuel Montagu & Co. Although the 'hard ECU' plan skilfully reconciles the British Government's key objectives in the current negotiations with the Delors programme, it appears not to have persuaded the Bundesbank, the European Commission or other European governments. For this reason it will not be discussed further here.[2]

Instead, the move to a single currency is increasingly being seen as a once-for-all replacement of existing national currencies by a new pan-European currency. As envisaged in the Ernst & Young/National Institute report *A Strategy for the ECU* there will

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1. The pamphlet *Europe Without Currency Barriers* was jointly written by Samuel Brittan and Michael Artis, and published by the Social Market Foundation in 1989.
2. Parallel currency proposals – of which the hard ECU plan is one – were nevertheless discussed in some detail in T. G. Congdon's 'European monetary integration in the 1990s' in the Institute of Economic Affairs' volume earlier this year on *The State of the Economy in the 1990s*. Samuel Brittan's definition of EMU in *Europe Without Currency Barriers* as 'an area of permanently fixed exchange rates' also plays no part in our analysis. Indeed, it is difficult to see how this definition agrees with his paper's title of 'Towards *one money* for Europe' (our italics). But Samuel Brittan says much else which is of interest.

be a 'Year of the ECU', when the crucial changes are made and 'prices should be quoted in ECU wherever practical'. Presumably on one day the pound, franc, deutschemark and so on will be the sole legal tender within national borders, but on the next the new European currency will be legal tender across the EC. Comparisons with Big Bang in the London Stock Exchange in October 1986 are tempting (and this route is sometimes called the 'Big Bang', too), but a better comparison is with German monetary union on 1 July 1990. Pohl has implicitly indicated his support for the Big Bang approach, describing a slow process of replacement as 'wishy-washy' and claiming that 'you cannot create a central bank in stages'. Pohl seems here to have rejected the stage-like evolution prescribed by the Delors Report.[3]

Although Pohl's view may appear contrary to the spirit of much of the previous EMU negotiations, it is probably the only sensible way forward. A money is accepted as such because it serves as a common standard of value and medium of exchange in a particular area. Proposals which explicitly envisaged a plurality of standards of value and media of exchange, such as those for competing and parallel currencies, always lacked credibility.

3. See report in *Wall Street Journal*, European edition, 17 May.

2
Some practical difficulties with 'Big Bang'

Transitional costs of contractual revision and upheaval in the banking system

Big Bang is to be understood as a particular time-period – perhaps a 'Day of the ECU' in the 'Year of the ECU' – on which the existing national currencies lose their separate existences. This is not to deny that there could be a timetable of anticipatory events which could stretch over several years. One such event could be the irrevocable fixing of exchange rates, in accordance with Delors' stage two. But it is to deny that the final act of introducing the ECU would be gradual and voluntary. It would have to be fairly abrupt, and there would be an element of compulsion.

The reference to 'compulsion' may raise hackles, but it cannot be avoided. Its meaning is simply that, on a particular day, the ECU, the liability of a European central-banking institution, would become legal tender, whereas the pound, franc, deutschemark and so on, which were the former liabilities respectively of the Bank of England, Banque de France, the Bundesbank and other national central banks, would lose their legal-tender status. As legal tender, the ECU could not be refused in payment without breaking the law. Its use would therefore be compulsory.

Mention of 'compulsion' may sound a cheap polemical point, but it is not intended as such. In every country of the modern world legal-tender monies are mere scraps of paper and have no value in their own right; they are accepted in payment only because they have the backing of the state. Although we British may like to think that we choose to take pounds in payment, in fact we are obliged to do so. (As are the French to take francs, the Germans deutschemarks and so on.) A new European currency would be no different in this respect from the existing national currencies, except, of course, that it would have the backing of the European Community as a whole, not of the nations which now comprise it.

The requirement to impose the new currency follows logically once the options of competing currencies and a parallel currency have been closed. In his Federal Trust speech on 24 May Sir Leon Brittan understood this. He rejected competing currencies on the same grounds as the Delors Committee, that 'it is a potentially anarchic way to lessen the role of national currencies'. He also doubted the value of a parallel currency, noting that it 'would not provide any greater genuine flexibility for national monetary authorities'. His conclusion was that, 'If we are to make the move to a single money, it is better to do it with our eyes open through deliberate political decision than with our eyes closed through a parallel currency route'. Although Sir Leon did not spell it out, 'a deliberate political decision' would involve laws and treaty changes to alter the legal-tender status of currencies. It would entail a 'Year of the ECU' or something like it and, hence, the extinction of existing national currencies on a particular date or in a short space of time. If there is to be no parallel currency, the existing national currencies would have to suffer a quick death on a pre-announced date.

The need for extensive contractual revision

This would create an immense practical problem. Many millions of contracts are expressed in terms of the existing national currencies. These contracts would have to be converted from the national currencies into the ECU.

The analysis of this conversion problem is perhaps best elucidated if we distinguish between two types of contract, those where the impact of the change to a single currency is nominal and does not affect the distribution of real returns between the parties, and those where it is substantive and the distribution of real returns is altered. It is clear that changing the price lists of groceries, re-calibrating taximeters and one-armed bandits, and amending other such 'contracts', are nominal changes, like those caused by decimalisation and metrication. They have a cost, but this is trivial as a fraction of national output and nothing important is affected.

The distinguishing feature of contracts affected substantively by the adoption of a single currency is that they have an interest-rate term. Contracts with two particular characteristics are most vulnerable. These two characteristics are:

1. Long-term in nature, e.g. in the case of a bond or insurance policy, with a redemption date or terminal date after the 'Year of the ECU' or, in the case of supply contracts, where goods are to be delivered or work completed again after the 'Year of the ECU', and
2. Fixed in terms of nominal prices or interest rates expressed in the existing national currencies, e.g. for a bond, redemption value and interest coupons; for an insurance policy and certain types of pension plan, the terminal value and benefits; for a supply contract, the prices of equipment.

The reason that such contracts are substantively changed by the introduction of a single currency is straightforward. If there is a single currency, there must also be a single interest rate, yield curve and inflation rate. But at present – and, indeed, at those times in the past when the contracts were agreed – there were several national currencies, and so several interest rates, yield curves and inflation rates. The conversion of long-term, fixed-sum contracts from the existing national currencies to a single currency would therefore constitute a radical change from the environment in which the contracts were drawn up.

Real returns would differ from those originally expected. For example, borrowers who incurred debt in currencies with interest rates higher than ECU rates would lose out, while lenders in such currencies would gain; and vice versa for borrowers and lenders in currencies with interest rates lower than ECU rates. The ability of companies and financial institutions to pay pensions and meet other commitments would be altered. The redistributions of real returns which would follow the adoption of a single currency would sometimes be large and essentially arbitrary. Lawyers and accountants would have a field-day.

Some of the implications need to be amplified. Consider, for example, the consequences for privately-issued fixed-interest sterling bond issues. The issuers of such bonds would obviously have suffered a real loss relative to their initial expectations and the holders would have captured a real gain. Both issuers and investors of existing bonds ought to be aware of these potential

consequences today, before the announcement of a single currency. But what of future bond issues? Doesn't the same problem apply to them? Until a clear-cut statement on a single currency has been made, corporate treasurers will be discouraged from issuing more sterling fixed-interest bonds.

A new kind of uncertainty

It is clear that a new kind of contractual uncertainty has been created. The difficulty is quite general and applies to government debt as well as private debt. Indeed, if the governments of the EC are serious about a single European currency, they should stop issuing debt denominated in their national currencies and instead issue debt only in ECU. They should take this step as soon as their commitment to a single currency is final. Thus, if Pohl's inner core of Germany, France and the Benelux countries do pledge themselves to introduce a single currency in the mid-1990s at the December inter-governmental conference, new issues of deutschemark bunds, French franc government bonds and so on should cease sometime next year.

Long-term, fixed-sum contracts have been examined in detail here, because they are a particularly awkward illustration of the problems of contractual revision. But it would be wrong to give the impression that contracts with variable-interest-rate terms will be easy to handle. Such contracts include mortgages, bank loans and bank deposits. There is a view that, as the credibility of EMU increases, inflation expectations and nominal interest rates will converge across Europe and that changing variable-interest-rate contracts from the national currencies to ECU would leave all parties in much the same underlying position.

But this view is not quite right, for two reasons. The first is that real interest rates vary across Europe, being particularly high at present in Britain. The move to a single nominal interest rate would imply a single real interest rate as well. Obviously, to move from a Europe with a wide diversity of real interest rates to a Europe with a single real interest rate would be a substantive change. Secondly, the present levels of personal indebtedness and company gearing across the EC reflect expectations of the future cash flows available to meet interest

payments. Even if real interest rates were to be the same with the ECU as our currency rather than the pound, the cash-flow strain of meeting debt obligations would almost certainly be different because of a changed level of nominal interest rates. A new time-profile of real cash-flow obligations would also be a substantive change.

This point on cash flows may sound a little abstract, but its significance is easily shown by an example. At present homeowners in Britain pay mortgage interest rates of about 15% and mortgage interest payments can take a big slice out of income. The 15% rate is in line with expectations of a medium-term rate of house price inflation of, say, 10% a year. If the ECU were our currency, mortgage rates might be 10% and the medium-term rate of house price inflation 5%. In one sense the real situation is as before. But the ratio of mortgage payments to income would clearly be lower in an ECU environment, which would be a substantive change affecting millions of people.

Our argument on the extent of contractual revision may have seemed technical and nit-picking, and an evasion of the central issues. In fact, it is basic. We have begun to mention politically sensitive words like 'pensions', 'mortgages', 'insurance policies' and 'bank loans' because such contracts would inevitably be affected by the adoption of a new currency. They are not only the stuff of financial markets, but are also of concern far beyond the City and the banking system. In the end they affect everyone. Curiously, Sir Leon claimed in his speech to the Federal Trust conference that it was 'simply not the case' that a common currency need 'interfere in any way with existing contractual obligations'. This comment must be judged extraordinary. If it were true, one might well ask what was the purpose of the whole exercise. But, of course, it is not true. The interference with existing contractual obligations, and the disturbance to the expectations which lay behind those obligations, would be drastic. In this respect the costs of transition to a single currency would be much higher than Sir Leon seems to appreciate.

Upheaval in banking systems

The burden of contractual revision would be particularly heavy

on the banking system. But this is not necessarily the most unwelcome new problem that banks would face. At present the various European countries manage their banking systems in very different ways. Each has its own arrangements for monetary control, prudential regulation and lender-of-last-resort assistance. If there is to be a single currency, it would be necessary to harmonise all these aspects of banking

What would the harmonisation of regulation mean for British banks? One key dimension of monetary management is the proportion of cash the banks are required to hold with the central bank as a reserve. Cash is an unprofitable asset to hold, since it is non-interest-bearing. In Britain the Bank of England obliges all banks to keep a balance with it equal to ½% of their eligible liabilities. But otherwise the banks are free to decide the appropriate figure. In practice, only the clearers maintain extra balances and these, intended to meet cheque-clearing commitments and purely operational in character, represent a tiny fraction of total assets. The effect of these arrangements is that the cost of the cash reserve for British banks is modest. Banking charges for the general public are held down and the international competitiveness of the financial system as a whole is strengthened.

Elsewhere in Europe the position is very different. In Germany reserve requirements vary from 4.15% on savings deposits to 12.1% on certain kinds of sight deposit. In Italy and Spain the central bank forces banks to leave a substantial proportion of total assets – exceeding 20% – with it and then lends these funds to the government. The system provides finance cheaply to the Italian and Spanish governments, but – by the same token – reduces bank profits. The banks have to recoup this by charging their customers more. This is an important reason why Italy and Spain have uncompetitive and inflexible financial systems. If there is to be a single European currency, which will dominate – the British or the Mediterranean approach towards bank reserves? Clearly, if British banks are forced to adopt Mediterranean-type reserve ratios, they would lose one of their main advantages in international competition. However, it is unlikely that other European countries would readily accept a move to the British system. Although Germany

and France do not regard high reserve ratios as a means of funding the government in the Mediterranean fashion, they do consider minimum reserve ratios a key instrument in monetary control. An important debating area is opened up.

Danger of monetary disequilibrium

A further danger needs to be highlighted. It is that, partly because of the difficulties of merging different systems of monetary control, the citizens of Europe would probably have either excess or deficient ECU money balances after EMU. This possibility has been very obvious in German economic and monetary union, with financial markets much worried before the event that a low ostmark-deutschemark exchange rate would result in excess East Germany money balances and higher German inflation.

If money balances are excessive, either the excess will be eliminated by inflation or monetary policy will have to be tightened; if they are deficient, either Europe will suffer deflationary pressures or monetary policy will have to be relaxed. How are governments and central banks to ensure, in advance of the event, that money balances are broadly appropriate to the new pan-European ECU price level? Isn't there a risk that people's and companies' attitudes towards their recently-converted ECU money balances will be very different from their attitudes towards previous holdings of sterling, deutschemark, French francs and so on? And how will monetary policy be conducted in the new environment?

These questions are vital to assessing the macroeconomic repercussions of EMU. In the 1980s financial deregulation in many European countries had a powerful effect on both financial institutions' ability to extend credit, and the private sector's demand for credit and willingness to hold money balances. These effects were very difficult to predict beforehand and, in some countries (notably Britain), they weakened the intellectual case for broad money targets. But the adoption of a single European currency across the entire Continent would be a far more drastic upheaval than the various measures of financial liberalisation seen in individual countries over the past decade.

Enough has been said to illustrate the economic difficulties

of transition from the present national currencies to a single European currency. The costs of transition are high and should not be entered into lightly. These costs relate partly to the need to revise contracts, but they also arise from conflicts between different national styles of monetary control. Moreover, if mishandled, the negotiations on EMU could damage the international competitive position of Britain's financial industries, which at present is undoubtedly very strong. It is not sufficient to point out the advantages to the European economy of the long-run benefits of a single currency, once the currency has been introduced and has settled in or – as economists might say – once the currency is in steady-state. The steady-state benefits need to be weighed against the substantial costs involved in transition to a new system.

3
A calculus of economic benefits and costs in the long run

But what are the steady-state economic benefits? How valuable would they be? And can they be considered in isolation or would they have to be balanced against any steady-state costs?

The main long-run benefits of a single European currency have been advertised as the achievement of price stability, the elimination of transactions costs involved in currency exchange and the greater transparency of cross-frontier intra-European investment decisions. Most economists would argue that there is likely also to be a cost to set against these benefits, namely the increased risk of high and persistent unemployment because currency realignments (which might otherwise ease problems of uncompetitiveness) are no longer possible. These benefits and costs can be considered one by one.

Single European currency does not imply price stability

A common tendency in recent political debate has been to conflate 'single European currency' and 'price stability', as if one logically entails the other. For example, a paper prepared earlier this year by the European Commission said that, among 'the likely benefits and costs of EMU', were to be reckoned 'the advantages of price stability'. Hardly any argument followed this claim, as if the connection were self-evident. Similarly, in his Federal Trust speech on 24 May Sir Leon Brittan at one point noted that, 'Price stability must be the primary objective of any monetary union'. Later – when discussing the effect of a single European currency on contracts – he suggested that analysis could be 'postulated on its success in achieving price stability'. There is clearly a widely-held belief that a single European currency would result in stable prices. Most commentators assume that, at the very least, it will lead to a pan-European inflation rate lower than the average of the inflation rates of the twelve EC members at present.

Why have these beliefs and assumptions become accepted? Surely inflation forecasts in a European monetary union are

conjecture. Inflation might be lower with EMU or it might be higher. We just do not know. In fact, there are two strong reasons for scepticism about associating EMU with price stability. The first is that, as we have seen, no agreement yet exists about the right procedure for monetary control in Europe. To assume in these circumstances that EMU must mean lower inflation is very surprising. How can monetary policy curb inflation if the nations of Europe are uncertain about how monetary policy is to be conducted? If price stability is more likely with EMU than with separate national monies, this cannot be because it would introduce better techniques of monetary management.

So it must instead be because EMU will somehow strengthen Europe's collective political will to control inflation. But how and why? Here we come to the second problem. Because the dominant central bank in the European Monetary System today is the Bundesbank, it is being taken for granted that leadership in a European Monetary Union of the future would effectively be that of 'the Bundesbank times twelve'. But this outcome is most unlikely. As is well-known, the French and Italian governments' enthusiasm for EMU arises partly from a wish to dilute German influence in the EMS. They want to reduce the Bundesbank's power, not to entrench it. The political will to control inflation is likely to be weaker in EMU than at present, not stronger. Much would depend, in practice, on any future European central bank's degree of political independence and the distribution of voting power within it.

EMU would not automatically and inevitably deliver price stability. It would not even, necessarily, lead to lower inflation than at present. Pro-EMU statesmen have fallen into the habit of regarding the introduction of a single European currency as tantamount to the achievement of price stability. But this is just another example of politicians being deluded by their own phrases. It is not anchored in practical realities. They need to be confronted by hard, real-world questions like 'how are interest rates to be determined in the brave new world of pan-European money?', 'who is to set them?', 'is the quantity of money to be targeted or not?', 'if it is to be targeted, what mechanisms of monetary management are to be adopted?' and so on. Much woolly phrase-making would then be exposed for what it is.

Reduction in currency conversion costs

The other two benefits of a single European currency are more firmly grounded. Clearly, with only one currency in Europe, there would be none of the costs now involved in changing from one to another. The European Commission has suggested that 'explicit foreign exchange costs may amount to at least 15 billion ECU on intra-EC transactions or about 6% of the net revenues of the banking sector in the Community' and mentioned substantial further 'supplementary bank charges on international transactions'. These charges are said 'to reflect the high costs of bank transactions across national frontiers in Europe in an imperfectly integrated financial market'.

While these figures are impressive, they should be kept in proportion. The 15-billion-ECU number is less than ½% of the EC's combined output. Moreover, it is vital to distinguish between the transactions costs of intra-European transactions and the transactions costs of having a number of separate European currencies. If only one European currency existed, there would still be intra-European transactions costs because the bank transfers, cheque clearances, cash withdrawals and so on would continue to absorb resources. Indeed, the Commission virtually concedes in its comment that the transactions costs reflect the inefficiency of an 'imperfectly integrated financial market' as well as the multiplicity of currencies. The extra transactions costs attributable to the multiplicity of currencies itself may not be much more than 1¼% of EC output. This is something, but it hardly justifies the radical re-assessment of national identity involved in the move to a single European currency.

Improved investment decisions across Europe?

The most persuasive argument of the advocates of a single European currency does not depend on the achievement of price stability, which is pure supposition, or on the reduction of transactions costs, which would be small. Instead it is based on the likelihood of improved investment decisions across Europe because of the elimination of certain kinds of exchange-rate risk. In this context the key investment decision relates to the location of operations. The most important risk is that – in a Europe of

several currencies – sharp exchange-rate fluctuations increase the volatility of returns from cross-frontier investment and alter their time-profile in unpredictable ways. As a result, less cross-frontier investment is undertaken than is desirable. Moreover, the reluctance to embark on cross-frontier investment may reduce the average size of operations and prevent the exploitation of economies of scale. One reason why living standards remain lower in Europe than in the USA must be that American industry, working in a truly integrated national market, can capture economies of scale more easily.

These are powerful points. However, they should not be accepted uncritically. The evidence is decisive that over periods of many years exchange rates are governed by the doctrine of purchasing power parity. According to this doctrine, exchange rates and price levels adjust to equalise the prices of traded products in different countries. It follows that exchange rates (a monetary variable) cannot change the relative profitability of investment in different countries (a real variable), and so the location of such investment, in the long run. Of course, the phrase 'in the long run' begs many questions. But the message is that the existence of separate currencies may not be a crucial influence on the allocation of international capital.

One feature of the European economy in the late 1980s agreed strongly with this conclusion. It was that Britain became the preferred location for international investment in Europe, even though Britain did not (and, at the time of writing, still does not) participate in the exchange rate mechanism of the European Monetary System. According to the latest *Annual Report* of the Invest in Britain Bureau, at end-1989 Britain accounted for 41% of the stock of all US investment in Europe, much higher than West Germany (16%) and the Netherlands (11.5%) which were in second and third place respectively. Japanese companies also favour Britain rather than EC countries. At end-1988 391 Japanese companies were manufacturing in the EC, of which 92 were in Britain; at end-1989 501 Japanese companies were in the EC (up 28%) and 132 in Britain (up 43%). Moreover, in the *Report's* words, 'The surge in Japanese projects which began in 1987 has been maintained for the third year in succession and available evidence suggests that Britain's share

of Japanese investment in the EC is growing.' The facts therefore argue that Britain's abstention from the EMS has not discouraged foreign investment. In this case currency considerations appear to have been secondary to other influences on international investment flows.

Adverse effect on unemployment

The final item in our calculus of costs and benefits is the loss of devaluation as a method of preserving competitiveness and sustaining employment. At present, if wages' growth and inflation are higher in Britain than elsewhere, the tendency for British prices to rise above those in other European countries can be offset by a fall in the exchange rate. High domestically-generated inflation need not result in a loss of market share, a drop in output and a fall in employment. The introduction of a single European currency would eliminate this option by definition. In the opinion of some economists, if Britain could not devalue its currency, it would run the risk of being marginalised in the European economy. Unemployment could be permanently higher here than is necessary.

For economists (often described as 'monetarist') who believe that monetary forces cannot change real variables in the long run, this argument should not have much appeal. Samuel Brittan has correctly pointed out in *Europe Without Currency Barriers* that, 'Devaluation does not provide the devaluing country with a penny of extra resources'. The option to depreciate a currency may be nothing more than a cloak for the option to run a higher inflation rate than neighbouring countries. Only in infrequent circumstances may devaluation be useful to counter a real shock (such as a large change in the relative price of exports and imports) rather than purely monetary imbalance. This point is relevant in Britain's case because its economic structure, with its large oil sector in Scotland and the role of London as one of the world's leading financial centres, is highly distinctive. In short, the danger of persistent unemployment because of the loss of the devaluation option deserves to be mentioned as an objection to a single European currency. But its significance should not be exaggerated. In particular, the argument should not be used by economists who think that domestically-based

anti-inflation policies have only transient effects on output, employment and the real economy.

Balance of economic costs and benefits unclear

What conclusions are to be drawn from our survey of the economic costs and benefits to Britain of a single European currency? In the transition to a single currency, there would be costs and no benefits. These costs would arise particularly from the upheaval of existing contracts and the difficulty of establishing new arrangements for monetary policy across Europe. On the other hand, in the 'steady state' when the single currency is established, there would be mainly benefits. But these benefits tend to be exaggerated. For example, the supposed benefit of price stability is mere sloganising and should not enter the calculation at all. The true benefits are the elimination of foreign exchange conversion costs between European currencies and the ending of certain foreign-exchange risks which impede cross-border investment. Against these benefits some economists would emphasise the dangers of increased unemployment because of the loss of the devaluation option now available to European governments.

Readers must make up their own minds whether this analysis justifies British participation in future moves to a single European currency. But it is clear that the benefits do not overwhelm the costs. On economic grounds alone the decision is not clear-cut. The question must therefore be resolved by other considerations, particularly the political implications.

4
No alternative?

Is there no alternative to a 'European' solution for the British inflation problem?

Before we discuss the politics of EMU, we should answer a common argument for British acceptance of a single European currency. This turns on the idea that, since Britain is now only a middle-rank power, its geopolitical choices are strictly circumscribed. On this view, 'Europe is the future' and we cannot disagree with the future. Whether we like it or not, we must participate in 'progress' towards 'European union'. If we do not, we shall be marginalised by our continental neighbours and become, even more than we are today, the 'poor man of Europe'. One development of this view is that our monetary policy is effectively determined by what happens in Europe anyway. In Sir Leon Brittan's words, 'The last time German interest rates went up UK interest rates followed about 30 minutes later'. By extension, we must involve ourselves in European monetary unification if we want to reduce inflation.

Pro-EMU statements often vague, metaphysical and inconsistent

This case, and the great miscellany of statements associated with it, need to be treated with care. Propositions like 'Europe is the future', 'European political union is inevitable' and 'while Europe is advancing, Britain is being left behind' are very common. But they are almost metaphysical in character, with none of the terms defined and hence no prospect of logical contradiction. The frequent use of words like 'the future' and 'inevitable', and the tendency to accompany them by the crude injunction 'we must', substitute verbal cajolery for serious reasoning. When attempts are made to give vague formulas of Euro-enthusiasm some genuine content, they often turn out to be self-contradictory. For example, it is claimed that 'we must join European monetary union to influence debates on economic policy which will determine our future'. But the abolition of the pound sterling and the extinction of the Bank of England would entail a massive loss of sovereignty, which by definition would reduce our ability

to determine our future. The common assertion that 'we must belong to a united Europe to keep our say in the world' overlooks the elementary point that in a fully united Europe there would no longer be a separate British state with its own distinctive voice.

The two claims – that our monetary policy is already determined by Europe and that participation in EMU (or in the EMS as a stepping-stone to EMU) is the key to inflation control – are also inconsistent. If our monetary policy is already determined by 'Europe' (or, concretely, by the Bundesbank's interest rate decisions), how have we been able to engineer an inflation rate so much higher than the European average? Monetary policy must be independent if our inflation rate diverges from that elsewhere. But, if our monetary management has been inferior to that in the rest of Europe in recent years, it must also have the potential to be superior in the 1990s. There is nothing inevitable about British inflation being higher than in the rest of Europe. Inflation rates are man-made, not a datum of nature or history.

Britain cut inflation sharply in early 1980s *outside the EMS*

When critics of the retention of monetary sovereignty claim that Britain could not reduce inflation to European levels if it stayed outside the EMS (and so EMU), they need to be asked two questions 'why did Britain reduce inflation to beneath the European average in the early 1980s?' and 'how have other non-EMS countries (notably, Switzerland) been able to keep inflation beneath the European average in the late 1980s?'.

The facts behind the first question are not in dispute. In the four years to 1980 consumer inflation in the EC averaged 10.7% a year, 2.7% *beneath* that in Britain; in the four years to 1984 consumer inflation in the EC averaged 9.2% a year, 1.7% *above* that in Britain. Nor is there much mystery about how this (almost 5%) favourable change in the EC/UK inflation differential was accomplished. In the early 1980s the British Government pursued a vigorous policy of financial restraint focused on money supply targets, expressed in terms of the broad money measure, M3. (The M3 measure of money, for which figures are no longer collected, was dominated by bank deposits.) For some of the period the exchange rate was deliberately neglected by policy-

makers. Success against inflation in those years was due to domestic monetary control.

The force of the second question is also difficult to escape. Swiss consumer inflation in the four years to 1989 averaged 1.9% a year, whereas in the EC it averaged more than twice as much, at 4.4% a year. It is true that the Swiss authorities used the exchange rate between the Swiss franc and the deutschemark as a guide to monetary policy. But they had no doubt that they controlled their own interest rates, kept control over domestic monetary conditions, did not belong to the EMS and were their own masters. Switzerland will not have to join the EMS (or EMU) to keep its inflation rate down. Success against inflation in the future here will also be due to domestic monetary control.

Most supporters of EMU know perfectly well that domestic monetary control could reduce inflation and, in due course, enforce stable prices. Their attempts to rebut monetary targets therefore tend to be evasive or unconvincing. In his pamphlet *Europe Without Currency Barriers* Samuel Brittan claims that the German Bundesbank has earned credibility for its low-inflation record by 'a pragmatic approach with a history of success'. He continues, 'Other countries, with very different reputations, are more likely to conquer inflation by tying themselves to the mark than by a search for a domestic monetary grail. This is the route which France has taken and Britain has not.'

Domestic monetary control the key to lower inflation

Samuel Brittan's view has to be answered. He is perhaps the most well-known and articulate advocate of full British membership of the EMS. He has also been immensely influential in discrediting domestic monetary targets and so making policy-makers think that no alternative to a 'European' anti-inflation programme exists. (A 'European' programme is to be understood here as EMS membership, EMS membership as a prelude to EMU, or EMU itself.) Samuel Brittan does not deny that domestic monetary targeting would reduce inflation. He merely claims that it would be an inefficient way of reaching this objective. But he has a problem. There has been ample experience in the 1980s of the relative efficacy of domestic monetary restraint and

exchange-rate targeting as means of curbing inflation. Five points are in order:

1. As already emphasised, when Britain pursued money supply targets in the late 1970s and early 1980s it successfully reduced inflation. When it abandoned those targets and moved towards exchange-rate management after 1985, inflation – after the usual lags – increased sharply. Whatever the theoretical rights and wrongs of the two approaches, the contrast in their practical results is difficult to dispute.

2. It is not true that France's attainment of a lower inflation rate than Britain in the late 1980s was due to its commitment to the EMS. On the contrary, in the early 1980s France belonged to the EMS, while Britain did not, but the British cut inflation by more than France. The change in French performance followed a re-assessment of financial policy in the mid-1980s, with the centrepiece being a more explicit role for domestic money supply targets. It was the determined pursuit of these targets which both kept the franc stable against the deutschemark and curbed inflation.

3. Most supporters of EMS membership see the anti-inflationary role of the Bundesbank as crucial. The argument runs, 'by tying ourselves to the EMS, we will capture the benefits of Bundesbank monetary restraint'. But how does the Bundesbank keep German inflation down? The answer is that it follows domestic monetary targets, set in terms of broad money. This argument for EMS membership therefore reduces to the claim that British inflation is likely to be better controlled as a by-product of the pursuit of German money supply targets by a foreign central bank than as a direct consequence of the pursuit of British money supply targets by the Bank of England. As a comment on British economic policy-making in recent years, that may

be fair enough if rather humiliating. But doesn't it sound odd?

4. If Britain joins the EMS, it would still have to keep monetary growth down if it were to restrict inflation over the medium term. It is striking that the acceleration in broad money growth in the mid-1980s was followed by an acceleration in inflation, just as the monetarist textbooks warned it would be. The shadowing of the deutschemark between March 1987 and March 1988, as advocated by Samuel Brittan, certainly did not dampen inflationary pressures. In the end, it was the exchange rate and inflation that adjusted to monetary growth rather than vice versa.
5. It is not correct that ERM membership would give clearer signals to macroeconomic policy than monetary targets. Two sharp debates have already developed between supporters of ERM membership. The first is between those (for example, the National Institute) who favour a 'low' exchange rate at entry, with the pound at under 2.5 deutschemarks, and those (Samuel Brittan among others) who want a 'high' exchange rate, with the pound at around or above 3 deutschemarks; the second is whether membership should be with the wide divergence band of 6% around the central EMS parity or the narrow divergence band of 2¼%. These debates are no more easily resolved than those between monetarist economists over the appropriateness of different measures of the money supply. In fact, British economists have agitated themselves for many decades about how to determine the 'best' exchange rate without reaching a clear-out, uncontroversial answer. By comparison, the problems with M3 in the early 1980s were minor. (An aspect of the exchange-rate question needs to be mentioned. Some economists both were worried in early 1988 that an exchange rate for sterling

above 3 deutschemarks was 'too high' because it would cause a damaging loss of competitiveness for British industry and have expressed concern in mid-1990 that unless the exchange rate were around or above 3 deutschemarks if would be 'too low' and would risk unnecessary inflation. Samuel Brittan's many articles in the *Financial Times* in the last three years are an example of the inconsistency.)

The consensus among British opinion-formers and policy-makers is that there is no alternative to a European solution to Britain's inflation problem. The truth is very different. It is that, if we want to cut inflation, there is no alternative to reducing the growth of the money supply. The Government – and particularly the Prime Minister herself – were very clear about this in the early 1980s. They were right. The puzzle, and it is a very deep puzzle, is how both the great majority of British economists and the official policy-making machine can overlook the obvious facts of experience. Britain does not have to join the EMS or participate in EMU to bring its inflation down. It can do so itself by resuming the appropriate domestically-oriented monetary policies. The notion that Britain cannot control inflation unless it abolishes its currency, embraces a new pan-European currency and surrenders its economic independence is nonsense.

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The political implications

In the end, the debate about EMU will not resolved solely by an appeal to economic costs or benefits. Ultimately EMU is about politics. Moreover, 'politics' is not to be understood here in a narrow party sense, but in the larger sense of how people, communities and nations live together and relate to each other. It is not about the election of particular governments and politicians, but about the constitutional arrangements which every government must respect. Indeed, it is about the very definition of the 'nations' to which the constitutional arrangements apply.

Monetary and political authority intertwined

Monetary and political authority are closely intertwined. If an organisation such as the Euro-Fed can print bits of paper, call them ECU bank-notes and have the governments of Europe give them the status of legal tender, it can require people to surrender real things (which are valuable) for the bits of paper (which have no intrinsic worth). In effect, the bank notes are equivalent to tax demands and the central bank can levy taxes. It follows that, if the power to issue money is transferred from national central banks to a pan-European central bank or Euro-Fed, the power to raise taxes would be shared between the Euro-Fed and national parliaments. The fiscal prerogative would no longer be exercised only at the national level.

An equally fundamental result of a single European currency would be the removal of the ability to influence inflation and unemployment from the governments of nation states. At present British interest rates are set by the Bank of England, taking instructions from the Treasury; in future, they could be decided by the Euro-Fed (or whatever), acting on its own supposedly non-political initiative. This element in the political debate, which is now central to party rivalries at Westminster, would be re-located to a European centre, probably Frankfurt but perhaps with strong influence from Brussels.

A single European currency, with all its accompanying rules

and regulations, would invade and quickly dominate the financial sector of the British economy. From there the effects would spread throughout industry and commerce, and eventually affect people's everyday lives. Without control over its own currency, Britain would no longer be an independent nation. It would be merely a region in a pan-European state. There is no way of knowing in advance what the precise division of powers, obligations and rights would be between the British Parliament and the central authority in a pan-European state. Moreover, Parliament's ability to control that division would be constrained by its condition of monetary subordination. The project to introduce a single European currency sometime in the coming decade is a project to end the independent existence of the European Community's member states, including Britain. In the words of Nigel Lawson, the former Chancellor of the Exchequer, 'It is clear that EMU implies nothing less than European government – albeit a federal one – and political union: the United States of Europe'.

A warning from the Soviet Union

The cogency of this argument has been demonstrated, with a poignant coincidence of timing, by recent events in the Soviet Union. As part of the latest phase of *perestroika*, the constituent republics are trying to assert their separateness from the Soviet Union as a whole. The two most important practical steps have been to proclaim the superiority of each republic's laws over union laws and to insist on the autonomy of their own central banks. It is not just that the Baltic states of Latvia, Estonia and Lithuania established central banks as soon as they presented their demands for independence. Even more strikingly the Russian republic has tried to create its own banks distinct from those of the Soviet Union. According to a report in the *Financial Times* on 24 July, 'The struggle for authority over the Soviet economy, and the whole process of economic reform, has suddenly become focused on the question of who runs the banking system – the state bank of the Soviet Union or the state bank of the Russian federation'.

The report described the prominence of the 'issue of banking control' as 'unlikely'. But the use of the word 'unlikely' is very

misjudged. Decisions taken by commercial banks are vital to the behaviour of any economy, even a planned economy of the Soviet type; and decisions taken by central banks are a powerful influence on decisions taken by commercial banks. In the words of Viktor Gerashchenko, chairman of the threatened and much affronted Gosbank:

> 'A single currency unambiguously dictates the need for the unity of rules for the regulation of the monetary system, and such unity is possible only when, in an area with a single monetary system, only one central bank legally functions'.

Recent Soviet developments contain a further warning. In his paper 'Towards one money for Europe' Samuel Brittan challenges the defenders of national sovereignty with the emotional remark, 'The cemeteries of Europe are testimonials to the false religion of the national state'. But presumably he would not deny that a war within Western Europe is already unthinkable, even though its nations are undoubtedly distinct, separate and sovereign. The banishment of war from Western Europe is largely due to the EC's success in forging a common market, particularly in industrial products. The establishment of a common government – as did exist until very recently in the Soviet Union – is no guarantee that tensions between regions and peoples will be eased or removed. On the contrary, it is clear that ethnic disputes are more bitter and violent in the Soviet Union than in Western Europe today, and that resentment of an intrusive common government is largely to blame.

Common market vs. common government

Market processes, particularly trade on equal terms with agreed rules, bring people together; politics, by contrast, too easily degenerate into interest-group pleading which divides them. A common market between sovereign nation states encourages market processes; attempts to create a common government over formerly sovereign nation states will provoke interest-group pleading, and arouse new and unnecessary political animosities. These are glib statements, but the events of 1990 give them obvious force. Of course, they have a Cobdenite, Manchester-liberal ring, but there is no need to apologise for that. Indeed,

in his paper Samuel Brittan recalls Richard Cobden, 'the great 19th century reformer and free trader . . . who wanted to tear down barriers between peoples', with admiration.

Even if it could be demonstrated that Britain would reap enormous gains in economic efficiency from participating in a move to a single European currency, the larger and more important question would be its meaning for our political independence. Experience in the Soviet Union emphasises the key point that monetary and political authority are closely intertwined. A single European currency is remote and hypothetical, and may prove unworkable. But that is only a matter of pounds and pence or, at any rate, of ECU (and *their* fractions). The loss of national sovereignty would be far more fundamental and serious in its possible results. There would be no excuse if British politicians were cavalier about that.