

Re-opening the debate on the euro – could staying out could mean missing out?

The financial crisis has revealed Britain's vulnerability in having world-scale banks but only a medium-sized currency. It was a close run thing when EU countries, after initial chaos, agreed a co-ordinated rescue package. Had they continued with "everyone for himself", and Britain been forced to match the bank guarantees given by other countries, then, with the five biggest UK-based banks alone having assets worth four times Britain's annual GDP, there is every likelihood that Britain would have been faced with a run on the pound.

This alone has sparked renewed interest in joining the euro. The ballast offered by a continental-scale currency, which has now got past its teething phase, was proven by the contrasting fortunes of Ireland and Iceland. Even in a moderately affected country like Denmark, the Governor of its Central Bank, Nils Bernstein, has drawn attention to the "economic cost of being outside the Eurozone". It is time for Britain too to re-examine the issue.

In May 1998, when European leaders agreed to fuse their currencies into one, critics predicted financial disaster. Several years later, when the euro was losing ground against sterling and the dollar, they were quick to deride it as a 'toilet currency'. However, ten years after coming into existence, the euro has confounded its critics, to such an extent that the same financial correspondents are now anticipating that the euro will supplant the US dollar as the world's principle reserve currency.

The move to the final phase of Economic and Monetary Union (EMU) - as well as ranking alongside the Bretton Woods agreement as one of the most important monetary reforms in modern political economy - marked a watershed in European integration. From Roy Jenkins' Jean Monnet lecture as President of the Commission in 1977, which outlined the concept of a modern monetary union, to its launch in 1998, the single currency has been a towering symbol of European integration. Indeed, according to Eurobarometer polls, along with the free movement of people, capital and labour, the euro is regarded by public opinion as the most positive aspect of European integration.

Indeed, steady inflation rates of a fraction over 2%, the lowest interest rates in a generation, the creation of 16 million new jobs and increased intra-area trade are some of the achievements on the Eurozone's balance sheet. Indeed, the euro's transformation from 'toilet currency' to the second truly global currency is no better embodied than by the fact that it now accounts for more of the global financial pie (at 45%) than the dollar. In a recent report, the House of Lords EU committee found that "none of the fears, expressed at the time of its launch, about a divisive or negative impact on European economies has been borne out".

The Eurozone also continues to expand. Since its launch nearly 10 years ago, five countries have joined - Greece, Slovenia, Cyprus, Malta and Slovakia, while a further five countries have joined the Exchange Rate Mechanism (ERM) II arrangements, membership of which is a step towards full membership of EMU. Denmark, which, like Britain, has an opt-out on euro membership, is planning a referendum on joining which opinion polls suggest will be won.

So, when will Britain (Europe's second largest economy) become a member of the Eurozone and adopt the single currency? Back in the 1990s it was widely assumed that, whilst Britain would not be part of the initial group of 11 countries to adopt the single currency, it would be one of the second wave of members. Even at the start of the decade, the question of Britain's membership of the euro was a case of when rather than if. While a majority of public opinion was against Britain immediately becoming a member, opinion polls between 1999 and 2002 regularly showed that between 60 to 70% of people expected Britain to have adopted the euro by 2010, a large majority especially when considering the weakness of the euro during this period.

Moreover, the Labour Government has consistently made it clear that it is committed to the principle of joining the single currency, laying down five economic tests to determine whether Britain becomes a member. In 2003, the Treasury published its initial assessment of whether the UK economy had met the tests, concluding that, although significant progress had been made and the potential economic benefits were clear, there still was not a "clear and unambiguous case" for UK membership at that time, but that it would continue to review the situation at regular intervals. Labour's commitment, in principle, to joining the single currency was confirmed earlier this year as part of the National Policy Forum document agreed in Warwick and approved at party conference in September.

However, despite the growing strength of the Eurozone, the debate on whether Britain should join the single currency has almost completely disappeared from the political radar. Britain's consistent economic growth during the past years, combined with the antipathy of the Conservatives and apparent apathy of the Labour government has pushed the euro off the political agenda. The stance of the Labour party seems to be to hope that the issue will go away. In 2005, Labour's manifesto stated that the party would hold a referendum and support our membership of the euro if its famous five economic tests were met, a position that was virtually identical to its stance at the 2001 election.

Despite this, the upheaval that the sub-prime crisis and consequent financial instability has wrought on western economies and, if investment decisions by major companies start to go against the UK because of Britain's status outside the Eurozone, a re-think may be in order. This paper attempts to re-open the debate; looking at what membership of the single currency could mean for the British economy and the political consequences of our continued non-membership.

Needless to say, it would be fruitless and inaccurate to claim that the euro has been an unqualified success, or that the development of EMU has been a painless process. Output and productivity growth has been lower than expected and several countries have felt the strain of having interest rates set jointly through the European Central Bank.

However, the case for monetary union remains a strong one, particularly in the light of the current economic turmoil. In an EU of nearly 500 million people and a single market that is the biggest trading area in the world, Helmut Schmidt's famous remark "who ever heard of a single market with 11 currencies" is as pertinent now as it was

when he made it back in the 1980s. Consequently, this paper looks at both sides of the argument, both political and economic, and assesses whether, in Britain's case, staying out means missing out.

The economics - successes and challenges for the Eurozone's second decade

The Eurozone's record is, in basic macroeconomic terms, a largely positive one. A case in point has been its control of inflation rates. The EU Treaties state that the primary function of the European Central Bank (ECB) is to maintain "price stability". The inflation rates of the original Eurozone members have converged, albeit at a rate slightly above the 2% ceiling set by the ECB. Nonetheless, the average inflation rate of 2.05% between 1999 and 2006 was lower than the rate in the UK during the same period. In real terms, interest rates in the Eurozone are lower than they have been for a generation, even in those countries which enjoyed the highest degree of economic stability before the adoption of the euro.

Its governing institutions have also confounded initial sceptics. At the launch of the Eurozone, many commentators predicted that bringing together a multitude of central banks would make the ECB's decision-making slow and unwieldy. Harvard economist Martin Feldstein even warned that the euro could lead to war in Europe! However, the ECB's handling of the credit crunch has helped silence critics.

In a short space of time, the euro has established itself as the world's second international currency. The currency's early decline against the dollar and sterling has long since been reversed. Indeed, the Eurozone is now even stronger against sterling than it was following Britain's withdrawal from the ERM. The euro is the second most actively traded currency and is used in more than a third of all foreign exchange transactions, while 25% of global currency reserves are in euros. In the words of the House of Lords EU committee, "the euro has established itself with remarkable speed as a widely accepted transactions currency".

Its record in stimulating employment has also been favourable. 16 million jobs have been created during the first decade of the Eurozone, employment has risen by almost 15% while unemployment has fallen to around 7% of the labour force. Furthermore, job creation in Europe has recently outstripped that of other developed economies such as the US. This will obviously be affected by the economic downturn, but the Eurozone is likely to suffer less than others from its effects.

It has led to more integrated financial markets, with increased cross-border consolidation amongst banks. Indeed, the sixteen largest banking groups now hold over 25% of their EU assets outside their home country. This development has been mirrored in equity markets, with the share of equity held in other Eurozone countries having increased from 20 to 40%. Indeed, as Rene Karsenti, President of the Internal Capital Market Association puts it, "it is the stable interest rates in Europe that have helped and the fact that the euro has strengthened and shown resilience".

Of course the Eurozone's record is not perfect. Economic growth has, at around 2% per year, remained stubbornly low, particularly in Germany and France. Moreover,

labour productivity has grown at 0.8% a year, down from 1.6% between 1989 and 1998 and well below the 1.6% achieved in the US between 1999 and 2008, while the Eurozone's per capita income has remained at around 70% of that of the United States. But, these differentials are, anyway, largely due to structural rather than monetary reasons.

Several countries have felt the strain of having common interest rates set by the ECB. Meanwhile, with currency devaluation no longer a quick fix allowing their finance ministers to engineer economic recovery, Spain and Italy (and no doubt others in the future) have to face up more quickly to the structural adjustments required to maintain the competitiveness of their respective economies. As the euro continues to get stronger, the pressures of adjustment to internal divergence are likely to be exacerbated, with greater differentials between Member States in terms of inflation, labour costs and current account positions.

Indeed, while many economists hoped that the euro would lead a series of structural reforms to increase the economic divergence of Member States, there have been marked differences from country to country. While some, notably Austria, Finland, the Netherlands and Germany, have implemented measures to make their labour markets more flexible and increase current account discipline, others, including the Mediterranean quartet of Portugal, Italy, Greece and Spain, have not, and are now seeing unit labour costs increase and a corresponding deterioration in competitiveness. Many countries made great efforts to qualify for the euro but treated accession to the single currency as marking the end of their reforms. One of the tasks for the Eurozone in its second decade, as the Commission and the ECB have acknowledged, will be to reinvigorate structural reform to make economic union a comparable success to monetary union.

Indeed, while fiscal consolidation has been improved, culminating in a deficit of only 0.6% in 2007 which, combined with reforms to the Stability and Growth Pact in 2005 has helped ensure that no Eurozone country had a deficit larger than 3% in 2007, governments need to do more to promote long term fiscal discipline and structural reforms if the Eurozone is to continue to develop. As the Commission recently admitted in its evaluation of the euro's first decade, "product markets within the euro area are still only partially integrated and cross-border provisions of services remains underdeveloped."

So, what can we anticipate in the euro's second decade? An element that will become a growing factor is the effect of the euro's rising international status and the sheer size of the Eurozone economy. The burgeoning status of the euro as the second international currency (and anticipated by many financial correspondents to rapidly supplant the dollar) offers potential advantages and responsibilities to the Eurozone. The euro's status will develop the financial industry in Europe, offer seigniorage gains from the use of the euro as a reserve currency and reduce exposure to exchange rate volatility. However, the strength and size of the Eurozone will mean that, increasingly, the policy decisions that govern EMU will be felt not just in Britain but across the global economy. This offers a significant increase in 'soft economic power' to the EU, which could have implications in other policy areas where the EU is a world leader, such as development aid, sustainable development and trade policy.

In addition to overtaking the dollar as the world's principle reserve currency, the next obvious step for the single currency will be for world commodity prices to be fixed in euros rather than dollars. This would create an extra argument in favour of British membership. At present, manufacturers across Britain and the Eurozone are hostages to fluctuations in the US economy that have nothing to do with either our suppliers or our own economy. Having world commodity prices fixed in euros would transfer a significant economic advantage from the US to Europe.

Would euro membership benefit Britain?

It is, needless to say, difficult to offer a concrete estimate as to how much our staying out of the Eurozone has cost us in terms of inward investment. The Treasury has argued that Britain is still the most popular EU destination for foreign direct investment (FDI). In broad statistical terms, this is true, but if we remove mergers and takeovers from the equation and look at investment in new productive capacity, the picture is somewhat different. Moreover, the Treasury admitted in 2003 that there had been a fall in FDI since the start of EMU, and a corresponding increase in the share of the Eurozone.

Indeed, a number of multinationals have made it clear that they will cut off future investment in Britain unless we join the euro. Just to give some examples of the feelings of the business community, Hans Haefeli, Vice President of US construction company Caterpillar, which employs 11,000 Britons, has stated that "fundamentally it would make life easier for us if Britain were in the euro" while Andreas Ludwig, head of Austrian company Zumtobel which employs 650 people in County Durham, commented that "not being in the euro means we are exposed to currency fluctuations and that is a problem". Meanwhile, the President of car giant Honda, Takeo Fukui, said in 2007 that his company had made a mistake in building its Swindon plant thinking that the UK would join the single currency, adding that "unless the UK joins the Eurozone, we can't add to our plant in Swindon".

Moreover, Toyota, the world's largest car manufacturer, is expected to decide within the next year whether to make a big investment in its UK plant in Derby or to increase its resources in other sites in Europe. Such decisions are a good litmus test of whether by staying out of the euro the British economy is being hamstrung.

Similarly, the Treasury's assessment in 2003 of the progress of the British economy on the five economic tests stated that "EMU membership could significantly raise UK output and lead to a lasting increase in jobs in the long term". This is based, in part, on the fact that intra-Eurozone trade has increased by around 20%, while the Treasury also estimated that the UK could enjoy an increase in trade with the Eurozone of around 50% over 30 years.

From a business perspective, joining the euro would eliminate conversion costs, a point of particular relevance to small and medium sized businesses. Ivan Massow, a millionaire businessman, and a former Tory candidate for London Mayor, has explained the economic sense of consumers not having to change money when they travel, commenting that if only half of us visited mainland Europe once a year at an

average exchange commission of three percent, this amounts to conversion costs of £5.4billion.

By contrast, the costs of British entry are often overstated. The accusation that a 'one size fits all' interest rate is not suitable for open and diverse economies simply does not stand up. In macro-economic terms, an independent monetary policy is a small and diminishing asset to a medium sized, open economy such as Britain's. Besides, the 'one size fits all' effect is not a problem that is unique to the Eurozone. British interest rates usually reflect the interests of the South-East and the City at the expense of our poorest regions and manufacturing heartlands. In any case, the five economic tests set by the Treasury include an assessment as to whether the UK and Eurozone economies are sufficiently converged for this not to be a problem. The 2003 Treasury assessment on convergence concluded that while the UK had met the convergence criteria for inflation, interest rates, government deficits and debt, there remained some structural differences with the euro.

Above all, the notion that joining the euro would amount to a massive loss of sovereignty can be comprehensively scotched. In one sense, the reverse is the case - outside the Eurozone we have no say or influence over the economic decisions which govern our continent and, increasingly, affect our own economic performance. Inside, as Europe's second largest economy, we would have a powerful voice.

Furthermore, commentators who argue that joining the euro would see us lose control of our economy and currency are akin to those who bolt stable doors after the horse has bolted. The notion that we have complete control over our economic destiny is fatuous - no one would argue that our economic performance is not closely related to decisions made in Washington DC and, increasingly, Frankfurt. Jointly deciding on monetary policy gives us a greater chance of resisting international pressures, while also leaving the key planks of economic policy making - fiscal policy and public investment - in the hands of national governments.

Moreover, the nature of Britain's economy means that we would benefit from the single currency more than other countries. Take, for example, our ability to attract foreign direct investment, and the status of the City of London as Europe's financial epicentre. Within EMU, London would stand not just as a centre of international finances, but as the centre of integrated euro capital markets. As has been amply demonstrated, being outside the Eurozone has caused foreign multinationals to be less willing to invest, at particular cost to some of our poorest regions.

Over the years we have also suffered from currency fluctuations, and currency exchange markets tend to 'overshoot' when attempting to adjust, causing currencies to be over or undervalued. Adopting the euro eliminates that problem within the internal market and, since around 60% of our trade is with the EU, this is a substantial benefit. It would level the playing field in the internal market. The UK's place outside the Eurozone forces our exporters to bear hedging and conversion costs that Dutch, French, German etc companies do not have to pay, giving the latter a clear competitive advantage.

Of course, staying out is not just an economic handicap but a political one. With each year that passes we are delaying the benefits of the euro, and the longer we leave it,

the weaker our negotiating position when we finally decide to join. The countries that were there in the beginning, and felt the strain when the euro was going through a difficult teething process, could be forgiven for not offering the UK favourable terms on euro entry.

However, there was a case, until the credit crunch crisis, to be made that Britain's absence from the euro has not had entirely adverse consequences on our economy. For example, between the first quarter of 1999 and the first quarter of 2008, the UK economy expanded by 28% compared to 21% in the Eurozone as a whole and 16% in Germany. Similarly, on inflation, since 1998 consumer prices have risen by 18% in the UK, the same as in Germany, below the 20% rise in France and the 26% increase in Italy. But economic growth figures are related more to structural, not monetary policies, and Britain's lower inflation rate has been at the price of higher interest rates, making investment (and mortgages!) more expensive.

Thus, as far as Britain's past, present and future economic performance is concerned, the balance sheet of pros and cons gives a clear reading: British membership of the euro would improve economic growth and the stability of our economy.

The impact of the credit crunch

The recent financial crisis, with many banks going bankrupt or being bailed-out, and the institutional structure of the financial market brought to its knees, has also demonstrated the value of the single currency to those in the Eurozone. Jean Claude Juncker, the Prime Minister and Finance Minister of Luxembourg, put it quite bluntly at a recent public meeting in Brussels, asking the audience to imagine how much worse the economic instability afflicting the western economies would be if we didn't have the single currency. Imagine that, instead of the euro, we still had the peseta, the lira, the Irish punt, French francs, etc. It is highly likely that they would have responded differently on exchange markets, and some might have been subject to speculative attack.

Currency market turmoil would have added to the instability, aggravating the crisis. Instead, the bulk of Europe's common market was able to rely on a stable and strong currency to help weather the storm, with the Financial Times's former bureau chief Stewart Fleming arguing that "the Eurozone is (once again) coping with the turbulence far better than would have been the case if the nation states of the Eurozone had still been clinging to their national currencies".

The crisis also demonstrated the need for co-ordinated intervention at EU level. At first we had a free for all. The Irish (followed swiftly by the Germans) guaranteed all cash deposits in their banks. This ensured that other European countries either had to follow suit or risk seeing massive amounts of cash flowing into banks in the countries which guaranteed deposits.

This was highly dangerous, both politically and economically as it was, in effect, the opening up of a bidding war in which the countries whose financial institutions had their fingers most badly burnt by toxic sub-prime debt were simply not able to compete. Moreover, the sheer scale of the liabilities that taxpayers were asked to underwrite was enormous. The Irish €400 billion guarantee package is more than

double Ireland's annual GDP. For Britain to do the same, just for its four largest banks, would mean the taxpayer underwriting a sum that would exceed by over four times our annual GDP. It was only after staring over the abyss that EU countries came together around a common approach and, indeed, led the way to world-level coordination on this.

Will Hutton has argued that joining the euro is the only way Britain can secure the future of its banks and economy. Of course, it is politically unthinkable that we should be bounced into a decision to join the single currency because of the credit crunch, although the crisis is now driving a shift in attitudes from other European countries such as Iceland (even though it is not even a member of the EU!) and Sweden. Indeed, Danish Prime Minister Anders Fogh Rasmussen recently pronounced that Denmark should join the Eurozone "as soon as possible", while Swedish European Minister Cecilia Malmström commented this November that "we should have joined the euro a long time ago, we would have been far better off," adding that "if we could hold a referendum tomorrow, we would".

While the pound is probably a big enough currency to be able to survive, it has weakened (by 25% in Autumn 2008) against the dollar, and lost about 30% of its value against the euro this year. The pound, with its floating exchange rate, is highly vulnerable to being squeezed between the twin currency giants of the euro and the dollar.

The political arguments - Why we should avoid missing European boats

The history of British involvement in the development of the European Union is one of "missing European boats" and then paying the price for these delays. Despite several decades of leading reform to the Common Agricultural Policy and Common Fisheries Policy, we are still paying the price for our non-involvement when they were set up and the other countries tailored the rules to suit their own interests. Our non-membership of the euro is further demonstration to some European nations that Britain is still a second class member of the EU and adds weight to the perception that we are still 'reluctant Europeans'.

If it is inevitable that, through sheer economic necessity, we will have to join the euro in the next decade, can we really afford to allow ourselves to be marginalised from the development of the Eurozone as we were from the CAP? Throughout the history of European integration, Britain has been reluctant - from the European Coal and Steel Community (ECSC), to the Common Market and Monetary Union. When we have then joined, we complain that the rules have been set against us.

Besides, whether we like it or not, European economic and monetary union is a reality, and we cannot merely opt-out of the debate and pretend that nothing is happening. If we are to stay out we must expect a bumpier economic ride, with a floating sterling exchange rate vulnerable to pressure from the Eurozone and the dollar.

The single currency has been viewed as a 'hot potato' by the mainstream wings of both the main parties. However, as millions of Britons begin to feel the pinch of the growing credit crunch, the success of the Eurozone - and its management by the European Central Bank, could increasingly see our status outside the single currency as a political and economic liability.

Britain should not leave its economy unnecessarily hamstrung and weaken our political impact in Europe by opting out of the Eurozone for a second decade. Instead, we should heed Willem Buiter, a former member of the Bank of England's Monetary Policy Committee, and his warning that "until the UK is a member of EMU, it will have second fiddle status in the concert of Europe". Rather than remain on the margins of the Eurozone, affected by its development, but powerless to map its course, we should seize the opportunity to be an influential part of it.

Time to re-open the debate

It is vital that Britain does not repeat its mistakes over the ERM, of joining at the wrong time, at the wrong level and for the wrong reasons. It is sensible to be circumspect about a decision from which Britain, or indeed any other country that joins, would find it extremely difficult to extricate itself from. Moreover, at a time of greater economic instability, with the benign economic conditions of the past decade apparently gone, a decision of this magnitude should not be taken lightly.

However, the evidence suggests that indefinitely delaying entry to the single currency will harm our economy and weaken our position in Europe. Clinging to the image of David Low's famous "very well - alone!" cartoon that so epitomised Britain's laudable stubbornness and bloody-mindedness (when it was appropriate!), but also underpins our propensity to be reluctant Europeans and will not protect our economy from being buffeted on the fringe of the developing Eurozone.

Above all, our future is with Europe. For over 50 years, Britain has missed crucial opportunities to lead in Europe, choosing instead to watch and snipe from the sidelines before reluctantly joining in. As Roy Hattersley put it - "The cliché is that we missed the bus, but that is only part of the problem. The real tragedy is that we are destined to run along behind it and one day scramble on board even if it is then deviating from the route we would have chosen". This attitude must not be allowed to characterise our stance on the single currency.

However, making the case for British membership of the euro on the basis that our future lies with Europe is, though substantial, not enough on its own - it must be on the basis that our economic prospects as a nation would be significantly enhanced by our membership. This increasingly is the case. Joining the euro would be good for British jobs, economic stability and prosperity, which it is both politically expedient and, ultimately, profoundly self-defeating to continue to ignore. With that in mind, let's make a strong case for British membership of the euro - it's high time to re-open the debate.

