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by Richard Layard

The status quo is not an option

With the Euro now a physical reality, Richard Layard argues that the economic case for Britain joining Euro-land is overwhelming.

There is only one economic reason to join the Euro – that it would give us greater prosperity. To prosper you need to belong to a large market, free of tariffs and non-tariff barriers and undisrupted by currency fluctuations. That is how the United States grew rich. Its huge market enabled firms to specialise and produce on a massive scale at low cost. At the same time the size of the market increased the competitive pressure on firms to be efficient and widened the range of suppliers from whom consumers could satisfy their needs.

In Europe, the Common Market, followed by the Single Market, has produced some of the same effects. But, as experience has shown, you cannot have a truly single market without a single currency. So the Euro is the coping stone of the Single Market programme, which Margaret Thatcher did so much to promote. And it is having its predicted effect. We are now seeing a major reorganisation of European industry and finance, achieving the economies of scale already seen in the USA.

It is easy to underestimate the impact of currencies upon economic life. If (like some monetarists) you believe that money is a veil, it is natural to believe that efficient markets can penetrate the veil. But businessmen know otherwise. If your costs are in sterling and your receipts in a foreign currency whose value fluctuates against sterling, you will be far more cautious about committing yourself to the foreign market.

A good example of how this works comes from Canada, which shares a common frontier and a common language with the USA but not a common currency. Canada trades far less with the USA than geography would lead one to expect. A Canadian province trades one sixteenth as much with a US state as it does with another Canadian province that is equidistant and of equal income. And, because Canada is so weakly integrated into the US market, its productivity is 20% lower than the USA's. Likewise, Britain's productivity per hour worked is 20% below that on the Continent north of the Alps. Among the reasons is our lesser integration into the large European market. That began with our late entry into the Common Market and it continues with our delayed entry into the Euro. After the War, European productivity per hour was way behind the US, but the Continent has now caught up with the US. Britain, however, lags and has grown no faster than the Continent over the last 20 years, despite our economic reforms.

The separate currency is a major reason for this and it will become even more damaging in the future. If you have a separate currency, its value will fluctuate. This creates uncertainty about the return to any long-term investment in export markets. The returns in the foreign currency are already uncertain and, since the currency risk cannot be hedged, this adds further to it. On top of this, currencies go through prolonged periods of misalignment, which are deeply damaging even when foreseen. The level of sterling over the last three years has been extremely harmful and is one reason why firms like BMW, Vauxhall and Corus are rebalancing their businesses away from Britain.

Such misalignments cannot be controlled. For, in the modem world of

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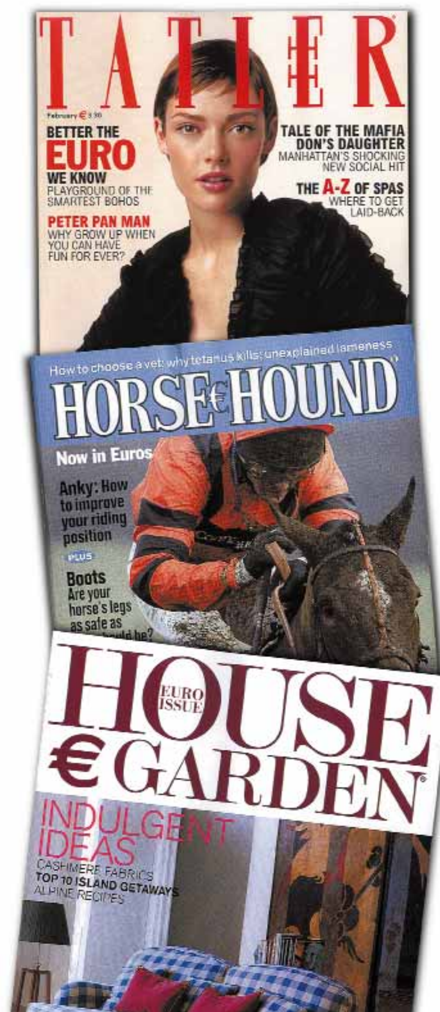
massive short-term capital flows, a floating exchange rate does not serve as a well balanced adjustment mechanism, as its advocates claim. Experience has shown that a floating exchange rate produces much more variation in competitiveness than occurred in the Bretton Woods period, when the exchange rate could be fixed. As capital becomes ever more mobile through electronically linked financial markets, the exchange rate is likely to fluctuate even more. The simplest remedy is to link ourselves to the currency of our closest trading partners.

The argument would be strong in any case, but it is even stronger when our partners have already linked themselves together. Before that happened, we were in the same position as any one of them. For example, a firm that sold into Germany faced exchange risk whether it produced in Holland, France, Italy or Britain. Now it faces no exchange risk if it produces in Holland, France, or Italy, but it does if it produces in Britain. So the longer we stay out of the Euro, the more firms are likely to move their business to the Continent. That is why so many businessmen are urging the government to join the Euro so that they do not have to face that agonising choice.

The key point is that, once the other countries have linked up, we are no longer in the same situation as before. We cannot choose the status quo ante. If we do not join, we are in a worse situation than before. So, even if we were happy with our previous situation, we cannot avoid a reassessment, now that the Euro exists.

These are the central economic arguments. But there is another indirect one. Our economy is strongly affected by what happens on the Continent – by its level of economic growth and by the regulations we face from Brussels through our membership of the EU. We want to be able to influence these. We can only influence growth in Europe by belonging to the European Central Bank, which sets interest rates on the Continent. And we can better influence European regulations if we belong to the committee of the Euro 12 (the countries that belong to the Euro). Increasingly, European business is done within that group and at present we are excluded from it.

That is the case in favour: to avoid currency fluctuations, we must adopt the single currency. But that also means accepting the single rate of interest on that currency. There lies the rub: we lose control over our own interest rates. So, if Britain faced a shock that affected it differently from other countries, it could not use monetary policy to offset it. This is the problem of "one size does not fit all" and it is a serious disadvantage.



However, the same problem occurs in the United States. If one region is hit by an adverse shock, the Federal Reserve can do little to help. Yet no one has proposed having separate currencies for different parts of the US.

So should Britain be as happy to use the Euro as California is to use the dollar? In this situation Britain's main drawback is that there is much less labour mobility between Britain and the Continent than there is between California and the rest of the US. Thus an adverse shock to Britain would be harder to offset by an exodus of population.

But there is also, of course, very low net movement of labour within Britain. Yet no one seriously advocates a separate currency for the North-East of England. Moreover, Britain has one key advantage that California has not. We have the freedom to run a budget deficit. Though in the Euro we lose our monetary weapon of stabilisation, we still have our fiscal weapon. US states have no such weapon, since most of them have to balance their budgets year by year. Thus, from the fiscal point of view, a European country is better placed than a US state.

The opposite is often alleged. It is said that California is better off than Britain would be because, when California's economy plunges, it gets an automatic transfer from the federal budget in Washington. By contrast, Britain would get no such transfer from Brussels. However, Britain does not need such a transfer, because it has the automatic stabilisers within its own budget. These are stronger than those in the US and Britain can, if it chooses, use discretionary fiscal change on top of this to offset a recession.

From a fiscal point of view, a European country is better placed than a US state

There is one other point. The California economy is very different from the average of the US economy. It is highly exposed to idiosyncratic shocks, which the Federal Reserve will not offset. By contrast, the economy of Britain is more similar to the overall economy of Europe than the typical US state is to the overall economy of the United States. So situations where our interests diverge from those of Europe as a whole should be relatively rare.

We must of course join the Euro at a time when our economy is at a similar cyclical position point to the European economy – i.e. when we would like to have similar interest rates. Sometime in the next two to three years looks ideal. But there are bound to be times thereafter when British and European interests diverge. That is the cost of joining in return for the greater benefits of currency stability.

Let me end by reviewing some of the less respectable arguments against joining. First, there is the argument that we should join the large American market rather than the large European one. In other words, join the North American Free Trade Area (NAFTA), not the Euro. This is absurd. For powerful economic reasons, over 50% of our trade is with the EU and only 16% with the US. These powerful forces cannot be bucked. Nor would the rules allow us to join NAFTA and remain in the EU.

Second, there is the argument that Europe is failing, so we should stay at arms length. Europe has indeed one serious weakness. France, Spain, Italy and Germany all have higher unemployment than we do. While some of the difference is cyclical, an important part is due to dysfunctional benefit systems and rigid wage structures, which need to be changed. But joining the Euro does not mean that we have to copy these countries. Within the British single currency area, the South-East has one third the unemployment of the North-East. In other words, the South-East has not imported the unemployment rate of the North-East. Within any single currency area there will always be local variations, but these are no reason to break up the Union.

Third comes the argument that the Euro would be a re-run of the Exchange Rate Mechanism (ERM). On the contrary. The ERM was an ill-fated attempt to peg a separate currency to other currencies. The Euro is a decision to merge the currencies so that exchange rates no longer exist between them.

Fourth, perhaps the most strident argument used against the Euro is that it is the thin end of the wedge on the route to a federal Europe in which we shall be forced to harmonise taxes and many other institutions where we prefer our own variant. There is in fact no such implication. The Euro is a self-contained arrangement concerning currencies. Britain can continue to veto tax harmonisation and most other changes we dislike. This is governed by the treaties we have signed, quite irrespective of whether we belong to the Euro or not. However, if we do belong to the inner club of Europe, it will in fact be easier rather than harder for us to resist pressures of the kind we disapprove of.

Finally, there is a common view that, while we would be better off inside the single currency, it is so difficult to manage the transition that we should not try. There are of course formidable political difficulties in persuading the British people. But it can be done. In the 1975 Common Market referendum 55% of voters were against membership six months before the referendum, but only 33% were against it on the day.* This time, the key conditions for success will be strong business support (which requires a reasonable exchange rate) and a popular government arguing clearly for a yes vote in a referendum. If these are in place, Britain will join the Euro sooner than many people expect.

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For a fuller presentation of the case for Britain joining the Euro, see R. Layard et al, *The Case for the Euro*, Britain in Europe, 2000

* Robert M. Worcester, *How to win the Euro referendum*, Foreign Policy Centre, 2000