Britain and Emu.

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14 January 1999.

Economic and Monetary Union (Emu) arrived *de facto* with the co-ordinated interest rate cut by all Euroland central banks on December 3, 1998. While it did not start *de iure* until January 1, 1999, the interest reduction was truly the first monetary policy decision of the European Central Bank (ECB). The UK, true to its long-established tradition of participating only late and reluctantly in new arrangements furthering European integration, will not participate in Emu until further notice.

This raises some obvious questions. First, will Emu be a success? Second, will the UK join and if so, when? Third, what are the costs of the UK not being in the first wave, both to the UK and to the Emu members? Fourth, if the UK were to join Emu in due course, should it (be required to) adopt an ERM-style narrow exchange rate band for some period prior to joining?

Will Emu be a success?

The recent Asian crisis, and its spill-overs as far away as South Africa, South America and the Russian Federation provide a useful reminder of the validity of my long-held view that, with unrestricted international mobility of financial capital, a common currency becomes the only exchange rate regime that is viable and permits the potential gains from capital market integration to be realised in full. Fixed-but-adjustable pegs are accidents waiting to happen. Market-determined or freely floating exchange rates are viable in the technical sense that they can survive, but only at the cost of excessive volatility and persistent misalignment inherent in the juxtaposition of a technically efficient financial market with sluggish price and wage adjustment in key parts of the real economy.

Emu will survive almost surely. It cannot be brought down by speculative attacks among member countries, either between January 1, 1999 and the date of the final demonetisation of the national currencies (no later than July 1, 2002), or afterwards. A speculative attack among Emu currencies could no more cause a collapse of Emu than a switch from £5 notes into £10 notes could cause a collapse of UK monetary union. Like any currency union, it could be brought down by one or more of the constituent member states or regions choosing to leave the currency union. A country could e.g. find the lack of a national monetary instrument prohibitively costly in the face of a particularly unpleasant country-specific shock to its output market. While the Maastricht and Amsterdam Treaties do not provide any mechanism for leaving

* The opinions expressed are those of the author alone. They do not necessarily represent the views and opinions of the Bank of England or of the other members of the Monetary Policy Committee.

Emu (or indeed any other of the EU institutions and arrangements), a country that truly wished to leave would no doubt be able to do so. The likelihood of this happening, in the absence of a major economic or political calamity, is very remote, however. The sudden emergence of massive unbalanced positions in foreign currencies alone would cause nightmares to businessmen and policy makers and would provide bankruptcy experts and lawyers with decades of gainful employment.

The ECB will deliver low inflation. The belief that a broad Emu meant a weak euro was always a nonsense. The mandate of the ECB and its constitution, including the terms and conditions of appointment of Board members and other Council members, all supported the view that the ECB was going to be a traditional, conservative, Bundesbank-style central bank. The composition of the Executive Board and of the collective of the 11 national central bank governors also made it clear that the ECB and the ESCB are run by a body of monetary hard-hats. This is not the same as a collection of anti-inflation nutters. Indeed, precisely because the acceptance of the overriding importance of price stability comes naturally to the ECB Council members, as well as being enshrined in the ECB's constitution, the ECB, like the Bundesbank before it, will be able to be more pragmatic, flexible and effective in its support of real economic activity in Euroland than would have been possible if the institution had been dominated by unabashed post-Keynesian employment activists.

Especially in the short run, the ECB's policies are likely to support a strong external value of the euro. In the longer run, the fact the Euroland is as closed (as regards trade) as the US, will encourage a policy of benign neglect of the external value of the euro, not unlike the policy of the Fed and the US Treasury towards the US$.

Emu will survive despite a poor start, with the shenanigans surrounding the appointment of its first President. I am not referring to the fact that the French government insisted on making the appointment of the first ECB President a *political* issue. The presidency of the ECB *is* a political issue. It is quite proper that the Euroland central bankers who thought they had settled the issue among themselves, were reminded of their proper place by the elected politicians. What was depressing was that the French president chose to make the presidency a *nationality* issue. This violated the letter and the spirit of the Treaties. The gentlemen's agreement that Mr. Duisenberg would serve for only four years and would be succeeded by 'a Frenchman' (any Frenchman?) was truly a rogues' agreement. It is my hope and expectation that the first incumbent will treat it with the respect it deserves.

The only real threat to the continued existence of Emu will be the popular perception that the ECB lacks political legitimacy. This lack of legitimacy has two dimensions: first, the lack of openness and accountability of the ECB and second the problem of monetary integration being ahead of general political and institutional integration.

The lack of openness, transparency and accountability written into the statutes of the ECB and apparently about to be reinforced by the ECB's own 'common law' operating procedures could yet undermine the viability of the whole enterprise. It is to be hoped that a culture of openness will nevertheless be established. The '16 year rule' for the publication of the minutes of the ECB (as close to 'not now, not ever, never' as one can get) does not bode well, however.

Mr Duisenberg is of course quite correct to refuse to testify before any of the national parliaments. He (and the other members of the Board) should be answerable, collectively and individually, to the European Parliament alone. Mr. Duisenberg could spend the best part of the year on a travelling road show around the Euroland capitals if he were to take the French request seriously. National central bank governors should of course be answerable to their national parliaments, although they also are mandated by the Treaties to act in the interest of the Union as a whole, and not as agents of their national governments or of other national interests.

The frequently heard argument that the votes of the individual members of the ECB Council should not be recorded, because without the cover of confidentiality national political pressure would be brought to bear on individual members deserves a closer look. In an interview, Mr Duisenberg is reported as saying *"If the vote of the national representative were known, there would be unpleasant questions with the aim of pressuring him in future votes*"[1]. I consider this argument to get it exactly backwards.

I accept that national political authorities will try to put pressure on 'their' national(s) serving on the ECB Board and on 'their' national central bank governor. While this is against the spirit and letter of the Treaties, it will surely happen. The question is how the Board members and national governors can be most effectively shielded from this pressure.

I predict that, whatever the formal confidentiality of the ECB Council meetings and votes, the national heads of government will know within three minutes of a vote being taken, exactly who voted in favour of what. Six Executive Board members, eleven national governors and countless staff will be present at the Council meetings. Leaks, and open breaches of any confidentiality arrangements will be the rule rather than the exception. The information required to bring effective pressure to bear will therefore be available, *de facto*, to the national political insiders. That information will not however, be formally available to the bodies charged with supervising the ECB (the European Parliament in the case of the ECB Board, and the national parliaments in the case of the national central bank governors of Euroland). Council members will be able to hide behind the confidentiality fig leaf and avoid having to justify having yielded to national political pressures. The exercise of undue influence is not deterred by secrecy and confidentiality, but by openness. Smoke-filled rooms and confidentiality are more likely to allow the ECB mandate to be perverted by national political pressures than openness and the occasional short-term embarrassment that this entails.

Confidentiality of the votes also destroys any vestige of individual accountability of ECB board members. It encourages excessive consensus-seeking and compromise. If enforced, it is likely to greatly enhance the power of the President relative to that of the other members. The only defence of the other Board and Council members against a complete Presidential monopoly of decision-making power is the extensive selective leaking and competitive media briefings that have been a characteristic of the Bundesbank. It is a poor substitute for proper accountability.

[1] Frankfurter Algemeine Zeitung, Monday, 29 June 1998.

While I believe that the individual voting records should be in the public domain as soon as possible, I believe that the minutes should be on a non-attributed basis. The reasons for this concession to opaqueness are practical. Verbatim transcripts, or even selected but attributed opinions of individual members, would kill the usefulness of the Council meetings. Members would come with prepared positions and statements which they would read into the record. There would be no scope for open-minded discussion of alternative courses of action, for 'what-if', counterfactual thought experiments. The formal meetings would become set-pieces, for the record only. The real discussions would move elsewhere, defeating the purpose of the publication of the minutes.

The foregoing is not a valid argument against a form of minutes that presents the key facts and considerations that determined how each of the members voted. The ECB has agreed not to publish the minutes to avoid false signals to financial markets. In the words of Duisenberg: "*If we would do this* (publish the minutes), *we would influence expectations of the markets ahead of the next meeting. We do not want to do this.*"[2]. By not publishing (non-attributed) minutes that offer a fair summary of the Council meetings, all that is achieved is that *informed* speculation by market participants is replaced by *uninformed* speculation. While there are neat examples in non-co-operative game theory of circumstances under which the release of more information worsens welfare, it is very difficult to think of conditions relevant to the setting of monetary policy by the ECB that would cause better and more timely information to worsen economic performance. The argument is wholly unconvincing.

The ECB will have to learn that independence, far from being inconsistent with openness and accountability, cannot, in a democratic society, survive without these two awkward customers. The ECB is the latest offshoot of a central banking tradition that views central banking as a sacred,. quasi-mystical vocation, a cult whose priests perform the holy sacraments far from the prying eyes of the non-initiates. This mystique of the central bank, and the excessive clubbishness and clannish behaviour, it sometimes encourages, is both entirely unwarranted and a threat to the legitimacy of the purposes the central bank is intended to serve: price stability, preventing and coping with systemic financial risk and minimising the output and employment gaps. The UK arrangements for central bank independence, while far from perfect, are in most respects superior to those likely to be operated by the ECB.

Monetary union involves a transfer of national sovereignty to the central or Federal level. Unless this transfer of power is perceived as legitimate by the residents of Euroland, the authority of the institutions of the ECB and the ESCB will be questioned and challenged by those who perceive themselves to be adversely affected by it. Generally in the past, central banks have been created when a stronger and more legitimate Federal governance structure was in place than is currently the case in the EU. There have been exceptions. The seven provinces that formed the Dutch Republic established a monetary union with only the weakest (con)federal political institutions and with almost completely decentralised fiscal authority. Belgium and Luxembourg were in a monetary union since 1922 without far-reaching political integration.

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[2] Frankfurter Algemeine Zeitung, Monday 29 June, 1998.

I have considerable sympathy for the traditional German position that further political integration should have accompanied (or even preceded) monetary union. On the other hand, the whole European integration experiment, from the Coal and Steel Community on, has been a political wolf dressed in economic sheep's clothing. It has been successful so far, and it could continue to do so. I would feel more reassured, however, if the European Parliament were to be strengthened to the point that it could act as an effective watchdog over the ECB. It is therefore good news that, on January 14, 1999, the European Parliament, for the first time, not only barked, but *very nearly* bit. While balking at forcing the resignation of the entire 20-member Commission following allegations of fraud, nepotism and mismanagement, it effectively put the Commission on probation until 15 March 1999, when an independent committee is to Report on these allegations.

Co-ordination between monetary and fiscal policy in Euroland is likely to be a problem for some considerable time. The Germano-Dutch wing of the ECB mistrusts the EuroXI as an attempt to undermine the independence of the central bank. While this concern is certainly not without merit, there appears to be little awareness among the ECB top that independent agents can choose to co-ordinate their actions and that co-operation is possible, and fruitful, even when the co-operating parties have non-coincident, divergent objectives. Economic policy is not a zero-sum game, so co-operation and co-ordination could benefit all parties. Statements by ECB Council members that the fiscal-monetary mix is not part of their mandate are misguided.

The primary objective of the European System of Central Banks, as defined in Article 2 of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), is to maintain price stability. Without prejudice to the primary objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. It does not seem unreasonably to assume that an appropriate fiscal-policy mix is one of the objectives of the Community. Provided it does not undermine price stability, the achievement of an appropriate monetary-fiscal policy mix is therefore a task of the ECB.

Even if the problem of mutual mistrust can be overcome, getting the balance or mix between monetary and fiscal policy right is a challenge at the best of times, even when there is a single monetary and a single fiscal authority. In the UK prior to Bank of England independence, a single authority, the Chancellor of the Exchequer, determined both monetary and fiscal policy. The track record of UK macroeconomic stabilisation policy since World War II is, however, hardly the envy of the world. Co-ordination between the ECB and eleven national finance ministries will be as much a logistical challenge and a political problem.

The use of fiscal policy for cyclical stabilisation will be severely circumscribed in Euroland until the average budgetary position of the member states is sufficiently below the Stability and Growth Pact ceiling (a balanced structural budget and a general government deficit-GDP ratio not exceeding 3%), to allow counter-cyclical increases in public sector deficits to perform their normal cycle-amplitude dampening function. The only alternative would be the non-enforcement of the budgetary ceilings. While some shading will no doubt occur, I anticipate they will be a binding constraint on a number of Euroland governments in the next two years.

Action to ward off an unexpected downturn will therefore have to be taken by the only player in the economic concert of Europe who has both bow and violin: the ECB. It is therefore most encouraging that its ante-natal policy action of December 3, 1998, has demonstrated that this new institution can be serious about price stability without suffering from rigor mortis when it comes to responding to developments that threaten the real economy.

Will Emu succeed in generating greater Euroland-wide prosperity that would have been likely under an alternative monetary arrangement? My guess is that, as regards macroeconomic stability it is likely to make a positive contribution, provided the national countries redesign their automatic fiscal stabilisers to generate more strongly anti-cyclical deficits.

Lower transaction costs and greater price transparency will help complete the single market, limit price discrimination and other restrictive practices. These are worthy and worthwhile gains, although they are unlikely to add up to a hill of beans.

A key issue for the continental Emu members is whether the impetus for structural reform of labour, product and financial markets that was so noticeable in the run-up to Emu will fizzle out now that the prize has been won. There are signs of PMF syndrome or Post-Maastricht-Fatigue syndrome in a number of countries.

EMU does not create a technical, economic case for a greater degree of harmonisation of regulatory, tax and subsidy policies, nor for a larger Federal European budget. However, the greater market integration due to the gradual implementation of the Single European Act will force national policy makers to harmonise taxation and regulation of highly mobile factors of production. Differences in tax rates (and in subsidy rates and regulatory standards) are sustainable when the tax bases are relatively immobile. The more mobile tax bases are across tax jurisdictions, the stronger the pressure for equalisation of rates. The political mechanisms of tax, subsidy and regulatory competition will force this convergence of rates at the lowest level for taxes, at the highest level for subsidies and at the most relaxed level for regulation. This is why workers and consumers ultimately bear the bulk of all taxes, wherever they are administratively paid and collected. Mr Lafontaine’s recent calls for greater harmonisation of taxes on savings and enterprises are unlikely to be silenced. It is a response to the market pressures, mediated through political tax competition mechanisms, towards equalisation of effective marginal tax rates on mobile tax bases at the lowest level.

To the extent that EMU is indeed the next step in the European Federalist agenda, it will create a political momentum towards a greater degree of centralisation or harmonisation of decision taking on certain aspects of economic and social life, and towards greater redistribution across member state boundaries. Fundamentally, though, it is the real economic integration delivered by Margaret Thatcher when she signed the Single European Act, that will provide the main impetus towards greater harmonisation of tax rates, subsidy rates and regulatory standards through the markets

Will the UK join and when?

It now really is a matter of when, rather than of whether the UK will join. The successful launch of the currency, and the repeated reminders, provided by the volatile international environment, of the benefits of belonging to the world's largest zone of currency stability, have shifted the perception, among the literate political classes, of the cost-benefit balance of Emu membership.

The UK will join as soon as a referendum on the issue can be won, following the first general election to be won by a pro-Emu party or coalition, and as soon as the existing Emu members are willing to let the UK join. It is not at all obvious that all the Ins will be clamouring for the UK to join as and when the UK gets round to applying for membership. History serves a warning here. After the UK, under Tory prime minister Harold Macmillan, applied to join the Common Market in 1961 (against the opposition of the Labour party under Hugh Gaitskell, who accused the prime minister betraying 1,000 years of history), General Charles de Gaulle twice vetoed the UK's membership, in 1963 and 1967.

It is true that the Maastricht Treaty stipulates that any country meeting the membership criteria laid down in the Treaty should be admitted to the single currency. However, the UK government has thus far expressed a determination not to (re)join the Exchange Rate Mechanism, one of the membership criteria laid down in the Treaty. It is likely (the issue is discussed at greater length below) that the current Euroland members will have to agree that sterling has exhibited sufficient stability in order for the UK to qualify for Emu membership. This will be a political judgement, and the UK could be made to pay a price, or could even face another veto.

For instance, a former finance spokeswoman of the SPD, Ingrid Matthäus-Maier, recently told a private meeting of British MPs that Germany would expect the UK to pay a price for admission to an successful euro, and that acceptance of tax harmonisation might be part of that price[3].

Domestic obstacles to UK membership do not appear to pose much of a threat. While the New Labour government may never again be as favourably positioned to win a referendum on Emu (or indeed on just about anything) as it was immediately following its general election victory in 1997, it is very likely to lose a referendum on joining Emu, if it campaigns actively and without internal dissent in favour of membership. The only circumstances I can envisage under which a referendum would reject Emu membership would be, between now and the referendum date, a disastrous monetary performance by Euroland coupled with exemplary and successful UK monetary and exchange rate policy. Clearly, if such were to be the case, no government in its right mind would want to join, so the issue would not arise.

The Chancellor outlined five economic tests that would have to be met before the UK would be willing to join Emu.

- Convergence of business cycles and economic structures.
- Flexibility of markets and institutions.
- The effect of Emu membership on long-term foreign investment in the UK.
- The effect of Emu membership on the City.
- The effect of Emu membership on growth, stability and a lasting jobs.

[3] Financial Times, 14 January 1999, page 8. "UK told price for Emu entry may be tax harmony".

All five criteria are sufficiently broad and vague as to have no real operational content. When the day comes, proponents of Emu will argue that all five have been met. Opponents will assert that the UK fails to meet any of the five.

I would be surprised if the UK were outside EMU by the end of 2003. It could well be earlier.

The costs of the UK being out.

There are costs both to the UK and to the current Euroland members. As regards costs to the UK, the political costs are important. The UK has no voice in the ECB Council and in EuroXI. It will have minor-league status in European macroeconomic decision-making, even in non-Emu issues. Beyond that, until the UK is a member of Emu, it will have generalised second fiddle status in the political concert of Europe. This loss of influence will extend well beyond the economic sphere.

As regards economic costs to the UK, they are both macroeconomic and microeconomic, including sectoral. As regards microeconomic transaction costs, a country contemplating joining a monetary union normally weighs the one-off cost of adopting the new currency against the perpetual flow of benefits from saving currency conversion costs. However, since in my view, the UK is going to join anyway, the only question being when, the transition costs of adopting the euro will be incurred in any case. The cost-benefit analysis therefore compares the savings from *delaying* the one-off transition costs for a few years to the loss of benefits from lower transaction costs for these years. The present value of waiting is likely to be negative.

There is likely to be some damage to London's position as an international financial centre. This is likely to be minor at first (Target irritations, the need to keep accounts in two currencies rather than one), but could become more serious if the UK's outsider status were to be perceived as more persistent.

International financial centres are in principle very footloose. They can be located just about anywhere there is access to a telephone (and the internet). For many financial transactions a physical market place is no longer required. The employment created by the financial services industries tends to be geographically concentrated because of conglomeration and face-to-face networking externalities. Other factors such as language, infrastructure and quality of life also play a role. These locational preferences are quite tenuous, however, and should not be taken for granted. Probably the greatest strength of London as the leading international financial centre in Europe is that is isn't Frankfurt..

As regards macroeconomic management, if sterling stays out, there is the threat of a gradual demonetisation of sterling and the complications this creates for monetary management in the UK. There are already examples of the numéraire and invoicing function of sterling being transferred to the euro, even for internal, domestic transactions. The means of payment and medium of exchange functions of sterling likewise will be nibbled away at gradually, first in international transactions, then in domestic transactions by agents who also engage in large volumes of euro-denominated business, and ultimately throughout the domestic economy. Both the numéraire and means of payment functions of sterling will never disappear completely, as long as the UK does not join Emu, but the gradual demonetisation of sterling (or eurofication of the UK) will complicate the conduct of monetary policy in the UK and reduce the costs of giving up monetary autonomy.

Sterling will be a mini-currency in a world dominated by two maxi-currencies, the US dollar and the euro, and one medium-sized currency, the yen. Regardless of the wisdom and skill of the UK monetary managers, unrestricted financial capital mobility and a floating exchange rate are likely to produce excess volatility and persistent misalignments of sterling's effective exchange rate. There are potential benefits from having a floating exchange rate and independent national monetary policy as a mechanism. They permit an effective response and adjustment to exogenous shocks. Against these benefits must be set the cost of the unnecessary and avoidable shocks and noise created or inefficiently propagated and amplified by a freely floating exchange rate and technically efficient integrated financial markets.

Finally, there is the risk, already referred to, that when the UK will want to join, the existing Emu members won't let it (or at any rate not without delays, costs or other irritations and embarrassments).

As regards costs to the existing Emu members, there is first and foremost the adoption of an ECB model and *modus operandi* that perpetuates some of the worst features of central bank secrecy, lack of openness and absence of collective and individual accountability**.** The statute law of the Treaty of Maastricht and the Treaty of Amsterdam could have been refined and improved with a healthy dose of British 'real-time constitutional design'. By the time the UK gets on board, the operating practices, conventions and procedures of the ECB are likely to be much harder to change in a direction of greater openness and accountability.

Also, to the detriment of existing Euroland members, Britain's outsider status weakens the liberal, market-oriented coalition in the EU at the expense of the dirigiste front. The continental economies are overdue for far-reaching reforms of markets, fiscal structures and welfare states. Germany and France have progressed least on the road to structural reform, and now appear to be backtracking even as regards the recognition of a need for such structural reform. The chances that Emu will work as a wedge for structural reform in Euroland are diminished by the UK's self-imposed exclusion.

Will the UK have to participate in a 'narrow-band ERM II'-type arrangement prior to joining Emu? Should it?

The letter of the law is ambiguous. The old criterion (2-year ERM participation with good behaviour prior to Emu) applied to the first-wave decision, but not necessarily to the late-comers. The UK's Emu derogation creates further ambiguity. The old criterion was violated by Italy and Finland. If it were to be extended to the late-comers, it is unclear what the relevant ERM bands would be (2.25% or 15.00%).

The lawyers can discuss the constitutional niceties. From the point of view of sensible macroeconomic management in the UK, it is important that any move to re-impose a narrow-bands ERM regime should be resisted. A fixed-but-adjustable peg under free international capital mobility is an accident waiting to happen. The story of the collapse of the ERM in 1992-3 can be re-read with profit.

If an ERM II-type arrangement were adopted for the UK, the inflation target set for the Bank of England by the UK government would have to be abandoned, to be replaced by an exchange rate target. Only if the defence of the currency peg (or narrow band) is given absolute priority over all domestic objectives, can the defence of such a peg be credible. The benefit from credibility is that a given impact on the exchange rate can be achieved with a smaller change in interest rates.

An alternative, and in my view superior, strategy would be to maintain the existing inflation objective until the date that the UK government decides it wishes to join Emu and the existing Emu members decide to let the UK in. It would be technically simple to change the inflation target definition from the current UK Retail Price Index (exclusive of interest payments), RPIX, to the Euroland Harmonised Index of Consumer Prices, HICP Since the UK's annual rate of inflation on the HICP index (1.4 percent) is below that on the RPIX index (2.5 percent), it would make sense to reduce the UK's numerical target rate of inflation (currently 2.5 percent per annum on the RPIX definition) at the same time that the definition were changed. The ECB's current target for the HICP index is an annual rate of inflation between 0 and 2 percent. It would not be too challenging to find room for the UK inflation target within that range.

The decision to join Emu involves two key elements: a *date* and a *rate*. I assume that once these have been decided, they will be irrevocable and credible. No doubt there will be considerable horse trading about the rate. Once a date and a rate have been set, the priority of an independently chosen UK inflation target will inevitably become compromised. The closer the accession date is (and the closer the spot rate to the accession rate), the more UK interest rate management will be constrained by the post-accession interest parity condition with the other Emu members. One option for a relative painless accession would be to adopt the inflation target of the Emu members as soon as the date and the rate are chosen.

All this is happening now or will be happening soon. Euroland is advancing, with the UK once again on the sidelines. One can only hope that this small west-European nation will soon recognise where its destiny lies.