

DEBATE

Why the United Kingdom Should Join the Eurozone

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Abstract

The message of this paper is that the global financial crisis that started in August 2007 provides another powerful and sufficient argument for the United Kingdom to join the EMU and adopt the euro as soon as technically possible. This new financial stability argument for UK membership in the EMU is separate from and in addition to the conventional optimal currency arguments for joining, which have also become more persuasive in the past few years.

I. Conventional Arguments for the United Kingdom Joining the Eurozone

These conventional arguments – (1) the incidence of asymmetric shocks or the asymmetric transmission of common shocks (cyclical convergence), (2) the degree of labour market and product market flexibility of and

international factor mobility and (3) the ability to use fiscal policy in a countercyclical fashion – all point firmly towards EMU membership as the optimal UK monetary and exchange rate regime as well. The opportunity cost of a common currency – the loss of national monetary policy, that is, of the nominal exchange rate and/or the short-term risk-free nominal interest rate as possible policy instruments – is likely to be negative for the United Kingdom.

A. Convergence

As regards cyclical convergence, the UK business cycle is now so synchronized with that of the eurozone that the country looks like a suburb of Frankfurt. Chart 1 makes this clear using the Total Economy Purchasing Managers Index (PMI) for the United Kingdom and the eurozone. These are monthly data. The degree of convergence has been high since the euro was created in 1999. In the last few years, including during the current recession,

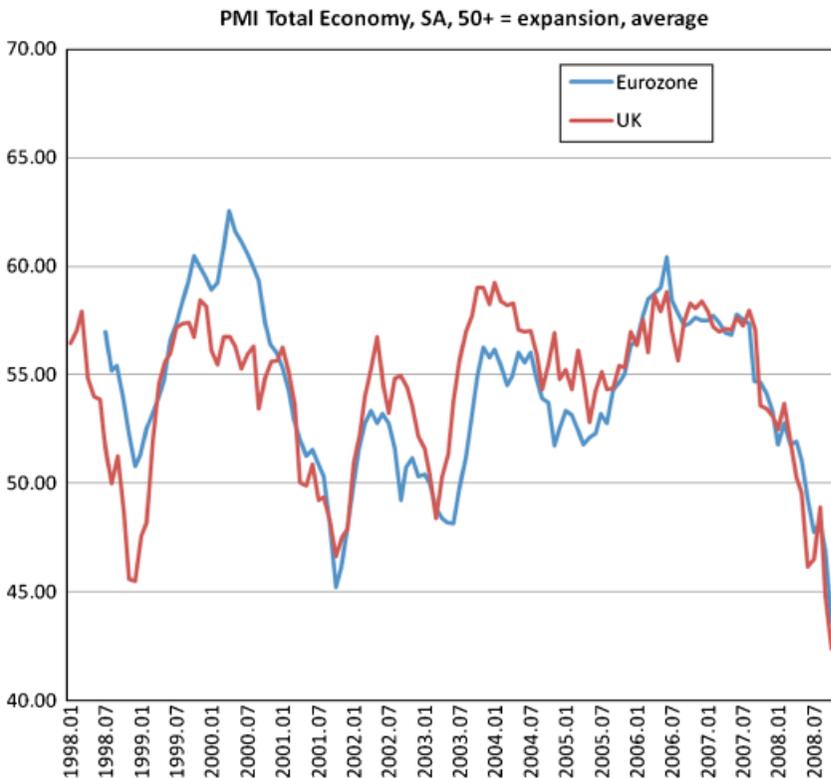


Chart 1: Cyclical convergence: United Kingdom and eurozone, 1998.06–2008.10

Source: Royal Bank of Scotland – Markit.

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Table 1: Owner-Occupancy Rates in Selected EU Countries, 2007

UK	Germany	Italy	The Netherlands	Spain	Sweden	France
67%	41%	78%	50%	78%	61%	54%

Source: Halifax.

it has become astonishing. We should also keep in mind the endogeneity of the optimal currency area [(OCA) criteria: independent monetary policy can be a cause of cyclical divergence; see Frankel and Rose 1998]].

A special dimension of *structural* asymmetry between the United Kingdom and the eurozone often brought up as an obstacle to monetary union is the housing market. The United Kingdom is alleged to have a higher degree of home ownership than the eurozone. Much UK residential mortgage financing is at variable rates, while more eurozone residential mortgage financing is at fixed rates. Most of this is myth. UK owner-occupancy rates are not exceptionally high among European nations, as is clear from Table 1.

Moreover, the implication of whatever structural differences exist between the housing markets for the desirability of an independent monetary policy is less than obvious. Martin Wolf often stresses the fact that ‘interest rates’ in the eurozone were below those in the United Kingdom, and that without those higher UK interest rates, things would have been much worse for the United Kingdom (see Wolf 2008). Chart 2 shows that he is correct in this assertion as regards short-term nominal interest rates, at least till November 2008.¹

Apart from the fact that the most recent, November 2008, bank rate is, at 3%, below the ECB’s 3.25% main refinancing operations fixed rate for the first time since the creation of the eurozone, Charts 3 and 4 demonstrate that long-term nominal interest rates and long-term real interest rates in the United Kingdom and in the eurozone have been closely aligned since at least the beginning of the decade. Long-term rates are arguably more important drivers of aggregate demand than short-term nominal rates in both the United Kingdom and in the eurozone.

I would emphasize that the judgement that the United Kingdom needed (needs?) systematically higher short-term nominal interest rates than the eurozone to keep the housing market from running amok is not convincing. Higher UK short-term nominal interest rates did not prevent the out-of-control housing finance boom and house price bubble that preceded the house price decline and home lending crash that started at the end of 2007. The UK model of housing finance is broken. Measures to encourage truly long-term fixed-rate financing (20-year or 30-year fixed rate mortgages) are

¹Eurozone data before 1999 are for a synthetic 11-country eurozone.

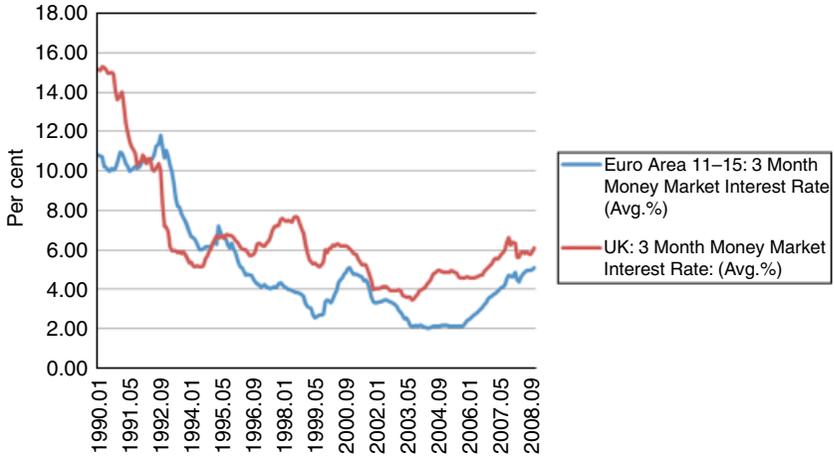


Chart 2: Short-term interest rates in eurozone and United Kingdom, 1990.01–2008.09

Source: Statistical Office of the European Communities.

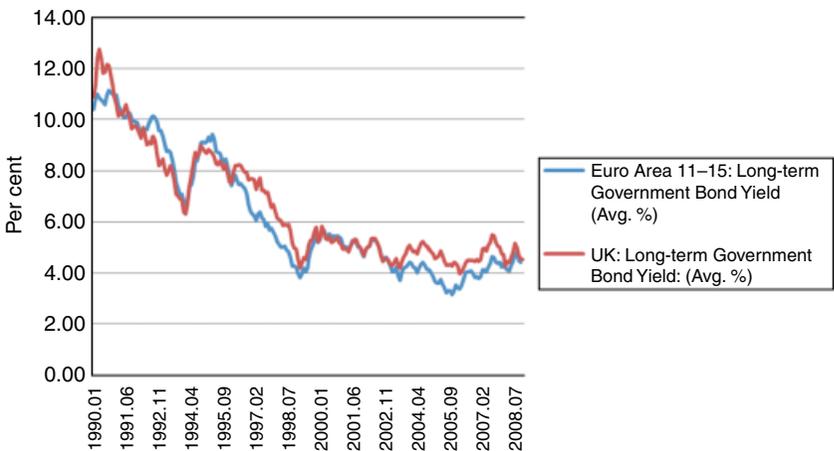


Chart 3: Long-term interest rates, eurozone and United Kingdom, 1990.01–2008.09

Source: DG II/Statistical Office of the European Communities.

long overdue. New mortgage financing has collapsed and the construction sector (residential and commercial) is teetering on the brink of disaster. The culprit was ineffective UK regulation, not just of residential mortgage finance but of household borrowing and of the financial sector generally. One indicator of the loss of financial control in the United Kingdom is that the UK household sector is the most leveraged in the developed world.²

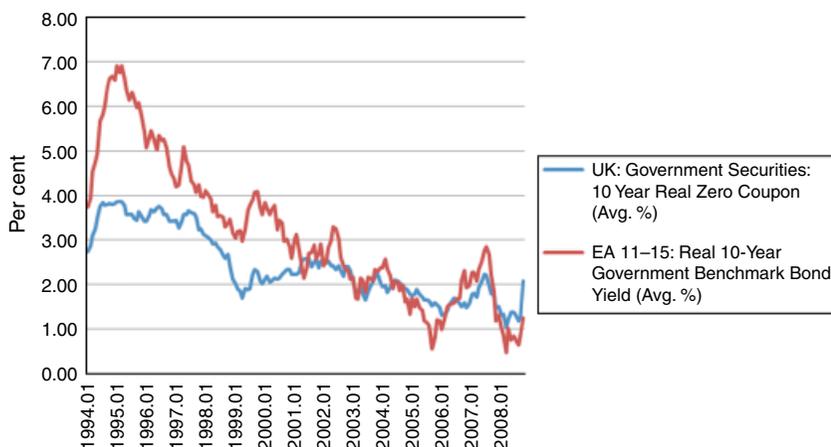


Chart 4: Long-term real interest rates in eurozone and United Kingdom, 1994.01–2008.10

Source: Bank of England and European Central Bank.

In the eurozone too there are countries that have dysfunctional housing finance, household sector financing and indeed discredited regulatory regimes for the financial sector as a whole. Ireland is one example. Spain, with its unprecedented almost two decades-long construction boom/bubble is another example. But there are also examples of superior continental models of housing finance and of financial regulation in general. The Netherlands and France provide superior templates, in my view. The current crisis and collapse of the UK residential mortgage financing system provide an ideal opportunity to redesign the system along best-practice European lines.

B. Flexibility

The UK economy's main product markets and labour markets are at least as flexible as their eurozone counterparts. Since 2004, there has been a further major enhancement in the country's ability to respond to any asymmetric shocks through the large-scale equilibrating flows of labour between the new EU Member States in Central and Eastern Europe (CEE) (especially Poland) and the United Kingdom. CEE workers came in their hundreds of thousands when the UK economy was booming. They are leaving in their hundreds of thousands

²The United Kingdom's ratio of household debt to annual household disposable income at the end of 2007 was 170%. In the United States the corresponding figure was 140%; in the eurozone it was 100%.

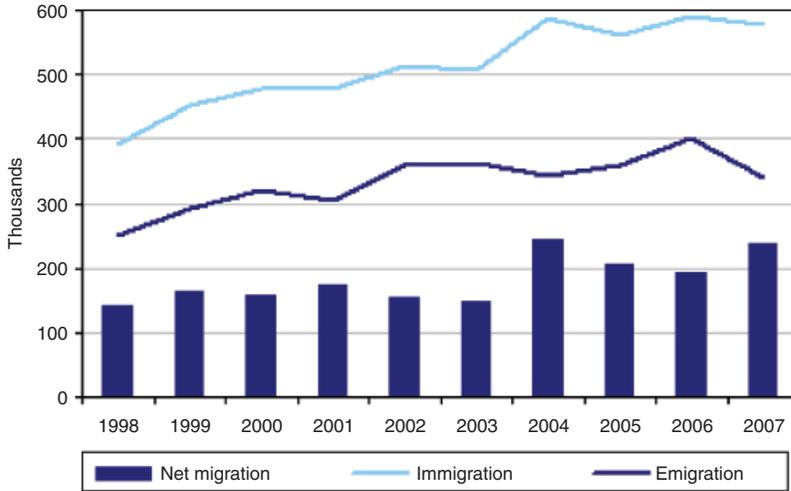


Chart 5: Total international migration to and from the United Kingdom, 1998–2007

Source: Office for National Statistics, National Statistics Online.

now that the economy is collapsing. Chart 5 shows the step-up in gross and net immigration into the United Kingdom in 2004. The ONS estimates that 96,000 Polish citizens migrated into the United Kingdom in 2007 (the last boom year), which was the highest inflow of any individual citizenship.

C. Fiscal Policy

The Stability and Growth Pact (SGP) currently applies in a slightly weaker form to countries that have an opt-out from EMU (the United Kingdom and Denmark): the financial sanctions that can in principle be imposed on persistent SGP transgressors, cannot be imposed on the opt-outs. As it is clear that even for full EMU members, the threat of financial sanctions being imposed on those who offend the letter and spirit of the SGP is not credible, the United Kingdom has no reason to fear that joining the eurozone will lead to a reduction in its ability to use fiscal policy freely to manage its national economy.

Even for the full EMU members, the SGP has not been a material constraint on national fiscal discretion. We have seen this during the boom periods, when procyclical fiscal policy was the rule. We are seeing it now during the downturn, when it is clear that no country will run into any form of trouble from Brussels for exceeding the 3% of GDP limit for the general government financial deficit. Exceptional circumstances require exceptional measures. An exceptional downturn requires large increases in government deficits. For better or worse, the SGP is not and will not be a binding constraint on national budgetary policies.

D. The Fine-Tuning Fallacy, or the Illusion that National Monetary Policy can be Used to Respond Effectively to Asymmetric Shocks

The argument that the United Kingdom suffers as the result of the loss of national monetary sovereignty and its replacement by a one-size-fits-all official policy rate and common external bilateral exchange rates, stands or falls with the usefulness of national monetary policy as a stabilization tool. I have argued for the best part of a decade, that a small open economy with a floating exchange rate and a very high degree of international capital mobility is better off as a member of a larger currency union, even if it is faced with asymmetric shocks (Buiter 1999a, b, 2000, 2008a). There is no evidence to support this view, and quite a lot of evidence to support the opposite view, that a floating exchange rate under conditions of high international capital mobility is not a shock-absorber or a buffer that permits necessary changes in international relative costs and prices to be achieved through costless changes in the nominal exchange rate rather than through painful changes in relative domestic and foreign nominal costs and prices – painful especially for those countries that have to reduce the rate of inflation or perhaps even the level of their home currency costs and prices.

Instead a floating nominal exchange rate when domestic costs and prices are sticky is a source of extraneous noise, excess short-term volatility and persistent medium-term misalignments of competitiveness when capital is highly mobile. The reason is that, far from being set at a level that puts international relative prices of goods, services and factors of production at their fundamental values, the exchange rate is determined/set proximately in asset markets. Like most other financial markets, the market for foreign exchange is, even when it is technically efficient in the sense of low transactions costs and few opportunities for profitable arbitrage, a highly inefficient pricing mechanism from the perspective of allocative efficiency. It reflects not just fundamentals (or people's view of fundamentals) but all the fears, phobias, hopes and impulses that drive foreign exchange traders and their principals. Bubbles, sudden mood swings from euphoria to despondency, from irrational exuberance to unwarranted depression, herding behaviour and bandwagon effects are the rule, not the exception.

Thus, a floating exchange rate under high international capital mobility is far from performing like an automatic stabilizer. It is even further from being an effective policy instrument. It is an outcome of uncontrolled and uncontrollable processes, many of which we do not understand and cannot predict.

Even a gun fired at random by a drunk may, from time to time, hit the target. This is what we have seen in the United Kingdom with the exchange rate this past year. As shown in Chart 6, between its peak in 2007.01 and

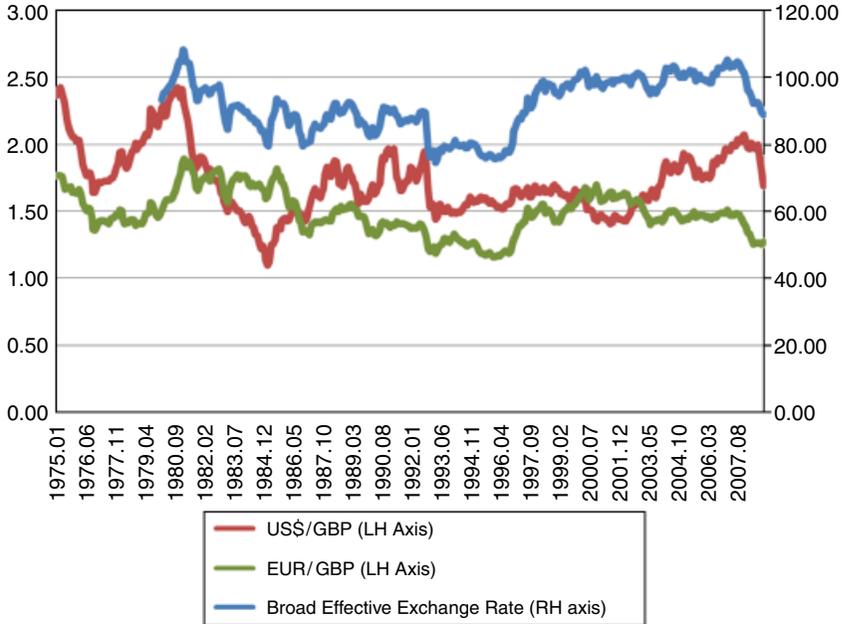


Chart 6: UK exchange rates, US\$, euro and effective, 1975.01–2008.10

Source: Bank of England.

2008.10, the broad effective exchange rate of sterling depreciated by 15.5%. Since then it may have fallen by another 7% or so, following the unexpected 150 basis points cut in bank rate in November 2008. This is good news for all those who try to produce things in the United Kingdom in competition with foreign producers. But this relief comes after a ten-year period of overvaluation, when sterling's nominal and real exchange rates were those of a country driven by the Dutch disease.

With the benefit of hindsight, we now can see that this may indeed have been what was happening, with the increasingly bloated UK financial sector playing the role normally played by the resource-extracting sector and the government budget in the Dutch disease scenario. The ten years of real economic damage done by sterling's real misalignment was not mitigated by sterling's nominal flexibility. The collapse of the United Kingdom's financial sector since August 2007 represents the end of the financial-sector-driven Dutch disease episode for the United Kingdom. It is helpful that the nominal exchange rate has, for once, done the right thing by depreciating sharply, to permit other tradable sectors to attract resources. But this is not something that one can count on. It was not predicted by the policy makers or planned by them. It happened to them. In the case of the United States, where a further real exchange rate depreciation is necessary to undo systemic external imbalances,

the exchange rate has gone the wrong way since last summer, driven by ephemeral short-run financial rather than by long-term fundamentals.

Even in a rather closed continent-sized economy like the United States or the eurozone, monetary policy works with lags that are often long and always variable and uncertain. In a small open economy like the United Kingdom, where much of the transmission of monetary policy is through the exchange rate, the uncertainty about the timing, the magnitude and sometimes even the direction of the effects of monetary policy and other shocks on the exchange rate and other variables of interest is such that independent monetary policy is a curse, not a blessing. By joining a larger monetary union and thus reducing the exposure of the real economy to the financial casino that is the foreign exchange market, the macroeconomic stability of the UK economy will be enhanced.

II. The Financial Stability Argument for UK Membership in the EMU

The argument that having an independent currency means increased financial instability for the United Kingdom does not depend on whether one agrees with my view that the Bank of England has, since August 2007, been the most inept of the leading central banks in area of liquidity management – the art and science of providing illiquid financial enterprises and illiquid markets with, respectively, funding liquidity and market liquidity. After a dreadful start in August 2007, when the Bank insisted on following what amounted to a ‘Treasury only’ collateral policy at its discount window (the standing lending facility) and in its repos, there were signs of real progress starting in the late autumn of 2007, culminating in the creation of the Special Liquidity Scheme (SLS).

Since then, it has all been downhill again, however. The SLS was restricted to asset-backed securities and covered bonds backed by ‘old’ mortgages and other underlying assets only – assets originated before 31 December 2007. This did nothing to revive the securitization markets for new mortgages.

Instead of extending the SLS to new originations, the Bank announced last summer that it would close the existing SLS to new business by 21 October 2008. This created a prominent focal point for coordinating those wishing to short-sell bank equity or to cut off credit lines to banks suspected of having significant amounts of SLS-type assets on their balance sheets. The demise of HBOS (Halifax Bank of Scotland) as an independent institution can be traced directly to this most unfortunate announcement.

The Bank of England recognized its error and announced an extension of the deadline for new business at the SLS during the height of the banking panic that followed the announcement that Lehman Brothers had filed for bankruptcy protection on 15 September 2008. It once again specified a

specific date for the end of new business, however – this time the end of January 2009. Once again, the Bank of England has created a perfect focal point for speculative attacks on banks holding (or suspected of holding) large amounts of illiquid assets. It is obvious that the terminal date of an arrangement like the SLS ought to be state-contingent rather than time-contingent: the SLS should be open for new business until, in the judgement of the authorities, the conditions necessitating its existence have vanished.

The Bank has also failed to address the widening of the spreads between the unsecured interbank lending rate (Libor) and the expected future official policy rate (as measured, say, by the overnight indexed swap (OIS) rate. While Mervyn King is no doubt correct that the 5–20 basis points spreads we saw before the crisis between three-month Libor and the three-month OIS rate reflected irrational optimism and underpriced default risk, it seems equally clear to me that the 200-plus spreads we have seen since the middle of September 2008 overstate fundamental counterparty risk.

Although it is regrettably true that the Bank of England too often has been part of the problem in the financial markets rather than part of the solution, and that the ECB has acquitted itself far better in that regard, this in itself is not the main reason why it would be desirable to get rid of sterling (see Buiter 2008b). The financial stability case against sterling and for the euro would exist even if the Bank's liquidity management and market support were of the very highest quality.

In a nutshell, the argument goes as follows. There is no such thing as a safe bank, even if the bank is sound in the sense that, if it could hold its existing assets to maturity, it would be able to meet all its contractual obligations. More generally, there is no such thing as a safe highly leveraged institution that borrows short and lends/invests long and illiquid. Government guarantees/support are required to make private financial institutions with leverage and asset-liability mismatch sustainable. Such support is provided in the first instance by the central bank acting as lender-of-last-resort and market-maker-of-last-resort (see Buiter 2008b). This central bank must be backed by a fiscal authority with spare fiscal capacity (the capacity and willingness to raise the present discounted value of its future primary surpluses).

When the short-term liabilities of the banks are denominated in domestic currency, there is no limit to the amount of appropriate liquidity the central bank can provide – costlessly and instantaneously. It can simply create additional base money. The only constraints on its willingness to provide liquidity would be fear of moral hazard and fear of the inflation the monetary expansion might create. Moral hazard can be dealt with by pricing the liquidity support appropriately and by imposing regulatory requirements on entities borrowing from the central bank. The threat of inflation is

present only if the borrowing banks turn out to be insolvent rather than just illiquid but solvent. In that case, if the solvency gap of the banks is large enough, it may not be possible for the central bank to recapitalize the insolvent banks by creating money without driving inflation above its target level. To avoid excessive inflation, the Treasury will have to recapitalize the insolvent banks instead of the central bank.

When a significant share of the short-term liabilities of the banking system (broadly defined to include the AIGs and GEs of this world) is denominated in foreign currency, there are limits to the foreign currency liquidity support the central bank can provide. Foreign exchange reserves, credit lines and swaps are small outside a small number of newly prominent emerging markets like China and some of the GCC states. For the United Kingdom they are negligible. The total amount of foreign exchange reserves of the UK (fiscal and monetary) authorities is around \$50 billion.

So to act as a lender-of-last-resort or market-maker-of-last-resort in foreign currency, the Bank of England would, in short order, have to approach the central banks of the only two countries/regions that have serious global reserve currencies: the United States (the US dollar makes up around 64% of global reserves) and the euro area (the euro accounts for around 27%). No doubt it would be possible for the Bank of England to arrange swaps with the Fed and the ECB (if the UK Treasury were to back such a request), but there would be a cost.

This insurance premium for foreign exchange liquidity risk would make the City of London uncompetitive compared with institutions operating in the jurisdictions of the Fed and the ECB. Clearly, the solvency of the UK sovereign is the ultimate determinant of the ability of the central bank to borrow foreign exchange at any price. In the case of a request for access to additional foreign-currency liquidity, it must be credible that the authorities in the borrowing nation are capable of making both the internal fiscal transfer (from taxpayers or from the current beneficiaries of public spending to the state) and the external transfer (from domestic to foreign residents) required to service the additional debt incurred by the state.

Given the size of the gross external liabilities of the United Kingdom (see Chart 7), many of which can be assumed to have short maturities, and given the size of the foreign currency liabilities of the UK banking sector (see Chart 8), which can safely be assumed to have shorter remaining maturities and to be more liquid than the foreign currency assets (it is banks we are dealing with!), the ability of the state to provide a credible guarantee for the survival of the UK banking sector cannot be taken for granted.

But it is not just a matter of fiscal sustainability and the solvency of the state. The fact that sterling is not a global reserve currency, but the euro is, will give eurozone-based financial institutions a competitive edge *vis-à-vis*

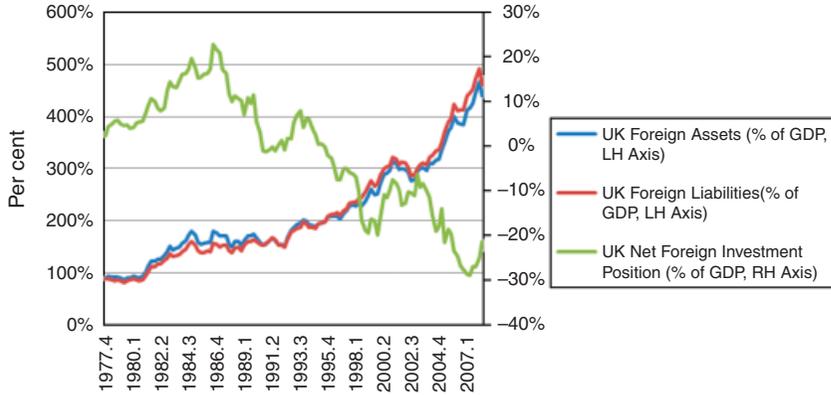


Chart 7: UK foreign assets and liabilities, 1977Q4–2008Q2

Source: National Statistical Office.

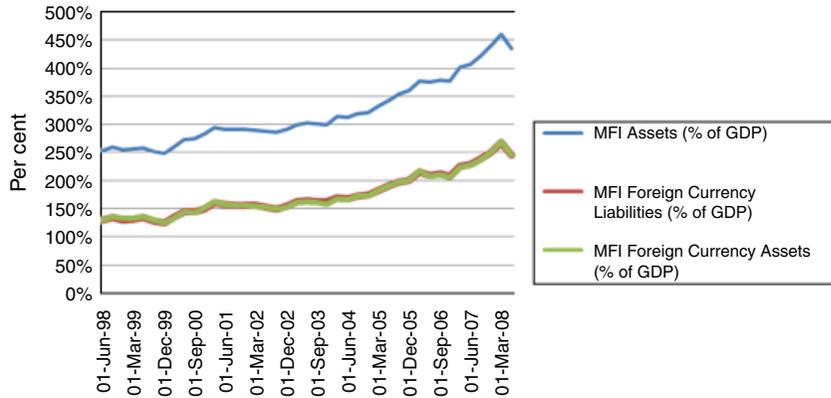


Chart 8: UK monetary financial institutions assets, foreign currency assets and foreign currency liabilities (% of GDP), 1998Q2–2008Q2

Source: National Statistical Office.

UK-based financial institutions. Global reserve currency status matters and can be a source of ‘dark matter’ (see Hausmann and Sturzenegger 2005).

Other countries are (were) even more vulnerable than the United Kingdom to a run on the foreign currency deposits of their banks or to a locking up of foreign currency wholesale markets. Iceland (where gross financial assets and liabilities reached almost 800% of annual GDP at their peak in early 2007 and banking sector assets were around 900% of annual GDP) is an example. Switzerland is another one (banking sector assets are about 660% of annual GDP), aggravated by the fact that Switzerland is a Confederation where the central fiscal authority has very limited revenue-raising powers.

Unless a strong and solvent fiscal authority backs up the central bank, the central bank cannot hope to access a significant amount of foreign currency liquidity when an emergency strikes.

The United Kingdom is more like Iceland than like the United States or the eurozone when we consider the size of its financial sector and especially the size of its external balance sheet (see Charts 7 and 8). With gross foreign assets and gross foreign liabilities both close to 450% of annual GDP, and with much of these assets and liabilities denominated in foreign currency, the United Kingdom is a highly leveraged entity – a hedge fund – and therefore vulnerable. In contrast, gross external liabilities of the United States are around 100% of GDP. And the US dollar is one of two serious global reserve currencies. Sterling, with 4.7% of the stock of global reserves, is a minor-league legacy reserve currency.

It is true that London has prospered with sterling in the past, even after sterling lost its world reserve currency status. But that was then – *then* being before the current global financial crisis. No one had even considered the possibility that all systemically important financial wholesale markets would seize up at the same time, making lender-of-last-resort and market-maker-of-last-resort support from the central bank essential for the very survival of banks and a whole range of highly leveraged financial institutions.

The Bank of England can, at best, be an effective lender-of-last-resort and market-maker-of-last-resort in foreign currency *at a cost* – a cost that will undermine the competitive advantage of the City. At worst, if the fiscal credibility of the UK authorities were to be in doubt also (not an inconceivable event, given years of procyclical budgetary policy), the Bank of England would not be able to operate at all as a foreign currency lender-of-last-resort and market-maker-of-last-resort.

There are just three ways to handle this problem. The first is to run down the international financial activities of the City even further than would be required in any case, even if the United Kingdom were to join the eurozone, to undo the excessive financialization of the UK economy. The second is to become the 51st state of the United States. The third is to adopt the euro. Only the third one is feasible and reasonable.

III. Conclusion

Immediate UK membership in the eurozone is dictated by both the conventional OCA criteria (convergence, flexibility, labour mobility, fiscal flexibility) and a new financial stability criterion: without eurozone membership, the United Kingdom is more vulnerable to a triple financial crisis – a banking, currency and sovereign debt crisis – because it belongs to a group of countries characterized by the inconsistent quartet: (1) a small

country with (2) a large internationally exposed banking sector, (3) a currency that is not a global reserve currency and (4) limited fiscal capacity relative to the possible size of the banking sector solvency gap.

Eurozone membership would eliminate the third member of the quartet. By reducing liquidity risk premia, it may even provide some minor relief as regards the fourth member of the quartet.

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