

VOL. 28 NO. 2



FEBRUARY 2005

The World Economy

Edited by

DAVID GREENAWAY AND JOHN WHALLEY

The Determinants of EU Processing Trade
Egger and Egger

The New Southern African Customs Union Agreement
Kirk and Stern

ASEAN-China Free Trade Area
Tongzon

AIDS Policy and Pharmaceutical Patents: Brazil
Cohen and Lybecker

Japanese Export Insurance Arrangements
Mah and Milner

The UK and the Euro
Mulhearn and Vane

The Balassa-Samuelson Effect in Estonia
Égert

Blackwell Publishing

ISSN 0378 5920

The UK and the Euro: Debating the British Decision

Chris Mulhearn and Howard R. Vane

Liverpool John Moores University

1. INTRODUCTION

THE debate over the central question of whether or not Britain should relinquish the pound in favour of the euro is presently the focus of much popular attention. Many commentators, analysts and academics have committed themselves to the euro cause; see, for example, Buiter et al. (2000), Buiter et al. (2002) and Begg et al. (2003). Many others have articulated the case against Britain adopting the euro; see, for example, Ball (1999), Thirlwall (2000) and Lascelles et al. (2001). In order to further illuminate this debate, we present below material arising from interviews with two leading economists who hold strong views on the euro.¹ Of our interviewees, Professor Willem Buiter (Chief Economist and Special Counsellor to the President, European Central Bank for Reconstruction and Development) is a member of the *Britain in Europe* group and has written several papers supportive of euro entry; see, for example, Buiter (2000). Professor Patrick Minford (Professor of Applied Economics, Cardiff Business School) is a member of the *Business for Sterling National Council* and his recent publications with a focus critical of the euro include Minford (2002) and Minford et al. (2004).

Our purpose in contributing to this debate is twofold. We want, first, to encourage some elaboration from both sides of the argument upon common themes. Most textbooks tell us, for example, that optimum currency area theory (see Mundell, 1961) has a critical bearing on the long-term future of the euro and the success of any British participation in it.² When we posed a question around this theme to our interviewees, both downplayed the significance of the question but in rather different ways. Approaching a number of familiar euro issues from

The authors wish to thank an anonymous referee for helpful comments on an earlier draft of this paper.

¹ We interviewed Professor Buiter on 7 May, 2003, and Professor Minford on 15 May, 2003. We would like to thank them both for their help, time and patience during the production of this paper.

² See, for example, De Grauwe (2000) and Krugman and Obstfeld (2003).

diametrically opposed positions yields surprising and interesting results. The second intention behind the interviews is to discover what, if any, shared ground there might be between economists who so sharply disagree on this fundamental question of policy. The answer turns out to be a fair amount: for example, we found some measure of agreement over certain shortcomings in the institutional architecture of the euro. There were also some commonalities over aspects of the politics of both the single currency and the European Union (EU), though our interviewees placed rather different constructions on both.

2. PERSPECTIVES ON THE POSSIBLE BENEFITS OF THE EURO FOR THE UK

We asked Professors Buiter and Minford questions about the benefits to the UK of adopting the euro under three main headings:

- the gains from lower transaction costs;
- issues around the possible reduction in exchange rate risk;
- the potential gains from greater transparency in prices.

a. Transaction Costs

On transaction costs both agreed that the gains to be realised are likely to be small. Professor Buiter pointed out that the direct changeover costs of replacing the pound with the euro are all upfront while savings on transaction costs are, like other benefits, continuous. Moreover, the changeover costs are themselves extremely modest: 'we are dealing with a single currency reform of the kind that many South American countries do on a periodic basis. For the UK it would be rather like decimalisation; it really is chicken-feed'. Professor Minford's view is that the savings on transaction costs are likely to be modest because 'the vast majority of transactions go through the banking system at zero cost' and they merely cancel out the costs of currency conversion: 'so fundamentally, transaction costs are zero and are too trivial to worry about'.

b. Exchange Rate Risk

Professors Buiter and Minford adopt very different stances over the question of what happens to exchange rate risk should the UK become part of the eurozone. Professor Buiter offers a carefully constructed argument which concludes that the UK's exposure to exchange rate misalignment would be reduced should it adopt the euro. His concern is not with the 'nuisance' of short-term exchange rate volatility but with persistent medium-term currency misalignments that, in his view, 'can be a real threat to prosperity'. Buiter considers the euro to be 'the largest

against the dollar. Macroeconomic instability is the euro's major cost for the UK. Note that this argument is UK specific; it does not apply to euro economies that are more integrated with each other and have fewer economic connections with the dollar area. It is in this 'UK specificity' sense that Minford downplays the significance of the optimum currency area debate.

Professors Buiter and Minford display a marked degree of unanimity over the shortcomings of some of the critical euro architecture, especially the Stability and Growth Pact and the ECB. In Buiter's view the Pact is 'inflexible' and in need of rethinking but, he notes, it is part of the Maastricht Treaty and this can only be changed by unanimity. Any modification or reinterpretation of the Pact would also raise serious questions about the credibility of the euro's fiscal framework. Ultimately, he expects that it will evolve into a less pejorative and therefore more constructive mechanism. Minford too finds the Pact 'inflexible and crude' but is much less forgiving about the possible course of its development. His concerns centre on zealous scrutiny by the EU of the UK's fiscal commitments which, for him, are properly a matter for Parliament. There are shared concerns too about the ECB. Both Professors Buiter and Minford are critical of its deflationary impetus, the utility of its preferred first pillar of monetary policy and the lack of transparency in ECB decision making. Again, however, Professor Buiter is more sympathetic to what he points out is a young and developing institution.

Finally, we come to the politics of the euro. Both Professors Buiter and Minford agree that this rather than economics is the force behind the creation of the new currency. For Buiter this is a positive thing – it is a commitment to try to shape a plural and prosperous Europe for the twenty-first century. The question for the UK is: does it want to be fully engaged with this process? In Buiter's view the enlargement of the EU will have important implications for its future direction as the new states will provide a liberal counterweight to the Franco-German *dirigiste* nexus which has been dominant for most of its history. This makes the immediate future a critical period: Britain 'doesn't want to be in its usual position of joining late and reluctantly, and then complaining loudly forever after that things aren't the way they ought to be, or would have been if only we had been there earlier'. Minford concurs about the desirability of enlargement as both a means of containing Franco-German hegemony and achieving a more plural, decentralised Europe. But for him this is a different debate to that concerning the euro, for which the economics are not right.

REFERENCES

- Ball, J. (1999), *The European Single Currency: A Bad Idea* (London: New Europe).
Begg, D., O. Blanchard, D. Coyle, B. Eichengreen, J. Frankel, F. Giavazzi, R. Portes, P. Seabright, A. Venables, L. A. Winters and C. Wyplosz (2003), *The Consequences of Saying No* (London: Britain in Europe).

diametrically opposed positions yields surprising and interesting results. The second intention behind the interviews is to discover what, if any, shared ground there might be between economists who so sharply disagree on this fundamental question of policy. The answer turns out to be a fair amount: for example, we found some measure of agreement over certain shortcomings in the institutional architecture of the euro. There were also some commonalities over aspects of the politics of both the single currency and the European Union (EU), though our interviewees placed rather different constructions on both.

2. PERSPECTIVES ON THE POSSIBLE BENEFITS OF THE EURO FOR THE UK

We asked Professors Buiter and Minford questions about the benefits to the UK of adopting the euro under three main headings:

- the gains from lower transaction costs;
- issues around the possible reduction in exchange rate risk;
- the potential gains from greater transparency in prices.

a. Transaction Costs

On transaction costs both agreed that the gains to be realised are likely to be small. Professor Buiter pointed out that the direct changeover costs of replacing the pound with the euro are all upfront while savings on transaction costs are, like other benefits, continuous. Moreover, the changeover costs are themselves extremely modest: 'we are dealing with a single currency reform of the kind that many South American countries do on a periodic basis. For the UK it would be rather like decimalisation; it really is chicken-feed'. Professor Minford's view is that the savings on transaction costs are likely to be modest because 'the vast majority of transactions go through the banking system at zero cost' and they merely cancel out the costs of currency conversion: 'so fundamentally, transaction costs are zero and are too trivial to worry about'.

b. Exchange Rate Risk

Professors Buiter and Minford adopt very different stances over the question of what happens to exchange rate risk should the UK become part of the eurozone. Professor Buiter offers a carefully constructed argument which concludes that the UK's exposure to exchange rate misalignment would be reduced should it adopt the euro. His concern is not with the 'nuisance' of short-term exchange rate volatility but with persistent medium-term currency misalignments that, in his view, 'can be a real threat to prosperity'. Buiter considers the euro to be 'the largest

chunk of currency risk for the UK'. He acknowledges that the effective exchange rate for sterling is also conditioned by what happens to the dollar but he is clear that, inside the eurozone, the variability of the UK's effective exchange rate would diminish and 'much more important . . . [would be] the elimination of persistent real exchange rate misalignments due to nominal exchange rate movements that are unwarranted, undesired and preventable'. Buitter points to recent periods of sterling overvaluation as an instance of the kind of difficulty that the euro would help the UK economy overcome. He notes also that the welcome sterling depreciation in early 2003 came about 'not through deliberate policy actions but because the market, for reasons not patently clear, decided that it [was] going to re-price the euro, the dollar and the pound'. This focus on the vagaries of the foreign exchange market leads Buitter to sum up his position as follows:

I do think that killing off the exchange rate as a mechanism that causes unwarranted . . . changes in the relative competitiveness of Britain and the continent is going to be a major gain for the UK. It is also a major gain from the point of view of firms contemplating investment here and contemplating expanding their operations here. Without the pound locked in place with the euro firmly and credibly, I think Britain will suffer and is already suffering, compared to what could have been achieved, from staying outside the eurozone.

Although roughly half of the UK's trade is with the eurozone, much of the rest is denominated in dollars. The evident issue here is that while eurozone membership might be good for trade with eurozone countries, it could conceivably harm trading prospects with the rest of the world if the relationship between the dollar and the euro is an unstable one. Buitter deals with this point in two ways. First, the enlargement of the EU and the eurozone will increase Europe's relative trade significance for the UK in the medium term. Second, he argues that it is important to distinguish between prices being denominated in dollars and prices being rigid or sticky in dollars: 'the fact that in Tashkent many hotels price their rooms in dollars doesn't mean that these prices follow US dollar hotel prices'. In other words the 'dollar content' of movements in the UK's effective exchange rate does not extend to those parts of the world where the dollar is a flexible numéraire. The overall implication is that the euro-related trade will loom larger for the UK in the future, while the significance of the dollar area has been overstated.

Professor Minford considers the reduction in exchange rate risk to be the most notable of the purported advantages of eurozone membership for the UK. However, he argues that there are two important problems with the analysis behind this claim. First, the balance of evidence is that currency variability has little effect on trade. He is critical of recent studies that have linked the two (see, for example, Rose, 2000; and Rose and van Wincoop, 2001) for their failure to disentangle complementary factors behind trade growth.³ In particular, can

³ Professor Buitter is also critical of these studies: 'You never serve a good cause by overstating the case for it'.

improvements in trade be causally explained by the stability induced in a currency union or might they be the product of close political relations and associated institutional arrangements? It is possible to isolate the significance or otherwise of a currency union by examining a situation in which one is established or dismantled and there is no political or institutional context. Minford cites a study of Ireland and the UK, where political relations were absent, which found that the release of the Irish punt from its ties with sterling in 1979 resulted in no discernible effects on trade between the two countries (see Thom and Walsh, 2002).

The second problem with the proposition that the euro will reduce the UK's exchange rate risk reflects Minford's view of the significance of dollar trade to the UK economy and the dollar's turbulent relationship with the euro. He argues that even if there were a currency risk to trade, UK membership of the eurozone would be more likely to increase that risk than diminish it. Because about half of UK trade is with the dollar area and the euro-to-dollar rate is 'incredibly' variable, were the UK to adopt the euro this would give rise to 'trade diversion due to the formation of a preference with other members of the euro area'. Minford sums up his view as follows:

I sometimes use an analogy of a seesaw, with the euro and the dollar at either end of the seesaw. If you join one end of the seesaw you're going to be unstable against the other end. Essentially that is what would happen. Currency risk against the dollar would increase massively. Suppose the currency risk against the dollar rose as much as the currency risk against the euro fell. Although, on average, there would be an equal amount of currency risk, welfare would decrease due to risk aversion. Halving a risk is much less good for you than a doubling of risk. In the case of the euro the actual level of risk would rise because the volatility of the euro against the dollar is so great. Now what happens outside the euro is that when one of these currencies goes up we sit in the middle of the seesaw. In this way we manage to keep our currency instability down, in spite of the great currency instability of these two big blocks.

Given their different positions on the implications of eurozone membership for the exchange rate risk, Professors Buiter and Minford predictably differ on the outlook for foreign direct investment should Britain adopt the euro. Buiter notes several characteristics that make the UK attractive to foreign investors: a flexible labour market, reasonably good labour relations and a relatively accommodating tax regime. Against this he sets human capital weaknesses and inadequate infrastructure. For the moment exchange rate uncertainties against the eurozone are also a potential problem. Adopting the euro would therefore be a net plus for Britain and would further cement it as a preferred location for FDI. Buiter takes at face value the statements by a number of multinational companies that they would think very seriously about investing or extending investment in Britain were it to remain outside the eurozone.

Why would they say it if it were not true? They have no incentive, pecuniary or otherwise, for distorting the truth. These are people who have serious money at stake, not ideologues with a political agenda.

Minford's view of FDI prospects is consistent with his seesaw analogy. If it is accepted that currency risk is a barrier to trade and investment is taken to be a part of trade, then while joining the eurozone would conceivably make the UK more attractive as a location for FDI because of closer links with the continent, there would be a disincentive to dollar investment in the UK since links with the dollar area would be much more tenuous and potentially unstable.

c. Price Transparency

The essence of the philosophy behind the euro can be found in the 'one market – one currency approach' of the Single European Act (1987). Arguably, this reduces to a faith in the power of price transparency to promote efficient decision-making and increased competition in markets. We asked our interviewees how important they thought the greater price transparency afforded by the euro might be for the UK and whether scale economies could play a significant role here.

Professor Buiter is persuaded more by the fillip price transparency will bring to the competitive process than by the reaping of any further scale economies in the single market. However, he stresses that the easy arbitrage the euro makes possible is in itself insufficient to promote more intensive competition; the creation of a European market devoid of internal barriers to trade is even more important:

A single currency is not the end of it. You can have a single currency and still not be able to buy a right-hand-drive car in Belgium because of some other silly administrative, legal or fiscal obstacle. What makes the single market – even more than the single currency – is the Single European Act and its gradual implementation across the existing union.

Professor Minford is much more sceptical about the possibilities afforded to the UK by greater price transparency inside the eurozone. He argues that arbitrage by consumers is usually not a pressurised process – there is time to do it and the business of currency conversion is just another aspect – an extra computer keystroke – of the familiar commercial system. Where there are important land borders he concedes that matters may be different. Minford cites Maastricht – the Dutch city sandwiched between Belgium and Germany – as a case in point. Here more than one currency is an inconvenience and may well act as a barrier to trade across the surrounding economic space. For the UK, no such arguments apply as there are no significant land borders. As with his views on exchange rate risk, this is another instance of a case of UK specificity advanced by Minford. He does not necessarily dispute the validity of the pro-euro argument, merely that it stretches to cover the British economy.

This theme is further amplified in Minford's views on the possibilities of greater scale economies for the UK inside the eurozone. Again, it is a question of the balance between what is gained and lost. Minford argues that UK trade with

the EU is largely based on manufactures, whereas trade with the US is much more in services. As there are scale economies available in both sectors, more trade with the EU will realise those in manufactures but trade diversion from the dollar area will restrict scale economies in the more dynamic service sector. This again assumes that currency risk has an influence on trade.

3. REFLECTIONS ON THE POTENTIAL COSTS OF EUROZONE MEMBERSHIP FOR THE UK

Our questions about the costs of the euro for the UK were separated under three main headings:

- the implications of loss of monetary independence;
- potential costs associated with fiscal harmonisation inside the eurozone;
- weaknesses in the institutional and policy framework of the eurozone.

a. Loss of Monetary Independence

As noted, there is some agreement both among academics and policymakers that the pooling of monetary sovereignty inside the eurozone demands of the zone sufficient labour and capital market flexibility such that it exhibits the characteristics of an optimum currency area.⁴ We asked our interviewees whether or not they thought the eurozone approximated an optimum currency area. In framing this question we must admit that we expected Professors Buiter and Minford to differ along predictable lines. Moreover, given that the general view amongst economists is that the eurozone is *not* an optimum currency area, we also anticipated that the question might pose a little more difficulty for Professor Buiter. So much for our expectations. Both the responses we got marked down the relevance of the question in ways which tie in to broader perspectives on the UK and the euro held by Professors Buiter and Minford.

Buiter argues that optimum currency areas are defined by modern unrestricted capital markets which means that 'all of Europe, the US, Japan, bits of central and South America, and other bits that don't have capital controls are an optimum currency area'. Inside this framework 'the desirability of different exchange rate regimes is really driven by your judgement about the efficiency of the foreign exchange market'. In other words, from an economic point of view, the regime of choice should be one that eliminates the persistent medium-term misalignments that Buiter considers so damaging; for the UK this means opting

⁴ See Eichengreen (2003), Kenen (2003) and Mundell (2003). These papers were all written at the invitation of HM Treasury to inform its work on the 'five tests' for UK membership of the eurozone.

for the euro. However, he acknowledges that political and constitutional issues are important too – independent monetary policy is an expression of national sovereignty and for some countries the economic and the political may not coincide as neatly as they do in Europe. Overall then the debate about whether or not the eurozone is an optimum currency area is largely irrelevant. Buiters concludes that:

Arguments about asymmetric shocks, about factor mobility, about the absence of a large federal tax authority capable of redistributing between regions – all these arguments are basically vacuous, either on logical *a priori* grounds or empirically.

Perhaps this statement requires some further explanation. On the basis of his experience as a member of the Bank of England's Monetary Policy Committee, Buiters is able to provide it. Optimum currency area theory suggests that, in the absence of appropriate levels of factor mobility, independent monetary policy is the only effective way to cope with asymmetric shocks. Buiters concedes that, in principle, 'shocks that require relative price or cost adjustments in order to evoke the right demand and supply responses' may be dissipated by 'an ideally managed nominal exchange rate'. Yet:

Unfortunately the exchange rate cannot be managed that way in a world where the exchange rate floats and is determined in a financial market that is driven by many substantive, fundamental or arbitrary and irrational forces. Britain has had an independent floating currency, more or less, since it was pushed out of ERM 1 on Black Wednesday. In the three years that I served on the Monetary Policy Committee we had sterling persistently overvalued, and an unbalanced economy where a sheltered sector was booming ahead. The internationally exposed sector, especially manufacturing, was being crippled, squeezed and squashed by the excessive strength of sterling. What did we do about it? Nothing. The exchange rate was not an instrument, the exchange rate just happened to us.

Bringing his argument up-to-date, Buiters refers to another asymmetric shock: the egregious boom in UK house prices. Can the independent monetary policy that the authorities have at their disposal be used to address this as optimum currency area theory suggests? Buiters's answer is:

No. Monetary policy is otherwise engaged targeting the rate of inflation. So the notion that the exchange rate is there as an instrument to be used flexibly to achieve relative cost or price changes which otherwise have to be achieved in painful ways – by one country inflating less rapidly than another or even being pushed into temporary deflation – is just an illusion. It has not happened here since 1992, and it has not happened elsewhere. The notion that asymmetric shocks make a case for monetary independence is bogus. The monetary authorities in a modern financially open economy cannot use the exchange rate so as to take care effectively of asymmetric shocks. I've been there. We tried and we couldn't.

If monetary independence is not a key consideration in respect of asymmetric shocks, what of the purported need for labour mobility inside the eurozone as an alternative compensating mechanism – is this still important? Again, Buiters's response takes us away from the conventional ground. He argues that monetary policy, operating through a managed exchange rate, has a temporary effect: in

principle it provides quick and less costly relative price changes than could be achieved through, for example, nominal wage adjustments. It is hard to envisage what would have to be a *reversible* labour mobility operating over an equivalent cyclical frequency and it is Buiters's contention that, for most countries, it does not do so. He concedes that there is more of this kind of labour mobility in the US than in the UK but even in the US it is still:

pretty minor. What this means is that either the US is not an optimal currency area (because even they don't get this kind of high frequency labour mobility between states), or that you can have an optimal currency area without labour mobility and cyclical frequencies. I think that the latter is the case. It would be nice to have greater labour mobility on the continent for many reasons, especially as it would allow regions to allocate resources more efficiently and grow faster. But exchange rate flexibility is not an effective substitute for not having that kind of labour mobility.

Note that this is not a denial of the significance of *secular* labour migration prompted by and compensating for structural depression in particular regions of a currency union. Secular migration is – by definition – a different process to cyclically reversible labour mobility.

Professor Minford's take on the whole optimum currency area question is rather different. He accepts that the eurozone probably fails to meet the relevant criteria but his concern is with the scale of the specific costs to the UK associated with the surrender of monetary independence. These costs reduce to an empirical question of whether the UK will be more or less stable inside the eurozone. In his view:

the issue is the volatility of the UK economy inside the euro area, compared to having your own currency and this degree of freedom, namely setting your own interest rate and by implication your own exchange rate . . . It is an empirical matter of how much you would lose in terms of extra variability of the economy if Britain were to join. You've got to tackle this question by looking at the economy and effectively modelling it. There isn't any other way that I know of at any rate, of actually assessing how much it would affect the UK economy to be in or out of the euro.

The results of the modelling exercise Minford undertook are reported in Minford et al. (2004). After simulating shocks to the economy in a variety of scenarios, the main finding was that, inside the eurozone, the variability of inflation in the UK was 'massively' increased. This is principally because of the significance of dollar-based trade to the UK economy and reflects the noted variability of the dollar against the euro. In the model this is translated into variability in the prices of traded goods. To return to Minford's metaphor: the euro moves the UK to one end of the seesaw but does little or nothing to diminish the importance of the other end. Greater variability in inflation was mirrored by increased variability in real interest rates; as in the Irish example, 'with inflation moving around you get huge real interest rate variability'. The study 'also found that output and employment variability increased by a significant percentage, by 20–30 per cent in terms of variance'. The final task was to summarise these findings.

We took a weighted average of these increased variances, giving a low weight to the nominal ones and the real interest rate, and quite a high rate to the real ones of unemployment and output, and came up with an average worsening of welfare of over 100 per cent. Essentially what one can say is that joining the euro would create a lot more variability in the macroeconomy. The welfare implications of increasing the boom and bust factor by over 100 per cent must be considered to be a significant cost in terms of the perceived preferences of the British people who don't like boom and bust. Although the welfare measure of variability is essentially arbitrary and we don't know how to translate it into an equivalent change in average living standards, in terms of what we know about the preferences of voters, that sort of variance increase is likely to be pretty important. That is the major cost of joining.

The theme of UK specificity was explored further in a subsequent question we raised with our interviewees regarding the British experience of the ERM. We asked Professor Buiter if joining the eurozone would be like joining a less-forgiving version of the ERM. His answer was clear and decisive.

No. That is a complete fallacy. The reason the ERM was the disaster it was, is that Britain's membership of the ERM did not represent an irrevocable commitment. That is the key thing and really the only thing that matters. If there is a chance that joining EMU would be like an old-fashioned promise to peg an exchange rate and then stand up and say 'over my dead body only', and everybody is already calling in the undertakers, then it would be just that. But it is not the way that the euro cookie is baked. It is an irrevocable commitment. What you are fixing is not an exchange rate but a conversion rate. The pound would cease to exist as an independent currency. It would simply be a non-decimal denomination of the euro. There is no comparison between the best of all possible worlds, which is a common currency, and the worst of all possible worlds, which is a not fully credible quasi-commitment to some fixed, or quasi-fixed, exchange rate regime.

We asked Professor Minford a slightly different ERM question. His contention that adopting the euro would make the UK less stable in macro terms because of its particular ties to the dollar area could be interpreted as a form of the 1980s bi-polarity case for keeping the pound out of the ERM. Both arguments seem to turn essentially on the issue of UK specificity. Was Minford simply deploying the bi-polarity thesis in a euro context? His reply confirmed the parallels but re-emphasised the importance of empirically examining the performance of the economy in euro and independent monetary policy contexts. Modelling the effects of shocks in these two sets of circumstances had revealed that the biggest cost associated with the euro arises from large real exchange rate shocks to the eurozone *vis-à-vis* the dollar.

This was quite an interesting finding. We hadn't realised until then how important the volatility of the euro against the dollar was in actually driving volatility in the UK economy. We discovered in the course of . . . stochastic simulations that this was a major factor. It accounted for the finding that our currency risk . . . was actually a little bit greater on average inside the euro area. A lot of that was because of the shocks of the euro itself on the UK economy. One can see this happening in real time with Ireland. When Ireland joined the euro in 1999, the euro promptly dropped by something like 20 per cent causing quite big disturbances for the Irish economy. Within three years Ireland had an inflation rate that peaked just below eight per cent. That was almost directly attributable to the euro dropping, driving up prices in Ireland in terms of euros for dollar trade. Dollar trade is immensely important to Ireland. You saw in real time this effect actually happening in the Irish economy with real interest rates going highly negative, feeding the boom and inflation rising sharply.

b. Potential Costs of Fiscal Harmonisation Inside the Eurozone

Minford (2002) highlights two further potential costs of the euro for the UK. One, concerning the move to increased harmonisation of taxes, he argues would adversely affect British labour market competitiveness and thereby damage output and employment. The other is the projected state benefit deficits of Germany, France and Italy which he believes would place a heavy burden on UK taxpayers. We asked Professor Buiter for his views on these concerns. He dealt with the public deficit issue first:

[This] is not just a *red herring*, it is a *scarlet herring*. The argument that the British worker bee will have to bail out the improvident butterflies or grasshoppers in France, Germany or Italy, with their large unfunded social security and state retirement pension schemes, is complete baloney. These countries do indeed face a serious problem of provision for old age. The current contribution rates by Italian and German workers are not sufficient – because of demographic and productivity developments – to realise the expectations for state pensions of current and future pensioners. Somebody is going to be disappointed. If the intergenerational conflict is limited to Italian workers and Italian pensioners, either Italian pensioners will have their pensions cut, or Italian workers will have to cough up more, or a combination of these two will happen. If neither the current Italian worker nor the Italian pensioner gets clobbered, then other beneficiaries of Italian public spending will suffer, or other Italian taxpayers will have to pay if public debt default is to be avoided. If none of this works, there could be public debt default. The [idea of] British taxpayers financing the continental benefit deficit is a complete nonsense. The Italians and Germans will sort out their own problems. It's an inter-generational conflict that came about because of inconsistent expectations and disappointments on population growth, longevity, the birth rate and productivity growth . . . The notion that having a common currency would make it more likely that somebody in a stronger position – even if Britain were in that position and I would deny that it is – would bail out a weaker brother is completely ridiculous. I think that this argument is the worst kind of cynical manipulation of underlying xenophobia. It is a dishonest argument and many of those that make it know that the argument is untrue.

Unsurprisingly, Professor Minford disagrees. His concerns centre on what might happen in a new institutional context – which is what the eurozone is – where the rules are to some extent still emergent. Thus, he argues:

If you join a club within a club, you are subject to all sorts of new pressures. Quite clearly in the context of the Treaty of Rome there's absolutely no way in which we could be called upon to pay for anybody else's pension obligations. But suppose we are inside the euro area and a country was having great financial difficulties and might default on its public debt. One can imagine the discussion inside the euro club – it threatens the currency, it threatens the credibility of our monetary policy, it causes all sorts of problems to us – we members should somehow take avoiding action. It's in this context that state pension arguments come into play. They are very hard to evaluate but clearly they pose, in principle, potential risks of quite large dimensions.

Buiter's view of the tax harmonisation issue is in one sense similar to Minford's. Buiter argues that tax competition in Europe is a force for good – a means of 'keeping the Leviathan under control'. Where he differs from Minford is in his interpretation and evaluation of the kind of federalism that is likely to develop in Europe:

joining EMU is not just an economic decision, it is also a political and constitutional decision. It is another step on the road to a more federal Europe, which I think is a good thing. Obviously,

if you don't like it, it's a bad thing. To the extent that joining, rather than not joining, represents the strengthening of the integrationist, federalist momentum in Europe, it is more likely that some things that were previously under national jurisdiction would now become a matter of common concern and joint decision, using qualified majority voting. Remember that all these areas that Professor Minford and others put up as evidence for the prosecution are all areas where unanimity is required. Unanimity means just that. If one country, even Luxembourg or soon Malta, votes against it then it won't happen. I actually believe that in certain areas greater harmonisation might well be desirable. In other areas [such as taxation] this is not true.

c. Weaknesses in the Institutional and Policy Framework of the Eurozone

We asked our interviewees for their views on both the Stability and Growth Pact as it relates to the UK's possible eurozone entry and the structure and functioning of the European Central Bank. These questions elicited perhaps surprisingly similar responses. Professor Buiter notes that as a member of the EU Britain is already subject to key elements of the Pact. However, he continues:

The Pact is an example of how legitimate concerns and good intentions may still lead to an unfortunate accident. It's inflexible, its numerical criteria are arbitrary and it does not provide the right incentives to achieve fiscal sustainability in the long term because it does not provide any direct incentives for fiscal tightening during boom periods. This has now been recognised. You don't get the President of the European Commission calling the arrangement stupid and rigid if there aren't widespread views that either constructive reinterpretation, or formal redesign, of the Pact is necessary. The Pact is part of the Treaty and the Treaty can only be changed by unanimity. Formal revision of the Pact may be a long-term exercise. In the short term we are going to see more of the *ad hoc* hand waving and disorganised flexibility that we have seen in the past. This is not a very pretty sight, but I think it is inevitable given the fact that the formal reconsideration of what the Pact should be is institutionally so difficult. When two of the largest countries, Germany and France, are persistently exceeding the key numerical deficit limit and are not falling off the edge of the cliff, the absence of a rationale for these limits becomes clear even to those who are most firmly attached to them. Most people who now defend them, defend them simply because they are there. Giving up on a commitment is bad for credibility, even when the commitment is to something arbitrary. The European Commission is in a box. It has the responsibility to enforce observance of a Pact that makes little sense. What do you do? Do you give up on the commitment and lose credibility, even if you construct a more sensible Pact? If you stick to it, you may end losing credibility anyway. I believe that in the end the light will shine even through this particular darkness and the Pact will become a way of leaning on fiscally suspect EU members to ensure that the longer-term sustainability of their public finances is not endangered.

Professor Minford's judgement here is of the same general form – he thinks the Pact is 'inflexible and crude', particularly in ignoring the effect of recession on actual deficits. However, his views on possible reform of the Pact are much less sanguine than those of Professor Buiter. He is concerned that any revised process for ensuring fiscal responsibility might undermine Parliamentary authority over public spending and taxation. Minford concludes that this is:

another example of a situation where there is a significant source of risk because you are not quite sure what the rules will be and what effect they are likely to have on you.

Professors Buiter and Minford also concur over certain perceived shortcomings of the European Central Bank. Minford's concerns are threefold: first, that

the ECB's framework does not appear conducive to good interest rate-setting behaviour. Here one problem appears to be an over-attachment to inflation targeting using the money supply pillar:

We know that money supply rules can be very easily distorted and they have not been upfront about the difficulties of that distortion. In the end they were forced to be by the sheer conflict between the inflation target and the first pillar.

The second problem for Minford is the asymmetric nature of the inflation target adopted by the ECB. The ceiling of two per cent has imbued policy with a 'slight deflationary twist'. Finally, he has concerns about the lack of transparency in ECB decision-making:

We don't really know what goes on inside the ECB Council and that makes it very hard to make plans about future monetary policy. There are rumours of great fights between the Germans and the Italians, represented on the ruling body, but we've no idea of what actually goes on. Interest rate decisions are announced like a bolt from the blue every so often, without much clarification. Most economists, and I'm certainly in this consensus, feel that the system needs quite a lot of overhaul.

Professor Buiters echoes these criticisms. His view is that the Bank of England's arrangements for the conduct of monetary policy, though not perfect, are generally preferable to the ECB's. A symmetrical inflation target, a willingness to look at a wide range of indicators to inform interest rate setting and a greater openness in its affairs are all measures the ECB needs to consider. For the moment however:

The ECB doesn't have an inflation target. The inflation rate that the ECB deems consistent with its price stability objective is an inflation rate between 0 and 2 per cent. It's too cute. They should have either a 1 or 2 per cent inflation target and make it symmetric so that it's clear that there is no downward bias. As a technical economist I would urge them to drop one of the two pillars for monetary policy. The value of broad monetary aggregates, as indicators of future inflation, is so restrictive and limited because of the noise in the velocity of circulation of the aggregates, that it deserves no more special consideration than a host of other monetary and financial indicators. By all means look at the monetary aggregates, but don't hang your supposed operational monetary policy hat on something which is a will of the wisp. Then there is their unwillingness to reveal the vote, which I think is unfortunate. This means that there is a lack of accountability and transparency. I would also like them to publish edited minutes. Currently a statement is made immediately following the meetings. This timing makes it clear that the statement was ready well before the meeting; it therefore has no value as an indicator of what the main arguments that shaped the discussion were. I also have some trouble – though again it is not a hanging issue – with their predilection for consensus seeking in decision making. You don't need a consensus, you need a majority. Disagreements in wild and woolly subjects like monetary economics are to be expected. This need to present a united front and consensus is part of the high priestly tradition of monetary policy making that is overdue for a clean out. On the whole I think that the ECB has a structure that can be turned into something that is really quite effective. As it is, they are not doing badly. Inevitably, since they are a very young institution, without any institutional pre-history, they tend to conduct policy by looking in the rear-view mirror. But as they gain self-confidence, and a track record, they will target future anticipated inflation rather than be driven excessively by the recent behaviour of inflation.

Professor Buiters concludes that none of these issues are a reason for Britain to hesitate over the euro. In fact he considers that British membership of the eurozone

will accelerate desirable reforms, especially if she is joined by Denmark and Sweden and several countries from Eastern Europe.

4. THE POLITICS OF THE EURO

We concluded our interviews by asking about the significance of the political imperatives behind the creation of the euro. Professor Buitter is clear and approving that politics has always been the key driver:

The EU, right from the days it was the European Coal and Steel Community in the early 1950s, from the Treaty of Rome on, has always been a political wolf dressed in economic sheep's clothing. The objectives have always been political, and they still are political. For me that's a good thing. But one has to be clear about that. I think too many proponents of EMU present it as a technical, economic exercise. While it's that too, with important economic aspects to it, the overriding issue is what do we want Europe in the twenty-first century to look like?

He is also concerned that, should it elect to reserve its position outside the eurozone, Britain will both collude in its own political and economic peripherality and hinder progressive dispositions and reforms in Europe:

From the long-term point of view of getting maximum British input into the European decision-making councils you have to join. Britain is already increasingly on the sidelines of economic decisions. People don't like to admit it, but more and more decisions are being made by the non-officially existent Council of the EMU12 and that will only intensify. In my view it is necessary for Britain to be inside the tent in order to counteract the *dirigiste* tendencies that are part of the continental tradition. However, there is also a part of the continental tradition that is much more liberal, like the Dutch, the Danes and the Belgians. There has never been a better opportunity to change Europe to a more liberal stance than now with new members coming in... We are going to see a very different European Union emerge and Britain wants to be there when it starts. It doesn't want to be in its usual position of joining late and reluctantly, and then complaining loudly forever after that things aren't the way they ought to be, or would have been if only we had been there earlier.

Professor Minford agrees about the centrality of politics to the euro project and also that the enlargement of the EU is a positive thing. His wish for enlargement is, however, driven by a desire for a particular kind of European future:

Someone like me who wants a Europe of nation states and is not in favour of a United States of Europe, for both political and economic reasons, welcomes enlargement. Enlargement is a ray of light in the whole process because it seems to me impossible to run an enlarged Europe without much greater flexibility and devolvement of powers than has currently been the model. Enlargement will challenge the Franco/German hegemony. While I welcome enlargement, I am pretty sceptical about how big an effect it will have in the medium term because these countries will be kept at a distance for quite a long time.

5. CONCLUSIONS

What then are the central points of commonality and departure arising in the interviews with Professors Buitter and Minford? Let us reflect first on the central issue

of currency stability. The primary economic advantage of the euro for the UK in Professor Buiters' view is the elimination of medium-term currency misalignments with our major trading partners in Europe. He cites the damage done to manufacturing by the recent overvaluation of sterling as a case in point. The possibility that the UK may be then subject to countervailing misalignments with the dollar is downplayed given the lower share of UK trade with the United States. Overall, the sterling effective exchange rate will become more stable. In turn this greater stability will have a positive effect upon foreign direct investment (FDI) flows into Britain and upon Britain's ability to compete effectively in the European single market.

Professor Minford views these issues rather differently. He uses a seesaw analogy to capture the economic relations between the euro and dollar areas. For the UK to attach itself to the euro area would mean absolute currency stability with our European partners but at the cost of much greater instability with the dollar and therefore the dollar area. Minford's conclusion is that the UK is best advised to maintain its present position at the fulcrum between these two currencies. Opting for the euro might improve FDI flows from the eurozone but it would imperil investment relations with the dollar area. Similarly, while the UK may find the possibilities of competition in the eurozone enhanced, they would concomitantly diminish in the dollar area.

However, somewhat surprisingly neither Buiters nor Minford was much exercised by the issue of whether or not the eurozone is an optimum currency area. The issue for the UK here is the potential cost of surrendering monetary independence. Does the UK need to retain the capacity to set its own interest rates in the event of UK-specific shocks that the ECB, taking interest rate decisions for the whole of the eurozone, may be unmoved by? Buiters, a former member of the Bank of England's monetary policy committee – the body which sets UK interest rates – thinks not. Because monetary policy is fixed on an inflation target, it is not possible to simultaneously direct it elsewhere. He referred to the persistent and damaging overvaluation of sterling during his term of office about which nothing could be done – 'the exchange rate just happened to us'. Presciently, given the Chancellor of the Exchequer's recent 'five tests' statement about convergence and the problems of the UK housing market, Buiters also referred to the latest UK housing boom. This, he argued, was an asymmetric shock, not happening elsewhere in Europe, 'could monetary policy be used to address it? No. Monetary policy is otherwise engaged, targeting the rate of inflation'.

Professor Minford, while agreeing that the eurozone is not an optimum currency area, emphasised that the UK's decision rests on the costs associated with sacrificing interest rate autonomy. The scale of such costs, in Minford's view, has to be determined empirically. His own work found that macroeconomic instability in the UK becomes considerably more pronounced when the economy is tied to the euro. Inside the eurozone, the UK would become, once again, a 'boom and bust' economy, principally because the euro itself is such a volatile currency

- Buiter, W. (2000), 'Optimal Currency Areas, Scottish Economic Society/Royal Bank of Scotland Annual Lecture, 1999,' *Scottish Journal of Political Economy*, **47**, 3, 213–50.
- Buiter, W., D. Currie, C. Hulme, W. Hutton, P. Kenen, R. Layard, R. Mundell and A. Turner (2000), *Britain in Europe: The Case for the Euro* (London: Britain in Europe).
- Buiter, W., C. Hulme, W. Hutton, P. Kenen, R. Layard and A. Turner (2002), *Why Britain Should Join the Euro* (London: Britain in Europe).
- De Grauwe, P. (2000), *The Economics of Monetary Union* (Oxford: Oxford University Press).
- Eichengreen, B. (2003), 'Reflections on the Coherence of the Euro Area', *Submissions on EMU from Leading Academics* (London: HM Treasury), 85–88.
- Kenen, P. B. (2003), 'What We Can Learn From the Theory of Optimum Currency Areas', *Submissions on EMU from Leading Academics* (London: HM Treasury), 147–60.
- Krugman, P. R. and M. Obstfeld (2003), *International Economics* (6th ed., Boston: Addison Wesley).
- Lascelles, D., D. MacDougall and P. Minford (2001), *The Economic Case Against the Euro* (London: New Europe).
- Minford, P. (2002), *Should Britain Join the Euro? The Chancellor's Five Tests Examined*, IEA Occasional Paper 126 (London: Institute of Economic Affairs).
- Minford, P., D. Meenagh and B. Webb (2004), 'Britain and EMU: Assessing the Costs in Macroeconomic Variability', *The World Economy*, **27**, 3, 301–58.
- Mundell, R. A. (1961), 'A Theory of Optimum Currency Areas', *American Economic Review*, **51**, 4, 657–65.
- Mundell, R. A. (2003), 'Answers to a Set of Written Questions from HM Treasury', *Submissions on EMU from Leading Academics* (London: HM Treasury), 197–202.
- Rose, A. K. (2000), 'One Money, One Market: The Effect of Common Currencies on Trade', *Economic Policy*, **15**, 30, 9–45.
- Rose, A. K. and E. van Wincoop (2001), 'National Money as a Barrier to International Trade: The Real Case for Currency Union', *American Economic Review*, **91**, 2, 386–90.
- Thirlwall, T. (2000), *The Euro and Regional Divergence in Europe* (London: New Europe).
- Thom, R. and B. Walsh (2002), 'The Effect of a Currency Union on Trade: Lessons from the Irish Experience', *European Economic Review*, **46**, 6, 1111–23.