Jonathan Attwood 30 November 2003
Tutorial Class: Mondays 9:00-10:00

International Relations:
Why is Britain hesitating about membership of EMU and what are the main issues?

On Friday January 1st 1999, "European dreamers finally saw their cherished hope become reality at midnight when 11 countries signed away their sovereignty over monetary policy and the single currency was born".[1] However, with the mass jubilation that followed the commencement of the final stage of Economic and Monetary Union within the European Union, there were still some sour notes amid the rhetoric. One included the argument from France that Wim Duisenberg (president of the European Central Bank) should step down in favour of a French president; the other major argument was the claim by Jacques Santer, European Commission president at the time, that Britain's membership of the single currency was inevitable. So why, 4 years later, has this "inevitability" not come into fruition? In order to answer such a question, one must derive first the meaning of EMU.

Economic and Monetary Union has been a European ideal for many years. The end of the Second World War heralded the start of a new European surge towards integration. On the one hand, France, left in ruins by occupation from Germany, held a hereditary fear of any further European conflict. As the dust settled, Charles de Gaul emerged as the leader of the Provisional Government of the French Republic. De Gaul was determined to avoid the mistakes of Versailles, and to make sure that such a situation as that of 1939 could never come about again. On the other hand, Germany, overstretched and then destroyed during the Second World War, held out its proverbial hand for Europe to take and lead it out of turmoil. Germany was thus split into 4 provisional sections, each controlled by one of the victori ous allied powers (Great Britain; France; USA and the USSR). The UK, under Winston Churchill, was stunned by the shear magnitude of the war, and the fact that for the first time in centuries, British soil had been invaded by an enemy power – the notion of Britain as an Island fortress was undermined. Thus, in the first three weeks of July in 1944 (as the war came to a close), delegates of 45 countries met to draw up an agreement to

[1] Charles Bremner, *Euro dream transformed into reality,* the Times, Friday January 1st 1999.

restructure Europe and create the foundations to a new "user friendly" world atmosphere.[2] What emerged was the Bretton Woods Agreement, which set up for the first time in history, almost universal institutions – the International Monetary Fund (IMF); the International Bank for Reconstruction and Development (IBRD); and the General Agreement on Tariffs and Trade (GATT). The first act of the IBRD was to give France an initial loan of $250 million in 1947 (after De Gaul's resignation) to help her rebuild her country. The Bretton Woods Agreement set in motion a new European passion for integration, influenced by a general fear of European Warfare and a new idealistic approach to economics devised by the British economist John Maynard Keynes. In 1952, France, Germany, Italy, Belgium, the Netherlands and Luxembourg; later to be confirmed in 1957 by the Treaty of Rome as the European Economic Community, created the European Coal and Steel community. This aimed to set up a common market, by phasing out trade barriers and setting up an external tariff. The treaty of Rome once again confirmed the new unprecedented European enthusiasm for further economic and social integration, as well as exposing the French determination to tie Germany further into agreements that would make war impossible. At the Summit of The Hague in December 1969, heads of State and Government decided to make EMU an official goal of European Integration. The Prime Minister of Luxembourg, Pierre Werner devised a plan whereby this could be achieved by 1980.[3] In 1969, the Werner Plan envisioned Economic and Monetary Union with three stages, including the permanent fixing of exchange rates; a single monetary authority to run monetary policy; unified capital markets; and the centralisation of fiscal policy at the community level. The next step towards EMU came with the European Monetary System, devised by France (president Giscard d'Estaing) and Germany (Helmut Schmidt), which aimed to create a zone of monetary stability in Europe, organised around the central Exchange Rate Mechanism (ERM). Finally, in 1992, after the Delors Report envisaged EMU in three stages, the Maastricht treaty was signed in Europe, creating a certifiable timetable for Economic and Monetary in Europe. Thus, EMU is not a new phenomenon, but is the result of a vitalised Continental European passion for integration within the European Union,

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[2] *Simply…how Bretton Woods reordered the World,* The new Internationalist, issue 257, July 1994, http://www.newint.org/issue257/simply.htm

[3] *From Rome to Maastricht: a Brief History of EMU,* 14th March 2003, http://www.europa.eu.int/scadplus/leg/en/lvb/l25007.htm

embodying the spirit and talent of idealistic politicians such as Lafontaine and Schumann as well as the fear exposed by Charles De Gaul.

Economic and Monetary Union in itself has many functions within the Eurozone area. First off, the European Central Bank has been given full control of monetary policy within the region. The ECB, under the guise of its President, Willem Duisenberg and the Governing Council (the highest decision-making body of the ECB, consisting of the President, vice president, the executive board and the 12 governors of the national central banks of the member states) sets a Monetary Policy Strategy which it implements by setting interest rates, thus regulating liquidity in National Central Banks; and by moderating the Monetary Aggregate (M3). The ECB was set up on the 1st June 1998, and henceforth has claimed to be the guardian of Price Stability in Europe.[4] EMU also maintains a fixed exchange rate throughout the Eurozone area. This means that each of the member states of the Eurozone cannot fluctuate their exchange rates to rectify balance of payments problems or maintain favourable environments for certain industries against foreign competition. The issue of fixed exchange rates has always been a controversial one – especially in Britain – and is not a new thing. From 1880-1914, many states in Europe (including Britain) were a part of the Gold Standard, whereby all currencies were tied to the value of Gold. Winston Churchill (then the Chancellor of the Exchequer) took Britain back into the Gold Standard after the First World War, with dismal results. Also, the Bretton Woods Agreement created a fixed Exchange Rate whereby currencies were limited to small fluctuations between each other. The Snake in the Tunnel mechanism followed this in 1972, which limited EEC currency margins to 2.25%, promptly joined by the UK, Denmark and Ireland in a gesture of solidarity. The next attempt, and arguably the most successful, was the Exchange Rate Mechanism, which became the basis for the fixed exchange rates of Economic and Monetary Union. The third function of EMU is to create a single currency. This currency (known as the Euro) was introduced to member states (Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) on 1st January 1999, and national currencies were completely phased out by January 2002. The new currency essentially performs the three classic functions of money – a medium of

[4] *Cornerstone: The European Central Bank,* The European Central Bank, pp.12-13, http://www.ecb.int/pub/pdf/ecbbren.pdf

exchange, a store of value and a unit of account – but is much more than that. The Euro is the most tangible symbol of a "European Identity" to date, and naturally it has a strong impact on Economic Developments throughout the area. So, why has Britain been so hesitant about joining this new "European Identity" in EMU?

First off, there is great emphasis on national pride in the United Kingdom. Much of this is a result of the glamorous history that "Great" Britain as an island has enjoyed. There has always been a notion that Britain was separate from Europe, a nation apart and above the trivial affairs of the continent. There are many factors influencing this outmoded notion of "Britishness". First, the supremacy of the British navy was always a semblance of national pride. Covering most of the waters of the world, Britain was known as the Workshop of the World because of her uncanny trading efficiency and almost monopoly of merchant shipping. The UK thus enjoyed a hugely favourably Balance of Payments, and huge investments into her economy. The sheer magnitude of the British Empire also influenced the feeling of superiority in Britain. At one point, the British Empire spanned ¼ of the world's population, exporting culture, language and its people. Hailed as founders of the New World, Great Britain held possessions throughout most of North America (until the inevitable American Revolution that ailing British Diplomats could not foresee). Britain was also the first nation to undertake an Industrial Revolution, developing steam engines, advancing hugely in the realms of physics and chemistry to bring its economy to a new level of production and creating new markets worldwide. Also, the British ability to preserve its monarchy after civil war is a source of pride. Whereas France especially despatched of her monarchy in a monumental bloodbath, to be replaced by dictatorship by democracy, the UK was able to hold onto the figurehead of monarchy, while moderating a new democratic emphasis into British Politics. However, these issues are not alone in this outmoded vision of British uniqueness and superiority in Europe. The British Pound has always been a symbol of national pride, representing power and prosperity throughout the civilised world. Pound Sterling was (until the First World War at least) the world's strongest currency, by which all others fashioned themselves. Even when America's Dollar muscled in on the British monopoly of currency supremacy, national pride was not disheartened. Thus, this hesitancy in joining a new currency that would once and for all eliminate the pound as the national medium of exchange can be partly explained by a national fear of change, of dissolving the very figurehead whereby a British Identity is formed.

Another possible reason for Britain's reluctance to place its faith on EMU might be past experiences of Economic cooperation with Europe. In the post-World War II era, Europe offered its proverbial hand to Britain on countless occasions. Many European politicians and Economists thought that the inclusion of Britain in any new European integration initiative was necessary for its success, due to the huge weaknesses suffered by the French and German economies after the detriments of war. Various British governments, however, saw British interests lying in loose cooperation with Europe, and nothing further; Europe was important to trade with, but not to integrate with. However, European sentiment itself changed with the election of Charles De Gaul as French President during the Algerian Crisis in 1958. By the time Britain realised its mistake in refusing the European hand, it was too late, and De Gaul repeatedly blocked British attempts to join the EEC. It was not until after his retirement that Britain finally got into the new European Union, having missed out on the major spoils of the new European trading block before the OPEC oil crisis of the 1970s. Also, many European Historians point out that British cooperation with Europe with Fixed Exchange Rates has ended badly before. Any British Government would inevitably hold an inherent fear of any repetition of the Exchange Rate Mechanism crisis in 1990-1992. Never mind that Britain joined at possibly the most inopportune moment it could have, or that it was through fault of Britain largely that the crisis came about. Britain was eventually forced by Europe to leave the ERM in 1992, a humiliating failure that many die hard conservatives never forgot.

However, there are more central reasons to why British membership of EMU has been such a controversial issue since Maastricht. First off, in joining EMU, a state must relinquish its power of control over Monetary Policy. Monetary Policy refers to Supply Sided Economic policy whereby Interest Rates are set to regulate the cost of borrowing to consumers and firms. The Bank of England currently sets interest Rates through its Monetary Policy committee. The committee looks at figures from the previous 3 months, reviews the last 12 months, and examines projected figures for the future year, and thus sets a Rate of Interest that it believes will benefit the economic environment. The Interest Rate set then has two effects: 1) It regulates the cost of borrowing money to Commercial Banks, firms and individuals, thus directly affecting the availability of funds, and indirectly affecting levels of inwards investment and consumption in the economy; 2) It sets the interest incurred on savings, thus either encouraging or discouraging individuals to put money away into

high interest accounts for future expenditure. Therefore, Interest Rates are seen as the main Government tool for curbing inflation, as they are used to slow down an over-heating economy, or fuel an economy in recession. Also, the Bank of England can regulate the money supply in the economy through Liquidity Ratios. All Commercial Banks and Building Societies have accounts with the Bank of England, which then sets a Liquidity Ratio, determining how much cash a commercial bank is allowed to make available for investment. Therefore, this again limits the circular flow of income in the economy, and as a direct result of a Keynesian Multiplier effect, can determine the extent of economic growth. The Bank of England also controls the money supply more directly. It decides based on reviews and prospected figures how many notes to print, and how many coins to mint, and thus controls directly the amount of money in the economy. Therefore, the Bank of England is understandably dubious about releasing its grip on monetary policy to a central bank in Brussels. However, to enter into EMU would not mean to lose this power indefinitely. The European System of Central Banks (ESCB) still maintains a large authority over the running of the ECB, as they represent 12 of the 18 members of the governing Council, which is the highest authority in the European Central Bank. Therefore, were Britain to join EMU, the Bank of England would not forego completely all power of setting Interest Rates and control of Monetary Policy.

Another fundamental part of EMU is fixed Exchange Rates. On 1st January 1999, all national currencies of the 12 Euro Area countries were given irrevocably fixed conversion rates for the replacement of their currencies with the new Euro Banknotes and coins. This means that each currency is now irrevocably fixed to another, creating a fixed Euro Area wide exchange rate mechanism. This means that import and export businesses do not now have to worry about currency fluctuations and speculation within the Euro Area, and companies can be safe in the knowledge that the money value of a deal in one country will be the same in another. It also means that travellers do not have the hassle of looking up conversion rates at commercial banks when exchanging currency. As well as this, one can now compare the prices of goods between Euro Area countries. However, the loss of exchange rate flexibility can pose problems to an economy, as a Government cannot use revaluation or devaluation as tools to warm or cool an economy. These problems are clearly illustrated by Britain's recent experience. In 1988, when the UK was only a "shadow" ERM member, the Government kept the pound down against the DM

(Deutchesmark), cutting interest rates to that end. Base rates reached a low of 7.5% in the spring of 1988, with the result that the UK suffered an uncontrolled boom that year. Then, from October 1990 when the UK formally joined the ERM, Interest Rates were held high to prop up the pound at the chosen rate of DM2.95. By late 1990, the economy was in "free fall". By holding Interest Rates at 15%, and then 14% until mid-February 1991, with only grudging falls thereafter, the recession had been prolonged and became a slump. The pound was also clearly overvalued, shown by the continued current account deficit even in the depth of recession. An even more cautionary tale is available from Italy, whose failure to devalue since 1987 combined with steady inflation above the EC average led to an overvaluation estimated at around 30%. Italy coped by state subsidies, both overt and hidden, to its trading industries. Subsidies create inefficiency and militate against the efficient allocation of resources.[5] Over the ERM disaster, Norman Lamont resigned as an outspoken critic of Margaret Thatcher's decision to enter, and thus an inexperienced John Major, fresh from the disaster of the Exchange Rate Mechanism, took office, to secure the UK an opt-out clause in the Maastricht Treaty. Also, in times of crisis, devaluation of an exchange rate can be a good measure to soak up an economic shock, a fact that seems to have passed the Euro Area by. By devaluing a currency, a Government can secure a Balance of Payments surplus, thus injecting money into an economy to cope with the problem. Having said this, the ECB holds vast amounts of foreign exchange reserves, amounting to around $300 billion, which it can use to create artificial demand for the Euro in times of crisis.

In order for Britain to join EMU, there are certain criteria that each party must fulfil. First, there are EMU convergence criteria. A prospective joining country must exhibit price stability, a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5% that of, at most, the three best-performing member states in terms of price stability. A Government budgetary position should not have an "excessive deficit". This will be assessed with reference to:

1) Whether the ratio of the planned or actual government deficit to GDP exceeds 3%, unless either the ratio has declined substantially and continuously and

[5] Patrick Minford, *Edward Gonner Professor, Department of Economic and Business Studies, University of Liverpool,* ***What Price European Monetary Union,*** Economics Autumn 1992, page 109.

reached a level that comes close to this value; or alternatively, the excess over 3% is only exceptional and temporary and the ratio remains close to this value.

2) Whether the ratio of the government debt to GDP exceeds 60%, unless the ratio is sufficiently diminishing and approaching this value at a satisfactory pace.

Exchange Rate Stability is also part of the convergence criteria. This requires the observance of the normal fluctuation margins provided for by the ERM, for at least two years, without devaluing against the currency of any other member state, on its own initiative, and without severe tensions. Long Term Interest Rates must also be kept in line with those in the euro area. For one year before the examination, a member state must have an average nominal long term interest rate that does not exceed by more than 2% that of, at most, the three best performing member states in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities.[6] The UK government passes all of these criteria with exception to exchange rate stability, which it has not kept within the ERM guidelines consistently. Thus, there is no real barrier to British entrance of EMU from Europe's perspective. However, the Chancellor of the Exchequer, Gordon Brown, has set five monetary tests, to be met before Britain should join the Euro.

First, the Chancellor asks whether Business cycles are compatible so that Britain could exist comfortably with the ECB's interest rates on a permanent basis. Secondly, the question of flexibility is brought up – whether there is enough to cope with any problems that might arise. Thirdly, Gordon Brown asks if the EMU would create a positive environment for Foreign Direct Investment (FDI) from firms looking to set up in Britain. Fourthly, the effect of EMU on the financial markets and firms is called into question – might it hinder their competitiveness as a whole? Finally, EMU's effect on growth, stability and unemployment is questioned.[7] Gordon Brown insists that the UK will only join the euro once all these conditions are met. A recent assessment summary by the Treasury office showed that while the UK was converging with Europe on many issues, there still remain "structural differences with

[6] Euro Focus – EMU update *issue 4,* **Convergence Criteria,** http://www.treasury.boi.ie/emu/criteria.htm

[7] HM Treasury, *Government policy on EMU and the Five Economic Tests,* http://assessment.treasury.gov.uk/page_01.html

the euro area, some of which are significant". Some economist question whether the UK business cycle, largely linked to that of the USA, will be in line with that of Europe any time in the near future. In terms of flexibility, the UK has a very strong labour market, and has a history of resilience to shocks. However, with around 1 million unemployed in the UK, and 1 million vacancies in London, this can be called into question. This has also been the case in the euro area, where individuals are apprehensive about moving country to find employment, and national companies are often more biased towards their own nationality employees. When examining whether the investment criteria might be met, one can suggest that in joining EMU, while advantages will be obvious with European firms moving in to exploit the low capital gains tax in the UK, some foreign firms already located within the UK might find it beneficial to move into continental Europe to exploit the single currency benefits of zero transaction costs. However, low interest rates in the euro area might produce an overall beneficial effect for firms looking to invest in Britain. The Financial Services test has been met, as it is evident that already there have been great benefits to Britain's wholesale financial services industry, and joining the euro zone could only increase these. However, links with USA financial services firms could be put in jeopardy by a gesture of European Solidarity. In response to the final test the Chancellor has set, it is probable that entry into EMU could produce substantial gains in output, national income, price stability and mobility of labour. However, such restrictions as the Growth and Stability Pact (fiscal deficit limited to within 3% GDP) might bare a hindrance to such benefits – although as France and Germany have successively shown, the Growth and Stability Pact is a mere gesture of good intention, and by no means a strict policy. Thus, while the tests and convergence criteria are on the whole compatible with the UK situation at the moment, some suggest that it might be reckless entering into EMU at the current time.

Relations with other countries outside EMU are also helping to hinder British entry. On 28 September 2000, the Danish people said a historic "no" to joining the euro, by a margin of 53% to 47%. This was in spite of 46 of the 48 newspapers, all the broadcast media, most political parties, business leaders and trades unions all urging a "yes" vote – and threatening dire consequences if the electorate said "no". On 15 September 2003, Sweden followed suit, by an even more emphatic margin of 56% to 42%. The UK shares very strong links with both Denmark and Sweden – indeed the UK set up the European Free Trade Association (EFTA) to

experience the benefits of free trade with them. Denmark is an open economy with offshore oil and gas as its only national resource. The UK is currently Denmark's third largest supplier with nearly 10% of the market. UK exports to Denmark amounted to £2.7 billion in 2002 and is the UK's 13th most important export market.[8] Sweden offers attractive opportunities for UK exporters. Trading links, which go back centuries, are strong and it is the UK's 9th largest and most important export market. The UK's trade in goods with Sweden was £4.19 billion in 2000, second only to Germany as its largest supplier[9]. Therefore, the fact that these two countries both said no to the proposal of EMU, suggests that the UK might be wise to stay out of it also for the time being. As well as this, since the Iraqi war, a strong link with the United States of America has been formed – more importantly a strong link between Tony Blair and George Bush. To march the UK into EMU at this current time, amidst the international political and social situation between these two countries, might be considered to be ill advised, as Britain tries to grow a prosperous relationship with her Atlantic cousins.

In Paradise Lost, John Milton described Hell as containing a furnace, but "from those flames no light, but rather darkness visible". So far the flames of the European debate have shed a remarkable amount of gloom on the subject of the single European Currency, and the EMU. The positive approaches by Tony Blair and Eddie George (Governor of the Bank of England) have helped to dispel some of this fog and kick-start the real discussion. There is no doubt that the Government is in favour of further intervention in Europe, but a degree of hesitancy is understandable from Gordon Brown's position, as perhaps the people of Britain are not yet ready to accept a break with the past and Monetary Subservience to the omnipotent ECB. However, there is a growing fear amongst Economists that Britain should join as soon as possible, or not at all, as the substantial benefits of EMU are withering and eroding as British Politicians debate over the issue.

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[8] UK Trade and Investment, *Denmark Country Profile,*
http://www.tradepartners.gov.uk/Denmark/profile/index/introduction.shtml

[9] UK Trade and Investment, *Sweden Country Profile,*
http://www.tradepartners.gov.uk/sweden/profile/index/introduction.shtml

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