Britain's Euro Test

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British Chancellor Gordon Brown's verdict on the five tests for Britain's entry into economic and monetary union has prompted much reading of tea leaves. Mr. Brown's assessment was sufficiently ambiguous, presumably by design, that all sides could take some comfort in his findings.

That the UK passed only one of Mr. Brown's five tests reassured the British euro skeptics that the date of entry was still very far away. At the same time, the Chancellor's conclusion that significant progress had been made on achieving cyclical convergence provided some succor for the euro's champions. They could take comfort in the fact that his view was more positive than when the five tests were last considered six years earlier and in his promise that the issue would be revisited in a year's time. When Prime Minister Blair followed with a joint Blair-Brown press conference where he promised to "ratchet up" the campaign for Europe, the true believers could be reassured that a positive decision was not far away.

Of course, only one of the five tests is really at stake. The test concerned with the impact on the competitiveness of the City of London has already been met. And the test concerned with the convergence of economic and monetary conditions between Britain and the euro area has been greatly helped by the depreciation of sterling's exchange rate. Now that the period of exceptional sterling strength has passed, it will become evident that the increase in trade with Europe resulting from the single market is bringing business cycles in Britain and the rest of Europe more closely into line. Since 1997 the short-term interest rate divergence between

Britain and the euro area has fallen from 4 percentage points to less than 2, as the Chancellor noted, while long-term interest rates have virtually converged. While cyclical convergence will never be complete until the country actually adopts the euro, the deepening of Britain's economic links with Europe means that it will become increasingly close.

And when the other tests are passed, those concerned with the impact of the euro on employment and investment will be met as a result. In the absence of other problems, the main effect of the euro will be to simplify and streamline Britain's international transactions, making the country a more attractive place to do business. Investment will benefit. So will employment. Indeed, this is the conclusion of the UK Treasury itself, as Mr. Brown acknowledged in his presentation to Parliament.

The final test, which asks whether Britain and the euro area have sufficient flexibility to deal with possible stresses, is thus the main sticking point. Here the UK Treasury is fixated on the housing market. Because Britons have flexible-rate mortgages whereas most euro area mortgages bear fixed interest rates, a sharp rise in interest rates may have a much heavier impact in Britain. If this keeps the country out of the euro area, it will be Margaret Thatcher's ultimate revenge. It was Mrs. Thatcher, recall, who pushed through the privatization of Britain's council houses, creating legions of new homeowners who presumably now fear disruptive interest rate policies. And it was Mrs. Thatcher who so fervently opposed the euro. If differences in UK and continental housing markets keep the UK out of the euro area, Mrs. Thatcher will go to her grave a happy woman.

In reality, of course, there is no reason why the structure of housing finance should deter Britain's adoption of the euro. If householders find themselves with a central bank that follows a more active interest rate policy, more of them will then demand fixed-interest-rate mortgages. And financial institutions, which are in a better position to diversify this risk, will have incentives to meet their demand. The structure of the housing market is not a datum to be taken into account by British policy makers considering whether to the euro. In fact, it will adapt to the monetary environment.

Nor is political integration the issue. Some have argued that Europe's monetary union will operate smoothly only with a high level of labor mobility, and that workers will move between countries only when welfare, pension and health care policies are harmonized, which requires political union. In fact, the role of labor mobility in providing flexibility has been much exaggerated. France was a monetary union for centuries, but it never had a geographically mobile labor force. What matters is wage flexibility, which is admittedly something that Europe needs to work on. But wage flexibility does not require political integration.

Similarly, it has been claimed that the euro area needs a system of inter-state fiscal transfers to protect its regions from shocks, and that large-scale redistribution will not be possible without political integration. This argument, like that concerned with labor mobility, points to the United States, where transfers between states via the federal budget occur on a large scale. But in the United States, most taxes are collected and most public spending is undertaken by the federal government, which necessarily assumes responsibility for buffering the individual state economies. In Europe, in contrast, most taxes and public spending are controlled by the individual member states. If they utilize their fiscal policies intelligently, running deficits in recessions and surpluses in expansions, there is no need for extensive inter-state transfers, and no need for political integration as a concomitant of monetary union.

In other words, where flexibility really matters is in the conduct of monetary and fiscal policies. And here Europe's record is far from reassuring. The ECB has been disastrously slow at cutting interest rates in response to the threat of deflation. Since the beginning of 2001, the Fed has cut the funds rate target by 525 basis points, and the market consensus is that it is about to announce a new 25 basis point cut. The specter of deflation has not yet been vanquished from the United States, but the U.S. central bank has signaled its readiness to do whatever is necessary to fend it off.

Over the same period, in contrast, the ECB has cut its repo rate by only 275 basis points. Partly because of this tight monetary policy, growth keeps slowing, causing the ECB to repeatedly slash its growth forecast, most recently to the range of 0.4 per cent to 1 per cent for 2003, anemic levels at best. Germany has now sunk dangerously close to deflation. The Chancellor is quite right to imply that the UK would be insane to adopt a currency that is managed in this way.

The main reason for the ECB's inflexibility is its structure. It has an unwieldy policy board with 18 members, which is too large to rapidly achieve consensus and make quick decisions. EU enlargement creates the prospect of an even larger board, with as many as 31 members in the absence of institutional reform and as many as 21 even if the ECB's proposal for the rotation of country representatives is adopted. Unlike the Bank of England, where technical policy decisions are delegated to a committee of six independent monetary experts (plus the governor and two deputy governors), the ECB board is dominated by national representatives who find it hard to agree on anything and are slow to recognize the needs of the euro area as a whole. Partly at their insistence, the ECB clings to an asymmetric policy target that attaches more prominence to inflation than deflation. It continues to fight the battles of the past.

The inflexibility of fiscal policy is even worse. The Stability and Growth Pact prevents euro area countries from using public spending to counter recession. This is particularly alarming in the current situation when a significant part of Europe is facing deflation. An increase in deficit spending is the single most effective remedy for deflation. Unlike conventional monetary policy, it will even work when a country has succumbed to a liquidity trap, as Keynes famously demonstrated seven decades ago. One indication of how close Germany is to falling into a liquidity trap is the reluctance of its banks to lend. These are precisely the conditions when fiscal stimulus is imperative. But France, Germany and Italy are all prevented from using fiscal policy because their deficits already exceed the 3 per cent ceilings of the pact. No British politician can in good conscience advocate joining an arrangement where fiscal policy is formulated in such a perverse way.

There is a sound argument, of course, that Britain should join the euro area precisely in order to reform these institutional arrangements. Within the ECB, it can be a voice of reason, lobbying for a smaller board of monetary experts without national allegiances and for a symmetrical inflation target. Outside, it will be safely ignored. Within the Euro Group of ministers, it can press for a more flexible fiscal framework. It can push for elimination of the arbitrary 3 per cent ceilings of the Stability Pact and the substitution of a framework that relies more on transparency and medium term planning, like the UK's own Code for Fiscal Stability. The current members of the euro area have used the constitutional convention as an occasion to make clear that the design and enforcement of the Stability Pact are decisions for them alone. They will not broach interference or welcome advice from countries unwilling to participate in their monetary experiment.

The history of the European Union suggests that it is important to be present when its institutional arrangements are first designed. The UK was not a member of the European Economic Community in the 1960s, when France and Germany designed the Common Agricultural Policy, and it has been fighting in vain ever since for reform of that program. It was not a member when France and Germany designed Europe's competition policy, and it has been fighting an uphill battle ever since for reform along Anglo-American lines. The next couple of years, when the Stability Pact faces its first real test, will be when its final form is decided. Similarly, the next few years, when the Central and Eastern European countries join the ECB, will be when the structure of the central bank's decision making processes are determined. By staying out, the UK creates for itself a self-fulfilling prophesy. By saying no to the euro, its influence over the euro area's institutional arrangements is diminished. This in turn reduces the likelihood that the members of the euro area will adopt reforms that create a more flexible economic and monetary union that would be more to Britain's liking.

It is at least conceivable that the other members on their own will adopt the kind of reforms that Britain desires. Or it may turn out that fears of policy inflexibility are exaggerated – that national governments and the ECB already possess the flexibility needed to head off potential stresses. If so, Britain will have no remaining justification for staying out. We now have the ultimate test of this proposition. Will the ECB and national governments show the flexibility and resolve to take whatever steps are needed to prevent deflation from infecting Germany and spreading contagiously to the rest of Europe? There are some signs of this happening: insiders report that two members of the governing council raised the possibility of cutting interest rates by an unprecedented 75 basis points at their June 5th meeting. Or will a preoccupation with inflation in Ireland and Portugal lead the ECB to continue doing too little, as it has up to now? Will Euro Group ministers sensibly relax the Stability Pact or continue to insist on perverse policies?

The stakes are high. A deflationary trap, once sprung, can be terribly difficult to escape – just ask our Japanese friends. From this point of view, Mr. Brown was right to err on the side of caution. If Europe is about to run aground on the shoals of deflation, he would be crazy to choose now as the time to board its sinking ship. But if Europe's captains are quick to right their vessel and steer clear of those shoals, then he should be quick to book a cabin. If he waits too long, he will lose his opportunity to influence the future course of the Good Ship Euro.

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