

A Hypothetical History: Had Britain Entered EMU

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Suppose that Britain had entered the euro when it was founded at the beginning of 1999, instead of spending ten years inventing reasons as to why entry would be a bad idea. It is commonly assumed that this would have been a terrible mistake, and that loss of the exchange-rate instrument would have imposed a catastrophic cost on the economy. The intent of this paper is to examine this contention.

I do not intend for one moment to disparage the importance of having a roughly right exchange rate for achieving sensible macroeconomic outcomes. Far from it: My argument is that Britain would have had an exchange rate consistently closer to its real needs if it had been in the euro than it had with an independently floating pound. Of course, that depends upon the entry rate being roughly right and the real rate not being carried somewhere greatly different, e.g., by differential inflation. Both of these conditions were, in my view, likely to have been satisfied. It also requires the condition that there be no important shock that would have required a substantially different real rate.

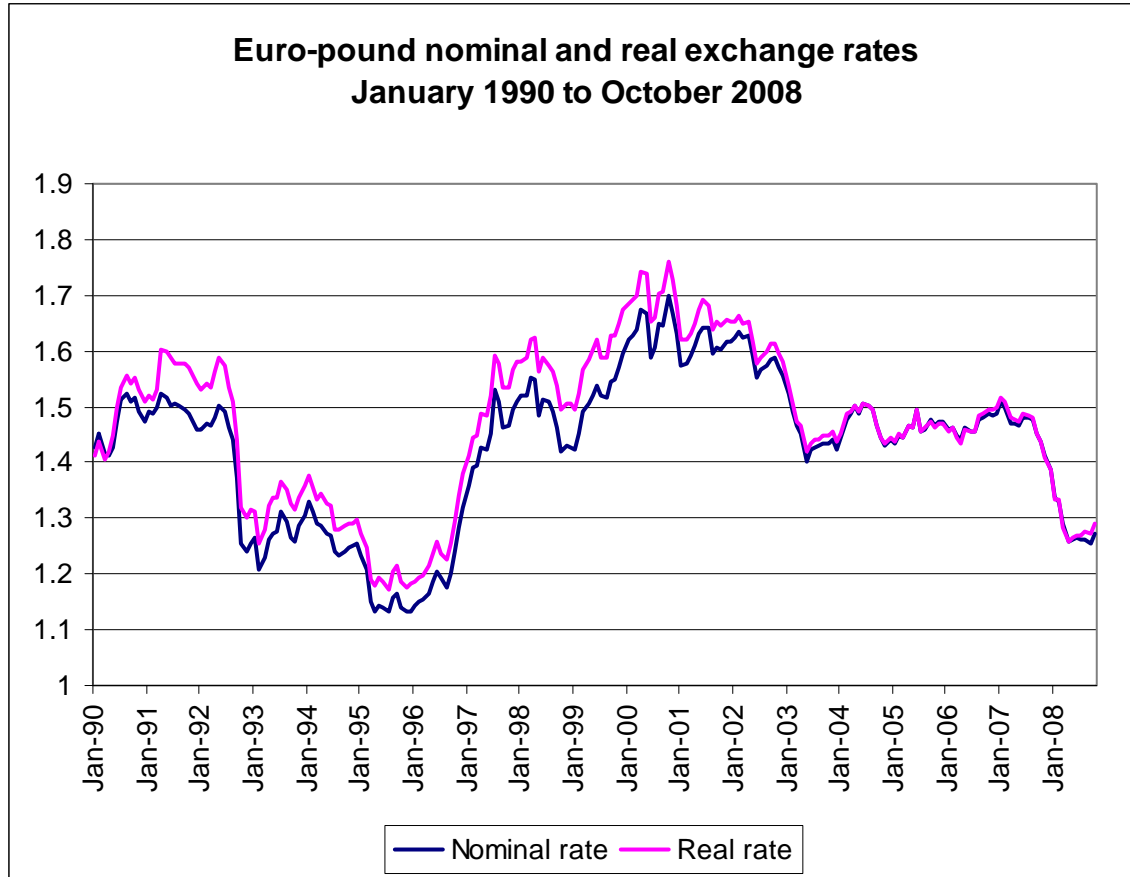
The Entry Rate

It is common knowledge that Britain could not have entered the euro at a rate greatly different from one the Bundesbank regarded as sound. One could not enter at a rate so undervalued that the Bundesbank feared it would give rise to an inflationary impulse in the euro area or threaten Germany's trading interest, nor at a rate so overvalued that the Bundesbank expected to be presented with bailout bills. It is true that German officials commonly mouthed at G-7 meetings the same sort of platitudes as most of their peers about the impossibility of making sensible judgments about whether or not currencies were close to their fair value. But the Bundesbank acted far more intelligently than German officials spoke: Look, for example, at its opposition to the overvalued rate at which Nigel Lawson had put the pound in the ERM in 1989, and its consequential refusal to rescue the pound in 1992. Discomfort at the depths the pound plumbed after 1992 doubtless made the Bundesbank unhappy too, though there is no public record of its misgivings comparable to the one that emerged after the ERM crisis.

What rate would have been picked if the pound had been a candidate to enter the euro at the start of 1999? The actual market rate was about 1.45, which happens to be

close to the mean for the period.¹ This is a rate well within the limits of historical experience (figure 1). There is no reason to imagine that it is the sort of entry rate that would have been blocked as unrealistic by the Bundesbank.

Figure 1



Note: The nominal rate for the euro was proxied by that for the DM prior to 1999.

Sources: *The Bank of England, the European Central Bank and the UK National Statistics Online.*

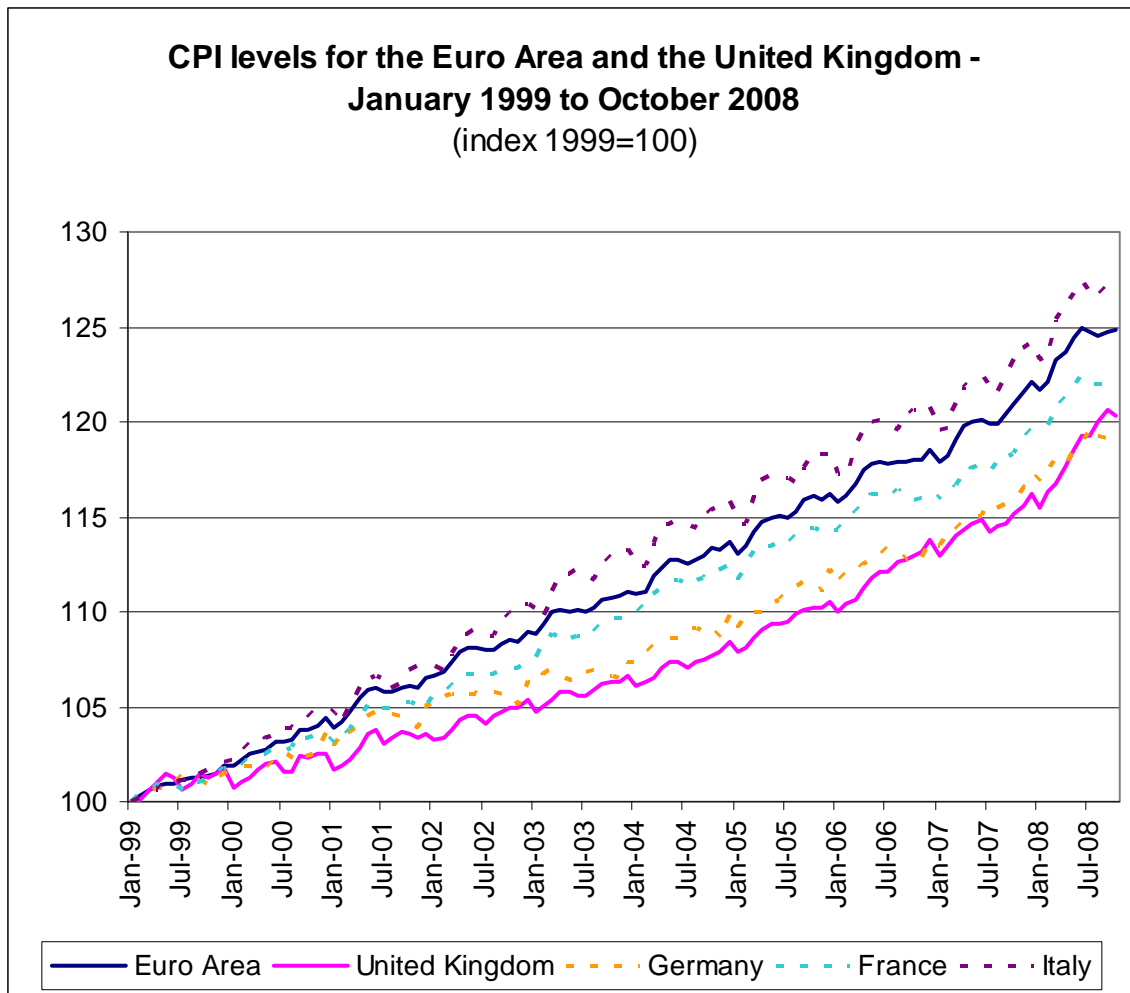
Changes in Equilibrium Exchange Rates

Even if a currency enters a currency union at a competitive but not inflation-inducing rate, the rate will become inappropriate over time if the equilibrium rate changes. The most important source of such changes in the past has unquestionably been differential inflation. At one time many Latin American countries devalued regularly to avoid losing competitiveness, and in the days of rapid British inflation many of us thought that Britain should have followed their example. Is there a threat that Britain could have become overvalued within the euro because British inflation exceeded that of our neighbors?

¹ A recent exercise conducted at the Peterson Institute for International Economics and published earlier this year as a Policy Brief by William R. Cline and myself entitled *New Estimates of Fundamental Equilibrium Exchange Rates* gave a somewhat weaker estimate of the FEER-equivalent rate of 1.3 euros per pound. Doubtless there are those who would have argued for a rate of 1.5, but 1.3 to 1.5 pretty much straddles the range of plausible estimates.

This question can be answered pretty definitively by comparing actual inflation rates in Britain and in the euro area, as is done in figure 2. It can be observed that aggregate euro area inflation was somewhat greater than that in Britain: The days of Britain as one of Europe’s chronic inflaters are (mercifully) over. As can be seen, inflation in Italy has been a lot more severe, and has served to erode Italian competitiveness to a point where there is discussion about whether Italy may one day be forced to withdraw from the euro. Reversing that loss of competitiveness without a devaluation is going to be painful, but will be essential if Italy is to remain part of the euro area. It is clearly desirable that Britain never face this type of situation if it did become part of the euro area. But the import of figure 2 is clear: Unless performance deteriorates notably in the future, there is no reason to fear such an outcome.

Figure 2



Source: European Central Bank

There are several other possible reasons for equilibrium exchange rates to change over time. Productivity may grow more or less rapidly than in competitive countries, with fast-growing countries tending to appreciate (the Balassa-Samuelson effect). However,

one of the advantages of forming a currency union with other countries at a similar stage of development is that there is a negligible chance of such an effect proving embarrassingly large. (The East European countries are another matter: This may well constitute a serious difficulty for several of them even before they enter the euro.)

Another reason that equilibrium exchange rates might change is through accumulation of foreign assets. If a country ran large surpluses on current account, the interest income that it could expect to get on the assets it was accumulating would make it progressively less necessary to have a competitive exchange rate to generate the exports needed to earn the foreign exchange to pay for imports. However, except for countries in which oil exports are large relative to the size of the national economy, the changes from accumulation or decumulation of foreign assets are going to be slow, ensuring that it will be possible to make offsetting changes through differential inflation.

These are the three sources for most changes in equilibrium exchange rates. One can never rule out the possibility that Britain is going to make some new discovery that will transform its balance of payments prospects independently of them, but it is not sensible to block change on account of the remote possibility that some unforeseen event will occur. All three sources give one confidence that Britain could live with a fixed nominal exchange rate against the euro area. There will continue to be need for modest changes in the real exchange rate, but these can be achieved by changes in differential inflation, which is no longer a loose cannon threatening to lead the real exchange rate astray.

Real Shocks that Needed Neutralizing

Those who believe that Britain was better off with a floating pound presumably believe that it floated up in 1997 and 1999 and down in 2002 and 2007 to neutralize some shocks to the economy. If one buys the argument in the preceding section that neither differential inflation nor differential productivity growth nor foreign asset accumulation created a big change in the equilibrium exchange rate, presumably they think there was some other real shock to the economy. They should specify what shock this was and what useful social function was performed by having the pound first float up and then down, presumptively imposing all sorts of real adjustments that served no obvious social purpose.

It seems clear that the real reason that the pound moved was that financial fads changed. In the 2000s it became fashionable to channel big flows of funds to countries like Britain and the United States that were prepared to run big current account deficits. It is precisely to defend the country against being held hostage to such financial fads that one wishes to see the pound's real exchange rate fixed at an equilibrium level in terms of Britain's major trading partner.

The History That Might Have Been

Look again at figure 1. The rate at which it is reasonable to assume that the pound would have joined the euro, 1.3 to 1.5, is within the range in which the euro-pound rate in fact

moved. At the time of formation of the euro, and for a number of years thereafter, the pound was stronger than its hypothesized entry rate. And recently it has reverted (as after its expulsion from the ERM) to a rate even weaker than 1.3.

Received wisdom argues that it was a good thing that the pound was free to float up in the early years of the period and to float down later on. Had this not been so, the United Kingdom would have been faced with inflation in the early years, inflation which it would have been impossible to counteract because monetary policy would have been run by the European Central Bank rather than by the Bank of England and directed toward British needs. In contrast, in recent years Britain would have been faced with deflationary pressures, which it again would not have been free to combat with monetary policy.

The fallacy in this argument about Britain being helpless on the seas of international finance is that there are two instruments of macroeconomic policy, not one. As well as monetary policy, there is fiscal policy. Everyone complained (at least in retrospect, even if some were silent at the time) about the failure of Chancellor Gordon Brown to maintain his early disciplined fiscal stance after Labour was reelected in 2001. There were large and growing budget deficits leading to a turnround in the ratio of public debt/GDP, which began increasing again during the years of golden global growth.

Suppose that Britain had been in the euro. Yes, it would have had easier monetary policy and lower interest rates. To prevent the lower interest rates being translated into excess demand, and thus inflation, the government would have been under pressure to raise taxes and/or cut down on the growth of public expenditure. Budget deficits would thus have been smaller (or nonexistent), and the debt/GDP ratio would have grown less rapidly, or more likely continued to decline.²

Come 2008, when sterling depreciated to a rate weaker than the rate the British economy would have had in the euro, the picture is less clear. Interest rates would still have been lower, so the easier monetary policy would have stimulated demand. On the other hand, foreign demand would have increased less. One cannot say a priori whether one would have needed a more expansionary fiscal policy to sustain demand or not.

What one can be certain of is that Britain would have been in a far stronger position to face the current crisis. It would have had less public debt and thus a lower debt/GDP ratio. And in most of the interim it would have had an unambiguously stronger balance of payments on current account, and would therefore have a stronger net wealth position vis-à-vis the rest of the world.

That is why the contention that Britain would have suffered from fixing its exchange rate at a sensible level vis-à-vis those neighbors with whom it does most of its

² If the fiscal tightening had exactly offset the lower interest rates resulting from being in the euro, then growth (or at least demand-side growth) would have been unaffected. That is why growth is not discussed in this essay: It is irrelevant. (There are more subtle long-term supply-side effects, but practically everyone would agree that these argue in favor of British membership.)

trade strikes me as completely unfounded. It resulted in skewing our fiscal/monetary mix in a fundamentally undesirable way, in going on an irresponsible splurge of fiscal spending, and in indebting ourselves to the rest of the world. Britain is now paying the price.