Making the Case for The Euro

No economy is an island, entirely of itself, or why Britain should join the EMU.

BY PETER B. KENEN

There has been a change in economists' thinking about monetary unions. When we wrote about them in the 1960s, we took as given the extent of trade and financial integration, then focused on their implications for the functioning of a monetary union. We paid little attention to the effects of a monetary union on the intensity of integration or to the ways in which a single monetary policy would its affect its members.

We were wrong to neglect these effects. The introduction of the euro is stimulating trade, foreign investment, and financial integration in the euro area. We must therefore ask what it can do for Britain—its trade and standard of living, its ability to attract foreign investment, the outlook for economic stability, and London's preeminent role as a financial center.

TRADE, PRODUCTIVITY, AND GROWTH

Adam Smith was right. Productivity depends upon specialization, and the scope for specialization depends upon the size of the market. That was the economic rationale for creating the European common market in the 1950s and for the ongoing effort to transform it into a true single market. But economists are be-

Peter B. Kenen is a professor of economics at Princeton University.

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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

coming aware of obstacles to trade that cannot be addressed merely by removing tariffs and harmonizing national regimes and standards. We know, for example, that trade between Canada and the United States is much smaller than interregional trade within each of those countries, and that the difference is not due to tariffs, transport costs, or differences in country size.

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There may be several explanations for this missing trade, but recent research suggests that the mere existence of separate currencies has strong trade-reducing effects. The costs of currency conversion are a small part of the story. Separate national currencies also complicate cost calculations and pricing decisions. The main trade-reducing effect, however, derives from exchange-rate risk, especially the risk of large, long-lasting changes in exchange rates. There is no way to hedge against it.

If a British firm could know precisely how many euros it would earn next year from its exports to France, it could hedge against exchange-rate risk by selling the euros forward for pounds. A change in the exchange rate, however, will also affect the firm's exports to France, so it cannot know how many euros it will earn and cannot sell them forward.

If the firm had a factory in France, it could shift production from Britain to France whenever the pound appreciated against the euro, limiting the impact on its euro earnings. To do that, however, it must have spare capacity available, and keeping it idle some of the time lowers its rate of return.

In brief, the existence of separate national currencies introduces a home bias into key business decisions about production, innovation, and sales promotion. Recent studies indicate that currency-union countries trade more intensively with each other than do other country pairs. Although this finding reflects the experience of rather small currency-union countries, it cannot be wholly irrelevant to large currency-union countries like those of the euro area.

In fact, the trade of the euro area tends already to confirm it. In 1998, just before the advent of the euro, German trade with the EU amounted to 27.2 percent of German GDP; by 2001, it had grown to 33.2 percent. French trade with the EU also grew strongly. But British trade with the EU contracted slightly as a share of GDP. A similar effect shows up in a careful study of trade between the members of the euro area, which finds that the shift to the euro has already raised that trade by about 15 percent.[1]

Today, British firms face exchange-rate risk in every foreign market. If the British adopted the euro, they would no longer face it in their most important market. It is the best way to combat the home bias limiting the size of Britain's markets. It is thus a promising way to raise productivity and foster faster growth in Britain's standard of living.

The euro may indeed produce concentrations of trading and talent that challenge the preeminence of London.

ATTRACTING FOREIGN INVESTMENT

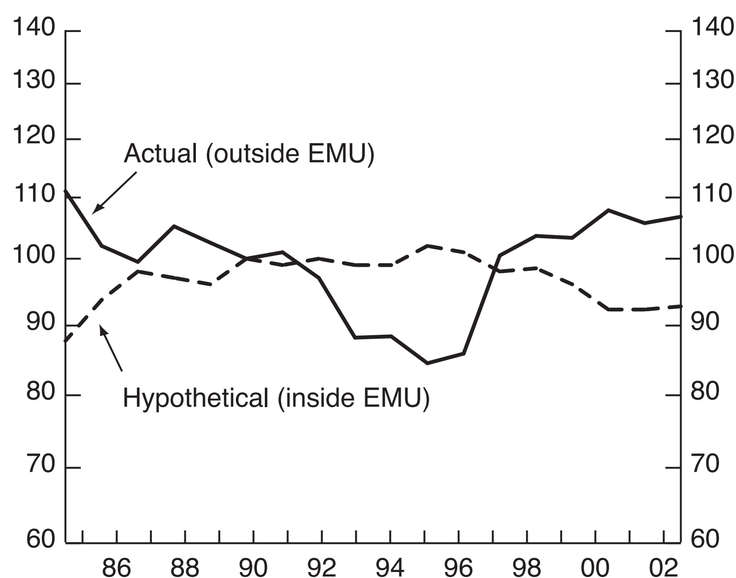
Foreign firms based in Britain also face exchange-rate risk when exporting from Britain. That is why so many foreign firms have warned emphatically that they will eventually have to move across the Channel if Britain does not adopt the euro. Yet Britain is still the

largest EU recipient of inward foreign investment. What's really happening?

Numbers in a recently published study show that Britain's position has actually weakened dramatically relative to other EU countries. In 1997–98, Britain attracted 52 percent of the foreign direct investment entering the EU. In 1999–2001, by contrast, it captured only 24 percent of the inflow—less than half as much.[2]

Bear in mind, moreover, that large investment projects have long gestation periods. There may thus be a further fall in the next few years, when projects on the drawing board appear in the data. Remember, too, that attracting foreign investment will get harder when low-cost countries like Poland, Hungary, and the Czech Republic qualify for membership in the euro area.

Figure 1
The Foreign Currency Value of Britain's Currency, In and Out of EMU, Trade-Weighted Indexes: 1990=100



Source: Layard et al. "Why Britain Should Join the Euro."

MAINTAINING MACROECONOMIC STABILITY

If Britain adopted the euro, it could no longer run its own monetary policy. That would matter importantly if Britain were likely to experience economic fluctuations markedly different from those experienced by the euro area. Recently, however, Britain's macroeconomic experience has become more similar to that of the euro area, and there is little reason to fear that it will suffer large idiosyncratic shocks. Should such shocks occur, moreover, they could still be met by using fiscal policy. If Britain adopted the euro, of course, it would be subject to the fiscal constraints of the Maastricht Treaty and the Stability and Growth Pact. But those constraints are unlikely to bind if Britain continues to follow a prudent fiscal policy. It will still have the leeway to run budget deficits when economic activity slows.

Furthermore, adopting the euro will reduce Britain's vulnerability to the macroeconomic shocks that are the by-products of exchange-rate fluctuations. Textbooks still tell us that a floating exchange rate insulates a country from external shocks. But that is true only when the exchange rate is driven by goods-market shocks impinging on trade flows. It is utterly untrue when, as now, the exchange rate is driven by asset-market shocks, including shifts in expectations about the future path of the exchange rate itself. On several occasions, indeed, an overly strong pound has caused sharp contractions in Britain's industrial output.

As a member of the euro area, Britain would still be exposed to fluctuations in the dollar-euro rate. But it would enjoy more exchange-rate stability, measured in terms of the trade-weighted value of its currency. The *actual* value of its currency, shown in Figure 1, has fluctuated more sharply and widely than the *hypothetical* value of its currency, which is the one that would have obtained if the euro had made its debut in 1986 and Britain had adopted it immediately.

The European Central Bank (ECB) has been widely criticized. Its definition of price stability is asymmetric, unlike the one used by the Bank of England. It has been somewhat slow to make interest-rate changes. It waits for its Governing Council to reach consensus, whereas the Bank of England and the Fed-

eral Reserve make decisions by simple majority voting. Nevertheless, one recent study finds that the ECB's recent decisions have not differed appreciably from those that the Federal Reserve would have made if it had been meeting in Frankfurt.[3]

It is worth noting, moreover, that the strategies and practices of the ECB are of its own making. Apart from the basic commitment to maintain price stability, they are not imposed by the Maastricht Treaty or by the member governments. The ECB has been reluctant to tinker with them, because it tends to equate continuity with credibility. But change will come, though slowly.

THE EURO AND THE CITY

London is by far the most important financial center in Europe. But the pound has little to do with it. Consider the currency composition of trading in London, the world's largest currency market. The U.S. dollar was the dominant currency; it was involved in 92 percent of spot, forward, and swap transactions (see Table 1). That's not surprising; the dollar is still the world's premier currency. But the euro also outranked the pound; it was involved in 41 percent of all transactions, compared with 24 percent for the pound.

The euro also has catalyzed the rapid growth, integration, and consolidation of financial markets in the euro area, and that process will continue. It may indeed produce concentrations of trading and talent that challenge the preeminence of London. Adopting the euro will not fend off that challenge but is a far better defense than retaining the pound.

TIME MATTERS

What can be said for waiting longer, to see how the euro fares? It could be quite costly, because big changes must made in the organization of the ECB.

A dozen more countries will seek to join the euro area before the end of the decade, and the ECB's Governing Council has to be restructured. It now has eighteen voting members—the six members of its Executive Board and the twelve governors of the members' national central banks. It is already too large and must not get larger if it is to function efficiently.

The Nice Treaty acknowledged the problem but did not resolve it, and various schemes have been proposed. The most radical scheme would shift decision-making powers to the Executive Board, depriving the national central bank governors—including the Governor of the Bank of England—of any future role in making monetary policy. The decision regarding reform will be made by all of the EU governments, but Britain's influence will be reduced if it has not yet decided to adopt the euro.

Table 1
Daily Currency Trading in London

Currency Pair	US$ billions	Percent
Dollar-euro	170.0	33.7
Dollar-sterling	102.1	20.2
Dollar-other	189.9	37.6
Euro-sterling	17.1	3.4
Euro-other	20.2	4.0
Sterling-other	3.6	0.7
All other	1.5	0.3

Source: Bank of England survey, April 2001

During the next few years, moreover, the ECB will acquire the experience and confidence required to reform its policies and practices. But it will then be slow to alter them again. Hence, Britain should join soon. It should not stay outside, waiting for perfection, but should get inside, working for improvement. ◆

NOTES

1. Alejandro Micco, Ernesto Stein, and Guillermo Ordoñez, *The Currency Union Effect on Trade: Early Evidence from the European Union* (Washington, D.C.: Inter-American Development Bank, 2002).
2. Richard Layard, Willem Buiter, Christopher Huhne, Will Hutton, Peter Kenen, and Adair Turner, *Why Britain Should Join the Euro* (London: Britain in Europe, 2002).
3. David Begg, Fabio Canova, Paul De Grauwe, Antonio Fatás, and Philip R. Lane, *Surviving the Slowdown: Monitoring the European Central Bank* (London: Centre for Economic Policy Research, 2002).