Student Economic Review, Vol. 22, 2008

SPLENDID ISOLATION: BRITAIN'S PAST, PRESENT AND FUTURE IN RELATION TO THE EUROPEAN MONETARY UNION

DAVID MADDEN

Junior Sophister

Was it politics or economics that kept Britain from joining the single currency? David Madden presents a brief monetary history of Europe since the First World War, and examines the question of Britain's dedication to the European project. Although it may have made economic sense to remain outside in the past, he suggests that the time is now right for Britain to join the single currency. However, he concludes that the eurosceptical attitude of the British public remains too great an obstacle, leaving economics to take a backseat to politics.

Introduction

Britain's committment to the ideals of the European project has always been in question. This lack of enthusiasm for integration was evident in the 1991 decision to obtain an opt-out clause from the Maastricht Treaty, which stated that it was not bound to join the monetary union. This allowed it to keep full control over monetary policy and avoid having to adopt the euro as its currency. Through insisting upon this opt-out clause, Britain has undoubtedly distanced itself from the rest of Europe. Of course this is nothing new in British history. In the late 19th century the British government, under the premiership of Benjamin Disraeli, followed a foreign policy known as 'splendid isolation' in relation to Europe. This involved keeping Britain firmly out of European affairs by not committing her to any of the alliances of great powers that were being formed at the time. It is this essay's intention to examine why 'splendid isolation' has become the defacto policy of the British government in relation to the European Monetary Union. The history of monetary integration in Europe will be discussed, followed by and examination of the rationale behind the formation of the EMU. This essay seeks to discover why Britain opted out, and questions whether Britain was correct in this decision by analysing developments since 1999. Finally there is a brief discussion of whether we can expect to see Britain's 'splendid isolation' from the EMU continue into the future.

A Brief History of Monetary Integration in Europe

The idea of monetary integration between European countries only became plausible following the collapse of the Bretton Woods system in 1973. Under this arrangement, gold was the ultimate source of value, with the dollar being the only currency directly tied to it. All other currencies were defined in terms of the dollar. High levels of inflation during the late 1960's and early 1970's forced the USA to suspend the dollar's gold convertibility in 1971 and devalue it by 10%. This led to a wave of exchange rate realignments designed to restore order to the system. Unstable currency markets and a lack of credibility in the system led to the decision in 1973 to abandon the 'fixed but adjustable' principle. This effectively meant that each country was free to choose its own exchange rate regime.

Europe's early and rapid reaction to this new system charted the path that would lead to a monetary union three decades later (Baldwin and Wyplosz, 2004, 2006). The 'European Snake' was formed to curb intra-European exchange rate fluctuations. It quickly collapsed due to the failure of a number of countries, including Britain, to keep inflation in check. What followed was the establishment of the European Monetary System (EMS) in 1979. At the centre of the EMS was the Exchange Rate Mechanism (ERM) whose stated purpose, according to the Council of Ministers, was to establish 'a greater measure of monetary stability in the community' through the joint management of fixed and adjustable exchange rates.

During the first ten years of the EMS, Eurpean inflation rates diverged markedly and realignments were a frequent occurrence. The transparent process of exchange rate realignments meant that the foreign exchange markets in EMS countries were subject to frequent speculative attacks. The only way to prevent such turmoil and uncertainty was to reduce inflation differentials between countries. Thus more and more countries took to emulating the monetary policy of Germany, as the largest country with the lowest rate of inflation in the EMS. In effect, the Bundesbank became the centre of the European monetary system. This however didn't prevent another series of speculative attacks in 1992 and 1993 which nearly destroyed the EMS and forced the margins of fluctuations to widen to ±15%. The EMS is still in existence but it now acts as a half-way house for member states seeking to gain entry into the EMU.

The EMS had always been seen as a preliminary stage in the EC's progress towards monetary unification (Davies, 1989). The fall of the Berlin Wall in 1989 had given the then President of the European Commission, Jacques Delors, the perfect opportunity to propose forming a monetary union. After lengthy negotiations the Maastricht Treaty was agreed upon in 1991, which committed the EU to forming a monetary union by 1999 and adopting a single currency by 2002. The establishment of the European Monetary Union represented a massive pooling of sovereignty between the eleven original member countries. It required members to transfer their control of national monetary policy and interest rates to the European Central Bank in Frankfurt, as well abandon their national currencies in favour of a new single European currency. There existed both an economic and a political rationale for the formation of the EMU. Economic motives included:

> 'enhanced monetary stability, improved spatial and industrial allocation of resources, boosted competition because of transparent prices, deepened integration, reduced transactions costs, access to wider markets, gains from economies of scale and from trade, as well as gains that come from harmonisation of policies' (Jovanovic, 2005: 119).

Political impetus centred on France's deep-seated fears that the reunification of Germany would lead to a return to German militarism. In their opinion this could only be prevented through an increase in the forces that tied Germany to Europe.

Britain's Opposition to Monetary Integration

Britain, along with other EU15 members Sweden and Denmark, has thus far chosen to opt out of EMU. But this is nothing new, it's attitude towards monetary integration in Europe has always been lukewarm at best. Although a member of the EMS, it refused to participate in the ERM until 1990. The main reason for this lay in the fact that Britain's rate of inflation was far above that of the European average. Had Britain entered into the 'fixed but adjustible' system of bilateral parities, sterling would have been forced into numerous exchange rate realignments in order to maintain trade competitiveness within the system.

However, by 1985 the rate of inflation in Britain was temporarily below the European average and it seemed to many, including the Chancellor of the Exchequer, that the time was right for sterling membership (Davies, 1989). Yet there were two obstacles to such a course of action. Firstly, sterling's position as a petro-currency remained important, prompting the government to argue that it would be both awkward and inappropriate to join the system at a time of greatly fluctuating oil prices (Davies, 1989). Secondly, most calculations showed that sterling was slightly overvalued against the Deutschmark. It was thus thought foolish to lock in such a high real exchange rate at a time when North Sea oil production was reaching it's peak, and when a downward trend appeared to be developing in the real price of energy (Davies, 1989). Both of these obstacles, coupled with Mrs. Thatcher's innate fear of being seen to cede British sovereignty to Brussels, succeeded in keeping Britain out of the ERM until 1990. By this stage it had become a political necessity for Britain to join, as failure to do so would seriously damage its chances of playing a constructive and active part in the negotiations surrounding discussions on monetary union (George,1990, 1994, 1998).

It was generally considered by observers that John Major had achieved quite a diplomatic and political success by obtaining the British opt-out from monetary union. Public opinion in Britain was firmly behind such a decision due to commonly held anxieties relating to both economic performance and sovereignty. Historically Britain had tended to be out of line with it's European neighbours when it came to economic cycles. There existed a fear in Britain that it might find itself in recession while the rest of it's partners were overheating, and consequently would be subject to a restrictive and wholly inappropriate monetary policy (Davidson, 1996). Counter-arguments pointed out that the impending formation of the Single Market would smooth out such cyclical disparities. However for most Britons forming a monetary union before the Single Market had even proved to be successful was too big a risk to take.

Abandoning the power to introduce a competitive currency devaluation was another source of disquietude in Britain. If the rate of productivity growth in Britain were to be consistently lower than in the other EMU nations, or if increases in unit wage costs were to be consistently higher, it would be unable to compensate by devaluation and its loss of competitiveness would be reflected in a politically intolerable increase in unemployment (Davidson, 1996). Other economic concerns included the politically independent nature of the proposed European Central Bank. The opinion of many was that such independence could only work well in a country such as Germany where there was a deep political and social commitment to the objective of low inflation (Davidson, 1996). In contrast, the population in Britain were less committed to low inflation and placed far greater emphasis on political accountability. The notion of having an unelected bureaucracy controlling monetary policy did not sit well on the British conscience. However, such economic concerns were minor in comparison to the widely held fear that joining the EMU would be the first step towards becoming part of a political union in Europe. The British public fiercely opposed any perceived attempts to erode it's proudly held sovereignty. In their eyes, adopting the euro in favour of the pound and transferring control of monetary policy to Frankfurt, would be the beginning of the end for British independence. Such narrow and uncompromising views were fuelled to a large degree by the virulent eurosceptical media.

Was Britain Correct to Opt Out of the EMU?

The answer to this question seems to be yes, but there are a number of mitigating factors to take into account. Since 1999 economic growth in Britain has far exceeded that of the Eurozone as a whole. Average growth in Britain has been 2.8% compared to 2.14% for the Eurozone (European Commisssion 2004). Between 2000 and 2005 interest rates in Britain averaged 4.87% compared to 4.48% for the Eurozone (ibid). Britain's inflation levels were much lower in the same period averaging 1.35% in comparison to 2.17% for the Eurozone as a whole (ibid). These simple statistics highlight a number of significant issues. Firstly Britain's economic cycle does indeed appear to be out of line with the rest of the Eurozone. Since the establishment of the EMU, it's growth has far outstripped the rest of Europe. In the event that it had transferred control of monetary policy to the ECB, it's economy would have been far more likely to overheat due to the unsuitably low interest rates that have existed in the Eurozone over th relevant period. However, it is worth noting that the British economy is one of the largest economies in the EU. Had it been part of the Eurozone, it would have had considerable influence over decision making in the ECB. This would have allowed it to push interest rates up above the level they were at between 2000 and 2005. Furthermore, the experience of Eurozone countries, such as Ireland, which experienced above average growth demonstrates that the negative effects of an inappropriate monetary policy are not nearly so great as first thought.

Has Britain's Attitude Towards the EMU Softened?

Although Britain does not apeear to have suffered economically by remaining outside the single currency, there exists a 'wait-and-see attitude' towards the EMU. When he was appointed Chancellor of the Exchequer in 1997, Gordon Brown devised five economic tests for assessing whether it was in Britain's interest to join the Eurozone. These tests related to the following: economic convergence with the Eurozone, sufficient flexibility to adapt, impact on jobs, effect on financial services and influence on foreign direct investment. After publishing 18 detailed studies and a lengthy assessment on British membership of the Eurozone in 2003, the Treasury's answer was 'not yet' (Jovanovic, 2005). It was found that the convergence and flexibility criteria were not fulfilled, that the investment and financial services tests were met, and the fifth test would be met when the first two were met.

Many commentators feel that the question of Britain remaining outside of the EMU ultimately hinges on the flexibility test. Christopher Swann wrote: 'Flexibility would be Britain's insurance policy inside the Eurozone' (The Financial Times, June 2003). Considering Britain has one of the most flexible labour markets in the EU, should it not be sufficiently flexible to join? Christopher Swann summed up the argument against this assertion by writing: 'If the Eurozone suffered an economic shock and other nations adjusted more slowly than the UK, the Treasury argues, monetary policy would become inappropriate for the UK' (ibid). Mr. Brown clearly believes that Britain will only be able to join the Eurozone when all of the EMU member countries are able to able to adapt effectively to shocks in the EU.

A second source of hesitation, apparent since 1999, involves the exchange rate issue (De Grauwe, 2007). The pound sterling has experienced strong cyclical movements against the euro. Between 1995 and 2000 it experienced a strong appreciation relative to the euro. From 2000 to 2006 this was partially reversed. Joining the EMU when sterling was in such a strong position relative to the euro, would have saddled Britain with low competitiveness and would have put downward pressure on economic growth.

Is the Time Now Right for Britain to Join?

After assessing Britain's past and present in relation to the EMU, it is now necessary to discuss the possibility that Britain will join at some point in the near future. It can be argued that the time is right for Britain to take its place as one of the dominant economies within the EMU. The success of the Single Market in facilitating labour and capital flows within the EU has meant that Britain is more economically tied in than ever to rest of Europe. This should lead it's asynchronous economic cycle to closer conformity to those of the rest of Europe. Labour market reforms in both France and Germany should also enhance the flexibility of the Eurozone as a whole in respond to shocks. Furthermore, the existence in Britain since 1997 of an independent Central Bank should facilitate the transfer of monetary sovereignty to the ECB, and lessen the culture shock to the British electorate. Sterling's depreciation in recent months in relation to the euro is another reason why it is in Britain's interest to join. Since November 2007 the pound has fallen by nearly 9% against the euro- a rate of decline not far off that experienced during sterling's enforced exit from the ERM in 1992, when it dropped 11% against the Deutschmark. By joining now, Britain could enhance its competitiveness and boost economic growth.

If all of these reasons were not sufficient to suggest that the time is right for Britain to join, the global credit crunch of recent months provides further justification for this argument. Among central banks, only the Bank of England took no contingency measures in August when the crisis erupted. This seriously calls into question its ability to adequately deal with the effects of global shocks on the British economy. Its failure to provide sufficient liquidity to the money markets has seriously undermined confidence in the stability of the banking system. It was this lack of liquidity that caused Northern Rock to get into so much financial trouble. In contrast, the European Central Bank provided weekly liquidity injections into money markets. This undoubtedly helped a number of European banks weather the storm more favourably.

Conclusion

There would undoubtedly be costs to Britain joining the EMU at this moment in time, but such costs would far outweigh the benefits. However, it is highly unlikely Britain will join the EMU in the short term. Anti-European sentiment still remains strong amongst Britons, clearly illustrated by the public controversy surrounding the ratification of the Lisbon treaty. Despite all of this, splendid isolation cannot last forever. The need for Europe to stand up and speak with one voice in world affairs means that EU integration will continue apace. Britain's splendid isolation from the EMU will have to cease if it wants to be at the centre of an increasingly influential and economically powerful EU.

Bibliography

Baldwin, R. and Wyplosz, C. 2006. *The Economics of European Integration*. London: McGraw-Hill Education.

Davidson, I. 1996. *European Monetary Union: The Kingsdown Enquiry: The Plain Man's Guide and the Implications for Britain*. London: Macmillan.

Davies, G. 1989. *Britain and the European Monetary Question*. London: Institute for Public Policy Research.

European Commission, 2004. 'European Economy: EMU after 5 years. Special Report'. No.1.

de Grauwe, P. 2007. *Economics of Monetary Union*. Oxford: Oxford University Press.

George, S. 1998. *An Awkward Partner*. New York: Oxford University Press.

Jovanovic, M. 2005. *The Economics of European Integration: Limits and Prospects*. Cheltenham: Edward Elgar.

The Financial Times. 2003. *Euro Decision the Five Tests: Brown reluctant to accept similar risks for labour market as eurozone states*. 10/06/2003.