Tony Thirlwall is Professor of Applied Economics at the University of Kent at Canterbury. He is the author of several books and articles in the field of growth and development, and has been an adviser in several developing countries.

THE FOLLY OF THE EURO[a]

Tony Thirlwall

In May, 1998, a decision was reached on eleven countries eligible to join the European single currency to be introduced from 1st January, 1999, with exchange rates irrevocably locked, and to be brought into physical existence in 2002 when from the 1st January of that year euro notes and coins will start to circulate and from July 1st national currencies will disappear. The United Kingdom decided not to join for the time being, and wisely so in my view, but the government has promised a referendum on the issue when it thinks the time is right to join. In fact, it makes no economic sense to say 'when the time is right' because countries can never know what economic conditions may prevail in the future which require the use of the very weapons of economic policy that countries joining the single currency will all surrender: namely, the exchange rate, monetary policy and fiscal discretion.

The fact that the countries joining the euro have met certain convergence criteria is irrelevant to the economic prospects of the countries in the future. The convergence criteria relating to inflation, exchange rate stability, interest rates, budget deficits, and government debt are all monetary in nature, but there is no guarantee that monetary convergence will generate the *real* convergence of the countries of Europe. On the contrary, the very opposite is likely to be the case, that real convergence requires monetary *divergence*. The two major economic variables that determine a country's economic performance and the lives of ordinary people are the growth rate of output and the level of unemployment. Already in Europe, there are large differences between countries, and between regions within countries, in standards of living, unemployment and growth performance, made worse in recent years by the pursuit of the monetary convergence criteria themselves. Now the situation will be made more problematic by countries that adopt the euro abandoning all the traditional instruments of economic policy-making, as if suddenly they are deemed to have lost their relevance. This I call 'the folly of the euro'. So what is the purpose of this venture?

For some, the purpose of the single currency is to further promote trade in Europe by reducing transaction costs and avoiding exchange rate fluctuations. It can be said right away that there is no firm empirical evidence to show that multiple currencies and exchange rates discourage trade. Where financial markets are well developed, traders hedge against currency fluctuations. For more than forty years since the War, and particularly since the Treaty of Rome was signed in 1957, trade in Europe had grown and flourished with multiple currencies, and it will continue to do so without the euro. Indeed, now that trade barriers between EU countries have all but disappeared the major determinants of trade will be the increased specialisation of

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countries and the growth of output itself. If the single currency creates a deflationary zone in Europe, which I believe it will, the euro will jeopardise trade. It could even give rise to protectionist sentiment. Of course, there will be some savings of transaction costs, but they will be small beer compared with the potential costs to countries of the loss of economic sovereignty.

If the purpose of the single currency is to complete the Single Market Programme initiated in 1986, again there is no reason why the lack of a single currency should impede the dismantling of non-tariff barriers to trade and the free mobility of the factors of production, labour and capital, if such mobility is thought desirable. Labour mobility depends on job opportunities, transport costs, housing availability and language barriers, not on whether currencies have to be changed across national frontiers. The determinants of capital movements in a single currency area are more intriguing. Without speculative opportunities and interest rate differentials to take advantage of, my guess is that there will be a switch of capital from intra-European flows to increased flows between Europe and other parts of the world. This will pose problems for the stability of the euro and, by implication, for interest rate policy to secure external equilibrium if the new European Central Bank in charge of monetary policy pursues an exchange rate target. If the desire is to maintain a strong euro, partly as an anti-inflationary device and partly to compete with the dollar as a reserve currency, interest rates could rise and remain high exacerbating the internal problems of already depressed economies.

The argument that a single currency is necessary for the completion of the Single Market is, in fact, the reverse of the traditional theory of optimum currency areas which is that an optimum currency area depends itself on the degree of factor mobility. Where mobility is low, particularly labour mobility, a single currency will not be optimal because large pockets of unemployment may persist which reduces welfare. This, in turn, presupposes that factor mobility is always equilibriating. I don't believe this myself. When migration of the factors of production takes place from depressed to more prosperous regions, it tends to set in train cumulative forces which reinforce the initial equilibrium. Demand falls in depressed regions and expand in prosperous regions. Firms, when they take decisions on where to locate, prefer locations where other activities are also located (to capture external economies of scale) and where the market is expanding fastest, unless induced to go elsewhere by generous subsidies. This is the essence of the regional problem in all countries, and the rationale for regional policies. All regions, and countries for that matter, are functioning in the presence of strong centrifugal forces which make the strong stronger and the weak weaker, and the rich richer and the poor (relatively) poorer. Thus, even if a single currency was an aid to the mobility of the factors of production, factor mobility cannot be regarded as a panacea for depressed regions or countries that have no weapons of economic policy to protect themselves. After decades of migration from the north to the south of Britain, and from the south to the north of Italy, the regional divide in these countries is as pronounced as ever.

Beyond the realms of economics, for many who support the single currency the purpose is political; to promote political union leading ultimately to a United States of Europe to avoid once and for all the prospect of internecine conflict that for centuries has plagued the countries of Europe. This was the vision of the founding fathers of the European Community, and is undoubtedly the game-plan of Chancellor Kohl and other political heavy weights in Europe who have been the driving force behind the various stages of EMU. We can all unite behind the desire for peace and co-operation in Europe, as we can behind the virtues of motherhood and apple pie, but the euro as the route to political union, even if that is desirable, is fraught with danger, and could just as well lead to the economic and political disintegration of Europe. Political wishful thinking often has the nasty habit of driving out economic common sense. The dangers are manifold.

Firstly, the single currency is profoundly undemocratic with the European Central Bank subject to no democratic accountability. Monetary policy will be determined by a group of unelected central bankers who will decide the short term interest rate that will apply across the whole of the single currency area regardless of individual country circumstances. The long rate of interest may vary somewhat according to the riskiness and maturities of assets, but for all intents and purposes lenders and borrowers will face the same rate whether in Madrid, Munich or Milan. Casual observation of the political mood in Europe suggests that this is not what the people want. The citizens of Europe are increasingly looking for more democratic control over their own economic destiny, and understandably so. The Scots and Welsh have recently voted for their own Assemblies; the Lega in northern Italy continues to attract strong support, and the unemployed in France are tired of having their lives dictated by the Bundesbank in Frankfurt. The single currency is being launched despite massive popular opposition to it in some of the affected countries. The regional disaffection that will be caused by deteriorating economic circumstances in countries that lack the policy instruments to deal with economic crisis can too easily become the breeding ground for nationalism and fascism and political resentment, as witnessed in Europe in the 1920s and 1930s. It seems that those who ignore history are bound to repeat it. By all means, let there be more co-ordination of economic policies in Europe, and let the countries of Europe strive for greater co-operation in areas such as defence, human rights and relations with other countries, but not by luring countries into an economic straightjacket over which there is no democratic control and from which there is no escape. This is a recipe for political turmoil and the fragmentation of Europe.

Secondly, the single currency means the abandonment of all the traditional weapons of economic policy that in the past have served countries reasonably well. This makes no economic sense, or therefore political sense. It is hard to imagine how the countries of Europe would have fared in the post-War years without the active use of monetary, fiscal and exchange rate policy. There would have been economic anarchy. Let us consider these policy instruments in turn. As indicated already, the euro implies one interest rate for all participating countries regardless of the economic circumstances of individual countries. This can only be described as the economics of the mad-house. The interest rate is a powerful weapon for influencing the level of economic activity, and particularly the balance between consumption and investment. There is no reason to suppose that the economic cycles of countries will ever be synchronised sufficiently that all countries require the same interest rate at the same time in order to regulate the level of economic activity or the rate of inflation. For real convergence, some countries also need to grow faster than others which means encouraging investment at the expense of consumption. This, in turn, requires lower interest rates in some countries than others. The interest rate decided by the European Central Bank will be some compromise rate which suits no one country in particular, designed primarily to target a European-wide inflation rate when the trade-off between inflation and unemployment also differs between countries, so that the cost of price stability in one country may be twice or three times higher than another in terms of unemployment. Individuals within the nation states of the single currency area will no longer be able to decide for themselves whether they would like their economies to expand or contract. Their livelihoods, the prices of their goods, their house prices and mortgage rates will be decided for them. Disenfranchisement is the route to revolt.

Then there is the issue of fiscal policy. The ability to vary taxes and government expenditure and to run budget deficits are also powerful weapons of economic policy. At the Dublin Summit in 1996, however, a stability pact was agreed that countries joining the single currency should not run deficits of more than 3% of GDP, without incurring a fine of 0.2% of GDP and 0.1% of GDP for every one percentage point of deficit over the 3% limit. The economic illiteracy of officials that could dream up such a mechanical formula for punishing apparent profligacy beggars belief. If the deficit itself results from a recessionary shock, the stability pact will compound the deflation, and the fine in such conditions would make the deficit even worse. At the very least, cyclical deficits need to be separated from structural deficits, as is already done for countries by the OECD.

Now we come to the exchange rate. Rates of exchange between countries that adopt the euro will, of course, disappear at a stroke when national currencies cease to be the legal tender from 1st July, 2002. For all practical purposes, however, the exchange rate as an instrument of economic policy will disappear from 1st January, 1999, when exchange rates become irrevocably locked. While exchange rates disappear, however, imbalances between exports and imports will not. When plans to import exceed plans to export, the exchange rate will no longer be there to take the strain, and balance of payments problems will manifest themselves not in the form of a depreciating currency which encourages exports and discourages imports, but as falling output and employment and higher unemployment. Regional problems within countries of slow growth and high unemployment are essentially balance of payments problems which, by definition, cannot be alleviated by exchange rate movements because regions within a country are already part of a single currency area. Likewise, a single European currency will *de facto* turn the countries of Europe into regions as defenceless as regions within countries with the added disadvantage that the European-wide budget to cope with pockets of deprivation and unemployment is far smaller in relation to the size of areas likely to be affected than the size of national budgets in relation to the regional problems of countries. There is no built-in mechanism for the automatic transfer and redistribution of resources between countries, as there is, for example, between States in the USA. I would concede that the exchange rate is of limited use in permanently raising the growth rate of a country, unless it can engineer a continual depreciation in the *real* exchange rate, but it remains an invaluable weapon to combat internal and external shocks, or gradually deteriorating competitiveness. Who knows where the shocks to countries will come from in the future, and how they will affect countries differentially, as they surely will? The consequences of a single currency (equivalent to exchange rate lock-in) in the face of a deterioration in competitiveness could be serious damage to the real economy, which means a loss of output and jobs.

Europe for at least the last decade has already been one of the most stagnant regions of the world economy with the growth of output averaging no more than 2% per annum and unemployment averaging more than 10% of the labour force. The pursuit of monetary union is mainly responsible. The stagnation looks like continuing with the launch of the euro. Interest rate policy is likely to be set to keep inflation below 2%, regardless of the level of unemployment, and to keep the exchange rate strong so that the euro can compete with the dollar as a reserve currency which it has the possibility of doing with EU trade accounting for over 20% of world trade and exchange reserves of \$350 billion (compared to \$50 billion in the US). The fiscal stability pact, if it is adhered to, will compound the deflationary tendencies. Nowhere in the pacts and conditions governing EMU and the single currency are there any safeguards against deflationary policies, such as governments running budgetary surpluses or other policies leading to falling prices or rising unemployment. The 'rules of the game' are asymmetrical, biased against inflation, as indeed they are at the international level whereby the International Monetary Fund penalises countries in balance of payments deficit but not countries in balance of payments surplus which therefore imparts deflationary bias in the world economy. Most euro-sceptics are not Keynesian economists, but even they might concur with Keynes's famous quote 'that it is worse in an impoverished world to provoke unemployment than to disappoint the rentier'. In the conditions now prevailing in Europe, it is hard to disagree.

The economic future I have painted for the euro-currency area is bleak, but I see no redeeming features, except small savings for businesses and tourists in exchanging currencies. The economic and political risks are enormous for such trivial gains. What regions and countries require as far as possible are individually tailored policies suited to their own particular needs. This is the direction in which economic policy-making ought to be moving for economic success and a more harmonious Europe, not the opposite of making one suit to fit all sizes. It won't work and could do irreparable damage to the cause of European integration.

As far as the United Kingdom is concerned, the promised benefits of ever-closer union with the rest of Europe have always been exaggerated. When there was a referendum on the Common Market in 1975 on whether the UK should accept the revised terms of membership, I (along with seven million others) voted against, not because I am anti-European in a petty nationalistic sense, but because I thought the new terms would still damage the country's long term interests. I believe the scepticism was justified. It is very difficult to demonstrate that the UK has benefited significantly from full membership of the European Community. The trading benefits could have been obtained from associate status without signing up to the Common Agricultural Policy and other arrangements that have made the UK one of the largest contributors to the European Commission budget. It was much to the credit of Mrs. Thatcher that she renegotiated our budgetary contribution, but it is still not widely appreciated that each family of four in the UK pays, on average, £1000 per year more for food than if the same products were bought on the free market. Even on the trade front, our European partners have penetrated the UK market much more successfully than UK producers have penetrated European markets with the consequence that massive trade deficits have arisen which have contributed significantly to the de-industrialisation of Britain. The growth rate of output since joining the Community in 1973 has not been the miracle promised in the various government White Papers published prior to entry. The average growth rate since 1973 has been no more than 2% per annum, lower than in the period 1950 to 1973, and reduced, of course, by the deep recession between 1990 and 1992 as a consequence of locking the pound sterling into the European Exchange Rate Mechanism (ERM) at an uncompetitive rate. That in itself should be a salutary warning to those pressing Britain to abandon the pound sterling and to adopt the euro as soon as possible.

Outside the confines of a single currency area, Britain has a wonderful opportunity to become the economic success story of Europe. There is no reason to suppose that trade, inward investment or the City of London would be adversely affected by staying out. At the 1998 World Economic Forum in Davos, Switzerland, countries of the world, including those of Europe, pointed with admiration at the growth performance of the British and American economies over the last few years. What matters above all for the economic performance of nations is sensible macroeconomic policy underpinned by solid micro-foundations. Macroeconomic policy *mismanagement* can easily negate the benefits of any microeconomic reforms. This was no more evident than in the UK in the early 1980s when despite some very sensible supply-side reforms, misguided macroeconomic policies completely nullified their effects leading to over 3.5 million unemployed in 1985. This should be a warning to the European Union, where unemployment averages over 10%, that no amount of reforming labour markets and reducing market imperfections will create jobs if there is inadequate demand for labour in the system. Europe urgently needs a growth strategy which will not be delivered by the euro.

If Britain retains control of its own exchange rate, and is able to decide its own interest rate and fiscal policy, it has the prospect of continuing the economic performance of the last four years. To sign up to the euro, and to lose control over the weapons of economic policy, would in my view serve no useful purpose. It would be churlish to wish the euro ill, but I fear it is going to do great damage to the economies of Europe and to the noble objective of greater European harmony and co-operation. The United Kingdom government would do well to steer clear of this risky venture for more than the lifetime of the current parliament.