BRITAIN, IRELAND AND EMU: the currency dilemma

By Brendan Halligan

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The prospects and timetable for EMU

The Maastricht Treaty laid down a timetable and set criteria for the establishment of what might more properly be called Monetary Union. The timetable is well known. It will come into effect in 1997 if a majority of the Member States comply with four conditions. Should no majority exist at that point, then monetary union will automatically come into existence two years later and is to consist of those Member States who satisfy the criteria. These too have entered the realm of the familiar; interest and inflation rates which approximate to the European average, a current budget deficit less than 3% of GDP and a debt to GDP ratio of 60% or less.

The four criteria reflect the priorities of the Bundesbank which is required by the Basic Law to protect the value of the D Mark. For perfectly understandable reasons, a sound monetary policy is the overriding policy aim of the German Central Bank and it used the full weight of its influence to impose German domestic objectives on the European Union in framing the preconditions for Monetary Union.

The other Member States had no option but to comply, given that the European exchange rate system was a D Mark area in consequence of long term German success in the pursuit of a strong currency policy and the corresponding failure of the great majority of Member States to do likewise. Putting it simply, perhaps harshly, the Maastricht Treaty was an invitation to other currencies to adhere to the D Mark on conditions laid down by the German authorities. Failure to accept would have resulted in no treaty, since the Germans would have refused to forego the stability and security of the Bundesbank regime for the uncertainties of a European currency infected by the weaknesses of sterling, the lira or the other minor (and weaker) currencies.

This analysis leads to a conclusion which is self evident but little discussed in public debate. The Germans, in particular the Bundesbank, hold a veto over monetary union. It cannot happen without them and it can only happen on their conditions. All other Member States have Hobson's Choice.

Public sentiment in Germany is strongly against giving up the D Mark, as opinion polls repeatedly confirm. Yet, at the same time, the political elite is strongly committed to the achievement of monetary union for higher political reasons, such as those spelled out with unusual honesty in the CDU/CSU paper of Summer '94.

Monetary Union is seen clearly as the necessary platform on which to construct political union. In fact, it is seen as indispensable. Political union is seen, in turn, as the essential precondition for the security of a united Germany which finds itself unexpectedly at the geographic heart of Europe, with its Eastern borders thrust yet again into a zone of instability and uncertainty. The enlargement of the Union to encompass the states of Central and Eastern Europe and the simultaneous creation of a political union involving common defence are therefore part of a grand strategic design to ensure the security of the New Germany. Accordingly the three building blocks on which the strategy is designed consist of monetary union, enlargement and political union (which, in turn, encompass a defence union). From a German perspective it is hard to refute the logic of this strategy.

The problem for Germany is that other Member States are slow to recognise its force or even to admit its validity. The speech of Karl Lammers to the Federal Trust in mid November 1994 reflects this German dilemma of how to convince their fellow EU members of the necessity for this grand design and at the same time to reassure their electorate that monetary union is part of a greater good.

It is in this context that the prospects of monetary union must be evaluated. Essentially it is an integral part of a coherent German strategy to satisfy the security needs of a united Germany. It will, nevertheless, be constructed on terms which the Germans have voluntarily imposed upon themselves for over four decades and which they now intend to impose on others. The problem for other Member States, and more especially for the markets and for business generally, is that this grand design is little understood and consequently the prospects for monetary union are being evaluated on only partial information and an incomplete set of criteria.

The result is that both markets and business are reacting to the prospects of monetary union in economic terms, whereas the fundamental motivation of Germany is essentially political. British media, and the market in particular, are sceptical of both the desirability and practicability of the Maastricht ambition to lock exchange rates irrevocably by 1999 at the latest and to create a single currency some time later. These attitudes are prevalent here as well, doubtlessly because of the influence of UK media. Even in the narrower confines of economics, the prospects for EMU now look more positive than they did in mid 1994.

The position of France is pivotal in any assessment of the possibilities for monetary union. Just as it would be inconceivable to press ahead without the D Mark, it would be equally unthinkable to proceed without the Franc. The Internal Market would be shattered were France to behave as Britain in floating the Franc against the D Mark and/or to abandon the fiscal and monetary policies that have underpinned the *franc fort*. Any assessment of French economic policy, as pursued by Mitterrand and conceived by Delors as Finance Minister, must conclude that for their own strategic reasons, the French are determined to lock onto the D Mark and to follow the policy guidelines laid down by the Bundesbank.

The independence granted to the Bank of France, as required by the Maastricht Treaty on the insistence of Germany, is confirmation of that strategic intent on the part of France. The conclusion to be drawn is that German and French policies on monetary union are moving in tandem, with Germany setting the pace as well as the parameters.

Equally it can be persuasively argued that the Benelux countries are pursuing the same strategy as France. This is particularly true of the Netherlands, as a Dutch Government position paper made clear in November ’94. Not to be outdone, the Belgians have indicated their determination to accept the rigours of the D Mark regime, although with less convincing credentials. The speech by Prime Minister Dehane to the French Institute for International Relations (26 October 1994) bears this out.

The same ambition is true of the Austrians and in their case is entirely credible in the light of the fixed relationship between the Schilling and the D Mark. It could also be argued that should the Danes undertake to follow the Germans then the Kroner would be a fit candidate for membership of a monetary union whenever constructed.

This analysis leads to the conclusion that, centred around Germany, there is an embryonic core group of Member States capable of constructing a monetary union. The key question is the extent to which the political will exists. The answer would appear to be that it rests solely on Germany to decide whether or not to press the button. The weight of evidence is that they are so willing for reasons which are political as well as economic.

An immediate riposte is that political will is not a sufficient condition in itself and that economic capacity is of equal importance. It seemed doubtful in the aftermath of the ERM collapse whether the EU economies could create monetary union even by the later date of 1999 laid down in the Maastricht Treaty. Subsequent developments have led to a revision of that estimation. The European economy is recovering and the Germans have again demonstrated their extraordinary capacity to mobilise national resources in the face of a crisis which would have swamped most other countries.

The annual economic report of the European Commission for 1994 concludes that the economic upswing is so encouraging throughout the Union that monetary union by 1999 is once again feasible. This view is shared by an increasing number of continental commentators and, more importantly, by the political elites. It is always the case that economic buoyancy fuels the integration process since it gives the politicians the confidence to move ahead on the basis of a general 'feel good' factor. This interrelationship between economic recovery and political will needs to be taken into account when assessing the prospects for a move as dramatic as monetary union.

As of the time of writing, it would seem that the restoration of the economic capacity to proceed with the ambition of meeting the Maastricht deadline has simultaneously revitalised the political will to do so.

The programme of the new German government confirms that belief. It stresses the importance of proceeding with European integration and warns that those who do not wish to subscribe to that goal should not be permitted to hold back those Member States determined to go ahead. The veiled threat to the UK puts the possibility of a hard core monetary union on the European agenda and is consistent with the ideas advanced in the CDU/CSU paper referred to earlier.

There, it was argued that the future of the European Union could well lie in varying degrees of membership with those committed to all aspects of integration comprising a hard core with the others limiting themselves to whatever areas of integration they deemed most compatible with their national interests. This explicit advocacy of what is called 'variable geometry' in Euro-jargon is supported in somewhat different language by the French, who describe such a series of arrangements as a Europe of concentric circles. Lamassoure, the Minister for European Affairs, recently dismissed any suspected differences of approach as being purely semantic in origin.

Prime Minister Balladur has been slightly more opaque, but it can be argued persuasively that the French and Germans are in general agreement that the speed of the European convoy will not be determined by that of the slowest ship. The Dutch Government paper previously quoted is emphatic on the need for monetary union and accepts the necessity for a hard core.

Variable geometry in the form of a hard core EMU raises issues of almost infinite complexity. It is sometimes suggested that monetary union could be initially constructed outside of the treaties, but it would be more rational to confine the hard core scenario to the modalities of the Maastricht Treaty, with 1999 pencilled in as the most probable deadline. If it were to emerge as an actuality then all other Member States would immediately be divided into two classes; those serving an apprenticeship with the aim of eventual membership and those volunteering to remain outside.

Presumably the first category would attempt to meet the four criteria over a period of time with particular emphasis on exchange rate stability. On the other hand, those opting to stay outside would have the freedom to vary their rates and might resort to competitive devaluations, a prospect which seems to seduce some British policy makers.

It is difficult to anticipate the reaction of the hard core were that to happen, but it is inconceivable that they would long tolerate such systematic behaviour, due to the competitive requirements of the Internal Market that all participants should play on a level playing pitch. Staying out for the sake of exchange rate flexibility may well prove no more than a chimera. At this point it is appropriate to examine the UK policy stance and political prospects in some detail.

British Prospects and Attitudes

Against the background sketched out for the main EU states, the UK emerges as a singular case. There would be widespread agreement that its economy remains weak and that the long run secular decline has yet to be arrested. Societal problems are, if anything, getting worse. Furthermore, the very issue of monetary union is itself the direct cause of a political crisis affecting the Conservative Party to the extent that even if the economic capacity to join monetary union existed, the political will to do so would be lacking.

At Maastricht, agreement between the twelve on monetary union was only made possible by granting the UK an opt out on entering the third stage of EMU. That strategy has since gained in importance as a central plank in the Government's defence against its Euro sceptics and should Major continue in office, seems most unlikely to be abandoned.

At the root of conservative opposition lies a deep psychological problem which requires to be sympathetically understood by other Member States. Basic to the constitutional order of the UK is the concept of the supremacy of Parliament, the result of a long historical evolution towards a democratic monarchy. That parliamentary supremacy extends to control over the central bank and consequently over interest and exchange rates.

The prospect of yielding sovereignty to an independent national authority is anathema to the British psyche, and is even more the case when the prospective independent authority is supranational and not amenable to parliamentary control in any conventional sense. The refusal of the UK to join the EMS in 1979 was consistent with that strongly held tradition. The brief membership of the ERM under Mrs Thatcher was an aberration she immediately regretted and the return to the 'normality' of a nominally independent exchange rate was greeted with relief (and much rejoicing).

Life, being what it is, politics is always more complicated than appears at first sight. British business is naturally less wedded to the concept of parliamentary sovereignty than the Members of the House of Commons and would appear, in the main, to support membership of a monetary union for the sort of reasons originally spelled out in the *Padua Schioppa Report*.

The CBI Conference of 1994 would broadly support that judgement. In addition, the City of London remains the great financial centre of Europe and is alarmed at the possibility of being left out of what is potentially the strongest currency union in the world. The siting of the European Monetary Institute in Frankfurt is a foretaste of things to come and presages a loss of influence and business which the City hardly finds attractive. This combination of the business and financial sectors is a force which the Conservative Government will have to deal with, but for reasons of internal party unity, are likely to ignore during the run-up to the 1999 deadline.

Combined with these legitimate expressions of economic self-interest is the Labour Party expression of its political self-interest. It had previously committed a future Labour Government to membership of EMU and has not deviated from that aim despite an electoral defeat and the election of a new leader. There are at least two reasons for this policy stance. Firstly, the Labour Party is less reverent than the Tories towards the conventions of the unwritten UK constitution, although some Labour MPs are traditionalists.

Secondly, the Labour Party under Kinnock underwent a conversion on Europe, helped on by what they regarded as the excesses of Thatcherism. Membership of the EMU was seen as an antidote to the cycle of booms and recessions and as a means of underpinning Britain's place within Europe. Should a Labour Government come to power before 1999 it is virtually certain that British policy on EMU would be reversed in favour of membership. The paradox is that a left wing government would be supported in a major shift of national policy by business and finance.

In the run up to the Maastricht Treaty deadline it seems likely that sterling will remain weak rather than regaining strength. The economy still suffers from structural imbalance, its manufacturing base has been seriously eroded and the Balance of Payments remains the Achilles Heel. Medium term sustained growth significantly higher than the Franco/German average seems elusive.

A further difficulty results from the absence of any medium to long term development strategy which carries conviction, especially in solving the conundrum of how to reconcile growth, inflation and the Balance of Payments. Should the Conservative Government lose the next election, which must take place by 1997, then the normal reaction of the markets to a Labour victory might be repeated and, if so, then sterling would weaken further. In the more unlikely event of Major continuing in office, then the market reaction would be somewhat more positive.

Even in that benign scenario (as viewed by the market, but not necessarily by others) the international markets might take a more sceptical view of the British economy's long term prospects, especially if the French and German recovery is as strong as predicted and if the rest of the EU responds at a somewhat similar rate. The inherent long term weaknesses in the British economy would, in those circumstances, be exposed with even more brutal clarity than in circumstances when everybody else is doing relatively poorly. The judgement of the international markets is likely to be harsh and could well compound the negative factors identified above. Another sterling crisis might lie ahead.

As against that, long run predictions are notoriously unreliable but the weight of evidence is that no new policy elements are in sight which suggest that the long term secular decline of the UK economy (as described by Dr FitzGerald in his paper to the IEA Seminar on UK prospects and policies) can be reversed by the end of the decade.

The conclusion to be drawn is that during the run up to the third stage of EMU, the pressures on the sterling exchange rate will be downwards rather than upwards. This would have its own inflationary consequences which, in turn, could lead to deflationary policies thereby reinforcing the downward spiral. It seems reasonable to deduce that any currency, such as the Irish pound, which linked itself to sterling would suffer from the same pressures.

The Triangular Relationship

The currency crisis of 1992/93 revealed chat the Irish authorities had less freedom in managing the exchange rate than had been believed. The period between 1979 and 1992 had come to be regarded as one in which the trade dependence on the UK had been progressively reduced to the point where the shock of a sterling devaluation could be absorbed.

The markets perceived otherwise and irrespective of the validity of the arguments on which that perception was based, the reality is that it influenced their behaviour and ultimately forced the Irish authorities to devalue. The net effect was to restore the direct linkage with sterling which many had believed ended. The Irish exchange rate has more or less shadowed sterling ever since and Irish interest rates are once again a function of those in the UK. The same phenomena could be described more graphically in terms of Ireland's candidacy for the monetary union – the link between the Irish Pound and the D Mark has been broken and has yet to be restored.

The belief that Irish dependency on the UK had been brought to an end depended on an analysis of trade flows which indicated progressively lower exports going to the UK and a corresponding increase to the rest of the Union. During the national debate on exchange rate strategy in the latter part of 1992, it was increasingly argued that the trade statistics masked a high degree of dependency in terms of jobs, specifically in the more labour intensive and lower value added indigenous industries. Analyses were produced which supported this claim and were in the end broadly accepted as representing economic reality, however unpalatable.

Majority opinion among the business community was to the effect that from a competitive standpoint, the exchange rate at the end of 1992 was unsustainable. Some economists added that the dependency was even greater than at first appeared, since UK imports competed on the home market and could displace Irish products. The negative effects, it was held, extended into the services sector, such as tourism and retailing.

The main aspects of this debate were summarised in the Institute's *Maastricht – Crisis of Confidence* report (1992) and are also the subject of the Institute's project on EMU. The main conclusion of the latter (as yet unpublished) is that the degree of exposure for the indigenous manufacturing sector will be still too great over the short term to contemplate joining an exchange regime which carried the risk of another sharp sterling: devaluation of a magnitude similar to that of 1992/93.

The dependency on the British economy (whether real or imaginary is immaterial for the moment given the perception of the market) could increase rather than lessen because of political events in Northern Ireland. The peace dividend is calculated by some commentators and business people in terms of greater North/South trade. There are differences as to the extent of the possible increase, but what is not in dispute is that policy makers in Dublin will be anxious to encourage the development of an all-Ireland economy and will be reluctant to adopt measures likely to discourage or prevent its emergence.

This ambition, if pursued energetically, could push the Irish economy towards greater interdependence with the UK and perforce would work contrary to what has been an implicit policy objective since joining the EEC in 1973, i.e. to lessen the dependency on Britain by diversifying international trade to the point where its distribution between different markets corresponds to the EU norm (presuming there is one). The end result of these divergent pressures could be a classic political dilemma; the national interest in one key area of policy would run counter to that in another.

The view in Northern Ireland is sometimes expressed quite differently. The argument goes (as expressed by Graham Gudgeon at the Conference in Belfast, in October 1994, organised as part of this project) that the Northern economy is so integrated into the British economy that the potential for increased North/South trade is actually quite limited.

The size of both economies is advanced as a further argument for not expecting any significant increase in the volume of trade either way. The conclusion drawn is that a triangular relationship between the Republic, the North and Britain is unlikely to emerge to any significant extent, and that the relationships are more likely to remain predominantly bi-lateral.

At this point in the debate it would be unwise to draw any conclusions as to the economic benefits of peace. The combined view of the Northern CBI and IB EC (such as expressed to the Forum of Peace and Reconciliation in December 1994) is that potential for increased North/South trade exists and could create about 75,000 net new jobs.

The Government will have no alternative but to take account of this forecast as a political fact. For the time being, the dispute between economists will be secondary to the more general belief that opportunities have been created by the peace process, and the Government will have to react accordingly. In summary, decision makers in the Republic will be required to assess their European policy against the impact on North/South relations. This will be the case until such time as the argument about the potential of an all Ireland economy is resolved, and it hardly likely to be answered conclusively before 1999. The result, it would seem, is that for the first time since 1973, the Government will be confronted by a Northern dimension to its European strategy. The triangular relationship cannot be ignored, albeit for political rather than economic reasons.

Should Irish Economic Policy Track the UK?

The exchange rate crisis of 1992/93 and the Northern peace process raise policy issues of unexpected (and unwanted) complexity. If neither had happened then Irish strategy on European integration would presumably have followed a predictable course. The line laid down by EMS membership in 1979, support for the Single European Act and opting for membership of EMU at Maastricht, would doubtlessly have been continued by actually joining the monetary union whenever created. Indeed, the conduct of the public finances has been governed by a determination to meet the Maastricht criteria, especially the reduction of the debt to GDP ratio to 60% by 1999.

Furthermore, the authorities have repeatedly expressed their intent of entering a hard core EMU and have expressed alarm whenever it appeared that we might be excluded. This determination to be part of the EMU is consistent with a larger strategy of supporting and participating in moves towards the goal of an ever closer European Union. As a consequence of desultory popular debate on national policy towards Europe, the question of monetary union is seldom discussed in this wider context. For the purposes of this project, however, it must be presented in terms of political economy rather than economics.

On the presumption that this formulation of the issue is accurate then the question to be addressed is whether Irish policy on European integration should be continued or, differently expressed, whether the degree of dependency on the British economy is such that Irish policy makers should cut their losses and resort to tracking the UK economy, specifically the exchange rate, for reasons of competitiveness and, hence, employment? The arguments on both sides are weighty.

It is reasonable to assume that having ratified the Maastricht Treaty the signatories will put it into effect and that a monetary union will be created. This will lead inevitably to some deeper form of political union, possibly as an outcome of the 1996 IGC. The Franco/German alliance will set the agenda. Should the Conservative Government remain in power up to the point of decision then the most likely scenario is that the opt out clause in Maastricht will be invoked or that the issue of membership (and possibly of the next stage of integration) will be put to the British electorate in a referendum.

Current indications are that the proposition to join would be defeated and variable geometry would then come into play. Any Member State aligning its exchange rate with sterling would have to follow the UK in remaining outside the monetary union. If, on the other hand, the British Labour Party came to power, the likelihood is that the UK would at least join the EMU and that Ireland would not be confronted with any problem since it too would assume membership.

The scenario of greatest complexity is that of continued UK opposition to monetary union. If brought to its ultimate conclusion of the opt out, and if the authorities here concluded that the economy could not afford to run the dangers of an uncompetitive exchange rate, then Ireland would simultaneously exclude itself from monetary union as an actual or potential member, compromise its participation in a political union and submit to UK exchange policy.

It follows that the main preoccupation of Irish policy would be to maintain competitiveness with the UK by broadly following movements in sterling. This would require a regime of low inflation, high productivity and moderate pay increases and if implemented would have the positive knock-on effect of sustaining competitiveness in other European markets. There would, however, be costs.

In the first instance, they would be political. By removing oneself from the mainstream of integration, influence would be lost in the various Councils. Secondly, they would be economic by jeopardizing Irish benefits from the CAP and other transfers (this is a complicated question on which work is being conducted elsewhere in the Institute). It could also be argued that the economic cost would include slower growth as a consequence of being tied to British growth rates, but this too is open to dispute.

The argument for joining the monetary union in circumstances where the UK opted out is mainly grounded on the proposition that membership of a broadly based European Union is politically and economically more advantageous than strengthened links with Britain and some indeterminate relationship with the rest of the EU. In political terms there is an expectation that a deeper Union will move over time towards some sort of association with elements of federalism. These might include a larger budget, although this is open to argument. In any event, enlargement to Central and Eastern Europe will increase competition for existing transfers and it could be argued that membership confers a better entitlement to some quantum of the EU budget and access to settled common policies, such as the CAP.

A place at the Council table is better than none and could be used to maximise opportunities and minimise threats. Continued participation in the Single Market would also be a valuable asset in developing the export potential of the Irish economy. Hence, benefits in terms of job protection would be at the expense of losses in transfers and the political ability to defend national economic interests within the Councils of a hard core monetary and political union.

Both sides of this argument have merit and need further evaluation. At this point it would hardly be prudent to take up an irrevocable position in the light of the uncertainties in the British political system and the as yet unproven impact of the peace initiative on North/South relations. The situation should be allowed to clarify over the next two to three years before a choice is made. In the meantime, better informed public debate should be encouraged as a prelude to any decision and the period up to 1999 should be used to ensure that if the decision is required, the authorities have the freedom to take whichever option they believe best.

Conclusion

The main points of this working paper could be summarised as follows:

- monetary union seems likely by 1999 at the latest;
- it occupies a central role in German strategy;
- a core of Member States exists around which it could be constructed: Germany, France, Belgium, Netherlands, Luxembourg and Austria;
- the core group would resist attempts by other Member States to frustrate its creation;
- the economic trends are favourable and are restoring confidence in the capacity of an EU hard core to meet the necessary criteria;
- under a Conservative Government the UK will refuse to join a monetary union unless approved in a referendum;
- under a Labour Government the UK would join;
- the problem for Ireland is that markets and much of domestic business believe membership of monetary union is impossible without simultaneous British membership;
- the problem is exacerbated by the prospects of increased North/South trade should the peace initiative endure;
- this would accentuate the interdependency on the UK economy and would run counter to established Irish policy of reducing it and of staying in the mainstream of European integration;
- consequently, a strategic dilemma results for which there is no immediate solution;
- the best way forward is to allow the political situation in the UK to clarify, maintain existing domestic economic policies and seek to create the freedom of deciding one way or the other should necessity demand;
- and, finally, to encourage national debate on the complexities since it would appear that there are no cost free strategies ahead.

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