Counting the heavy cost of a single currency

ECONOMIC VIEWPOINT

Dr Gerard Lyons argues for more co-operation in Europe but warns that monetary union brings great risks and is unnecessary

I AM IN favour of greater co-operation amongst European countries but not through the straitjacket of monetary union. Sterling's membership of a single currency is not necessary for Britain's economic success. In fact it could cause problems.

The movement towards a single currency is likely to gather momentum ahead of next year's Inter-Governmental Conference. But politics cannot dominate economic fundamentals, as the collapse of the exchange rate mechanism showed a few years ago.

The economic conditions need to be right if a single currency is to be successful. A precondition for a single currency is that countries have low inflation, low budget deficits and stable currencies.

The idea of all European countries achieving these conditions is fanciful. Let's face it, Spain's or Greece's economy is never going to perform as well as Germany's. Even those economies that can converge in these areas will find it difficult to do so by 1997, the earliest date for a single currency. By 1999 convergence will be possible but only for about six of the EU's 15 members. Ironically, Britain is likely to be one, alongside Germany, France, Denmark, Luxembourg and the Netherlands.

Technical factors could also delay the process. Remember how long it took to introduce decimalisation here? Imagine combining different currencies into one. The problems are immense and will take time, even though plans are already under way to ensure a smooth transition.

At present, European currencies float, with each country adopting its own goals, such as a monetary target in Germany, or an inflation target in Britain.

To achieve a single currency two routes are possible. First, resurrecting the old ERM as a stepping stone. By next year the economic conditions could be in place for this.

However, European politicians may not be keen to allow the markets an opportunity to force another collapse in the ERM. Instead, they may want the second option — to go straight to monetary union. But only a few countries could join in so it may not be popular all through Europe. Despite this, there may be a desire to have a single currency among a few countries to begin with. So a key point is that a single currency could happen, but not immediately, and it would only consist of a few countries. Instead of being a European Monetary Union it would resemble more a Deutschmark bloc.

> **'Britain would lose the right to set its own interest rate to suit domestic needs'**

There appears to be a fear that if sterling is not a member to begin with, then Britain could miss out on something. This is wrong. Those firms trading with Europe would gain from the removal of currency uncertainty but benefits such as these would be more than outweighed by the costs.

The biggest cost is the loss of monetary sovereignty. By giving control of monetary policy to a European Central Bank, Britain would lose the right to devalue if it wished, or to set its own interest rate to suit domestic needs.

The need to respond to shocks is an important part of economic policy. And this room for manoeuvre would be removed if sterling joined a single currency. Sterling's exit from the ERM, for instance, was the catalyst for the recovery but this would not be possible within a currency union.

There would also be the risk of monetary overkill, as an independent central bank pursues deflationary policies that could keep interest rates too high for too long.

A single currency would not guarantee consistency between monetary and fiscal policy. If there was only one European-wide interest rate there would need to be an effective fiscal policy to respond to shocks.

This is a key economic and political problem. Within a monetary union, taxes between countries could not move too much out of line, as the standardisation of European VAT rates already shows.

Meanwhile, the financial markets would limit the ability of countries to boost domestic spending plans. There would still be fiscal sovereignty but the room for manoeuvre would be limited. Instead, there would have to be increasing emphasis on an effective regional fiscal policy, which effectively gives Brussels more power.

Even then it is not clear that the richer regions in one country would wish to bail out the poorer regions in another. Ironically the net result could be diverging regional economic performance between the haves and have-nots.

The single currency has also diverted attention from the key issue — the need for Europe's single market to work. This market would allow the free movement of labour, goods and capital. It would have tremendous economic rewards.

Some argue that a single currency is essential for a single market. I disagree. Different countries can trade heavily without the same currency, just look at Canada and the US. In fact a successful single market would be the best way of politicians ensuring that European economies became integrated. A successful single market would allow European unemployment to fall. By contrast, the policies required for a single currency may have the opposite effect.

A key problem of monetary union is that all the gains come at the end of the process. Then there is low inflation and low interest rates. All the costs are up front. And as we saw when sterling was in the ERM, these costs may be too high, with below trend growth and high unemployment.

● Dr Gerard Lyons is chief economist and executive director of DKB International, the London-based subsidiary of Japan's Dai-Ichi Kangyo Bank

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