

The Financial Crisis: Implications for Britain and the Euro

It is now more than a decade since the formation of the euro area currency union. The European Central Bank, located in Frankfurt, is responsible for setting interest rates and controlling the issuance of euro bank notes and coins for sixteen members of the European Union (EU). The United Kingdom is the largest EU member state not to have adopted the Euro, instead choosing to retain the pound sterling as a national currency unit, and leave responsibility for the supply of sterling and the setting of sterling interest rates with the Bank of England. British membership of the euro area appears to have fallen off the domestic political agenda, despite the strong economic and financial ties between the UK and the rest of Europe. In this article I review some of the arguments that are central to the debate over whether Britain should adopt the euro. I then focus on how the effects of the credit crunch and global recession may impact upon this debate.

The Economics of Monetary Union

The defining feature of a monetary union is the adoption of a single currency, the euro in the case of the European Monetary Union. There are two immediate and important implications of such a framework. Firstly, fluctuations in national exchange rates between member countries are eliminated. Compared to two years ago, British tourists holidaying in Spain this summer will have returned home to see hotel fees and restaurant bills paid in Euros showing up as much larger credit card bills in pounds and pence. The same is not true for their German counterparts, who pay for their time by the Med using exactly the same currency units that they receive each month as part of their pay cheque.

Secondly, monetary union implies similar interest rates across member states. Whilst in the 1990s the *Banca D'Italia* may have set much higher interest rates than the *Banque de France*, the European Central Bank now sets a single interest rate at which central banks across the Euro area make loans to commercial banks. If the interest rate in Italy were to be set higher than that in France, Italian borrowers would simply borrow Euros in France and use them to do business in Italy, rendering the higher Italian interest rate redundant. Recent work by European Central Bank researchers indicates that the single interest rate set by the European Central Bank has been associated with convergence of the long-term interest rates paid on government bonds, which in turn set the cost of borrowing for many businesses and home owners.¹ The combination of a fixed exchange rate between member countries and the imposition of a common interest rate are what economists have in mind when they refer to a loss of national monetary autonomy within a single currency area.

The arguments in favour of a single currency area are well known. Trade economists point to the savings on transactions between countries. The German tourist travelling to Spain no longer loses a portion of his or her holiday money at the foreign exchange desk. A French car producer working on orders for the Italian market no longer has to wait and see how its revenues are affected by the exchange rate at delivery date, but can instead use a guaranteed amount of euros to grow its business immediately.

¹ See 'Convergence and Anchoring of Yield Curves in the Euro Area' by M. Ehrmann, M. Fratzscher, R. Gurkaynak and E. Swanson, European Central Bank Working Paper Number 817.

Economists argue that trade between European nations has grown as a result of the lower costs of doing business.² In effect, the domestic market place for companies such as BMW or Siemens has expanded from the 80 million people of Germany to the 328 million people of the Euro area. Access to larger markets allows businesses to exploit economies of scale, which lower unit costs and increase competitiveness in a way that boosts long-term growth prospects, as well as delivering better value for money for consumers.

At a macroeconomic level, economists point to the potential for improved policy under monetary union. In the era of 16 national currencies, the prospect of currency attacks (in which investors sell a currency aggressively in the belief that it is over-valued) forced authorities such as Banca D'Italia to invest in large holdings of foreign currencies that could be used to purchase Italian lira, and supports its value in the event of attacks. These expensive foreign currency holdings are minimised under a currency union, given the reduced number of currencies vulnerable to attack. More generally, the European Central Bank pools expertise from many individual central banks, and economists have argued that the policy errors that resulted in high inflation outcomes in southern European countries during the 1980s and 1990s will be avoided under the new policy framework.

The main disadvantage associated with monetary union is the inability to use the instruments of monetary policy to achieve macroeconomic goals such as stable inflation and full employment. Whilst multiple national interest rates have been collapsed to just one in the euro area, the same is not true for inflation rates and unemployment rates. This tension leads to the prospect of very inefficient macroeconomic outcomes across countries.

In order to see argument at hand, consider Figure 1. The bottom panel graphs the inflation rate (π) against the level of national output (y). The long-run aggregate supply curve (LRAS) is the constraint on which the economy must operate in equilibrium, and embodies the notion that there is no long-run trade-off between inflation and output (in the long-run, the natural level of output, y^* , obtains). The short-run aggregate supply curve (SRAS) intersects LRAS at the expected inflation rate (π^*), which can be interpreted as the inflation target. The aggregate demand curve (AD) measures the amount of output that agents wish to purchase at each rate of inflation. The top panel depicts the IS (investment-saving) curve, which measures the impact on output demanded from changes in the real (net of inflation) interest rate, r .³ A recession of the kind currently gripping the world's economies leads to leftward shifts of the IS curve (IS_0 to IS_1) and the AD curve (AD_0 to AD_1), as firms and households contract expenditure at each level of r and π respectively. The economy is then in recession: Output (y_1) is less than the full employment level (y^*) and inflation (π_1) is less than the target (π^*). Stabilisation of the economy using monetary policy requires a reduction in real interest rates to r_1 , which induces the extra private sector

² See 'Trade Effects of the Euro: Evidence from Sectoral Data' by R. Baldwin, F. Skudelny and D. Taglioni, European Central Bank Working Paper Number 446.

³ See 'Macroeconomics: Imperfections, Institutions and Policies' by W. Carlin and D. Soskice (Oxford University Press, 2006) for a full discussion of the framework described in Figure 1.

spending necessary to return the aggregate demand curve to AD_0 from AD_1 . Output is restored to a level consistent with full employment, and inflation to π^* .

The drop in interest rates to r_1 provides a simple representation of the monetary policy implemented by central banks around the world during the past 12 months. The potential inefficiency of monetary union arises from the fact that it imposes the same r_1 on all member states. In practice some countries may require larger interest rate reductions if they are more exposed to the global recession (AD drops by a larger amount), if constraints on inflation adjustment cause the fall in demand to impact mainly on output (the SRAS curve is flat) or if the private expenditure needed to replace the negative demand shock responds very weakly to cuts in the real interest rate (the IS curve is steep).⁴ When there exist structural asymmetries of this kind, the interest rate policy adopted by the ECB may provide insufficient stabilisation in some countries, whilst running the risk of an excessive demand expansion and overshooting of the inflation target in others. On the other hand, a separate interest rate policy for each country offers the prospect of stabilisation of each national economy at the target inflation rate and the natural level of output. This contrast measures the macroeconomic inefficiency associated with monetary union.

The question that arises from the discussion in this section is whether or not the benefits of monetary union exceed the costs. This depends crucially on the extent of inefficiencies arising from the implementation of a single monetary policy. The Nobel Laureate Robert Mundell famously argued that labour mobility may substitute for monetary policy as an adjustment mechanism following asymmetric demand shocks. If Ireland were to be hit by a macroeconomic downturn more severe than that in the Netherlands, Irish workers that remained unemployed even after the common monetary policy expansion could migrate to the Netherlands in order to achieve full employment in both countries. Ireland and the Netherlands would then constitute an Optimal Currency Area (OCA). Unfortunately, the consensus is that the countries of the euro area and the UK lack the international labour mobility needed to qualify as an OCA on Mundell's criterion. Alternative adjustment mechanisms have been discussed in the literature. Using the example to hand, Irish inflation could fall sufficiently that its exports become more competitive and the resulting increase in demand for Irish goods restores full employment, or national fiscal policies could be used to fill the gap left by monetary policy. A full discussion of these options and whether they would compensate the loss of monetary autonomy in the UK in the event of euro area membership is beyond the scope of this article, but readers are referred to the items listed in footnote 4 for more on these issues.

The Impact of the Financial Crisis on Prospects for UK Membership of the Euro Area

The world economy currently faces some of the most challenging circumstances in living memory. The credit crunch that started in 2007 has led to many calls for radical changes to the global financial

⁴ For an excellent discussion of some of the important structural differences between the British economy and the national economies of the Euro area, see 'Asymmetries in Housing and Financial Market Institutions and EMU' by Maclennan, Muellbauer and Stephens, Oxford Review of Economic Policy, vol. 14 no. 3 1998, and also H.M. Treasury's 2003 assessment of the five economic tests to be used for judging the desirability of UK entry into EMU, http://www.hm-treasury.gov.uk/int_euro_index.htm.

architecture. The recession that has subsequently taken hold poses major challenges to the macroeconomic frameworks that have been credited for the stability of the 1990s and the first part of the current decade. In this section I provide some observations regarding the origins of the crisis, responses to the crisis and their implications for potential UK entry into European Monetary Union.

A first observation is that the crisis illustrates the potential for asymmetric shocks across the euro area and UK economies. Accounts of the crisis frequently trace its origins to problems in the US sub-prime mortgage market. Sub-prime borrowers were able to meet their mortgage costs only provided mortgage interest rates stayed low and their own labour income remained intact. As soon as these conditions failed, borrowers defaulted on loan payments and banks were forced to write-off the value of the funds invested in those loans. These losses threatened the viability of banks around the world and forced them to contract their lending to both prime borrowers and sub-prime borrowers (the credit crunch). This in turn caused households and businesses to trim their budgets, leading to the fall in demand that induced the global recession.

The UK's exposure to these problems was more immediate and more pronounced than that of some other European countries, for at least three reasons. Firstly, the structure of the UK mortgage market more closely resembled the liberal US model, leaving the UK to confront its own version of the sub-prime problem. Secondly, given the relatively strong economic and financial linkages between the UK and the US, UK investors had committed a large amount of funds to the American banking system and stood to lose from the bad loans emanating from the US sub-prime mortgage sector. Thirdly, British banks relied on global capital markets much more heavily in funding loans to firms and households than did many European banks, which relied on more traditional sources of funds such as deposits from savers. When the losses from the sub-prime crisis caused funds to be diverted away from global capital markets, British banks were forced to pass on reductions in loan supply to others in the private sector much more quickly.⁵ All of these factors contributed to the view that the UK was more vulnerable to the credit crunch and global recession that originated in the US than was the Euro area, and would therefore face a relatively large leftward shift of AD and require a larger interest rate reduction (see Figure 1).

A second, and related, observation is that in responding to the recent crisis the United Kingdom has made full use of its monetary autonomy outside the single currency area. This can be seen in at least three ways. Firstly, since the onset of the financial crisis the pound sterling has depreciated significantly against the Euro. During summer 2007 one pound purchased as much as 1.50 Euros, compared to a current rate of approximately 1.15. The resulting fall in the price of British goods exported to the Euro area has provided a much needed boost to the sales of the UK manufacturing sector. Additionally, by increasing the price of goods imported from the Euro area to the UK, the depreciation of sterling has prevented consumer price deflation. Policy-makers are particularly keen to avoid such a scenario because declining prices encourage households to delay spending in the hope of better value for money

⁵ The crisis in the banking system also points to reduced financial sector profitability in the years ahead, and the UK is likely to be hard hit by this given that financial services represent a relatively large share of GDP.

in future, which in turn tends to prolong downturns in the real economy through slowing economic growth and raising unemployment.

Secondly, the Bank of England responded to the crisis by reducing interest rates by 4.5 percentage points in 5 months, whereas the European Central Bank cut rates by 3.25 percentage points, spread across 7 months. Thirdly, in addition to the conventional monetary policy easing represented by interest rate cuts, the Bank of England has introduced an Asset Purchase Facility (APF) through which it has spent £125 billion of newly created money, principally acquiring government bonds, but also investing in a small amount of corporate bonds issued by firms seeking to raise liquid funds. The APF, which will be expanded to £175 billion during 2009, is one example of 'quantitative easing'. This policy was adopted by the Bank of England when it became clear that interest rate cuts were failing to support aggregate demand during the recession. Although the Bank of England policy rate (essentially the overdraft interest rate charged to commercial banks when they deal with the Bank of England) had dropped to 0.5%, most bank loans are funded from investments in banks by pension funds and other large investors, the supply of which remained limited in the aftermath of the credit crunch. Quantitative easing is intended to address this problem through increasing the share of cash in banks' total assets and thereby providing the liquid funds needed to support bank lending to firms and households. The European Central Bank embarked upon a similar quantitative easing in July 2009, but the amount committed is approximately £50 billion for the entire 16 nation Euro area, and at present just 10% of these funds have been invested. As in the case of interest rate policy, the European Central Bank has been much more conservative in responding to the crisis via quantitative easing than has the Bank of England.⁶ The lesson that appears to be emerging is that due to the asymmetric responses of the UK and euro area economies to episodes such as the credit crunch, different monetary policy reactions (underpinned by separate currencies) are central to efficient macroeconomic management.⁷ Based on this assessment, it seems that the prospect of UK entry into the Euro area is more distant than it was before the current crisis broke during the summer of 2007.

To close this article, I offer one perspective on the events of recent years that may be interpreted as an argument in favour of British membership of the Euro area. This relates to differences in the targets of monetary policy at the Bank of England the European Central Bank. The Bank of England has a long established policy of targeting inflation. During the early part of this decade UK interest rates were set low in response to exceptionally low and stable inflation, an outcome many observers attribute to cheap imports from China and downward pressure on wages from inflows of workers from Eastern Europe. One side effect of the low interest rate policy may have been to support the growth in sub-prime lending, which can appear viable when interest rates are at historical lows. This outcome may have been

⁶ The move to lower interest rates and the adoption of quantitative easing appear to have resulted from the realisation that Europe's economic performance is being adversely affected by non-performing loans made by euro area banks in Eastern Europe, and the decline in export revenues as the world economy slowed.

⁷ On a similar theme, the UK government has responded to the crisis with a large fiscal expansion, highlighting the role that fiscal policy has to play in macroeconomic management. In view of this, the constraints on fiscal policy imposed under European Monetary Union appear particularly unattractive.

avoided if UK monetary policy had been set in view not only of inflation, but also the growth rate of broad measures of the money supply such as M4, which accelerated at the end of the 1990s and regularly exceeded 10% during the first part of the current decade. Monetarist economists working in the tradition re-established by Milton Friedman would argue for tighter monetary policy in response to money growth on this scale, on the grounds that it feeds future inflation. The European Central bank stands out amongst the major central banks in specifying a reference value for broad money growth that is consistent with price stability, the first pillar of its monetary policy strategy. It is possible that had the European Central Bank been responsible for setting interest rates in the UK during the last 10 years, higher interest rates would have been implemented, possibly restricting sub-prime lending in the UK and the scale of the economic correction currently being observed in response to it.

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Figure 1: Monetary Policy Responses to a Demand Shock

