

### Statement by Jacques Mélitz

Yes, I still adhere to the view that you quote from my report to the Swedish Commission of inquiry on entry into EMU. To my mind, the economic case against entry into a monetary union rests essentially on insurance against certain macroeconomic risks. Let me start by restating that position briefly.

On the benefit side, some of the economic advantages of entry into monetary union are clear, though their size is not. The benefits are essentially microeconomic: they relate to private economic activity and trade. On the other hand, the economic costs of monetary union are not exactly plain: they are not inherent and may not exist. Those costs hinge on the chance of getting better monetary policy from the authorities at home than those in a monetary union.

In analyzing the costs and benefits of monetary union, economists often proceed on the assumption of perfectly optimizing behavior by central bankers who reflect national preferences and possess complete knowledge of the structure of the economy. The analysis also assumes that the structure of the economy stays the same under monetary union. In those conditions, the national monetary authorities can do no worse than the international ones and generally will do better from a national perspective. But those assumptions are questionable. In practice, national monetary authorities have imperfect information and make mistakes. Furthermore, they also sometimes operate under strong political pressures that cause them to take shortsighted actions. Therefore, the national authorities may even do much worse than the international ones from a national perspective. Monetary union may also lead to structural economic changes. Consequently, any judgment about the wisdom of monetary union must rest largely on the quality of the monetary constitution at home, the historical record of monetary policy, the possibility of structural breaks under monetary union, and last but not least, the probability of big idiosyncratic national shocks that the national authorities can be entrusted to handle better than the international ones. These considerations underlie my view that the economic case against entry rests on risk aversion and insurance.

With this view in mind, I still find the economic case for British entry into EMU to be vague. In other words, I consider both the microeconomic benefits of coming in and the insurance benefits of staying out important. If so, given the modest economic ground for strong opinion, the decision on British entry should rest mainly on political rather than economic considerations. In addition, recent events lead me to regard both the economic benefits and the economic costs of entry to be higher than they seemed only a while back.

There are two developments dating since 1999 that improve the argument for British entry. First, the EMU got off to a good start. The European Central Bank quickly convinced the markets that it is a worthy successor of the Bundesbank. From the beginning, it has acted in a responsible manner. There is every reason to expect the ECB to continue to pursue moderate inflation in the future while paying reasonable attention to the business cycle. In addition, of course, the Maastricht Treaty provides the ECB with strong constitutional protection against undue political influence from the outside. Very

significantly, in this regard, the initial fears that the institution would suffer from internal dissention because of conflicts between different national representatives have proven unfounded thus far.

Second, recent research implies that separate moneys explain some of the strong effects of national borders on foreign commerce. Rose (2000) estimated that membership in a monetary union would more than triple the trade between the members. Subsequent research, to which he contributed as well, would show that a doubling is a better estimate. But even a doubling is enormous. The most important empirical results conflicting with those of Rose, in my opinion, stem from case studies of entries and exits into and from monetary unions, like the Irish adoption of a separate currency from the pound in 1979 (Thom and Walsh (2002), Nitsch (2002)). Such studies show nothing close to the impact of monetary union on trade that Rose's estimate would imply. In addition, of course, we simply do not understand the basis for the magnitudes of Rose's estimates. As applied to British trade with the current members of EMU, those estimates would imply a larger change in the British economy than seems likely.

Yet Rose's results fit well into a larger pattern of empirical work and help to resolve a piece of a larger puzzle in the field of trade. People trade much more with their own compatriots rather than foreigners than we can explain on grounds of transportation costs, differences in language, trade protection, and adjacency (or its absence). After introducing a number of reasonable explanatory factors, the effects of political boundaries on trade remain surprisingly large. Rose's results help to explain this riddle: they would mean that separate moneys resolve part of it. There is also recent evidence issuing from a completely different data source than Rose's that confirms his findings (though not necessarily his orders of magnitude). Parsley and Wei (2001) show that, even if we allow for the usual political and economic influences, separate currencies significantly raise international discrepancies in prices of individual goods between many cities over the globe. In sum, it may well be that the economic benefits of monetary union consist largely of an increase in market integration, and therefore go far beyond economies in transaction costs and costs of buying cover for foreign exchange risks. These wider benefits of a single money probably stem from a common unit of account, more price transparency, and the definitive elimination of exchange risk.

All the same, an important qualification comes to mind. Rose's data and methods also show that monetary union increases trade between members and non-members (though less so than between the members) (Mélitz (2001)). This last result seems particularly important for the UK. Already British citizens need only one foreign currency for travel to different member countries of the EMU. They also benefit from a single unit of account (besides the pound) in trade with all the member countries. In addition, they obtain some of the same advantages of greater price transparency and total eradication of exchange rate risk that people in the euro zone get. In other words, even without adopting the euro, the UK will get many of the advantages of EMU, just as the Canadians now profit from a single currency in the US. Of course, this qualification holds for the Danes and Swedes as well. But as regards these other people, the qualification has less force because of a counter-effect of less consequence to the British: the invasion of the euro in

domestic trade. The phenomenon is less important in the UK, and the British economy is large enough to expect the pound to hold its own against the euro at home in the future.

The outstanding recent development arguing for keeping the *status quo* in the UK is the charter of independence of the Bank of England of 1997. To my mind, this reform, and the subsequent behavior of the Bank of England, undercut a good part of the economic arguments in favor of entry into EMU. In the recent pamphlet by the advocates of entry into EMU, *Taking a Pounding*, the contributors argue convincingly that the record of British monetary policy in most of the twentieth century offers no basis for confidence in a separate pound. Given the policy record, independent monetary policy in the UK poses as much, or more, of a risk of disturbances stemming from movements in the euro/pound than any protection against inappropriate monetary policy by the European Central Bank. However compelling this argument concerning the not too distant past, I believe that it has lost conviction. Since the Monetary Policy Committee acquired control over monetary policy, the quality of central bank performance has improved greatly. The Bank of England now plainly pursues an inflation objective. It communicates frequently and clearly with the public. In terms of timely exposure of internal policy discussion, letting everyone know the official reasons for actions and the official aims, if anything, the Bank of England has a better record than the ECB since 1999.

Finally, there is the issue of the Stability and Growth Pact (SGP). Does the Pact pose an obstacle to entry into EMU? According to basic logic, if the UK gives up its monetary-policy independence by joining the EMU, the country requires its fiscal policy independence even more. Of course, the UK is already party to the Pact. But as a member of EMU, the country would be subject to the sanctions envisioned in the Pact as well, and would be more constrained by the Pact. It is important to observe that the underlying motivation for the Pact is sound. Constraints against fiscal irresponsibility are not a bad idea. Countries joining in a monetary union may be wise to engage in a joint commitment to fiscal discipline. The basic criticism of the Pact has always centered on the precise numbers about debt and deficits: the 3% ceiling on fiscal deficits in particular. The issue has ceased to be academic, as the ceiling has now become an embarrassment for the largest countries in the EMU. Of course, the rigid interpretation of the 3% ceiling by the European Commission (in spite of the escape clauses in the Maastricht Treaty) has not helped either. Yet in my judgment, the 3% figure does not represent a fundamental reason for the UK to stay out. The means of enforcing the ceiling are too weak, and this is true to no small extent because of the limp justification for the ceiling. It would hardly be surprising, given the inability simply to flout so flagrant an aspect of the SGP, if an explicit reform of the interpretation of the ceiling took place, possibly as part of a general revision of the SGP. To my mind, fiscal policy will likely remain a protection against unforeseen idiosyncratic shocks in the event of British entry into EMU.

#### References

Britain in Europe (2002). *Taking a Pounding*, London: Centurion Press, September.

Glick, Reuben and Andrew Rose (2002). "Does a Currency Union Affect Trade? The Time Series Evidence," *European Economic Review* 46 (June), 1125-1151.

Méltiz, Jacques (1997). "The Evidence about Costs and Benefits of the EMU," *Swedish Economic Policy Review* 4 (1997), 359-410.

Méltiz, Jacques (2001). "Geography, Trade and Currency Union," *CEPR Discussion Paper no. 2987* (October).

Nitsch, Volker (2002). "The Non-Causality of the Common Currency Effect on Trade: Evidence from the Monetary Union Between Belgium and Luxembourg," Bankgesellschaft Berlin, draft.

Parsley, David and Shang-Jin Wei (2001). "Limiting Currency Volatility to Stimulate Goods Market Integration: A Price-Based Approach," *NBER Working Paper no. 8468* (September).

Rose, Andrew (2000). "One Money, One Market: Estimating the Effect of Common Currencies on Trade," *Economic Policy* 20 (April), 7-45.

Thom, Rodney and Brendan Walsh (2002). "The Effect of a Currency Union on Trade: Lessons from the Irish Experience," *European Economic Review* 46 (June), 1111-1123.