Mr. Wellink looks at the United Kingdom and EMU Speech by the President of the Nederlandsche Bank, Dr A.H.E.M. Wellink, at the meeting of the Nederlandse City Lunches in London on 16/6/98.

Introduction

Britain has a love-hate relationship with Europe. Love, because the UK, too, favours a powerful Europe generating peace and free trade relations worldwide. At the same time, however, Britain has always been in two minds about its own role, opposed as it is to a federal Europe, where national sovereignty is curbed. It is not for nothing that Churchill did not envisage his own country as part of a united Europe at that time.

The relationship between the United Kingdom and Europe is complicated further by the existence of a third party: the United States. The United States sometimes seems a more attractive partner. It is always easier, in a relationship, be it between states or between husband and wife, to operate with someone from one's own background, in this case Anglo-Saxon, than with a partner from a totally different culture.

All told, however, the British seem to be favouring Europe. Newt Gingrich, the Chairman of the US House of Representatives, is wrong. He has said that Britain would do better to join the North American Free Trade Association than to take up with EMU; but what is the point of that? After all, both economically and politically, the UK has much stronger ties with Europe. Tony Blair is evidencing a greater sense of reality when he holds that his country's future lies in the heart of Europe. The question is, however: is he talking about the next few years or about the distant future?

The British are hesitant about European integration, as they have always been. The UK only joined the EC in 1973, when they were sure of its success. A similar process would seem to be taking place where EMU is concerned. At first, the UK was eager to be in on the process, completely liberalizing its capital movements, but it subsequently demanded an opt-out clause so as not to be forced to take further action. Such an approach is risky. There is always the chance than when jumping onto a moving train, one ends up between the train and the platform. A few years ago, no one was able to foresee that on 1 January 1999 EMU would be setting off with eleven out of the fifteen Member States. Now the UK is the only large Member State which is not joining the monetary union. Today I will be making out a case for the UK's participation in EMU, and I will discuss a policy which may make it easier for it to join EMU.

The desirability of British membership

I can be brief about the advantages for Europe of the British taking part in EMU. Obviously, the union is strengthened by the participation of a country accounting for 16% of the EU's GDP. It would mean a larger zone of exchange rate stability, a larger market, and better chances of the euro becoming an international currency. In these respects, British membership of EMU is just as important as that of, let us say, France. Because EMU is built around French-German cooperation, and it is hence also about politics, it has been suggested that France's membership is a must. But the UK, too, has a contribution of its own to make to EMU. After all, the UK has the City, the financial centre of Europe. It would be peculiar, to say the least, if the leading financial centre of an economic power such as the EU were to lie outside the euro zone. Another issue of at least the same importance is the considerable contribution which Britain can make to the policy discussions about greater labour and product market flexibility. The reduction of the working week in France and Italy to 35 hours, on the conditions now envisaged, indicates that continental Europe could do with some counterweight on this point.

Let me say something about what entry into EMU would mean for the United Kingdom itself. In principle, the British Government is in favour of joining EMU. In October 1997, Gordon Brown said in the House of Commons: "If, in the end, a single currency is successful, and the economic case is clear and unambiguous, then the Government believes Britain should be part of it".

The UK could benefit materially from joining EMU. Exchange rate stability, greater comparability of prices, and larger money and capital markets offer the British economy additional opportunities for growth. It must furthermore be remembered that even if the UK does not join, it will be feeling the impact of EMU. Geographically, the UK may be an island, but it is not economically. So much is evidenced by the degree to which the British economy is affected by the exchange rate movements of sterling. That influence being as great as it is, then surely it is better to be seated at the table where the policy affecting your economy is determined. That means joining EMU. After all, so long as the UK remains outside EMU, it will not be permitted to take part in the euro-X group, where the economic policies of the euro area are coordinated by the Ministers of Finance.

The City, too, stands to benefit substantially from Britain's participation, because it will become part of deeper and more liquid financial markets. Obviously, the City's position as Europe's financial centre is not yet in peril. As my colleague, Eddie George, neatly pointed out, the number of people working in the financial sector and affiliated industries in Greater London equals the population of Frankfurt: 600,000. But the City is not impregnable. Take, for instance, Liffe, which lost its leading position in the trade in futures of German central government bonds, the most important contract in European government bonds, to the Deutsche Terminbörse in Frankfurt within only a short period of time. If the UK were to remain outside EMU for a long time to come, some City activities could well be gradually shifted to financial centres on the continent.

Policy-making for membership

From whatever angle you look at it, the UK would do well to enter into EMU. From where we stand, EMU is incomplete without the United Kingdom. The question is not so much whether the UK should join, as when. Research by the Treasury shows it is too early. Of the five economic tests developed by the Treasury, the crucial one assesses whether the British business cycle is sufficiently in line with that in other European countries and is not marked by major outliers, the question being whether the single monetary policy actually fits in with the UK's economic policy. At present, the interest rate set by the Bank of England is double the monetary policy rate in the core countries of the future euro zone, viz. 7.5% against 3.3%. This is in line with Britain's cyclical conditions. At this stage, considerable reduction of this short-term interest rate would be at odds with the British inflation target of at most 2.5%. But apart from the question whether this is an economically favourable time to join, there are institutional impediments to the UK's immediate membership as well. For one thing, the British population have to voice their approval in a referendum and, for another, the UK still needs to meet the exchange rate criterion for joining the monetary union.

Let us take a closer look at these obstacles. First of all, the British Government will have to convince the people of the importance of membership. This will be possible if the advantages are presented in a convincing way, since the idea of joining monetary union is no longer an unfamiliar one. But the exchange rate criterion, which applies for countries in search of EMU membership, is another, more complex and more formal, matter. Countries wishing to join EMU on 1 January 1999 are required to have taken part in the exchange rate mechanism of the European Monetary System for the last two years, without the fluctuation margins being exceeded. Countries joining at a later stage are basically subject to the same rules. But the exchange rate mechanism which will take effect as from 1 January 1999 differs from that currently in force. In my opinion, ERM2 will replace ERM1. But legally, it is not that simple, and my view is not shared by everyone. For the time being, the UK is not making any moves to join the new exchange rate mechanism. I understand the UK's reluctance to join ERM2, considering its unfortunate experience with ERM1. Although the UK only joined ERM1 in 1990, it was already forced to leave in 1992. Naturally they feel that the experience does not bear repetition. But the circumstances prevailing at that time, viz. an excessively high entry rate for sterling and, more importantly, a macroeconomic policy which did not fully support the exchange rate objective, are in no way comparable to those in evidence in the UK and Europe today.

Now let us take a look at Britain's cyclical conditions and economic policy. The exchange rate movements of sterling largely reflect the cyclical divergences between the UK and the European continents. I already noted, it is crucial to British participation in EMU that, in the longer term, its economic development does not diverge substantially from those in Europe. The UK's economy has always been subject to greater turbulence, and its business cycle is invariably ahead of those on the mainland. But the cyclical outliers seem to be decreasing. It is gratifying to note that the political stop-go cycle of interest rate policy has made way for a monetary policy aimed at keeping inflation under control. The Government's economic policy is now also directed at putting a stop to the well-known British pattern of stop-go, boom-bust. Gordon Brown's first budget had a moderating effect on the exuberant cyclical conditions. Right now, the first signs of a cyclical slowdown are showing up. Hopefully, they do not portend a bust for the British economy. But we will have to wait and see.

Like the business cycles of countries such as the Netherlands and Germany, that of Britain will never run exactly parallel to the European average. This is the consequence of conducting a single monetary policy in an area as large as the euro zone. The differences among the countries will have to be addressed through their budgets, within the confines of the Stability Pact, and especially by flexible labour and product markets. In these respects, the UK is streets ahead of the other major EU countries, and is therefore well placed for EMU.

Conclusion

Ladies and gentlemen, I have come to the end of my speech. All things considered, the prospects are good for the UK making a successful entry into EMU somewhere in the first few years of the 21st century. The British Government's commitment to membership of EMU, and their refusal to adopt a wait-and-see attitude can be regarded advantageous. In the meantime, the British should have a say in matters. They are a full-fledged member of the EU, and have been in on the process towards EMU throughout. Outsiders should not become outcasts. From the Dutch perspective in particular, it is desirable that the UK should put its mark on the shape of the European economy and EMU, also during the run-up to its participation. Britain can play an important role in boosting the flexibility of the European labour and product markets. Such a role is needed to stimulate the European economy, and to offer Europe's 18 million unemployed the prospect of a new job. To quote Helmut Kohl: "To cooperate as closely as possible with Britain 'in building Europe', Europe needs the United Kingdom, and vice versa. The European Union needs, above all, that unique British blend of realism and traditionalism, pragmatism and idealism, level-headedness and love of freedom". With which I could not agree more.

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