## Sir Martin Jacomb, writing in the Sunday Telegraph on 24th March 1996

***As European Union leaders gather to address critical issues for its future, including Brexit, we re-visit an extraordinarily prophetic article written by Sir Martin Jacomb in advance of a similarly important inter-governmental conference 22 years ago.***

***He argues that without political union a single currency would be disastrous.***

# EMU: only fools rush in

Economic and monetary union was conceived as a political idea by the original six members of the Common Market. They had all been overrun in the Second World War; the nation state as a concept had failed them. But does their grand plan make economic sense?

It would be a first. Countries have been in monetary union, but never before have several separate nation states agreed to have a single (non-gold) currency on an irrevocable basis. States which have done it have always had political union as well, such as Germany, Italy and the United States.

The advantages which monetary union would bring to the single market are clear. It would remove the uncertainties and expense of having to deal across the foreign exchanges. It would benefit trade and investment within the single European market. Imagine trading within the US with separate currencies for different states of the union. The extra inefficiencies are obvious.

But is EMU feasible?

First, goods, labour, services and capital must be able to flow without restriction throughout the European Union. However this - the single market, not yet fully achieved - is not enough. In addition you need a single monetary policy.

A single currency with different monetary policy and different interest rates in different member countries is not a possibility. You could not have high interest rates for Federal funds in Los Angeles and lower rates in Chicago. There must therefore be a single central bank putting into effect a single monetary policy. Once this was in operation the Bank of England and other national central banks would become like local Federal Reserve banks in the US, which carry out the Federal Reserve policy decided in Washington.

This brings a difficulty at once because, if you have inflationary conditions prevailing in one country but not in another, you cannot choose to have tight monetary conditions in the former but not in the latter.

We were given a very unpleasant foretaste of this when the exchange rate mechanism linked EU currencies closely together and Germany imposed a tight modern monetary policy for unification reasons. The recession throughout Europe was thereby exaggerated, to the extent that 20 million people are now unemployed in the 12 countries, and the ERM was bust wide open.

In the US (using that example again), labour migration and other economic forces ensure that inflation is roughly the same throughout the country, so that a single monetary policy for the entire nation is workable.

Some argue that opting irrevocably for monetary union would force policy throughout the EU to become permanently locked into sound market economy principles which would stop national governments making an interventionist mess of things.

A single currency under the control of a European central bank, independent of political pressure and dedicated to price stability, does indeed have attractions as a theoretical concept. Nevertheless, whatever the advantages, there is a major, possibly insuperable, hurdle in the way.

Distribution of economic resources within a single currency area is affected by two factors: market forces and political intervention. Market forces magnetise resources to economic centres, political action is needed to counterbalance this.

Within any single currency area resources are magnetised to centres of activity: to counterbalance this there are continuous flows of resources from rich to poor regions as a result of political action. These take place not just by the flow of regional aid but also by transfer payments under social security systems, educational and infrastructure expenditure, and so forth. Were it not for these transfers, market forces within a single currency area always tend to make rich regions richer and poor regions relatively poorer. Workers migrating to shanty towns around big industrial centres are a vivid example.

Thus monetary union inevitably favours a shift of economic activity from less successful to highly developed regions.

If monetary union were imposed with no effective political mechanism to counterbalance this magnetism, the result could be disastrous for the less successful regions of the EU. It is thus clear that, to make EMU work properly, there would have to be a central authority able to make and enforce the decisions needed to transfer resources from the rich to the poorer regions.

These transfers would need to be of a different order of magnitude to the existing EU structural funds: the process would require institutions with real, continuous and unified political power at the centre, not periodic bargaining by separate sovereign governments. But at this juncture this is not realistic.

There is no example of a group of nation states with a currency union, and therefore having a single monetary policy, even on a non-irrevocable basis, agreeing to transfer massive sums from rich countries to poor countries on anything like the scale which every individual nation state does between the regions within its own borders all the time.

On average, in EU member states, government spending is not far short of 50% of gross domestic product, a big proportion of which represents this redistributive process. It is not yet possible to contemplate one nation state, albeit a rich one, agreeing to contribute on this scale to its poorer neighbours. After all, the total EU budget is 1.25% of EU GDP.

If you go to monetary union before you have a single government at the centre you thus risk locking in the gulf between rich and poor regions. For the poor regions would not have the benefit of adequate transfers from the rich and they would have lost the ability to correct imbalances by making themselves more competitive through the devaluation of their currency.

There are examples, even within Europe, of what can happen. In the German states the Zollverein (customs union) came into being in 1818 and was complete by 1833. That was the single market. Economic convergence, led from Prussia, was occurring. Nevertheless, it took decades more to achieve political union and it was only thereafter that they had a single currency. Successful monetary union presupposes first economic convergence and then the centralisation of economic policy, after which you can have full political unification. A single currency comes at the end.

The Risorgimento in Italy was quite different. This was in effect militarily imposed on states where there was no convergence. Railways are a good measure of the then state of affairs. In 1850 Italy had 400 km of working railways, while Germany as a whole had 6,000 km. Several causes, including opposition of the Papal States to railways, prevented convergence in Italy, and living standards between north and south differed greatly.

The net result was the magnetisation of resources, particularly skilled labour to the north, which over the past 125 years has helped crystallise permanently the relative poverty of southern Italy.

The risks and dangers mentioned above were taken at least partly into account at Maastricht. Hence the criteria which have to be satisfied before countries can qualify. But it is highly doubtful whether the scheme represents a workable programme. Fortunately, Britain has an opt out.

EMU is irrevocable. No member state could ever again devalue if its labour costs got too high. Inflation in one country or region not matched elsewhere would be punished by falling economic activity and rising unemployment. A good discipline in theory, but the political realities may mean that it is not workable over the long run.

If convergence, although initially achieved, were not maintained, then the monetary policy appropriate in one part of the EMU area would not be appropriate in others, leaving a dilemma as to what policy the central bank should pursue. This would be economically catastrophic but it might also be politically. It might blow the whole union apart if a country with high unemployment found the bank's policy too restrictive. And an independent central bank is quite capable of doing just that.

Even with EMU, nations could still run deficits and borrow. In order to try to keep members in line, there are treaty obligations to prevent excessive national fiscal deficits. But treaty obligations do not amount to an absolute guarantee. Only political union could provide that.

If political union were really on offer, great difficulties would still remain: importantly, the inflexibility of the labour market. In the US, if one part of the country falls on hard times, people move to where the employment is available.

There are no difficulties of language or foreign habits to contend with.

In Europe it is different. Even with 20 million people wanting jobs, unemployment ranges from 7% in Holland to 23% in Spain and still there is not much migration.

Given the real wage adjustments needed plus the inflexibility of nominal wages throughout Europe and low labour mobility, you would have thought that further exchange rate adjustments would be needed for some time to come.

If all of the convergence criteria were satisfied and could all be sustained, and if labour mobility could somehow be conjured out of the air and the inflexibilities were removed so as to ensure that centrally decided monetary policy was not inappropriate in some areas of the EMU region, then, and only then, would a single currency be a plausible idea on economic grounds.

But this still does not address the political questions. Can or should you have a central bank without unified democratic political control? Do you not have to have a single political control to handle transfers to poorer regions?

But can we in the UK simply turn our backs on EMU if others are going for it? Many respected voices claim that we can. However, nothing is that simple.

Our economic links with our European partners are already deep. In 1995 more than £90 billion worth of goods and services were exported to our European partners while we sold only £64 billion to the rest of the world. Western Europe accounts for more than 60% of all our exports.

It is obvious that this cannot be disregarded. It does not compel us to join in, but what if others moved to EMU and then decided to defend themselves against devaluations by the rest of us and threaten to erect barriers to shore up those defences? Bear in mind that in 1995 the Germans bought more from us than the Americans.

France bought more from us than the entire Commonwealth and Holland more than the six Asian tigers plus China, Indonesia and the Philippines put together.

What does it all add up to? A single currency imposed before the countries of the European Union are ready for it, both in terms of convergence and popular acceptance of the idea, could cause the EU to disintegrate in the future. We must persuade our partners that this risk is real.

Eventually, with telecommunications and air travel taking the place of the railways in the 19th century and Roman roads 2,000 years before, the economies of Western Europe will converge naturally. Then we shall want a common defence and foreign policy to look after our collective interests. Some form of political union will begin to emerge and then, and only then, is the safe time for a single currency.



*Listen to Sir Martin Jacomb discussing his career with Sue Dougan on Track Record, in April 2015.*