Beyond Prospective Accountancy: Reassessing the Case for British Membership of the Single European Currency Comparatively

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Abstract

The fact that Britain will, at most, be a late signatory to the single European currency means that the strategic deliberations it faces in deciding whether to enter EMU are rather different to those of earlier entrants. However, this crucial point is lost in almost all discussion of the subject. To date, the academic debate has been dominated by what we term 'prospective accountancy', in which a series of abstract counterfactuals ostensibly inform a stylised cost-benefit analysis. This article moves beyond such an approach by combining conjectures about the specificities of the British case with a concrete analysis of the experiences of the Eurozone member whose economy appears most closely to resemble Britain's: namely, Ireland. The comparative dimension of our work facilitates more empirically based analysis of the merits and demerits of British entry into EMU. Yet, it is important not to lose sight of the limits of an exclusively comparative approach, for the British growth model is qualitatively different to that of other European Union economies. British growth since the early 1990s has been consumption-led, and this in turn has been fuelled to a considerable degree by the release of equity from the housing market. The likely impact of EMU on the British economy will be determined to a significant extent, then, by its effect upon this key catalyst of British growth. Sadly, no retrospective comparison can inform such an assessment.

Introduction

There has been a marked imbalance between prospective and retrospective analyses of the decision to enter the final stage of European Economic and Monetary Union (EMU) and, hence, to adopt the single currency. Few studies have been undertaken of the *actual* impact of EMU in the post-1999 period, certainly when compared with the number of studies that were undertaken of the *likely* impact of EMU in the pre-1999 period (although, see Martin and Ross 2004). So much of the academic debate about the single currency has been projected forwards in time rather than backwards. Such studies are of limited use, though, when it comes to weighing up the advantages and disadvantages of British membership at some time in the future. British policy-makers may well be interested in analytical claims about how EMU *might* work with Britain as a full member of the Eurozone, but they also need to know how EMU *has* worked since 1999 with Britain on the outside. There is now a world of experience, as well as a world of conjecture, which can be drawn upon to inform the decision about the suitability of the British economy for EMU entry.

However, it is precisely the world of experience which tends to be overlooked in the existing literature. Typically, debate within the literature proceeds on the basis of standard accountancy techniques, appealing narrowly to a cost/benefit calculus in order to gauge the likely impact of membership of the single currency. All the presumed benefits of joining EMU are lined up on one side of an ostensible accounting ledger, all the presumed drawbacks are lined up on the other side, and judgement is passed on whether the former outweighs the latter (see, for example, Hall and Franzese 1998). The only difference from standard accountancy is that accountants are trained to deal only with known facts. They audit retrospectively on the basis of transactions which have already occurred. However, the cost/benefit analyses of the academic literature on EMU relate to economic trends that *might* occur in the future, provided that the trajectory of the national economy post-EMU has been correctly inferred in the present. It is in this sense that we write of a bias towards 'prospective accountancy' within the existing literature.

Such a bias runs deep, consistently characterising interventions which are otherwise split along normative and analytical lines. Our aim in what follows is to take the debate about British EMU entry beyond a reliance on prospective accountancy. We are helped in this respect by the fact that, if Britain is to join the Eurozone at all, it will do so as a latecomer.

This allows for a more comparative, empirical and retrospective mode of enquiry. Each aspect of this requires some explanation.

First, the question of the appropriate comparator is perhaps most easily answered. We choose the Irish economy because, on all measures of institutional similarity used in the 'varieties of capitalism' literature, it appears to be more like the British than any other Eurozone economy. In section one, we introduce a number of benchmark indicators for the subsequent analysis by assessing the performance of the Irish economy post-1999. Second, the question of which empirical issues to compare is also relatively easily answered. In this, we follow the existing literature by adopting the heuristic distinction between the microeconomic and the macroeconomic dimensions of EMU, before focusing on each in turn. In section two, we draw lessons from the Irish case in order to offer a cautious assessment of the impacts of EMU on the business models deployed by British firms and on the business cycle of the British economy as a whole. Third, we acknowledge that there are difficulties in a purely comparative and retrospective analysis. This is because the British economy contains so many particularities that the effects of the single currency cannot simply be read off from the experience of another economy, however similar that economy might be in institutional terms. In particular, the structure of the British housing market finds no direct parallel anywhere else in the EU, especially in the way in which it lies at the heart of the national economy's current growth model. In section three, we conclude that the overall impact of British EMU entry is likely to depend significantly on what incorporation into Eurozone policy-making dynamics does to confidence in the pricing structure of the housing market. This, though, remains unknown. Neither the prospective accountancy technique nor our preferred alternative can ever render it anything other than that.

Establishing Benchmarks for Comparison: The Irish EMU Debate and the Performance of the Irish Economy Post-1999

Given the considerable debate within Ireland about Britain's (non-)participation in the Eurozone, it is perhaps disappointing that Ireland's own experience of EMU has received so little attention in British political discussions. Of the twelve countries currently participating in EMU, it is Ireland whose economy most closely resembles Britain's. Whilst the two countries clearly differ in terms of economic size and political influence within the EU, they nevertheless share a number of key structural characteristics. These include their high levels of trade openness; their reliance on foreign direct investment; their relatively flexible labour markets; their traditions of 'liberal' welfarism; their membership of the European Union since 1973; and their common language. More than this, Britain and Ireland also share a common economic legacy (Daly and Yeates 2004), with Ireland operating in effect as a sub-region of Britain with respect to trade until the 1960s (Bradley 2000). In addition, it was not until 1979 that its links with sterling were broken with membership of the European Monetary System. Ireland's strong economic ties with, and structural similarities to, Britain thus make it a particularly interesting test case for debates about British participation in EMU.

The Irish EMU Debate

Ireland's decision to join EMU was not driven by a similar assessment of the anticipated economic gains and losses which dominates the British debate. This was a politically- rather than an economically-motivated decision, guided in particular by the desire to operate at the heart of EU decision-making. In turn, this reflected a conscious strategy, which has informed Irish public policy since 1973, to deepen Ireland's European integration as a means of overturning a long reliance on Britain in economic, political and diplomatic terms (Smith 2005). Such was the commitment to this strategy that an *Irish Times* editorial (14.03.98) described any decision other than to join EMU in the first-wave as "Ireland reclassifying itself, effectively, as a UK dependency".

Discussions of the potential economic consequences of EMU were, therefore, not an integral feature of Ireland's political debate about the single currency. Yet, they did receive attention from both the business and the academic communities. The business community was quite naturally preoccupied with the microeconomic impact of EMU, whereas the academic community focused in general on its macroeconomic effects. It is useful here to consider both of these dimensions in turn, with a view to drawing out what, if anything, Britain can learn from the Irish debate and its subsequent experience.

Taking first the microeconomic dimension, the business community was broadly optimistic about the potential effects of EMU on its day-to-day activities. For example, one survey by the Irish Business and Employers' Confederation (IBEC) found that over two-thirds of its members expected EMU to impact positively on their business, with the remainder more indifferent than negative (IBEC 1999). Foreign firms, too, expressed their explicit support for Ireland's decision to join (*Irish Times*, 01.05.98). The anticipated benefits for business included sustained low inflation (with the European Central Bank required to keep inflation below 2% under the terms of the Maastricht Treaty); lower interest rates (thus reducing the cost of capital for firms); the elimination of currency transaction costs (with the European Commission estimating that the cost of savings could be as much as 1% of GDP for open economies such as Ireland's); the elimination of exchange rate uncertainty (with investors no longer requiring any risk premium for investing in Irish assets); and increased price transparency and stability (helping Irish companies to expand into the Eurozone market of 280 million consumers) (IBEC 2000).

This is not to imply, however, that the business community was united in welcoming EMU entry. But those concerns that were expressed related not so much to Ireland's prospective membership of the Eurozone *per se* as to its decision to do so without its closest trading partner, Britain. In 1998, just before EMU entry, Britain accounted for nearly one-third of Irish imports and just over one-fifth of Irish exports (CSO 1999). With Britain opting out, it was thought that Ireland could be left vulnerable to sterling volatility and, especially, to sterling weakness. The fear was of a significant loss of competitiveness in sterling-sensitive sectors.

An alternative view suggested that such dangers were overstated (see, for instance, *Irish Times*, 05.03.97, 01.05.98). Whilst a sharp fall in sterling would certainly have impacted upon a range of traditional sectors, this would have been unlikely to pose serious difficulties for the economy as a whole. The preceding years of rapid employment growth in the most modern and dynamic sectors of the economy, such as electronics and pharmaceuticals, tended to be in sectors which serve European and US markets. As such, the most important sectors of the Irish economy are not, in any case, sterling-sensitive. The sectors which tended to serve the British market were those such as clothing and textiles, in which there had already been large-scale rationalisation (OECD 2001, 30). This process of sectoral change had allowed the Irish economy to loosen its historic dependence on British markets. Thus, whilst sterling-sensitive sectors certainly remained vulnerable to any further loss of competitiveness with respect to Britain, any such effect was only likely to accelerate the ongoing reorientation of the Irish economy.

Commentators also warned that the dangers of opting out of the euro could be more significant than the risks of signing up (see, for instance, Baker, Fitz Gerald and Honohan 1996). The Irish economy has become heavily dependent on foreign direct investment, with total inward and outward FDI stocks representing the equivalent of 60% of Irish GDP by the mid-1990s, as compared to just 13% for other European Union countries (UNCTAD 2003, 278). As such, Ireland was peculiarly exposed to the investment effects of any sudden reversal in its support for EMU. Ireland had gained much from European single market legislation, welcoming throughout the late-1980s and early-1990s an influx of investors looking to gain access to such a large pool of consumers (Görg and Ruane 2000: 413). If Ireland were suddenly to put the brakes on further integration – the path it had consistently chosen since the 1960s – this would have created uncertainty for foreign investors and likely worsened the climate for investment. The microeconomic case for Irish EMU entry therefore looked strong.

In contrast, however, the academic community was rather less sanguine about the potential macroeconomic effects of the single currency. In particular, commentators highlighted the limits on Ireland's national policy autonomy which EMU would impose (Barry 2001; Leddin and Walsh 1998). Ireland would be required to cede formal control of monetary policy to the European Central Bank, but the ECB would primarily be concerned with the needs of the continental core of the Eurozone economy rather than the Irish periphery. Whilst the same would be true to some extent for all countries within EMU, the perceived risks were particularly severe for Ireland due to its export and investment dependence on Britain and the United States. With the misalignment of the Irish and Eurozone business cycles, the interest rate demands of the Irish economy are unlikely ever to be met by the

ECB. Moreover, since currency devaluation is no longer an option, EMU leaves Ireland much less able to adjust to country-specific shocks. The monetary straitjacket of EMU appears to force the Irish Government to rely upon fiscal policy to adjust to any such shocks and to compensate for a sub-optimal interest rate. Yet, such policies are themselves constrained by the 3% budget deficit limit imposed by the Stability and Growth Pact, leaving labour market flexibility as the only means of alleviating macroeconomic imbalances.

Not all economists took such a bleak view, however (see, for instance, Baker, Fitz Gerald and Honohan 1996). For some, the constraints of both the delegation of monetary responsibility and the Stability and Growth Pact are a good thing. They were seen as mechanisms to lock-in responsible financial behaviour based on the preservation of underlying monetary values. For many years, orthodox theories of macroeconomic policy-making had called for the introduction of external enforcement mechanisms to act as automatic pilots for policy (see, for instance, Stevenson, Muscatelli and Gregory 1988; Persson and Tabellini 1990; Drazen 2000). Despite concerns that this led to the depoliticisation of economic policy, most economists nonetheless advocate the forced subjugation of governments' autonomous policy choices. And this is precisely the sort of discipline which EMU provides. Governments might be predisposed to retain some degree of policy autonomy in order to manage the business cycle, but orthodox economic theory suggests that self-imposed discipline in any case reduces the fluctuations of that cycle, leaving less to manage.

As we have seen, then, concerns were expressed in Ireland about the economic implications of first-wave entry into EMU. In general, the microeconomic implications raised by the business community related to the exchange rate risk for producers in sterling-sensitive sectors in a Eurozone which did not include Britain, whilst the macroeconomic implications raised by the academic community related to the inability of Irish policy-makers to alleviate the business cycle through active monetary policy. Have such fears been realised seven years into the operation of EMU?

To answer this question, let us begin by evaluating the concerns raised by the business community prior to EMU entry. To do so, it is necessary to consider changes in the exchange rate pre- and post-1999. Figure 1a shows the punt-sterling exchange rate prior to EMU entry and the Euro-sterling exchange rate following entry. Figure 1b presents similar data on punt-dollar and Euro-dollar exchange rates. Both graphs include trend lines for the period 1990-99 and 1999-2004.

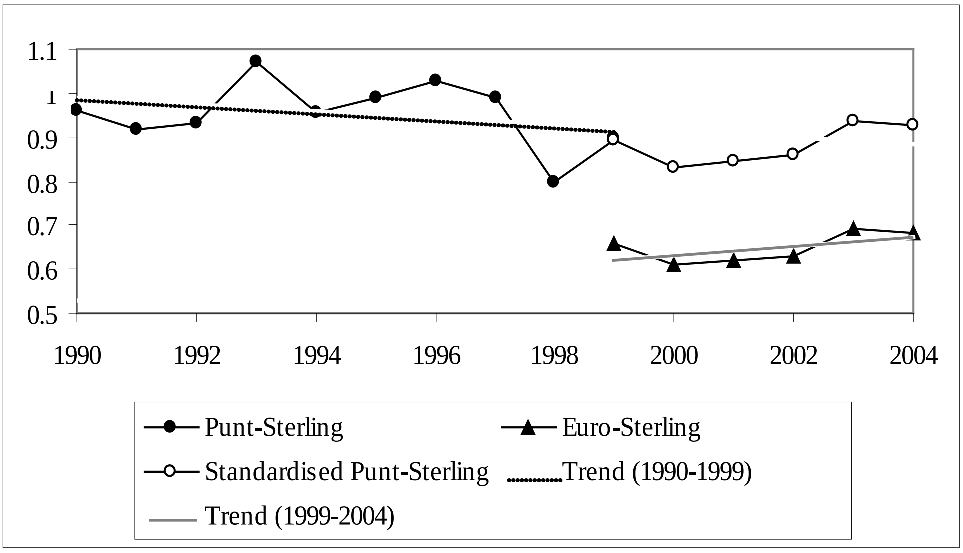
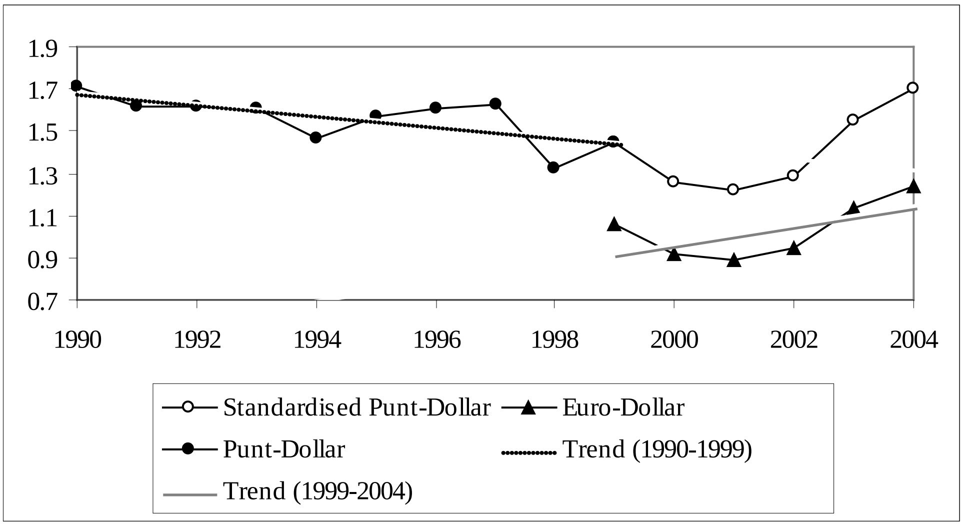


Figure 1a: Punt/Euro-Sterling exchange rate, 1990-2004

Source: HM Treasury, Pocket Book Bata Bank; authors' calculation



Source: HM Treasury, Pocket Book Data Bank; authors' calculations

Figure 2 presents standardised plots for both the dollar and sterling exchange rates, expressed in 1999 punt equivalents. This composite figure is the most effective in showing variations in the exchange rate between the Irish economy and its principal Anglophone trading partners between 1990 and 2004. Any appreciation in the value of the standardised punt equivalent represents a loss in simple price competitiveness, whilst any depreciation represents a gain in simple price competitiveness.

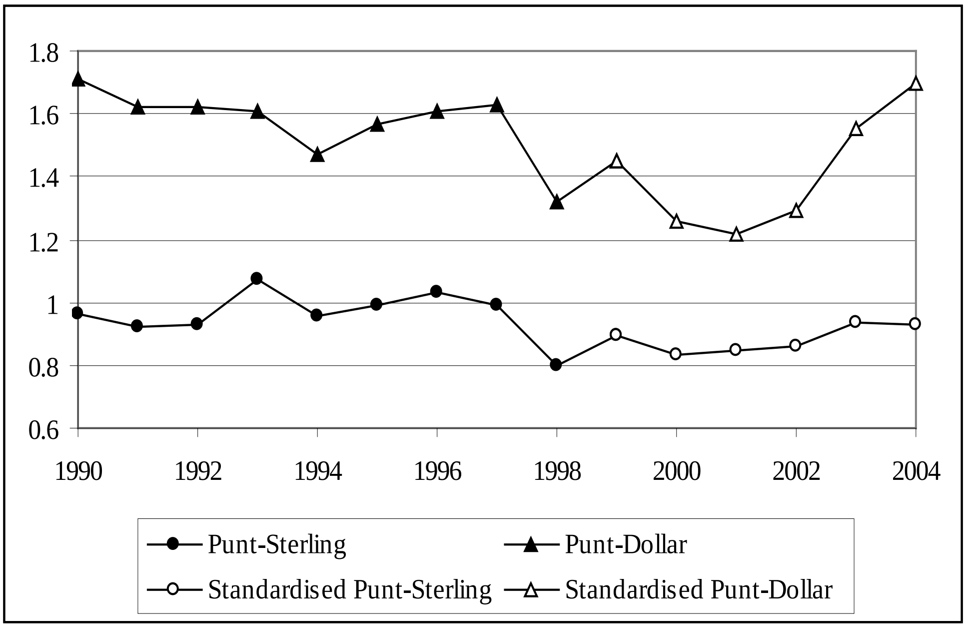


Figure 2: Standardised Punt-Sterling and Punt-Dollar exchange rates, 1990-2004

The picture that emerges is an interesting and complex one which, despite superficial impressions to the contrary, is not easily reconciled with the fears expressed in the debate on Irish entry to the Eurozone by exporters to Anglophone markets. On the face of it, it may seem that the sceptics had a point, for the euro has indeed appreciated against both sterling and, in particular, the dollar in the period 1999-2004. By contrast, the clear trend in the punt-sterling and punt-dollar exchange rates in the period 1990-1998 was in the opposite direction. The 1990s saw a secular improvement in simple Irish price competitiveness with respect to Britain and the US as the punt depreciated against sterling and the dollar, whilst the period since EMU has seen a reversal of Irish price competitiveness trends.

However, any closer consideration of the data reveals this to be an over-simplification from which precisely the wrong inferences are all too easily drawn. The anticipation of EMU entry during 1998 did indeed see the appreciation of the punt against both the dollar and sterling, penalising Irish exporters to these markets. Yet, the initial trend after EMU entry was downwards, continuing that established throughout the 1990s. This improved Irish price competitiveness in Anglophone markets. Indeed, the overall loss of Irish competitiveness in the period since 1999 is, in fact, almost entirely attributable to a depreciation of the dollar and, to a lesser extent, sterling which occurred from 2001 onwards and not before. Moreover, this is not a direct EMU effect. It is not the single currency so much as exogenous shocks – the slowdown in the world economy before and after 9/11 and the Second Iraq War – which account for both the timing and relative magnitude of the appreciation of the euro. Moreover, the loss of competitiveness with respect to the British market is scarcely significant, the punt equivalent having appreciated by scarcely 3% with respect to sterling between 1999 and 2004. There is little evidence here to suggest that EMU entry in itself has had any impact on simple Irish price competitiveness. In this sense, the concerns of Irish EMU-sceptics have not been realised.

In fact, the Irish economy's economic performance since 1999 has been most impressive, continuing a trend established early in the 1990s. Figure 3 presents comparative data on inflation and long-term commercial interest rates for Britain and Ireland, whilst Figure 4 presents comparative data on rates of economic growth since the mid-1980s.

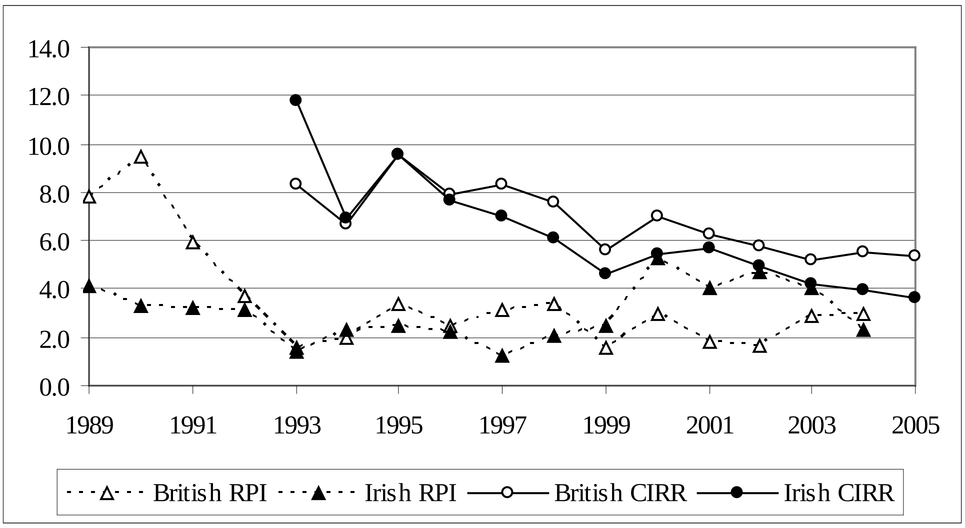


Figure 3: Interest rates and inflation, 1989-2005

Source: OECD Statistics Portal (www.oecd.org), for Commercial Interest Reference Rates (CIRR)

HM Treasury, Pocket Book Data, for Retail Price Index (RPI)

The picture is, again, both interesting and complex. Both economies have seen significant and, for the most part, sustained reductions in interest rates and inflation over this period. Today, both enjoy amongst the lowest long-term interest rates and the lowest rates of inflation they have experienced in the entire post-war period. The British economy has seen the larger decrease in inflation, the Irish economy the larger decrease in interest rates. Yet, what is particularly interesting here is the comparative performance of the British and Irish economies since the latter's membership of EMU in 1999. Britain's impressive inflation record has been almost perfectly reflected in a very similar interest rate record. Whilst these parallel trends have continued throughout this recent period, a very different trajectory is visible for Ireland. Between 1999 and 2002, in particular, although ECB-set interest rates continued to fall, Irish inflation rose quite significantly and remained unchecked. This is evidence of precisely the macroeconomic difficulties of membership of a single currency to which many Irish EMU-sceptics pointed.

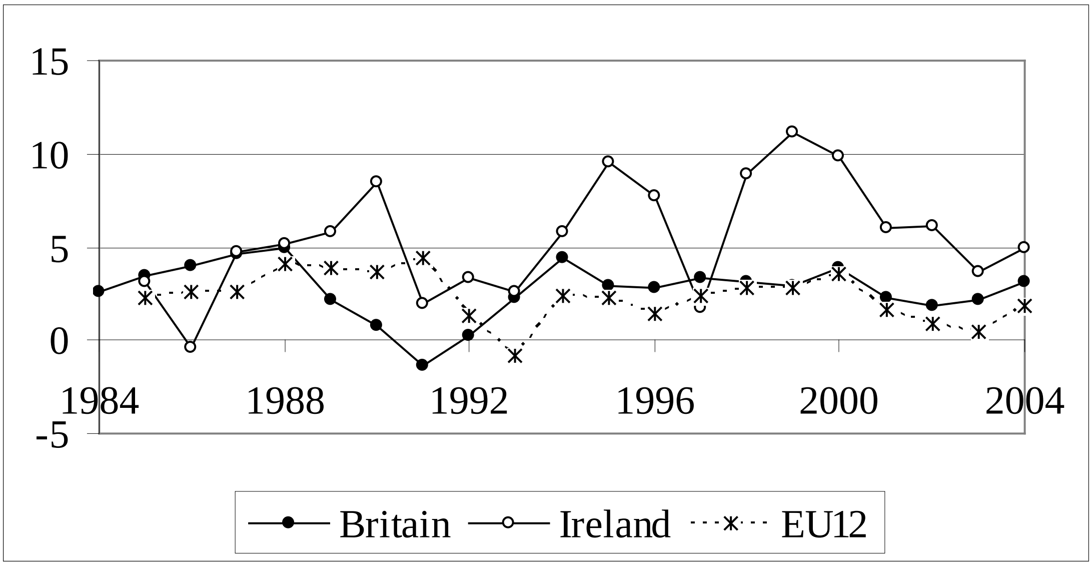


Figure 4: Growth of real GDP, 1984-2004

Source: HM Treasury, Pocket Book Bata Bank

During this period, the continued high growth rate of the Irish economy saw inflationary pressures build. This effect was only compounded by the initial appreciation of sterling and the dollar against the euro, with a consequent increase in the price of imports from Ireland's two largest trading partners. Ireland has a uniquely high import-dependence on two non-EMU economies, with 48% of its imports coming from Britain and the United States in 1999, for instance. Hence, it has a greater sensitivity to exchange rate variations than other Eurozone economies and, as such, it is unremarkable that inflationary pressures post-1999 significantly exceeded those for the Eurozone as a whole. This, of course, presented a problem. With interest rates set by the ECB for the Eurozone economy as a whole, not for the specificities of Ireland's peculiar inflation dynamic, no monetary policy solution to this over-heating was possible. Moreover, a fiscal policy induced deflation of this magnitude was, perhaps understandably, something the Irish Government was reluctant to engage in, especially as seemingly punitive tax rises would have to be presented as a consequence of the EMU membership which it had done so much to promote. In the end, Ireland was helped by a series of totally unpredictable factors – most significantly, the consequences of 9/11 and the Second Iraq War on export demand from the US and the associated depreciation of the dollar against the euro. However, concerns about macroeconomic management undoubtedly remain should asymmetric inflationary pressures in the Eurozone return again. This is likely to be a significant issue for both Ireland and Britain, and it is a point to which we return in the following section.

Engaging in Cautious Comparison: The Lessons for Britain from the Irish Case

Before seeking to draw any lessons at all for Britain from the above analysis, it is important to reiterate the inherent difficulties of the task at hand.

We began by noting that the vast majority of the debate and the literature that it has generated on the merits and demerits of British membership of the Eurozone has adopted what we termed a 'prospective accountancy' approach to the question. This involves developing a series of abstract counterfactuals leading to a stylised cost-benefit analysis. As we suggested, now that EMU has been in existence for the best part of a decade, there is a case to be made for a rather more comparative and retrospective mode of inquiry, looking at the experience of Eurozone members since 1999 as a guide to the credibility of the merits and demerits proposed in the earlier literature.

Yet, there is no escaping the fact that it is simply not possible to evaluate objectively the impact of EMU membership on, say, Irish economic performance since 1999, because there is no baseline to rely on of how the Irish economy would have performed in the absence of EMU. Nor, even were this possible, would one be able to transfer such an analysis simply and unproblematically to the British case. Ireland and Britain may well be alone in the EU in sharing a number of structural factors highly significant in EMU terms: the phases of their business cycles; their comparative historical insensitivity of output levels to interest rate variations; their extensive trading links with the US; their reliance on FDI and so forth. But this should not lead us to overlook the crucial specificities of each case. If the Irish economy has performed well since 1999 – and, for the most part, it has – this does not necessarily entail *any* of the following:

1. That Ireland has performed well *because* of its membership of the Eurozone;
2. That Britain *would have* performed similarly well *had* it been a member of the Eurozone since 1999;
3. That Ireland will *continue* to perform well in the Eurozone;
4. That Britain *would* perform well in the Eurozone were it to join; or
5. That Britain *should* join the Eurozone.

Consequently, in what follows, we do not suggest, and should not be mistaken for suggesting, any of the above propositions.

Nonetheless, a number of potential lessons can, we think, usefully be drawn from the Irish experience. These relate, in particular, to the microeconomic consequences of EMU and the question of competitiveness, the macroeconomic consequences of EMU and the question of managing the monetary constraints of a single currency, and the impact of entirely exogenous and contingent factors. We now move to consider each in turn.

The Microeconomic Lessons

Insofar as there are positive lessons to be drawn from the Irish experience, they would seem to be associated more with the microeconomic than the macroeconomic side of the equation. Whilst it is, of course, impossible in an article such as this to specify precisely the magnitude of the effects involved, it would seem as though Ireland, like other EMU member economies, has benefited from reduced transactions costs, more effective price signalling mechanisms and the elimination of exchange rate uncertainty with its Eurozone trading partners. This is confirmed by the growth in the share of Irish export trade going to EU markets and, indeed, Eurozone markets in particular. Ireland's trade dependence on Britain has continued to diminish since 1999, and with it so has its sensitivity to fluctuations in the sterling-euro exchange rate. Moreover, as we have seen, fears about loss of simple price competitiveness with the important British and US markets, based on the anticipated strength of the euro against the dollar and sterling, would seem largely to have been misplaced. Until 2001, the euro did not appreciate against either currency and any subsequent exchange rate trends would seem to be attributable to exogenous factors which would have impacted upon the Irish economy irrespective of EMU membership. Indeed, the increase in the share of Irish exports destined for EU markets since 1999 has undoubtedly served to protect the Irish economy from the loss of simple price competitiveness with respect to Britain and the United States that it has experienced since 2001.

It is also worth noting that, despite the global downturn in 2001-2002, Ireland has continued to attract impressive levels of foreign direct investment. Inflows in 2002 were more than double the 2001 figure, making Ireland one of the few countries to experience such an increase (UNCTAD 2004, 1). Of this, inflows from the Eurozone accounted for more than two-thirds of the total (CSO 2003, 4). This was matched by a rise in employment (by 24,000 in 2002 and 26,000 in 2003), which is notable given that most developed nations experienced a fall in employment at this time (Department of Finance 2003, 9; Forfás 2004, 2). Thus, fears of significant job losses due to a loss of competitiveness with respect to Britain have simply not been borne out (see also Figure 5).

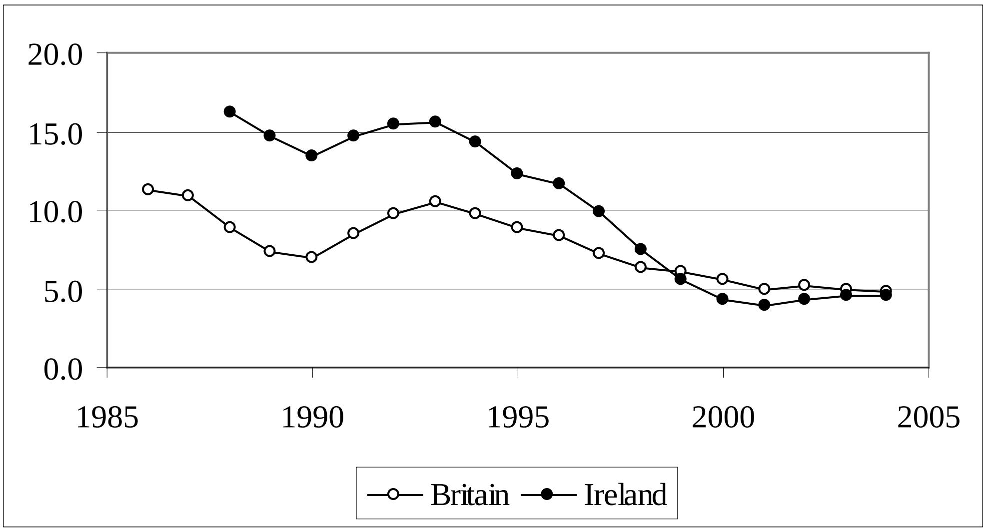


Figure 5: Standardised unemployment levels, 1986-2004

Source: HM Treasury, Pocket Book Bata Bank

Overall, then, the microeconomic audit for the Irish economy of EMU entry would seem to be strongly positive. But how much of this might apply equally to the British case? That is, of course, a difficult question to answer definitively. However, there is no reason for thinking that the British economy would not also enjoy the benefits, within EMU, of reduced transaction costs, more effective price signalling mechanisms and the elimination of exchange rate uncertainty. Moreover, now that close to 60% of British export trade and 55% of import trade is with the EU, such effects are likely to be comparable in size to those enjoyed by the Irish economy since 1999 (see Figure 6 for the picture with respect to exports).

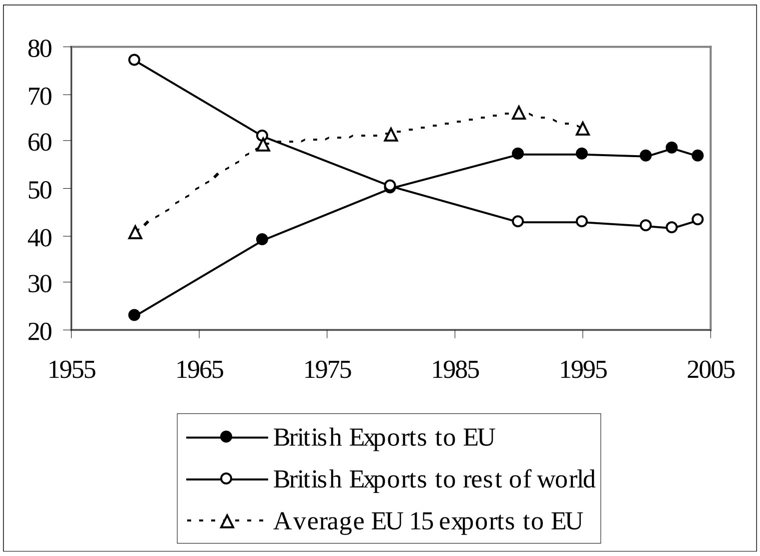


Figure 6: British exports to the EU as a percentage of total exports, 1960-2004

Source: Calculated from European Commission (1996) *European Economy*; *UK Trade Information Dataset* (www.ukintrastat.com).

Of the three factors, it is arguably the elimination of exchange rate uncertainty with the Eurozone that is the most significant. With a substantial and still ongoing decline in industrial and manufacturing output, a mounting balance of payments deficit, and an ever growing share of the imports required to service high levels of consumer demand now coming from within the Eurozone, the British economy is perhaps more exposed to inflationary pressures arising from a sharp appreciation of the euro than ever before. Britain's increasingly high import dependence on the EU and, more specifically, the Eurozone, is a strong argument in favour of EMU entry.

The Macroeconomic Lessons

The macroeconomic lessons are rather less ostensibly positive, although they are by no means unequivocally negative. Nor are they simple. Here, the comparison with the Irish case is particularly instructive. In comparison to the rest of the EU, the British and Irish economies have exhibited parallel business cycles, both have enjoyed recent high and stable rates of economic growth, both are more highly integrated with the US economy, and both have historically exhibited a certain insensitivity of demand to active monetary policy. Arguably, then, the macroeconomic predicament which Ireland experienced between 1999 and 2002, as described above, is one the British economy might easily have faced had it too joined the Eurozone as a first-wave entrant.

The problem is, in essence, very simple. If the Irish and British business cycles are not closely aligned with the aggregate Eurozone business cycle, and/or the Irish and British economies are characterised by a different sensitivity of output to interest rate variations, then the interest rate set by the European Central Bank for the Eurozone as a whole will not be appropriate for the control of inflation in either Ireland or Britain. This is exactly what happened in Ireland between 1999 and 2002. The result was an over-heating Irish economy whose inflationary pressures were not kept in check by the common Eurozone interest rate.

In itself, the scenario of a sub-optimal interest rate need not necessarily present a problem. For, *ceteris paribus*, a deflationary fiscal policy might be activated to control inflation when ECB interest rates are inappropriate, just as fiscal surpluses might be expended to boost demand. Indeed, for both Britain and Ireland, such a fiscal policy would be likely to prove strongly counter-cyclical and, if by some chance it was activated at exactly the right time, it could depress the fluctuations of the business cycle in a classically Keynesian fashion. Ignoring for a moment all the practical problems of timing – which are of course substantial – this might in fact provide a powerful case in favour of British EMU entry (see, for instance, Hay 2003). Yet, as the experience of the Irish case between 1999 and 2002 shows, largely for electoral reasons, governments are reluctant to engage in sizeable fiscal-induced deflations. Moreover, the problem is not merely one of deflating the economy when interest rates are too low to suppress inflation, but also one of injecting demand into the economy when interest rates are set so high as to suppress growth. This reveals a further problem. For, across the business cycle as a whole, such fiscal policy activism is likely to violate the terms of the Stability and Growth Pact and is thus, ostensibly, outlawed.

The implications of this for Britain are, essentially, four-fold: (i) membership of the Eurozone would almost certainly force upon the British Treasury renewed responsibility for the management of inflation, this being a responsibility that it surrendered with the Government's decision to grant operational independence to the Bank of England in 1997;

(ii) such a scenario would effectively impose upon the Government a degree of fiscal policy activism across the business cycle that it has thus far strongly resisted; (iii) in all likelihood, prevailing circumstances would require a strongly counter-cyclical fiscal stance, inadvertently recommitting the Treasury to something resembling a textbook Keynesian strategy; and (iv) in order not to worsen Britain's good recent record for controlling inflation, another major EU economy would have to be allowed to ignore both the terms and the principles of the Stability and Growth Pact. In the absence of an agreement amongst Eurozone members to re-examine the terms of monetary and fiscal policy coordination, the macroeconomic case for British EMU entry is weak. Moreover, there is nothing that either British or EU policy-makers can do to make that case strong, because all of the above would have to take place in the absence of knowledge of when, precisely, to activate the counter-cyclical tendencies of fiscal policy stimuli.

Exogenous Shocks and the Unknown

The foregoing already points to the significance of the unknown, which leads us to one further brief but important lesson from the post-1999 experience of the Irish economy. That lesson concerns the crucial significance of factors that are both totally unpredictable and totally exogenous to the dynamic of the EU economy. Arguably, and as we have sought to demonstrate, the performance of the Irish economy since 1999 has been shaped more significantly by contingent factors external to the Eurozone economy than it has by anything to do with the decision to join the single currency itself. If our assessment is correct, the microeconomic evidence from the Irish case suggests that EMU membership has proved marginally beneficial, whilst the macroeconomic evidence suggests that Ireland's management of inflationary pressures has been impeded somewhat by EMU membership. Neither factor, however, has proved anything like as significant as the slowdown in the world economy and the appreciation of the euro against the dollar immediately before and after 9/11. In all likelihood, the future performance of the Irish economy will be shaped in just as decisive a fashion by factors beyond its control and beyond our anticipation. That is an appropriately chastening thought when attempting to engage in comparative lesson-drawing. We now turn to further problems of comparison which arise from the specificities of the British case.

Comparing Dissimilar Cases: The Particularities of the British Growth Model

The macroeconomic indicators outlined in the previous sections tell us only about the aggregate performance of the two economies; they tell us nothing about how those economies came to perform in that way in the first place. The recent growth *trajectory* of the British and Irish economies may be broadly similar compared with their respective longer term trends, but the figures for industrial production (see Figure 7) hint at an important difference in the two economies' underlying growth *models*.

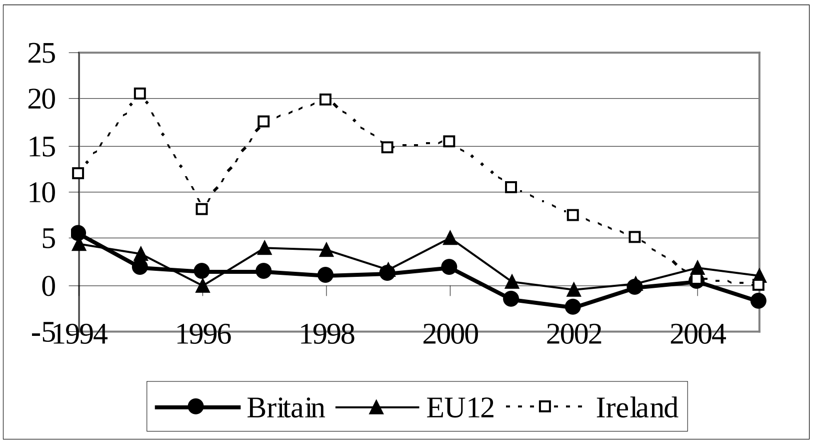


Figure 7: Annual Growth in Industrial Production, 1994-2005

Source: HM Treasury Pocket Book Data Bank

Over the last ten years, Irish industrial production has grown, on average, by around 10% per annum, whereas British industrial production has scarcely grown at all. The single most important feature of recent British growth is nothing to do with prior investment in new productive capacity. Instead, it is the wealth effect associated with rising house prices (Watson 2003). This has had a positive impact on British growth rates through the additional consumption which has been facilitated by the release of equity via rising property prices. To offer a rather crude distinction between the respective economies' growth models over the last decade, Ireland's growth trajectory has been largely production-led, Britain's almost entirely consumption-led.

Britain's growth model has, in essence, been financialised at the level of the individual household, with a range of credit-based instruments increasingly used to fund additional household consumption. The British economy is as well placed as any other to provide opportunities for individuals to expand their consumption in this way. Its liberal financial system has always been a market leader in terms of financial innovation, which has led to the creation of innumerable new credit instruments (see, for instance, Buckle and Thompson 2004). This, on its own, would be of little consequence if individual households are risk-averse (i.e., cautious about their ability to re-pay loans). However, this is to overlook one extremely important contextual factor which is specific to the British economy over the last decade. The substantial increase in house prices over this period has led to an increasing tolerance of households to short-term debt positions, on the assumption that short-term debt will quickly be cancelled out by the wealth effect arising from a buoyant housing market. Something of a self-reinforcing cycle has consequently been established, encapsulating ever higher house prices, reduced levels of risk-aversion, additional household borrowing, expanded consumption, new sources of economic growth and greater confidence in a growing economy's ability to sustain ever higher house prices.

House Prices and British Growth

Average house prices in Britain have risen by more than 5,000% since 1965, with an average annual increase of just over 10% (Council of Mortgage Lenders 2005). Since 1997 house prices have risen, on average, at 12% per annum. If we consider that the average house price in Britain in 2004 was around £175,000, whilst average annual earnings were around £28,000, the wealth effect originating from the housing market in that year was of quite staggering proportions - three-quarters of the average person's annual earnings.

Set in such a context, it is perhaps understandable that consumption in Britain seems to have been structurally decoupled from income for paid work. Income plus the wealth effect from the housing market alone now sum to £77,000 per year for the average double-income home-owning family, as against £56,000 income from paid work alone. Given this disparity, individuals are likely to feel increasingly less constrained by the need to match consumption to income from paid work. If they accept short-term debt in order to enhance current consumption, this is likely to be wiped out very quickly by the wealth effect from the housing market. It may come as no surprise, then, that average household debt has risen to record highs in Britain in recent years (*The Economist*, 21.05.05).

What is more, the British growth model is now entirely conditional upon the limited risk aversion which has developed amongst the British population in relation to the credit economy. Precise assessments of the actual size of credit-based consumption are difficult to come by, but most estimates are in the region of 4-6% of GDP. Given that the average growth rate of the British economy over the last decade has been around 2.8% (see Figure 4), the impact on GDP of credit-based consumption outweighs average annual growth by a factor of two. In other words, remove the growth effects of credit-based consumption and the underlying growth rate of the British economy would have been as highly negative as it has been positive.

If there is to be an EMU effect on the British economy, then, its most likely transmission mechanism is via its impact on credit-based consumption. In circumstances in which the introduction of the single currency in Britain has no effect on the underlying structure of household risk aversion, we would expect the current British growth model to be reproduced without too many difficulties. However, in circumstances in which the introduction of the single currency undermines confidence in the credit economy, the current British growth model would become increasingly dysfunctional, so reliant is it now on credit-based consumption. The task that remains for us, as we draw our discussion to a close, is to decide which of these two scenarios is the more likely. Our reflections on this issue return us, by necessity, from empirical analysis to the realm of conjecture.

Possible EMU Effects on the British Economy

The most important issue when it comes to assessing the likely EMU effects for Britain concerns the economy's future inflation performance. This is because consumer confidence in the credit economy is strongly correlated with expectations of changes in the general price level. The first thing to note in this respect is that British inflation performance has been strong, in historical terms at least, since the early 1990s (see Figure 3). The result has been a trend decline in British interest rates, which makes it cheaper to borrow money to fund current consumption and, as a result, it makes credit instruments much more attractive to the household which seeks to expand its consumption possibilities in this way. Households are more likely to engage in credit-based consumption in periods of low inflation, for the simple reason that low inflation is usually coincidental with low interest rates, hence reducing the cost of borrowing.

Is there any reason, though, to suspect that joining the single currency might be harmful for British inflation performance and, as a consequence, detrimental to the reproduction of the British growth model? Much of the pre-1999 discussion of likely EMU effects focused on the inflation penalties that an economy would experience if its business cycle was out of alignment with that of the Eurozone as a whole. In such circumstances, ECB interest rates, whilst appropriate for the Eurozone, would be inappropriate for the misaligned economy. As we have argued, the post-1999 Irish inflationary experience is perhaps best explained in this way: ECB interest rates in 1999 were set for a Eurozone economy which was growing more slowly than the Irish economy and, as a consequence, the misalignment of business cycles led to additional inflationary pressures in Ireland. The question becomes, then, whether the business cycle in Britain is aligned with that of the rest of the Eurozone?

The answer is almost certainly that it is not. With one or two partial exceptions, Ireland currently being the most notable, the business cycles of existing EMU members fluctuate roughly in line with one another. The stimulus for this alignment was the concerted efforts that were undertaken throughout the 1990s to meet the Maastricht convergence criteria in order to guarantee entry into the third stage of EMU. The convergence criteria imposed a deflationary bias on the Eurozone, pushing all economies towards the low point of the business cycle and extending that experience for those who reached the low point first. The British Government, by contrast, made no attempt to subject the British economy to the convergence criteria, as the political commitment to EMU was absent. As a consequence, the British economy did not experience the same pressures for business cycle alignment as first-wave EMU entrants. When compared with the Eurozone as a whole, Britain's most recent business cycles have been of a different magnitude and different duration, and their peaks have been seriously out of sync. Quite conceivably, then, were Britain to join the single currency, the result would be an inflation penalty exacted via inappropriate ECB interest rate settings (inappropriate, that is, solely from the perspective of the British economy). But how would this impact upon the British growth model?

For a start, it is necessary to note that the British housing market has proved remarkably resilient during recent inflationary episodes. When inflation is met by interest rate increases, mortgage rates also increase, reducing the incentive to borrow in order to finance house purchases. In general, then, we would probably expect the housing market to cool in such circumstances, leading to a fall in nominal prices. However, inflationary episodes also erode the real value of house prices. This, in turn, acts as a stimulus for activity in the housing market, as investors act on the perception that property has suddenly become cheaper. The extra activity in the market is likely to keep nominal price trends buoyant, continuing to force them upwards even in the midst of an inflationary episode. The two consequences of inflation on the housing market – the increase in mortgage rates on the one hand and the erosion of the real value of house prices on the other – seem largely to have cancelled one another out in the British economy in recent decades.

Note, though, that these two consequences cancel one another out *only* within a context of interest rate settings appropriate to the point in the business cycle. Would the same effect be evident within the context of EMU, assuming that the business cycle in Britain was out of line with that of the rest of the Eurozone and that ECB interest rate policy was set for the Eurozone as a whole? The most likely answer has to be 'no'. In such circumstances, it would both be extremely fortunate and extremely unlikely were interest rate settings to continue to balance the rising cost of mortgage lending in an inflationary period with falling real house prices. The most likely effect of any failure to achieve this would be a loss of confidence in the housing market with consequent effects on house prices, access to credit and the release of equity to finance consumption. In the context of a stagnant housing market the wealth effect disappears, forcing a renewed convergence between current consumption and income from paid work. For the average double income household, using the figures for 2004, consumption possibilities would fall by almost 30 per cent. Needless to say, current rates of growth could not be sustained in such a context.

Of course, all this presupposes that the housing market acts as a predictable transmission mechanism, whereby a given shock in the monetary economy leads in all circumstances to the same effect in the credit economy. However, the housing market does not operate in this way. It is propelled more by the psychological determinants of a feel-good factor than it is by the economic determinants of a monetary shock. As such, we might well be able to construct likely economic scenarios relating to an EMU effect, but we cannot know for sure that these scenarios will materialise in practice. Whilst the trajectory of the housing market is governed by the ability to maintain confidence in that market, what maintains confidence is much more difficult to quantify.

The structure of the mortgage lending market provides one reason for thinking that confidence levels may prove to be robust, irrespective of any putative EMU effect. That market is now all but saturated with mortgage providers, and the consequently competitive nature of the business ensures that providers work on tight margins, thus keeping to a minimum the costs associated with mortgage borrowing. The supply-side of the mortgage lending market therefore appears to offer few threats to existing levels of confidence in the housing market. However, the really important factors in this respect relate to the demand-side of the mortgage lending market: that is, whether households can be persuaded to continue to enter that market on the assumption that house prices will continue to rise. It is here that EMU effects might be more noticeable.

For a start, an EMU referendum campaign is likely to involve exaggerated claims on both sides about the possible impact of monetary union on the economy. Claim and counter-claim are likely to foster increased uncertainty about macroeconomic prospects, and uncertainty usually involves higher levels of diffidence in relation to long-term investments, including those on the housing market. Moreover, the transition between national and supranational modes of monetary policy-making is likely to lead to additional uncertainty about the future success of counter-inflationary policy. Nobody at present can say for sure just how much Britain's business cycle is misaligned with that of the Eurozone as a whole, and nor will anybody know for sure at the time at which a decision is made for Britain to join EMU. A period of 'wait and see' will necessarily follow, as investors attempt to assess the impact of the new institutional arrangements for monetary policy-making, and this period will probably be marked by a more conservative approach to investment in the housing market. As it is, much of the recent confidence in the British housing market has been driven by the reduced inflationary expectations associated with the British economy, as evidenced by changes in the price of inflation-linked assets traded on London's futures markets. In turn, these reduced inflationary expectations have resulted precisely from the fact that Britain has established credible institutions for counter-inflationary policy *outside* of EMU. All of these factors suggest that the process of managing the transition to monetary union might prove detrimental to maintaining confidence in the British housing market. However, all of this remains pure conjecture.

One thing we can note with greater certainty, though, is the potentially fragile nature of the British growth model. That model is entirely conditional upon maintaining the wealth effects which result from high levels of confidence in the housing market. Yet, this underlying confidence is extremely sensitive even to small shifts in investor sentiments, and such shifts need have no obvious economic trigger. EMU effects may not need to be particularly large, then, and may not even need to have a logical economic transmission mechanism, in order for them to have a significant impact on the overall performance of the British economy.

Conclusion

In this article, we have sought to establish the value of retrospective, empirical and comparative analysis in assessing the merits and demerits of prospective membership of EMU – in this case, for Britain. Our argument has been based on an assessment of the lessons that can be drawn from the post-1999 experiences of Ireland, the most similar country case to Britain currently within the Eurozone. Yet, as we have consistently pointed out, and as the previous section makes especially clear, retrospective empirical comparison cannot entirely replace prospective conjecture. Nonetheless, in both its similarities to the British case *and* its notable differences, consideration of the Irish experience within EMU encourages a series of important thought experiments which shed light on both the microeconomic and macroeconomic merits and demerits of British entry.

Piecing together the various threads of our analysis produces at first a somewhat disparate set of conclusions. The microeconomic case is perhaps the clearest and is also the easiest when it comes to drawing inferences from the post-1999 trajectory of the Irish economy. There is no reason for thinking that the British economy would not also enjoy the benefits, within EMU, of reduced transaction costs, more effective price signalling mechanisms and the elimination of exchange rate uncertainty. In macroeconomic terms, however, the lessons to be drawn from the Irish experience and the overall picture that results are both more complex and more equivocal. EMU effects are likely to be evident in an inflation penalty arising from the fact that ECB interest rates will be inappropriate for Britain's business cycle, which is not aligned with that of the Eurozone as a whole. The result is likely to be either a loss in the reputation for counter-inflationary discipline that Britain has acquired in recent years, or the adoption of a strongly counter-cyclical fiscal policy to compensate for a sub-optimal monetary policy. Given the Irish experience between 1999 and 2002 and the British Government's seemingly rather greater antipathy to the use of fiscal policy to constrain demand, the former is by far the more likely.

This could conceivably be a price worth paying for the potential microeconomic benefits of entry were it not for one factor: the potential impact upon the housing market and, in turn, upon Britain's peculiarly consumption-driven growth dynamic. Although this is where our argument is at its most speculative, British membership of EMU in the absence of a much closer alignment in business cycles might destabilise the already fragile growth model of the economy. By the same token, however, this peculiar and highly distinctive growth dynamic is far from stable anyway. As such, whilst Britain should perhaps be cautious about EMU entry at this point when considering the issue solely on economic grounds, it may well find itself in the years ahead in search of a new model of economic growth. If it can find one that is not so heavily reliant on consumption dripped into the economy through the release of equity from the housing market, it too may be able to enjoy the microeconomic benefits of EMU entry in due course. Whether it will do so and what that growth model will look like, however, are questions that take us beyond both prospective accountancy and retrospective comparison and, therefore, beyond the terms of this article.

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