THE FEDERAL TRUST

Enlightening the Debate on Good Governance

One Currency One Country?

Christopher Johnson

European Essay No.7

A Definition of Federalism

Federalism is defined as 'a system of government in which central and regional authorities are linked in an interdependent political relationship, in which powers and functions are distributed to achieve a substantial degree of autonomy and integrity in the regional units. In theory, a federal system seeks to maintain a balance such that neither level of government becomes sufficiently dominant to dictate the decision of the other, unlike in a unitary system, in which the central authorities hold primacy to the extent even of redesigning or abolishing regional and local units of government at will.'
(New Fontana Dictionary of Modern Thought)

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Introduction

If you want a comprehensive overview of the Euro issue, here it is. Christopher Johnson's long experience of the arguments for and against a single currency is magisterially displayed in this short essay that encompasses virtually all you need to know about the new currency.

Against the background of the history of earlier monetary unions and the theory of optimal currency areas he surveys the permutations of one currency and many countries, many countries and one currency. He offers various ways of appraising the single currency - as a convenient financial innovation, as a step towards a United States of Europe or as part of a new kind of political union. He is particularly acute in opposing the views of previous Chancellors of the Exchequer one against the other, or in reviewing the political priorities of present and previous Foreign Secretaries. And his conclusions merit close attention, not only for the clarity of the distinction he makes between the variety of language and culture and the homogeneity of a single currency zone, but even more importantly for the juxtaposition of federalism and decentralisation which gives the lie to the myth of the superstate. His ten point summary could well be distributed to all politicians before they opine in public about the Euro and in particular its relation to the pound.

The essay is controversial, but controversial on the basis of a deep knowledge of the facts. If the public debate in this country were consistently conducted at this level we should all benefit from a broader understanding of the issues at stake. For some it would allay their fears, for others strengthen their resolve. For all of us it would ensure that half-baked opinion, sauced with enthusiasm, could not pass itself off as a nourishing intellectual diet.

Those who are looking for the quick fix of an opinion on the date when Britain should join the Euro will be disappointed. Those who are looking for a reasoned presentation of the issues - albeit with an assumption that the single currency will one day embrace the pound - will be pleased to have at hand a well presented set of arguments. Those who first heard them presented in a paper at the Federal Trust conference in Cambridge earlier this year will be delighted to find them in this published form. They will help to enlighten the debate.

Martyn Bond
Director, The Federal Trust
April 2000

About the Author

Christopher Johnson has been UK Adviser to the Association for the Monetary Union of Europe since 1991. He was Chief Economic Adviser to Lloyds Bank in 1977-91, a General Manager of the Bank in 1985-91, and Editor of *Lloyds Bank Review* and *Lloyds Bank Economic Bulletin*. He was Visiting Professor of Economics at Surrey University in 1986-90, a Visiting Scholar at the IMF in 1993, a specialist adviser to the Treasury Select Committee of the House of Commons in 1981-97, and Chairman of the British section of the Franco-British Council in 1993-97. He is a member of the Council of Britain in Europe. He was Diplomatic Correspondent, Foreign Editor, Managing Editor, and a Director of the *Financial Times* between 1963 and 1976.

He is author of numerous books including *In with the Euro, out with the Pound: the Single Currency for Britain* which was published by Penguin in 1996. He broadcasts, writes articles, and gives lectures about the Euro and other economic and financial topics.

He was made Chevalier de la Legion d'Honneur by the President of the French Republic in 1996.

ONE CURRENCY, ONE COUNTRY?

by Christopher Johnson

This essay begins by examining possible permutations of currencies and countries and moves on to discuss a number of different ways of seeing the European single currency, before focusing on the different approaches to EMU adopted in the UK. It concludes by showing how a European Union of nation states with a federal structure will be a quite different kind of entity to the United States of America.

This approach to EMU follows on from this author's attempt to set out a calculus of the political and economic advantages or disadvantages for the UK of joining Economic and Monetary Union (EMU).[1] It was argued there that if the political case for entering EMU was good, the economic arguments need be no better than neutral, and that if the economic case was good, the political arguments need be no better than neutral. It is argued here that both the political and the economic case for EMU are good. What applies to the existing members holds good for the UK. Kant's categorical imperative applies: 'The 'maxim' implied by a proposed action must be such that one can will that it become a universal law of nature'.[2] If the UK believes that EMU is good for the existing members, then, by the same logic, it is good for the UK. If the UK believes that it is right for itself to opt out of EMU, than it would be right for any existing member country that chose to opt out.

The object of this essay is to put the British arguments in the wider context of where EMU fits into the wider structure of the European Union as a whole.

WHAT ARE THE PERMUTATIONS?

One country, one currency

A world of independent countries, each with its own currency, is the paradigm of the international economic system that we were all brought up with. The one-to-one mapping of countries and currencies is so ingrained in popular psychology that a currency seems to become an attribute of a country, along with the flag, the head of state, the armed forces, the frontiers, the passport, and so on. The history of the rise of nation states is closely linked with that of their currencies, and goes back centuries in some cases. But it represents a capsule in world history, preceded by and doubtless to be followed by, quite different arrangements. In another century there may or may not be nation states and, quite independently of that, there may or may not be national currencies.

The historical origins of national currencies are as much political as economic. Rulers of empires – Athenian, Roman, Carolingian, German, British – wanted to impose their authority on their subjects by means of coinage showing their heads and other symbols. They imposed a monopoly of minting coinage, thus squeezing out rival authorities and exacting rent ('seignorage') from the users. They debased the metal content of coins to finance military and other expenditure, while hanging any subjects presumptuous enough to attempt the same fraud. The arrival of paper money enormously increased the possibilities of monetary financing for governments, albeit at the cost of inflation – a cost to the subjects, but revenue in the hands of the rulers.

The success of single currencies is thus only as good as the competence and integrity of governments in controlling their issue and use within a wider framework of stable economic policy. *Quis custodiet custodes ipsos?* As long as governments are sovereign, neither the gold standard, nor independent central banks, nor international authorities such as the IMF can ultimately prevent them using their political authority over their own currencies for bad rather than good ends. Governments can, however, agree with each other to pool sovereignty over money in a way that both preserves their independence and guarantees sound monetary management.

Optimum currency areas

Mundell's framework of optimum currency areas[3] (OCAs) can be used to justify the economics of single countries having single national currencies. An optimum currency area has freedom of movement of labour and capital within its borders, which provides a mechanism for adjustment necessitated by the operation of a single currency and a single monetary policy. Countries generally allow freer movement of labour and capital within their own borders than across them, so to say that a single country is an optimum currency area is almost a tautology. However, whatever the *de jure* freedom of movement of factors of production within a country, the *de facto* position may be quite different. Mundell himself pointed out that, in a sense, the Eastern and Western seaboards of North America were as good candidates for OCA status as the whole of the United States.

The UK today is a good case of an OCA in theory but not in practice. Capital is of course free to move north where there is cheap land and surplus labour. It does not do so without substantial state aids, particularly when faced with high interest rates designed to damp down a boom in the south-east. Labour is of course free to move south, where new investment is being inhibited by manpower shortages. It does not do so without massive skills training programmes by Government, and even then the cost of housing may be prohibitive. If the UK is not an OCA, *a fortiori* nor is the European Union as a whole, it is argued by British eurosceptics. However, the Single Market programme and EMU itself are making giant strides towards freer movement of labour and capital across borders. As in North America, there may be better OCAs across borders than within them; for example the Benelux countries plus northern France and western Germany. Short of redrawing national boundaries to fit OCAs, it seems better to reserve the OCA as a tool of analysis than to use it as a policy prescription. There are good economic arguments for widening the scope of leading currencies, and there are good economic arguments for allowing capital and labour to move freely. The two sets of arguments should be seen as overlapping, but independent of each other.

Several currencies, one country

When a country cannot create financial confidence in its own national currency, it is normal for other countries' currencies with better reputations to circulate alongside it, or even to displace it. In the Communist countries, the dollar was widely used as a black market currency, even though it was illegal, and 'speculators' sometimes even faced the death penalty – as they still do in China. It is more common today for other major currencies to circulate legally in other countries, which at least brings down the outrageous black market exchange rates created by the artificial scarcity due to legal prohibitions. The US is estimated to earn seignorage of $12bn a year by not having to pay debt interest on the $200bn in dollar banknotes circulating outside the country. Countries such as Argentina, Ecuador and Mexico have toyed with 'dollarisation' as a way of keeping inflation down, but the same effect can be achieved by credibly linking the national currency to the US dollar by means of a one-to-one backing through a currency board.

The D-mark has achieved the same status in central Europe as the dollar in the world as a whole. It is widely used as an alternative currency. Estonia successfully linked its kroon to the D-mark, and Kosovo and Montenegro have adopted it as their only currency, as it is clearly more stable than the fast sinking Yugoslav dinar. It will of course become the Euro after the beginning of 2002. The possibility opens up that the Euro will seep into central Europe – and perhaps even the UK – as an alternative currency, even before these countries join EMU or the European Union.

The presence of two or more currencies in one country creates an unstable situation, like earlier attempts to maintain currencies on a gold and silver standard at the same time when the exchange rate of gold against silver fluctuated. According to Gresham's Law, bad money drives out good, but it only holds where the exchange rate between the two is fixed. If the Mexican peso can always be exchanged into the US dollar at a fixed rate, people will hoard dollars and use pesos. But under floating rates an anti-Gresham's Law applies, where good money drives out bad. If the Mexican peso is constantly falling against the US dollar, people will use dollars both to spend and to save, and get rid of pesos.[4]

The widespread use of the US dollar, and to a lesser extent the Euro or its constituent currencies, in many countries carries the risk of instability. Not only are the two currencies unstable against each other, but they are both unstable against most national currencies, notably the pound. At least the 11 eurozone countries have stability of the Euro against their own currencies, which are merely manifestations of it until they disappear altogether at the beginning of 2002.

Several currencies, several countries

In a world without nation states or national currencies corresponding to them, there can be several currencies circulating in a number of countries or territories. This was the case in the Dark Ages and Middle Ages after the fall of the Roman Empire. Coins were judged on the reliability of their metal content and the reputation of their issuers. Trade was financed by different coinages from all over Europe, and in some cases commodities such as peppercorns were used. The silver Maria Theresa thaler, originally an Austrian coin in the 18th century, continued to be used until almost the end of the 20th century as the standard medium of exchange in the Arabian Gulf.

The world could return to a similar state of multi-currency chaos as a result of globalisation combined with currency competition. At one end of the scale there might be an expansion of local currencies based on local exchange trading systems (LETS), which are a more sophisticated version of multilateral barter. At the other end there might be a proliferation of internet currencies similar to 'Beanz', to allow payments to be made world-wide for e-commerce without going through the cost of exchanging conventional currencies. Such developments could be open to all kinds of fraud. The argument for conventional currencies is that they can be controlled and supervised by monetary authorities in a way that commercial currencies cannot. The proliferation of banknotes issued by different commercial banks in the US and the UK and other countries in the 19th century under 'free banking' caused runs on banks and financial panics when the notes of some banks ceased to exchange at par with those of the most reputable ones, or could not be converted into bullion.

Several countries, one currency

There are more instances of monetary unions – different currencies with fixed exchange rates – than there are of currency unions - single currencies circulating in more than one country. In a monetary union, such as the Latin Monetary Union of the 19th century, it is easier and cheaper for one country to leave the union than if it had entirely abolished its national currency. Most existing currency unions are a legacy of colonial or neo-colonial days. Thus the CFA franc circulates in 15 former French colonies in Africa, and the US dollar in 16 Caribbean and Pacific territories, including five British colonies or former colonies. Some cases are intermediate. Each country in the Latin Monetary Union had the franc as its currency, and the different national francs were at par with each other.[5] Similarly, in the Scandinavian Monetary Union of the late 19th and early 20th centuries, Denmark, Norway and Sweden all had crowns exchanging at one-for-one. In the Anglo Irish monetary union of 1922-79, the two pounds, though differently labelled, were at parity.

It is difficult to find a precedent for a monetary union such as EMU, where countries abandon national labels in order to share a single currency – apart from the vestigial presence of national symbols on the reverse of the Euro coins. In Germany in the mid-19th century, the still independent states of the confederation adopted either the North German thaler, or the South German guilder, or the Austrian florin, which were set at a fixed rate of 1 to 1.75 to 1.5 in 1853. There were thus three currency unions linked in one monetary union. It did not last, because Austria went its own way, and the North and South German currencies merged into the mark, as their states joined together in a single German Empire.

This example may suggest that several countries and one currency are a transitional combination that will eventually lead to one country with one currency, as in the German case. However, German political union had its own momentum, irrespective of monetary developments. Had monetary union actually brought about political union, it would have been a remarkable case of the tail wagging the dog. Austria did not merge with Germany, in spite of having a monetary union; instead, the two countries went to war with each other. The absence of political union may or may not make monetary union unsustainable, but the creation of a monetary union does not make political union necessary or inevitable. It would hardly be surprising if EMU was *sui generis*, with no historical precedents, since the same is true of the European Union as a whole since its beginnings in the 1950s.

Most cases of existing monetary unions arise where one country and its former colonies or territories move apart politically, but continue to use the same currency, or different national versions of it. Such centrifugal monetary unions come about by the opposite process to that exemplified by the centripetal European monetary union. Recent econometric evidence by Professor Andrew Rose of Berkeley shows that countries within a monetary union do over three times as much trade with each other as countries with different currencies, even if those currencies' exchange rates are fixed.[6] Since living standards rise with trade, a single currency can be expected to bring about higher economic growth in the area where it operates, compared with different currencies.

WAYS OF SEEING A SINGLE EUROPEAN CURRENCY

A convenient financial innovation?

Financial markets have expanded enormously in the last quarter of a century by devising innovative products to suit the needs of their customers, as well as generating substantial profits for themselves. The most successful innovations have been derivatives based on the primary markets, such as forward rate agreements, swaps, options, and futures. They have been derived from short-term interest rates, bonds, stock market indices and foreign exchange. One type of innovation is the basket which pools risky financial instruments in such a way as to reduce the total risk. Investment funds are all basket products. Foreign currency baskets were once provided by banks, until the official sector moved in. The IMF's basket, the Special Drawing Right, invented in 1967, never caught on as a market currency. The ECU basket, launched in 1975 as the European Unit of Account, was more successful, although it suffered from not being backed by a single central bank. The ECU has been superseded by the Euro, which has eliminated the risk between the participating currencies by permanently fixing their rates and thus their proportions in the basket, by the simple expedient of abolishing them. The internal risk is replaced by the external risk of volatility between the Euro and the US dollar, the yen, the pound and other currencies. For countries whose risks lie more in their dealings with each other than with their dealings with the outside world this is an advantageous trade-off.

The birth of the Euro should be followed up by a further wave of financial innovation in the markets where it is used. The bond market in Euros has been the first to benefit from the action. Far larger issues have been possible than could be achieved in individual currencies such as the D-mark, and on some measures the Euro has overtaken the dollar in bond markets. As Euroland governments have issued fewer bonds, the corporate sector has moved in to fill the vacuum. The innovation here has been in access to the bond market for lower-rated, but still attractive issuers offering higher yields. The Euro equity market is sure to follow, but it will take longer to break down the national barriers and proprietorial pride which still divide Europe's equity markets. Accounting conventions will also have to be harmonised if Euro shares are to be valued on a comparable basis across national stock markets.

The Euro can also be seen as a worth-while innovation for consumers within Euroland, who will no longer have to use foreign currency in tourism or in shopping. However, the globalisation of tourism and e-commerce means that other currencies such as the US dollar, or new commercial currencies, will also need to be used. If the Euro is a useful financial innovation, a single world currency would be even more useful. The extension of the scope of a currency can be seen as a matter of commercial convenience rather than a major political step. However, questions of the control of the issue of currency, and the regulation of the institutions handling it, are still going to arise at the international level. A world currency could not be insulated from political controversy any more than can the World Trade Organisation.

A step towards a United States of Europe?

The creation of the Euro is a major political event, because of the pooling of monetary sovereignty and the coordination of wider economic policies which it requires. It can also be seen as a step towards a United States of Europe. In the United States of America, political union preceded monetary union. Although the dollar was the single currency from 1785, the freedom of commercial banks to issue their own dollars meant that not all dollars had the same value, and there was no national monetary policy. The Federal Reserve Board was set up only in 1913, and it began to operate a single monetary policy only from 1933. Euroland has started with a European Central Bank and a single monetary policy alongside its single currency. Its political institutions fall well short of those of a single national entity. The question is whether they need to develop further in order to ensure the effective working of the single currency, and whether EMU – or the single market, for that matter – is a means of bringing about a United States of Europe as an end in itself, and not just as an adjunct to the single currency.

The founding fathers of the European Union argued for a United States of Europe as a way of avoiding a recurrence of the two World Wars and the Franco-Prussian War. Half a century later, the original objective has become a distant memory for people too young to remember even the Second World War. It is also clear that no political union is proof against the burning desire of one or more of its members to secede. The examples of the American Civil War and the break-up of former Yugoslavia are among the worst that come to mind. It is sometimes said that democracies do not go to war; neither Bismarck's Germany nor Hitler's were democracies. It therefore makes sense for the European Union to require that its members adopt and retain democratic forms of government. If a country leaves or does not join because of a democratic deficit – recent developments have led some to believe that Austria could exemplify the former, Turkey the latter case – the risk of conflict does not go away, but is shifted from the internal to the external plane.

A different rationale for the European Union is that it provides a mechanism for the settlement of disputes between member countries about trade, investment, finance and immigration which would otherwise lead, not so much to armed conflict, as to cold war situations within Europe, bringing lower living standards and strained international relations. Latin America is an example of what happens to a continent lacking overarching political and economic institutions. The British beef war can be cited as an example of how much worse matters might have been but for the ability of the Commission to seek and impose solutions, with at least partial success. Provided that member countries are committed by prior agreement to implementing collective decisions, they do not need to abandon national independence in favour of a super-state. Any territory which feels that its vital interests are being sacrificed will ultimately seek to secede, whether from a single state or from an association of states. A voluntary association such as the EU has the advantage over a super-state that it needs to retain the loyalty of all its members by showing that their national concerns are being met, rather than imposing it by the force of central authority.

Part of a new kind of political union?

The term political union is often interpreted to mean a super-state, but this is not what it means to most politicians in Europe. Neither the French nor the Germans are prepared to terminate their national independence when they talk about political union. They are thinking in terms of closer cooperation at political level over a wide range of issues; money, trade, economics, immigration, enlargement, defence and foreign policy, for example. To the extent that there are European political institutions, such as the Council, the Commission, the Parliament, the Court of Justice and the Central Bank. Already, political union could be said to exist. What is needed is to give it greater democratic legitimacy by building bridges between the European institutions and national institutions, and between the peoples of Europe. This implies greater efficiency and transparency, and an end to the culture of corruption and bureaucracy.

Economic and Monetary Union can be seen as a template for a wider kind of political union. Its main features are: a timetable, a central institution with a federal structure (the European Central Bank), a forum for inter-governmental cooperation (Ecofin or, increasingly, the Euro 11 Council), and a constitution (the Maastricht Treaty). Success in setting up EMU, albeit after a number of false starts, should encourage the EU to set up parallel structures in other fields of policy.

The second and third 'pillars' of the Maastricht Treaty, the Common Foreign and Security Policy and Justice and Home Affairs, have made much slower progress in the decade since they were set up than has EMU. This is partly because they were deliberately set up on an inter-governmental basis rather than on a Community basis, so as to limit their supra-national character. The example of EMU and the single market shows that inter-governmental cooperation works better within a structure of Community-type institutions. As Pedro Solbes, the EU Commissioner for Economic and Monetary Affairs, has said about EMU: 'Europeans are learning about the joint exercise of one of the great attributes of sovereignty. That will provide valuable experience for the development of an 'ever closer union' between the Member States'.[7]

THE BRITISH PERSPECTIVE

The Euro and political union – Lawson vs.Clarke

When Lord Lawson was Chancellor of the Exchequer in the 1980s, he advocated British membership of the Exchange Rate Mechanism, on the grounds that it would help to stabilise the pound. He disagreed with Mrs Thatcher about his policy of 'shadowing the D-mark', which he saw as the next best thing. His dispute with her adviser, Professor Alan Walters, on this issue led to his resignation in 1989. However, he saw the ERM as an end in itself, not as a step to EMU and the single currency, which, he said, 'implies nothing less than a European government – albeit a federal union – and political union; the United States of Europe. This is simply not on the agenda now, nor will it be in the foreseeable future'[8]. The ERM turned out, as Professor Walters correctly foresaw, to be a half-baked solution as far as the UK was concerned. It could achieve a stable exchange rate only at the cost of unstable interest rates, because it lacked the commitment and credibility of a single currency. It worked, after some setbacks, only for countries which were politically committed to joining the single currency.

A later Conservative Chancellor, Kenneth Clarke, took the opposite view when he said: 'It is quite possible to have monetary union without political union. It is a mistake to believe that monetary union need be a huge step on the path to a Federal Europe.'[9] Clarke's reassurance became something of a mantra to the many British advocates of joining the Euro who either genuinely believe that it does not require any further political integration or are afraid of scaring away popular support in a referendum by implying that the Euro could mean the end of British national sovereignty. No one can predict where the European Union will go next now that the Euro is a fact of life. It is impossible either to rule political union in or to rule it out, even supposing that one can agree on what it means. The future of political union, as we have shown, depends on many factors other than the Euro. The extra degree of political integration needed just to ensure the success of the Euro may turn out to be far less than what is needed to make progress in other areas of policy, notably the second and third pillars, which may affect British interests even more closely than EMU.

But it is clear already that joining the Euro does involve pooling monetary sovereignty. Gordon Brown's

October 1997 policy statement acknowledged that 'to share a common monetary policy with other states does represent a major pooling of economic sovereignty'.[10] But he went on to say 'the constitutional issue is a factor in the decision but it is not an over-riding one', provided that the economic benefit was 'clear and unambiguous'. In other words, there is a trade-off between politics and economics. One gives up political control over one aspect of sovereignty in return for a certain economic pay-off.

The Bank of England is part of the British Constitution, and it is its sovereignty which will have to be pooled. Its new-found independence, awarded by Mr Brown, will have to be merged into that of the European System of Central Banks. The difference is that the independence of the Bank of England is revocable by the Government, but that of the ESCB is not, since it is enshrined in the Maastricht Treaty. It is hardly surprising that the Governor and a number of his colleagues do not seem in a hurry for Britain to join the Euro, since their independent powers will disappear. It is fanciful to suggest, however, that this involves a major loss of national independence. The Bank of England can change UK interest rates in a way that it could not if Britain was in the Euro. But this does not mean that its decisions will always be better than those of the ECB. It has no control of the exchange rate, which is an important component of monetary conditions. It has been surprised by the extent to which financial markets have raised the external value of the pound, and it has toyed with the idea of trying to bring it down, only to abandon the idea because it does not know how to do it.

As for fiscal sovereignty, fears of its loss have been deliberately exaggerated by eurosceptics. The UK, like other member countries, would have to keep its budget deficit within a ceiling of 3 per cent of GDP in EMU. Now that the Budget is in balance, this is unlikely to become a constraint, save in the unlikely event of a political maverick becoming Chancellor of the Exchequer. The UK, like other countries, would be free to choose its levels of taxation and spending in relation to national income. The limited degree of tax harmonisation required, mainly on VAT and income on savings, is a function of the single market, which the UK supports, and not of the single currency. There is a case for further harmonisation of corporate taxes, in order to achieve a level playing field for European competition, but again this is not entailed by the single currency, even if the recognition of its need may be a by-product of the Euro. The UK and other countries will have to achieve what the French have called the 'reconquest of national fiscal policy' in order to make up for the loss of national control of monetary policy. That hardly amounts to a sacrifice of sovereignty.

Priorities for political Europe – Owen vs. Cook

No one would now support the UK rejoining the ERM, except as an ante-chamber into the Euro – and even that particular approach path may yet be circumvented. But there is a respectable body of pro-European opinion which believes that the UK should give priority to the second and third pillars, and to enlargement, rather than to the Euro. This view is represented by the New Europe group, poised somewhere between the europhiles and the europhobes.[11] Its chief advocate is

Lord Owen, the former Foreign Secretary, and its most eloquent spokesman is Timothy Garton Ash. On this view, it is more important to fill the vacuum left by the end of the Cold War by including the former Communist countries in the European framework than to complete the membership of the single currency. This view had more plausibility when the Euro had not yet been fully established, and before the negotiating difficulties of enlargement became evident. To postpone UK entry into the Euro for another five to ten years – the time required for enlargement to be completed – is effectively to take it off the political agenda, in the way that Sir Samuel Brittan has rather surprisingly advocated. [2]

The entry of the UK and the other three 'out' countries into the Euro is the unfinished business of the 1990s, which needs to be dealt with as soon as possible. Enlargement, and the Common Foreign and Security Policy that goes with it, is the barely begun agenda of the 2000s. Enlargement, and its financial consequences, are if anything a less popular cause among both the existing EU members and the candidates members than the Euro itself, so it seems odd to try to reverse the priorities. It is clear that if enlargement is to be worth while, it will involve the new members joining the Euro, if necessary after a transition period in the Exchange Rate Mechanism. As has been the rule up to now, widening and deepening will go hand in hand, rather than being alternatives. As a non-member of the Euro, the UK will be an outsider on many related issues linked with enlargement and foreign policy until it decides to join.

We come to a point of divergence between old Labour and new Labour Foreign Secretaries, rather than between Chancellors of the Exchequer. The present holder of the office, Robin Cook, has given a higher priority to joining the Euro than his colleagues in 10 and 11 Downing Street.[13] He can see that Britain's influence in Europe and in the world will be diminished by not joining the Euro. If the UK joins, it may be due more to this fear of being left out rather than to a positive enthusiasm for being counted in. It was as much the fear of exclusion as the economic advantages which persuaded the UK to join the European Community in 1973 in the first place. If Euro entry can be presented to the British public as part of a wider package of giving the UK its full voice over a wider range of European issues, it could be made more palatable. It will be a hard, but not impossible balancing act for Mr Cook and Mr Blair to show that Britain can take its place 'at the heart of Europe' without submerging itself in a super-state. The New Europe claim that Britain will have more influence as an EU member outside the Euro than inside is not even plausible.

Unfortunately the call for 'flexibility' by some of the Euro member states could be interpreted as a two-speed Europe by another name, with Britain and other non-Euro countries travelling at the slower speed, soon to be caught up by the more advanced enlargement countries. The British desire not to be left behind is understandable, but it carries the danger that Britain is seen as trying to hold other countries back rather than as trying to speed up its own pace. EMU is such a central part of the European edifice that failure to join by the UK will be taken as typifying the British attitude on other matters. The British reputation for doing too little too late will be difficult to live down. The lesson for other countries is that they fare best when they start by pressing ahead without the British, knowing that they will catch up sooner or later. The UK's image among its partners as a reluctant follower is hard to square with that of enthusiastic leader which Mr Blair tries to put across when he is on the continent of Europe.

At least a two-speed Europe is better than one in which some countries move ahead, and others stand still altogether in some areas. The danger of opt-outs is that they end up with a Europe *à la carte*, in which countries pick and choose the dishes that they like, while sending the others back. In a Europe of trade-offs between national advantages and disadvantages, such an approach cannot work. The Conservative demand to renegotiate European Union membership on these lines would lead to total withdrawal if, for example, the UK tried to retain the advantages of the single market without making any contributions to the EU Budget. It is better to aim for longer transition periods if some countries need them, rather than permanent opt-outs. For example, it would transform the picture if the UK agreed with its partners a timetable for Euro entry by, say, 2003-05. If, on the other hand, the UK tries to extend the opt-out principle from EMU to other aspects of European Union, it will set a disastrous precedent for the enlargement negotiations. Enlargement on such terms would be unacceptable to the existing members of the EU, including the UK. Widening Europe is not an alternative to deepening. EMU has already happened, while enlargement is some years away, and will go together with the extension of the Euro to the new members. This is a case where the blinkered pursuit of British national interests without considering the effects on Europe as a whole becomes self-defeating.

CONCLUSION: IF NOT THE UNITED STATES OF EUROPE, WHAT?

National languages and cultures

The nations of the European union will remain nation-states. Each will retain its own language or languages, its national culture, its distinctive institutions, and its historical tradition. A Europe of nation-states is not the same as de Gaulle's *Europe des patries*, which has overtones suggesting that nations can work together without any supranational structures. But Europe will never be a melting pot in the way that the United States has been – to a limited extent. When different ethnic groups cross the Atlantic to a new country, they are not as inclined to maintain separate national identities as if they remain on their ancestral territory. Europe may in fact end up with rather more nation states than it began with. The UK and Belgium could go the way of former Yugoslavia or Czechoslovakia, preferably following the latter rather than the former example, although such radical solutions seem on balance unlikely at present. National identities will remain, and with them national boundaries delimiting states which are both independent and inter-dependent, or *solidaires*, to use a French concept which does not translate or transplant easily into English soil.

Different European national identities and cultures may become more important in the outside world than within Europe itself. While the European Union will act as a single entity in an increasing number of ways, for the purposes of trade, finance, immigration and competition policy, for example, in other ways the nation states will still matter, in such areas as foreign direct investment, taxation, tourism and cultural exchanges. They will have a similar, but somewhat enhanced importance in diplomatic life beyond that of the foreign representations of the Australian or Canadian provinces, or the American States.

Federalism and decentralisation

The idea of a federal Europe has become confused with that of a super-state. Europe can be federal in structure even if the constituents of the federation are still independent nation states. This concept is sometimes referred to as a confederation, but since the Swiss single-state federation calls itself a confederation, this terminology does not advance matters much. The concept of subsidiarity is closely linked with that of federation. The powers of government should be exercised at whatever level – supranational, national or local – yields the maximum efficiency, according to the subsidiarity principle. 'In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of effects of the proposed action, be better achieved by the Community.'[14] If efficiency includes the idea of subjecting decisions to the democratic control of those most affected by them, then a federal structure with subsidiarity implies delegating power down to the lowest level consistent with efficient government. In many cases there has to be a division of powers between levels of government. For example, mergers below a certain size can be dealt with at national level, those above that size at Community level.

A federal structure goes hand in hand with the separation of powers between different institutions. Montesquieu's concept of the separation of powers was based on how he thought 18th century Britain operated. However, Britain moved towards a much more centralised system based on the supremacy of Parliament, while the United States followed Montesquieu in distributing powers among the President, the Congress and the Supreme Court on the one hand, and the Federal Government and the States on the other. The European Union has followed a similar path, with the Council, the Commission, the Court of Justice and now the Central Bank each having separate Treaty-based powers, and providing checks and balances on each other. The British should not be misled into trying to impose their own model of a political system on Europe. The British system is itself in the throes of fundamental reform. The European system also needs reform, but its theoretical basis is sound, if it can be made to function in a more open and effective manner. A federal structure is consistent with decentralisation, and the United States is only one example of a federation, which can take various forms. The dictionary definition of federalism can apply equally well to the United States, or to the quite different set-up of the European Union: 'that form of government in which two or more states constitute a political unity while remaining independent as to their internal affairs'[15].

SUMMARY OF MAIN POINTS

1. The identification of national currencies with nation states is an episode in world history, which has shown itself open to abuse by unscrupulous and unregulated governments.
2. The case for single currencies covering several countries is strong, and is independent of the equally good case for creating optimum currency areas by promoting free movement of labour and capital.
3. The Euro is a beneficial financial innovation, comparable in its risk-spreading features to the creation of mutual investment funds, but it needs to be regulated by a political authority.
4. Monetary union cannot prevent wars, but is an essential component of the European Union, which provides a means for the peaceful settlement of disputes which might otherwise lead to conflict between member states.
5. The UK's use of the opt-out principle could be damaging both to itself and to the European Union, and is morally inconsistent.
6. EMU is a Community-type structure, which should be used as a template for more effective inter-governmental action on the Maastricht second and third pillars of common foreign and security policy, and justice and home affairs.
7. EMU may, but need not lead to political union, but it

already comprises the political act of pooling monetary sovereignty, and may require closer cooperation in other aspects of economic policy. It does, however, imply greater national autonomy in the use of fiscal policy.

8. Widening Europe is not an alternative to deepening. EMU has already happened, while enlargement is some years away, and will go together with the extension of the Euro to the new members.
9. The member states of the EU will remain independent nation states, while pooling their sovereignty in a number of key areas. European Political Union will thus be a quite different kind of entity from the United States of America.
10. The European Union will have a federal character, in that powers will be decentralised to independent member states and lower levels of government within the framework of Community structures.

[1] *The Politics and Economics of a Single Currency: Three Views*. Wolf, Scharrer and Johnson. Discussion Paper 69. Royal Institute of International Affairs. 1997.
[2] *The Oxford Companion to Philosophy*, see **categorical imperative**. OUP.1995.
[3] "The theory of optimum currency areas", *American Economic Review*, no.51, September 1961, pp.717-25.
[4] *The New Palgrave Dictionary of Money and Finance*, vol.2, pp286-288.
[5] Italy continued to call its currency the lira, although it was at par with the various francs.
[6] "One money, one market: estimating the effect of common currencies on trade". Andrew K.Rose. Working Paper 7432. National Bureau of Economic Research, Cambridge, Mass. December 1999.
[7] Interview with *Infeuro*, newsletter from the European Commission, no.14.
[8] Speech to the Royal Institute of International Affairs, 25 January 1989.
[9] Speech to the European Movement, 9 February 1995.
[10] Statement on EMU by the Chancellor of the Exchequer, 27 October 1997. HM Treasury Press release 126/97.
[11] Statement of general principles: common sense on the single currency. Neweurope. Undated.
[12] "Why Blair should forget the Euro for five years". Samuel Brittan. *Financial Times* 3 February 2000.
[13] Speech to Britain in Europe, 23 November 1999.
[14] Maastricht Treaty, Article 3b.
[15] *The Shorter Oxford English Dictionary*, third edition, reprinted 1959.

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