

The failure of the european exchange rate mechanism



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The failure of the Exchange Rate Mechanism was a setback for UK's ambitions to join the European Monetary Union and adopting the single currency. However the recent studies argue that there were many factors that lead to the currency crises of 1992-93, which resulted with the UK's pound (and other currencies) leaving ERM. This essay attempts to critically analyze to what extent the failure of the ERM was decisive for the UK's decision to stay out of EMU. It will begin with a brief overview of the history of the ERM, continuing with a critical elaboration of its functionality and the UK's decision to join the ERM. It will then deepen in the analysis by discussing more intensely the causes of the ERM failure and the implications that UK faced in the system. The essay will give a glance of the optimal currency area and how it affected the UK's opt out of EMU. Finally a conclusion will be offered.

Since World War II, attempts had been made to maintain currency stability amongst major currencies through a system of fixed exchange rate - the Bretton Woods System. Albeit the Bretton Woods System collapsed in the early 1970s, European leaders were keen to maintain the principle of stable exchange rates rather than moving to the policy of floating exchange rates, which was gaining popularity in the USA. In the 1972, the so-called currency snake, or joint float, of some EEC currencies came into existence. The snake suffered early defections by the United Kingdom and Italy, and France was an intermittent participant. However in the 1978 a fixed system " Exchange Rate Mechanism" that would supersede the snake was launched (Thygesen 2004). The launch of European Monetary System and its centrepiece, the exchange rate mechanism (ERM) was generated by the German chancellor,

Helmut Schmidt, and the French president, Valery Giscard d'Estaing (Mulhearn and Vane 2008, pp. 37). The EMS was established to pursue three main policy objectives: the creation of a 'zone of monetary stability' involving both low inflation and stable exchange rates; the provision of a framework for improved economic policy cooperation between member states; and the easing of world monetary instability through the adoption of common policies in relation to third countries (European Commission, 1989, p. 2, in Arestis et. al. 2001, pp. 20). The new EMS plan was different from the previous attempts at a fixed exchange rate system in two major ways. First, it set its own central rates independent of the U. S. dollar. Second, the EMS was formed with economic and political objectives in mind. The EMS consisted of three elements—the Exchange Rate Mechanism (ERM), the European Currency Unit (ECU), and the European Monetary Fund (EMF). These three elements were designed to work together to achieve monetary integration among the EC member states.

The ERM became operational in March 1979. The central economic purpose of the ERM was to create a zone of monetary stability in Europe. This had two dimensions:

ERM members' exchange rates would be stabilized against one another.

This would simultaneously necessitate the maintenance of low and stable inflation rates.

The Exchange Rate Mechanism (ERM) consisted of four components:

European Currency Unit (ECU), the parity grid, the divergence indicator and credit financing.

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The ERM and the ECU work in tandem to form the hybrid exchange system on which the EMS is based. This hybrid system forces the EC currencies to be pegged to each other, but allows them to float against the U. S. dollar. According to the EMS, central or “ parity” rates are established for the various currencies in terms of ECUs. Once these central rates have been fixed, a table of cross rates is tabulated for all EC currencies. This arrangement is, in effect, a system of fixed exchange rates. The ECU is a weighted basket of all EC currencies. The weight of each currency is determined in proportion to the economic strength of each country. Since Germany is by far the strongest EC nation, the deutschemark holds the most weight in the ECU basket. Because of this strength, the deutschemark is often referred to as the anchor of the ECU. Initially, each EC currency was allowed to fluctuate within a margin of 2. 25 percent around the central rate. A few exceptions to this general rule were Italy, the United Kingdom, and Spain, which were each allowed a larger margin of plus or minus 6 percent (Hamvi and Niroomand, 1995).

The divergence indicator was used to give a warning when a country was diverging from its central rate. The divergence indicator acted as a supplementary intervention device. When movements in the daily exchange rate pegged against the weighted average movement of the other EMS currencies exceeded 75 per cent of the maximum possible divergence spread, it signalled the need for a country’s monetary authority to take corrective measures (Arestis et. al. 2001 pp. 21). The ERM provided a tool for locating the position and movement of a currency in relation to the central ECU rate. It was actually a form of intervention designed to bring a currency

back into alignment when it threatened to move outside of its maximum band. For example, if a country's currency was appreciating, the ERM required the country's central bank to adopt expansionary monetary policy through increasing its domestic money supply. Consequently, inflation rose and its currency appreciation was moderated. The opposite also held true. To facilitate intervention, short-term credit was exchanged between the central banks, and medium-term credit was available through the European Monetary Cooperation Fund. In the past, when intervention activities failed to bring a currency back within its allowable margin of fluctuation, realignments of exchange rates among the EC currencies took place, thereby making the EMS, in effect, an adjustable-peg system of exchange rates (Hamvi and Niroomand, 1995).

In joining the system each member was accepting an obligation to maintain its currency within a narrow band $\pm 2.25\%$ or wider band $\pm 6\%$ either side of a declared parity with the Deutsche Mark and with all other currencies in the ERM. Since Germany had enjoyed an enviable record of inflation control throughout the 1970s, particularly in comparison to the other large European economies. The ERM - through its requirement for exchange rate management and monetary discipline - would effectively secure the monetary policies of participants to that of Europe's most anti-inflationary economy. At the same time, exchange rate stability would continue to foster European trade and the economic growth prospects of the customs union. Partnering in the ERM with Germany would necessitate that members follow the kind of restrictive monetary policy - expressed for many member economies through untypically stringent interest rates - favoured by the

Bundesbank. Any temptation to use lower interest rates for some other purpose - such as to stimulate demand, output and employment - would have to be resisted simply because this would obviate the basic principle of the system: currency fixity. ERM members could not have it both ways. Either you were in the ERM maintaining agreed parities and therefore anchored to German monetary policy and closing in on its low inflation rate: or you applied a different set of monetary policy priorities, your currency depreciated, inflationary pressures accumulated and you left the ERM (Mulhearn and Vane 2008, pp. 37).

There is evidence that participants in ERM for a period of time enjoyed greater exchange rate stability with one another and many credit it for the decrease in inflation and the increase in economic growth which occurred in Europe in the 1980 (Grosand and Thygesen 1998, in Hamvi and Niroomand, 1995).

The inflation issue was certainly the view of the British government that elected in 1990 to take up ERM membership as a means of inflation control. As stated in King (1997) over the past decades, the history of monetary policy in the UK has been a search for a nominal framework that would provide both an anchor for the price level and some credibility for the government's commitment to low inflation. Targets for the monetary aggregates were introduced in the 1970s, first for broad money and subsequently for narrow money. Large and unpredictable changes in velocity led to the abandonment of these targets in the mid-1980s. Attention then switched to the exchange rate, first with an informal target against the Deutsche mark (DM) and then with full membership of the Exchange Rate <https://assignbuster.com/the-failure-of-the-european-exchange-rate-mechanism/>

Mechanism (ERM). First attempt to join ERM was made in middle of 1980 were monetary policy in this period was dominated by problems in monetary targeting and unwanted exchange rate movements. Policy makers in general, but above all Nigel Lawson who became Chancellor of the Exchequer (Minister of Finance) after the 1983 election, became convinced of the desirability of exchange rate stability and began to favor entry into the ERM. It was argued that ERM membership would offer a more credible framework for policy than that provided by monetary targets that were frequently missed, together with an alternative nominal discipline to keep inflation under control. However, ERM entry was vetoed by Thatcher in November 1985 (Cobham, 1997).

In the 1988-89 the UK economy was in the boom and the monetary authorities were increasing interest rates in order to bring the boom and the associated rise in inflation under control. By mid-1990 the rise in economic activity had come to a halt, inflation was rising more slowly (it peaked at 10.4% in 1990 Q3) and unemployment had ceased to fall (it reached a trough of 5.6% in 1990 Q2) (Beeby et. al 2004). In the meantime, entrance to ERM was becoming a one way road for UK monetary authorities. In the European Council meeting held in Madrid (june, 1989) PM Thatcher articulated the conditions under which sterling would enter the ERM: these included the abolition of all foreign exchange controls, further moves towards completion of the Single Market and free markets more generally, and the reduction of UK inflation. During this time Nigel Lawson resigned as Chancellor of the Exchequer and John Major was introduced as new chancellor. As stated in Cobham (1997) Major revised the key remaining Madrid condition for

sterling's entry (the other conditions were open to considerable interpretation), so that, instead of a reduction of E-K inflation into line with that in ERM member countries, only a reduction in prospective inflation into line with the others was now required. On 8 October 1990 Britain entered the ERM at a rate of 2.95 Deutschmarks to one Pound Sterling.

The initial effects of ERM membership were benign, the pound remained (until the summer of 1992) reasonably stable and inflation fell sharply, from its peak of 10.4% in the quarter before entry to 3.6% in 1992 Q3. On the other hand GDP fell by 2.1% in 1991 and 0.5% in 1992, unemployment rose continuously from its trough of 5.6% in mid-1990 to 9.6% in 1992 (and 10.3% in 1993), house prices fell sharply, and mortgage foreclosures and repossessions rose dramatically (Cobham, 1997). There was official concern about the burden of outstanding debt in the housing market and in the corporate sector, and about the possible effects on the financial system of defaults triggered by a rise in interest rates.

The financial markets confidence was shaken by the no vote in Danish referendum to move to EMU at existing exchange rates. The speculative pressure on the sterling began to develop, particularly after the Bundesbank raised its interest rates in mid-July. These pressures came to a head in September and the UK left the ERM in the crisis of 16 September 1992, commonly referred to as Black Wednesday, despite a last minute increase in interest rates and massive (and unprofitable) foreign exchange market intervention (Cobham, 1997). The currency crises also forced the Italian lira to abandon the mechanism. In 1993 the France found itself in similar position as the UK in 1992, however, member states agreed to widen the “
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narrow" band in the ERM from 2.25% to 15% around the central rates (Beeby et. al 2004)

There is significant literature on the causes of the EMS crises of the 1992-93. The explanation is given through the models of exchange rate determination, competitiveness the German unification, expected policy change and speculative attack models (Cobham, 1996).

However let us start with the concerns regarding the viability of the EMS that were raised at an early stage. As stated in Arestis et. al (2001) the EMS faced the asymmetry problem of a fixed exchange rate system that deficit countries are under pressure to deflate but surplus countries are not under similar pressure to reflate. When two currencies reached their agreed limits, both countries had to intervene in the strong currency to buy the weak currency. The weak-currency country could use the very short-term facility to fund intervention. But a problem existed when a currency approached its lower limit; speculators would enter the foreign exchange market selling the overvalued currency, thus forcing the weak country to intervene before the currency reached its limit. This intra-marginal intervention was discretionary and the strong-currency country was not bound to take action, nor was very short-term facility available. The full burden of adjustment falls on the weak currency. The rules of the EMS may have been constructed to insure that the immediate effects of intervention were perfectly symmetric. However, the final liquidity effects need not be symmetric. Central banks sterilise foreign exchange interventions and the EMS does not legislate in this respect. This gives rise to asymmetry because hard-currency countries find it easier to secure the large amounts of foreign currency required to engage in sterilised

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intervention than weak-currency countries. Asymmetry in the system was aggravated further by two other factors: intra-marginal intervention which far exceeded formal obligatory intervention, and the lack of a common policy toward the dollar. The EMS was also susceptible to disruptive capital flows; as the dollar weakened the DM replaced it as a reserve currency, causing the DM to appreciate within the EMS and further destabilising the system. This highlighted the degree of interdependence in the world economy - the EMS experienced shocks even though the developments occurred elsewhere in the world.

As mentioned above, the introduction of this new exchange rate system occurred against the backdrop of large inflation differentials between participating countries. Changes in relative prices between countries shift competitiveness. Between 1979 and 1987, there were eleven realignments within the ERM. These realignments were by high inflation countries devaluing their currencies to remain competitive with the low inflation countries. Countries were forced to implement capital controls to prevent the destabilising effects of capital flows. This highlighted the fundamental weakness of the ERM, a fixed exchange rate system operating without the coordination of monetary and fiscal policies (Arestis et. al, 2001, pp. 24)

When in 1986 the EU amended the Treaty of Rome with the Single European Act, the end of 1992 was set as a target date for the removal of all remaining barriers to the free flow of goods, services and resources. A greater degree of macroeconomic coordination among member states was now required, as a consequence of which the EMS was strengthened because of the desire to achieve greater convergence in economic policies. Between 1987 and 1992 <https://assignbuster.com/the-failure-of-the-european-exchange-rate-mechanism/>

there was only realignment a 3.7 per cent technical depreciation of the Italian lira to allow for the narrowing of the fluctuation margin. At last the EMS appeared to realise its purpose and variations in the real exchange rates and money supplies among EMS members (Germany, France and Italy) were smaller than non-members (Japan, UK and US) between 1979 and 1988 (MacDonald and Taylor, 1991, in Arestis 2001). And among EMS members, there was convergence in inflation rates, interest rates, budget deficits and government debt as a percentage of GDP between 1987 and 1992 (Salvatore, 1996, p. 605). By July 1990, all restrictions to intra-community capital movements were removed. The status quo, however, could not remain unchanged: a fixed exchange rate system is only compatible with the free flow of capital if macroeconomic policy is fully coordinated (Arestis et al, 2001, pp. 22).

There was a suspicion that a large aggregate demand shock would unsettle the whole system, and in 1992 it was about to be tested. Germany was grappling with the cost of financing the restructuring of East Germany, and had historically high interest rates to control inflationary pressure.

Mulhearn and Vane (2008) argue that the ERM crisis of 1992, which saw the pound's membership suspended, alongside that of the lira, was prompted by the inflationary implications of German reunification in 1990. The West German government had made huge fiscal commitments to underwrite the reconstruction of East Germany following reunification. The upward pressure this put on German inflation was met with an increase in German interest rates and consequent speculation in favour of the mark. The tightening of German monetary policy posed serious difficulties for other ERM members, <https://assignbuster.com/the-failure-of-the-european-exchange-rate-mechanism/>

especially the UK. Having joined the ERM in 1990 in the midst of recession, the UK was not in a position to raise interest rates in response (to maintain the pound within the agreed band against the mark), nor could it afford to devalue the pound without wrecking its own newly hatched anti-inflationary strategy. With the knowledge that the UK was also carrying a record deficit on the current account of the balance of payments (and hence would need to devalue the pound at some stage), the foreign exchange markets viewed sterling as a one-way bet and adverse speculation eventually forced its suspension from the ERM.

King (1997) highlights that after Britain joined the ERM, domestic considerations pointed to the need for lower nominal interest rates, but the consequences of German unification were posing a dilemma for the ERM as a whole. Following that shock to the German economy, a rise in the real exchange rate was necessary so that output could be switched from net exports to meet the increased domestic demand resulting from unification. The required rise in the real exchange rate could have been brought by either an appreciation of the DM within the ERM or higher inflation in Germany than elsewhere. The system as a whole failed to deliver the former, and with the commitment to price stability in Germany, the latter could be achieved only by extremely low inflation in other ERM countries. In the absence of a DM appreciation, German interest rates were increased, and the level of short-term interest rates consistent with membership of the ERM was higher than was appropriate for the domestic economy in the UK.

Ozkan and Sutherland (1994) argue that national authorities are thought of as maximizing a welfare function which depends on domestic output with the <https://assignbuster.com/the-failure-of-the-european-exchange-rate-mechanism/>

latter affected by interest rates. Domestic interest rates in turn are affected by external shocks. There is some threshold level of foreign interest rates at which the government's optimizing decision is to abandon the fixed exchange rate and lower its own interest rate, and the private sector knows what this threshold is. As foreign interest rates push up domestic interest rates, the probability of that threshold being reached increases, and the consequent probability of the fixed rate regime being abandoned is incorporated in the risk premium, which makes domestic interest rates rise more rapidly and accelerates the crisis.

As stated in De Grauwe et. al (1994) countries participating in a fixed exchange rate system are subjected to asymmetric economic disturbances, leading to divergent movements of economic fundamentals, such as prices or current accounts, requiring adjustment. The fact that countries have promised not to use the exchange rate often makes the adjustments more difficult and costly in terms of employment. The authorities have an incentive to renege on their promise not to change the exchange rate. Recognition of this by market participants may be sufficient to undermine the credibility of the fixed exchange rate and induce a speculative crisis.

Most fixed exchange rate systems have suffered from a lack of credibility because of a combination of adjustment and liquidity problems. The EMS is no exception (De Grauwe et. al 1994). Questioning the credibility of the UK monetary policies Manson (1995) argues that joining the European Monetary System's exchange rate mechanism, or ERM, in October 1990 was clearly to enhance the credibility of monetary policy so as to achieve a reduction of the high rate of inflation with minimum effects on unemployment, yet the <https://assignbuster.com/the-failure-of-the-european-exchange-rate-mechanism/>

speculative attacks leading to the withdrawal of the pound from the ERM two years later are clear evidence that credibility was not achieved, despite a substantial reduction in inflation. Moreover, Winckler (1991) has suggested that the entry of the pound into the ERM at an appreciated rate (2.95 DM) signalled the firm anti-inflationary intentions of the authorities.

The competitiveness approach to the crises is supported with the arguments that a number of countries were suffering from declining competitiveness, because their inflation rates were higher than the EMS average and competitiveness had not been restored by devaluations (Bacchetta, 1994, Micossi and Padoal, 1994). The country to which the competitiveness argument has been applied is the UK, which is claimed to have suffered from inadequate competitiveness mainly because it had entered the ERM at an overvalued exchange rate. Wren-Lewis et al. (1991) found that sterling was overvalued by around 10% at the time of entry. The authors used Williamson's (1983) concept of the fundamental equilibrium exchange rate (FEER).

For most economists the collapse of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1993 came not as a surprise.

Indeed, in the past many authors had argued that without the introduction of capital controls the EMS could never survive. De Grauwe et. al (1994) has pointed out that the fundamental reason for the fragility of the system lies in the fact that the promise to fix exchange rates lacks sufficient credibility.

Nominal and real divergence will sooner or later undermine the credibility of a fixed exchange rate arrangement. Countries like Italy and Spain suffered,

for instance, from losses in competitiveness as they had higher rates of
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inflation than Germany, which was not compensated for by a devaluation of their currencies. Furthermore, the credibility of exchange rate arrangements may be undermined because member countries may disagree with the monetary stance taken by the leading country. In fact, one explanation of the breakdown of the ERM is that due to their high and increasing levels of unemployment countries like the UK and France were unwilling to follow the restrictive policy stance taken by the Bundesbank after German reunification (Knot et. al. 1998)

Cobham (1997) highlights that the UK authorities had not properly understood the constraints involved when they entered the ERM in 1990. The author highlights that the strategies adopted in trying to get through the period of turbulence were exceptionally high-risky. The UK monetary authorities wanted lower interest rates for domestic reasons but were not willing to allow sterling to depreciate. They consistently resisted upward pressures on domestic interest rates, particularly after the Bundesbank rate rise in July 1992, and they allowed sterling to fall to the bottom of its wide band in the ERM. They repeatedly declared their unwillingness to devalue the pound, but they also allowed it to become clear to the financial markets that they were desperate to see interest rates come down, and they exerted strong public pressure on the Bundesbank President to lower German rates at the Bath conference in early September. This strategy was risky because it involved the successive exhaustion of all the government's strategic options. It might have succeeded, if external events had been different, but it stood a good chance of failure and yet the authorities had no fallback

strategy, no contingency plan which might have avoided the crisis and the loss of credibility it produced.

Economic analysis offers 'optimal currency area' (OCA) theory as a framework for the discussion of the pros and cons of monetary union. Thus, the discussion on what optimal currency area theory suggests is very important regarding the monetary union analysis.

The traditional economic analysis of monetary unions, optimal currency area theory, was shaped by the pioneering contributions of Mundell (1961) and McKinnon (1963). An OCA has been implicitly defined by (Mundell 1961, in Ricci, 2008) as a currency area for which the costs of relinquishing the exchange rate as an internal instrument of adjustment (i. e. within the area) are outweighed by the benefits of adopting a single currency or a fixed exchange rate regime. Frankel (1999) defines optimal currency area (OCA) as "a region which it have a single currency and a single monetary policy" (Frankel 1999, in Bordo, 2003)

As stated by Artis (2000) the central argument of OCA theory is that the costs of monetary union consist in resigning the possibility of using an independent monetary policy, and appropriate exchange rate changes, to deal with shocks that are asymmetric between the potential partner countries. This cost can be mitigated if the partners agree on a federal fiscal arrangement that cushions asymmetric shocks, if labour mobility between the partners is sufficiently high, or indeed if internal labour market flexibility is great enough. It is generally agreed that EMU will not feature any federal fiscal arrangements (such as do exist in the United States) for the

foreseeable future, and it is also quite clear that intra-Union labour mobility is rather low, again as compared to the United States. Capital market integration may also assist the process of adjusting for asymmetric shocks in so far as it helps promote risk-sharing. One of the aims of EMU is to realise a more integrated European Financial Area. The benefits of monetary union are primarily to be identified with the removal of transactions costs in the exchange of one currency for another. It is popular to argue nowadays that a single currency, through the transparency it lends to the practice of discriminating monopoly, also helps to increase effective competition.

Across EU regions, the correlation of shocks is low, labor and capital mobility are relatively scarce, and the adjustment due to the EU fiscal system is insignificant; before the EMU, most of the adjustment to shocks seemed to arise through relative price movements and domestic fiscal policies (Ricci, 2008). Regarding the correlation of shocks, Erkel-Rousse and Melitz (1995) find that it is higher across U. S. regions than EU countries, a result confirmed also by Cheung and Hutchison (1997). Regarding the role of labor mobility, Blanchard and Katz (1992) show that in the United States labor mobility has played a major adjustment role, substituting for price flexibility, while evidence of lower European labor mobility is given by Bayoumi and Prasad (1997) and by Eichengreen (1993). Regarding capital mobility, Atkeson and Bayoumi (1994) find that capital mobility is higher among the U. S. regions than among European countries (Ricci, 2008). Kim and Chow (2003) suggest that the OCA theory can be a valuable tool in explaining a country's exchange rate arrangement. The theory at least helps us understand that the core group of countries that satisfies OCA criteria better

than any other countries in Europe should be most willing to join EMU. The fact that the UK ranks consistently low suggests that her decision to choose out may have been influenced by OCA considerations.

Business cycle synchronisation is desirable when a single currency is in use, according to work on Optimal Currency Areas (Garnier 2009). Rubin and Thygesen's (1996) search for codependence leads them to suggest that there is little difference to be found between a core and periphery. In particular, the UK has been clearly identified as failing to share in the same cycle as the major continental countries, along with Ireland, whilst Sweden and Finland also tend to stand out in these studies as idiosyncratic (Artis 2002). The idiosyncrasy of the UK cycle has been emphasised also by Artis (2003). The author highlights that there has been, something a bit different about the UK business cycle and the UK economy's experience of shocks that has marked it out from continental European experience. In one version the UK business cycle is identified as more sympathetic with that in North America than with that in continental Europe. Another argument is that it is possible to identify a 'core and a periphery' in the EU, and that the UK has belonged to the periphery rather than the core. The author concludes that the UK's cycle is strongly correlated with that in the US, somewhat more so than with those in Europe, and also that the UK's GDP fluctuations seem to have been sharper than those of the major continental European economies. However Massmann and Mitchell (2002) and Hall and Yhap (2003) have pointed out that the UK cycle was getting closer to continental Europe. Barrell and Weale (2003) have also suggested that economic cycles were coherent between the UK and the Euro Area (Granier 2009). The study by

Garnier (2009) reveals that the UK output cycle weakens the relationship between the individual cycles of the Euro Area and their common cycle, by decreasing the size of the variance explained by the latter and by decreasing their correlations. Besides, on average over the past decades, the UK cycle is closer to the US cycle than to the Euro Area. On the other hand, the author concludes that UK GDP cycle does not diverge substantially from the other cycles of the Euro group in that a) its variance is as much determined by the common cycle as the other countries, and b) it is explained by similar frequencies.

The debate on participation of UK in European Monetary Union has been ongoing for years between opponents and advocates of UK in EMU. The Opponents of British participation argue for steering well clear of an ill-considered experiment that will impose a severe competitive handicap on the countries that participate. By standing aside, the UK will avoid the instabilities that the single currency will cause, and will keep its present competitive edge. Taking a broader view, some opponents of EMU argue that the UK's future lies not in economic alliance with Europe, weighed down by sclerotic and over-regulated economies, but rather with the dynamic market economies of the Pacific Rim. The UK should be thinking not at a European level but globally about its economic and political place in the world. In addition critics of the Euro argue that the new currency does not meet the requirements of an optimal currency area and that structural economic differences between countries will undermine the success of the project. The most important argument is that joining a single currency reduces Britain's monetary policy autonomy. Britain might be better off if she retains the

flexibility to set interest rates to meet her own economic objectives. Entry to the Euro Zone means a permanent transfer of domestic monetary sovereignty to the European Central Bank. Another big concern of rigorous-minded EMU doubters is that EMU will ease the market constraints on excess borrowing by profligate governments, (Greece case) leading to an EMU “debt trap”(Currie, 1997).

Advocates of the UK's participation say this is all wrong. If the country stands aside it will be marginalised in its most important market, with consequences that go far beyond trade with the EU. The UK would become a much less