Eurozone membership is still no answer for UK

The Financial Times November 19, 2008

by **Martin Wolf**

Is this the time for the British to swallow their pride, admit they made a mistake and beg to enter the eurozone? A growing number of people argue it is. They are wrong.

The reason for having a floating exchange rate is that it should float. In an uncertain world, an economy needs mechanisms of adjustment. The exchange rate is the most powerful such mechanism. Only exceptionally flexible or exceptionally open economies cope well with big shocks without any exchange rate flexibility.

The UK is now suffering relatively severely (and so "asymmetrically") from six large negative shocks.

T*he remainder of the article can be read here*

<http://www.ft.com/cms/s/0/d48ccc12-b5a3-11dd-ab71-0000779fd18c.html> .

Discussion from our forum members and contributors appears below.

November 19th, 2008 in Europe, Eurozone, UK economy, UK politics | Permalink

6 Responses to "Eurozone membership is still no answer for UK"

Ronald McKinnon: Martin Wolf as usual is provocative, but this time he leaves out the strongest argument against allowing a steep devaluation of the pound in the name of preserving exchange "flexibility".

In times of a global economic downturn with all countries feeling great stress, any one nation has a great incentive to allow its currency to fall relative to the others. By the end of the 1930s, these were called “beggar-thy-neighbour” devaluations. Today, what seems to be in the idiosyncratic interest of Britain is damaging to others, particularly British trading partners across the English Channel.

One of the great successes of the euro has been to bind most European countries together so that their exchange rates cannot change suddenly. Any one euro zone member cannot suddenly devalue, whether deliberately or inadvertently, to secure a mercantile advantage over the others. However, perfidious Albion prefers to play a nationalistic monetary game on the sidelines which creates more near-term stress for its European Union trading partners while not being in Britain’s own long-term interest.

Posted by: Ronald McKinnon | November 25th, 2008 at 6:31 pm | Report this comment

Martin Wolf: Ron McKinnon is quite right in his analysis. That is exactly what I want. The choice is between playing the mercantilists’ game or being destroyed by them. I would rather the UK chose the former than the latter. If the most important economy in Europe pursues structural beggar-my-neighbour policies, then everybody else has the right (indeed, the duty) to play the same game. The alternative may be to accept decades of stagnation. That is not a policy any sensible country should adopt. That is why preserving exchange rate flexibility is so important.

Other structural mercantilists - i.e. persistent users of beggar-my-neighbour macroeconomic and exchange-rate policies - are, of course, China and Japan. In the old days (i.e. up to a year or so ago), I thought it possible to offset such surpluses smoothly via the excess of spending over income (that is, the financial deficit) of the private sectors of other advanced countries. This crisis has proved that this is impossible, in the long term. The price, it seems, is overindebtedness and financial meltdown.

So, as I have argued in my column, borrowing countries have to be able to turn the tables on the structural surplus countries, without suffering prolonged depressions. The fault, in my view, lies with the surplus countries. Keynes did, of course, think much the same thing.

Posted by: Martin Wolf | November 25th, 2008 at 8:59 pm **|** Report this comment

Kumiharu Shigehara: Martin has invited me to look at his remarks in response to Ron McKinnon. In the light of my long career as an international civil servant (OECD economist) and a Japanese central banker, I presume he wants me to comment on the following remark made in his article: "Other structural mercantilists - i.e. persistent users of beggar-my-neighbour macroeconomic and exchange-rate policies - are, of course, China and Japan".

To assess this assertion, I would simply review Japan's experience in the latter half of the 1980s and the1990s.

Between mid-1885 and November 1988, the yen's effective exchange rate increased by 76 percent largely as a result of a quick and huge appreciation of yen against the US dollar following the Plaza accord as well as declines in the dollar values of the currencies of Korea and some other Non-Japan Asian economies. This led to a sharp fall in Japan's share in world export markets from a peak of 10.5 percent in 1986 to 9.3 percent in 1991, the year when the Japanese bubble bursted.

Moreover, in contrast to the currencies of most OECD countries which declined significantly from the burst of bubble in the late 1980s or early 1990s, the Japanese yen followed an uptrend even after the collapses of domestic equity and real estate markets. Indeed, following a 10 per cent downward correction of the yen's overshoot from November 1988 to end-1990, the yen's effective rate rose again sharply by 64 per cent between end-1990 and April 1995. As a result, Japan's share in world exports, which had already fallen from a peak of 10.5 per cent in 1986 to 9.3 percent in 1991, declined further to 7.9 per cent in 1996 and 6.8 per cent in 2001.

After the burst of the bubble, declines in Japan's net export volumes made negative contributions to real GDP growth. However, positive, though low, output growth was achieved by sustained growth of domestic demand, supported by increased public works expenditure and fairly steady rises in private consumption despite sharp falls in business fixed capital formation and housing construction. Household confidence and spending collapsed only after the sudden failures of several Japanese financial institutions in late 1997 which coincided with a sharp, in retrospect premature, tightening of Japanese fiscal policy and the outbreak of the crisis in emerging Asian economies. As a result, Japan recorded a 1.1 per cent decline in real GDP in 1998, the first negative growth since the 1974 recession in the aftermath of the first oil crisis.

Given this episode of Japan, I cannot understand why Marin put Japan in the same group of countries with China. As Ron McKinnon noted, Martin was here again successful in provoking us.

Readers are invited also to look at my response to Martin's comments on my article "Japan's monetary authorities must act more aggressively", published in the FT Economists' Forum on November 25, 2008. My argument there is that yen depreciation from current levels consistent with no changes in Japan's net export volumes in the coming two years (rather than declines as projected recently by the OECD) will definitely be compatible with the shared goal of avoiding "beggar-thy-neighbour" policy.

Posted by: Kumiharu Shigehara | November 27th, 2008 at 6:59 am | Report this comment

Martin Wolf : I agree with my respected friend Kumiharu Shigehara that I have been unfair to Japan.

None the less, I would note that Japan has been a savings surplus country, on a substantial scale, for decades. I do not want to go deeply into the question of whether this is the result of policy choices or deep structural features of Japanese economy and society. The point I would make is merely that this is extremely problematic, at the global level.
We have no way of absorbing such surpluses in an efficient and sustainable way. More precisely, the world could do so if only Japan were in surplus. But this is not the case. In aggregate, the surplus countries have been generating excess savings at a higher rate than the world can efficiently and sustainably absorb. That is largely why, in my view, we have today's financial crisis.

This has become a pressing concern because the private sectors in the US, UK and other heavy borrowers are now going to raise their savings. So where are these surplus savings in the rest of the world going to end up? There are only four possibilities: first, they will be absorbed via increased spending at home; second, they will be absorbed by the soaring public sector deficits of the erstwhile borrowing countries; third, they will be absorbed by other countries (principally emerging countries); or, fourth, they will be destroyed by a global depression.

In my view, this is the biggest macroeconomic policy question now confronting the globe. Japan, as the world's second largest economy, must be part of the solution. In my view, also, the first option must provide a substantial part of the answer.
Posted by: Martin Wolf | November 28th, 2008 at 3:57 pm | Report this comment

Kumiharu Shigehara: I agree with my respected friend Martin Wolf that Japan, as the world's second largest economy, must be part of the solution.

On details, I shall come back after my return to Tokyo from Europe where I am traveling and where I have a lot of trouble in connecting my PC to the local server.

Posted by: Kumiharu Shigehara | December 4th, 2008 at 5:56 am | Report this comment

Kumiharu Shigehara: Back in Tokyo, I wrote an article "Managing the international economic crisis" which was published by the Japan Times (English edition) on 10 December. This article can be read as my response to Martin Wolf's comments shown above.

Kumiharu Shigehara, a former chief economist and deputy secretary-general of the Organisation for Economic Co-operation and Development, is currently president of the International Economic Policy Studies Association.

Posted by: Kumiharu Shigehara | December 11th, 2008 at 4:20 am | Report this comment

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