

## WHAT DIFFERENCE WOULD EMU ENTRY MAKE?

- If sterling were to join EMU, the way the UK economy behaves would change. We would become more responsive to some kinds of economic shock, less responsive to others.
- Using OEF's global macroeconomic model, we have explored the impact of three shocks on the UK in and out of EMU.
- The three shocks are: an oil price shock; an increase in inflationary pressure from the labour market; and a global fall in equity prices combined with confidence effects. The tables below summarise the results. (The GDP numbers reported are percentage differences from the underlying base *level*, not differences in the growth rates).

**Table 1: UK out of EMU: % changes from base**

Effects after...	Oil price up \$10 pb			Higher UK wage inflation			Global equity prices down 25%		
	GDP	CPI inf'n	Int rate	GDP	CPI inf'n	Int rate	GDP	CPI inf'n	Int rate
1 year	-0.2	0.4	0.1	-0.4	0.5	1.0	-1.1	-0.3	-1.3
2 years	-0.3	-0.1	-0.2	-1.7	0.7	1.5	-1.0	-0.9	-1.9
3 years	0.0	-0.1	-0.1	-2.0	0.2	0.6	0.2	-1.0	-1.3
4 years	0.1	0.0	0.1	-1.2	0.0	0.0	0.9	-1.0	-0.9

**Table 2: UK in EMU: % changes from base**

Effects after...	Oil price up \$10 pb			Higher UK wage inflation			Global equity prices down 25%		
	GDP	CPI inf'n	Int rate	GDP	CPI inf'n	Int rate	GDP	CPI inf'n	Int rate
1 year	-0.4	0.4	0.5	0.0	0.5	0.0	-1.4	-0.4	-0.4
2 years	-0.8	-0.3	0.1	-0.2	1.1	0.1	-2.1	-1.2	-1.2
3 years	-0.4	-0.3	-0.2	-0.8	1.5	0.2	-0.9	-1.8	-1.1
4 years	0.4	-0.2	-0.2	-1.9	1.4	0.4	0.5	-1.5	-0.9

- Entry to EMU would mean that the exchange rate channel – as a means of absorption or transmission of shocks – would be partially closed. And interest rates would no longer respond to UK conditions alone, but to EMU-wide conditions, which the UK would only partly influence.
- **An oil price shock highlights different policy rules.** An increase in the price of oil would have an impact right across Europe. But the UK would probably be hit harder by such a shock in EMU than out, because the MPC would be more likely to accommodate the first-round inflationary impact of that shock than would the ECB.
- **A UK-specific inflationary shock would mean higher UK inflation within EMU.** A UK-specific shock such as higher wage inflation would be more painful to the UK in the short run outside EMU than in. First, the ECB would be less

likely to respond with higher interest rates than would the MPC. And second, the exchange rate channel of the monetary transmission mechanism would be partially closed, so any increase in interest rates by the ECB would have a smaller impact on demand. But in the long run (beyond 4 years), this shock is more damaging in EMU than out. Since the inflationary shock has been accommodated, higher UK inflation within EMU will drive down UK competitiveness and mean lower profits, output and employment in the longer term, with a fixed nominal exchange rate.

- **A global fall in equity prices: asymmetric effects of a symmetric shock.** This shock would be more painful to the UK in EMU than out, since the impact of such a fall would be more pronounced in the UK than in other Eurozone economies. So the ECB would cut interest rates by less than would the MPC in response to the same shock – by less than would be appropriate for the UK.
- In general, the loss of monetary sovereignty that EMU entry would involve, means that when UK-specific shocks occur, or when global shocks have asymmetric effects across countries, adjustment is likely to be more protracted and more painful inside EMU than outside.
- **A clear example of this is the recent US hard landing.** This global shock would be expected to have a bigger impact on the UK than on the rest of the Eurozone – trade links are more important, equities play a bigger role, and UK confidence is probably linked more closely to the US. Accordingly, the cuts in interest rates by the ECB have been smaller and have occurred later than those by the MPC in response to this shock. The MPC has cut the repo rate by 75 basis points since the start of the year, with the cuts starting in February. But the ECB has only cut by 25 basis points, with that cut delayed until May. Within EMU, the UK would have borne the brunt of the US hard landing, since Eurozone interest rates would fall by less than would be appropriate to the UK.
- Advocates of EMU entry will argue that this cost is offset by increased certainty about the exchange rate, and by the trade-related benefits that will bring. Overall, the economic costs and benefits of EMU membership for the UK are probably broadly in balance.