CAHIER COMTE BOËL

n° 10

The Euro:
Required Steps to Success

LIGUE EUROPEENNE DE COOPERATION ECONOMIQUE
EUROPEAN LEAGUE FOR ECONOMIC CO-OPERATION

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Introduction to ELEC

The Monetary Commission of ELEC [1] was founded by Hermann Abs, post-war chairman of Deutsche Bank. Its yearly meeting in Kronberg (Germany) is one of the foremost meetings of European monetary and financial experts. The members of its twin committee, the Monetary Panel, which meets more often than the Commission, are drawn from a wide cross-section of European financial institutions and represent a broad spectrum of commercial, rather than academic or official, economists and banks active in the Euro-denominated financial markets.

ELEC's Monetary Panel - and its individual members - has been intimately involved in the EMU debate since the launching of the Delors Report in 1989. They feel that they are well placed to offer this set of constructive criticism, and helpful proposals, to ensure the Euro's long-lasting success.

The members of the Panel are listed on the back cover. They have contributed to this pamphlet strictly in their personal capacity; the views expressed here do not necessarily represent the views of the institutions they serve. Moreover, the members do not necessarily agree with every view expressed in this paper.

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[1] ELEC, which was founded in 1946, is a non-profit making international organisation, without political affiliation, whose goal is to promote

- The economic integration of those countries of Europe that are in a position to unite
- The closest possible co-operation with the other countries of Europe; and
- Active co-operation with the rest of the world

Key Recommendations

The Monetary Panel of ELEC recognises that the EU is at the threshold of a period of major change. Completing EMU - by introducing the notes and coins - will have a major psychological impact. It should also open the way for the euro to assume a role on the world's financial stage that corresponds better to that of the Euroland economy. This should force political leaders to complete the single financial market to give citizens the full benefits of the single currency. The immense task of enlarging the EU gives remarkable new economic opportunities, but carries the risk of a political setback if public opinion is not properly informed of the costs and benefits. Failure to complete the single financial market and enhance political legitimacy will damage the prospects for a durable monetary union. So we present our recommendations:

Short term:

- **The euro's economic underpinnings must be maintained**: excessive government deficits are ruled out under the Treaty, while governments have committed themselves under the Stability and Growth Pact to achieve "the medium-term budgetary objective of positions close to balance or in surplus". Correspondingly, policy co-ordination must be re-inforced.
- **The ECB should build on its policy of opening up its forecasts** by explaining the reasons for differences with outsiders. That would enhance the predictability of its actions - and thus its credibility. It would also underline that its price stability mandate is different from the US Federal Reserve's price/growth targets.

Medium term:

- **For the success of EMU,** making a success of the post-Laeken Convention is key: European leaders must give a clear articulation of the directions to be pursued at the EU level and the policies and budgets to achieve them; the type of international economic order they want to promote; and the ways in which the challenges of enlargement and internal reform will be addressed.

- **Financial reform must accelerate**. The Financial Services Action Plan (FSAP) is designed to remedy many of the problems that exist in developing the euro-denominated financial markets.
- **It is inconceivable that the constitutional problem raised by the recommendations of the Lamfalussy Group - on FSAP secondary legislation - cannot be resolved**. The solution may lie in the direction of a genuine transparency and a sunset clause for the Securities Committee. Market participants should not be concerned about its disappearance, since its legislative enactments would continue in existence.
- **Structural reforms are still needed in a number of areas to complete the Single Market**. Special efforts are needed to improve the fiscal, legal and regulatory environment, particularly for SMEs, and to foster entrepreneurship. In particular, greater flexibility in labour markets is necessary to reduce the EU's unacceptably high unemployment rate.

Longer term:

- **EMU broadening**: A successful involvement of civil society in the setting of the objectives of the EU in the post-Laeken Convention may encourage the "out" states. That could enable the British government to hold a referendum before the spring of 2003. To convince the sceptical citizens in Britain and the Nordic countries, determined and brave political leadership is needed.
- **EU enlargement:** In the run-up to accession, the candidate countries should concentrate primarily on furthering the process of structural and economic reform leading to strong well-functioning market economies. This requires a build-up of the appropriate administrative and institutional capacity. In addition, the candidate countries should be actively engaged with the EU to prepare them for economic policy co-ordination when they become members of the EU and later of EMU.

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Background

ELEC has been campaigning since the 1960's for Monetary Union as a natural complement to the creation of a single market in Europe. It has always emphasised at the same time that a number of conditions, in particular economic and institutional convergence, were the necessary ingredients of the process leading to Monetary Union. The path to monetary integration has been marked by a number of crises; the most serious, in the last decade, was the 1992-93 crisis in the exchange rate mechanism. Nevertheless a high degree of convergence, both economic and institutional (e.g. on central bank independence), was achieved in the second half of this decade and the vital step towards monetary union occurred on 1 January 1999 with the advent of the Euro in 11 countries of the European Union.

Almost three years after this decisive step, the Monetary Panel of ELEC feels it appropriate to take stock of what has been achieved and to reflect on the further steps that are required to ensure the success of the euro as a stable and internationally respected currency. More importantly, the Panel considers the extra steps needed to achieve the broader objectives of Economic and Monetary Union (EMU): Sustainable growth and employment creation; acting as a catalyst for further European integration; and reinforcing Europe's capacity to rise to the major challenges at the beginning of this new millennium.

In this report, the Monetary Panel has reflected on the following topics:

- Progress in the use of the euro
- The reasons for the weakness of the euro since it was launched
- The performance of the European Central Bank
- The need to improve (and to co-ordinate better) economic policies in the euro-zone
- Completing the integration of the euro-denominated capital markets

- Improving the institutional underpinning of the EU
- Facing up to the challenge of enlargement, and
- Re-connecting with the European citizen.

The comments that follow are addressed to the policymakers of the European institutions and of the 12 Members States that currently participate in the Monetary Union. However, other states - whether already in the European Union or candidates for membership - should be encouraged to understand that the locking of the exchange rates is not the end of the process. As a similar pooling of monetary sovereignty has never been attempted by such a wide group of independent states, this exercise must be one of continual development as economic and political circumstances evolve. When unforeseen problems arise - as is inevitable - they must be examined and resolved with the same powerful conviction that launched the process. To allow it to be de-railed by any problems would be to betray the vision of a Europe moving 'towards an ever closer Union' as envisaged in the Treaty of Rome preamble.

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The Euro: One of the most widely used Currencies after 1.1.2002

After along period as a virtual accounting currency, the euro has finally taken on physical form at the beginning of 2002. Statistics about its introduction are impressive: More than 14.5 billion euro banknotes were printed and some 56 billion coins minted - worth €664 billion in total. But what are the statistics that demonstrate the global significance of the euro-denominated monetary system - given the importance of the Euroland economic space?

The dollar is still the pre-eminent international currency today. By the late 1990s, nearly 70% of all foreign-exchange transactions involved the dollar and more than half of world exports were denominated in dollars. The proportion of official reserves held in dollars rose from about half in 1990 to two-thirds in 1999. But until the euro came into being in 1999 there was no economic entity of a comparable size to have a currency that might challenge the role of the US dollar. Could the euro become important enough to reduce the dollar's stranglehold?

The importance of the Euroland economic zone

Euroland's 310 million people constitutes a more populous currency area than the United States' 280 million population. Looking ahead and including all EU members and all accession candidates, the population could top 550 million. While a large block for Western standards, it still is dwarfed population-wise by the 1 and 1.3 billion population of India and China. If counted as a single economy, Euroland, with a GDP of €6.4 trillion in 2000, is the second biggest economy of the world after the US with a GDP of €10.8 trillion and ahead of Japan with €3.5 trillion. The combined GDP of an integrated and enlarged Europe would be €10.7 trillion.

The people of Euroland are more active in international trade than residents of the US. The ECB estimates that Euroland is about 50% more "open" than the US. That greater openness brings external exports from Euroland to within range of those from the US: €1.0 trillion from Euroland, compared to €1.2 trillion from the US in 2000. But the US trade deficit shows up in its vastly greater imports: the US was the world's largest importer - €1.3 trillion in 2000 compared to €1.0 trillion into Euroland (at current exchange rates) excluding intra-Euroland trade.

However, the advent of the euro seems to be stimulating trade more within Euroland than outside it. Germany's trade with the EU (exports plus imports) has leapt from 27% of GDP in 1998 to 31% in 2000. Similarly, France's trade has risen from 28% to 32%; Italy's from 23% to 24%. Over the same period, Britain's trade with the EU has edged down slightly to 23%. (For the EU as a whole, the average cross-border trade has grown from 29 % of GDP in 1990 to close to 40 % now).

Bond markets

Turning to the capital markets, it is spectacularly clear that the euro has become a major currency in the international bond market. In the first half of 2001, €509 billion of bonds were issued denominated in euro, compared to €479 billion (equivalent) of international bonds in dollars.

But the stock of debt outstanding still reflects the historic importance of the dollar. For example, the Salomon Smith Barney Broad Investment Grade Performance Index (with a minimum size requirement of €500 million outstanding) shows the U.S. dollar component at €6.2 trillion (equivalent) at mid-year. As the euro component was only €3.4 trillion, the U.S. is at about twice that level. That calculation includes both the domestic and "offshore" markets so is an "apples and apples" comparison.

But the European Central Bank produces data on bonds eligible for "repo money market operations" - effectively all euro denominated bonds - that totals €6.8 trillion of bonds outstanding - about the same size as the US market, though the US would also have the corresponding tail of small issues. But the key point is that, after quite a short period of development of the euro market - only 2.5 years - the two markets are of a comparable size. Moreover, they have begun a rapid structural change - corporate bond issuance has risen six-fold compared with pre-EMU days.

Global investors are likely to look first at the government bond market because these bonds have a "benchmark" status, as the best credit in the market. Total EU-12 government bonds outstanding reached €2.5 trillion at the end of June 2001. The corresponding numbers were €1.9 trillion for Japan and €1.8 trillion for the US. So the US market, at the time, was actually smaller than Japan and thus only the third largest market. As an aside, the UK's Gilt market is only €0.3 trillion, so the Euro market is 7 times its size. The Government debt managers of Euroland took an intellectual and emotional decision several years ago to compete head on with the US Treasury and so set about reforming the size and types of their issues as substantial redemptions came due in recent years. However, these developments did not alter the political reality - set in the Maastricht Treaty - that national debt remains solely the responsibility of national governments.

Now the debate has moved to trimming spread differentials by focussing on the minutiae of clearing and settlement as the ECB resolved the payments issues by setting up the TARGET real-time gross payment system as a preliminary part of EMU. These are the final details in the push to eliminate barriers to cross-border trading, both institutional and retail.

Bank lending

The comparison with bank funding of the economy is also interesting, as there is competition between bank loans and securities to provide credit to the EU economy. The ECB figure of €6.8 trillion for all bonds compares with bank loans to Euroland residents (excluding governments) of €6.3 trillion. So the capital market is already a supplier of credit that is of a comparable size to the banks – within Euroland. Has the amount of international bank lending in euro increased since the launch?

BIS data for international bank activities showed that - in March 2001 - Euroland currencies accounted for 29% of all international bank assets, compared to 42% for the dollar and only 7% for the yen. As the dollar is already less important as a domestic currency lent abroad out of New York than are the combined former currencies of the Eurozone lent out of their home bases, it is the greater use of the dollar for loans from one non-US country to another that gives it the edge. But the physical introduction of the euro (and therefore the completion of the transition to a single currency) may spur growing use of the euro in loans between non-Euroland countries. That trend is evident already: Between December 1999 and March 2001 international bank lending of ”Euroland legacy currencies as a foreign currency” rose by 28% compared to an 18% rise for the dollar. Foreign currency deposits of Euroland legacy currencies rose 30% compared to 24% for the dollar.

Official Reserves

But the key issue remains: Will the euro develop towards a major official reserve currency? Great predictions were made for the euro before its launch. They have yet to be realised. IMF figures show that, even in 1999, dollar reserves actually rose, as a share of the total. In 2000, the dollar accounted for 68% of total identified official holdings of foreign exchange, while the euro represented only 13% and the pound sterling less than 4%. But these changes take time and the weakness of the euro versus the dollar will have retarded the process. However, the physical manifestation of the euro may act as a trigger because the risk of a breakdown has become lower in the perception of large foreign exchange reserve holders.

Many of the fundamentals are in place. The principal factors influencing the demand for official reserves in a particular currency are set out in an IMF working paper from last year: Trade flows, financial flows and currency regimes. [2] Trade flows count for a larger share of GDP in Euroland than in the US and Europe is developing big, liquid capital markets. If the enlargement candidates decide to adopt a euro-based regime - such as a euro peg, currency board, or "euro-ize" ahead of their eventual euro membership - demand for euro will increase. Notwithstanding the current global downturn, the US has a fundamental economic problem that is absent in Euroland: It has a current account deficit of huge proportions, whereas the EU is in rough balance.

Advantages of a world currency

One significant advantage of having a world currency comes from seignorage - the more governments can finance their deficits by issuing banknotes, the less they have to pay in interest on bills and bonds. Two thirds of all dollar banknotes are held outside the US so the US uses the dollar to finance its payment deficit. The extra-territorial use of euro could also contribute to financing the balance of payments of Euroland. In 2001, 30-40% of DM cash (DM 70-100 billion) was circulating "outside", mainly in Eastern Europe and Turkey. This accounted for about 12-16% of Euroland's cash in

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[2] "The currency composition of foreign exchange reserves: retrospect and prospect", by Barry Eichengreen and Donald J. Mathieson.

circulation. But it remains unclear whether DM cash was changed into euros or dollars (or other currencies) or simply paid into currency accounts.

Another set of advantages will come to the European financial services industry in the international banking and bond markets. The retail savings institutions of Europe will be the natural suppliers of euro to the market, so that should give Euroland-based institutions a competitive edge in providing finance to the rest of the world.

Secondly, there is the political clout that goes with being the operator of the reserve currency. If a country has borrowed in a reserve currency then slips into a currency crisis, it will turn for help first to the government issuing that reserve currency. That constitutes political power - a standing on the world stage. If that borrower has to make two stops - one in Frankfurt/ Brussels, and the other in New York/Washington - then a key development will have occurred. Presently, clear-cut economic power is backed up by financial power, and that is held entirely by the United States. If, or when, that changes, the euro will have had a dramatic impact on heightening the international standing of the European Union.

Conclusion

The euro is not completely there yet. As a virtual currency, it has been little more than the size of constituent currencies - with the clear exception of the money and bond markets. The Financial Services Action Plan (FSAP) is designed to remedy many of the problems that exist in developing the euro-denominated financial markets to parallel the efficiency of US markets. That should open the way for the euro to assume a role on the world's financial stage that corresponds to that of the Euroland economy. If the other members of the EU, and all the enlargement candidates, sign up to EMU, then the total GDP of Euroland would comfortably exceed that of the US.

For further reading, ECB August 2000 Bulletin; ECB September 2001 article on the International role of the euro.

<u>A Euro is a Euro</u>

The background: Since the euro was launched at the beginning of 1999, public perceptions regarding the new currency's success and its future prospects have been adversely affected by the impression of persistent weakness and steady declines against other major currencies. It is an incontrovertible fact that the euro has been much weaker than most commentators expected, and those responsible for economic policy cannot afford to adopt an attitude of "benign neglect" to the currency's performance on the international forex markets. However, for the vast majority of EU citizens, the real (as distinct from the psychological) effects of the falls in the euro's external value have been considerably less serious than has been widely assumed. Indeed, in some important respects, the effects have been beneficial.

The scale of euro decline is exaggerated: It is quite easy to depict the euro's decline in dramatic and exaggerated terms. The currency has fallen from $1.18 per euro at the beginning of 1999 to less than 83 cents per euro at its low point in the autumn of 2000. This is a fall of 30% in the value of the euro, which means that each dollar was able to buy, at that time, some 40% more euros than in January 1999, when the new currency was established. In the early months of 2001, the euro staged a net modest recovery of some 5%-8%, but the single currency is still at a level that most analysts would regard as too low. At the same time, the practice of always comparing the euro's value at any particular time, with its value at the beginning of 1999 when the currency started, while understandable, is potentially misleading. This is because most legacy currencies comprising the euro registered significant net rises against the dollar during 1998. This is not to deny that the euro is still undervalued, if assessed in relation to objective economic fundamentals. However, since the basis of most comparisons is usually with a date when the euro was almost overvalued, the scale of the currency's underlying weakness tends to be consistently exaggerated.

The euro reduces drastically the Euro-zone's sensitivity to forex market movements: Those expressing concern over the consequences of the euro's decline do not give adequate weight to the way in which the establishment of the European single currency has changed fundamentally the nature of the Euro-zone's exposure to forex market changes. The key point is that, while the individual EMU members are, without exception, open economies with very large external sectors, the huge Euro-zone economy, taken as a whole, is a relatively closed economy, with only a small external sector. Intra EU-trade as a percentage of GDP increased at about 1 percentage point each year over the last decade and will reach 40 % in 2002. Precise definitions vary but, for the typical individual Euro-zone economy, exports or imports can account for more than 25% of GDP. In such a situation, a sharp fall in the external value of the currency can push up significantly the domestic rate of inflation. However, for the Euro-zone economy as a whole, imports or exports account for only about 15% of GDP, and the impact of forex market movements is therefore fairly small.

Inflationary impact of euro decline has been limited: Not surprisingly, the falls in the euro since early 1999, although clearly a factor, have had a much more modest impact on the Euro-zone's domestic price level than is often argued. The most important influences on Euro-zone inflation have been the increases in the world (dollar) price of oil, other forms of energy and food. Admittedly, the inflationary performance of the Euro-zone has been rather mixed. Inflation has been for much of the time slightly above the 2% ceiling set by the ECB (reaching a peak of 3.4 % in May 2001), and this has undoubtedly been one of the factors making it difficult for the ECB to ease monetary policy more aggressively, in reaction to weakening economic activity. However, the ECB was certainly right not to over-react. Euro-zone inflation has remained broadly under control, in spite of its slight upturn, and price pressures eased gradually in the second half of 2001. They are expected to continue doing so in 2002. The fall in world oil prices has obviously helped to reduce Euro-zone inflation, even without a sustained recovery so far in the euro exchange rate.

The beneficial effects of a weaker euro: A responsible Central Bank such as the ECB has to care about the stability of the currency. However, in the particular circumstances facing the Euro-zone since early 1999, the fall in the euro exchange rate has played a positive role in boosting the region's net exports, thus helping to offset partially the weakness in the region's domestic economic activity. A more competitive exchange rate has helped many businesses in the Euro-zone's exporting and manufacturing sectors to sustain output, employment and profit margins. At the same time, the potential inflationary pressures that might have resulted from the euro's decline have been only modest, because the Euro-zone economy as a whole, unlike its constituent members, has only a relatively small external sector. Against this background, the ECB was entirely correct in not over-reacting to the euro's weakness.

Main conclusions: The euro's movements on the foreign exchange markets have been a matter of concern to professional traders, analysts, financial journalist and politicians. **However, the vast majority of the Euro-zone's 310 million citizens have remained virtually unaffected by currency fluctuations. But the virtual nature of the currency until the end of 2001 - at best involving dual pricing (though few people looked at the euro price) - meant that most people had no way of realising the true situation: That the purchasing power of the euro was indeed stable.** In contrast, the adverse psychological effects of the euro's weakness on the foreign exchanges have been considerable; and this contributed to the lack of enthusiasm towards the new currency among many ordinary people.

The critical role of euro-denominated notes and coins: The public's concerns have been reinforced by the impression that, until recently, the euro was only a "virtual currency". As long as the legacy currencies retained their role as legal tender in the various Euro-zone countries, an erroneous view was created amongst many people that, in accepting the euro, they were being asked to abandon an existing "hard currency" for a new inferior euro. Fortunately, this problem has been solved by the rapid adoption of euro notes and coins ahead of the official deadlines.

A euro is a euro: It is often said that Americans are much more insular than Europeans; but the indifference (and even ignorance) of most ordinary people in the US towards the dollar's foreign exchange rate is understandable. For most Americans "a $ is a $" and they have little interest in, and knowledge of, forex markets developments. Although people in Europe are unlikely to become as insular as those on the other side of the Atlantic, they might also gradually develop a degree of indifference towards the fluctuations of their new currency on the forex markets, and they will learn to accept that “a euro is a euro”. When the euro eventually recovers, as seems likely, the probability is that many people will not pay too much attention to the event. Of course, this is not to say that a policy of benign neglect towards the euro foreign exchange rate is justified. No doubt, it would be desirable that the US and the EMU coordinate better their macro-economic policies in view of maximising sustainable economic growth at the global level, having particularly in mind the impact of their overall economic policies (including trade and exchange rate) on less developed countries.

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<u>ECB Monetary Policy: successful - but needs better communication</u>

The European Central Bank (ECB) has done a good job in securing price stability since it took over full responsibility for monetary policy in early 1999, though the self-imposed definition of price stability - inflation between 0 and 2% - was not met in 2000 or 2001. Due to the combination of a strong oil price hike, a weak euro and food-related special factors (BSE, foot-and-mouth disease), the inflation rate in Euroland reached 2.4% in 2000 and averaged 2.7% in 2001. However, and very importantly, the ECB managed to dampen secondary inflationary effects, especially in the wage-setting process so Euroland will probably meet the norm for price stability in 2002 - as was the case in 1999. A first assessment of the monetary policy itself is therefore positive.

However, the ECB’s strategy must fulfil two needs: Monetary policy itself has to be **robust,** and the Bank has to orchestrate a **clear communication** with the public and the markets. A robust strategy is intended to make the central bank’s internal monetary policy decisions flexible yet stable. A stable strategy has the advantage that repeated discussions of principle among the monetary decision-makers, which might result in market uncertainty, are avoided. Since the ECB could not simply slip into the mantle of the Bundesbank and take over its credibility, it has to practise transparent monetary policy in order to build its own credibility. If the central bank pursues a clear communication policy, the result should be monetary transparency which will reduce uncertainty over the future course and which can thus stabilise inflation expectations of market participants at a low level.

As far as that communication is concerned, the ECB is basically doing a good job on the form and the organisational aspects. The monthly ECB bulletin, regular press conferences and the communication to the European Parliament are exemplary. In that regard the ECB is transparent. According to a transparency indicator developed by Bini-Smaghi and Gros [3] the ECB scores 19 on a scale of 20. The Fed scores 14. Only the Bank of England makes the perfect grade. If any criticism is warranted, one could argue that the ECB is perhaps even communicating too much, which makes it harder to distinguish between important and less important messages.

But that begs the question: To what extent is the ECB predictable. **In the first three years, the ECB had definitely more trouble getting its message across than giving it.** As CEPS (2001) puts it: "Despite this high formal rating of transparency, the ECB does not seem to be understood by the markets… All in all, it thus appears that the ECB has at its disposal all the instruments necessary to function in a transparent manner, but it does not use them properly." If it wants to avoid wrong footing the market all the time, it should do something about this because, despite explanations, its monetary strategy has repeatedly come under fire. The main point of criticism has been that the two-pillar strategy is too complicated, partially contradictory and, critically, not very easy to communicate.

The two-pillar strategy of the ECB is a relatively broad approach. It aims for price stability on the basis of an analysis of money-supply

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[3] "Is the ECB sufficiently accountable and transparent?" by L. Bini-Smaghi and D. Gros, ENEPRI Working Paper, n° 7, September 2001

growth (first pillar) and of other economic and financial indicators (second pillar). The approach is indeed a good way of developing a coherent concept from the variety of strategies previously used in Europe and finds wide acceptance within the ECB. But it is not very binding internally or externally.

The flexibility and acceptance by internal policy-makers attendant on the two-pillar strategy can cause problems, too. The two pillars may send out conflicting messages, partly due to their different time horizons. For example, signals from the second pillar that tend to refer to the short term might point to waning inflationary pressure, while at the same time the first pillar might indicate inflationary pressure over the medium term.

Moreover, contradiction between the two pillars gives different lobbies within the ECB’s Governing Council (and amongst the general public) good arguments in favour of one or another monetary policy shift. While this does not necessarily block policy decisions, there is a danger of contradictory signals causing policy-makers to “dig in their heels”. In particular, those who want to postpone policy decisions will likely make use of such contradictions to delay objectively necessary decisions.

This is the real problem with the two-pillar strategy: Contradiction between the two pillars will repeatedly trigger discussions of principle about the focus of current monetary policy. But that is precisely what a robust and stable monetary policy strategy is supposed to prevent. The unclear relationship between the two pillars leads to another fundamental disadvantage of the two-pillar strategy: Contradictions hamper communication of the strategy and thus the rationale for key rate decisions. The ECB itself points out that "it is not practically feasible to combine these two forms of analysis in a transparent manner in a single analytical approach". [4]

The ECB certainly could explain the strategic interlocking of both pillars better. In particular, President Duisenberg's run-down on the

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[4] European Central Bank, Montly Bulletin, November 2000, pp. 37-48

current annual rate of M3 at the beginning of his statement during the monthly press conferences gives the impression that he is reeling off a set piece rather than presenting the outcome of in-depth economic analysis. After all, the ECB only discloses the **results** of its discussions and analyses. But, for the market, it is very important to know the details of the arguments favouring or opposing the eventual decision.
Therefore the publication of ECB forecasts was a welcome initiative, although the forecast range is too wide, which leaves little information Moreover, the ECB downplays its own forecast, raising questions about its use. Perhaps the ECB would do better to compare its forecasts with the private sector's consensus and explain why they diverge.

As an example, the credibility of the ECB was badly shaken in the run-up in 2001 to the May 10th official rate cut. Since the beginning of the year, the ECB had been in stark denial of the economic slowdown (market pressure for a monetary easing was rejected with the (in)famous quote "I hear, but do not listen". Nevertheless, interest rates were cut shortly afterwards on the basis of a technical argument (distorted money growth figure), which on the basis of earlier declarations by the ECB could never have been an argument in itself for cutting interest rates.

Another problem is highlighted by the ECB’s attempts to play down the relevance of its projections. Although they should form the quintessence of the second pillar cast in figures, they do not represent an integral part of the two-pillar strategy. So the ECB should put more weight on its forecasts, confronting them with private sector ones and **give the balance of risks around the forecasts**.

Otherwise, it therefore needs little imagination to visualise President Duisenberg being asked at press conferences whether his inflation assessments and those of the Council differ from his staff’s predictions and what need for monetary action can be deduced from this. Members of the European Parliament have already said they expect the ECB president to make a statement on his bank’s inflation projections as part of his regular reporting to them. Detailed discussion of medium-range price projections would open up the possibility of a better understanding of monetary policy.

One of the basic problems so far is that the ECB speaks with many voices, and this has been instrumental in unsettling the markets. That is not a problem of policy strategy but does lead to contradictions, misunderstandings and, ultimately, to a monetary policy that does not satisfy the aspiration of high transparency. If the two-pillar strategy is implemented consistently, a robust and transparent monetary policy is still possible. That leaves the burden on intensive communication between the central bank, the politicians and the financial markets. The ECB's current initiative - to decide on the appropriateness of the interest rate level only at the first ECB Council meeting of the month and to leave the communication job up to the President - is an initial step in the right direction.

It would help to make the ECB's policy decisions easier to understand, if (perhaps temporarily) a "policy bias" was published after monetary policy meetings. Even if no interest rate decision is taken, a change in the bias would give valuable information on the ECB's assessment of the economic environment and accelerate the markets learning process of the ECB's monetary policy. Predictability will certainly be enhanced. It would also help to avoid misinterpretations of comments given by ECB council members in between meetings. Moreover, publishing a policy bias would give the ECB an additional tool, i.e. shaping market's' expectations.

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Further Budgetary Consolidation still needed in most EU Member States

"Further budgetary consolidation is still needed in most EU Member States to recreate the necessary scope to face adverse cyclical developments and to prepare for the longer-term budgetary challenges associated with an ageing

population." This recommendation made in January 2000 [5] is as valid today as it was then.

There are signs that the good intentions of the fathers of the Maastricht Treaty and governments in the subsequent seven years leading up to the introduction of the euro in 1999 are beginning to wane as a consequence of "convergence fatigue". Unless governments take firm action now to re-establish a practice of sound public finance much of the benefit of the single currency will be dissipated and the past efforts to observe the so-called Maastricht criteria so as to qualify for entry into EMU will be wasted. This is particularly true in the uncertain economic situation prevailing as this pamphlet is written.

The commitment is quite clear: Excessive government deficits are ruled out under the Treaty, while governments have committed themselves under the Stability and Growth Pact to achieve "the medium-term budgetary objective of positions close to balance or in surplus".

The importance of this policy flows from the benefits for growth of a stable economic policy in a stable economy, and the danger inflation poses. Central to this is the influence fiscal policy has on the level of economic activity and inflationary pressures. It must be said that this drive for sound budget balances is not peculiar to the Euro Area but reflects generally accepted principles: thus a similar policy is followed by other members of the G7, except Japan which has particular problems of its own.

Hence, in the context of the Euro Area, the sounder the budgetary policies carried out by member states, the more the Central Bank, whose primary objective is maintaining price stability, can run its monetary policy in a growth-compatible manner. Furthermore, the ECB should not be encouraged to lower interest rates in the interests of growth to take account of an unsatisfactory fiscal policy stance by Member States.

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[5] ELEC "*The Euro: Next Steps to Success"* Cahier Comte Boël No 8.

It is true that in historical terms, the fiscal situation in the near past looks much improved in that the year 2000 saw the first budget surplus for the EU as a whole for over a quarter of a century. Nevertheless that was achieved in the favourable circumstances of strong economic growth and additional receipts from the sale of mobile phone licences.

It was, thus, worrying to read [6] that "the (cyclically-adjusted primary balance) did not improve significantly in 2000 compared with 1999, indicating that on average no discretionary fiscal consolidation efforts were made. Indeed, it deteriorated in many member states, and especially in Germany, France and Italy (the three largest economies in the Euro Area which still have substantial budget deficits) indicating they did not use favourable growth conditions to improve budgetary positions."

This inability to take advantage of the good times has left a number of Euro Area countries, and especially the larger ones, apparently more vulnerable in the face of the current slowdown in that they have less room for manoeuvre than would otherwise have been the case. Given this situation it is important that there be no deterioration in countries' cyclically adjusted structural deficits.
A major challenge facing governments in achieving this is how to sustain sound budget positions while at the same time acting on longer-term problems such as the need to lower the tax burden especially where this impacts unfavourably on the incentive to work, and the need to restructure public expenditure to prepare for known future "shocks" such as the consequences of an ageing population. This will have to include both pensions and health care reform in many countries but also the creation of extra budget leeway by reducing the burden of outstanding stocks of public debt.

The relationship between public finances and growth is such that there is a need to improve performance through better economic policy coordination. Given the construction of EMU with its single monetary authority, the ECB, and its 12 national budgetary

[6] European Commission. *Public Finances in EMU – 2001"* European Economy No 3 2001.

authorities, coordination is particularly important so that Member States' budgetary policies can deliver a correct policy mix both in the aggregate at Euro Area level, and at national level. This was emphasised earlier in 2001 when there were clear signs of overheating in some countries' economies.

Improved coordination is also necessary when reacting to shocks such as rapid changes in oil and other commodity prices. This, not only adds credibility to those who decide economic policy, but also reassures the wider world that the euro is being well managed. Finally it strengthens those who seek to pursue sound budget policies.

The tragic events of September 11th have caused a economic shock not only to the United States: The European Commission has reduced its growth forecast for the euro area in 2001 from 2.8% in the Spring forecast to 1.6% in the Autumn version. With such economic uncertainties, there are great temptations for governments to err on the side of too much fiscal relaxation as a stimulus to economic growth. The danger is that any such fiscal stimulus would tend to be pro-cyclical, only having effect after the economy has already started to grow once again, something expected to occur from the first half of 2002 and to continue into 2003.
Undoubtedly, the "automatic stabilisers" will have an effect anyway in loosening the budgetary stance and the Commission's forecasts for 2002 deficits have expanded by a full percentage point, to -1.4% of GDP. However, the plans for 2003 suggest that the downward trend will be resumed and the hard work of the 1990's will not be lost. Certainly, financial market participants do not seem to be expecting a major setback: The yield curve from 5 years onwards has flattened somewhat since the September events, which suggests that the ECB's policy - in conjunction with fiscal policy - is seen as credible. **It seems that the first major test of the euro area's economic management is about to be passed.**

All this highlights the need for action by government leaders and for statesmanlike decisions.

Before ending this section one should mention that economic policy has an impact on public opinion, and policy-makers need to learn to take account of this. On 12 February 2001 the ECOFIN Council noted that "The Irish budget for 2001 is expansionary and pro-cyclical and therefore inconsistent with the Council's 2000 broad guidelines for the economic policies, which state that the Irish authorities should 'be ready, already in 2000, to use budgetary policy to ensure economic stability given the extent of overheating in the economy'."

It went on to issue a public recommendation that Ireland "remove the inconsistency with the broad guidelines of the economic policies, engendered by the budget plans for 2001." This was a procedure clearly laid down in the Treaties and the recommendation was not only appropriate at the time but also made with all (non-Irish) ministers' agreement. Nevertheless, the Commission and the Council had great difficulty making an impact with their point of view on Irish public opinion, when faced by an unrepentant finance minister. This event suggests that both Commission and Council need to develop better communication skills so that when in situations of disagreement they are not only right, but also perceived as being so by the populations most affected by their recommendations. The treatment of the more recent cases of Germany and Portugal was in that respect a step in the right direction.

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<u>Flexibility in Labour and Product Markets</u>

This flexibility is required to respond to globalisation and technological change, as well as to country-specific economic developments. The pursuit of a comprehensive and coherent agenda of structural reforms is essential to the success of EMU. Structural reforms are in any case required, although perhaps with differing levels of urgency, in all EU Member States to stimulate economic growth, improve productivity, enhance private sector confidence and lower the substantial level of structural unemployment. They are also needed to enhance the ability to deal with globalisation, environmental problems and technological change. As monetary policy is geared to maintaining price stability in the euro area as a whole, the paramount consideration is for product and labour markets to become much more flexible - to respond smoothly to country-specific economic developments. Only more adaptable markets will be able to cope with the asymmetric shocks which will inevitably affect the euro area in the future.

Despite remarkable achievements, the Single Market Programme has not been fully completed. In particular, the very important Directive on Take-Overs failed to be approved by the European Parliament and a number of Directives aimed at liberalising some key sectors such as energy have not been transposed into some national legislation. Special efforts are needed to improve the regulatory environment for Small and Medium-sized Enterprises (SMEs) and foster entrepreneurship.

Inflexibility in labour markets is potentially the real Achilles Heel of EMU and the main source of the EU's unacceptably high rate of unemployment, which constitutes a real waste of resources.

The types of structural reforms that are required in labour markets are more and more recognised and the Member States that have made the most progress in implementing them, while pursuing sound macro-economic policies, are seen as having significantly improved their employment situation. While some countries are moving in the direction of an overall reduction in working time, it appears that more effective policies involve the following:

- Raising employability through education, training and lifelong learning;
- Lowering taxes and social security contributions on low-paid workers;
- Re-assessing eligibility criteria and duration in unemployment benefit systems;
- Ensuring the portability of pensions and other benefits;
- Promoting active job placement policies.

At the Lisbon Summit, in March 2000, the European Union adopted an ambitious agenda to become by 2010 "the world's most competitive and dynamic knowledge-based economy, combining sustainable growth, quantitative and qualitative improvement of employment and greater social cohesion". This process was added to other initiatives launched by preceding European Summits in Luxembourg, Cologne and Cardiff. However, the momentum in implementing these various processes risks being lost while it is difficult for public opinion to follow what has been actually achieved to fulfil these over-lapping objectives.

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Completing the Integration of the Euro Capital Markets

The Financial Services Action Plan (FSAP) is designed to remedy many of the problems that exist in the euro-denominated financial markets so as to match the efficiency of US markets. After such high expectations have been aroused by the Action Plan, bad - or even no - legislation is likely to cause significant disappointment about the EU's ability to undertake the serious reform that is necessary to make a success of the euro.

In reality, the Member States are already well past the point-of-no-return on the journey to a single capital market that is actually outside the ability of any single state to control through its own administrative actions. As technical matters such as clearing, settlement and payments move to a pan-European basis, that passing of the point of no return will become ever more apparent. But a loss of nerve now - epitomized by attempts to throw sand in the wheels of the evolving financial system - are only likely to rebound at great cost to the political project of "ever closer union".

Legislative progress continues "as normal" but the problem of power sharing between the institutions must be resolved if progress is not to grind to a halt. A constitutional crisis is at hand as crucial proposals are on the table: Will the EU's governance be up to the task? If not, what conclusions should be drawn about the longevity of the euro - the fruit of a political system that turns out to be flawed?

The Commission has now proposed most of the FSAP measures so the focus is moving to the Parliament and the Council. But the private sector also faces a “commentary” overload and market participants want to see maximum transparency in decision-making with adequate time for public analysis and debate of the rationale for proposals framed in the light of the consultations that have taken place. Such a process should create a powerful set of forces to allow the facts to speak for themselves.

Regrettably, revision to some legal texts has already proved to be a practical necessity, rather than some remote theoretical risk. Council set deadlines for the Commission to produce proposals and the rush to meet them unfortunately produced an adverse result - on the first occasion. The Prospectus Directive has admirable - and essential goals - but the proposal that has emerged would, in the judgement of a wide array of market professionals, have exactly the opposite effect to the original intentions. Could this time pressure result in ambiguities - or errors - that eventually defeat the whole object of the exercise? But this is not the only problem. The period of revolutionary change in financial markets will call for detailed up dating of legislation.

The essence of the proposal in the Lamfalussy Report was to put this detail into secondary legislation so that any problems could be remedied more easily. It is a mark of the immaturity of the European institutional system that the mechanisms for secondary legislation have not yet developed. But the need to bring citizens the full benefits of the single currency is about to force a constitutional innovation. That is exactly why the three institutions - Commission, Council and Parliament - are determined to set precedents now that will preserve “their institutional prerogatives”. They are petrified by the risk of setting precedents in the field of financial services that could be applied elsewhere.

That debate is now inextricably bound up with broader constitutional issues. Perhaps that was always inevitable as the nature of the single currency is that it will affect the daily lives of all Euroland citizens in a uniform way. There is therefore a risk of a corresponding inevitability that public policies to regulate the use of this "commodity" will have to be uniform as well. The financial services industry merely provides the mechanisms for using the commodity.

But that is precisely the need for legal certainty in cross-border transactions that has led to the creation of the over - detailed primary legislation that is now under attack. Moreover, there is a risk of a clash with the principle of subsidiarity. In the specific case of financial services, the consumer may well do better by having pan-European laws that enable the full range of services to be offered cross-border - but that brings in wider constitutional points that should be considered by Parliament and Council.

But there is a constitutional problem to solve now and possible solutions seem to include maximising genuine transparency and giving the Securities Committee process a probationary period until 2004 to see if it does pay full attention to any problems that the Parliament may be called upon to resolve. Market participants would not be concerned about the disappearance of the Securities Committee itself at that stage, but that should not mean that any of its legislative enactments would cease to have effect. That **would** be disruptive. [7]

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Prospects for Enlargement: After Nice, what can be done at Laeken?

The Nice Summit represented an important step - as Mr. Romano Prodi declared at the European Parliament on 12th December 2000 - in the direction of "binding together the countries of our continent into a wide area of peace, stability and greater economic potential.

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[7] This commentary is based on the Federal Trust's study of the Lamfalussy Report. For full details, see: www.grahambishop.com/fedtrust.

As a step, it was shorter than we had hoped to make or indeed could have made. But we are moving in the right direction".

It is well known that the enlargement process has important consequences for both candidate countries and current EU Member States. Obviously, the implications are quite substantial for the candidate countries: basically, they have to transpose the *acquis communautaire* into national law and satisfy several other conditions for entry. A wide range of areas is affected by the negotiations for accession: agricultural policy, industrial competition, international trade, labour and capital movements, legal, judicial and institutional arrangements. In all of these areas deep reforms are still needed to bring former centrally planned towards market based economies.

At the same time the enlargement process heavily affects the current EU Member States in a number of delicate issues such as free movement of labour, the Common Agricultural Policy (CAP) and structural funds. In all of these areas proper reforms are to be undertaken. Even if difficulties should not be taken as an excuse to delay the enlargement process, the economic and social implications of those reforms should not be underestimated. This is the main lesson, perhaps, stemming from the recent Irish Referendum results. A second lesson is represented by the clear need for better public information campaign to promote the benefits of the enlargement.

But the enlargement process turns out to have primary implications also for the EU institutional and political functioning. The EU's internal decision making and the operating mechanisms obviously need to be changed. These mechanisms are well known to be weak at present. But they would risk becoming totally inadequate for the efficient working of the EU after the enlargement. Of course, delicate issues lie behind the technicalities of any process of institutional reforms. In this case, they stretch to the very heart of European political life, and their complex implications have been left unattended for a long time. The final success of the enlargement process requires that they are now properly addressed and solved with no further delay. This was the main task of the Nice Meeting.

On the institutional functioning front, a number of decisions were taken in Nice, regarding, in particular, the weighting of votes in the Council, a limited expansion of majority rules, and the composition and organisation of the European Commission and of the other EU Institutions.

The European Parliament, the Economic and Social Committee and the Committee of the Regions shall include representatives of the new Member States provided their accession treaties are signed, and ratified, by 1st January 2004. The European Commission will include one representative of each Member State from 1st January 2005 while a principle of rotation shall be applied when the EU consists of 27, or more, Member States. The voting rights regarding both present and accession candidate countries have already been stated in the Treaty while an agreement dealing with the institutional functioning of an enlarged EU has been reached on a specific protocol annexed to it.

There was only a limited extension of qualified majority voting in Nice. Member countries will keep the veto choice on important sectors such as taxes, social security, immigration, parts of trade policy, and structural funds (until 2007). However, eight countries will be entitled to launch a reinforced cooperation. In this respect, *avant-garde* countries will be *de facto* in the position to speed up the process of European integration on a certain number of matters, even if not all countries agree.

The Treaty of Nice has not changed the composition of the Governing Council of the European Central Bank, which comprises the members of the executive board and the governors of the national central banks. It has, however, allowed modifications to be made to the decision-making rule, presently based on simple majority of the members (each with one vote). The Governing Council is expected to propose an amendment to the voting rules. This change will require a unanimous European Council decision, which must be then ratified by the Member States.

On the political functioning front, the Nice Summit, while recognising the deep political implications of the institutional reforms needed for the well functioning of an enlarged Union, called for a wide debate about the future development of the EU. It has been stated, in particular, that at the meeting in Laeken, in December 2001, the European Council should agree on a Declaration on the Future of the European Union. The declaration would have to contain appropriate initiatives regarding the respective competencies of the EU and of the Member States, the role of national Parliaments in the European architecture, the simplification of Treaties and the status of the EU Charter of Fundamental Rights proclaimed in Nice.

The Laeken Declaration should help prepare a new Inter-Governmental Conference, to be held in 2004, by launching a Convention on the future of Europe. This Convention should include national and European Parliamentarians, and through them, should involve civil society in defining the objectives of the enlarged Union - and the policies and budgets to achieve them.
The Charter of Fundamental Rights is to be viewed as an important result of the Nice Summit, even if the discussion on its legal enforcement and on its possible inclusion into EU Treaties has been postponed. The adoption of such a Charter would help provide a stronger political identity and common ethical foundations to the enlarged Union, which will be increasingly diversified from a cultural, social and political point of view and yet is to be felt as a “Common House” for each European citizen.

Of course, much work has to be done to facilitate the enlargement process, on one side, and to improve both the institutional and the political functioning of the European Union, on the other side. The Gothenburg European Council, in June 2001 made further progress in implementing the new enlargement strategy based on the principle of differentiation. It has been agreed that those countries that are ready should be able to complete negotiations by the end of 2002, so that they can participate in the European Parliament elections of May 2004 as members. It has been also stated that candidate states, which have concluded accession negotiations with the EU, shall be invited to participate to the Inter-Governmental Conference to be held by 2004, and that the other candidates shall be invited as observers in any case.

The European Council meeting at Laeken has launched this ambitious process. The Belgian Presidency - which was given the task of drawing up the parameters of the debate by the end of 2001 - defined in the Laeken Declaration the key questions about Europe's future which will be debated in the Convention. This would help overcome deficiencies in the Nice Treaty and prepare adequately for the 2004 Inter-Governmental Conference.

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The Citizens' Perception of the Euro

The euro differs in several ways from its predecessor, the ecu, but they both have had in common their lack of popularity. From the moment it was launched in January 1999 as the official currency of the then 11 Members States [8] of the Economic and Monetary Union (EMU) until the "euro-kits" appeared at the end of 2001, the public largely ignored it. The general feeling in the public about the arrival of euro notes and coins was, until they actually arrived, indifference, despite the historical significance of the replacement of national currencies by what will one day become the common currency of 500 million Europeans.
How could one explain this disaffection?

Firstly, a currency is not just money; it is also the symbol of common values. European leaders, however, have failed to articulate a clear vision of Europe's values that would underpin the euro.

Secondly, economic growth and employment have remained disappointing in the euro-zone. Citizens associate EMU - rightly or wrongly - with the restrictive policies imposed by the convergence

[8] With Greece joining on January 2001.

criteria. Most will recognise that more responsible public finances were needed, that competitive devaluation and borrowing extensively at the expense of future generations are now rightly banned. But the temporary inconveniences were presented as investments for a better future which they do not yet see.

Except for a satisfactory growth rate in 2000 - although still far below the rates of growth experienced in the US, and a slight fall in unemployment, the future remains far from the promises. With a rate of 8%, unemployment in the euro-zone remains about twice the level in non-euro EU Member States and the US. Income per head in Europe has now fallen behind that in the US by the same margin that existed in the early sixties. The issue is of importance for the citizens of the pre-in countries: Why would they join a currency of a group of countries with slower growth, higher unemployment and higher taxes (for the UK at least).

Thirdly, so far citizens have seen few advantages from adopting the euro. Banks have not progressed in adopting the International Bank Accounting Numbering (IBAN) system approved by ISO in 1997 to facilitate trans-border payments, and the single financial market is still in the making. Citizens, rightly, wondered why they were asked to go through the complication of changing monetary units if the basic supporting infrastructure is still incomplete. The euro was associated with rising, rather than falling, banking costs - clearly not a good selling point.

Fourthly, the intensive euro information campaign was only recently targeted to the citizens and it was at time misguided. There was initially too much emphasis on the "how's" of the euro. During the early years, the campaign should have focussed on the "why's" of the euro, keeping practical information for the last year of the transition. Also, most national posters and leaflets showed only the national sides of the coins, with the logical result that some citizens still think that there are different euros for each country.

Many of these difficulties can be traced back to the lack of citizens' participation in the process leading to Economic and Monetary Union (EMU): As demonstrated by Nobel Prize Winner Amartya

Sen, basic economic and social choices (such as those implied by EMU) are best decided with citizens' participation. The French strikes of December 1996 and misguided opposition to globalisation and European integration are also the results of difficult choices being made without adequate popular participation.

Further adjustments to the regulatory environment may be needed to boost the European economy but are of a political nature: Tax and legal harmonisation, transfer of specific responsibilities to European level, etc…. In democracies, such changes require public endorsement. After "No's" in Denmark, Switzerland and Ireland, how many more do political leaders require to understand the need for a more democratic process to support European integration?

The current discrepancy between monetary policies being decided at the European level and economic and social decisions being taken by national authorities has to be remedied by a stronger co-ordination of economic policies by the Eurogroup. While further political integration is broadly felt as necessary to sustain the euro, citizens also aspire today at more direct democracy. Unless the democratic deficit in the European construction is filled or compensated by a more efficient allocation of sovereignty among the European, national and regional decision levels, the allocation of more economic power at European level, will be unacceptable and one can fear growing nationalistic feelings - as demonstrated in the recent successes of nationalistic parties in Austria, Italy, Denmark and the Netherlands.

The issue of the democratic deficit was addressed in the recent White Paper on "European Governance" published by the European Commission. A number of concrete proposals were made to enhance the activities of the European institutions: Openness, participation, accountability, effectiveness and coherence - while reinforcing proportionality and subsidiarity. However, these recommendations are made in the context of the existing Treaties. There is no doubt that the crucial subject of governance should be among the pre-occupations of the post-Laeken Convention and of the 2003 Intergovernmental Conference.

The successful introduction of euro notes and coins will probably give Europe a renewed popular support: The “euro effect”. With ”Europe in their pockets”, greater price transparency and simplicity, citizens now have the facility of travelling and trading from Helsinki to Lisbon and from Athens to Amsterdam with the same currency as well as holding coins with the image of 12 countries. This should create a “sense of belonging to a same community”. Will the fact that national sovereignty has lost a key piece of imagery, create a greater sense of European citizenship and help build a more balanced relationship between regional, national and European authorities?

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Broadening the Euro Area

Britain and the euro

In his speech to the Labour Party conference in Brighton, Prime Minister Blair said Britain should join the euro in this Parliament if the economic conditions were met and that the Labour Party should have the ”courage” to make that argument to the country. The conventional wisdom, that terrorism had reduced the likelihood of a euro referendum, was turned on its head. The Prime Minister conclusively demonstrated his determination not to be swayed on this issue by arguing that the new world order strengthened the political arguments for joining. Since that speech a number of cabinet ministers have echoed this sentiment.

But what of economics? A new view has emerged that while the political case may be strong the current economic climate was an insuperable barrier to the UK joining. The Prime Minister has re-iterated that only the Five Economic Tests stand in the way of EMU membership. But economic divergence between the UK and euro-area is significantly less than in 1997. GrahamBishop.com’s UK-Euro-zone Divergence Index is down from 100 in 1997 to 23 this year. Convergence is expected to continue at least until 2003, despite the current economic downturn. During this period - in which the Treasury is committed to assessing the Five Economic Tests - the UK could be less 'divergent' than Germany. The OECD recently confirmed this analysis, saying that the UK is closer to the core of the euro-zone than some existing euro-zone countries. It forecast that growth in the euro-zone next year will be just 0.3 percentage points different to growth in the British economy, that output gaps will be almost identical and 10-year interest rates will remain practically the same.

Despite this evidence, there will never be absolute certainty. That is why Labour Party Chairman, Charles Clarke, rightly argued for a change in the burden of proof for joining the euro-zone from the “beyond reasonable doubt” position of the Treasury to “a balance of probabilities”. The Treasury’s recent paper on it’s “preliminary and technical work to prepare for the Assessment” stated three times in the first three paragraphs that the results of the economic tests must be “clear and unambiguous". But the dismal science of economics is rarely so precise, and cannot ever be for tests that are broad and subjective. A sensible evaluation would recognise that there will always be risks to joining the euro as well as staying out. But at the end of the assessment, it is the Chancellor’s judgement that must be clear and unambiguous.

Barring the imposition of impossibly rigorous demands on the economic assessment, the “only” remaining barrier is public opinion. But there were signs in the General Election that when the issue of the euro was put at the forefront of debate, opposition receded. While the public may be two-to-one against joining the euro today, only 27% of voters say they could never be persuaded to join. Furthermore, whatever their own views on the issue, over half the public expect Britain to be using the euro by 2005, according to GrahamBishop.com’s MORI poll. The view that euro-scepticism is “soft” may encourage the British government to hold a referendum before the spring of 2003 so after the Laeken Convention on the future of Europe has concluded its work and when the Chancellor’s economic assessment can reflect the currently low levels of divergence between the UK and the euro area.

Nordic Perspectives

The five Nordic countries, Denmark, Finland, Iceland, Norway, and Sweden with clear similarities in economic policy priorities since the second half of the 20th century have taken strikingly different stands vis-à-vis the European Union and EMU.

Norway remains outside the Union but is associated through the European Economic Space. The Prime Minister as of October 19, 2001 of a new centre-right coalition has stated that his government will cease to exist if the coalition partners put membership of the European Union on the agenda.

Iceland has chosen the same form of association with the European Union as Norway, i.e. through the EFTA - European Economic Area agreement. In view of the European Union's dominant role as export market for Iceland a successful integration with EMU would have positive effects on growth and stability.

Denmark became a member of the European Union in 1973 but so far a majority of the Danes have voted to remain outside EMU. From a strict economic point of view this is surprising, since the Danish economy is in very good shape with moderate inflation, healthy growth, low unemployment, and stable public finances. The Danish krone is successfully linked to the Euro through the ERM 2, so that Denmark meets the membership criteria and would obviously gain by closer integration.

Finland has distinguished itself as an enthusiastic, active member both of EU and of EMU: from a Nordic perspective, best in class. Geopolitical considerations of getting close to Western Europe have no doubt influenced the approach.

The official Swedish position vis-à-vis EMU has been one of wait and see ever since Sweden joined EU in 1995. A recent statement why can be summarised as "Sweden not being ready to join". It has to be ascertained that the physical introduction of Euro notes and coins works according to plan and that Sweden meets its own economic tests - more specifically a wage formation process that does not stoke up inflation; a Swedish business cycle synchronised with Europe's; and a clarification of the need for buffer funds. These views repeat the same considerations as in 1997 when the Riksdag decided that Sweden would not join EMU.

From the outside, the excellent performance of the Swedish economy since the middle of the 90's makes the wait and see attitude unconvincing. Economic growth has been strong; inflationary expectations have been brought down to levels not seen since the beginning of the 1960's; the central government budget is in surplus; open unemployment is low; and the current account is generating a surplus. In key respects, this performance is superior to most of the core countries of EMU.

The weak spot is the external value of the Swedish krona - high volatility and a substantial depreciation vis-à-vis the Euro especially since the beginning of 2000.

With hindsight more self-confidence among economic policy makers and determined political leadership in forming public opinion in favour of the Euro would have facilitated economic policy making and added currency stability to the above-mentioned excellent performance.

Such an argument could also be seen as having influenced public opinion, which has turned into a majority for joining. A successful change over to the Euro and a continued weak krona vis-à-vis the Euro is likely to reinforce the yes-opinion. Furthermore, a development can be foreseen where the Euro will be introduced as a parallel currency to the krona in Swedish businesses where, to a great extent, turnover already is euro-based.

To convince the sceptical citizens in the Nordic countries, determined, brave political leadership is needed - arguing clearly for the Euro and offering concrete visions of the advantages of a deeper and broader European integration process.

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The Euro and Enlarging the EU

The macro-economic stability delivered by the euro has been to the benefit not only of the euro area but also to that of the candidate countries, which as other countries with a high degree of trade and integration have benefited from the euro-induced stability.

This stability is still, however highly vulnerable, given the unfinished state of the transition process, high current account deficits (particularly in the Baltic countries and Poland), relatively high foreign debts (Hungary) and weak banking sectors (Czech Republic). This vulnerability, combined with the need for high capital inflows and a commitment to complete removal of capital controls, makes the choice of an appropriate exchange regime a pressing issue.

In this connection, a clear distinction must be made between (i) the pre-accession period, (ii) the period of EU membership outside EMU, and (iii) the full EMU membership.

Before accession, there are no constraints from the Union side on the exchange rate policy the candidate countries may follow. Each candidate country should ensure that it adopts a policy that suits its own economic conditions and is consistent with its other main policies. There is currently a great diversity of regimes in the candidate countries, most of them having moved, from relatively fixed exchange rates in the direction of floating rates. Two countries - Estonia and Bulgaria - have adopted a currency board linking their currency to the euro. Lithuania, which had a currency board linked to the dollar, is moving to a link with the euro. In the pre-accession period, candidate countries should be encouraged to move progressively to full liberalisation of capital flows and to enact laws ensuring the independence of the central bank and prohibiting direct or indirect monetary financing of government deficits.

Once a candidate country has achieved accession, it will have to treat its exchange rate as a matter of common concern and to join as soon as possible an ERM2 type of arrangement (which, would not be consistent with a crawling peg). Narrower bands than 15% would be logical in the case of currencies for which a currency board has been operating successfully.

According to the Treaty of Maastricht, full participation in EMU requires the previous fulfilment of the convergence criteria and participation for two years in the ERM2. A question in this connection is whether these conditions involve a deflationary bias, given the higher overall inflation rates in the accession countries resulting from the more rapid productivity increases in the traded goods sector than in the non traded goods sector (the so-called Balassa-Samuelson effect). It seems however that this effect could be relatively limited and taken into account in the assessment made of the fulfilment of the Maastricht conditions.

This suggests that what is most important is real convergence. In the run-up to accession, the candidate countries should concentrate primarily on furthering macro-economic stability and structural reform, leading to strong well-functioning market economies. This requires a build-up of the appropriate administrative and institutional capacity. In addition the candidate countries should be actively engaged in a broad multilateral economic policy dialogue with the EU in order to prepare them for economic policy co-ordination when they will become members of the EU and later the EMU.

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Conclusion - The Need for a clearly articulated Vision

The euro never was an objective in itself, but a powerful catalyst for the broader, and more political, concept of European integration. In the longer term, having a single currency entails a feeling of belonging together - a form of social cohesion that cannot be imposed from above but must be nurtured over time through concrete programmes and enlightened political leadership. In the end, it might be a matter of clarifying, and developing further elements of a common European culture.

Taking inspiration in our shared ideals and proposing a well-articulated vision of Europe's future and of the type of economic and political order Europe wants to promote in a globalised world are the greatest challenges for the European leadership at the beginning of the new millennium [9]. The EU faces simultaneous needs to:

- Develop a strategic approach (a) to enlargement to 13 and perhaps more very heterogeneous candidate countries and (b) to relations with prospective neighbours of the EU who are unlikely to become members (in particular Russia).
- Prepare, through the proposed Convention, the 2004 IGC, which has to take up the unfinished business of the Nice Treaty in terms of working out the full implications of enlargement for the institutional and procedural cohesion of the Union.
- Develop ways and means to connect better with the EU citizens, to improve governance and the quality of constitutional democracy in the EU, and
- Propose a model of society that is socially and environmentally sustainable in the age of globalisation. This model must work for Europe and also offer hope for the non-European nations.

A successful EMU is one important component of that ambitious agenda for the future. However, its success also depends on Europe's capacity to articulate and to sustain internally and externally such a wide-ranging common project, justifying a genuine "European patriotism".

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[9] See David P. Calleo "Rethinking Europe's Future". A Century Foundation book, Princeton and Oxford, 2001

Participants in the ELEC Monetary Panel (2001)

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