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FOREWORD—What this report is about

2008 marks the tenth anniversary of the creation of the European Central Bank and the setting of conversion rates between the currencies of the original participating countries of the eurozone. Since then the euro has been introduced in fifteen Member States with negligible transition costs. Before its launch there were widely differing views about the impact of the euro: on the one hand, fears were expressed that it would be the victim of speculation and collapse within months, and that the rancour it might create between EU members could lead to a disintegration of the entire Union. On the other side the euro’s proponents suggested that it would stimulate a period of growth in Europe exceeding that of other major world economies, become a global reserve currency, and pave the way for further single market reforms.

This report examines the structure and governance of the eurozone institutions and developments in the eurozone economy in the past ten years, including the management of inflation and the impacts on trade and economic growth.

Our primary conclusion is that the young currency has made a positive start to its life, but it is too soon to state what the future holds based on the experience to date. We found little support for extremely optimistic or pessimistic predictions for the currency's future, although we note that the currency is still in its early stages and has not yet been fully tested. Ten years is a relatively short period in economic history. While the euro appears to have established its resilience in the face of some significant challenges, other external factors may pose a stiffer obstacle in the future.

This report does not address the United Kingdom’s position with respect to the currency; we also think it inappropriate to reach conclusions on the impact of current liquidity shortages in financial markets while conditions remain unsettled.
CHAPTER 1: THE DEVELOPMENT AND GROWTH OF THE EURO

Introduction

1. The euro was created on 1 January 1999, when it was introduced as a legal currency and the exchange rates of the participating countries were irrevocably fixed to it; simultaneously the European Central Bank assumed full control of monetary policy for the euro area. The establishment of the single currency was the product of a long period of experimentation with other means of controlling exchange rate fluctuations, latterly through the exchange rate mechanism (ERM) of the European Monetary System.

2. This Committee last examined the euro in 2003. The approach of the tenth anniversary of the European Central Bank’s foundation is an appropriate time to reflect on developments in the past decade. This report is not about the United Kingdom’s position with respect to the currency, and we also think it inappropriate to reach conclusions on the impact of current liquidity shortages in financial markets as we took evidence before these issues became apparent. We will return to this issue when markets have stabilised. Our focus is on the mechanisms and institutions which govern the economic and monetary union (EMU), and the union’s impact to date on trade, the capital markets, and economic growth in Europe.

The Development of the euro

3. Following the establishment of the exchange rate union in 1999 the currency was given physical form in January 2002 when euro coins and notes were issued for the first time. The efficiency of this massive logistical exercise has rightly been praised. The size of the euro area increased from the original 11 to 12 with the accession of Greece in 2001, to 13 with the accession of Slovenia in 2007 and to 15 with the accession of Cyprus and Malta in 2008. A further five countries have joined the ERM II arrangements, membership of which is a step on the way to full membership of the EMU. The euro area is thus now of considerable size and diversity, and its members contribute 72% of EU Gross Domestic Product (GDP).

4. Externally the euro has established itself as a significant world currency and acquired the credibility that is necessarily absent from a new currency. The currency’s early decline against the dollar and sterling has since been reversed. The impacts on trade and the European capital markets to date (reviewed in Chapter 3) appear to have been substantial, although it is not possible to determine to what extent these effects might have occurred had other policies been in place.

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2 Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.
3 Denmark, Estonia, Latvia, Lithuania and Slovakia. Denmark has an opt-out from full membership of the single currency.
4 Illustrated in Figure 6, page 23.
5. As the euro has established its global credentials, this report also considers the various adjustment problems that the euro poses for individual member countries. Indeed it is the nature of these adjustment problems that has prompted from the beginning a variety of critical comment on the viability of the monetary union⁵. The fact that, so far, the more extreme predictions have not been realised does not in itself prove that the underlying analyses were wholly wrong. The monetary union could still be tested by sufficiently large and persistent external shocks.

6. The diversity of the Union and the variety of adjustment problems that this implies strongly coloured the evidence we received. Monetary policy in a monetary union is set centrally for the currency area as a whole and cannot be regionally differentiated. This means that at any point in time the monetary policy that is right for the Union as a whole will not be right for each and every individual member country (as indeed is the case in a national currency area within an individual country’s borders). How much this matters depends among other things on the extent of the diversity of the Union and on the availability of alternative means of stabilization. Among the latter are fiscal policy and the flexibility of labour and capital markets.

7. Some countries may be better than others at responding to the challenges involved: Professor Goodhart, of the London School of Economics, for example commented that Germany “is a very difficult country to live with”, referring to the adjustment that Germany has successfully undergone in recovering its competitiveness (Q 7). While this comment implies admiration for the way the Germans have held down their labour costs it also highlights the difficulties that remain for other Member States who may be less effective at improving their competitiveness.

8. Pedro Schwartz & Juan Castañeda of the Universidad CEU San Pablo in Madrid and the Universidad Nacional de Distancia, Spain, also stressed the fact that membership of the euro area removes the balance of payments constraint on investment (and spending in the country more generally) and typically reduces the interest rate facing borrowers below what it would otherwise have been⁶ (p 70). Whilst this means that investment opportunities in any eurozone country are substantially free to be exploited by the import of capital from elsewhere in the euro area, this may at the same time be accompanied by substantial inflationary pressures on domestic prices. In the long run this would imply that the country loses competitiveness; it is no longer able to correct this by a devaluation of its exchange rate and can only adjust through restrained fiscal policies that will bear down on domestic cost pressures and employment. Portugal and Greece were cited by witnesses as prone to this problem. Italy was cited as a country which had been particularly badly hit by a lack of demand in external markets and was finding the required adjustment difficult, complicated by the burden of its public debt (QQ 7, 92–94).

⁵ Many economists predicted that the eurozone members would not be able to reach agreement on monetary policy. In his paper EMU and International Conflict (Foreign Affairs November/December 1997) the American economist Martin Feldstein set out a hypothetical scenario of how policy disagreements within the monetary union could result in the acrimonious collapse of the European Union.

⁶ The removal of any apprehension that the currency might be devalued implies that investors from one eurozone country looking to invest elsewhere in the zone need no longer take into account any devaluation risk. This simultaneously removes the need for an interest rate premium to compensate for such a risk.
Future growth of the euro area

9. The enlargement of the eurozone is seen as a sign of the strength and sustainability of the euro; new Member States wish to join because they consider that the benefits outweigh the costs. All new Member States are bound by their Treaty commitments to join the eurozone as soon as they satisfy the criteria and are deemed eligible to do so.

10. Professor Dr Norbert Walter, Deutsche Bank, considered that the eurozone’s expansion should allow the entire zone to benefit from the economic growth that new Member States experience on joining the EU and the eurozone (p 77). He added that this should not be overstated: the impact of the nine potential additional members on the eurozone economy will be limited as their overall economic size is only 7% of the existing eurozone’s GDP and the more prosperous potential members are not expected to join the eurozone in the near future.

11. It was impressed upon us that there is no need to rush the process of enlargement of the eurozone and countries should not be allowed to join for purely political reasons before fulfilling all the criteria for entry (Bruegel p 57). Premature entry could be counterproductive and have adverse effects both for the country entering the zone and for the eurozone as a whole. The adjustment period for some of the new Member States is expected to be as difficult as it was for some of the existing members; new members will thus have to ensure that their monetary and fiscal policies in the build-up to accession will provide them with the necessary cushion that accession to a monetary union with the structural particularities of EMU requires.

12. The entry criteria are seen by witnesses to be fair when taken as a whole, although the inflation criterion in particular is considered too restrictive on economic growth and difficult to meet in high growth countries such as the Baltic States, especially in conjunction with the exchange rate stability criterion (Professor Portes, London Business School Q 169). Estonia, for example, had satisfied other criteria for entry to the eurozone on its accession to the EU but withdrew its application because of concerns that it would not meet the inflation criterion. It has been suggested that candidate countries should be required to meet an average of the inflation rate in the three euro area countries with the lowest inflation rather than the harder target of the average of the lowest three rates in all EU Member States (Wickens, Portes QQ 82, 170) as is required at present. The Committee is sympathetic with this point of view but it is essential that new countries enter at the appropriate inflation rate; otherwise, if a country comes in with an inflation rate that cannot be sustained in the medium and long term, the effect on the eurozone in general and interest rates in particular will be negative.

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7 Only members of the EU are eligible to join. Newer Member States who are yet to join are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia. Sweden does not have an opt out but citizens voted in a 2003 referendum against joining the currency union. The UK and Denmark have an opt-out from the relevant provisions of the Treaty, although the Danish Prime Minister announced in November 2007 plans for a referendum on the subject within the next four years.

8 The criteria are set out in Article 121 of and a Protocol to the Treaty establishing the European Community. The criteria have not been changed by the Lisbon Treaty and will form Article 140 of the Treaty on the Functioning of the European Union.
Our inquiry

13. The membership of the Sub-Committee that undertook this inquiry is set out in Appendix 1. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 2; all the evidence is printed with this report. We thank the Library of the House and HM Treasury for their advice on sources of data for the figures. We also thank the Sub-Committee’s specialist adviser, Professor Michael Artis of the University of Manchester. We make this report for information.
CHAPTER 2: EMU MECHANISMS AND POLICY CONSIDERATIONS

The European Central Bank

14. The European Central Bank (ECB) stands at the centre of the European System of Central Banks (which comprises all the central banks of the EU member states) and at the centre of the Eurosystem (the set of central banks of countries participating in the euro area). It is charged with the responsibility for formulating monetary policy for the Euro area and for organising and coordinating its execution.

15. The principal instrument of monetary policy is the setting of the main refinancing rate; this is the rate that emerges as the result of the ECB indicating the minimum price at which it will accept bids for the purchase of eligible assets in “repos” (repurchase agreements). Money market operations to enforce the rate are, so far as possible, devolved upon the money market operations of the participant Member States’ central banks. The ECB can engage in operations in the money markets to relieve as necessary any perceived lack of liquidity (or to reduce liquidity if conditions demand such action). The ECB is able to intervene in foreign exchange markets (and has done so), but generally matters concerning foreign exchange markets are reserved for decision by the Council of Ministers (which has not so far exercised this role) and are subject to a condition that any such interventions should not be in conflict with the ECB’s primary responsibility to maintain price stability. Witnesses generally commented positively on the ECB’s handling of monetary policy, although some said that its communication with the market left a lot to be desired (Goodhart Q 13).

16. Professor Schwartz, Juan Castañeda, Professor Goodhart, Professor Walter and Roger Bootle also drew attention to the institutional difficulties that will emerge as more countries switch to the euro and expressed concerns that the decision-making committees will become more unwieldy (pp 73, 77, QQ 39, 144). In our 2003 Report on the ECB, we discussed the rotation system for membership of the ECB Governing Council agreed that year; Professor Walter expressed concern about the complexity and lack of transparency of the institutional structure, which as the eurozone grows will also deprive the biggest economies in the eurozone of a permanent voting right (p 77). We concluded in 2003 that the rotation system was not an appropriate mechanism for appointing the body to set interest rates in the euro area; that it capped the number of voting and non-voting members of the Governing Council at a level which is too high; that it is not transparent; and that it is overly complicated and difficult to communicate. These issues were not generally raised by witnesses during this inquiry, nor was there significant pressure to introduce reforms during the Lisbon Treaty process. We conclude that only our concern about transparency still holds: the ECB

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9 Article 111 TEU, which will become Article 219, Treaty on the Functioning of the European Union if the Lisbon Treaty is ratified.

10 The most significant of these is the Governing Council—the committee setting monetary policy, which involves the Governors of the national Central Banks and the Executive Committee of the ECB. The governors are required to act as independent experts rather than in their own national interest, and national governments are bound by the treaties not to seek to influence the decision-making bodies of the ECB.

Governing Council has gained public acceptance and market credibility.

The Eurogroup

17. The Eurogroup gains formal recognition in the Lisbon Treaty, although the Protocol for the Group reflects current practice. In our recent report on the impact of the Treaty of Lisbon, we concluded the change should not have a significant impact. Angela Eagle, Exchequer Secretary to the Treasury, explained that the Government expected its inclusion in the Treaty to narrow ECOFIN’s “scope for mission creep” and described it as “informal recognition”. Initial concerns that the Eurogroup was becoming an exclusive “club” within ECOFIN were not raised by witnesses and there is no suggestion that Member States consider the system to be working badly. Suggestions have been made for increased European Parliament participation in the governance of the common currency and for a stronger role for the Eurogroup, as a democratically legitimate forum, in setting the inflation target for the ECB (Pervenche Berès MEP, Julian Callow and Professor Portes p 56, QQ 59, 160). However, these are not new proposals and neither found support during the Lisbon Treaty negotiations. We therefore conclude that there is currently no need or desire to reform the way the eurozone is governed.

The Inflation Target

18. The European Central Bank is enjoined in the Treaty establishing the European Community to regard its primary statutory duty as being that of maintaining “price stability”. The definition of price stability was left to the ECB itself and was subsequently defined by the Bank’s Governing Council in October 1998 as a “year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of less than 2%”, to be maintained over the “medium term”. In May 2003 the objective was further refined to read “below but close to 2%.”

19. Across the world inflation targeting has taken a wide variety of forms and no one model can be said to be correct. For example, it is common to find an inflation target formulated as a central target rate plus or minus an agreed band, and stated for a given period of time ahead. Political support for the target rate may be found in it being set by the government of the day, with the Central Bank having “instrument independence” to use its policy instruments to achieve the target set for it. The ECB, on the other hand, is accountable to the European Parliament only for the way it has carried out its mandate and has “the medium term” in which to realise it.

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12 Meetings of Finance Ministers from Member States participating in Monetary Union, normally held on the eve of Economic and Financial Council (ECOFIN) meetings. These meetings are not an official formation of the Council of Ministers and the Group has no formal role.


14 Ibid. at Q A22–A24.

15 For example, some witnesses to the Committee’s 2000 report on the single currency expressed concerns that the Group might try to take influence from ECOFIN. European Union Committee 18th Report (1999–2000) How is the euro working? (HL 124)

16 Article 105(1); this will become Article 127 Treaty on the Functioning of the European Union if the Lisbon Treaty is ratified. The Article gives this duty to the European System of Central Banks, whose decision making is centralised through the decision-making bodies of the ECB.
20. Figure 7 (page 24) suggests that inflation rates of the initial eurozone members have converged, albeit at a rate slightly above the 2% ceiling: the annualised rate of change in the HICP from 1998 to 2006 was 2.05% (Julian Callow, Barclays Capital Q 59). In evaluating its own performance the ECB highlights the fact that surveys of long-term inflation expectations in the euro area consistently point to 2%, even when realised inflation and short-term expectations have surpassed this figure. This suggests to us that the policies followed by the ECB (including its pronouncements and explanations) have in fact succeeded in anchoring expectations at an appropriate level—which is what is expected of a successful inflation targeting policy (Commissioner Alumina, Schwartz and Castañeda pp 52, 72). We agree with those witnesses who argue that the ECB has run a credible price-stabilising policy in the euro area and successfully anchored market price expectations.

21. The ECB’s inflation target set-up is different in the formality of its expression and in its underlying political governance context from that to be found in some countries. The Lisbon Treaty does not adjust the ECB’s remit to define monetary stability (by setting an inflation target) or its interest rate setting mechanism. Witnesses were generally in favour of a system, such as that in the UK, where the target inflation rate is established by elected representatives and the implementation of policy is left to the central bank (Callow, Portes QQ 59, 160). Concerns were raised, however, that it would prove hard if not impossible for politicians to agree unanimously on a target inflation rate. The Lisbon Treaty also confirms the ECB’s independence in setting policy vis-à-vis other EU institutions or governments, ignoring suggestions made at the time of its drafting that MEPs, the Eurogroup or the Council should set policy to be then implemented by the ECB.

22. The formulation of the ECB’s mandate encourages it to pursue other policy aims when these can be prosecuted “without prejudice” to the price stability objective\textsuperscript{17}. The Committee received conflicting evidence regarding the possible negative impact of the ECB’s policies on economic growth. Some witnesses called on the ECB to develop policies to contribute more widely to economic growth and employment (Berès, Bootle p 56, Q 130). Professors Goodhart, Portes and Walter, Julian Callow, Commissioner Almunia, Schwartz and Castañeda argue that—contrary to public belief—the ECB’s policies have not been overly restrictive (QQ 13, 59, 160, pp 52, 72, 77). For, although the ECB’s primary statutory duty is to preserve price stability, that objective has been set to be realized “over the medium term”. This gives the ECB ample room for manoeuvre to phase any necessary interest rate increases over time in such a way that employment and growth are not prejudiced. In addition, Professor Walter noted that nominal interest rates have been lower, including in Germany, than in pre-euro times (p 77).

23. The Committee agree with the majority of the evidence: the ECB is performing its primary role of maintaining price stability effectively, and its behaviour since 1999 and the evidence of its monetary policy decisions show that it looks to factors other than price stability when setting interest rates.

\textsuperscript{17} Article 105(1) of the Treaty establishing the European Community (which will be contained in Article 127(1) of the Treaty on the Functioning of the European Union) allows the Bank to “support the general economic policies in the Union”—notably the internal market, sustainable development, a competitive social market economy, full employment and economic cohesion.
24. The Treaty establishing the European Community contained the criteria to be fulfilled for a country to be admitted to the group participating in monetary union—among them the ratios of public debt and budget deficit to GDP. Further rules laid out in the Treaty have been in place since the start of the monetary union to ensure sound fiscal policies, the primary responsibility for which remains at the national level. The Stability and Growth Pact (SGP) elaborated on the fiscal criteria to be observed by Member States. In particular the SGP stipulated that member countries should avoid a current budget deficit of more than 3% of GDP and established mechanisms of surveillance (the “preventive arm”) to provide early warning of such a contingency and of correction (the “corrective arm”) in the event that a breach of the 3% reference value for the deficit ratio occurred. Both the need for a framework of added fiscal discipline (in addition to the actions of the national governments concerned) and the precise way in which such a framework should be applied have been subjects of controversy throughout the period of European monetary union.

FIGURE 1
Annual Government Current Account Surplus/Deficit (as % of GDP)

25. Figure 1 shows a reduction in government deficits in the late 1990s followed by a rise in the first part of this decade. This might suggest that Member States demonstrated the necessary discipline and appetite for reform ahead of the establishment of the single currency (Goodhart, Berès Q 9, pp 58–59). The drive for reform slowed down after 1999 and some eurozone members may have missed the opportunity to take advantage of the positive economic conditions.

18 The Pact was adopted by the European Council in 1997, based on provisions in the Treaty. Although most of its provisions fall formally on all members of the European Union, there is greater stringency in relation to those countries participating in the monetary union.

19 Source: Eurostat.
environment of the early part of this decade to implement structural reforms to reduce public debt and implement fiscal discipline. Such moves would have afforded the opportunity to set the eurozone economies on a stronger footing in the medium term.

26. Enforcement of the SGP has relied on peer pressure rather than use of the formal sanctions available to the Commission (Callow, Berès Q 64, p 56): however, while small and medium sized Member States were asked to conform when they were in breach of the Pact, others defied the rules. The breach, in 2003, of the Pact’s rules by France and Germany, two of the biggest economies in the eurozone, and the Pact’s subsequent reform in March 2005 had no noticeable impact upon financial markets20. We received no evidence of lingering frustration in the small and medium sized countries.

27. This may have been because the rules put in place by the original SGP seem to have been in some cases too restrictive: many of our witnesses viewed the system that was originally instituted as being very tight (Goodhart, Tilford, Bootle QQ 30, 96, 133). Its formulation did not sufficiently allow for the normal accommodation of cyclical effects and the discipline it potentially imposed was unrealistically harsh. The post-2005 SGP allows for the sustainability of public finances to be taken into account (Schwartz and Castañeda p 71) when considering whether to implement steps in the excessive deficit procedure. While some witnesses suggested that the reform of the SGP weakened the rules of the Pact and others promoted the need for fiscal discipline, the consensus view was that the changes introduced in 2005 enhanced the economic rationale and the flexibility of the budgetary rules over the economic cycle to take better account of (longer) periods of weak growth (Commissioner Almunia, HM Treasury, Leon Podkaminer, Schwartz and Castañeda pp 51, 63, 69, 71).

28. Pervenche Berès MEP, chair of the European Parliament Economic and Monetary Affairs Committee argued that there is a need for co-ordination before Member State governments publish their budgets (p 56). So far, in practice, the co-ordination has taken the form of peer pressure on the basis of actual returns. Co-ordination of Member State budgets as they are prepared is theoretically desirable from the perspective of monetary union but politically unrealistic. We accordingly oppose calls for supra-national co-ordination of fiscal policies.

29. The revision of the SGP has coincided with data which show that the deficit of the eurozone’s general government sector for 2007 is likely to have been below 1% of GDP (it was 1.6% of GDP in 2006—see figure 1). Italy, Germany, Greece and Portugal have brought their rates down from above 3% to below the 3% mark (Callow Q 64). These figures have in part been the result of a benign period of global economic expansion and the Commission noted that greater attention must be given to the implementation of structural policies that enhance growth potential and long-term sustainability of public finances (p 51).

30. We welcome the revision of the Stability and Growth Pact but agree with the Commission that greater attention must be given to the

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20 The reform maintained the targets of public deficit under 3% of GDP and debt under 60% of GDP. However some flexibility has been introduced: for example the excessive deficit procedure will not occur if the country experiences any negative growth (previously -2%), and countries can cite “relevant factors” as the cause of their deficit (pp 63, 71).
implementation of structural policies that enhance growth potential and long-term sustainability of public finances.

Fiscal integration

31. Increases in the mobility of capital have made it increasingly difficult for any government to maintain a stable currency. Methods for so doing include a dollar peg or membership of a monetary union: the latter—depending on its structure—offers the advantage of shared control of monetary policy.

32. The traditional theoretical approach describes the cession of monetary policy to the Union’s central bank as one of the costs of joining a monetary union. Monetary policy is no longer available to deal with the economic shocks—both exogenous and self-inflicted—that hit the member country. If those shocks have the same impact across the Union as a whole then there is no cost, since the Union central bank’s policy will be appropriate. If the shocks have diverse impacts in different states within the monetary union, then the extent of the cost incurred in joining the monetary union will depend, among other things, on how effective monetary policy would have been in dealing with them had the country stayed out of the union. Counterbalances include the availability of alternative policies (e.g. fiscal policy) and the easing of credit constraints that may accompany the formation of a larger capital market and the abolition of exchange rate risk.

33. In the eurozone’s case the loss of control over monetary policy was one of the main issues of debate when discussing membership of the currency union. Italy's inability to use monetary policy to deal with the loss of competitiveness in recent years is an example of the effect that loss of monetary sovereignty can have. It remains to be seen to what extent the inability of Member States to determine their own monetary policies may prove divisive in the short term during a period of unfavourable economic conditions.

34. EMU is a monetary union without fiscal union, and the theoretical effect that this might have on the sustainability of the eurozone and the ability of its Member States to co-ordinate their policies in order to achieve stronger economic growth was widely discussed before the currency was introduced. Pervenche Berès MEP advocated further co-ordination (p 56) and the Treaty of Lisbon offered the opportunity to introduce integration based on the experiences of the first years of the zone’s operation. The fact that no further integration was suggested for inclusion in the Treaty of Lisbon suggests that eurozone members see no pressing need for any fiscal integration.

35. External shocks have not, to date, had the feared effect on the monetary union. The increase in oil prices from 2001–2008 constitutes a severe external shock with sharply differential effects on eurozone member states (some of whom (e.g. Italy) have no indigenous energy source, whereas others

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21 This can be the case within a single nation state: for example, it is widely acknowledged that at any one time the appropriate monetary policy for London may not match the policy required to stimulate growth in Scotland.

22 An asymmetric shock would impact one industry more than others and consequently have a larger effect in a country that specialised in that industry.

(e.g. France) have major domestic nuclear power programmes). Yet the stability of the common currency seems to be unaffected by the price increases. The steep fall of the dollar, and now sterling, against the euro affects Germany as a major exporter, more than most eurozone countries, but it too has not posed any problem for the cohesion of the eurozone.

36. Those witnesses who continued to speculate about the fragmentation of the euro area in their written evidence admitted on questioning that their scenarios were highly unlikely to occur (Wickens, Tilford QQ 76–77, 91). The common currency has solidified its position among decision makers, financial markets and consumers as a major international currency. The political and economic cost of leaving the EMU makes the possibility of a country submitting to popular pressure to withdraw unlikely even in the instance of a severe economic crisis (Simon Tilford, Centre for European Reform Q 95).

Financial Stability

37. As is the case in other North Atlantic economies, the ECB is required to balance the need to maintain low inflation expectations with the desire to support the financial system. But the European Central Bank (ECB) has no formal role in respect of supervision of financial institutions; this is assigned to the national central banks and the relevant national supervisory/regulatory agencies. The ECB coordinates these entities through the Banking Supervisory Committee and has instigated the publication of a semi-annual Financial Stability Review.

38. During the current periods of reduced liquidity in the financial markets the ECB has made very substantial interventions in the markets, over and above the regular monthly longer-term refinancing operations, to relieve possible liquidity shortages. In November 2007 the Bank announced that these operations would be renewed as they expired, and in December 2007 actions were taken to ensure that sufficient liquidity remained available over the year-end holiday period. The ECB has also acted with other central banks as part of the coordinated action to ensure sufficient liquidity remained in the financial system.

39. The difficulties in the financial markets commenced after we had taken evidence for this report and are unresolved. We have not therefore felt able to comment definitively on this aspect of the ECB’s operations. However, the role of “lender of last resort” within the eurozone remains the responsibility of the national central banks, co-ordinated by the ECB.24 We will return to this subject once conditions return to normal.

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40. Among the anticipated effects of the introduction of the euro, the clearest was that there would be a positive effect on trade within the eurozone; it was also expected that there would be substantial effects on the capital markets of Europe and positive effects on the stability and thereafter the growth of real output. More guardedly there was an expectation that in the course of time the euro could establish itself as a reserve currency. In this chapter we consider how far these expectations have been realised to date.

Trade

**FIGURE 2**
Values of total trade flows

![Graph showing trade flows](image)

Source: Eurostat.
41. Figures 2 and 3 chart values of trade flows within the eurozone, between the zone and the rest of the EU, between three major non-eurozone European economies and the rest of the world, and over a longer time-period, between the eurozone and the rest of the world. The charts are not adjusted for inflation. The charts show similar rates of growth in trade for all the flows with the exception of trade between the eurozone and the rest of the EU, which has more than doubled during the period.

42. There were good reasons to expect a positive impact on trade. The elimination of the cost of currency fluctuation between members of the eurozone involved a direct reduction in the cost of trade. As an extension of this, the reduction in the foreign exchange costs of trade was seen as reducing the fixed costs of trading, and making it easier for firms to establish the activities needed to support trading activities. Importantly, this effect has supported trade with non-eurozone countries as well as with eurozone countries alone. These factors and the introduction of increased price transparency are also seen by Commissioner Almunia, Pervenche Berès MEP, the European Investment Bank, Schwartz and Castañeda as having a positive effect on the economic performance of the eurozone (pp 50, 55, 59, 64–6, 70).

43. There exists a wide range of estimates of the effect of the introduction of the euro on trade but some of the earlier estimates27 of a very positive effect have been substantially qualified by the realisation that it is inherently difficult to isolate an effect of the euro from the lagging, and ongoing, effects of other integration measures, in particular the Single Market programme, and the

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26 Source: Eurostat.

27 For example, HM Treasury noted in their EMU study, *EMU and trade* (HM Treasury, 2003) that some studies had suggested a potential doubling in trade, although an impact of up to 10% was thought to be more likely.
end of the communist bloc in Eastern Europe, with its strict controls on trade and migration. Indeed, the introduction of the euro can itself be viewed as a part of the creation of the Single Market. **We conclude that the introduction of the euro has been a major influence on increased trade both within the eurozone and with other countries**, but we are inclined not to subscribe to particular quantified estimates since it is inherently difficult to disentangle the effect of the euro from the Single Market process and other influences on trade (Philippe Maystadt, European Investment Bank p 65).

**Capital markets**

FIGURE 4

International money market instruments, bonds and notes

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44. Witnesses agreed that the euro has strongly stimulated the integration of European capital markets, most particularly the bond markets. According to Professor Walter (p 75), debt markets—in particular the government and corporate bond markets—have reached a high level of integration both in terms of liquidity and the availability of instruments. (By contrast, integration of equity markets has proceeded more slowly due to different national legal and tax systems.) Much of this activity is currently centred on the City of London.

45. One feature of this integration is that home bias—the tendency for investors to hold assets issued by institutions in their own country—has lost much of its importance. The euro area’s mutual fund industry has increased its proportion of non-domestic stock holdings from 40% in 1995 to 70% in 2003 (p 75). The European Investment Bank (p 66) notes that the decline in home bias in bond portfolios has occurred more in the eurozone than elsewhere.

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29 Finance theory suggests that investors’ portfolios should hold assets from different countries in proportion to the assets’ market capitalisation. The lack of integration in global markets prevents this.
elsewhere, and quotes IMF research that shows that the share of assets from other EMU countries has increased notably in the portfolios of EMU countries and, to a slightly lesser extent, in the three non-EMU countries of the old EU15. In non-EU countries, on the other hand, EMU non-national asset holdings have not changed dramatically.

46. The ECB have also examined the changes in home bias (p 68). They also find that the reduction in home bias is indeed much more pronounced in euro area countries than elsewhere and there is little evidence to suggest that this is a global trend; the reduction in home bias of euro area investors has been much more pronounced in bonds than in equities.

47. There has also been a substantial expansion of the euro area debt markets with the vast majority of the debt issued by euro area issuers. Figures from the Bank of International Settlements show that in the first quarter of 1999 the outstanding quantity of euro-denominated fixed-income securities was €6.4 trillion, whereas by the fourth quarter of 2006 it was €11.7 trillion. Julian Callow told us that paper denominated in euro now accounts for about 27% of the total outstanding global stock of debt securities. This compares with 22% of stock in 1999, and 14% denominated in yen in 2006 (Q 45). New bond issues denominated in euros now exceed new dollar denominated issues. Mr Callow believed that the EMU has also substantially accelerated the integration of the markets themselves in terms of improving standards of best practice for issuance and for transparency (Q 50).

48. The process of monetary union has encouraged investors to treat the European capital markets as a single space and to look for diversified investment opportunities in several Member States, rather than only in those States that dominated investors’ preferences in the past (Callow, Commissioner Almunia, European Investment Bank Q 50, pp 51, 68). However, this process is not yet complete: having spent many years moving together, spreads have widened between German-issued bonds and less-traded eurozone government bonds, such as those issued by the Italian, Greek and Spanish governments in recent months.

49. Even though the money markets and the markets for government securities and private sector bonds are now highly integrated, and progress has been made towards the integration of stock markets, the integration of banking markets—in particular retail banking—is lagging behind. While consolidation of the banking sector notably through mergers has been fostered by the euro, credit markets remain fragmented, in large part due to regulatory and tax differences across Member States and the very limited extent of cross-border competition among banks (Bruegel, Podkaminer pp 59, 69).

50. The creation of a common market in financial services has been recognised by all Member States as an increasingly important policy objective in the past decade (COM(2007) 226). The introduction of the euro does appear to have fostered some

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30 This can be largely attributed to the liquidity shortage although the phenomenon had been identified before the summer of 2007. Spreads have widened in less frequently traded debt instruments while German debt remains a benchmark product and is thus relatively liquid. Market participants suggest that the initial convergence was caused by an influx of capital into the eurozone as sovereign wealth funds rebalanced their holdings into euro (Financial Times, 27 February 2008).


32 This issue is also discussed in chapter 7 of European Union Committee, 5th Report (2007–08): The Single Market: Wallflower or Dancing Partner (HL 36)
financial integration both within the eurozone and in the wider EU, although some of this might have occurred in any event. The introduction of the euro has stimulated integration in parts of the capital market and the Eurobond market has become well established. This still needs to be reinforced by other measures; historically, the protection afforded to national retail banking markets has resisted a substantial “euro effect”.

Reserve currency

**FIGURE 5**

Percentage of known reserves (measured in US Dollars)\(^{33}\)

51. Figure 5 shows the proportion of different currencies held in known currency reserves (measured by value). For the years prior to the introduction of the euro, holdings in ECU's and pre-euro currencies are compiled as a proxy for euro holdings. The Euro has become an important reserve currency. The value of ECU and legacy currency reserves fell in the run up to the creation of the Euro due to uncertainty about its impact. The currencies of the countries going into the euro area constituted about 17% of international reserves at the beginning of 1999, and since then the proportion of reserves held in euro has risen to about 26.4% (as at Quarter 3 2007). This rise, which slightly exceeds the reduction in holdings in the late 1990s, has been at the expense of the Yen and US dollar. However, the dollar remains the dominant reserve currency as well as the currency of preference when it comes to trading in the foreign exchange markets.

52. The Euro has established itself with remarkable speed as a widely accepted transactions currency. There are now more euro than dollar notes and coin in circulation across the world. The €500 note is the highest

\(^{33}\) Source: International Monetary Fund.
value note of any major currency in circulation; concerns that it might be subject to widespread counterfeiting have not yet been realised\textsuperscript{34}, but Professor Goodhart noted its potential use in the black economy (Q 38).

\textbf{Exchange Rate}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{exchange_rates_graph.png}
\caption{Exchange rates\textsuperscript{35}}
\end{figure}

53. Recent developments in the euro-US dollar exchange rate—which have continued in the past four months—have caused some concern, in particular because of the effect that the increasing value of the euro has on exports of European goods. This process has potential for an asymmetric effect on the eurozone, with regions where exports make up a significant proportion of economic activity worst hit. It has been suggested that the current weakness of the dollar and strength of the euro is leading several countries to consider switching part of their reserves from dollars to euros, an action that would further weaken the value of the dollar (Callow, Portes QQ 60, 166).

\textsuperscript{34} The ECB publish biannual information on Euro bank note counterfeiting which indicate that lower denomination notes are more commonly produced by counterfeiters.

\textsuperscript{35} Source: European Central Bank. The Euro Nominal Effective Exchange Rate Index is used to represent the basket indicator.
Economic growth

FIGURE 7
Annual inflation rates in original eurozone countries\textsuperscript{36}

FIGURE 8
Annual GDP growth rates in original eurozone countries\textsuperscript{37}

\textsuperscript{36} Annual harmonised index of consumer prices. Source: Eurostat.

\textsuperscript{37} Source: Eurostat.
FIGURE 9
Annual GDP growth rates in the eurozone & selected other industrialised countries

54. Figures 7, 8 and 9 chart inflation rates in the eurozone and growth rates in the eurozone and other industrialised countries.

- Figure 7 shows that inflation rates in the original eurozone countries are beginning to move in alignment with each other, although there is more divergence in rates than in 1997 and 1998, when all but one member had rates within 1.5% of each other.

- Figure 8, GDP growth rates in the original eurozone countries, indicates that growth rates are becoming more aligned, although the eurozone members still have significant differences in annual growth rates.

- Taking the eurozone as a whole, figure 9 indicates that growth has generally been below the rates achieved in the USA and Sweden, but broadly similar to growth in the UK, Denmark and the EU as a whole.

55. Clear evidence on the effect that the introduction of the common currency has had on growth in the eurozone is difficult to establish, not least because of the short period of time that the zone has been in place. We received no evidence that growth has been impeded by the single currency. Figure 9 shows that growth in the eurozone has been broadly in line with other developed countries in Europe and worldwide. The lack of structural reforms (especially with regard to product and labour markets), the failure to complete the single market, and a general failure to implement the Lisbon Agenda for Jobs and Growth aggressively are impediments to growth that may have undermined the impact of the single currency. Alternatively there

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38 Annual growth rate of Gross Domestic Product. Source: Eurostat.
is the possibility that growth during this period was being boosted by the lag effects of earlier single market reforms, and the enlargement of the European Union in 2004.

56. Many of the benefits of EMU came about before the adoption of the single currency as a result of the structural reforms undertaken by Member States to meet the criteria laid down by the Maastricht Treaty for the adoption of the euro. This pace of reform has however slowed down since 1999 (as noted in Chapter 2). Several Member States took advantage of the short term benefits of eurozone membership (i.e. low interest rates, exchange rate stability) which helped them finance their development but have not taken advantage of the recent stable economic period to implement the necessary structural reforms that would allow them to make further, sustainable, reductions in their levels of national debt (see paragraphs 24–30).

57. In addition the increase in trade due to the adoption of the single currency (discussed in paragraphs 41–43) has had a positive impact on economic growth in the eurozone.

General conclusion

58. The euro has resisted external shocks to date, and does not face any foreseeable likelihood of disintegration. None of the fears, expressed at the time of its launch, about a divisive or negative impact on European economies has been borne out. Its existence has contributed to economic development and low inflation in the eurozone. This is a static analysis of developments during the first decade of the currency’s operation and not a comparison with what might have occurred without the currency. The relatively short history of the currency makes firm conclusions difficult to draw after only one decade of the currency’s operation.
CHAPTER 4: SUMMARY OF CONCLUSIONS

59. The ECB Governing Council has gained public acceptance and market credibility. (paragraph 16)

60. There is currently no need or desire to reform the way the eurozone is governed. (paragraph 17)

61. We agree with those witnesses who argue that the ECB has run a credible price-stabilising policy in the euro area and successfully anchored market price expectations. (paragraph 20)

62. The ECB is performing its primary role of maintaining price stability effectively, and its behaviour since 1999 and the evidence of its monetary policy decisions show that it looks to factors other than price stability when setting interest rates. (paragraph 23)

63. Co-ordination of Member State budgets as they are prepared is theoretically desirable from the perspective of monetary union but politically unrealistic. We accordingly oppose calls for supra-national co-ordination of fiscal policies. (paragraph 28)

64. We welcome the revision of the Stability and Growth Pact but agree with the Commission that greater attention must be given to the implementation of structural policies that enhance growth potential and long-term sustainability of public finances. (paragraph 30)

65. The fact that no further integration was suggested for inclusion in the Treaty of Lisbon suggests that eurozone members see no pressing need for any fiscal integration. (paragraph 34)

66. We conclude that the introduction of the euro has been a major influence on increased trade both within the eurozone and with other countries. (paragraph 43)

67. The introduction of the euro has stimulated integration in parts of the capital market and the Eurobond market has become well established. This still needs to be reinforced by other measures; historically, the protection afforded to national retail banking markets has resisted a substantial “euro effect”. (paragraph 50)

68. The euro has become an important reserve currency. (paragraph 51)

69. The euro has established itself with remarkable speed as a widely accepted transactions currency. (paragraph 52)

70. The euro has resisted external shocks to date, and does not face any foreseeable likelihood of disintegration. None of the fears, expressed at the time of its launch, about a divisive or negative impact on European economies has been borne out. Its existence has contributed to economic development and low inflation in the eurozone. This is a static analysis of developments during the first decade of the currency’s operation and not a comparison with what might have occurred without the currency. The relatively short history of the currency makes firm conclusions difficult to draw after only one decade of the currency’s operation. (paragraph 58)
APPENDIX 1: SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

Sub-Committee A

The members of the Sub-Committee which conducted this inquiry were:
- Lord Blackwell (until November 2007)
- Lord Cobbold (until November 2007)
- Baroness Cohen of Pimlico (Chairman)
- Lord Giddens (until February 2008)
- Lord Haskins (from November 2007)
- Lord Inglewood (until November 2007)
- Lord Jordan (until November 2007)
- Lord Kerr of Kinlochard
- Lord Maclennan of Rogart
- Lord Moser (from November 2007)
- Lord Renton of Mount Harry (from November 2007)
- Lord Steinberg
- Lord Trimble
- Lord Watson of Richmond
- Lord Woolmer of Leeds (from November 2007)

Declaration of Interests

A full list of Members’ interests can be found in the Register of Lords Interests:
http://www.publications.parliament.uk/pa/ld/ldreg.htm
APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only; those without an asterisk gave written evidence only.

Joaquín Almunia, European Commissioner for Economic and Financial Affairs

* Julian Callow, Barclays Capital
Pervenche Berès MEP, Chair, Economic and Monetary Affairs Committee, European Parliament
Alan Ahearne, Research Fellow, Jean Pisani-Ferry, Director and André Sapir, Senior Fellow, Bruegel

* Roger Bootle, Capital Economics
* Simon Tilford, Centre for European Reform
Professor Dr Walter, Deutsche Bank
Philippe Maystadt, President, European Investment Bank
HM Treasury

* Professor Charles Goodhart, London School of Economics
* Professor Richard Portes, London Business School
Jean-Paul Fitoussi & Éloi Laurent, OFCE/Sciences Po Centre for Economic Research
Professor Pedro Schwartz & Mr Juan Castañeda
Leon Podkaminer, Vienna Institute for International Economic Studies

** Professor Michael Wickens, University of York
APPENDIX 3: CALL FOR EVIDENCE ISSUED ON 7 FEBRUARY 2007

Since its introduction in 1999, the euro zone has continued to mature. With its membership likely to expand before the end of the decade, the Sub-Committee, under the Chairmanship of Baroness Cohen of Pimlico, has decided to conduct an inquiry into the progress of the euro. This inquiry will focus on five particular subjects, examining the impact and development of the Euro as a currency.

The inquiry will seek to answer the following key questions:

- What contribution has the introduction of the euro made to levels of trade within the Euro zone, and between the Euro zone and the rest of the world?
- What effect has the introduction of the euro had on the functioning of European capital markets?
- Are there any lessons to be drawn from the changes in euro exchange rates since 1998?
- Was the recent reform of the Stability and Growth Pact appropriate?
- What effect has the introduction of the Euro had on individual member countries’ economic development?
- Has the ECB’s monetary policy been too restrictive?
- What impact will the expected enlargement of the Euro zone have on
  - The functioning of the Euro zone economy?
  - The management of monetary policy in the Euro zone?

The Sub-Committee would welcome written comments on these issues.
APPENDIX 4: GLOSSARY

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<tr>
<td>ECOFIN</td>
<td>European Council of Finance Ministers</td>
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<tr>
<td>EIB</td>
<td>European Investment Bank</td>
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<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
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<td>ERM</td>
<td>Exchange Rate Mechanism</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>HICP</td>
<td>Harmonised Index of Consumer Prices</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>SGP</td>
<td>Stability and Growth Pact</td>
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APPENDIX 5: REPORTS

Recent Reports from the Select Committee
Proposal to establish the European Institute of Technology (25th Report session 2006–07, HL Paper 130)

Session 2007–2008 Reports prepared by Sub-Committee A
Solvency II (6th Report session 2007–08, HL Paper 42)

Other recent Reports prepared by Sub-Committee A
Stopping the Carousel: Missing Trader Fraud in the EU (20th Report session 2006–07, HL Paper 101)
Funding the European Union (12th Report session 2006–07, HL Paper 64)
The World Trade Organization: The Hong Kong Ministerial 13th–18th December (17th Report session 2005–06, HL Paper 77)
Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON THE EUROPEAN UNION
(SUB-COMMITTEE A)

TUESDAY 5 JUNE 2007

Present Blackwell, L Cobbold, L Cohen of Pimlico, B (Chairman)
Steinberg, L Trimble, L

Examination of Witness

Witness: PROFESSOR CHARLES GOODHART, London School of Economics, examined.

Q1 Chairman: Welcome, Professor Goodhart. Thank you very much for coming to help us with this inquiry, which will be very useful. It sounds awfully police like, but I would like to warn you that everything you say will be broadcast. It goes on the website. You will receive a transcript of the evidence afterwards and you will have a chance to look at it and say, “No, really that did not quite work,” but it is being broadcast live, as we speak. We have a list of questions, which I am sure you have, and we have all read your papers, but would you like to start with a general statement or to start with questions?

Professor Goodhart: I have not prepared a general statement, so would you like to go straight into questions.

Chairman: We will go straight in.

Q2 Lord Cobbold: Good morning. In your paper Some Lessons from the Eurozone you support the German economists’ theory which says that currency unification should be one of the steps in a much longer process of harmonisation. If we had done that, is it not the case that we would not have a single currency in the Europe now?

Professor Goodhart: I do not think that we would now have a single currency in the Eurozone. That might have been a good idea. I think it is highly possible that the optimal arrangement in Europe would be two zones, one for north/central Europe and one for the Mediterranean members of the Euro area.

Q3 Lord Cobbold: Then you would have a currency fluctuation between the two. Surely the main benefit of a single currency has been the enforced discipline on avoidance of competitive devaluation, which was one of the scourges of the 20th century, so it has been positive.

Professor Goodhart: That argument does not follow in North America—where, as you know, they have the North American free trade area—which is a free trade area. Currencies do fluctuate between the Canadian dollar and the US dollar and between the Mexican peso and the US dollar, and that does not seem to be a particular problem for them. The argument that you would have to have a single currency in order to maintain an area of free market and free movements of goods, services and capital, does not seem to me to be at all proven. Again, there is this fear of competitive devaluation but that occurs usually when there have been periods in which the exchange rate has been pegged and the government decides to lower it by a step-change, and the step-change is frequently large enough to induce an initial competitive advantage. If the currencies are floating and the authorities are not intervening (for example, we do not have a Chinese situation, where the Americans argue that because of intervention, the Renminbi is significantly devalued) the idea that there is a competitive devaluation when the exchange rate is determined by free markets does not seem to me to hold or to follow.

Q4 Lord Blackwell: You make the point that a single currency area, to be effective over the long run, depends on, in particular, a flexible labour market.

Professor Goodhart: Yes.

Q5 Lord Blackwell: You argue that the movement of capital is probably not going to be adequate to make up the inadequacies in the labour market. Europe, as of now, does not have the same kind of free movement of labour for a whole set of cultural as well as economic reasons, as America. Do you conclude from that that, unless some action is taken—and I am not sure what action could be taken to create that kind of free movement of labour in Europe—the single currency area covering north and south is ultimately doomed or not going to work effectively?

Professor Goodhart: I think it will face great difficulty, but as I think Samuel Johnson said, “there is a great deal of ruin in countries”. Countries can go through really very difficult times without that causing separation. For example, it is arguable that it would have been better if Italy had never been unified and southern Italy had been able to operate as a separate state and vary its exchange rate against the rest of the
world, including northern Italy. Nevertheless, the Italian state has survived, despite the fact that southern Italy has had a fairly difficult and a rough time. If one takes into consideration the very considerable penalties that would be applied on any country that would seek to exit the Euro, one can see that it is perfectly possible for the Euro area to continue almost without limit but probably with a significant number of regions in the Euro area, including countries within the Euro area, probably having a far less beneficial economic outcome than there would be if they had gone their own way.

Q6 Lord Blackwell: Is there anything that could be done, do you think, at this stage to reduce the pain on those countries or areas?

Professor Goodhart: There was of course always the possibility of trying to have greater fiscal centralisation. It does not need to be the complete harmonising of all taxes and expenditures on employment benefits and other public goods, but there was an attempt that was made by the Commission, to consider the fiscal measures that would accompany the single currency and they set up a special committee with external members, of which I was one, in 1991/1992 to consider what was the minimum fiscal centralisation necessary to provide fiscal support that would enable the Eurozone to carry on effectively. I think that we did, in fact, a very good exercise. It was the paper which was called Stable Money: Sound Finances. It was published in the European Economy and the supporting papers were published in another issue. We advocated that we could provide stabilisation, but not redistribution, effects for a relatively small amount of money. The amount of money that was required was to shift the proportion of funds going into the central budget in the Euro area from about 1.3 or 1.4 at the time to about 2.25 or 2.5% of GDP—which did not seem very much to me—but when the report was considered it was thrown out absolutely, at which point, I must say—this was back in the early 1990s—I came to the conclusion that if there was not enough political harmony and fellow feeling between countries within the Euro area to have a minimum degree of fiscal centralisation to ease these kinds of adjustment problems, then it was going to be very difficult for a monetary union flag to fly.

Q7 Lord Steinberg: You mentioned Italy going through a severe spell a couple of years ago. Do you believe the reasons that Italy weighed up the consequences of coming out were the reasons they decided to stay in: because the penalties would have been too great had they gone out?

Professor Goodhart: I do not know, I accept, what went through their minds, of course. I think there is a danger of some populist-type politician going to the electorate, the public, and saying, “We can get away from all these problems we may be facing”. The problems have not reached, as yet, a particularly serious stage. That was partly due to the fact that that when the Eurozone started with the single currency in 1999, Germany—which is a very difficult country to live with because they manage their economy rather well and everyone else has to keep up with them—in fact had a very overvalued currency, owing to the problems it had faced with unification. That means there has been a great deal of room for Germany’s competitiveness to improve and the Mediterranean countries’ competitiveness to get worse, as a trend, without putting too much pressure on the system as a whole. In the meantime, the countries that have been losing competitiveness, like Spain and Italy and Greece, benefited during this period from a very considerable reduction in interest rates which led them to have a considerable housing boom—for example, in Spain, an enormous housing boom. If you take into account the fact that the trend started favourably for the Mediterranean countries and they had the benefit of very sharply declining interest rates, the adverse trends arising from fact that the competitiveness has been getting systematically divergent between Germany and the Mediterranean countries has not yet really shown up. The fear is that the housing boom may come to an end as the ECB starts to raise interest rates, and that, combined with the low competitiveness in countries like Spain, could lead Mediterranean countries fairly rapidly to move into a much more difficult condition than they have faced recently. If the politicians and their advisers weigh up the costs of leaving the Euro area I think they would have to think many, many, many times before escaping.

Q8 Chairman: Could I ask a supplemental question. We have started to talk about housing and capital mobility. You do not set great store in your paper by the ability of free movement of capital to aim off, as it were, some of the difficulties of adjustment. I believe we know the movement of capital has greatly helped the stabilisation pact. If we all go and buy houses in poor countries, that moves capital. Do you believe in general in capital mobility? Do people say, “I will go and set up a factory in a very poor part of Italy” rather than moving those people?

Professor Goodhart: My version is that, if anything, the reverse happens, that people move to areas that are successful. There is a kind of conglomeration effect in areas that are successful. In the City of London there is a sort of conglomeration effect. You do not move your investment bank to, shall we say, Bucharest because there are a lot of low-paid bankers in Bucharest. Capital tends to follow success rather than failure.
Q9 Lord Cobbold: The existence of membership of the single currency is a useful discipline and has worked with the national governments to help improve the way they manage their own economies, has it not?

Professor Goodhart: The fiscal record improved very considerably between 1990 and 1999, in most cases, when they were trying to achieve entry, but that was partly as a result of a reduction in interest rates, so the amount of interest they had to pay, in the cases where they had quite large debts, declined. Since then, I think, the Stability and Growth Pact has led to the deficit being lower during the relatively slow growth of recent years than it might otherwise have been. It has had some effect on fiscal discipline. I am not quite sure what other kinds of discipline you had in mind.

Q10 Lord Cobbold: I was thinking particularly of fiscal discipline and complying with the Stability and Growth Pact which is obviously an important part of the whole picture which you have not really talked about.

Professor Goodhart: I think the Stability and Growth pact gets a somewhat unfair press, if you compare what happened in the Euro area to what happened in other countries such as the United States and, indeed, in this country. The turnaround in the scale from surplus to deficit in the United States was almost unparalleled between around 1999, when there was a surplus, and 2002. At that time there were those in the US Treasury worrying about what happened when they bought back all the bonds, and there were no more government bonds outstanding. Between 1999 and about 2002/2003, I think there was a shift from surplus of about 2% to a deficit of about 6% GDP. I take the numbers slightly from the wall but the turnaround in the US was huge. The turnaround in this country was quite large too. The turnaround in Europe was very, very much less. The Stability and Growth Pact might not have been met in detail by major countries; they may have gone through the limits that they were supposed to uphold; but the argument that it had no effect therefore, I think, is wrong. I think it had quite a considerable impact.

Q11 Lord Blackwell: But you could have had the Stability and Growth Pact directly without the single currency area.

Professor Goodhart: Yes.

Q12 Lord Blackwell: The UK was a member of the Stability and Growth Pact. Some of the governments may not have taken it as seriously but it does not necessarily go along with the single currency.

Professor Goodhart: Indeed. There was always the question with the Stability and Growth Pact whether the sanctions were realistic. I doubt very much whether we in the UK would have taken much more notice of the broad economic policy guidelines brought forward by the Commission than they did in Ireland. When the Irish had a large surplus, they were told by the EEC to have an even larger surplus, and the response was “Get lost”—which I must admit I have a certain sympathy for.

Q13 Chairman: This question relates to the previous discussion. How do you feel about the ECB’s monetary policy? Has it been too restrictive? For instance, how do you feel the policy of upper inflation limit rather than a target zone (as in the UK) contributes to this?

Professor Goodhart: There is, again, a very considerable difference between the conduct of policy and the measures they took, and the presentation of policy. I think the presentation of policy was poor, in that the ECB did not appear to commit itself to a symmetric policy in which undershoot was as important as overshoot. They did not ever clearly indicate the limits of their ranges with which they would be happy—they had no sort of upper and lower bands. It is fairly clear that they get a bit uncomfortable when inflation, as measured by their harmonised CPI, goes significantly over two and it is clear that they do not want it to go below zero, but it is not symmetric and it has never really been made clear. There is another problem as well, which is that they set the target for themselves. I think it provides enormous protection for a central bank to get politicians to set the target because it then commits the politicians to it. When I was on the MPC I always used to say that, if anyone wrote in to say that they did not like what we were doing, the way we should answer was: “If you disagree that our policy was the best way to achieve the target set by the Chancellor, we would be very interested in your technical arguments. But we guess that what you do not like is the target, in which case go and talk with the Chancellor.” A central bank can deflect most of the criticisms by getting the politicians to set a target. I do not believe that the Euro-group ministers of finance would set a target which would be much different from, shall we say, the UK target of one to three, with a central point of two. That would have both protected the ECB and prevented the rather undignified squabbles that we get still between ministers of finance, or some ministers of finance, and the ECB. I think the presentation of policy has not been well done by the ECB. In terms of conduct of policy, I do not think the claim that they have been systematically deflationary stands. Interest rates, both nominal and real, have been very low systematically and the inflation outcomes have, on average, been clearly above what the ECB would want and probably what a Euro-group set of ministers of finance would have asked them to achieve. On balance, I think the ECB has done as
much as it really could to support growth within the Eurozone, conditional on the fact that it has been the primary target of achieving price stability. I would give the ECB a grading of C minus or D for presentation and a pretty high grading, in the As, for the conduct of policy.

Q14 Chairman: Could I pursue your idea about having the Euro-group or ECOFIN set an inflation target. I was thinking about this before the meeting and I could not work out how you would achieve what would probably be needed—that is, unanimity—unless within a range so wide as to be not useful. Have you given some thought on the mechanics of this?

Professor Goodhart: It is the same problem as you get in the mechanics of almost any other Euro decision. If it is by unanimity, you would get into difficulty. If it is by qualified majority, there would be those who would feel it is too important an issue to be managed by qualified majority. I understand the problem, and I take entirely the point you are making, but I think this is on a much more general issue of the governance of Europe and the Eurozone as a whole, which goes much more widely than just monetary policy.

Q15 Lord Blackwell: Does this not reflect back on the earlier point you were making, that if you do not have the conditions for a natural single currency area then a single interest policy or a single monetary policy will be right for some areas but wrong for areas and the ones for which it is wrong will ideally want to set different conditions.

Professor Goodhart: The problem has been made worse by the fact that the single interest rate in the countries which are already somewhat deflationary and, in the German case, have had low consumption and are gaining competitiveness, and this makes monetary policy tight, whereas in the countries which are already more inflationary, monetary policy becomes easier. This is known as the Alan Walters’ critique of a single monetary policy and still has some force.

Q16 Lord Steinberg: Professor, this may not be something directly relevant but it is something which is occupying people’s minds, and that is the strength of sterling at the moment against the dollar. Can you see any danger resulting from that in regard to the euro?

Professor Goodhart: I am not sure whether you want me to respond to the question: Is the euro dangerously high against the dollar? Or: Is sterling dangerously high against the dollar?

Q17 Lord Steinberg: Either or both.

Professor Goodhart: Let us take the euro first. There are certainly fears that the global imbalances and the large current deficit of the US will involve at some stage a further depreciation of the dollar, perhaps because central banks will not wish to go on putting a lot of money into a depreciating currency. Under that circumstance, if the Asian economies continue to try to control their exchange rates, by and large, particularly the Chinese, then the counterpart of the depreciation of the dollar would fall primarily on the euro because that is, in a sense, the alternative and so the euro would have its exchange rate rise a lot against the dollar. Again, there are qualifications. If you take the Euro area’s effective exchange rate, it trades a lot with local areas in the East, the Middle East and Africa, which are probably likely to move with the euro rather than the dollar. The effective exchange rate will not get as much variation as the euro to the dollar exchange rate, nevertheless it is perfectly possible that the exchange rate of the euro relative to the US dollar could become uncomfortably high. What is uncomfortable, I do not know, but at some point it is quite likely that a significant number of leading politicians in the Eurozone, notably, I would think, the new President of France, Monsieur Sarkozy, will say enough is enough and will then try to use the rather ambiguous phrases in the Maastricht Treaty to require the ECB to intervene to prevent the euro appreciating any further. Whether and when that would happen and whether that approach that Monsieur Sarkozy has clearly outlined would get sufficient support elsewhere in the Eurozone, for example from Germany, nobody knows.

Q18 Lord Cobbold: Pressure is being put on the Chinese, for example, to revalue gently their prices so as to stop the build up of dollar reserves and the switching from dollars into euros, is it not? Is pressure being put gently on the Chinese to help the problem?

Professor Goodhart: The Chinese tend to be rather resistant to pressure.

Q19 Lord Cobbold: They have done a bit already. They have made two steps in the right direction.

Professor Goodhart: One of the problems for them is the more they revalue their Renminbi the greater the fall of the value of their massive existing reserves. The likelihood that the Chinese will allow a floating exchange rate or any significant jump, I think, in the value of the Renminbi is quite small. It will go on trending upwards against the dollar but relatively slowly.

Q20 Lord Cobbold: Which would be diversification out of the dollar into the euro.
Professor Goodhart: Yes.

Q21 Chairman: This begins to open up what I think is a very interesting area because it is shocks to the system that we are talking about, is it not? Presumably, if you call upon the ECB to intervene to stabilise or to prevent the euro appreciating further, I cannot think of another weapon open to the ECB other than to drop interest rates.

Professor Goodhart: No, they could undertake sterilised intervention. They can intervene directly on the exchange rate. They just buy dollars and sell euros.

Lord Blackwell: Do you think their budget would allow them to do that?

Q22 Chairman: They would have to buy lots of dollars.

Professor Goodhart: There is no practical limit. You can sell the currency that you produce as much as you want. There is a problem that if they should sell euros and buy dollars and the dollar should then depreciate nevertheless, they would make a loss, which might be described as a speculative loss, and that could be embarrassing because it would reduce the amount of seignorage that they could then transfer to other countries. But the loss would have to be very large indeed, I think, before it actually brought about a significant budgetary problem.

Q23 Lord Blackwell: Could I come back to the Stability and Growth Pact. If I understand the arguments you have been making about the single currency area, you are saying that ideally the single currency area ought to be followed, at least be ratified, by integration of fiscal policy and political entities in order to make it work effectively. To the extent that has not happened and may not happen, that causes strain. Secondly, ideally you would have free labour movement, which is a constraint. So we have a system which does not have some of the conditions fulfilled and is creating various strains, therefore, around the euro area. The Stability and Growth Pact is an attempt to hold things together. To what extent do you think the recent reforms of the Stability and Growth Pact have been useful, appropriate? Is there anything missing? Is there anything else you would do, given that some of those fundamental conditions are still not in place?

Professor Goodhart: I would not have approached the problem in quite the way that they did. One of the questions is what is the problem that the Stability and Growth Pact is meant to deal with. And one of the responses to that is that there is the problem that a country might get into such trouble that it might have to default and to prevent that, because it would be disastrous, the Central Bank might have to undertake inflationary policies. In practice, it is not the default of a government that really is disastrous, it is the fact that the value of its debt goes down really sharply and the financial intermediaries in the country involved then collapse. For the Argentines, it was not the default of the Argentinean Government, it was the fact that their banking and financial system got into really terrible trouble. Moreover, once you have a single currency and you are a national state, you cannot pay off all your bonds by simply printing more money, so they cease to be riskless investments. The regulators in the Basel Committee and elsewhere never like telling their political masters that they are anything less than perfect. So the Basel Committee and the financial regulators treat all government debt as if it is riskless but, in fact, once you no longer produce your own currency, and you can therefore always pay it off, it ceases to be riskless. I would have started in a different way by requiring a rising capital requirement on the bonds of any single obligor, particularly one’s own government, so that as the Belgian, for example, banks and/or insurance companies were getting more and more stuffed with Belgian Government debt—and I take Belgium as a hypothetical example, not a particular case—the capital adequacy requirement would rise to a point at which no national government could, in effect, stuff its own financial intermediaries with such a lot of its own debt that, if it went bankrupt, effectively the financial system of that country would collapse at the same time. Having tried to force a government to sell its debt on the open market rather than effectively channel it in to the financial system then I think the interest rates would rise and you would get a penalty for excessive debt and excessive deficits. That would be a market discipline to constrain fiscal positions of the member countries of the Eurozone. There is still a problem about what happens if they all start increasing their deficits at the same time. Does that not mean you get an imbalance in the economy? There I think there is a case for having some independent body, maybe related to the European Parliament or the European Commission, considering the question of what the aggregate deficit over the whole European area might be and then there are some quite interesting ideas about maybe having tradable permits. Say the independent body said that the Eurozone-wide deficit should be 2% of GDP, and a particular country wanted to go to 5% of GDP, it might be allowed to subject to a tradable permit, so that countries which were prepared to go below the 2% could trade with the countries that wanted to go above. There are a lot of technical and other problems, but my feeling is that the Stability and Growth Pact started at the wrong place, that once you no longer have the ability to control your own interest rate and exchange rate you need more flexibility rather than less flexibility in national policies, and they really should have chosen a
completely different route of trying to maintain member countries’ fiscal disciplines. I think the Stability and Growth Pact is just wrong but I can see why they sought to do it. As I said before, I think it has had an effect on fiscal discipline.

Q24 Lord Blackwell: The risk is, you say, that even with that discipline there is not enough sanction on countries that may over-extend their national debt. Professor Goodhart: Again, I think the Stability and Growth Pact was just wrong. The idea that a country will pay a sanction and hand over money to a European central body and would impose a tax on its own citizens when its own politicians think that the deficit is right and are defending it, in my view was not a credible threat because it was so patently politically impossible. I can imagine campaigning against paying over a tax to the central Euro budget. Any sanction I think has to be market based. This is why I think, for example, that imposing an appropriate capital adequacy requirement, so that interest rates rise as the national government within the Eurozone has an increased deficit or an increased debt, would be a far greater way of doing it because a market discipline is credible. The kind of discipline involving the Stability and Growth Pact is just not. It was always a system with a set of sanctions which were not properly considered.

Q25 Lord Blackwell: Without the kind of discipline that you propose, do you think there is a real risk that at some point the market may look sceptically on the equal risk of all euro debt and start to speculate against the Italian debt, for example? Professor Goodhart: I think a lot of us have been surprised by how small the spread is between the debt of those who can clearly live within the Eurozone more easily and those countries which may have some potential problems. But, again, I think that is partly because the people in the market have looked at the costs of exit from the Eurozone and reckon that they are so severe that they will only happen through political miscalculation, but political miscalculation is always possible.

Chairman: All of us are riveted with interest, but it takes us to Lord Trimble’s question.

Q26 Lord Trimble: In your paper you have set out the sort of scenario which you have just been touching on, where some people are having difficulty with the adjustment that has to take place and because of poor competitiveness make a political mistake, and then you envisage that there would be very dramatic events happening in terms of the market that would take decision-making out of the hands of the particular politicians and force an exit, rather similar to the situation we were in back in 1992. You think this could happen simply through a political miscalculation and yet the consequences for that particular economy would be massive.

Professor Goodhart: Yes. One hopes there would not be such a miscalculation but it could happen. One rather dreads to think what would occur if a country became so uncompetitive and so depressed within the Eurozone that it regarded continuation of the status quo as politically unacceptable. What would happen then, I simply do not know.

Q27 Lord Trimble: You do not think there is a serious risk of it happening through other investors looking at the situation and saying, “That economy is having so much difficulty adjusting that we think there is an added risk on it of government debt.” You do make the point that there is virtually no spread at all but you think that is going to remain stable like that and there is no chance of the market taking a different view. Professor Goodhart: Again I do not know. The issue is essentially political. Unless these trends of competitiveness can get reversed, there will come a point at which a number of countries, probably in the Mediterranean area, will reach such a condition of depression and deflation that politically it becomes unacceptable. The question is what happens next. Then we write a political scenario. It is not an economic scenario. I have no comparative advantage in saying what will occur now. All I can see is unless these trends reverse we are quite likely to get to a situation where the political outcome could be difficult.

Q28 Lord Trimble: Would there then be a case for saying that if this is happening, taking the case of what people call the “Club Med”, which is stagnating, and this looks likely to continue, and if it does continue does there come a point at which other Member States or the Commission should say there is going to have to be some major adjustment? Professor Goodhart: I think this is understood. I think this longer term concern is well understood within the European Commission and by many in the Eurozone. For the time being, the situation is not really serious. The Spanish economy, the Italian economy, are doing quite well at the moment, it is just that one foresees that it could become serious. One of the possibilities is that the German economic machine, which has delivered extraordinarily low, often negative changes in unit labour costs, will cease to be such a difficult powerful force to live with. The Germans are very uncomfortable people to live with because they bargain to achieve low increases in nominal wages and then quite high increases in productivity, which means that everybody else has to keep up with a situation, if they are going to maintain unit labour costs, where there own unit labour costs are terribly low. If your productivity is lower than the
Germans, which is the case in Italy, for example, that means no wage increases or wage declines, if they are going to keep up. There are those who hope that the German discipline will slip and the German workers will get, instead of settling for 2 or 3% increases per annum, will start demanding and getting, say, 5 or 6% or even more. It is very difficult living with as disciplined a group as the Germans.

Q29 Lord Trimble: There is not much prospect of the Germans moving in the direction of a large wage increase, is there? Professor Goodhart: No, but then, in a sense, you see the problem.

Q30 Lord Steinberg: Over the last 15 or 20 years, quite a number of countries, including our own, have had substantial currency fluctuations. Is it not the case that now we are in a much more benign situation, because we have low interest rates and because inflation is pretty low, and that this period of substantial fluctuation in currencies is more a thing of the past than it was a number of years ago and that we should not pay quite as much attention now and there have not really been massive fluctuations recently. Part of that, I suppose, is the stabilisation of the euro within so many countries in Europe. Professor Goodhart: We have been going through, in economic terms, an extraordinary golden age over the last 15 years or so. Output has been growing very steadily, particularly in this country. Inflation has been low and stable and, as you say, the exchange rate movements have not been perhaps as severe as in the past, though they have been still greater than one would have expected. Given the stability of the various countries and the fact they have all had constant low and stable inflation rates, you would have expected almost no changes in nominal exchange rates and yet there have been quite a lot. The exchange rate volatility has been greater than one would have expected given the conditions of the individual countries. The problem is that nobody really understands exactly why everything has been so stable. It is partly good policies around the world, and all the rest of it, but you nevertheless have had substantial currency fluctuations recently. Part of that, I suppose, is the stabilisation of the euro within so many countries in Europe.

Q31 Lord Cobbold: It all depends on the Asian economies and the growth in China, does it not? Professor Goodhart: Yes, but as Charlie Bean, the Chief Economist at the Bank of England, pointed out, the benefit that you get by having lower manufacturing goods prices is offset by the greater upwards pressure on commodity prices. The Chinese are hoovering up all the spare commodities. I do not think one can necessarily say that China has been an entirely beneficial agent in world economic development.

Q32 Lord Trimble: Just to take it back for a moment to the benign situation we have had for the last decade or so and the way in which inflation rates and interest rates have been so low, is there not a serious worry at the moment that inflation here particularly going to get out of hand? Professor Goodhart: It will not get out of hand. The Bank of England is mandated to ensure it will not and the Governor and the Monetary Policy Committee will do everything they can to prevent that. I think there is a significant possibility that the increase in interest rates necessary to achieve that mandate will be higher than is now generally expected. The general expectation is that there is another quarter per cent there to come and that might well be the top. Looking at developments in the world, including the longer run trends in monetary and credit growth around the world and also the upwards pressures that there are in commodity prices, which is partly due to the continuing very fast growth in Asia, I think there is a considerable likelihood that the required increase in interest rates to maintain stable and low inflation could be greater than is currently expected in markets.

Lord Cobbold: We have already covered most of what I wanted to ask, but I just wondered whether you thought there were any circumstances in which it might be in the interests of this country to join the common single currency.

Q33 Chairman: This is not quite what our report is going to be about but I would nonetheless welcome your view.

Professor Goodhart: I believe there are two stable situations. You either move towards a fully federal Europe—federal in the sense that there is a considerable centralisation of both democratic, legible mandates in Europe: for example, I would very much like to see the President of the European Commission democratically elected rather than appointed by the Prime Ministers. I think a fully federal Europe would be an attractive possibility. The alternative, which I think is an entirely acceptable and stable regime, would be one of a free trade area with free movements of goods and capital and all the rest of it, but you nevertheless have national controls over the major economic instruments, such as interest rates and fiscal policy. For that to work, because of the concern about competitive devaluation which you mentioned...
earlier, I think it would have to be a requirement that all the governments in this free trade area to provide an exchange area to float absolutely freely. At the moment we have neither one nor the other. We neither have a federal system which is clearly sustainable nor do we have just a free trade area with national controls. We have a free trade area with the addition of this unified monetary policy. For the reasons I have been trying to set out, I think this is going to be subject to very considerable strain. Again, for reasons I have tried to set out, because of the costs of exiting, I think it may continue for a long time but, potentially, very largely at the expense of certain regions which could become depressed and deflated almost without limit, like the South of Italy. I do not know whether, if we did enter, we would be in the Club Med mode or in that part of the Eurozone which would probably benefit. I think it would be very risky because I do not think the regime is one which is nearly as sustainable as the other two which I have described.

Q34 Lord Blackwell: In relation to financial markets and exchanges, do you think there is any linkage between the notion of a single currency area and the development of global scale exchanges in financial markets or, alternatively, does the experience of London suggest that you can do that without a single currency?

Professor Goodhart: You can do it without, as indeed you mentioned, in London. It is perfectly easy to hedge currency risk and exposures. We have had the development of the global financial system during periods in which exchange rates have been capable of moving against each other and potentially to do so with quite a lot of volatility. Chairman: I am particularly keen to get on to the whole area of enlargement and entry criteria for the Eurozone.

Lord Steinberg: People say, and I am inclined to agree with them, that the entry of Romania and Bulgaria was too quick because they had not met the requirements, particularly in relation to their history of rather unsatisfactory, putting it fairly mildly, dealings, where within the country there has been a great deal of graft and so on. I am really seriously worried that we are going to take people into the Eurozone who are not really prepared for it as yet. And of course we are going to have another big discussion about Turkey over the next period of time. Chairman: If I can slightly reformulate the question, we are really asking about the entry criteria and do they make sense. It is not a question of us letting them in, it is a question of them letting them in really.

Lord Steinberg: Yes, the Chairman is being much more succinct than I was.

Q35 Chairman: Does it make sense?

Professor Goodhart: Could I ask you to clarify. Are you talking about entry into the European Union or entry into the Eurozone?

Q36 Chairman: Into the Eurozone.

Professor Goodhart: I do not think the criteria for entry into the Eurozone do make sense, with one exception. The exception is a fiscal one. I was recently in Hungary and the Hungarians have a really very significant fiscal deficit. You may remember that rather extraordinary occasion in which the Prime Minister, who had just been re-elected, reportedly told the public that he had been lying in the morning, lying at lunch and lying in the afternoon and this was of course about the fiscal position. The Hungarians are now beginning to rectify it, but they did have a very difficult fiscal position, and I think it is perfectly understandable that the Euro-group finance ministers in the ECB would be very wary of allowing in a country whose fiscal position was not sustainable and in good shape. The problem is that they have a lot of other criteria as well relating to relative inflation rates and relative interest rates. The point is that, unless you are really quite wildly inflationary to begin with, the moment that you adopt the euro you get the interest rate and the inflation rate more or less of the rest of the Eurozone, so those criteria are really quite unnecessary, and they are in some ways counterproductive. If you take a relatively fast-growing Eastern European transition economy, say in the Baltic States, a country like Estonia or Lithuania or Latvia, because they have had an inflow of new capital and new technology and so on which they have not had before, they are very likely to have very fast rates of growth in their manufacturing sector. That will lead to wages being bigger.

Q37 Lord Steinberg: Presumably from a very, very low base.

Professor Goodhart: Yes, of course. That will lead to wages being bid up there which will feed through into the service sector where productivity inevitably is lower, so that you are bound to find that fast-growing transition economies have a somewhat higher inflation rate than there is in Central and Western Europe. To prevent those economies joining the Eurozone when they could perfectly easily do so because of a mild difference in inflation strikes me as simply counterproductive. I have never really been able to understand why the ECB has taken such a strong stand on that point.

Q38 Lord Steinberg: I am concerned, as a great many people are, and I would like your opinion on the 500 euro note which I believe causes money laundering and all the other kinds of villainy that you could mention. It is far out of synch with any other
currency and I would be pleased to hear your comments.

**Professor Goodhart**: I am entirely on your side. I have written a number of articles, as have many other economists (Ken Rogoff, for example, who then became Chief Economist at the IMF), effectively stating that the very high value, large denomination currency notes issued by the ECB effectively provide a degree of subsidy or a degree of benefit to the black economy, to the drug dealers. The increase in the outstanding value and proportion of these notes is enormous. It is entirely unclear what went through the minds of the ECB when they agreed to do it. My understanding is that the ECB has simply modelled itself to a large extent on the Bundesbank and the Bundesbank had very large value deutschmark notes. The ECB simply said, “If the Bundesbank did it, we will do it too.” I think it was an entirely mistaken policy. The only beneficiaries of this are the members of the black economy and I do not think any normal person would hold one and yet the increase in the outstanding value of these notes is enormous. The euro has really taken over from the dollar as being the currency of choice for every evildoer you can think of.

**Q39 Chairman**: Perhaps I could be allowed to trespass upon your time and ask one more wind-up question which is really about enlargement. What impact do you think the expected enlargement of the Eurozone will have on the functioning of the Eurozone economy and the management of monetary policy in the Eurozone. I think we know who is going to enlarge it but in terms of the likely entrants into the Eurozone what do you think will happen?

**Professor Goodhart**: This is a governance problem in the European Union that is common and it is not only in monetary policy. It is very difficult to have a good discussion which has to-and-fro arguments when you have a committee of, shall we say, 28 people sitting around the table. How the Governing Council will operate I do not know. As you know, under, I think, the Treaty of Nice, they had an agreement whereby the ECB could in any way be separated. If they cannot, they cannot. I was just picking to see if the questions could in any way be separated. If they cannot, they cannot.

**Q40 Chairman**: I know that you cannot separate economically the question of governance from the question of how the thing works, but, assuming that the governance can be fixed, are there any economic consequences that you would foresee through enlargement of the sort of new high-growth countries that we are thinking about? The last round of entrants.

**Professor Goodhart**: Again, I think the questions are really rather more political than economical. It is a question of how far you want to have a club type arrangement, where members are increasingly diverse. Lord Steinberg was raising the point about the Romanians or the Bulgarians already so diverse in their cultures, standards of living and so on that it might make it difficult. This of course raises the question of Turkey and, indeed, further to the east, countries like the Ukraine. But I do think that this is a realm in which the politician rather than the economist really ought to be the dominant.

**Q41 Chairman**: There is no obvious economic reason why, let us say, admitting Bulgaria and Romania to the Eurozone would particularly affect anything.

**Professor Goodhart**: The more you get diversity, the harder it is to have redistribution because the flows would be so large that, without a great deal of political fellow feeling . . . The Dutch and the Germans, shall we say, are not going to want to want to transfer very large sums to the Turkish and the Bulgarians. I do think it is a political issue rather than an economic issue.

**Q42 Chairman**: Colleagues, before we let Professor Goodhart go, does anybody have a burning question? I have one that has been left over. We were talking about a dialogue whereby the ECB could fundamentally gain support for its views, where countries would consider what inflation rate they...
wanted. In the general conduct of the Eurozone would it be helpful if the European Parliament were the place to which the ECB related?

Professor Goodhart: It does of course relate to it already, but it is a kind of one-way relationship. The President of the ECB comes and addresses the European Parliament and tries to explain what he has been doing and why, but there is nothing the European Parliament can do about it if they do not like it. There is no constraint which the European Parliament can impose on the ECB which is independent to an extraordinary degree of the political framework. There is the question of what are the relative roles of the Executive and the legislature in trying to set the objective. In this country it has been the Executive. If you feel that the Executive cannot agree, then the case may be for having it done by the European Parliament, but that is simply a way of getting a form of majority voting into the process of setting the inflation target. Presumably the European Parliament will never be unanimous.

Chairman: Thank you very much indeed for coming. It has been the most helpful and comprehensive debate and we do thank you very much.
then last year this ratio was 17.5% of the outstanding equity market held by foreigners of listed companies in Italy, if we consider the entire proportion of the example, another interesting statistic, I think, is that year was 46%, up slightly from 45% in 2005. For of those equities which were held by foreigners last referred to as the CAC 40, then the actual proportion the main stock market index for France, which is considered the 36 biggest companies which constitute European equity markets. For example, if we equally there has been tremendous change in the debt markets. Of course I think it must be stated that been a very substantial expansion in the euro area denominated in yen, so you can see that there has 43% for those denominated in dollars and 14% denominated in yen, so you can see that there has been a very substantial expansion in the euro area debt markets. Of course I think it must be stated that equally there has been tremendous change in the European equity markets. For example, if we consider the 36 biggest companies which constitute the main stock market index for France, which is referred to as the CAC 40, then the actual proportion of those equities which were held by foreigners last year was 46%, up slightly from 45% in 2005. For example, another interesting statistic, I think, is that in Italy, if we consider the entire proportion of the equity market held by foreigners of listed companies then last year this ratio was 17.5% of the outstanding equity stock, up from 15.5% in 2005, it would seem to me that there has been a substantial degree of integration in equity markets. You were asking why the fixed-income integration has been seen perhaps to be pursuing at a more rapid pace. I think that is partly to do with the nature of the fixed-income markets themselves. Obviously, you do not need to have a particular understanding of individual companies to be investing in fixed-income markets, if they are issued by the public sector, for example; so in a way the market can be considered a little simpler. As well you have had, I think, a long culture in continental Europe of focusing more on what we can call the credit markets, the fixed-income markets, for financing the economy, as opposed to the equity culture, which obviously is much more prevalent in the United Kingdom and in the United States. I think there could be some historic and cultural reasons why we might be seeing some differentiation here, but certainly I would suggest also that, in terms of how the equity markets have been transformed in the last ten years, the transformation I would say really is quite similar in scale to what we have been seeing in the fixed-income capital markets.

Q44 Chairman: Good morning, Mr Callow. Thank you very much for coming. Can I just say that this session is on the record, which means it is being recorded for webcast; therefore, could you use the microphone. Witnesses do get a transcript of all that is said during the session. How would you like to start; do you want to make a general statement or shall we start with the questions? Mr Callow: I am happy to pursue in whatever manner you are happy with; thank you.

Q45 Chairman: There is a list of questions but we hope this is going to be a fairly wide discussion and people will come in on questions, and stray, no doubt, from the subject matter. If I may start; really we are interested in the effect of the introduction of the euro on the functioning of European capital markets. This is factual: what has happened? The evidence we have received so far suggests that debt markets have integrated much more quickly than equity markets. Do you believe that is the case, and, if so, why?

Mr Callow: I think certainly it is true to say that there has been a tremendous expansion of the euro area debt markets. If we consider, for example, the outstanding quantity of euro-denominated fixed-income securities, in the first quarter of 1999 this was €6.4 trillion, whereas by the fourth quarter of 2006 it was €11.7 trillion. The bulk of that has been issued by euro area issuers, and in terms of the outstanding global stock of debt securities those denominated in euro now account for about 27% of the total. That is up from 22% in 1999 and it compares with a figure of 43% for those denominated in dollars and 14% denominated in yen, so you can see that there has been a very substantial expansion in the euro area debt markets. Of course I think it must be stated that equally there has been tremendous change in the European equity markets. For example, if we consider the 36 biggest companies which constitute the main stock market index for France, which is referred to as the CAC 40, then the actual proportion of those equities which were held by foreigners last year was 46%, up slightly from 45% in 2005. For example, another interesting statistic, I think, is that in Italy, if we consider the entire proportion of the equity market held by foreigners of listed companies then last year this ratio was 17.5% of the outstanding equity stock, up from 15.5% in 2005, it would seem to me that there has been a substantial degree of integration in equity markets. You were asking why the fixed-income integration has been seen perhaps to be pursuing at a more rapid pace. I think that is partly to do with the nature of the fixed-income markets themselves. Obviously, you do not need to have a particular understanding of individual companies to be investing in fixed-income markets, if they are issued by the public sector, for example; so in a way the market can be considered a little simpler. As well you have had, I think, a long culture in continental Europe of focusing more on what we can call the credit markets, the fixed-income markets, for financing the economy, as opposed to the equity culture, which obviously is much more prevalent in the United Kingdom and in the United States. I think there could be some historic and cultural reasons why we might be seeing some differentiation here, but certainly I would suggest also that, in terms of how the equity markets have been transformed in the last ten years, the transformation I would say really is quite similar in scale to what we have been seeing in the fixed-income capital markets.

Q46 Chairman: The proportions you give for the equity markets, the CAC 40 held 46% by foreigners, are foreigners anybody who is not French or anybody who is not euro zone?

Mr Callow: Anyone not French.

Q47 Chairman: The Italian proportion, I have reason to know, being a Director of the London Stock Exchange, is quite low?

Mr Callow: Yes. I think obviously this will reflect local conditions, in particular, as I am sure you are aware, My Lord Chairman, that we find differences in the standards of corporate governance which apply in different countries in Europe. The standards, for example, for issuing a fixed-income security will be very similar, whoever you are, wherever you are from, in terms of disclosure of information, and so on. I think, historically, it has been the case that we have had quite substantial differences in the level of regulation, for example, in ownership restrictions. It is an interesting fact, as well, I think, that if we consider ownership concentration then this tends to be much heavier among continental European equity
markets than it does in the case of the United States or the United Kingdom; in other words, the proportion of outstanding equity that is held by one individual, for example. Again, here is some evidence perhaps to suggest that things have been different but, there again, they are changing, and I think the euro is certainly part of this and the focus on having very integrated capital markets. I think many international investors would say that there has been a tremendous transformation in the standards of corporate governance that apply to European companies as a whole, in terms of their accountability to shareholders, their level of transparency that they present to investors and their general focus on profitability also.

Q48 Chairman: The point you are making, if I make a shot at paraphrasing it, is that it is always a matter of loss and debt and fixed interest, about corporate governance, or how much you know about what you are buying, and of course it matters very much if you are buying equity?
Mr Callow: That is right; it reflects it.

Q49 Chairman: You do believe also there has indeed been an increase in people buying equities in each other's countries?
Mr Callow: Yes; without doubt that has been very important. With equities, as I say, really you need to have a lot more information, because you are investing in a specific company and obviously you need to understand its products and its strategy and its balance-sheet. For investing in fixed-income securities, you are investing in something which has a credit rating, and I think, in a way, the investment decision is a little easier, for one thing, which can make it easier for institutions to be investing across borders in fixed-income securities. If we look at who the investors are, they tend to be large institutions, mutual funds and pension funds, typically, for example, and again they have got this background of being very much inclined to be investing in fixed-income securities in Europe. In a way, this reflects the fact that many European countries historically have had very high levels of government debt so there has not been a lot of alternative.

Q50 Chairman: In all of this inquiry, the trick is, what all of it is trying to do is strip out the euro effect, the effect of increased trade, people knowing more about each other. Would you suggest that there was a great deal of euro effect in this, that we are all buying fixed-interest and bonds, and so on, because it is in the same currency, because it is an easier currency?
Mr Callow: Yes. I think that must be true, really, and you can see some evidence for that in terms of the very sharp compression of margin in the yields that you obtain if you invest in government bonds. Obviously, when we had monetary union there was a tremendous yield compression here and at the current stage, if you invest in an Italian bond, for example, or a Spanish bond, you are getting only a very small margin, a few basis points, as we would say in the markets, over what you would have if you invested in a German bond. That was made possible by monetary union, and in turn that has promoted liquidity in the financial markets. I think, as a precondition of EMU, we must not forget a vital precondition was the abolition of capital controls within Europe. That could have happened perhaps without EMU, but without doubt EMU required that to be brought about, and in turn that accelerated the process, and that is fundamentally very important for this particular topic. Lastly, I would just mention how EMU has really concentrated investors' minds. For example, if you are a central bank based in Asia and you wish to invest in government securities, I think you will have much greater confidence in investing in, for example, Italian government securities, knowing that Italy is part of EMU. I think the process of monetary union has been such as to cause investors to treat the European capital markets much more as one and to look for differences between them, rather than perhaps just investing in, say, Germany and forgetting what is happening in Italy because it was too complicated to establish. I think EMU has also been substantially accelerating the integration of the markets themselves, clearly, for reasons to which I alluded, also in terms of raising best practice for issuance, for example, and for transparency and fixed income as well as for equity.

Q51 Lord Blackwell: Mr Callow, putting sovereign debt to one side for a moment, could you comment more on what benefits you think may have come about from the deepening of this euro bond market, both from the debt issues and the capital markets? You could argue that companies have always been able to issue debt and if they wanted to remove the counter risk there is a big dollar bond market. The capital markets happily trade whatever bonds are being issued, in whatever currencies, so the fact that bonds denominated in euros have grown, how do you argue that has any economic benefit?
Mr Callow: I must confess, in preparing for this hearing, I obtained some information from a European Central Bank report, and this was actually considering the proportion of debt liabilities, that is loans and debt securities, which is accounted for by debt securities only; this is the ECB Occasional Paper No.63, which was published in June of this year. For 1999, a table on page 17 gives us a ratio of 8.7% for debt securities as a proportion of debt liabilities, rising to 10.8% in 2005, so an increase of roughly two percentage points, in other words, the share of loans...
as a proportion of interest rate liabilities is still nearly 90%. That is the euro area. If we compare the situation in the UK in 1999, the ratio of debt securities, on the same basis, in the same table, is 25.3%, rising to 26.5% in 2005. In the United States, the ratio in 1999 was 41.1%, in other words, the actual loan proportion was 58.9% then, and the debt security ratio in 2005 actually fell slightly to 39.3%. What I am trying to show you here is that there has been some increase in the debt securities as a proportion of the non-financial corporate sector’s balance-sheet; nonetheless, the overall ratio is still actually quite low.

**Q52 Lord Blackwell:** It is mirrored in an increase equally in sterling and dollars, is it?  
**Mr Callow:** If I may say so, the dollar share actually fell slightly, from 41% in 1999 to 39% in 2005, and in sterling the increase was a little over one percentage point; so, yes, it is only a small degree of evidence. I think where we have seen much greater issuance, however, has been in the financial sector, which is, in particular, obviously, the banking sector but also non-bank financial institutions, which have really accounted for over 90% of the growth in the issuance in euro-denominated debt securities that I referred to at the start of my comments. Clearly, those institutions therefore have done so, in terms of issuing euro-denominated, for the reason that they can actually diversify their funding base and obtain capital more cheaply. I think there is clearly substantial room for improvement here, certainly it seems to me that there is quite a long way to go in terms of the financing of the non-financial corporate sector, which was the figures I was just referring to in response to your question, for the Euro Area. Nonetheless, still, for me, I think it is true to say that in my experience the euro has acted as a kind of focal point which has enabled some growth in these markets.

**Q53 Lord Inglewood:** Forgive me, if I might, just to go back right to the start of your remarks, there was something which I think I just did not hear quite clearly; which was, first, in response to the Chairman’s questions, you explained that the amount of fixed-interest debt had gone up from, I think it was, 2001 to 2005. Then you referred to the amount of equities in the French premier league, which were owned by those outside France and how that had increased. What I am not clear about is the timeframe over the increase you described; was it from 2001 to 2005, or what to 2005?  
**Mr Callow:** One of the issues obviously is retaining information from different sources. I have to say, from my own perspective, related to the work I do, it is considerably easier to obtain information on the fixed-income markets than on the equity markets, but nonetheless I wanted to give some observations. For the equity markets, all the figures I mentioned related to the end of last year and comparisons with the end of 2005.

**Q54 Lord Inglewood:** That is a year, is it not?  
**Mr Callow:** It is only a year. I think we would find that, had I dug down and got the information—- -

**Q55 Lord Inglewood:** What I was really pushing towards was the rate of increase over that year; is that, in your judgment, a rate of increase that if you went back to, say, 2001, probably you have seen that, roughly, year on year?  
**Mr Callow:** I think we would be seeing a similar rate of increase, if we were to go back to, particularly, for example, 1997, before EMU had got going. I mention that simply because in my career I have been focusing on the European economy since about 1990 and I was very conscious, in the mid and the later part of the 1990s, that there was a tremendous explosion of interest among investors in the European equity market. I think that would correspond with a substantial degree of increase in the foreign ownership; so I agree with your comment, yes. Just as a point of clarification, the figures I gave initially, the initial figure of €6.4 trillion of euro-denominated debt outstanding, this refers to the first quarter of 1999.

**Q56 Lord Kerr of Kinlochard:** Thinking of fixed-income instruments, can you give us a feel for how the geographical distribution of the markets has changed in the last eight years? I am thinking both of issuance and of trading. Which markets have grown more than others?  
**Mr Callow:** Really I can only give you figures based a little bit on my own perception for this, but I think clearly it was the case that before monetary union began the debt markets in general across Europe were relatively fragmented, in other words, if you wanted to issue debt you would probably be very much inclined to be using a bank from your local country. I think what EMU did was a revolution for the capital markets, of which obviously London has been a very important beneficiary, because it meant that expertise was no longer confined to just one country. What you have seen, if we take the last ten years here, I think, has been a consolidation of the ways in which bonds are being issued, a much greater degree of specialisation, which has been particularly centred out of London in this respect, and therefore a much greater degree of internationalisation in terms of the financial institutions which are arranging the debt issuance. I am afraid I do not have on me precise information about the share of London in terms of Euro Area debt issuance, but what I think is very true...
is that, if we compare the situation as we have it today, where we have, of course, many American firms and some British firms as well which have a very important position in terms of issuing euro-denominated debt, including of course my own bank, we can see that this is something which was coming about as a result of the creation of the single currency and the unified capital markets in Europe. I hope that goes some way to answering your question.

Q57 Lord Kerr of Kinlochard: I would be right to conclude that, although all have gained, some have gained more than others and London is one of those?

Mr Callow: I think that would be the view of many people in the financial markets, including myself, yes. If we consider London as a financial centre and think back to a kind of discussion we might have had in 1998, when we were also conscious of Frankfurt as a financial centre, or Paris as a financial centre, and think to where we are now, in a way you could say that monetary union has been, I think, very important for London, but in a way this has helped to spur London on to being a truly global financial centre.

Q58 Lord Kerr of Kinlochard: Can I ask what barriers to further integration of these markets you think still exist?

Mr Callow: In the fixed-income markets, I do not consider that there are particularly substantial barriers operating within the markets. There are differences in the settlement procedures of securities and this is something which the European Central Bank is seeking to examine and to change, with its so-called Target2 initiative, but in general I think the fixed-income barriers are really not substantial. In terms of equity markets, I think we find that there are clearly different stock exchanges, they have, to a degree, different rules, there is obviously an attempt to be moving towards harmonisation, but it would seem that the equity markets, I think, again, for historic reasons and also because they are focused of course on retail as well as institutional investors, have a greater degree of harmonisation still to be seen. I think the most important distinction though is that we do have still differences in regulation across Europe; really we have one Central Bank but we do not have one regulator. That means, therefore, a tremendous panoply of different regulations, which, particularly in terms of integration in the financial sector more generally, with banking and with insurance, certainly can be a complicating factor. Even this is beginning to change in some respects but, nonetheless, that is perhaps where, in terms of the financial markets, I think we see the most significant barriers to integration at the current stage.

Q59 Chairman: There has been a most useful discussion. Do you feel that the ECB’s monetary policy has been too restrictive? Do you feel the policy of an upper inflation limit rather than a symmetrical target contributes to this; and should ECOFIN or the Eurogroup have the power to set the inflation target? How is this going, from a banker’s point of view?

Mr Callow: This is very much on my home turf, so I am delighted to be able to comment on it. Of course the European Central Bank was created in June 1998. Let us take the average level of the Harmonised Index of Consumer Prices for the Euro Area which was prevailing in 1998 and consider its change up until 2006. The annualised rate of change in this HICP, the key price index for the European Central Bank, during the eight-year period, was 2.05%. The Governing Council of the European Central Bank has said that it considers an inflation rate of “below but close to 2%” for HICP inflation to be an appropriate definition of price stability. We can consider, therefore, if the policy has been restrictive by reference to the outcome, and the outcome, as I say, over the last eight years, has been an average annualised inflation rate of 2.05%, which is narrowly higher than the objective which the European Central Bank has set itself. On that definition, of looking at the outcome, one might argue that the policy has been slightly on the loose or the accommodative side. There are other ways we can consider restrictiveness.

We can consider the so-called real interest rate, where we take the ECB’s actual interest rate, which is called the refi rate, and subtract the inflation rate from that; this real interest rate, since EMU began, in 1999, has averaged 80 basis points, that is, 0.8 percentage points. That is actually considerably below what most estimates of a neutral interest rate by economists would be, which tend to be around 2% for the real interest rate. Again, if we consider the actualhistoric real interest rate, compared with what we might consider the neutral real interest rate to be, it has been around 0.8 percentage points and the neutral real interest rate, in many economists’ opinion, would be considered to be around two percentage points. Again, on this basis, policy cannot be considered to have been restrictive. Finally, if we were to consider the policy with respect to the growth of nominal income in the economy, what economists call nominal GDP, the ECB’s refi rate has been, on average, one full percentage point below the rate of nominal GDP expansion in the Euro Area, which again constitutes a loose policy. If you consider the experience of the Bank of England over that period, since 1999, the Bank of England’s repo rate, its key policy rate, averaged about half a percentage point below nominal GDP expansion. On all of these three measures I would argue that ECB’s monetary policy has not been restrictive but rather on the accommodative side; we see this as well in the
tremendous inflation of asset prices which has prevailed since the ECB was created in 1998. In terms of an upper inflation limit rather than a symmetrical target, yes, I agree, I think it is preferable to be having a symmetric inflation target. I think the problem that the European Central Bank had was that when it formulated its definition of price stability it did so in 1998 when the headline inflation rate was very low, in fact approaching only 1%. As a result of that, it felt that it could not really set an inflation objective of 2%, even though many of the key central banks forming monetary union previously had adopted a target of 2% inflation. It adopted this rather strange definition of below 2%, which then, in 2003, it redefined to be below but close to 2%; but, I must say, that is quite a mouthful and I think that to say simply around 2% would be understood better by economic agents and therefore would be a preferable definition, with a band around that. I would say also, certainly, in the ECB’s favour, that to have achieved inflation of 2.05% over the last eight years is a considerable achievement, because there have been many shocks which generally have been in a positive direction for prices, such as the rises in energy prices and commodity prices and food prices, and German Value Added Tax went up recently, of course, as well, many other charges by the Government, set too in Europe, having gone up sharply too. In this sense, the ECB, I think, has done an extremely good job at keeping inflation almost in line with its self-defined objective. I think, as well, the focus on asset prices is appropriate for the European Central Bank; so we should not consider, I believe, just a pure CPI-based inflation objective but we should consider the longer term and issues concerning financial stability, and, of course, related to that, debt. In terms of whether politicians should have the power to set the inflation target, I think that is a reasonable request, actually. I think we need to have democratic accountability in setting monetary policies. The politicians, of course, set the mandate for the ECB to maintain price stability; that is the primary objective of the ECB in the Maastricht Treaty. They did not define this further. It seems that they might have had in mind something around 2% inflation, but they have never been explicit on this. I think, again, it would help the transparency and the robustness of the monetary policy framework of the Euro Area if we did have the politicians, or a political group, such as ECOFIN, or the Eurogroup, establishing the inflation target. I hope that addresses your questions.

Q60 Lord Cobbold: I wanted to ask about the exchange rate at the moment and whether you are concerned about the possibility, what we see is going on, of reserve diversification, the huge reserve holdings of the Chinese and the Japanese, in predominantly US dollars, whereas the US dollar is weakening, with their selling and buying the euro, and that is affecting the euro exports to the United States, among other things, and is this a serious problem which is going to get worse?

Mr Callow: I think it is a serious problem. The Chinese current account surplus has been literally exploding and last year was a little above 9% of Chinese GDP. This year it could get to around $400 billion, which would be 12 or 13% of Chinese GDP, based on information which is currently available for the first half of this year. Last year the Chinese current account surplus was $249 billion. In the case of Japan, the current account surplus is also rising rapidly and this year could approach $200 billion, and the rest of Asia, apart from China and Japan, is likely to have a current account surplus this year of some $130 billion. If we put all this together, 130 plus 200 plus 400, you can see that we are getting, for Asia, an aggregate current surplus of $700 billion to $800 billion, which is a tremendously large surplus for one region to be having, and its counterpart is the United States, generally speaking. It is clear that in the case of China the size of the current account surplus is creating particular pressures for controlling the supply of money in the economy, and therefore for controlling economic balance and particularly inflation, and therefore the Chinese authorities are responding by having a very gradual appreciation in their currency. What has happened has been a tremendous rise in Chinese competitiveness, brought about by such heavy investment, which really dwarfs any kind of braking effect and dampening effect which might come about from having some minor currency appreciation. Of course, Chinese trade, its exports to Europe are growing at least as fast now and are of a similar magnitude as they are to the United States, so I think this is putting a lot of competitive pressure on the European economy, for one thing, and then there is this issue about the diversification of the FX reserves, leading to some upwards pressure on the euro also. In conclusion, I have given you quite a lot of numbers but I think there are some very substantial risks associated with this. One is the fact that China has invested so heavily, but, by increasing rates of intervention, has been keeping its exchange rate fairly constant. Really one can argue that it is warranted for it to have a significantly stronger exchange rate now, proportionate to its improvement in competitiveness.
US Treasury will take often, in conjunction with the US Federal Reserve system. Therefore, it seems to me that Europe is agitating but in a very polite way, which means that the bulk of the attention and the pressure that is noticed out of Beijing will tend to be vis-à-vis Washington. I think that things have been changing so much that there is a strong argument for greater dialogue between Europe and China on this matter. I think it is very important to realise that there have been a lot of economists who have tried to argue in the past that the Chinese authorities do not need to have a significant currency revaluation, but the current account surplus, even if we go back two or three years, was a much, much smaller proportion of Chinese GDP, just a few per cent of GDP, compared with the situation which has happened now, so things have changed very significantly. I think actually where Europe might be most effective is in seeking to have China see a higher level of domestic consumption. The household saving ratio in China is around 40%, which is very, very high because there is not an effective welfare system in place, and therefore China is moving in this direction. If it can create a high level of security among households, through some development of its social security framework, then I think this would serve to lower such a high household saving ratio, and in turn that would go quite a long way towards redressing this very large imbalance.

Q62 Chairman: I am sure it is a worry and I am sure that Europe negotiates in a rather complicated way. I am trying to get us back to what difference does the euro zone make in this? Would it be an appropriate role for the Central Bank to go and nab China’s central banks, for example; or is that not how it is done? Does the presence of the ECB give them, as it were, a word to say in this debate?

Mr Callow: In general, it seems at the international level, matters concerning exchange rates really are led by finance ministries and therefore are not traditionally the preserve of the Central Bank. In the case of monetary union in Europe, I think there are particular ambiguities in this relationship. This is partly because in Germany there is a long history of leaving exchange rate matters to the Bundesbank, by the Finance Ministry, but that has not been the view adopted by other countries, and therefore there is a clear sensitivity on this point. The ECB exists, and I am sure it does seek to give a view here. It is clear that Mr Trichet, the ECB President, does refer to the need for exchange rates to reflect fundamentals, and China has been mentioned sometimes in this respect and Asian countries in general. I think, as well, really this initiative needs to come from the finance ministers but then you have the issue of the Eurogroup and how strongly they can enforce a view.

Q63 Lord Inglewood: Can I first ask a question, as I understand it, which Lord Kerr put to you, which strikes me as being interesting. I thought you said it was your view that the existence of EMU was something which had driven forward London’s financial position, taking the world as a whole, and so there is a direct correlation between London’s pre-eminence in various areas and the introduction of EMU. That was what you said: yes?

Mr Callow: Yes, I would agree with that.

Q64 Lord Inglewood: If I might, on a more sort of general point, we have a Stability and Growth Pact, which is the framework for the single currency: do you think that is the right sort of framework for such a project? In a more particular way, if you go back to the recent reforms of the Pact, do you think they were about right, or they go too far or not far enough, or what?

Mr Callow: As we know, there was a reform a few years ago of the Stability and Growth Pact which was designed to make it more flexible, less mechanical, in its implementation, and in particular to give more discretion for the implementation of pressure if excessive deficits are identified. So far, I think, the revised Stability and Growth Pact has been performing well; in particular, we might observe that the deficit of the euro area General Government sector for this year is likely to be below 1% of GDP, and last year it was 1.6% of GDP, which is certainly a low ratio compared with ratios of a little below 3% of GDP, for example, in the United Kingdom. Therefore, it seems that, so far, there has been good intent which has been executed soundly within the Stability and Growth Pact, and I think one can identify here particularly the way that Italy, Germany, Greece and Portugal have turned their deficit ratios, which were well above 3%, down to ratios below 3%. In the case of Germany, this year, the General Government deficit might even be zero, on current trends. It has to be said that we have been living in an extremely benign time. Over the last four years we have had global economic expansion which has been well above trend. Really you have to go back to the early 1970s to find global expansion so rapid in the global economy. In particular, there have been some very pleasant surprises, with fiscal revenues being much stronger than expected, in recent years. The climate has been very helpful for a reduction in budget deficits. The Stability and Growth Pact does rest very heavily on peer pressure; really it is a club of finance ministers, deciding among themselves on the appropriate action, and so far that has worked well. Germany has very nobly taken the lead itself in bringing down its deficit, and in
Germany it is clear that there has been strong cross-party consensus for achieving that, and strong opinion within Germany on the need to lower its deficit. Italy has also been successful; and Portugal, in particular, has seen a considerable sacrifice of economic expansion because it has been cutting its deficit. So far, so good, but if there were to be a particularly grave economic shock then the question which still arises is how committed governments would be towards fiscal restraint, particularly, of course, if that shock were applying to a particular region.

Q65 Lord Blackwell: As you said, the euro has operated so far in a fairly benign economic climate, low inflation, and you mentioned earlier that in that environment real interest rates had been quite low. Do you worry at all about, if we do have a period of shock, whether the ability to sustain that same interest rate over what are still quite different economies will cause problems, even if they manage to contain their deficits, and do you think there is enough capital and labour mobility to underwrite maintaining that similar currency area and single interest rate?

Mr Callow: I think the challenge which central banks face in general, and certainly this is true for the European Central Bank, as the Governor of the Bank of England, Mervyn King, has identified, is that we have lived through a very benign period on inflation and that has had the effect of keeping inflation expectations low and relatively stable. At the same time, we have been seeing rising pressures in global commodity markets in recent years, and the global economy is in a mature phase and increasingly in a resynchronised phase of expansion, which means that inflation pressures may become more prevalent, which could cause inflation expectations to shift higher, which would mean then that central banks would have to start to get much tougher than they have been. In a way, you could argue that central banks have been coasting a little bit on the tail-wind of their previous tough policies, which were implemented in the 1990s, so far this decade; they have had a relatively easy ride, which means that they have been able to keep monetary policy a little bit on the accommodative side, but things may start to get tougher. In the case of the ECB, that is going to raise some important challenges. I think the most important issue is I do not believe it to be agreed unanimously across Europe that the Central Bank has to set an inflation rate as its primary objective. Clearly, in some political circles, there is the view that there should be some trade-off between inflation and growth objectives, even though modern economic thinking tells us that growth is a very important determinant of inflation, so really you cannot focus on an inflation objective if also you are pursuing a growth objective. A particular pattern of growth will lead to a particular pattern for inflation. As the European Central Bank raises interest rates further I think there will be pressure on it from politicians, who feel that it should be starting to pay more attention to growth and who will question its independence. That is perhaps the most significant challenge, as I would see it, that the European Central Bank is likely to face. As well, things may look good in aggregate, stable, there has been good progress on the deficit side, as I mentioned, inflation rates are broadly fairly similar across the euro area, but there have been some tremendous differences in the economic performance of manufacturing sectors across Europe. In the case of Germany, we have seen what is really a tremendous improvement in competitiveness and in productivity and this has led to Germany having an ever-rising current account surplus and German companies advancing in market share within Europe. Whereas, at the same time, in Spain we have seen a very large widening of its current account deficit, and that is connected with the fact that in Spain the share of construction in GDP is now 18%, which is very, very high. You might think that a more normal ratio might be ten or 12% for this. We have some very substantial imbalances across the Euro Area; in a sense, they are starting to resolve. I think now we look at a horizon where, in Germany, consumption can improve, there is more jobs' growth in Germany, so Germany starts taking back some of the dividend which has been accumulating from its restructuring efforts. That, in turn, means that if Germany is expanding more significantly it may have slightly higher inflation, and that will mean that countries like Italy and France and Spain will need to have low inflation to keep the average inflation rate in line with the ECB's target. This really, I think, is the second related challenge which will be presented by the European Central Bank.

Q66 Lord Blackwell: Presumably, given that different economies, you said recently, will have very different exposure to imported commodity inflation, different dependence on oil, different dependence on construction versus other services, this could lead to situations where, if you like, a fit for each country, monetary policy could be very different. Without labour or capital, well, capital mobility, I guess you would probably argue, is adequate, but without labour mobility is that sustainable?

Mr Callow: Yes. I think, on labour mobility, I noticed the European Commission had reported that in Europe this is about half of that across the United States. For example, in the ten years to 2001 only 4.4% of EU residents had moved to a different country, and only 21% had moved region within their country. In Italy, last year, the unemployment rate in the north was 3.8% and in the south it was 12.8%,
which provides us with some powerful evidence that there was not a strong movement within Italy itself. Even for a country which is not particularly large, in a geographic sense, like Belgium, you can find differences in regional unemployment rates which seem quite significant. To my mind, the labour mobility issue is reflecting the fact that is partly cultural but partly the generosity of social security systems, which mean that the financial incentive to move region in Europe is significantly less than it is in the United States. Therefore, this does mean that if a region has lost competitiveness and it is slow to wake up to the fact, and I think there is evidence to suggest that can happen, then it is going to be set for a much weaker period of economic activity. We have the example of Portugal, which has had weak growth and fiscal consolidation, so Portugal, I think, shows us that tough measures can be undertaken, but it has been a considerable strain, I think, for the Portuguese Government to achieve, and even now one could say that it is not completely in the clear with its adjustment. In respect to your question then there are going to continue to be problems associated with differences in interest rates not being appropriate by region. Against that, I think we have to say that this argument obviously was being made before monetary union, and I think one could say, if I may, that monetary union probably has proceeded in a more benign way, as we look at it nine years on, than might have been expected in the light of all the many shocks we have had, particularly from energy prices and currency volatility. Certainly there are going to be considerable challenges ahead, particularly if central banks have to start getting a bit tougher on the inflation issue.

Chairman: Thank you very much, Mr Callow. As often happens to us, with a knowledgeable and experienced witness, we have run out of time. If you have got anything in writing we should be terrifically pleased to receive it, because you have been most helpful and given a very clear banker’s view, from somebody based in a sterling area, which is extremely important to us, it gives you a slightly different view on the euro. Thank you very much indeed for coming; it was very good of you.

Memorandum by Professor Mike Wickens, University of York

HOW TO MAKE THE EURO SUSTAINABLE

To judge by the success of the European Central Bank (ECB) in maintaining average eurozone inflation between 1.6–2.5% since 2000 it may seem unwarranted to question the sustainability of the euro. It is only when we examine the inflation and output performance of individual countries that the strains in the eurozone become evident. Moreover, there is nothing that the ECB can do about this. The following table reveals the problem.

<table>
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<th>Bel</th>
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<td>18.6</td>
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<td>4.8</td>
<td>31.0</td>
<td>18.8</td>
<td>22.8</td>
<td>19.9</td>
<td>23.1</td>
<td>29.3</td>
<td>18.0</td>
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<tr>
<td>GDP</td>
<td>16.0</td>
<td>14.9</td>
<td>14.9</td>
<td>10.6</td>
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<td>10.0</td>
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<td>9.4</td>
<td>27.7</td>
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Percentage Growth of Price and Output 1999–2006

The table shows that some countries have experienced large increases in their price and output levels, while others have had small increases. At one extreme we have Ireland whose price and output levels have increased by 31% and 44%, respectively. At the other extreme we have Germany which has price and output increases of 5% and 11%. Thus, although Ireland has experienced a loss of competitiveness compared with Germany of 26%, its relative output gain is 33%. In contrast, the UK, which is not a member of the eurozone, has an inflation and growth performance similar that of the EU average. EU inflation and growth have both been 15% while the corresponding UK rates are 18% for inflation and 20% for growth. Thus, over this period, through having an independent monetary policy, the UK has maintained its competitiveness with the eurozone—though currently at the cost of a 1.75% interest rate premium.

Two additional pieces of evidence are pertinent. First, the higher the level of inflation on joining the euro, the greater has been the increase in the price level. Second, since the start of the euro, there has been no tendency for country inflation rates either to converge or to diverge.

How can we explain this evidence? One explanation is the “one-size-fits-all” monetary policy. According to this view setting a single nominal interest rate for all eurozone countries implies that high inflation countries will have a low—even a negative—domestic real interest rate, while low inflation countries have a higher—and positive—domestic real interest rate. Since domestic economic activity is negatively related to the real interest rate, and inflation is positively related to economic activity, high inflation countries will have greater...
economic activity and higher inflation, and hence price levels. This view also suggests that country inflation rates will diverge. This argument does not therefore explain the evidence. Although it accounts for the diverging price and output levels, it is not consistent with the observed lack of divergence in inflation rates.

Taking the argument a step further, countries with more rapidly growing price levels will be losing competitiveness to those with slower growing pricing levels. This, together with the greater economic activity in higher inflation countries, should act to raise the exports of the lower inflation countries to the higher inflation countries. Thus activity would be reduced in high inflation countries and increased in low inflation countries. The widely-held expectation is that these effects will be strong enough to act as an automatic corrective to the divergence otherwise inherent in having a common monetary policy. Unfortunately, the evidence suggests that this has not happened. At best it has prevented inflation rates from diverging, but has not resulted in inflation and output growth rates converging.

Mindful of Ronald Reagan’s inadvertantly insightful dictum about economists—that they are people who see things working in practice and try to explain them in theory—Wickens (2007) provides a theoretical explanation for why the two automatic correctives do not result in inflation and output growth convergence.

This leaves two problems for the eurozone, one for the long term and one for the short term. The long-term problem is that, sooner of later, the divergence of price and output levels will threaten the sustainability of the euro. What, therefore, needs to be done in order for the eurozone to survive in the longer term? The short-term problem is that, having given up two of their three macroeconomic policy instruments—namely, control of their interest rate and their exchange rate—countries have only their fiscal instrument left to stabilise their economies. This suggests that eurozone countries require greater fiscal policy flexibility in the short term and not less, as prescribed by the Stability and Growth Pact.

The solution to the long-term problem is to find other ways to regain competitiveness. This could take the form of improving productivity—the Lisbon agenda—or of switching out of economic activities in which competitiveness has been lost. This is what has happened in the UK, and recently in Ireland. In the 1960’s, UK manufacturing comprised over 60% of GDP; now it is only 15%. The enlargement of the EU will accelerate this process; manufacturing will inevitably gravitate to the accession countries due to their lower real wages. The high wage countries will therefore need to rely increasingly on innovations as this will give them permanent respite through a series of temporary monopolies. The broader implication is that it is only by improving the single market for goods, labour and capital that the single currency will survive in the long term.

The problem in the short term has been recognised by M. Sarkozy but, apparently, not by other EU countries. The Stability and Growth Pact has constrained both deficits and debts when what is needed in the short term is greater flexibility in using fiscal policy for stabilising the real economy. The recent amendments to the SGP, with their fines and deficit reduction requirements, therefore went in the wrong direction. The SGP was originally designed to prevent countries running up large debts which they might then be tempted to seek to monetise or default on, thereby imposing costs on other eurozone countries, but it is based on the wrong fiscal principles.

The correct framework for fiscal policy is to tax-finance permanent expenditures and debt-finance temporary expenditures. For example, increases in state health and education expenditures should be financed through higher tax revenues, generated either through economic growth or higher tax rates. But higher expenditures associated with the business cycle, such as unemployment benefits, should be debt-financed. There are two reasons for this. First, it is neither easy nor sensible to vary tax rates in the short run. Second, debt finance maximises the stabilising benefits of these temporary expenditures. There is, however, an important condition that must accompany these fiscal rules: subsequent fiscal surpluses must be used to repay the extra debt, and not used to pay for additional expenditures, or for tax cuts. In this way, greater fiscal flexibility in the short term will not compromise long-run fiscal sustainability, and should therefore result in the SGP being satisfied in the long term.

In summary, there are inherent problems with the euro that, in the long term, could even threaten its existence. One solution may be to leave the euro and, like the UK, have an independent monetary policy. Since this solution comes with a cost—in the case of the UK an interest rate premium of 1.75%—there will be a strong preference among eurozone countries to find a solution in which the euro is sustainable. That solution does not lie with the ECB, which is unable to do anything about the problems, but with individual countries and with EU rules. In the long term it requires a strong commitment to the single market, and in the short term re-fashioned fiscal rules are required that give greater flexibility to achieve economic stabilisation.


July 2007
Examination of Witness

Witness: Professor Michael Wickens, University of York, examined.

Q67 Chairman: Professor Wickens, welcome to the Committee. It is very good of you to come. I need to say to you that you are being recorded and some of this will appear on the website and that you will get a transcript of your evidence at the end of this. How would you like to do this? We have read your most recent paper, which you kindly sent us. Would you like to start with a general statement, or would you like us to start asking questions?

Professor Wickens: Thank you, My Lord Chairman. Having sat on the other side of the table for about nine years with the Economic Affairs Committee, my experience is that if you give an opportunity to someone to make an opening statement they go on for ever and then they cover all the issues and there is no time left for the questions; so I think we should go straight to the questions.

Chairman: Excellent; then we will do that.

Q68 Lord Inglewood: Professor Wickens, do you think it is possible to have a monetary union without a fully functioning single market which has common taxes and labour market integration? In any event, do you think that Europe will not be able to reap the full benefits of currency unification unless you have those kinds of things?

Professor Wickens: I think this is an excellent question that goes to the heart of the matter. One could spend perhaps the whole session discussing this. I think it is possible to have a monetary union without a fully functioning single market, but I think there are very few precedents. Perhaps as a result of this all members of the euro zone, and new members of the EU, are required by the EU to join the euro, to satisfy the Stability and Growth Pact and to enter into the single market, though there is now some question about the degree to which competition is required. I think that, nevertheless, and despite the fact that this is what has happened in the EU, it is possible to have a system which allows individual countries to make their own decisions. Obviously, for the UK, this is a very important issue. It does not seem to me that it is an issue which has been addressed by the EU, and it does not seem to me that the systems which the EU has developed make it easy to pursue one's own policies, and not to have common policies. There are two types of problems that we face; one is long term and one is short term. What we have seen in the long term is that the system is not functioning very well for individual countries; meanwhile it is performing very well at the aggregate level, and this is a bit of a conundrum. In the paper that I sent you I was trying to explore the implications of having a single currency. It is well-known that if you have a single currency then the interest rates which are set will be too high for low inflation countries, like Germany and France, and they will be too low for high inflation countries, like Ireland and Spain. As a result of this, of course, countries with high inflation and low real interest rates will find that capital is relatively cheap. There will then be an incentive to invest, and the increase in output is likely to put pressure on domestic resources and increase the inflation rate. The opposite occurs for countries which have low inflation, like Germany. If one looks at some of the figures, Ireland has had a 31% increase in its price level since 1999 and a 44% increase in its own output. If you take the opposite extreme, Germany, has had a 5% increase in prices and only an 11% increase in output. So if you look at individual countries there seems to be a problem, but if you look at the EU as a whole, one finds that the inflation rate is about on target and an average level of growth is produced, which is okay for some and not for others. The problem then is how one copes with a system which structurally seems to generate such internal imbalances, I think this is the question that we have to address. In my paper, I tried to answer the question usually put at this stage, which says that countries with high inflation and rising price levels are going to lose competitiveness, and if they lose competitiveness that means this is going to put a brake on their economic activity.

Q69 Lord Cobbold: May I interrupt; were they not starting from a lower base and lower prices, and therefore just catching up rather than forging ahead?

Professor Wickens: In fact, what one can show is that there is a very high correlation between the price level increases which have occurred over the eight or nine years, and the initial rate of inflation at which they went into the EU. So there is no sign of convergence in inflation. One might have expected that there would be convergence, and indeed one would expect that, if the system is sustainable in some sense, this convergence is required. What I find is that there has not been convergence, nor has there been divergence in inflation rates. The fact that there are different inflation rates and they are not converging has led to this loss of competitiveness, but the loss of competitiveness does not seem to be able to provide the necessary long-term stabilisation. I think this is the problem. It is not a problem that the ECB, for example, has been keen to address, because their remit, as we shall come on to later on in the questions, refers to the EU as a whole, or the Euro Zone as a whole. The long-run problem is how to deal with this.

Q70 Lord Blackwell: Can you just explain that point about why the loss of competitiveness you think is not causing a brake on inflation in those areas?

Professor Wickens: I think the loss of competitiveness is stopping inflation rates from diverging, but is not causing inflation rates to converge. The arguments of
most people, and the argument of the President of the Bundesbank, have been that Germany’s competitiveness is improving so fast that we are going to be benefiting from this. The evidence does not show that, and my theory, for what it is worth, does not show it either. In principle, one might expect this to happen, but it does not look as though it does. We need to find some system, some way of coping with this, otherwise we are going to run into long-term difficulties. There is another question. That is the long-term; and the short-term problem is that we have found as a result of giving up a single currency, that we have given up control over our own monetary policy, we have also given up control over our own exchange rate, and that means that all we are left with is fiscal policy. How can one use fiscal policy? The answer is that in the long term one cannot really use fiscal policy, so fiscal policy does not really provide us with a long-term solution; fiscal policy can only provide us with some short-term stabilisation possibilities. I will not develop that point now because I think it comes up in later questions, but I think this is something one needs to think about, the short-term flexibility which might be required for fiscal policy, which in my view is not there now.

Q71 Lord Cobbold: How will fiscal policy cope in the long term?

Professor Wickens: Governments provide public goods and these public goods have to be paid for. They are paid for, in the long run, out of taxes. In the short term, however, government expenditures might rise through unemployment payments, due to business cycles, and these expenditures can be paid for through debt. This is not, in fact, the view of the current Government; the current Government’s view is that current expenditures should be financed from current taxes and that capital expenditures can be financed from debt. In my view, this is completely wrong. What one should do is use debt finance for temporary increases in expenditures, and use tax finance for permanent changes in expenditures. What is the role of fiscal policy? Fiscal policy can help provide public goods, it can help provide public capital, it can help generate productivity gains, and this has been a major plank of the UK Government’s policy for a number of years, in trying to improve productivity. Unfortunately, the evidence is that it has not been very successful. Ideally, and this is what the Lisbon Agenda was all about: how to enable productivity gains to be made so that there can be catch-up and stability within the EU overall. My view is that this is a very difficult task for fiscal policy to achieve in the long term.

Q72 Lord Blackwell: Can I just go back to these fiscal transfers, both the direction and the size. What is confusing me initially is, if you have a high inflation country with a low real interest rate, which is therefore expanding fast, you would expect that at some point that high inflation would mean that, the fact is, production will become uncompetitive, and that would mean that eventually the country would suffer high unemployment and therefore would need transfers to it from the other countries. I thought I understood from your paper that you run the other way round?

Professor Wickens: Yes, indeed, and the view you have expressed I think is the standard view. That is why I wrote the paper: because it seemed to me that the evidence did not support the standard view. Thinking of Ronald Reagan’s great statement about economics, that an economist is somebody who sees something working in practice and wonders if it will work in theory, I thought I ought to try to provide a theory which explained the evidence. Of course, there is a lot of ex post rationalisation, but the theory at least does explain the evidence, that inflation rates are not converging.

Q73 Lord Blackwell: You would expect that countries like Germany would need to receive fiscal subsidies from Ireland and Spain, etc., because you would expect high unemployment in Germany?

Professor Wickens: I do not really think that. What I think is that, for high inflation countries there has got to be some kind of inflation tax, which is used to help low inflation countries. This happens in the short term, because, if you take regions of the country, high activity in the South East and low activity in the other regions of the UK, typically results in more unemployment benefits in the low activity regions, and this comes from the tax revenues raised by the high activity regions. Within a country like the UK, and like the US, transfers do take place, and this is what one would expect to happen in the short term. I think the problem is a long-term problem and the long-term problem is much more difficult to deal with using fiscal policy, for the reasons I have tried to explain. We do not even have, currently, in the EU, a short-term stabilisation scheme that works; in fact, the amount of money which is provided by the EU for stabilisation is negligible, virtually zero.

Q74 Lord Blackwell: Regardless of which countries it is and in which situation, depending on the theory or the facts, would you agree that the likelihood is that, as a result of differences in the structures of the economy and different exposure to the world, we will end up within areas under a similar interest rate, some areas that are less competitive and with higher unemployment rates than other areas? If that is the case, if I follow your argument, normally the political lid would be kept on that by transfers; without the possibility of transfers then you have a political conflict between the areas with high unemployment...
and the Central Bank. Am I extrapolating too far; is that what you were saying?

Professor Wickens: No. I think that is a reasonable way of putting it. I would not disagree with most of that.

Q75 Lord Kerr of Kinlochard: I agree entirely with Lord Blackwell. It is a perfectly reasonable way of putting it, but it is not the real world that the European Union lives in, because there is not going to be a big fiscal flywheel transferring resources. In the 1980s and the 1970s it was proposed that there should be, but the decision in the 1990s, reinforced in this decade, was that it was not going to happen. This is why, I think, Professor, you are not arguing there should be fiscal transfers, you are arguing that since there will not be fiscal transfers the monetary union is fragile; which brings me to whether it is not always true of monetary unions. I remember a previous Governor of the Bank of England getting in serious trouble for admitting that the monetary policy being practised by the Bank of England was sub-optimal for Newcastle.

Professor Wickens: As, indeed, it is.

Q76 Lord Kerr of Kinlochard: This is life, and in any entity the policy practised with the aim of being in the interests of the average, or the generality, will produce difficulties somewhere in the periphery. I am puzzled why you call your paper Is the Euro Sustainable? because the implication of that question, given that you talk about the fragility of any monetary union, is that you think it is not sustainable. It seems to me we live in a grey world; we will not have the fiscal transfers, we will not have an unsticky labour market overnight, we will have an imperfect economic distribution of the effects of central policy on the union. That is life. We live in an imperfect world. Am I wrong?

Professor Wickens: I agree with all of that. The only thing I would add is that one has to calculate the costs involved, and the cost may be very high. I think this is the question: how much is a country willing to pay in order to belong to a system which is not otherwise ideal for it. I think this is the problem which has been facing the UK for a long time, and by staying out of the euro it has tried to get the benefits of a single market without the costs of an inappropriate monetary policy. Newcastle, unfortunately, does not have the opportunity to do that, but we wait to see whether Scotland acquires it.

Q77 Lord Kerr of Kinlochard: Is not that a sort of reductio ad absurdum? The idea of a monetary frontier at Gretna Green seems to me to be totally absurd, speaking as a Scotsman. You are not seriously arguing that we should contemplate going for smaller monetary units, are you?

Professor Wickens: No. I am just picking up your point. I do not think the euro will collapse. I think that countries will be willing to pay the cost of being in the euro. So I agree with you entirely that it is not a realistic view to hold—that the euro will collapse. My paper, with the title Is the Euro Sustainable? was really to ask the question what are the problems with the euro and what does one need to do in order that, as we all believe, it will be sustainable. If I gave a question like “the euro is sustainable”, no-one would be very interested, I suspect.

Q78 Chairman: I think the question we are trying to tackle is what can be done to increase mobility of labour and capital within the euro zone to help restore equilibrium after shocks; one of the questions we are trying to tackle. Presumably you believe that there are things which can be done?

Professor Wickens: Yes. May I return, just to add one more thing which relates to this question. We have been talking about the long term but I think the short term is also very important and we have not really talked about the short term. If I may, I would like just to comment on the Stability and Growth Pact. I think the Stability and Growth Pact is completely inappropriate, and one of the problems that the EU has, in my view, is it is neither necessary nor sufficient. It is not necessary because it is perfectly possible to have much higher levels of debt, as we have seen in Italy and Belgium, without there being any downside for the rest of the community, in terms of generating inflation or of excessive unemployment. It is not sufficient because we need to have a criterion which is more forward-looking. What we need to do, effectively, is be convinced that governments can pay off their debts. If the markets are convinced that governments can pay off their debts, it does not really matter what the size of the debt is. What we observe in the SGP is these rigid rules which say that deficits cannot exceed 3% and debts cannot exceed 60%. In fact, over half the original members of the EU have debts greater than 60% and yet nobody says that this is likely to bring down the EU. The recent changes to the Stability and Growth Pact have required that governments which have deficits in excess of 3% have got to bring them down, what is it, half a per cent of GDP per annum; but this is only likely to make matters worse for countries which suffer a shock and need to have higher deficits in the short term in order to stabilise their economies. It seems to me that there are great difficulties in tackling long-term problems, but most of the short-term problems we are seeing can be solved by recasting the Stability and Growth Pact in a way which is consistent with the general principles of fiscal finance. I think this is a problem which the EU must address, and the recent changes it made to
the Stability and Growth Pact have not helped at all in this.

Q79 Lord Cobbold: Surely that is the purpose of the Stability and Growth Pact, to provide some club rules for those members of the single currency for their fiscal policies? Once they are prevented from devaluing their currency, competitive devaluation for debt, surely then they rely on fiscal policy and the Stability and Growth Pact gives the rules of the game?

Professor Wickens: Do we really need rules of this sort? The problem is, because you have given up your monetary instruments and you have given up your exchange rate instrument, how are you going to manage your economy? The only way you can do that is to have a more flexible fiscal policy, and that flexible fiscal policy requires you to allow intermittent stabilisers to work in terms of dealing with negative shocks. This requires higher deficits, possibly. The constraint on the deficits that we have now may slow down, and even prevent, the return to some sort of full employment. In addition, if one has a debt criterion which says that debt may not rise above 60% then that means one is unable to spend more in the short term and finance it by borrowing. I think the fact that there is a rule, in a way, is neither here nor there. What worries me more is that it is a bad rule. I do not mind having a good rule but the Stability and Growth Pact is not a good rule; we need a different rule, and the UK needs a different rule too.

Q80 Lord Cobbold: It is relatively new, it has been revised once and it needs perhaps a slightly greater degree of flexibility in the light of experience?

Professor Wickens: It is not very encouraging though to see that, in the light of experience, the changes that were made have gone in the wrong direction.

Q81 Lord Kerr of Kinlochard: It sounds to me as if you should accompany President Sarkozy to ECOFIN next Monday, where he appears to be going to make a case which you will like. Professor, that the rules need to be further relaxed. I must say, it seems to me the crucial rule is “no bail-outs”; that is at the core of the idea. If I am the new Finance Minister of Rutirania, a member of the euro zone, I have just got in, I am tempted to reduce taxes and raise debt, and to believe that all will be fine because the ECB will stand behind me for ever. I need to believe that is not true. I need to believe that they will not bail me out if the markets go for me. In order to have something to give credibility to that ultimate sanction of “no bail-out”, you do need some sort of agreement, rules of the game, as Lord Cobbold would say, surely?

Professor Wickens: Yes, I agree. It is certainly true that if we look at the role of capital recently, there has been a dramatic change in the extent to which countries borrow from other euro countries, and that is important for stabilisation. I think I had a figure somewhere, which I seem to have mislaid, but I think it has gone from something like 15% of national borrowing to something like 60; that is an enormous change in the reliance on other European countries, and that must be good for stabilisation. Also it reflects the fact that sovereign debt is not thought to be likely to be defaulted on. We notice also that bid/ask spreads have been reduced considerably, and this shows that there is greater liquidity for governments to borrow from the private sector. Also we have seen that the risk premia have fallen on government debt, which is another sign, I think, that there has been greater certainty about the abilities of governments to be able to sustain their debts. All of this supports the argument that we can sustain a high level of debt in the short term. The markets have looked at the situation and they seem quite confident that the system is working well. I do not think that loosening these debt criteria is going to make life that different. I think markets would be quite sanguine about that. In fact, they might even like it, because hopefully it will allow these countries to continue to grow faster.

Chairman: That is very interesting. Lord Jordan.

Q82 Lord Jordan: Has the European Union’s enthusiasm for enlargement led to a situation where the entry criteria for the euro zone are just a reflection of a country’s ability to join the currency area, and are there elements in those criteria which you feel are really harmful, as a starting-point?

Professor Wickens: Most countries, of course, want to join in order to be able to get the benefits of lower borrowing costs; most countries that join face very high interest rates relative to the rates they would face once they are in the EU, and they want the benefits of trade. Then the country is required to meet the inflation criteria, the SGP criteria, and for some countries that is a difficult thing to do. The only concern that I have seen expressed is that the inflation criterion is too strict, that countries have got to meet the rates in the best three inflation countries rather than the average; that might be too tough. The countries in Europe obviously want to join the EU and they are willing to pay the price, so to speak, of stabilising their economies in order to do so. I think the answer is that in a way it is something which is outside the control of the EU, because once countries want to join and they have satisfied the criteria it is difficult to keep them out. I think that is the message, even though obviously there are other consequences, which could be quite costly.
Q83 Lord Jordan: Is not there a case, therefore, for making the criteria even more difficult?
Professor Wickens: All one wants really is that countries which join should not default on their debt. I think, provided that is true then the spill-over effects to other countries are relatively small. As a result of the expansion, of course, what we have seen in Europe is globalisation within Europe; all the problems of globalisation that we talk about are in Europe. Jobs have been lost to new countries which have come in, because they have got lower wage costs, so that is a cost to workers, but the benefit to the consumer has been lower prices. All the while you have the tension between the benefit to the consumer as opposed to the worker. We have also seen labour mobility within Europe and I think labour mobility again has benefits, in that it keeps wages down. But obviously it raises costs to everyone else, in terms of the pressure on resources—as we have seen. Somehow or other, what we have got to do is get the benefits of this at the same time as managing the downside, and I think the downside is quite high, in the short term, but maybe, in the long term, those costs will tend to disappear.

Q84 Chairman: We wanted to ask you about the impact of the expected enlargement of the euro zone. This was not a sensible question because if very small countries join it cannot be going to make any difference, but would you like to attempt the question in terms of, if Poland or some other really large country joins, what would you expect to happen to the function of the euro zone economy and the management of monetary policy in the euro zone?
Professor Wickens: It is true. If a country comes in—to deal with the last point first—with a high inflation rate then the average inflation rate in the whole euro zone rises and therefore interest rates will have to be raised. Of course, that can only make the position of Germany—low inflation countries—worse. So it is clear that you have to have fairly strict inflation criteria for entering countries. I think that is fairly obvious. If we look at the case of Poland, what is offered is the opportunity of cheap labour, as I was mentioning before. A lot of German companies, for example, have moved to Poland. A lot of production now takes place there; this has harmed German jobs. If you look at the UK, in 1960 something like 66% of UK GDP was produced by manufacturing industry and now it is down to 15%; and the same sort of thing has happened in the US. What we have observed is that countries like the UK—high-income countries—specialise increasingly in hi-tech goods and services. Poland and many of the other recent accession countries are still in manufacturing mode; they are still providing us with cheap goods, they are not competing in services; they are also providing us with labour because people in those countries recognise that they are getting relatively low wages, want to have high wages immediately and want to move. As a result of this, we are seeing a lot of migration taking place. This is globalisation, which we talk about in terms of the world, but is occurring in almost exactly the same way within the EU. So if you think globalisation is a good thing you will certainly be keen on expanding the EU.

Q85 Lord Cobbold: What about a single world currency?
Professor Wickens: I do not think a single world currency would be something I would support. And I think it would be a long way ahead.

Q86 Lord Cobbold: Slightly relating to that last comment, how do you see, in the global economy context, the exchange rate of the euro versus the dollar being adversely affected by a Chinese surplus, a switching from reserves, and do you think this is a problem which is going to affect the economy of the Union?
Professor Wickens: I think the evidence is that there has been very little real exchange rate adjustment for the EU in recent times. Again, if one looks at China and the United States, the Chinese economy has been very good for the consumer because it has provided cheaper goods; you could argue it has been bad for the producer because it has meant that more goods are produced in China than are produced in Europe. This will only increase the trend towards specialisation in services and hi-tech activity, and away from production using standard technology. If you look at the United States, we have got the completely opposite problem. The United States has run a large trade deficit, and that has been good for Europe, in the sense that we have been able to sell more goods to the United States as a result. The United States probably has had to run a large trade deficit because the world demand for its assets is so strong. Because the balance of payments has got to balance, the only way you can offset the huge capital inflow is to have a large current account deficit, in other words, a large trade deficit. To some extent, that is inevitable. If there is a correction to the exchange rate in China, so that the renminbi appreciates and the dollar depreciates, we are going to reverse some of those things. More expensive goods will be worse for the consumer but better for the European producer; a lower dollar will be worse for the European exporter but will be better for all those goods which are priced in dollars in the world. As always happens with these things, it really depends on who we are talking about. Interestingly, traditional economic analysis always measures welfare in terms of the consumer rather than the producer, so if you look at the benefits for the consumer you would welcome what has been
happening in China and probably you would prefer to have a lower value of the dollar.

**Q87 Lord Jordan:** Is not the cost gap in China’s manufacturing and Europe’s manufacturing so large that any appreciation of China’s currency would hardly dent that competitive edge? **Professor Wickens:** I think that is right. We have been gainers, as consumers, from China, as I have mentioned, and I think it is very unlikely that the Chinese Government will allow the renminbi to appreciate substantially to make any significant difference. There is not much that the EU can do about it. I remember being at an ECB meeting when it was announced at the start of the meeting that the ECB was intervening in the foreign exchange market, and I thought to myself at the time: I bet that does not have any effect. It turned out that it had an effect for about half an hour; so there is not much that the ECB can do to control the euro exchange rate.

**Q88 Chairman:** It falls to me to thank you very much for coming, Professor Wickens. We found your paper most interesting, and if there are any other papers you would like to put in, in evidence, we would be very glad to receive them. We are most grateful to you for coming to talk to us today. **Professor Wickens:** Thank you very much. You have added a large number of very useful questions that I can pass on to my students in the future. **Chairman:** Good. Thank you.
Q89 Chairman: Good morning and welcome to our Committee. I apologise on behalf of our Chairman, Baroness Cohen, who is away, and I am standing in for her on this occasion. May I just remind you that this session is recorded and a transcript will be available and will be sent to you. Is there anything particular that you would like to say before we start? Mr Tilford: No, I do not think so, that is fine.

Q90 Chairman: You have had a list of the topics? Mr Tilford: I have had a list of indicative questions, yes.

Q91 Chairman: I thought in this session we might start with a more general question. As we have seen in your paper which you have circulated to us and we have had a chance to look at, you seem to recognise some of the successes of the eurozone but to be doubtful about its long-term sustainability, and the question is do you really think it will crack, and if so why or can it be saved and if so how? Mr Tilford: I think the balance of probabilities still is that it will not crack but many Member States have underestimated the disciplines and the implications for policy of membership and they have done that because there has not been sufficient recognition of what membership of a currency union implies. We have seen marked divergences in competitive positions within the eurozone which at some point will have to be arrested and reversed. On current trends I think there are some serious tensions that cast some doubt over the sustainability of the current membership but on balance I think it will not crack because obviously a currency union can survive huge divergences as long as the costs of leaving outweigh the costs of remaining in the currency union. However, that does not mean that life is going to be comfortable for many Member States that have lost competitiveness. I think that we are going to see a number of economies experiencing very weak growth and a really rather torrid time almost indefinitely without taking steps to regain competitiveness, but I do not see it cracking on the balance of probabilities, no.

Q92 Chairman: What do you think have been the good points about it to date? Would we have been better off if we had not had it?

Mr Tilford: The problem really is that many of the issues that countries such as Italy, Spain and Portugal have are problems that they would have had in any case. One of the points we drew attention to in the piece we wrote is that in some ways membership has insulated them or has provided them with the space and the opportunity to go slow on necessary reforms, so if you take Italy for example, back in 2000, Italy had a huge primary budget surplus of about 5% of GDP. Instead of using suddenly much lower debt servicing costs to consolidate its public finances it basically eased up, particularly under Berlusconi, and much of the work that the Italians did in the run-up to joining the euro was reversed and undermined by that Government, and Italy went from having a 5% primary budget surplus in 2000 to no primary budget surplus at all in 2006. Had they still had their own currency they would not have been able to do that because there would have been a run on the lira and they would have faced much higher debt servicing costs and hence there would have been problems, but that is not necessarily an argument against the euro. I think it has enormous potential. If it enables us to fulfil the potential of the Single Market and to develop a truly integrated European economy then great, but there is nothing inevitable about that. For it to be able to do that there has to be a recognition of what is needed to make a currency union work effectively. When you are dealing with a currency union like the eurozone where there is virtually nothing in the way of labour mobility between the Member States—there are bits of labour mobility but nothing really and, for example, there is more labour mobility within the US than there is between individual states of the USA let alone across the eurozone so there is no labour mobility and there is very little in the way of fiscal transfers—so if an economy, say a state in the US, gets into trouble, loses competitiveness, its growth weakens, there are mechanisms to cushion the blow on that state because there are transfers to wealthy more dynamic states. In the eurozone we do not have that so we do not have labour mobility, we do not have fiscal transfers and in the absence of those two things it is of paramount importance that a number of other criteria are met. You need the economies to be as integrated as possible so trade flows, trade of goods and capital, which can prevent differences in inflation
becoming entrenched between the Member States. You need a very high level of competition across as much of those economies as possible to force economies into being more innovative, boosting productivity. One of the key problems we see in the eurozone is posed by weak productivity growth. If productivity growth is weak, the burden of adjustment between economies that have lost competitiveness vis-à-vis more successful ones has to fall on wages, and that can be hugely costly, particularly if wages in the most competitive economy, ie Germany at the moment, are not rising.

Italy faces a big challenge at the moment: how to regain competitiveness and how to undercut the Germans when German unit wage costs are stagnant or falling, and that is a big problem. For Italy to regain competitiveness it needs to boost productivity but the policies needed to boost productivity only take effect in the medium to long term. In the short term they are going to have to make sure their unit wage costs rise less rapidly than in Germany. That is a problem, so you need competitive markets; you need the economies to be as fully integrated as possible; you need flexible labour markets so that real wages can fall relative to real wages in other Member States and to make it easier for workers to move from under-performing sectors to higher growth sectors or more productive sectors; and you need fiscal discipline because particularly in the absence of a mechanism for fiscal transfers, you need public finances to be managed on a very sustainable basis so that if an economy does lose competitiveness it has the opportunity to cushion the blow just by loosening fiscal discipline to a certain extent so as to cushion the blow and put policies in place that should enable the economy to gain competitiveness. Ideally you also need some convergence in per capita GDP so the economies respond to external shocks in a roughly similar way.

Chairman: We will be going into some of these topics in more detail. You mentioned Italy and—

Q93 Lord Steinberg: I was going to come in before you move on. As more and more countries join the eurozone they are generally the weaker rather than the stronger countries that come in and that is obviously going to place a greater strain on the rest of the eurozone whose economies, relative to theirs, are quite strong. What do you see being done about helping and assisting the weaker countries who are in the process of joining the eurozone?

Mr Tilford: I do not think much is going to be done to help. I think there is a lot of unease about further expansion to include relatively weak Member States. I think the problems that a number of countries have found themselves in like Portugal (which stands out), Italy, and potentially Spain (and Spain is held up currently as an example of a successful economy but if you look at what has been driving growth there are some real question marks over the sustainability of that boom because Spain has lost even more competitiveness than Italy), there is not the necessary solidarity within the eurozone for a mechanism for fiscal transfers to be put in place. It is almost impossible to imagine the more successful, richer Member States such as the Netherlands and Germany agreeing to that. And I think there is a real risk that if further Member States join before they are ready then we could see them getting into similar difficulties as some of the Mediterranean economies currently find themselves in and we will see the stronger Member States benefiting disproportionately from the eurozone, which I think is what we are seeing at the moment. The Germans and the Dutch are clear winners from this. Ironically they were expected to be among the losers but only in the very short term will the winners I think be the Italians and the Spanish because in the very short term they saw huge reductions on their debt servicing costs, very low or even negative real interest rates, but that is a very short-term benefit. The clear message that we are seeing so far is that it is the Germans and the Dutch that are emerging as the clear winners from this.

Q94 Lord Blackwell: Could I then come on specifically to Italy. The general case as you have set it out and as I understand it, is weaker economies like Italy going into the euro have had effectively a free ride in the initial period because they have been buffered by cottoning on to the stronger economies and low interest rates and the confidence that that has provided, but that is building up, nevertheless, the need to make adjustments sooner or later to deal with competitiveness divergence. The Italian economy nevertheless at the moment is forecast to grow at a reasonable rate over the next couple of years. What are the adjustments that you think are needed in the Italian economy? You have talked about things that are needed across the EU in terms of labour mobility and fiscal transfer, et cetera, but if you take Italy, what do you think are the adjustments that are needed in the Italian economy and what will drive them against the political background in Italy to want to face up to making those adjustments?

Mr Tilford: Two things are needed for Italy to regain competitiveness. One is a sustained pick-up in the German domestic economy, and I think this is neglected. Germany for a number of years now, for seven or eight years, has been dependent for a good part of its growth on rising net exports to other members of the eurozone. That is not to say Germany is pursuing very good labour policies, it is not, but I think much as membership has lessened the necessity for the Italians to put their public finances on a sustainable basis, I think it has also undermined
pressure on the Germans to address the underlying reasons for the weakness of their domestic demand because they have been able to rely on their exports. For Italy to regain competitiveness, I think first and foremost you need the German domestic economy to strengthen so for German growth to be carried as much by the domestic economy as by exports, and indeed if you look at how Germany has gained competitiveness in recent years, it did that by holding down wage settlements essentially. Productivity growth was not that impressive, it just held down wage settlements, but because wage settlements were too high in Italy and Spain and a number of other economies it managed to reduce its unit wage cost dramatically vis-à-vis the eurozone average. For Italy to be able to do that, firstly it needs to address some of the domestic obstacles to stronger productivity growth, so I think that requires them to look very carefully at much of their service sector much of which is essentially protected from competition and highly regulated, and that is a major obstacle. If you look at its productivity in the service sector right across Europe, but particularly in southern Italy, that is holding back our economic performance as a whole vis-à-vis the US. If you look at the last ten years in particular we have seen a huge pick-up in service sector productivity in the US which has not been matched across Europe, with the exception of one or two economies. They need to look very carefully at that. I think Italy more broadly has a very unfavourable industrial structure which is concentrated in low to medium-tech goods which are relatively slow-growing and where it is actually difficult to boost productivity. I think there is a weak use of ICT in Italy. If you look at levels of investment in information technology in Italy they are much lower than in comparable economies even in Europe, let alone compared to the States. There are all kinds of things, ethnic skills generally, higher education, levels of R&D—they need to look at a whole range of issues. The problem with all of those things is that they are all addressable, and of course they can do that, but they need to move very quickly to prevent further loss of competitiveness. My concern really with what we have seen in recent years is that it is going to be very difficult for them to do that without Germany picking up because it is one thing for Germany to gain competitiveness vis-à-vis other countries when they are pursuing relatively irresponsible labour market policies and when their wage settlements have been excessive, but for Italy to regain competitiveness when German wage settlements are going to remain where they are. They have picked up maybe but you are probably not going to see increases in German unit wage costs overall, so I think it is challenging for Italy, I am not saying it is impossible, but I think there is a tendency to underestimate the extent of the challenge some of these economies face.

Q95 Lord Blackwell: In your report you put at 40% the probability that Italy would not successfully make the changes necessary to make the euro work and a 40% probability that it would leave the euro at some point.

Mr Tilford: I think that is too high. I think what we are seeing in Germany is positive. I think there is a much greater chance than appeared likely a year ago that the German economy will start growing sustainably, ie that we will see a real pick-up in domestic activity. I think it is still too soon to be truly confident that that is going to happen because they still remain quite dependent on the external sector and if there was a big external shock then German economy world slow quite rapidly, but it is much easier now than it was 12 months ago to be positive about that outcome for Germany. That will make it much, much easier for Italy. Also I think I underestimated the costs that Italy would incur from leaving, so on balance there is still a chance that it could happen but I think we overstated the likelihood of it happening. That does not mean I am any less positive about what we are seeing in Italy. I do not think the new Italian Government has done that much really, and they have only made some small changes so I am not really more optimistic on that score, but I am more optimistic about Germany and more pessimistic about Italy being able to cope with the costs of leaving.

Q96 Lord Trimble: I wanted to refer you to the European Central Bank and just ask you what your views are with regard to the policies that the ECB has been adopting and the way in which it is managing the euro?

Mr Tilford: I think this is a second order issue. If you look at the tensions within the eurozone, I think a lot of criticism has been levelled at the ECB for pursuing an allegedly excessively restrictive definition of inflation. I think it is perhaps a little bit too restrictive because for example I think it makes it harder for economies that have lost competitiveness to regain it if the inflation does not stay at 2% because that increases the risk of deflation or excessively low inflation with the obvious impacts on output. Two or close to 2% is too low. At the same time I do not think we would be materially less concerned now about what we are seeing in the eurozone had they been pursuing a 2.5% target rather than a close to 2% one. I think generally they are right to constantly allude to the need for certain types of reforms and to argue that fiscal discipline is an absolute necessity. I think where there has been a problem is a failure to differentiate sufficiently between current spending and investment spending but that is not an ECB thing; the Stability and Growth Pact needs to look at that. They have reformed to an extent but I think one of the worrying things we have seen across Europe in recent years is
the decline in net public spending, particularly on infrastructure, and that has happened in many countries because they have been trying to control public spending and because the Stability and Growth Pact has not made a distinction between current spending and investment spending.

Q97 Lord Trimble: We went to visit the ECB a couple of weeks ago and in meetings with them we put the familiar arguments about their target being too inflexible and how if they had a more flexible approach such as we had here this might make things easier, and I was struck that each time we raised this issue the ECB response was, “Well, these countries have to reform, they are going to have to do it anyway, and us being a bit more flexible is not really going to help them in the long run, they just have to do it.” That approach might have some economic merit from a banker’s point of view but it is leaving out the political dimension that some of these countries are going to have huge difficulties making the political decisions that are necessary. I am curious as to how all that is going to work out in the long run.

Mr Tilford: That is the core challenge. In the case of some countries it is going to be very difficult because they have got to do this at a time when public support for market-orientated reforms is on the wane. People are very, very anxious about the impact of globalisation and more open markets generally are having on their living standards and on their security and it is very hard for governments. The argument they have to win is without doing this we are not going to be able to compensate the losers from globalisation, without we can boost growth in productivity we are going to be very poorly placed to compensate the groups in society that are going to lose from this process. Clearly that is a big argument to make, particularly in economies where there is a visceral suspicion of more open markets and of the merits of globalisation, and so I think it is a tough one, and hence that is why we struck a rather downbeat tone in the piece we wrote because we see that some countries do face big challenges.

Q98 Chairman: You argue the fact that the Single Market is not yet complete and that is one of the points that is threatening the sustainability of the single currency. Can you tell us any steps that might be taken to complete the Single Market?

Mr Tilford: I think a huge missed opportunity was the Services Directive. I think this is one of the few downsides of enlargement. Had we not had enlargement then I think the original Services Directive would have stood a much greater chance of being agreed but because of the fear of “dumping” from some of the new Member States, that was watered down to the point where the returns, I think, will be relatively modest. Clearly services are never going to be as tradable as goods but the fact that services account for only 20% of intra EU trade and they have remained that proportion for a number of years now, and have actually fallen slightly, is a problem. Information technology has made more and more services tradable and we should be seeing the proportion of intra-EU trade accounted for by services rising; we are not. I think one of the reasons why our productivity performance is so poor compared to the US is that large parts of the service sectors of our economies do not have the necessary scale and incentives therefore to invest and to innovate in the way they do in the US and that is why productivity is low. One thing we really need to do is accelerate the integration of service sectors. I think the Commission with some of its sectoral inquiries is doing a lot of good work in that area. Completing the Single Market is hard. You cannot just continue to regulate and regulate and regulate because obviously we find ourselves in a very different position as compared to the late 1980s. Lots of the growth industries now are high tech, they are service based, and you cannot standardise across all of these sectors. You have to find new ways of making sure that markets are competitive and open without legislating across every last little bit of activity because obviously those regulations quickly go out of date. I think we have to concentrate on removing the principal obstacles to greater integration within the EU. It is interesting that intra US exports are 70% higher as a proportion of US GDP than they are within the eurozone. We are still not that integrated. There is this perception that the Single Market is complete and that we are now integrated. We are really not and we are nowhere near as integrated as I would argue we need to be.

Q99 Chairman: That is something that is growing all the time, is it not?

Mr Tilford: Much less than you think. It is interesting that intra eurozone trade has barely grown more rapidly than, say, UK trade with the USA since 1999. There has been a slight deepening but it is nothing like what people expected. To accelerate that deepening I think we are going to really need action on services.

Q100 Lord Inglewood: I was involved in the political debate in Europe about the Service Directive and I can corroborate it, but it is part of a wider problem which is in terms of completing the Single Market, as always with these things, you deal with the easy bits first. I wonder whether you can argue from what you have told us that the introduction of the eurozone is going to have the effect of driving the Single Market towards completion. You can make quite a strong argument from what you have told us in your
problem and the urgency of doing something about it. Government that they appreciated the extent of the problem and the urgency of doing something about it. Certainly there was no sense under the Berlusconi right, in Italy will be able to take the necessary steps. I think you would need to see the moderate elements on the Italian economy but from what I can see I would be in other ways if they were to leave could at some point focus minds. I am not sufficiently expert to me the eurozone project is actually going to drive forward the Single Market. What is your view about that hypothesis? Mr Tilford: That is certainly the hope. I was a firm advocate of the euro and indeed UK participation in it, and that was one of the reasons for my confidence and for my belief that it was a good idea and the “there is no alternative” argument was a strong one. Ie that because the costs of inaction would be so fierce countries would have absolutely no option but to take the necessary steps, and if you rule out the option of devaluation what better way of forcing governments to ensure their economies are sufficiently flexible? The problem is that since the adoption of the euro, the pace of reform has actually slowed, so instead of seeing an acceleration of the kind of reforms we would need in terms of labour markets and product markets and the completion of the Single Market, the pace of reform really has actually slowed and it has been no more rapid than in, say, the free EU 15 Member States that did not join and who actually start from a much more favourable position. I agree that because the only option is a hugely costly one, ie to leave, that should limit governments’ options and leave them with no choice, and long term, yes, the hope is that will happen but so far there is real cause for unease.

Q101 Lord Inglewood: There are two ways to get things done, you can either dangle the carrot or wave the stick. It sounds to me the way you have put it that the pace of change has declined and so the carrot is not really there any more but the stick in the form of pain may be the thing and we need a bit more pain, on this hypothesis. Mr Tilford: It is all a question of how countries respond to the pain. In Italy’s case although we argued that we thought there was a very significant chance that they would end up actually being forced out, I think awareness of quite how great the pain would be in other ways if they were to leave could at some point focus minds. I am not sufficiently expert on the Italian economy but from what I can see I think you would need to see the moderate elements on both the centre left and the centre right coming forward to force through the necessary changes. It seems unlikely that the Government, the left or the right, in Italy will be able to take the necessary steps. Certainly there was no sense under the Berlusconi Government that they appreciated the extent of the problem and the urgency of doing something about it. I think the current coalition is very broad-based and they have taken some steps but they are hostage to certain groups within that coalition that are very firmly opposed to the kind of steps that I think most economists believe Italy needs to take.

Q102 Lord Inglewood: In the context of Italy, are the publicly produced statistics we have seen relevant or is the Italian economy so different in reality from the picture that is painted by the statistics that we cannot be sure about all kinds of things in Italy? Mr Tilford: Obviously Italy is experiencing a cyclical upturn.

Q103 Lord Inglewood: The Italian statistics—there is a big black economy in Italy. Mr Tilford: But that is taken into account anyway.

Q104 Lord Inglewood: And you are still happy that your reservations are accurately taken into account? Mr Tilford: I am not an expert in Italian economic data but the country’s economic statistics are accepted by the OECD, by the IMF and by the European Commission and I do not think there are significant concerns over the reliability of Italian economic data. However, I am not an expert.

Q105 Lord Maclean of Rogart: Although the route towards the completion of the Single Market may point to sunny uplands, if it were to be implemented it must be the case that in the medium term there are winners and losers and that the pain of losing is such that it is difficult for governments like that in Italy at present to contemplate the necessary steps, although they clearly seem to have recognised the need. It is with that political problem that it seems to me the Union needs to grapple and, consequently, I am puzzled by your statement that you do not think there is the necessary solidarity within the European Union to help to ease the passage. Mr Tilford: I do not think there is the necessary solidarity. If we take fiscal transfers to cushion the blow, I am not even convinced that that would help necessarily because they had a big fiscal cushion for several years, and that was the solidarity if you like, because following the adoption of the euro they had several years of much, much lower interest rates than they otherwise would have had and the opportunity was largely squandered. My argument there though is that I do not see the solidarity needed for a system of significant fiscal transfers.

Q106 Lord Maclean of Rogart: What is sufficient is not calculable, obviously it is a political judgment, but if there was a willingness to recognise on the part of some of those other rather better-placed countries that there was a global problem to overcome and that if they were willing to make a contribution (it might not be very much) then it could have the necessary
effect of making the Members who were not succeeding so effectively succeed.

Mr Tilford: I do not think there is any sense in the more successful countries that they share responsibility for what is happening. The debate in Germany, which I follow very closely, is basically along the lines of: “The Italians are in this position because they have failed to take the necessary steps. We have taken tough decisions in recent years and we are now reaping the rewards of those tough decisions and the Italians have to do similar things.” That is the line that the ECB takes and it is the line that most of the central banks take. As I said earlier, that is not the whole story because I think in some ways Germany is part of the problem here. We cannot have easily the biggest economy in the eurozone living indefinitely from the external sector so I think Germany is part of the problem, but there is no recognition in Germany or Holland that they are part of the problem. If one was to argue that in those countries there is no sense of that being the case.

Q107 Lord Maclennan of Rogart: The Stability and Growth Pact in a sense is very one-sided because it is addressing only certain aspects of the bigger problem. Is there any reason why in the desire to have a pact, if you like, that does implement all these competitiveness improvements and labour market demand that some of those transitional problems should not be addressed within a revised Stability and Growth Pact?

Mr Tilford: I think there is a case for it.

Q108 Lord Maclennan of Rogart: That is what I am saying.

Mr Tilford: I think there is a case for it but I do not think it is politically feasible.

Q109 Lord Maclennan of Rogart: That is a political judgment?

Mr Tilford: Yes.

Q110 Lord Maclennan of Rogart: It is not an economic judgment?

Mr Tilford: No, I think there is an economic case although it is weakened somewhat by the fact that the economies that find themselves in trouble, particularly Italy, wasted a big opportunity to put their public finances on a firmer footing and to use the opportunity afforded by reasonable growth at the beginning of the decade to implement structural reforms, so I think there is an economic case potentially but politically I find it unfeasible and also economically it might not help, it depends on if the governments in question use the opportunity to actually take steps or whether it just gives them an opportunity to delay further implementing those necessary policies.

Q111 Lord Blackwell: I want to come back to this point on the Single Market. I wonder whether you are not perhaps being a bit optimistic that an open and competitive Single Market will force the adjustment. It seems to me the other possibility which we may be seeing signs of is that faced with these kinds of adjustments the Single Market is being turned into a social market with regulation being used to prevent the adjustments and share out a level playing field rather than to force open competition.

Mr Tilford: I think the strongest argument against common economic and social policies as an answer to the divergences we see in the eurozone is that you could then see the institutionalisation of rigidities in labour product markets at a European level. I do not think that would be in anyone’s interests. I think the only way we are going to achieve a situation where adjustment happens relatively fluidly is if there are flexible, open, competitive economies working within the Single Market. I think that is the only way we will get the necessary adjustment. Obviously policies in one country affect others and that is unavoidable but I do not think we would address the problems we face by that kind of institutionalisation at the European level.

Q112 Lord Blackwell: No, but are you confident which direction it is going?

Mr Tilford: Not entirely, no, for the reasons we discussed earlier that I think there is an increasingly protectionist, anxious mood across Europe and that makes it much harder to argue the case for the kinds of reforms that we are talking about. It makes it harder to argue the case that we need these reforms in order to ensure competitive outcomes and that economies continue to grow. It is not helped by the fact that in many Member States we have seen widening inequality in recent years in response to certain types of economic reform. That makes it harder to sell further reforms, it makes it very hard, so I think it is challenging.

Q113 Chairman: Do you think the new French Government may have rather material effects and a beneficial effect on overall growth in the Community?

Mr Tilford: I think their strategy towards the French labour market is the right one but, like many other people following this, the reservations they have over European competition policy and the support for certain types of relatively protectionist industrial policy are potentially damaging. I do not think there is any argument at all for any dilution of European competition policy or for greater allowances to be made for support for state aid for European companies. The argument that we need to allow matching aid—ie if there is competitive state aid given to companies that European countries should be able to that match state aid—ignores the fact that
when companies are choosing between various locations to make an investment, the three or four locations are usually all in the European Union, so if you allow the French to start providing more generous state aid to companies, all that is going to do is come at the cost of various other European locations and risks triggering subsidy wars between the various Member States. I think he is responding to French unease about the declining economic influence of Europe and the mounting challenge that we face from various Member States. I think the only way of underpinning our competitiveness and addressing the problems we have is by investing more in skills, in education and in infrastructure, and ensuring that we move into higher value-added sectors, and I do not think that is going to happen by making it more possible and by making it easier to support certain companies.

Q114 Lord Inglewood: Just arising out of that, paraphrasing what you said, the problems or the challenges are in implementing these strategies. The strategies are good; it is implementation that is going to be the problem.

Mr Tilford: On the labour market?

Q115 Lord Inglewood: Absolutely. Do you think he is going to succeed?

Mr Tilford: In the short term no, because I do not think things are bad enough in France for the French to accept that. I think the portrayal of France, particularly in the media here, is often excessively negative. France has some problems but things are nowhere near as bad as I think many people think they are and there is no perception of crisis really. There might be a sense of an existentialist crisis but there is no sense of a social and economic crisis outside of various suburbs of Paris and Marseilles, so I do not think it is going to be easy, no. He has a decent mandate and I think it is hard to imagine him backing off and retreating in the way previous Presidents have done, certainly President Chirac, but I think it will be difficult. I do not know but I suspect that in the short to medium term we will probably only see modest reform and we will only get substantive reform in the long term when problems are rather greater.

Q116 Lord Steinberg: Can I ask you about what governments need to do in terms of fiscal discipline and labour market deregulation to reap the full benefits. If I can elaborate on that a bit. About a year ago in this Committee we discussed the Lisbon Agenda the ideals of which are perfectly sound in asking for more employment to take place throughout the EU (but in practice is something that every country wants to see anyhow) and it has an ideal of employment control and regulation seems to be an absolutely dead duck insofar as it is really stating the obvious that every country wants to improve its labour force in terms of reducing the amount of unemployment. So when we talk about labour market deregulation, do we mean complete access between country and country without any restrictions whatsoever? As you well know, Britain’s policy of open doors for people within the EU is beginning to receive quite a bit of criticism, and I am not talking about the other unfortunate aspects that we have had to suffer recently; I am talking about the influx of people and particularly the lack of abilities in trade, and by trade I mean the employment of people who are specialists in their various jobs. It may well be, and this is not an exact example, that perhaps Poland, and we have had a big influx of people from Poland here, have got skills for example in joinery and plumbing (I do not know whether that is true) and maybe in Italy they have got skills in other areas. Do you think that it is a realistic thing to have complete labour deregulation without any real control?

Mr Tilford: We have had that in the EU 15 for many years now without experiencing too many problems. Clearly the EU has become much more heterogeneous. The differences in living standards are much bigger now than they were even between Poland, which is not the poorest EU Member, on the one hand and the UK and Ireland on the other hand, clearly there is a gulf in salary levels if not quite such a big gulf in actual living standards. I think it depends on the country. In the UK’s case it has been hugely positive. This happened at a time when we were suffering skills shortages across a whole range of sectors. The overwhelming majority of people who have come in are actually doing work which they are skilled for, so we have brought in a lot of young, skilled people which I think has been a huge boon for the UK economy. That is not to say that the UK or the Irish policy on this would have been the right policy for every country. I think it is understandable that the Germans, for example, who were suffering very high unemployment at the time and who had a surfeit of people in the kind of sectors where we had a shortage, ie construction, opted against opening up from the very outset, and I think the fact they have a transition period in place is understandable. I would not like it to last indefinitely and it probably will not now that their economy is picking up and unemployment is falling. I do not think there are insurmountable obstacles to a fully open market within the existing EU. Many of these countries are developing rapidly and the difference in living standards is big, but it is closing. The big question is how many of the people who have come over to the UK will actually remain here; obviously that has consequences for both the UK and the countries themselves and if they do not then clearly we are
going to experience considerable shortages in some areas which will have implications for economic policy in the UK, but also if they stay then there will be problems for the countries themselves. Poland is now actively recruiting in the Ukraine and Belaruss and even further afield for labour because the labour shortages are very serious due to the number of people who have moved away, so it will have consequences for both. I do not think there are huge obstacles.

Q117 Lord Steinberg: My colleague Lord Inglewood very briefly mentioned the black economy, and when we were taking evidence from another gentleman recently it was obvious to us—and we have just completed an investigation into missing trader fraud so we are very au fait with it—that there is a great deal of black economy operating throughout the EU. My question then was the same question that I am going to ask you: because it is recognised that there is so much of a black economy, why on earth does the EU still print €500 notes?

Mr Tilford: I am afraid I am just not qualified to answer that. I really do not know.

Q118 Lord Steinberg: But you would agree that it does aid the black economy.

Mr Tilford: I cannot really see many reasons for people wanting €500 notes given that anyone buying something costing that much would generally do so electronically, but I really do not know enough about the subject.

Lord Steinberg: Forgive me for asking.

Q119 Lord Inglewood: We have talked a bit about labour mobility and, as you have said, it is interesting to see quite how mobile the Poles have been than many other people in Europe. Is there a particular reason, do you sense, for that?

Mr Tilford: It is just very high levels of youth unemployment amongst people who are relatively skilled, who can imagine moving. It is also a huge opportunity; for the Poles in particular it is a huge thing to be able to move right around Europe, as it is for all of these new Europeans, and it is something that we took for granted for so long. It is largely economic and demographic.

Chairman: There are large numbers coming from other countries as well, the Czech Republic and Romania.

Q120 Lord Inglewood: It is not what I wanted to talk about at all, but it is quite interesting that there is this clear distinction with this willingness to move between those from old Europe and those from new Europe, for obvious reasons, but it may have some bearing—to get back to what I was talking to you about earlier—about needing a bit more pain. What I really wanted to talk about is not labour mobility so much as flexibility or lack of flexibility of the labour market, particularly in old Europe. It seems that there is a degree of general agreement that we must encourage greater flexibility within the labour market there otherwise we will have problems that can only be dealt with by way of physical transfers, is that not right?

Mr Tilford: It is not just flexibility in terms of excessively tight employment protection, we also have a big skills deficit. One of the problems we have in Europe and the reason why we are not doing as well in the high tech sectors as we should be if you go back to the early Nineties and the hopes for the single market, one of the key objectives was obviously to strengthen our comparative advantage in the high tech sectors and close the gap with the US. That has not happened. The EU economy has not become more specialised in the high tech sectors and if anything we have fallen further behind the US. A big reason for that is that we do not have the necessary skills. If you look at the profile of our labour skills, a lot of it is most suited to producing medium tech goods—electrical and mechanical engineering goods—which is good. I am not downplaying the importance of, say, the German engineering sector to the European economy. One of the problems we have is that we are just not investing enough capital, either at the level of schools or at the higher education level, so when I talk about flexibility I am not talking just about labour market regulations, I am actually talking about the ability to do the job. Companies will only invest more in R&D, will only innovate more, if two things are in place—if they are confident that there will be demand for the products, the innovative products, and companies will only adopt new technologies if they can find people who can operate those new technologies. In many ways not the whole of Europe but if you look at Europe as a whole we are lagging behind; clearly, some countries are in the leadership, the technological frontier if you like on all of these things—the Nordics and the Dutch—and then there is a group of economies—the Germans and the British do rather better—but then there is quite a long tail where there is real under-performance in most of the sectors and where our technological readiness is just very weak. Labour and lack of the relevant skills is a big part of that, so flexibility I would define more broadly.

Q121 Lord Inglewood: Is that principally the consequence of the domestic education policies or is it something to do with the lack of investment on the part of businesses, or is it a bit of each?
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Mr Tilford: It is a bit of each. I certainly think we are under-investing as a whole in higher education and, given the fiscal constraints, the additional finance will have to come from the private sector. The US invests a similar proportion of its GDP in public spending on higher education, but then obviously the total amount spent is doubled by private spending. Given the fiscal constraints we are going to have to come to terms with a greater role for private money in higher education. At school level there have been big improvements. You alluded to the Lisbon agenda and I do not think it has been such a damp squib; it was not realistic to expect it to transform the European economy. The goals it set were hugely ambitious and obviously there is only so much any government can do to boost expenditure on R&D, it is the product of a complex set of dynamics, but governments now look to see what other governments are doing and there is more awareness of successful qualities elsewhere in the EU than there was and there is more general debate and awareness of what should be done and how similar economies have managed to do it, so it has been very positive in that sense but it was handicapped by the excessive expectations that people placed on it. Obviously, something such as that can only achieve so much and the responsibility for most of the things on the Lisbon agenda lies with national governments; if national governments choose not to take steps to address these issues then there is only so much the EU can do beyond naming and shaming.

Q122 Chairman: On balance do you think the euro has been a success? It has been a tremendous benefit. Mr Tilford: On balance, yes. It is difficult to know because it is counter-factual; where would Europe be without the euro? We would not have seen the integration of financial sectors that we have seen, the euro has emerged as a strong, stable currency and the ECB has established its credentials, but we need to set out our expectations rather higher. At the moment there are too many question marks over the adoption of the euro for it to be a catalyst for the kind of integration and the competitiveness gains that everyone hoped adoption of the euro would lead to. We now have the currency, it is established and institutions are working effectively, but we have not seen it exerting the sort of transformation of the European economy that people hoped it would. There is still even now an assumption that just by being in existence things will happen, that reforms will be made, that transformation will take place, and that is just not the case. I agree that if the pain gets fierce enough then governments will be forced into taking steps; the problem is of course that by the time that happens it will be much more painful than it would have been because their competitive position will deteriorate to the point where they are going to feel much more pain than they otherwise would have done. The lack of urgency is very disappointing and of real concern.

Q123 Lord Blackwell: My Lord Chairman, if I could just put the counter-argument. Based on your paper it is that without the euro those countries that needed to adjust would not have been able to put off making those adjustments and we might have had more adjustments sooner. Similarly, Germany would have not been able to coast along without dealing with its problems. Mr Tilford: That is the argument I make and I think it is a strong argument.

Q124 Lord Blackwell: Therefore, to the extent that actually we postponed the necessary adjustment in Europe, is that not a counter argument on the benefits of the Euro? Mr Tilford: It is a counter argument, yes. It is not inevitable that Italy would have taken those steps, it could have just devalued again and postponed the necessary reforms because devaluation would have given it a temporary cushion. It might have made things even worse; Italy might now be living with a debt to GDP ratio of 200% because it had gone through a series of devaluations so it might have been in an even worse position. It is a counter argument and a good one—I have made it myself—but it is not necessarily the case that they would have adjusted, you could have just seen a whole series of currency crises.

Q125 Lord Inglewood: Would it be true to say that having got thus far for it to collapse now would be as it were the worst of all possible worlds? Mr Tilford: Yes, if it was to collapse now it would be the worst possible outcome.

Q126 Lord Steinberg: Would you also say that it is still not for us here in Britain? Mr Tilford: Actually Britain fulfils more of the criteria than most of the current Member States but we have got in a number of areas some pretty big issues: one is the lack of an effective market in land. The supply of residential accommodation in the UK is incredibly unresponsive to changes in demand, so we would definitely need to address that and also some skills deficits and vocational training. Generally, however, we meet more of the criteria than most of the current Member States.

Q127 Lord Inglewood: Can I ask why the land point is so important? Mr Tilford: Had we joined and had we experienced much lower interest rates over the last seven years than we have done, which we would have done—interest rates would have been very considerably
lower, they would have been higher in the eurozone than they have been because Britain is a large economy and would have exerted some weight on the overall average, but interest rates would have been much, much lower and we would have had a huge asset price boom. If you see what has happened in Ireland, Ireland has managed because the Irish have built a huge number of houses, a massive number of houses, and that has kept a lid on prices. House prices have risen dramatically but that is despite building large numbers of new houses. Despite the fact that house prices have risen dramatically in recent years and there is clearly a huge pent-up demand, the actual volume of houses that we build has remained largely stagnant so we would have had to address that problem, we would have had to ensure that land was available to actually build houses for which there was so much demand, else we would have had an even more problematic build-up of house prices.

Chairman: On behalf of our Committee may I thank you very much indeed for your contribution.

Examination of Witness

Witness: Mr Roger Bootle, Managing Director, Capital Economics, examined.

Q128 Chairman: Good morning and welcome; thank you very much for agreeing to come and talk to the Committee. Our Chairman, Baroness Cohen, is not able to be here today but I am standing in on her behalf. As you know this is a recorded session and there will be a transcript of what is said which will be sent to you after the meeting. Is there anything particular that you would like to start with, or a general comment on the situation?

Mr Bootle: Yes, I will make a few general remarks, if I may. First of all, on the whole question of what has gone well and what has gone badly, as it were, in the euro area, I feel that both the hopes and the fears with regard to monetary union were always grossly overdone. In my view the most important things that happen in economies are real, not monetary, and we had a period when the advocates of monetary union fondly imagined that merely bringing currencies together and abolishing exchange rate fluctuation would unleash a wave of prosperity, which I always thought was naïve. Equally, we have had of course a number of people who thought that forcing currencies together would bring some sort of disaster; that has also proved to be completely wrong. The issues are much more nuanced and balanced and, in particular, I would take issue with those people, both within the eurozone and outside, who see the weaknesses in European economic performance recently as stemming largely from the euro; to my mind they stem from real factors.

Q129 Chairman: At least one thing that has been achieved is lower inflation. Competitive devaluation and very high interest rates have been effectively eliminated by the single currency.

Mr Bootle: On the point about low inflation, I am not sure you can say that countries of the eurozone have achieved low inflation because of the advent of the euro; after all, we have achieved low inflation and we are not in the euro. Countries all around the world have achieved low inflation without being in the euro so I see low inflation as being an international thing to do with a series of forces, but which could in principle have been achieved by countries who did join the eurozone had they remained outside it.

Q130 Chairman: Do you think that the ECB’s monetary policy has been too restrictive?

Mr Bootle: The record is very interesting. If you look at the history of inflation in the eurozone it does not strike you as evidence that this is a monetary policy regime that has been much too restrictive; after all, what would you expect to see? What you would expect to see is inflation, I guess, decidedly below the target, but in fact that is not what you see, what you see is inflation pretty much bang on the target, around about 2%, and indeed the average recently is slightly above 2%. If you want to argue that the monetary policy has been too restrictive you would have to argue one of two things. The first is that the target itself was too tight, and I have some sympathy with that; perhaps it should have been acceptable for the inflation rate to be slightly higher, and that particularly is so if the eurozone is expanded to accommodate the fast-growing countries in the former Eastern Europe. The second thing you might argue is that effectively there is a horizontal Phillips curve—if you drew a line linking the rates of unemployment on the one hand with rates of inflation, rather than the traditional relationship under which you had some sort of trade-off such that in order to have lower inflation you had to put up with higher unemployment, if you had a straight line you could have the same inflation rate with wildly different rates of unemployment. If you believe that, then the fact that the inflation rate was pretty much bang on the target would not necessarily mean that the policy was not restrictive; that is to say you could argue that the ECB has not given growth enough of a chance. In the United States, for instance, under Greenspan for a prolonged period there was a policy of giving the economy a chance and the result was that the economy grew quite strongly and carried on growing, with unemployment falling, without
inflation picking up. The root of this is the argument that there is quite a lot of inertia in the inflation rate, and if it goes to a certain level it is liable to stay there and it is liable to stay there if unemployment is 2 to 3% lower. I might argue something along those lines; the ECB has not given European growth enough of a chance and is now perhaps tightening policy too much too fast if it wants to give European growth something of a chance.

Q131 Chairman: How should that be remedied? Should the decision be made by the central bank or by ECOFIN?

Mr Bootle: It is very difficult to come up with simple answers to this issue and even though I have heard myself saying what I have just said I am very conscious of the political dimension in the European Union. There is a great danger for academic commentators in particular to come up with regime commentaries and criticisms based on some textbook idea of how a central bank should operate; the problem is that the institutional structure in the eurozone is very different and I think quite weak and the difficulty is that you have a very new, young, institution with a young currency and the potential for substantial political interference in the regime, against a backdrop where the new President of France is making all sorts of difficult noises, shall we say, along those lines. In a pure sense I would argue that the ECB should not tighten quite as much as it has, but in the practical circumstances in which we are living I understand why it is doing it and, what is more, the idea that somehow or other you should interfere in the set-up by having ECOFIN taking more of a role is potentially extremely dangerous. The fault lies with the overall institutional framework, the fact that the politics of the eurozone are extremely difficult.

Q132 Lord Inglewood: I would like to dig a bit deeper if I may. I was going to put the question originally somewhat differently and say if you had been setting up a framework for a currency in the eurozone would you use the Stability and Growth Pact as the box in which you set it?

Mr Bootle: I am tempted to say, like the Irishman when asked the way to Cork, “I would not be starting from here”.

Q133 Lord Inglewood: I am afraid you are.

Mr Bootle: Exactly. The Stability and Growth Pact really does put into a nutshell the institutional difficulties to which I was referring earlier on. It seems to me that there has got to be some sort of fiscal restraint, otherwise the free rider problem is quite significant: that is to say that countries can run irresponsible fiscal policies confident in the belief that the costs of these will be borne by the eurozone as a whole in the shape of higher short term interest rates and probably higher bond yields, and the country running the irresponsible fiscal policy will have marginally higher bond yields but not that much higher compared to the situation outside the currency union. Some sort of restraint, therefore, is desirable. The particular system that was originally instituted was very tight and I welcome its relaxation under the reforms of however long ago it was, but I still do not think it is an ideal set-up in that it is in principle too restrictive. Our own fiscal arrangements are in a pure sense superior, but they have got their problems as well, notably the leeway granted to the Chancellor in effectively deciding what is investment and what is not investment, when the cycle begins and when it ends. That is far from ideal but in principle our arrangements are better. The difficulty is if you had that sort of system in a European context how on earth could it work? Would we allow the French government to decide what was investment and what was not investment, to decide when the cycle started and when it ended? I do not see how one can ideally structure that. My feeling is that the revised system is not too bad given the circumstances that actually exist.

Q134 Lord Steinberg: This question concerns the size of the US trade deficit and the Chinese surplus and the rationale for asking is do you think there is any significance as far as the eurozone is concerned in relation to these two vastly different powerhouses of the world now? We know that the United States has been running a deficit for umpteen years and they are perfectly comfortable with it; equally well we know that China is now running this huge surplus and nobody seems to be happy about it. They are two different aspects; do you think that they have any relevance in relation to the eurozone and if so what?

Mr Bootle: Yes, they have for a start a major macro relevance and, secondly, a relevance in particular European countries. On the macro front the relevance is the danger first of all of a further substantial appreciation in the euro; there is a significant risk that at some stage or other the dollar will fall significantly and unless there is some change in the attitude of the Chinese authorities to the management of its own currency it is almost inevitable that the euro is going to rise against it because there are not that many big currencies to go up instead, the yen being one. This would pose a significant risk to the European economy in that you could end up with the euro significantly higher. The other related macro danger in this situation is that the world could be driven in a protectionist direction. It is understandable in many ways the frustration that the Congress in America feels with the Chinese trade policy, in particular with this apparent tolerance of an enormous surplus. I do not think it is actually in
China’s interests to run such a distorted economy with such an enormous surplus and there is an issue about quite why they do seem to think that it is in China’s interests. Given that, one can imagine a situation developing in which America gets really very fractious, imposes duties and penalties and China responds and Europe feels it has to respond as well. That is potentially extremely ugly, not just for Europe but for the world as a whole so this issue is of key relevance to the eurozone for both those reasons.

Q135 Chairman: Should the ECB be putting some pressure on the Chinese authorities to gradually allow their currency to appreciate?

Mr Bootle: The answer is yes, but it should be done through the usual international bodies and I do not think currency appreciation alone is remotely going to be enough, we have to see this in the round. If you are going to try and reduce the Chinese trade surplus then, other things equal, that will of course result in lower demand in China overall and increase unemployment which, understandably, the Chinese authorities do not want. The policy of raising the exchange rate in order to cut down the surplus must be accompanied, therefore, by policies to boost the level of domestic demand in China, principally consumption. There does not need to be any increase in investment which is already absolutely enormous, it is the low level of Chinese consumption that needs to be boosted.

Q136 Lord Trimble: That presumably means increasing wages in China.

Mr Bootle: It may mean increasing wages, it has not necessarily got to mean that but that would be one way of doing it. In essence it means either a laxer monetary policy or a laxer fiscal policy and in the circumstances probably in China it means a laxer fiscal policy. The Chinese have got ample scope to run a bigger budget deficit.

Q137 Lord Steinberg: Can I just come back, My Lord Chairman? You are foreseeing a bit of a turbulent time in relation to this. We have had in the past ten years since the eurozone was set up fairly stable currency movements throughout the world. Are you now seeing that just as here in Britain the newspapers are full of two dollars and one cent to the pound, that will become even wider and are you seeing as a result of that the euro will increase substantially so that we are going to go into a period now of turbulence in the currency markets?

Mr Bootle: “Seeing” is far too strong a word and I have been doing economics long enough to know that no economists see anything clearly with regard to exchange rates, they are not possible to forecast. I am not trying to say that I can see anything through a crystal ball as it were, but having said that there is a significant danger that all economists can see—structural flaws and problems—and I am by no means alone in worrying about the implications of the huge imbalances in the world. The dollar has fallen quite a long way and of course the euro has gone up, so it is not as though things have been completely stable. To answer your question directly, yes, I am concerned that although at the moment there seems to be a sort of Faustian pact between the Chinese and the Americans, where the Chinese are supplying the goods to America and supplying the finance to buy the goods, this is a deeply unstable and worrying situation and, at some point or other, one senses that there could be some major instability in currency markets and, worse than that, difficulties facing the open world trading system.

Q138 Chairman: There is diversification of reserve holdings which is weakening the dollar against the euro and making our exports to America more difficult.

Mr Bootle: Yes, that is one factor that is going on and contributing to the strength of the euro. Difficult though the relationship is between the euro and the dollar, the most important distortion in the world is the under-valuation not just of the Chinese currency but more or less of the whole of Asia, which applies to the yen as well and lots of the smaller currencies. To redress the imbalances in the world what we need to see is an up-valuation of just about all the Asian currencies against both the euro and the dollar.

Q139 Lord Trimble: Going back to your opening comments, which I found interesting because you were saying that you were more interested in the real factors affecting economies rather than purely monetary matters, if I understood you correctly, looking at the position within the eurozone over the last number of years it looks rather disappointing in terms of comparatively low growth. What do you see as the causes of that? Are they the real economy or are they things that are linked to the introduction of the euro?

Mr Bootle: They are primarily real with, I guess, one exception. I do not want to say that monetary things are completely unimportant, I do not believe that, but you could argue that Germany’s weak performance until recently was partly down to the euro because she may well have entered monetary union at too high an exchange rate for the deutschmark, and certainly German trading performance was initially quite weak after the inception of the euro. You cannot argue that now, however, because Germany has improved its competitiveness no end. Paradoxically I would say that now the euro’s restraints and difficulties and problems are most acute for Italy which, in normal circumstances outside the euro, would by now have
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devalued. It would have carried on, presumably, having its inflationary cost increases, but it would have devalued and so maintained competitiveness. The roots of the eurozone’s lower growth are the same as people have talked about for ages and ages and ages: excessive levels of taxation, over-regulation, particularly with regard to the labour market, insufficient investment in IT perhaps related to all of those things, lack of an entrepreneurial culture, all those things which have got next to nothing, frankly, to do with the euro.

Q140 Lord Trimble: One thing you mentioned there was IT. It has been said to us that one of the weaknesses of Europe is that it has got too much focus at the medium level in terms of technology and not enough at the higher level.

Mr Bootle: I do not know. I do not think I can comment on that. I just look at the official numbers on IT investment and it is quite striking how low the eurozone is compared to both the US and the UK; the UK has come out comparatively well recently.

Q141 Lord Maclellan of Rogart: Do you take the view that more mobility of labour and capital within the eurozone would be helpful to deal with its current problems?

Mr Bootle: I am not sure I do, for two reasons really. One of them is that economists refer to mobility of labour as though it is some sort of impersonal, inhuman thing, but what we are actually talking about is the uprooting of substantial numbers of people and communities with substantial social cost and social difficulties for both the areas they leave and the areas that they come to join. This strikes me as not a simple costless procedure, whatever the economists might think. The second thing is that given that this is in reaction to short term economic difficulties and fluctuations I am really not sure that the is the appropriate way forward. If you use the word “shock” maybe in relation to fundamental economic trends that are going to be with you for a long period then a greater degree of labour mobility would be desirable, but it seems to me that much more preferable to a greater degree of labour mobility would be much greater labour market flexibility so that people on the whole could stay more in their own communities and countries. That is where so much of the EU in general and I guess the eurozone in particular has fallen down, that the labour market is pretty inflexible, has not been particularly good at creating jobs, has not been able to absorb both the shocks and the trends and so it has tended to have quite large levels of unemployment.

Q142 Lord Maclellan of Rogart: How would you see relatively the importance of other instrumentalities for improving the flexibility of education, training, corporate commitment or even, possibly, interventions of governments within the eurozone?

Mr Bootle: There clearly is a significant role for better education and for the government in promoting better education although, interestingly, in a number of the Central European countries that have had high unemployment the educational standards are pretty high anyway. I do not think the evidence is clear that that is the essential problem; the essential problem is really rather more to do with labour laws, levels of benefit and the behaviour of labour unions or arrangements governing pay. Those three things combined and their interaction are really where the problem does lie.

Q143 Lord Maclellan of Rogart: What about Italy, a country about which you expressed the greatest concern?

Mr Bootle: Italy of course has shared in the fall in unemployment, along with a number of the other countries recently in reaction to improved economic circumstances, but there as well the essential problem is to do with the difficulties facing the functioning of the labour market; it just does not function in a free and efficient manner. In particular, if you look at the burdens facing employers in taking on labour and the difficulties they face if something should go wrong, it is no wonder, frankly, that rates of job creation are as bad as they have been.

Q144 Chairman: Do you see the eurozone expanding in the future and other countries joining? Do you think this is a good thing and how far do you think it should go?

Mr Bootle: I suppose it will expand if some of the new EU members come to join. I do not see it as being a hugely significant problem in that the economic size of these countries is actually comparatively small. I actually did tot up the size of all the new entrants in the last two rounds who are not yet members of the eurozone and it comes to something like 8% of eurozone GDP, so if these countries were to join the eurozone it would amount effectively to having a country join that was somewhere between the size of the Netherlands and Spain. This is not insignificant but overall it is not enormous and the relative size of Germany within the eurozone would fall from something like 27 point something per cent to 25 point something, so it is not enormous. I do not think in itself, therefore, it is a big problem, but where the difficulties are liable to lie is rather in the functioning of the ECB where these countries with their own central bank governors will have a seat on the governing council. Decision-making will become unwieldy and there will be a problem to do with the relative weight of large countries and small countries; that is potentially a difficulty.
Q145 Chairman: The advent, for example, of a large country like Turkey, if that were to happen, would be a significant change.

Mr Bootle: That would be a significant change indeed but I have not even begun to consider that; they are not even quite on the horizon so far as joining the EU is concerned never mind joining the euro so I think that is some way off.

Q146 Lord Inglewood: We have developed monetary union across a number of separate Member States' economies where we do not have common taxes and we do not have labour market integration. Presumably you would say that if we had greater integration the euro would provide greater benefits. Do you think that this disintegration, if that is the opposite as it were of integration, poses a fundamental threat to the longer term stability of the project?

Mr Bootle: No, I do not think the lack of integration, harmonisation or whatever is somehow or other minimising or restricting the size of the benefits of monetary union. As I tried to indicate at the beginning, the benefits of monetary union were always going to be minuscule, with the danger that there would be particular events which would otherwise demand and receive some exchange rate accommodation and that that could cause significant losses, coupled with the difficulties facing individual countries. Although I do not think monetary union has had a major economic impact for the countries of the Union as a whole, it has had the effect of boosting Ireland and Spain, initially restricting Germany and more recently restricting Italy. If we went ahead to have fiscal harmonisation, for instance, I do not think there would be some vast pool of gains from monetary union that would suddenly be unleashed. The sort of non-monetary element whose more effective functioning could improve the overall level of GDP and welfare in the Union is really the labour market, but that is not so much to do with harmonisation, it is actually to do with flexibility.

Chairman: If there are no more questions, thank you very much indeed for coming along. It has been very interesting and we are most grateful to you.
Chairman: Good morning, Professor Portes, and welcome to the Committee. This session is on the record, it is being recorded for webcast and you will get a transcript of what was said. You have had a copy of the questions; would you like us just to start or is there an opening statement you would like to make?

Professor Portes: Let me give you just a brief background, My Lord Chairman. I am a Professor of Economics at the London Business School and President of the Centre for Economic Policy Research, which is a fibrous network of economic researchers around Europe and beyond. My own expertise is on exchange rates, capital markets and, in particular, European financial markets, and indeed I teach a course at the London Business School on European financial markets. I have been following the monetary union story for 20 years or so, partly through the activities of CEPR researchers. In fact, we had a conference exactly 20 years ago, October, in fact, 1987, in which the basic rationale for a monetary union was set out by Tommaso Padoa-Schioppa, who subsequently, as doubtless you know, became a member of the Executive Board, the first group on the Executive Board of the European Central Bank. CEPR throughout the years has published quite a lot on monetary union, including, fairly recently, work on the trade consequences of monetary union, which is probably the most cited single article (Andrew Rose) in economic policy, probably the most cited single article on the subject. Most recently, however, we have published something by our Research Director, Richard Baldwin, which challenges the Rose conclusions. This is interesting literature. If you want me to talk about the effects of the euro on trade, I can certainly do so. I think, with that background, we can proceed to whichever topics you want to cover.

Chairman: That is great. I have got a general question to open with, which is what effect has the introduction of the euro had on individual member countries’ economic development? The bit that we keep trying to get a handle on is what has the introduction of the euro zone done for growth, and it also obviously has to do with trade, and we have read the Rose/Baldwin difficulty on that. You can see what a currency union does; what we are trying to get a grip on is whether it actually encourages economic growth and actually increases trade: anything you can tell us about that will be most kindly received?

Professor Portes: This is not research of my own but I know quite well the research of others on this topic, and indeed I was at a conference, or workshop really, last week, in Cambridge, Massachusetts, at the National Bureau of Economic Research, CEPR’s counterpart organisation, which was on this topic. Precisely the topic, in a sense, the way in which you put it, My Lord Chairman, the effects of the euro on growth, on trade and on structural reforms. I think trying to identify effects on growth goes through so many different stages that it is extremely difficult to distinguish. What you can do and what one participant in this workshop claims to have done is identify effects of the euro on structural reforms. Since that has been the mantra of the past ten years, what is necessary for growth and structural reforms, you might think that this is relevant. Alberto Alesina, Professor of Economics at Harvard, has preliminary results, they still are preliminary, but they were quite convincing to the participants in this workshop, which show that there has been a differential effect on structural reforms for the countries of the Euro Area relative to the counties in the EU outside the Euro Area and relative to a wider control group of OECD countries, that there have been positive effects since the introduction of the euro. It is quite clear, the data, the structural break, if you like, as of 1999, which suggest that, despite his, the researcher’s, expectations, there really is a clear effect on both labour market reform and product market reform. I think, in some sense, the more important of these is probably product market reform. We have had quite a lot of emphasis, in discussion of these issues, on labour market reform, but I think, in terms of the effect on growth, as opposed to unemployment, wage flexibility and all that, it is product market reforms where the action is, and that is where you can see this effect of EMU most clearly. That is point one. Point two, again coming out of this workshop, which was really extremely interesting, is some new work, this old issue of the effects of the euro on trade. Take it for granted, I think no-one will dispute it, that there is a relationship between trade and growth; that we know. It is hard to get a precise handle on it because of the neutral causation between trade and growth, but we can be pretty sure that more trade goes along with more growth. That said, as you know, not just...
in the Rose work and the Baldwin work, in the voluminous work done for the Treasury’s inquiry into EMU, and so on, there have been different estimates. There is a new set of estimates and they come out with a fairly strong effect, not the 300% differential currency union effect which Professor Rose has found, which no-one believed, even himself, although it was robust econometrically, and so on and so on, but effects which look on the order of, say, 30%, so far. I stress the “so far” because there is a big point here, that I will come back to in a moment before finishing. About 30% on trade, that is to say, extra trade, among the countries in monetary union relative to trade elsewhere in the European Union, without trade diversion, that is to say, without harming the trade of those countries in monetary union with other countries in the EU. The reason why that is proposed in this research, and again these are preliminary results, the reason why this effect is not as strong as some people might have conjectured it to be is simply the lapse of time. It does take time, apparently, and the econometrics support this, without going into details, for these effects to show up; they are showing up, they are showing up gradually but powerfully.

Q149 Lord Kerr of Kinlochard: Can I test you on this, for just a second. Some argue that a large part of the boost to trade is the result of the lagged effects of the single market programme, 1992, barrier removal, and facilitation of trade. You are pointing to differential effects as between euro zone and non euro zone, but the non euro zone, with the exception of the British and the Danes, had not been in the EU for long. The new Europe is catching up on the single market programme, trying to do it in one go when it joins the EU, so the lagged effects perhaps are further down the track? When you compare your euro zone countries, where the boost to trade has been greater, what are you comparing them with; are you sure it is apples and apples?

Professor Portes: There are two comparison groups. My Lord. One is the countries which were not in EMU at the outset, in which case Greece is included there as well, so you had four of the 15 then. A second comparison group is a broader group of industrial countries, not just European Union countries.

Q150 Lord Kerr of Kinlochard: But then they would not have been involved in the single market?

Professor Portes: They would not have been involved in the single market programme; that is correct. Certainly you could argue that the single market programme, and that is partly the Baldwin story, was more important, but this differential effect seems fairly strong and fairly distinct, in particular, in its timing, in the single market programme. The trade expansion from the single market programme began before the introduction of monetary union and both the timing and the comparison, with admittedly a relatively small control group of other countries, seemed to be, all the same, rather convincing, and seemed to convince not just me but the other people in this meeting last week.

Q151 Lord Inglewood: Could I come in on one point arising from this, which is that you explained that there was the greater growth in the euro zone and it seems to be taking time. Do you think that it is increasing its pace all the time, or do you think that the graph will flatten off?

Professor Portes: What I was pointing to was loss of trade, the effects of that on overall economic growth may themselves operate with a lag.

Q152 Lord Inglewood: I expressed myself badly, but do you think this is going to increase, or do you think it will flatten out?

Professor Portes: In general, I am optimistic about most things, My Lord, but tempered by the evidence. I think the evidence does suggest, to me, yes, that part of what is happening now is not just, as some claim, a cyclical recovery, there is an element of that, of course, but if that were all that was involved then we would see a different pattern in the European expansion from the US expansion, and so forth, and we do not see that. We do not see a pattern which suggests that this is just a cyclical upturn. There is no doubt that there has been a substantial improvement in economic activity in Germany, as well as a number of other countries in the Euro Zone. I think myself that the prospects are rather good, but that is not controlling for all the other things that can happen in a macro economy. I think the structural reform story is actually quite promising, and for Spain, for example, it is a labour market story, for Germany it has become partly a product market story, and so on. I think, in part, at least, that is quite convincing a response to the constraints, if you like, which are imposed by the euro, and even Italy is beginning to show a little bit of this but with more of a lag.

Q153 Lord Kerr of Kinlochard: There is another theory, is there not, which says that, again, thinking about lags, the best thing that EMU did happened before EMU was born? The effect on economic and fiscal policies in would-be candidate Member States of the EMU was very striking in the nineties, and the trade effect could have something to do with that. This is not to say it is not to do with EMU; but the theory is that it is to do with the prospect of EMU rather than the policies of the ECB. Is there anything in that?

Professor Portes: I think that is a reasonable conjecture. We should not claim too much for monetary policy, in any case, and I think that is a
common mistake. What EMU involves is simply the imposition of a common monetary policy and a single exchange rate, of course, and the inability to use devaluation, in particular, as a policy tool to compensate for the absence of other policy tools, for the inappropriate use of other policy tools, and that is the limit. One should not exaggerate these things. You are right about the constraints that this imposes on macroeconomic policies; it is evidence in the Italian case but it is also evident—now this is *ex post* and this comes to the question that is in the notes that I have about the Stability and Growth Pact. People say, “Oh, the Pact was broken as soon as it was tested by a big country,” or two big countries, “it broke down and it’s now a sham and fiction,” and so on and so on. I think this is demonstrably false. I think the Pact has clearly constrained, and there we come back again to the issue that you have just raised, the macroeconomic policies of Portugal, for example, for the good. They needed the constraint, they needed the turnaround, and I think the pressure from Pact and from the peer review and from all that has played a very significant role. Greece is another case, where the Minister of Finance, who, I have to say, used to be my colleague as Professor at Birkbeck College, Georgios Alogoskoufis, has been very effective in appealing to the Pact and using the Pact domestically to help them prove the—and they have done a remarkable turnaround actually, in the fiscal position there. We will get to France perhaps in a moment, you might wish to get to France, but even Germany clearly has felt constrained by the Pact, or, let us put it this way, by all the discussions, by all the work done on showing that fiscal policy had got out of line in Germany, and again there has been a very substantial turnaround.

**Q154** Lord Kerr of Kinlochard: Were you surprised when the new President of France went to ECOFIN to explain that the revised Pact discipline was too tough for France, and that two years’ deferment was required; and were you surprised by ECOFIN’s reaction?

**Professor Portes:** I do not think anyone should ever be surprised by the actions of the new President of France; he is not always predictable, and that is actually a breath of fresh air perhaps. To the subject, no, I was not surprised and I do not think myself that his proposals are as inconsistent with the Pact as the media comment has suggested. The revised Pact has an explicit provision for flexibility when there are substantial reforms being undertaken and we will see whether the reforms that actually are brought in are as substantial as have been proposed. But that is a rationale I think which can be supported, even within the terms of the Pact, and the slightly hysterical reaction from some commentators, including some officials and politicians of other member countries I think is misplaced at this stage. We do not know, it is early to tell, we do not know what the numbers look like, we will know I think fairly soon, we do not know what the actual reforms look like and what the cost of reforms will be, we will know that fairly soon. There has been, I think, an excellent book published in France by Jacques Delpla and Charles Wyplosz about how to get reforms in a vast mature economy; how do you do it? You have got all these vested interests; what can you do: you have got to buy them out, and that is basically the set of proposals that is made in this book. They go across various different sectors, estimating how much it would cost to pay off the taxi-drivers, to pay off the pharmacists, what is the capitalised value of their rates: pay it and say, “Okay, now we have competition.” It is perhaps, you might say, at least in certain areas, not totally feasible or not realistic, but the basic principle, I think, is absolutely correct, that you cannot get past those obstacles just by trying to run a steam-roller over them all, or sometimes the President of France has the steam-roller aspect to him. Nevertheless, you do need very often to have transfer payments which compensate people for what they are losing if you have reforms and, now I am going back to the basic point, there is a fiscal cost to that.

**Q155** Chairman: Can I explore this point, because I hope I understood you correctly when you said that one of the things which had contributed to growth in the euro was the structural reforms which had come with the euro, and I suppose one is talking about exactly the kind of things that France is now going to have to do, and people did it presumably because they realised they would have to. Then you said that probably there were not huge amounts to be gained from growth on the labour relations side, with a term with which I am not familiar, that the money lay in the product market reform: what is product market reform?

**Professor Portes:** For example, take Germany; significant steps have been taken in dealing with retail shop hours. You might say, this is not serious, this is not a big deal; well, actually, if you look at the sources of productivity growth in the United States over the past ten to 15 years, it is fairly well established now that a big part of the jump in the rate of total factory productivity growth in the US comes from retail distribution. You can localise it; it is in retail distribution, it is in the Wal-Marts and the Costcos and the Targets, and so on, and the greater efficiency of getting products to consumers at substantially lower cost. The reform of shop hours is not the only thing but it is part of a process that is taking place in Germany of shifting towards big retailers, towards a more modern form of retail distribution. This has been relatively slow in France, despite Carrefour and Leclerc, and so on, they are
really small relative to the American style, and here too we have had tremendous productivity improvements in the retail sector over the past decade. That is one aspect, My Lord Chairman, of the product market reforms. Another is more generally in competition policy, and here I am distressed by at least the rhetoric which the new President of France has employed in this area, and the concession which was made to him at the recent European Council meeting. I hope that the legal commentators are correct in believing that dropping the reference to competition policy, competitive, whatever it is precisely, dropping that reference in the Treaty revision will not actually emasculate competition policy, because this is central. What we know is we have pretty strong evidence that competition is what drives productivity change, competition that drives out the weak tail of performers and that shifts resources towards the stronger firms. It is in that sort of area, it is competition policy, eliminating a whole range of restrictive regulations, I have talked about shopping hours and the retail sector but you can go across all the professions, for example, not least my own. Oh, yes, if you look in France or Germany the protection of inefficient, really inefficient, university organisation which has direct and identifiable consequences on tertiary education and research and development; that protection is very strong, and President Sarkozy has indicated that is one of his priorities.

Q156 Chairman: This is true, is it not, yes? Professor Portes: I think, rightly so.

Q157 Chairman: Before I let Lord Kerr in, who wishes I am sure to ask about competition, I am very interested in that point about Germany, because for many years people have banged on, trying to get the German consumer to consume. I have always wondered how they were meant to do it with no shops open; that simple example! Professor Portes: This may be a marginal effect but nevertheless it is part of an environment which discourages child-bearing, because if you have children you would like to be able to have more flexibility in when you can go and shop; they put constraints on you, you know.

Q158 Lord Inglewood: Really I wanted to come back to your comments about Sarkozy, which, as I understand it, you say is a much more friendly approach to the existing structures than British commentators have commented. If you were advising Sarkozy, or even if you were Sarkozy yourself, in the predicament he finds himself in, would you be going in the direction in which he is moving?

Professor Portes: You are taking me a bit outside the point.

Q159 Lord Inglewood: I know I am, and you have the right not to reply, but I am just interested, from an economic perspective, where you sit, whether you think this is a way of dealing with those sorts of problems? It is a combination of the bits which he has put in place.

Professor Portes: I am encouraged by the beginnings, with the exception that I have noted, that I do not think a “pick the winners” industrial policy, with protection, and so forth, is the right way to go about those matters, and we will see how far he pushes that. Elsewhere in the set of reforms, his priorities—they were market reforms and university reforms—I think are absolutely right and very positive. I am quite pleased to see all this, I have had a long-term research and teaching affiliation with an institution in Paris and I spend a fair amount of time there. My wife is French. I am quite concerned by these matters, and I think that the beginnings are good, and he has been making the right appointments. I think perhaps not a lot has been made of the composition of his Cabinet and other ministerial posts; it is really a very fresh crew, with a diversity which was not seen previously, has not been seen in previous French Governments, and all that, I think, is part of it. I would like, at some point, if we may, My Lord Chairman, on this question of reforms, to get to the capital markets, which is something that actually I do research on: we will get there, I am sure.

Q160 Lord Kerr of Kinlochard: I agree with you that the Sarkozy line on competition at EU level will be rather important. I hope that it will be a different line from the Chirac line. I do not think we know. I think you can be reassured that the removal of the words “competition that is free and unfettered” from the draft constitutional Treaty will have no legal impact whatsoever. The words were never in the Treaty of Rome, or Maastricht, or Single European Act, or Amsterdam or Nice. I know, because I wrote them in 2002, and, alas, the French never liked them, at the time. Now my words have disappeared. Since they never were in a ratified Treaty, that has no effect on EU competition policy, run by that brilliant Frenchman Michel Petite, in Brussels. His powers will be in no way constrained by their removal. I agree with you, it is interesting because we do not know the President’s motive. If on national champions, economic patriotism, he is going to run against Brussels, we are back to Chirac. If, on the other hand, he is going to maintain domestically that he has changed Brussels, and so reduce hostility to Brussels, there possibly one could see the sad death of my language as a good outcome, if it enables him to change. I was going to take you on from competition...
policy to Paris' attacks on another brilliant Frenchman, M Jean-Claude Trichet, and the way the ECB operates monetary policy. M Trichet is told on a daily basis, or was, in President Chirac's time, that his monetary policy is too tight, his interest rates are too high, and the euro is so ludicrously hard as to seriously penalise French trade. Do you think the ECB has operated monetary policy wisely? The stress on the inflation objective, is that right, or should they have, as French commentators have argued down the years, an additional growth objective? And do you think the objectives should be set by ECOFIN or by M Trichet?

Professor Portes: You will recall, of course, My Lord, that the conflict between President Chirac and Mr Trichet, when he was Governor of the Banque de France, was exactly the same conflict over the franc before, and that did not change. It is natural, it is absolutely natural, that politicians, where the independence of the central bank has not been fully established, should take that line; we are familiar with that, we saw plenty of it. What we have not seen, quite interestingly, since 1 May 1997, is that kind of political grandstanding pressure, whatever you like, in this country, and I think that is quite interesting but not totally the point. Let us get to the point, which is the sorts of questions which you put about monetary policy itself, that is to say, some of Mr Sarkozy's criticisms, whether economically well informed or not, might there be some justice in them. I think, on the whole, not; no. Take the first question about the restrictiveness of monetary policy. If you compare long-term real interest rates in the United States and the European Monetary Union since the inception of monetary union you will find that there is very little difference, we are talking at most times about differences of 50 basis points; nothing in it really. That is what we think is relevant for growth, we do not think that the short-term policy rate is relevant for investment decisions. What we have observed is, as I say, regardless of the monetary policies being applied, very similar long-term interest rates, and therefore, from that point of view, a very similar environment for growth, and the Fed has not been criticised on that count. The second way of looking at it is something which was popular for a while among academic researchers and recently has been taken up by private sector economists. I will put in the technical term but then I will try to make it reasonably intelligible, the Taylor Rule, looking at what a Taylor Rule would suggest about the behaviour of the central banks. The bottom line of all this is to try to formulate, quite precisely and econometrically, what it is that, say, the Federal Reserve Board of the United States, or the old Bundesbank, would have done if they had been facing the same economic data as the European Central Bank faced. You can investigate the behaviour of the Fed and of the Bundesbank over time and then say, suppose you had that decision-making process and the way in which it was operating, what would they have done if they had been looking at the same employment, price stability, all this stuff. The answer, uniformly, whether it is academic researchers or private sector economists who are doing these estimates, is that the Fed and the Bundesbank both would have run more restrictive, tighter monetary policies than the European Central Bank actually has done. There was a little piece in *The Economist* about this, a year or so ago, maybe it was two years ago, coming out of a piece by David Mackie, of JP Morgan, which had done this in a reasonably intelligible way, and the evidence is fairly clear on that. I do not think the policy has been too restrictive. I think the problems of growth in the euro area have been problems of a different kind and, as I said, now we can see some progress on that. Should the ECB consider other factors than price stability; well, the short answer is, of course, the Treaty says no, the Treaty says only when those are without prejudice to price stability, considering those other factors. That said, look at the practice, and if you actually look at the behaviour of the ECB since 1999, I think it is fairly clear that they have looked at other factors besides price stability. They have looked at that, they have looked at the level of economic activity and this comes out just from looking at monetary policy decisions and what the data were that were there at the time. I think the simple answer is, whether you think it should or not, whether you think it ought to have a different mandate from the one that it actually has, in fact, it has not been looking only at price stability, I think, and that is probably clear. This is relevant to the inflation target issue, if you look at the actual performance on inflation, sometimes it has been 80%, more often than not, month by month, it has been above 2%, actually. If you do just a simple count of the annualised rate of inflation on a monthly basis, from month to month, in fact, the majority of months it has been at a rate above 2%. In that sense, again, you might say that, in practice, they are running a regime in which 2% is not the upper inflexible limit but, in fact, it is rather more symmetrical, around 2%; but that just comes out of the data again. Should ECOFIN or the Eurogroup have the power to set the inflation target, ECOFIN, no, ECOFIN has no standing, in my view, in this matter, it is a Eurogroup matter. Yes, I think that here the UK model is absolutely correct, the target should be set by the political authorities, and that is a matter of policy, that then the Bank is there to implement. The current position, which is effectively the result of the Maastricht Treaty, that the Bank decides whatever it wants to do on the target, I think that is wrong. I think it gives the Bank too much independence and does not give a proper political/
policy dimension to monetary policy. There is a role for the political authorities. I think we have it right in the UK.

Lord Kerr of Kinlochard: This was the inherent tension at Maastricht: the majority of those who are now in the Eurogroup would totally agree with you, but the Germans did not, so we ended up where we did.

Q161 Chairman: For fear of running out of time, I am going to jump to the back end of the questions because it is what you really want to talk about. I have the question formulated as what has been the impact of the euro on the functioning of European capital markets, and then we go on to the levels of trade. Can I say, before we start talking about the European capital markets, I have noticed from your CV that you are one of the wise men who advise MTS. I sit on the Board of the London Stock Exchange and currently, as you will know, we are proposing a merger with Borsa Italiana. I just thought I would mention that before we started, because it does seem to me to bear on reform structure, while we are at it. Can I get you to talk about what you have been doing in the function of European Capital Markets?

Professor Portes: I can talk at great length, My Lord Chairman, about MTS, but I shall not; perhaps on another occasion. I was involved as President of the Wise Men Committee in adjudicating on the matter of the Citigroup operations on MTS in August 2004, which raised quite a ruckus at the time and triggered investigations by the various supervisory authorities, including the FSA, which ultimately fined them its largest single fine and the Wise Men Committee also imposed sanctions. I learned in that exercise quite a lot about how the government bond markets operate. I should say that the euro has had a tremendously positive effect on the functioning government bond markets in Europe, i.e. minus the function of corporate bond markets; let me take the two in turn. The smaller countries, in particular, now find that their bond markets are much more liquid than they were before, they have much more foreign participation, for the simple, obvious reason that they are all now denominated in the same currency. Buying a Finnish bond is buying something which is denominated in euros without the currency risk that you would take, as a member of another Euro Area country, resident in another Euro Area country, if you were to adopt a Finnish bond denominated in markka before 1999. The smaller countries have benefited, as I say, enormously from this, and the result is that if you look at the functioning of the European government bond market, the Euro Area government bond market, now, in some respects it compares quite favourably with the US Treasury market. I will not go into details there, but the Treasury’s market is the model for how a government bond market should operate, and so on and so on. In terms of the efficiency of the way the Euro Area bond markets operate, and in particular the role of the futures market, much more developed, actually, in the Euro Area than in the United States in the government bond markets. Corporate bond markets, we at CEPR did studies last year on both these markets in relation to MiFID and the transparency requirements of MiFID and whether they should be extended to the bond market. We discovered among other things that the spreads in the Euro Area corporate bond market are now lower than those in the US, in the corporate bond market in the United States, and on that criterion, which is a pretty common criterion, what does it cost you, in terms of margins, to trade, the Euro Area corporate bond market is more efficient than in the US. If you look at equities, where you will be very familiar with the transformation that is taking place, it is still a very complicated landscape. If you look at the chart, there is a famous chart, which is put out by FESE, the Federation of European Stock Exchanges, where you can see all the Exchanges and the interconnections among them and their relations with the derivative markets and it looks like a big bowl of spaghetti of different colours, gradually some of the spaghetti is being eaten and that chart is getting a little bit simpler as we go over time, with the gradual consolidation, if you like, of the equity markets. The big obstacle there, as you doubtless recognise, is clearing the settlement and that is a topic which is so arcane in some ways and complex that it is difficult for ordinary people to talk about it. I have no great expertise in it but I do know what the costs are, and that is the biggest single obstacle to rationalising, to expanding equity market activity in Europe, but that is not just the euro area that is throughout the European Union. If you then look at the data on bond issuance, and that sort of thing, since the introduction of the euro, you will find, for example, that two years ago, and since, the Euro Area passed the United States in the issuance of international bonds. In terms of current flow, there is more international bond issuance denominated in euros than in dollars. Nobody would have imagined that before 1999, if anybody had said what would be the effects of the European Union. There has been an explosion of activity in the capital markets and I think in the Euro Area in particular this is bound ultimately to have substantial effects on growth as well.

Q162 Lord Kerr of Kinlochard: May I ask a follow up from that? I agree, nobody would have predicted the astonishing take-off of the bond market and I hazard a guess that nobody would have predicted either that the location which has done best of all is a
market not in the euro zone, i.e. the London market. I would not have predicted that, at the time; would you have?

Professor Portes: In what sense do you suggest that the London market has done better than the euro one?

Q163 Lord Kerr of Kinlochard: In terms of places where eurobonds are traded?

Professor Portes: Yes, that the trading would be concentrated, that would happen mainly here. I think that is right, it was not predicted and certainly I did not predict it. On the other hand, by the way, if we look at the operation of the corporate bond market in the United Kingdom we find that spreads are significantly higher than in the euro area as well. Again, by that measure of efficiency, we see that things are actually operating rather well in the euro area.

Q164 Chairman: That is astounding. Has the same effect been seen not just in bonds but in fixed interests and derivatives?

Professor Portes: Derivatives, as I say, the contract on the Bund is the biggest futures contract in the world. It is quite interesting, there is a structural difference in the way in which the US market operates and the way the Euro Area government bond market operates, as I said, in the role of derivatives and the futures markets. Roughly speaking, turnover in the Euro Area government bond market is about one third in the cash market and two thirds in the derivatives market. It is exactly the other way round, it is one third in the derivatives market and two thirds in the cash markets, in the United States. You can make a rather technical argument that this is actually to the benefit of the euro area, that the greater role of the derivatives markets here gives a more efficient market overall. We will see, of course, what happens now that the Chicago Board of Trade and the Chicago Mercantile Exchange are merging; they will become a stronger competitor to Eurex. One thing we have learned over the past decade or so, really I think the first clear evidence of it was in 1997, when LIFFE lost the contract on the Bund, that is to say, the ten-year German government bond futures contract was traded primarily in London, on the London International Financial Futures Exchange, which is now the property of Euronext; within a period of months this business transferred to Frankfurt. This is something that we do not expect in the financial markets, we did not expect anyway; normally liquidity creates liquidity and so it is hard to move liquidity, but in this case it moved very rapidly, and the reason for it was primarily technological. They introduced a better trading system in Frankfurt and everybody realised this and, zap, off went the business, it was cheaper and quicker to do it there. What this shows is that it is not only currencies and all that which matter, the technology is very important now and the technology seems to be even more important as we go forward because of the increasing role of hedge funds in trading in bond markets and their desire, many of them, to do programme trading which involves reacting within I will not say nanoseconds but mere seconds to little tiny changes in prices, or divergences in prices, and trying to arbitrage those away. That means you need very efficient electronic technology to trade, if you want to act that fast, and the Exchanges which have the best technology will get the business. I am not sure that answers your question.

Q165 Chairman: I was just brooding as to whether it did. It answers my question about that the derivatives growth you would tag directly to the euro zone?

Professor Portes: I think a good part of it, yes. The business in the main derivatives contracts for euro area government securities has grown enormously. Let me just try to explain why. The basic point is that those derivatives contracts on the German government bond are used as a hedge for all trades in the euro zone. That is to say, if you take a position in Italian government bonds in the cash market you will hedge it against a futures contract in the German government bond, or if you take a position in the French government bonds, it will all be hedged by operating in that futures market. Having a single common security with which to hedge is a great promoter of the efficiency of the market and activity in the cash markets.

Q166 Chairman: How very interesting. There is a question we usually ask at some point, and it may be that this is the moment. Do you think the euro itself is becoming used increasingly as a reserve currency? It sort of bears on all this.

Professor Portes: Indeed, and this is something on which I have written, on the international role of the euro. I think I and my former colleague, the current Finance Minister of Greece, wrote the first paper on this issue in 1991 and then my new colleague at the London Business School, Helene Ray, and I published a paper on the subject in 1998, and currently I am working on about three different papers on this. This is about as close to my own research area as you can get, which makes it harder to answer your question because there is too much to say. Let me try to boil it down. The role of the euro as an international currency has not been emphasised by the European Central Bank, quite to the contrary, it has played a very hands-off role here, in saying explicitly and at any time you ask that it seeks neither to promote nor to hinder the development of the euro as an international currency. That derives partly from the stance of the Bundesbank in the old days, which resisted the use of the Deutschmark as an...
international currency, in the belief that this would make monetary policy more difficult, you would lose control of the money supply, and so on. I think that argument and that policy stance are questionable and I am working on that issue currently. The facts so far are that the currencies of the countries going into the Euro Area constituted about 17% of international reserves, Central Bank reserves, at the beginning of 1999, when the transition to the euro came, and now the euro is about 25% of international reserves. The United States dollar is still dominant on reserves. The growth of the euro’s role has been primarily at the expense of the yen and sterling and the Swiss franc; the share of the dollar has not fallen very much, if at all, over that period. The reserve currency role, first, is not the only game in town, it is not the only issue, for an international currency. An international currency is also a currency which is the centre of trading in the foreign exchange markets, and there the dollar dominates completely, at least according to the most recent data that we have. Where a currency is traded in only a limited number of markets, the dollar is the standard of reference. If you want to trade between Indian rupees and Brazilian reals you go through the dollar and you do not go through the euro. That may change but that is the state of play right now. On the other hand, in financial markets, as we discussed before, the role of the euro has expanded greatly, and in private financial markets the euro as an asset currency has greatly increased its role since 1999. The euro is an invoicing currency, as far as we can tell, that is to say, in what currency do you bill people, in what currency do Japanese firms send out their invoices to firms in other countries, and the answer is that the role of the euro has been growing significantly, gradually but significantly, say, for Japan, now. Japan’s firms used to invoice a lot of their exports to the euro area countries in dollars and now they are invoiced almost entirely in euros, that sort of thing. The future, I think, will be an increased and growing role for the euro, but the euro area central banks and authorities should be very careful about this. If there were a sudden shift of portfolios from dollar-denominated to euro-denominated assets the exchange rate effects would be very powerful, and we are talking about the euro going to $1.40, well, you can see it going a lot higher than that if there was a major shift. We have seen, for example, some of the sovereign wealth authorities, sovereign wealth funds, some of these big, emerging, market capital, big reserve holdings, are putting some of their reserves into special sovereign type of wealth funds which invest in different ways from the central banks. Norway has done this for a long time with its oil money. Singapore has done it for a long time. Now other countries are joining in. Those sovereign wealth funds are looking to diversify and they do not like being so heavily in dollars, and they are shifting,

we can observe, to some extent anyway, from dollars to euros. As I say, if that process were to gather speed then the consequences for international financial markets would be very considerable, and not necessarily benign, in terms of exchange rate stability, and so forth, so one has to watch for that. I think the bottom line is that the euro is challenging, in a sense, the dollar in its role as an international currency, in various dimensions; there are a couple of dimensions in which that challenge is not yet apparent, but in a broad range it is, and that is perhaps a cause for celebration in the Euro Area, perhaps not. I think, getting outside your European remit, it may be a cause for concern about the stability of the international financial system. After all, the last time we observed a change in the dollar and currency in the international system was the 1930s, when the dollar took over from sterling. This was only a part of what was going on.

Q167 Chairman: It was a difficult time; not a happy time.

Professor Portes: We refer to this sometimes. There is a doctrine, if you like, perhaps that is elevating it too much, but a view, called the hegemonic stability theory, or hypothesis, the idea that you need in international financial markets a hegemon, a dominant currency, in order to ensure stability. If that hypothesis is true we may be in for a rough ride. Chairman: Thank you very much. I think that we have just about got time to get through one more question.

Q168 Lord Inglewood: Moving area, if I may. If we go back to the euro zone, and looking particularly at those countries which are outside it and would like to come into it, how do you feel about the appropriateness of the criteria they have to meet in order to become members?

Professor Portes: In: that is to say, inappropriate.

Q169 Lord Inglewood: Exactly, yes. I am being neutral.

Professor Portes: Estonia could have, and should have, come into the euro area from day one, from 1 May, 2004. It had been anchored to the Deutschmark then the euro in a currency board system since June of 1992 without any hint of currency instability whatsoever. There was no reason why Estonia—it had, in that sense, demonstrated its capacity to take a single monetary policy, in fact, the single monetary policy of the European Central Bank, since 1999, because, effectively, for all practical purposes, the kroon was the euro, and still is. Estonia does not have an independent monetary policy because its currency is anchored through a currency board to the euro, so it could have gone in straightforward. The broader issue, which many of us pointed out well before this
all came up, is that the conjunction of the inflation criterion and the exchange rate stability criterion is very difficult to meet because countries which are growing relatively fast, as these countries are, relative to the euro area countries, are catching up. All that we know about that process suggests that these countries will have to have some degree of real exchange rate appreciation, and there are only two ways in which that can come about. Either their nominal exchange rate appreciates, and this is what was happening in Poland, for example, for quite a while, and then they violate the exchange rate stability criterion, or the other way you can get real exchange rate appreciation, and this is not obvious perhaps to the non-economist but if you consider it, is by having a faster rate of inflation than other countries. The point about real exchange rate appreciation is that it compensates for the differential of productivity growth. Those countries are catching up, they have somewhat faster productivity growth than the euro area countries; you would expect that to be compensated somewhat by an exchange rate appreciation so that their goods did not become ridiculously cheap. If productivity is increasing fast and their exchange rate stays constant, in real terms, then they become hypercompetitive. You do not expect to see that happen and indeed one of the problems we are having with China now is that China is not having the rate of inflation that you would expect it to have in order to compensate for this fast productivity growth, with a fixed exchange rate. In a sense, it is the opposite side of that which happens in these countries which are catching up; with flexible exchange rates, if you try to keep the exchange rates within the ERM II sort of band then you would expect to have higher inflation, and so it is very hard to satisfy those two criteria at the same time. I will not get into the question of whether the Maastricht criteria themselves make economic sense, but that is a different issue. I am just saying it is harder for these countries.

Q170 Lord Inglewood: If you were given the job of refining these criteria, how would you jump?  
Professor Portes: I think I would go with the inflation criterion, and there are various ways you can adjust it. It is an unrealistically tight criterion in the way it is framed as well, because it is the average of the inflation rates in the three lowest inflation countries, not in the Euro Zone, in the EU. What is it right now, is it Sweden that has got this—this is slightly absurd, more than slightly absurd actually, and that does not make sense, but that was formulated, of course, at a time when it was thought that all the countries would be in the monetary union, but it has not turned out that way. That is the criterion I would look at. There are various ways you could give it more flexibility and I think it should have more flexibility.

Chairman: Thank you very much, Professor. Colleagues, what have we not asked?

Q171 Lord Kerr of Kinlochard: I would like to ask just one, about the stability of the whole system. I am smarting from what Professor Portes has just said about the Maastricht criteria. I am going to retaliate by saying I remember him, in the mid nineties, I think, or perhaps early nineties, being pretty strong on the exogenous shock theory. I remember being quite strong on it myself. The exogenous shock theory has gone out of fashion. Brent crude at $78, that looks quite like a shock, with differential effects. The system, although it has not yet had the labour market reforms, and it does not have and it is not going to have a big fiscal flywheel, seems to be stable: would you comment on that? To ask what you would have expected, had you been looking from, 1995 or thereafter, is a bit silly, because very few of us would have predicted quite how many would join EMU from the start; but how has its fragility/ stability worked out compared with your expectations?  
Professor Portes: I can remember very clearly discussions in the mid 1990s and even closer to 1999, suggesting it was all going to end in tears very quickly and there would be speculation. Indeed, the Chief Economic Adviser to the Department of Trade and Industry, who had just stepped down, wrote a well-known pamphlet, given great publicity, saying George Soros will be there and the speculators will bring it down within months of January 1999. Of course, this was nonsense, as some of us did point out at the time, but I can remember quite a number of meetings in the City saying “It can’t work; the legal obstacles, the technical obstacles, running a counter monetary policy, is so difficult, with all these different monetary policy systems in different countries and institutions, and a single payments area.” My goodness, payments systems are so complicated, how can they possibly put them all together at the same time. It worked out rather differently, and every time I see a new pamphlet of this kind, and doubtless some of you will have seen something which came out from the Centre for European Reform, of all places, in the autumn, which talked about the high risks of a break-up of the euro area.

Q172 Lord Kerr of Kinlochard: . . . It was worry about Italy, and bond markets, wasn’t it?  
Professor Portes: I think the chances of a break-up of the Euro Area are minimal, not zero; treaties have been abrogated in the past. This is, after all, a treaty; you do not just walk out and say, “Bye-by, actually I want to go back to my own currency now.” This is a rather more formal obligation than that and it has huge political dimensions to it which I think countries would not lightly violate. On political
grounds, I think that the break-up of the euro zone, or an exit from the euro zone by any country in it, is extremely unlikely; on economic grounds. I do not think it would be particularly warranted either. It is true that the economics literature, I did not contribute to this literature myself, I hasten to say, did have quite a lot in the mid 1990’s about the risk of asymmetric shocks when a particular outside event, like a rise in the price of oil, would affect different countries in the zone differentially. Normally they would want to have different monetary policies and exchange rate policies, or exchange rate flexibility, to react to that shock, and they could not, so there would be tensions, and that would be exacerbated by the absence of labour market flexibility and the absence of a fiscal redistributive system, and so forth. First of all, all that is based on economic analysis, for which its author, Professor Robert Mundell, got a Nobel Prize, but nevertheless it was economic analysis which was done at the beginning of the 1960s when we did not have open capital markets. That is a huge difference, a huge difference. The capital markets have provided a lot of the missing flexibility which labour market adjustment or fiscal federalism was called upon to provide before you had open capital markets. That is the first point. We do have much more of a range of adjustment than was originally discussed, and it was not really discussed much in the mid nineties either. The second is, which was unexpected as well, there is a greater degree of labour market flexibility in practice than people expected simply looking at migration patterns among the euro area countries. Why? Because, the same reason that we have had a remarkably flexible labour market for the past several years: immigration from outside; in the Spanish case, from North Africa, and Rumania and Bulgaria actually too. The Spanish labour market has been much more flexible over the past several years than anybody expected, because they have had migration, so they have been able to accommodate this boom, about which everybody said “Oh, it can’t last.” To some extent that may be true, but so far so good, and part of that has been facilitated by the availability of labour resources. Here was Spain with a high unemployment rate, that unemployment rate has come down very radically, and at the same time they have been importing workers to do the jobs that Spanish workers do not want to do, just as we have been importing Polish builders, and so on. The conclusion I would come to is that there is more labour market flexibility in practice than was expected when the original discussions of these things took place. To sum up, I do not think that the euro and the single monetary policy have imposed constraints on countries and economies that those economies will be unable to bear. Italy has big problems. Italy would have had big problems without monetary union. We can hope that, in fact, the constraints imposed by monetary union will push Italy to resolve those problems, as, to some extent, clearly, they have pushed Germany.

Chairman: Thank you very much. You have given us most generously of your time. It was a terrific experience. Thank you very much indeed for coming.
Written Evidence

Memorandum by Joaquín Almunia, Commissioner for Economic and Monetary Affairs, European Commission

Thank you very much for your kind letter dating from 8 February 2007 and for the interest the House of Lords European Union Committee shows in the development of the euro and the euro-area economy.

The euro is a key symbol for EU integration and, as recently recalled in the Declaration of Heads of States at the occasion of the 50th anniversary of the Treaty of Rome, “it makes us [the European Union] strong”. The euro has raised both, trade inside the euro area and trade of the euro-area Member States with the rest of the world. It has also contributed to the increased integration of European capital markets. Furthermore, a look at broad exchange rate indicators and longer time horizons reveals that movements in the euro exchange rate since 1998 have not been abnormally large. At current, the euro’s real effective exchange rate is standing just above its long-term average. Turning to fiscal policy, the reformed Stability and Growth Pact has increased the economic rationale of the fiscal surveillance framework. The experience with the revised Pact has been rather positive. The overall budgetary situation as well as economic development in the euro-area Member States has improved remarkably in the recent past, supported by the ECB’s stability-oriented policy framework, providing a stimulus through low interest rates, and by consistent fiscal policy decisions. Euro-area enlargement is also proceeding although at a different speed than originally envisaged.

In Annex 1, you will find the detailed answers to the questions raised in your letter.

Annex 2 gives list of links to key documents from the Commission, or economic papers by Commission officials, relating to subjects raised by the Committee’s list of questions.

I would be very grateful if you could keep me informed on the outcome of your current inquiry.

30 March 2007

Annex 1

1. What contribution has the introduction of the euro made to the levels of trade within the euro zone, and between the euro zone and the rest of the world?

With a seminal paper, A.K. Rose launched the debate on the euro’s trade effects. Rose concluded that monetary integration could lead to quite substantial increases in trade. According to his first estimates, trade between countries sharing a common currency could be up to three times larger than trade between otherwise similar countries. Given its magnitude, this initial estimate was greeted with substantial scepticism and Rose’s methodology was criticised on several grounds. Estimation techniques and models were henceforth amended and refined by a number of researchers, including Rose himself. These methodological improvements led to a considerable reduction of the size of the estimate but the overall conclusion of a significant effect of common currency on trade remained.

In recent years, with data on intra-euro area trade flows becoming progressively available, a number of studies have endeavoured to assess the size of the so-called Rose effect in the euro area, taking advantage of the existence of a control group of countries (the UK, Denmark and Sweden) sharing many common features with euro-area Member States except the currency. Most of these studies have reported evidence of a positive effect of the euro on trade with initial estimates ranging between 5 and 30%. Some of this work does not seem to be fully exempt of the methodological weaknesses that beset some of the earlier Rose estimates and, in a 2006 critical review of the literature, R. Baldwin has proposed a narrower, but still significant, range of 5–15%. It is important to note that the euro not only boosted trade among euro-area Member States, but also between the euro area and the rest of the world, including with the UK whose exchange rate with the euro has been very stable over the last few years.
2. What effect has the introduction of the euro had on the functioning of European capital markets?

The introduction of the euro has eliminated currency risk in the bulk of cross-border financial flows in the EU. In consequence, financial transaction costs were lowered and the demand—both actual and latent—for cross-border financial services has increased. In this way, the euro has already contributed directly to a more integrated EU financial system. Secondly, the euro has also made an important indirect contribution to financial integration, by highlighting the opportunity costs of the remaining sources of market fragmentation. The pace of integration has been faster in the case of financial instruments with agreed definitions, common conventions and common infrastructure while progress has been slower for instruments which are more affected by national regulations, market conventions, taxation, and legal frameworks.

Accordingly, the euro area’s money and derivatives markets have rapidly become fully integrated. This has been fostered by the monetary policy of the ECB, which has implemented monetary-policy operations on the basis of euro-area wide demand for liquidity. As a result, the price differential for interbank lending operations has largely vanished and operations are based on the uniform price references EONIA (Euro Overnight Index Average) and EURIBOR (Euro-Inter-Bank Offered Rate), while the EUREPO is the benchmark rate for secured money market transactions in the euro area’s repo market.

Moreover, the re-denomination of the amounts outstanding of first eleven and now thirteen national bond markets created a substantially larger and more homogenous bond market. Yield differences between euro-area sovereign borrowers have been reduced to very low levels. The increased competition for investors has generally encouraged cross-border diversification of portfolios and reduced the traditional “home bias” in the purchase securities. In equity trading, the impact of the euro has resulted in a re-orientation of asset managers’ investment strategies towards a sectoral, pan-European approach.

3. Are there any lessons to be drawn from the changes in the euro exchange rates since 1998?

The euro experienced a marked depreciation in the first 2½ years after its inception and an appreciation thereafter. However, a look at broad exchange rate indicators and longer time horizons shows that the movements of the euro exchange rate have not been abnormally large.

It is useful to extend this analysis using “synthetic” euro exchange rates, which are calculated on the basis of the euro’s predecessor currencies for the period before 1999. This reveals that the last period of euro depreciation against the US dollar had started already in late 1994 and lasted until mid-2001. However, the depreciation of 1994–2001 was smaller than the depreciation in the first half of the 1980s. Against the yen, the euro depreciated almost 30% from January 1999 to November 2001 and thereafter appreciated gradually, almost reaching JPY 160 in early 2007. The comparison over longer time horizons shows that the low at JPY 91 in 2001 was unprecedented, while the current exchange rates could be observed for the last time in 1998.

In real effective terms, the euro was at a level almost 20% below its long-term (1980–2005) average by the end of 2000 and was widely considered undervalued. Its overall appreciation since then has been far more muted than the bilateral exchange rate against the US dollar or the yen would suggest, since the currencies of other trading partners have appreciated against the euro in the past three years. In early 2007, the euro’s real effective exchange rate is standing just above its long-term average. Hence, euro-area exports are not particularly expensive at the moment.

4. Was the recent reform of the Stability and Growth Pact appropriate?

The review of the Stability and Growth Pact (SGP) took place against the background of deteriorating budgetary performance in many EU Member States and increasing economic diversity in the enlarged EU. In September 2004, the Commission issued a Communication suggesting that an enriched fiscal framework with a strong economic rationale would contribute to an enhanced credibility and greater ownership of the SGP in the Member States. The revised SGP formally entered into force in summer 2005, with the adoption by the Council of a corresponding package of secondary legislation. Overall, the Council reached a balanced agreement, confirming the fundamental rules and principles of the Treaty and increasing the economic rationale of the framework.

Among other things, the revised SGP gives greater attention to the implementation of structural policies that enhance growth potential and long-term sustainability of public finances. It requires Member States to strengthen budgetary consolidation in economic good times. An increased focus is put on structural fiscal consolidation efforts rather than only on short-term nominal results. Finally, the revised SGP no longer requires a Member State to aim for a uniform budgetary position in the medium term. Rather, differentiated medium-term objectives are set for each Member State, taking into account country-specific economic and
b Budgetary circumstances. The 2005 reform of the Pact also recognised that—complementary to the Pact—national institutional conditions for fiscal and statistical governance have a crucial role to play in ensuring fiscal discipline and in helping countries to achieve their budgetary targets.

In June 2006 the Commission made an early assessment on the functioning of the revised SGP, one year after its inception. The Commission concluded that the experience with the revised SGP was rather positive. It notably welcomed the smooth and consistent implementation of the excessive deficit procedure and the improvement in the overall budgetary situation.

Importantly, however, the preventive part of the reformed Pact is becoming increasingly relevant with most Member States formerly under the Excessive Deficit procedure now having to achieve their medium term objective of close to balance or in surplus. This effort has to be seen against the background of favourable economic conditions, which should be fully used to complete the consolidation. The Commission attaches high importance to avoiding the mistakes of the past and taking advantage of this “good times”.

5. What effect has the introduction of the euro had on individual member countries’ economic development?

EMU has created a stable macroeconomic framework, which is beneficial to all participants. Among other things, it has brought low inflation, low interest rates and clear incentives for securing sound public finances. As the introduction of the euro happened in parallel with a number of adverse shocks in the global economy, it is easy to confuse the outcomes of the two phenomena. In fact, EMU has provided a better framework to cope with the challenges of globalisation and the euro has served as a shelter from international turbulences rather than amplifying them. Still, growth performance of the euro-area economy has been lacklustre in recent years. Although the euro area achieved an average annual economic growth rate of 3.2% in the first two years of the single currency’s existence, annual growth since 2001 has averaged only 1.5%. Overall, average growth was close to 2% in both the 1992–98 and the 1999–2006 periods.

The rather subdued growth performance of the euro area as a whole hides differences between individual countries. Many smaller euro-area countries have performed better than the larger ones. Since 2001, Finland has had an average growth rate of 2.9%, Spain 3.3%, Luxembourg 3.7% and Ireland 5.1%. These growth rates compare well with the growth performance of advanced economies outside the euro area. Average growth in the euro area has been influenced by country-specific adverse developments in Germany and Italy. German growth has been dragged down by structural rigidities and by economic adjustment to unification. Italy as well has been suffering from structural rigidities translating in an erosion of its international competitiveness in recent years. It is important to note that the disappointing economic performance in Germany and Italy pre-date the launch of the euro. Without these two countries, the euro area grew by 2.5% from 1999–2006, a figure that is close to other industrialised countries.

Effective implementation of the Lisbon agenda can help the euro area to cope better with economic challenges in the future. Although much remains to be done, positive signs have already been recorded. Euro-area growth is expected to reach 2.7% in 2006, the best outcome since 2000. Labour market reforms have improved job creation: from 2000–06 close to eight million jobs were created in the euro area. The more balanced growth pattern in the euro area and the ongoing structural reforms are expected to further stimulate potential growth, leading to a more sustained expansion than in past upturns.

6. Has the ECB’s monetary policy been too restrictive?

The Treaty gives the ECB the mandate to focus primarily on price stability. Price stability makes relative prices more transparent, reduces inflation-risk premiums in interest rates, leads to better resource allocation, reduces distortions of tax systems, and prevents arbitrary redistribution of wealth (eg from creditors to debtors). Thus, from a theoretical perspective, it is widely accepted that price stability leads to higher welfare.

The ECB has established an impressive track record of forward-looking, stability-oriented policy since 1999. It has succeeded in anchoring medium-term inflation expectations of markets, businesses and social partners. Interest rates—both in nominal and real terms—have also been at low levels. By ensuring that medium to long-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability, the ECB helps to support economic growth and job creation in the euro area. Monetary policy indeed played an important role in the euro-area’s recent economic recovery. Following the decline in economic activity since the cyclical peak in 2000, it has helped to spur economic activity and to promote confidence through historically low interest rates. Between 2003 and 2005, the ECB’s policy interest rates were at a lower level than ever attained by the Bundesbank in the period prior to monetary union. As the recovery was becoming more firmly established in 2005 and 2006, the stimulus provided by monetary policy was gradually withdrawn.

The euro: evidence
7. What impact will the expected enlargement of the euro zone have on the functioning of the euro zone economy and on the management of monetary policy in the euro zone?

The economic weight of the recently acceded Member States (RAMS-12), i.e. the countries that joined the EU in May 2004 and January 2007, is small in comparison to euro area as a whole. Their aggregate nominal GDP currently accounts for about 10% of the euro-area aggregate. Broad money (M3) in the RAMS-12 represents around 2% of euro-area M3. This suggests that the effects on euro-area macroeconomic aggregates and growth dynamics resulting from accession of RAMS-12 countries to the euro area can be expected to be rather limited. Euro-area enlargement would only substantially affect the euro area as a whole if Denmark, Sweden and, in particular, the UK joined the euro area, as their weight in euro-area aggregates would be much higher. In fact, the recent most successful introduction of the euro in Slovenia is a good example of the smooth integration of a RAMS-12 country into the euro-area.

Preparing the ECB Governing Council for future enlargements of the euro area, the decision-making procedure was amended in 2003. According to the current institutional arrangements, the Governing Council consists of six Executive Board members and the central bank Governors of the euro-area Member States. In order to maintain the Governing Council’s capacity for efficient and timely decision-making as its membership widens, it was agreed that the number of NCB Governors exercising a voting right should not exceed 15. When the number of NCB Governors exceeds 15, they will exercise a voting right on the basis of a rotation system. The rotation system is designed to ensure that the NCB Governors with the right to vote are from Member States which, taken together, are representative of the euro-area economy as a whole. Consequently, the NCB Governors will exercise a voting right with different frequencies depending on an indicator of the relative size of the economies and financial systems of their Member States within the euro area. Based on this indicator, NCB Governors will be allocated to different groups. This allocation determines how often they can exercise a voting right. Initially, there will be two groups and, once there are 22 euro-area Member States, there will be three groups.

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ANNEX 2

STABILITY AND GROWTH PACT

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**European Monetary Union**


**Memorandum by Pervenche Berès, Committee on Economic Monetary Affairs, European Parliament**

Further to your letter dated 8 February related to the inquiry led by the House of Lords European Union Committee into issues related to the Euro zone, I am glad to provide you with the following comments.

**What contribution has the introduction of the Euro made to levels of trade within the Euro zone, and between the Euro zone and the rest of the world?**

1. The Euro and the single monetary policy, coupled with the internal market, have fostered trade and integration while currency stability has been delivered to participating countries. Since the launch of the Euro there has been a significant increase in both intra and extra-euro zone trade. This rise may be partly related to the introduction of the Euro. Exports and imports of goods within the Euro zone increased from about 26.5% of GDP in 1998 to around 31% in 2005. Over the same period, exports and imports of goods with trading partners outside the Euro zone rose from about 24% of GDP to almost 30%. This is mainly due to an increase in global trade integration and a very sizeable increase in trade with the ten new member states of the European Union. Thus, partly due to the Euro, the openness of the Euro zone countries, starting from an already high level, has still risen while at the same time the integration has been strengthened. No doubt that without the Euro, the main economies of the zone would have suffered a lot while the international economies have been going through important international financial crisis. Thus the internal trade of the zone, but also by contagion of the EU as a whole, is yet immune from some major impacts of the global imbalances.

**What effect has the introduction of the Euro had on the functioning of European capital markets?**

2. The introduction of the Euro has allowed and fostered financial integration in the Euro zone. The degree of integration varies substantially between market compartments. The money markets and the markets for government securities and private sector bonds are now highly integrated and progress has been made regarding the integration of stock markets. The integration of banking markets, in particular retail banking, is lagging behind, though consolidation of the banking sector notably through development of mergers has certainly been fostered by the Euro. But the main paradox is that even though it is because of the existence of the Euro that those progresses have been made possible, due to the law of the internal market and the absence of specific rules for its functioning inside the Euro zone, the benefit of the integration of the Euro zone financial market has never been specific to the zone.

**Are there any lessons to be drawn from the changes in Euro exchange rates since 1998?**

3. In the context of the prevailing global system of floating exchange rates, the exchange rate of the Euro against the main currencies has strongly fluctuated, notably against the US dollar with which the order of magnitude of fluctuations has been around 50%. These developments have highlighted the need for improving the external representation of the Euro-zone.

4. Actually the Euro has experienced tremendous growth in international markets since its creation. It is now the second world currency. Whether it was a voluntary policy or not, does not matter. The reality is that the Euro has now become a major reserve currency. This creates some new responsibilities which need to be faced. The challenge is to achieve a better representation of the Euro-zone to gain European influence based on its acquired credibility. Notably there is still some confusion among institutions (the Council, the Commission,
the ECB) as to which one is responsible in terms of representation of the Euro, which could be a problem in view of the risks of rapid adjustments of the global imbalances that could result in abrupt changes in the Euro exchange rate against the US dollar with direct impact on growth. A better representation of the Euro-zone in international institutions is needed. Specifically the European Parliament calls for a single Euro zone seat at the IMF Board.

Was the recent reform of the Stability and Growth Pact (SGP) appropriate?

5. The SGP was reformed in 2005 on one hand by reinforcing its preventive arm by taking into account the debt criteria vis-à-vis the one on public deficit and on the other hand by softening the corrective arm. Though it is too early to judge the effect of the reform, this reform went into the right direction.

6. Even though, much more can and should be done. The SGP is an ex post constraint whereas there is a need for an ex ante budget coordination. The challenge lies in the fact that the member states of the Economic and Monetary Union (EMU) have renounced national monetary policies for a single monetary policy whereas they have retained full responsibility for the budgetary policy. The coordination of the fiscal policies has not taken place so far and anti cooperative policies have even occurred. Large countries like Germany and France, where social consensus to implement structural reforms is harder to find, have been affected more sharply. Some small countries which are by nature more open to trade have used social and fiscal dumping. Divergences in the Euro-zone economies with countries for which growth is mainly based on exports (Germany, Austria for instance) and countries for which growth is mainly based on internal demand (France, Spain for instance) are a proof of the need for better coordination and could result in antagonistic effects which may cancel each other out.

7. In the absence of exchange rate adjustments, a lack of collective agreement is detrimental for every member state, at some time or another, and this lack contributes to reducing EU growth. The current coordinating tools are still on their way for improvement. For instance, the Broad Economic Policy Guidelines should have a better impact on the definition of national fiscal policies. Coordination would infer that governments share the same assessment of the economic situation and define common priorities and investment strategies. So far, in practice, the coordination has taken the form of peer pressure on an ex post basis.

8. Some progress has already been achieved in coordination though. The reinforcement of the Eurogroup through a stable presidency was an important step forward and the pragmatic action of Jean Claude Juncker as head of the Eurogroup is to be praised. For instance promoting budgetary coordination using same macroeconomic data and converging budgetary schedules is indeed useful.

Has the ECBs monetary policy been too restrictive?

9. The attitude of the ECB can be considered as overcautious. The monetary policy has been asymmetric: the ECB is quick to raise interest rates when risks for increased prices are looming and slow to reduce interest rates when there is no inflation risk and poor growth forecasts. Everybody accepts the need for price stability as a precondition for a healthy economy, and there is also a consensus on the idea that an independent authority can deliver it most efficiently. But a central bank should also contribute to economic growth and employment, especially if price stability has been achieved. More specifically the EU Treaty in its article 105 says that the monetary policy should support the economic policies of the EU having achieved price stability. Several central banks in the world in practice pay attention not only to price stability but also to both output and employment, such as the US Federal Reserve.

10. The truth is there is no similar situation in the world in terms of independence as the one experienced by the ECB. The status of the US Fed is much different since the institution before which it is accountable is also the institution which confirms its nomination and can modify its status. Moreover there are still progress to be made concerning the transparency of the ECB which by not publishing its minutes prevents a debate from developing which could help define coordination between the fiscal policies and the monetary policy. The strong degree of independence of the ECB calls for a clear democratic counterweight. This means that there is still some progress to be made to increase the weight of the Eurogroup. I am fully convinced that this should never be perceived as a threat towards the independence of the central bank but as a mean to have a really balanced approach inside the Euro zone. That would allow to optimise the outcome of the zone in the interest of its members but also of the EU as a whole.

11. A policy which is simply orientated towards price stability and institutional arrangements have neutralised monetary policy, which is detrimental to growth in the Euro-zone. No real pro-active relationship between the Eurogroup and the ECB has still taken place. The reasons put forward by the ECB for explaining slow growth is the lack of structural reforms. But comparisons show us that countries which have managed
to reform their economy such as Canada and Sweden have been helped by a more dynamic monetary policy and higher growth to facilitate these structural reforms. By contrast with the lack of active monetary policy and budgetary policies in the Euro-zone, it can be recalled that the US policy mix is much more active and the US Federal Reserve is praised and respected for its balanced action.

What impact will the expected enlargement of the Euro zone have on the functioning of the Euro zone economy, the management of monetary policy in the Euro zone?

12. The enlargement is subject to the strict fulfilment of criteria set by the Maastricht Treaty. To the extent that these criteria are strictly fulfilled, the enlargement will be beneficial. But there is no need to speed up such a process since it is clear that the Euro zone countries have experienced diverging trends in inflation, growth, competitiveness in the past years. These diverging trends, though not abnormal in the short term, will raise concerns if they were entrenched. In this context, any enlargement of the Euro zone reinforces, if ever it was needed, the pressure to make sure that the governance of the Euro zone is optimal. Actually some institutional changes are necessary to revamp effectively the EMU framework.

13. Firstly there is a need for better coordination of national fiscal policies (see question 4). Secondly there is a need for better coordination between fiscal policies and the monetary policy (see question 5). Actually in addition to the insufficient coordination of national economic policies, the inadequate policy mix in the Euro-zone is also due to the overcautious attitude of the ECB. Thirdly the external representation of the Euro-zone has to be strengthened (see question 3).

14. Apart from the Eurogroup, which is an informal structure, a specific representation of the Euro-zone would contribute to strengthening it as the core of the EU. Before enlargement, the Eurogroup formed the bulk of the Ecofin Council. Now that it represents 13 countries out of 27 countries some specific mechanisms have to be devised to strengthen the core of the EU. Some impulse could be given by a European Council specific to Euro-zone member states which would devise better coordination mechanisms. There is a need to think out of the box on convergence of tax and fiscal policies, wages, minimum wages. . .

15. The involvement of national parliaments in this process might also help and this is why as chairwoman of the ECON I have taken for three years the initiative to invite representatives of national Parliaments as well as Commissioner Joaquin Almunia and Jean-Claude Trichet to discuss together the priorities and the way of improving the functioning of EMU. In this respect I invite you to refer to the ECON website: http://www.europarl.europa.eu/comparl/econ/hearings/default_2007_en.htm

12 April 2007

Memorandum by Alan Ahearne, Research Fellow, Jean Pisani-Ferry, Director and André Sapir, Senior Fellow, Bruegel

Are there any lessons to be drawn from the changes in euro exchange rates since 1998?

1. During its first two years of existence the euro displayed considerable weakness in foreign exchange markets, depreciating nearly 15% on an effective trade-weighted basis between 1999:Q1 and 2000:Q4 (see figure on next page). The surprising weakness of the common currency during that period threatened to push up inflation in the euro area, implying higher euro interest rates. The authorities responded to the drop in the euro by intervening in foreign exchange markets in late 2000. In the event, the euro began to recover in early 2001 and has been on a steep upward path since then. Over recent months, against a backdrop of a pick-up in economic growth and rising interest rates in the euro area, the euro has posted sharp gains vis-à-vis the dollar and has soared to record highs versus the yen. The euro-pound exchange rate has remained stable within a relatively narrow range over the past four years.

2. Ambiguities remain about who is responsible for exchange rate policy in the euro area. These ambiguities complicated efforts to coordinate intervention in foreign exchange markets in autumn 2000. According to the EMU Treaty, responsibility for exchange rate policy is divided between the Council of Ministers and the ECB. The Council chooses the exchange rate regime under certain provisions and subsequently the national central banks in the euro area carry out the interventions. Article 111 of the Treaty does give the Council power to “formulate general orientations for exchange rate policy.” These orientations have not yet been used and it is unclear how the Council might use this power.
3. The euro’s position as an international currency has been increasing since its launch in 1999, but so far the euro has posed less of a challenge to the U.S. dollar as a global currency than observers had expected. The dollar remains the world’s premier invoicing currency, and the vast majority of foreign-exchange transactions involve the dollar. Moreover, the bulk of official reserves continue to be held in the form of dollar assets.

4. A major concern for policymakers in the euro area is that a disorderly unwinding of global current account imbalances may lead to an excessive appreciation of the euro. While the euro might reasonably be expected to strengthen further against the dollar in the context of global adjustment, further appreciation of the euro on an effective trade-weighted basis does not seem justified. It follows that currencies in Asia will need to appreciate significantly both on an effective basis and against the euro.

### Euro: Nominal Effective Trade-Weighted Exchange Rate
1995:Q1 to 2006:Q4

![Graph of Euro: Nominal Effective Trade-Weighted Exchange Rate](image)

Source: Eurostat.
Note: Data before 1999:Q1 refer to the value of a synthetic euro. An increase in the index refers to an appreciation.

5. Few issues have stirred as much controversy since the launch of the euro as the Stability and Growth Pact (SGP). To its supporters the pact is the cornerstone of the rules governing the single currency, which must be upheld to ensure monetary stability and economic growth. To its detractors the pact is “a nuisance”, whose strict application is detrimental to short-term or even long-term economic performance. One reason why the SGP generated so much controversy was that there is no consensus over its rationale. In fact, it was designed to address three main issues: avoiding that fiscal profligacy in one country spills over into other countries; ensuring sufficient macroeconomic stabilisation; helping fiscal consolidation in the face of ageing population. Over time, the third factor has gained clear prominence and is now often seen as the primary motivation for the SGP.

6. Fiscal consolidation is clearly needed in many euro area countries to ensure sustainable public finances. However, it is doubtful whether the SGP is the right instrument to address this issue and above all whether the electorate’s perception matches the view of their economic authorities. Take the issue of pensions, which is clearly a primary concern for most European voters. Most citizens seem to be aware that important reforms are needed to ensure the sustainability of their pension system. But very few perceive a link between the SGP and pension reform, which is normal since the original pact had no reference to public finance sustainability or pensions.
7. In the mind of the public, the SGP basically means that government deficits must remain below the 3% limit, although this obligation was already contained in the Maastricht Treaty. By contrast, the central tenet of the pact, namely the requirement to respect “the medium term objective of budgetary positions of close to balance or in surplus”, was never grasped by the public. The upshot is that fiscal consolidation staled as soon as the single currency was adopted, despite the fact that five of the eleven initial members had actual deficits of around 3% at the launch of the euro, indicating potential problems for respecting the “close to balance or in surplus” requirement. Four of these countries had deficits above 3% for several years after the 2001 economic downturn, which shows that the SGP suffered from two mutually reinforcing problems: a lack of political ownership by national authorities and the public; and an absence of a clear timetable for compliance with the medium-term objective of the pact.

8. The combination of tough but ill-grounded and weakly enforced rules that characterised the original pact was bound to break under the weight of repeated violation by the four countries, which together account for more than 70% of the euro area GDP. The question now is whether the revised SGP adopted in 2005 will fare better than its predecessor. The new SGP is definitely more flexible than the old one. So the question really is whether it offers better grounded and more strongly enforced rules than its ill-fated forerunner.

9. The new SGP is certainly clearer in terms of rationale. In particular, it now states unambiguously that the main concern is fiscal consolidation, including pension reforms. But will the new pact be enforced better than the old one? Enforcement should be easier now that the pact has a stronger and clearer economic rationale. But effective enforcement also requires that national authorities share a sense of ownership towards the rules of the pact in general and towards fiscal sustainability in particular. A positive development in this respect has been the change of German leadership and the determination of Chancellor Merkel to abide by the German-inspired rules. Her determination seems to have been noticed by the governments in the other delinquent countries which have also adopted measures to respect the limit of 3% of GDP. But the real test of the new SGP will come when the next downturn occurs.

10. In the eyes of its promoters, the single currency had three main internal economic objectives: to ensure lasting macroeconomic and especially price stability in participating countries; to facilitate economic integration within the EU; and, indirectly, to foster growth.

11. The first objective has by and large been achieved. Consumer price inflation in the euro area has remained very close to the “below, but close to 2%” target of the ECB. Furthermore, long-term price expectations derived from the market for inflation-indexed bonds are in line with this objective (see figure on next page). This is a remarkable achievement for an area composed of countries whose inflation record is far from homogenous.

12. Two provisos should nevertheless be added. The first is that throughout the euro area, perceived inflation differs from measured inflation: Surveys consistently indicate that households blame the euro for higher inflation. The explanation is that on the occasion of the changeover in 2002, several service sectors experienced very significant price hikes. While the corresponding items do not have a large weight in price indices, they often correspond to frequent purchases and therefore have a larger weight in perceptions. This has contributed to a gradual weakening of popular support for the euro. The second proviso is that price developments are far from homogenous in the euro area. Inflation in Spain, Portugal and Ireland has exceeded average euro area inflation by more than one percentage point per year. While in the case of Ireland this reflects a catching-up phenomenon, the same cannot be said of Portugal, nor probably of Spain. The risk is that sustained divergence in inflation rates will result in the overvaluation of real exchange rates in certain countries and as a consequence will require a painful correction process.

13. Economic integration within the euro area was expected to result from the elimination of exchange rate uncertainty and transaction costs as well as from increased price transparency. The corresponding process is by nature long-term and the full effects of the euro remain to be observed. So far, only its impact on financial markets has been dramatic. The money market has become completely integrated and yields on euro-denominated bonds and other assets of the same class have converged. Furthermore, the share of bonds and equities of other euro area countries in national portfolios has risen significantly. Domestic and foreign investors tend to consider the euro area as a single entity. Only credit markets remain fragmented, due to regulatory and tax differences across countries and the very limited extent of cross-border competition among banks. In the case of trade, nothing of this magnitude can be observed, yet careful evaluations suggest that the single currency has already increased trade within the euro area by about 10%, certainly much less than some analysts had expected but nevertheless a non-trivial effect. Labour markets, however, remain as
fragmented as ever. The process of integration triggered by the euro can therefore be described as effective, but uneven.

14. The growth effect of the euro has not, at least not yet, been observed in the area as a whole. Countries in which convergence came late such as Spain and Portugal have benefited from the demand effect of the drop in long-term nominal interest rates, but on the whole the supply-side effects widely expected from the move to a single currency have not materialised. Evidence is scant, but if anything the euro does not seem to have acted as an accelerator of structural reforms. It may even have had the opposite effect due to the removal of the threat of exchange rate crises and to the constraints placed on using monetary and fiscal policy to alleviate the short-term costs of reforms. Here again, however, it is too early to tell whether the adoption of the euro will ultimately lead to structural changes.

**Market expectations of inflation at various horizons, euro area**

![Euro area real and nominal yield curves](image)

**Source:** Reuters

10 April 2007

**Memorandum by Jean-Paul Fitoussi and Éloi Laurent, OFCE/Sciences-po Centre for Economic Research**

*Is the Euro serving European public goods?*

1. The European Union (EU) should aim at providing European citizens with European public goods. In a pseudo-federal system like the EU, political deliberation should be about how to finance and produce the public goods that benefit all European citizens, and not only member states individually. Sustainable development is the typical example of a European public good, but there are many others, some of which belong to the economic policy domain: macroeconomic stability, full employment, social integration...

2. Those European public goods are far more important to the welfare of European citizens than the scrupulous observance of doctrinal criteria of budgetary and monetary stability, which, at their best, constitute intermediary objectives for economic policy and, at their worse, prevent the final objectives from being reached.

3. The Euro zone was built in order for European citizens to benefit from economic sovereignty in a fast-globalizing world. Because of the doctrinal bias that has presided to the design of the Euro zone economic institutions, the Euro is in today’s globalization a symbol without sovereignty. As such, it does not serve well European public goods.
4. Since 1999, the Euro has indeed been “strong” when the economy was “weak” and “weak” when the economy was “strong” (see Figure 1). In other words, the Euro exchange rate has destabilized the Euro zone economy instead of contributing to stabilize it.

Figure 1. The (non) European exchange rate policy

Source: OECD.

5. While the consequences of the chaotic European monetary system were logically negative for European countries, one could reasonably hope that the creation of the single currency would give the Euro zone economy a true monetary sovereignty. It has not been the case so far. Yet, the major difference between the respective history of the ECU’s and the Euro’s parity is that the former was a currency basket: no one was responsible for its fluctuations. So one would have hoped that this would not be the case with the Euro, which was born out of a coherent political project backed by a strong institutional framework.

6. The priority has clearly been given since 1999 to price stability over exchange rate stability (with an undeniable success, as shown on Figure 1) in the Euro zone. The activism of the European Central Bank (ECB) on the Forex market has been asymmetric: it intervened when the Euro depreciated (threatening price stability), but not since it has appreciated.

7. It is thus clear that the Euro is not only a currency without a State, but a currency without sovereignty. It is not governed because it has been de facto put under the sway of an independent authority whose conviction is that the Euro zone should not have an exchange rate policy. On the contrary, one can make the argument that the Euro zone economically needs an exchange rate policy and is legally entitled to it.

8. European law, on this point ambiguously unambiguous, gives the share responsibility of the exchange rate policy to the ECB and the Council. The ambiguity runs both ways: the Council can formulate general orientations for the exchange rate policy but must respect the ECB lexicographic order (price stability is first, then comes the rest, Article 105 of the EUT) and the ECB, submitted to this order, must support those orientations when they are formulated (Article 111).

9. More precisely, since, as the ECB itself puts it, the “ultimate responsibility” for the exchange rate policy lies with the member states, a distinction must be made between independence of means and of objectives. The ECB appears to be independent in terms of the means chosen to achieve the general objective set by the Council. But these objectives have to be discussed between the Council and the ECB. And these objectives and that of price stability have to be compatible. The exchange rate policy is thus (although somewhat tortuously) unambiguously a shared competence between the Council and the ECB.

10. Instead of conforming to this institutional framework, the Euro zone members states have opted for the bizarre creation of the Eurogroup, the informal gathering of Euro zone economic and finance ministers, which has been created in 1997 with no legal basis to “dialogue” with the ECB.

11. Apart from the regional pro-cyclicality mentioned above, the consequences of the non-exchange rate policy of Euro zone are twofold. At the regional level, it reinforces spurs for member states to engage in social-tax competition. The case of Germany since 2000 is spectacular in the respect. Since the nominal exchange rate is intangible and the common exchange rate policy non-existent, member states are encouraged to develop their own individual exchange rate policy through their social-tax compact (ie their real exchange rate policy). This
creates a “new European competitive disinflation” detrimental to the least competitive member states and, more importantly, to European growth and cohesion.

12. At the global level, the Euro zone is only an involuntary player in the international monetary system, through the derivation circuit played by the Euro with respect to the dollar. But the Euro can thus be said to serve as the adjustment variable to global imbalances. Without an exchange rate policy of the Euro zone, movements of the exchange rate of the Euro simply reflect the exchange rate policies of the rest of the world. If the dollar was to brutally depreciate, as it could easily do, the Euro zone would face a situation of crisis without a crisis management mechanism.

6 April 2007

Memorandum by HM Treasury

1. The Euro was created on 1 January 1999. At this time the euro was introduced as a legal currency, the exchange rates of the existing national currencies were irrevocably fixed against the euro, and the ECB assumed control of the monetary policy for the 11 founding members. In January 2002, Euro-denominated notes and coins replaced the existing national currency denominations.

2. Greece adopted the Euro in 2001, Slovenia in 2007 and Cyprus and Malta will join the Euro area in January 2008, which will take the number of participants to 15 countries.

3. The macro-economic framework of the Euro area consists of an independent European Central Bank that implements the single monetary policy of the Euro area; and an EU fiscal framework, which applies to other European Union members as well the Euro area countries. This has two arms: the Excessive Deficit Procedure and multilateral surveillance. Within this framework, national fiscal authorities of each member state have autonomy over fiscal policy. The House of Lords has taken evidence on aspects of the macro-economic framework of the Euro-area on several occasions, most recently the Report of the Select Committee of the European Union on the question “Is the European Central Bank Working” (2002–03) and the inquiry of the same Committee into the “Stability and Growth Pact and the European Central Bank” (2003–04).

MACRO-ECONOMIC FRAMEWORK

4. Strong macroeconomic frameworks are essential for achieving and sustaining high and stable levels of growth and employment, and for maintaining long-term economic stability. An effective framework is characterised by credibility, flexibility and legitimacy.

— A credible framework is one in which the policy makers’ commitment to long-term sustainability commands trust from the public, business and markets. This means that agents will not expect policymakers to sacrifice their long-term goals to short-term pressures;

— A robust framework will also provide appropriate short-term flexibility to allow policy makers to respond to shocks. This flexibility must however be delivered while maintaining a credible commitment to long-term objectives; and

— Legitimacy can be achieved through building a consensus about the appropriate goals and about the institutional arrangements through which they can be delivered.

ECONOMIC PERFORMANCE OF THE EURO AREA

5. Annual growth in the Euro Area averaged 2.1% between 1999 and 2006. Following a protracted period of slow growth, a cyclical recovery emerged in the second half of 2005, driven by the robust export performance and a gradual rise in investment expenditure. This recovery became more broad-based in 2006 with growth of 2.9% and the euro area’s strength extended into the first half of 2007. More recently, survey readings of euro area and country-specific business and consumer confidence have fallen following the disruption in financial markets, potentially signaling a slower expansion in the quarters to come.

6. Nevertheless, reasonably solid growth is forecast to continue during the rest of 2007, largely due to the momentum implied by stronger than expected outturn data in the first half of the year. Growth is expected to moderate to around 2% in 2008, its trend growth rate.

1 Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain.
**Monetary Policy in the Euro Area**

7. Low and stable inflation is a key condition for achieving the goal of high and stable levels of growth and employment. Monetary policy in the euro area is conducted by the Governing Council of the ECB with the primary objective of maintaining price stability in the euro area as a whole. The ECB has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. In the pursuit of price stability, the ECB aims at maintaining inflation rates below, but close to, 2% over the medium term.

8. Annual headline inflation rates in the euro area have averaged 2% between January 1999, when the euro was first introduced, and October 2007. Core inflation, which excludes energy and unprocessed food, has averaged around 1.7% over the same period. More recently, inflation has risen sharply bringing the rate of inflation to 2.6%, significantly above the inflation target. Inflation expectations have also increased markedly, with recent European Commission’s household surveys registering a sharp rise compared to previous years.

**Fiscal Policy in the Euro Area**

9. The EU fiscal framework has two arms: the Excessive Deficit Procedure (EDP) and multilateral surveillance. The Treaty and Stability and Growth Pact set out an EDP. This may be initiated under one or two scenarios: a government deficit exceeds 3% of GDP; or government gross debt exceeds 60% of GDP, unless the level of debt is “sufficiently diminishing and approaching the reference value at a satisfactory pace” (Treaty Article 104.2). The surveillance arm is designed to give an early warning if risks exist of a member state having an excessive deficit.

10. The UK supports the principle of a strong Stability and Growth Pact founded on sensible policy co-ordination. However, initial experience with the operation of the SGP highlighted a number of issues that undermined its effectiveness and credibility. These included implementation that tended to focus on short-term deficits rather than debt levels and longer-term fiscal challenges, and too little attention being paid to cyclical factors.

11. In March 2004, the Treasury published a discussion paper on the SGP, setting out the rationale for a strong and effective Pact to ensure long-term sustainability, promote fiscal co-ordination and provide the flexibility to respond to shocks. The Government supports a prudent interpretation of the SGP, which takes account of the economic cycle, the sustainability of public finances with low levels of debt, and recognises the importance of public investment.

12. The SGP was reformed in March 2005. The reformed Pact places a greater focus on reducing and maintaining low debt, providing more flexibility for low debt countries to invest in public services. Enlargement has brought countries into the EU with relatively low debt and high investment needs. The reforms also place a greater focus on the avoidance of pro-cyclical policies.

13. The Government works closely with Member States and EU institutions, as the success of the reforms will depend on how they are implemented. It is also essential to recognize the importance of national frameworks and national ownership of fiscal policy.

**European Economic Reform**

14. Experience has shown that effective frameworks for macroeconomic policy can make a significant contribution to prosperity and economic stability. However, the most significant challenges for the EU and its member states remain structural. It is clear that, three years away from the original 2010 deadline set in 2000, the Lisbon vision to make the EU “the most competitive and dynamic knowledge based economy in the world” will not be realised. The EU and its Member States still need to implement significant economic reforms to improve the flexibility of product, capital and labour markets, and to encourage greater investment in skills and innovation.

15. These reforms will strengthen the single market, which has been one of Europe’s defining achievements and has delivered jobs, growth and greater choice and prosperity for Europe’s citizens and businesses. By removing cross-border barriers to the free movement of goods, services, capital and people, and strengthening competition, the single market had by 2006 created an additional 2.8 million jobs across the European Union and boosted its GDP by €225 billion. Europe is now the largest market in the world and accounts for 20% of world trade. But there is more to be done to ensure the single market continues to deliver benefits in the face of new challenges. For Europe to benefit from the opportunities of globalisation and rapid technological change, it needs to adopt a new, modern and more flexible approach. This also reflects the fact that,

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increasingly, global markets are the destination for European products as well as the source of many goods and services consumed in Europe.

16. Structural reforms are also vital in supporting a well-functioning currency union. Transactions between different currency areas include the costs of currency exchange, and are subject to the risks associated with movements in the exchange rate. These increase the costs and reduce the volume of trade between currency areas, relative to that in a single currency area. However, these potential benefits are contingent on having well-functioning labour, product and capital markets that enable economies to maintain high levels of growth and employment within the constraints entailed by a currency union. Within a monetary union individual countries are unable to use monetary policy to adjust to country-specific shocks. Adjusting to shocks and accommodating economic change without putting at risk high and stable levels of growth and employment demands greater market flexibility than outside a currency union.

THE EURO AND UK FINANCIAL SERVICES

17. Since the introduction of the euro, the UK has attracted a significant level of wholesale financial services business and the City has strengthened its position as the world’s leading international financial centre. The City has become a major centre for euro foreign exchange, reflecting its dominance of international foreign exchange markets, of which it is estimated to account for 32%.

18. When the euro was introduced, some commentators feared that both the financial services industry and British business as a whole would lose out from the Government’s decision not to join the single currency. But based on a careful assessment based on the five economic tests, the Government judged both then and again in 2003 that it would not be in the UK national interest to join. That decision remains under review on an annual basis. Earlier this year the then Economic Secretary said in a speech to the British Chamber of Commerce that so far that 2003 assessment had stood the test of time. Fears that flows of foreign direct investment to the UK would suffer, or the City would be set back, had not proved correct.

November 2007

Memorandum by Philippe Maystadt, President, European Investment Bank

1. What contribution has the introduction of the euro made to levels of trade within the Euro zone, and between the Euro zone and the rest of the world?

1.1 The early literature on trade effect of currency unions tended to exaggerate the gains

1.1.1 The issue of whether currency unions boost trade did not arise only with the euro, but the question certainly received renewed attention with the single currency. One very influential empirical study of the trade effects of a common currency prior to EMU was by Andrew Rose, released in 2000. Applying a standard gravity-equation framework to bilateral trade data of 186 countries, he found that countries that shared a common currency on average traded three times as much as those that did not. In the discussion that followed it soon became apparent, however, that these results offered little insight to the possible trade effects of the euro. Currency unions prior to EMU, included those in Rose’s study, tended to involve small and relatively poor countries, typically in a post-colonial context. That these countries traded much more with their currency union partners was the result of many other factors than the shared currency per se.

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4 http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/econsec/speeches/speech_est_160407.cfm
6 “Gravity” models are based on the notion that the size of bilateral trade flows between countries can be derived on the basis of their respective size (GDP) and distance from each other. This model, in its simplicity, has long been remarkably accurate in replicating actual trade flows.
1.2 New empirical evidence points to substantial trade creation as a result of the euro, both within EMU and with outsiders

1.2.1 The euro area countries have relatively little in common with those studied by Rose and his followers. All the members of the euro area were highly developed, with a high degree of trade openness and integration in the wake of the single market. A few years into EMU, there is now enough data to make a more reliable assessment on the euro’s trade effects.

1.2.2 I will focus this discussion on one recent paper, by authors who have been recognised to provide one of the methodologically most solid studies on this topic. Harry Flam and Håkan Nordström released the first version of their study in 2003 but has updated this extensively in a new paper released in late 2006. These studies have been particularly influential because they have paid attention to problems that have plagued other studies, in particular the distorting influence of exchange rate movements. By limiting their data to that of exports (as opposed to two-directional trade flows), their work also conforms better to the theoretical underpinnings of the applied trade model.

1.2.3 Flam and Nordström use bilateral export data in a sample consisting of the euro area countries and another 10 OECD countries (OECD-10) of comparable level of developments. The sample period is 1995–2005.

1.2.4 The chart below differentiates between three series: (1) exports between euro area members; (2) exports from members to non-members; and (3) exports from non-members to members. All series are shown relative to exports between the 10 OECD countries in the sample that are not members of the currency union.

1.2.5 This chart is suggestive of the euro’s trade effects. While the exports of euro area members (both to each other and to the non-members in the sample) rose by around 25% relative to trade between non-members, exports of non-members to euro area countries rose by a more moderate 5–10%.

1.2.6 While indicative, these observations do not provide hard evidence of the euro’s trade effects. It could be that other factors—unrelated to the euro—coincided with the euro’s launch to boost trade between euro area members. The authors thus proceed with econometric analysis to discern how much of the increase in trade is accounted for by the euro itself, when we also take these other factors into consideration.

1.2.7 Like Rose, the authors estimate a gravity trade model, which assumes that bilateral trade flows between two countries increase with their combined economic size (measured as the product of their GDP) and decrease with trade costs (which include distance between the two economies, language differences and various trade restrictions). They also control for bilateral real exchange rates. The way the euro effect is tested is to

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9 Australia, Canada, Denmark Japan, New Zealand, Norway, Sweden, Switzerland, UK and the US.
10 This time period was chosen for several reasons First, Austria, Finland and Sweden joined the EU in 1995, so their change of status does not have to be accounted for. Second by 1995 the single market programme was well under way. A longer time period would risk misinterpreting some trade creation from the single market as coming from the euro. Still, the authors take measures to control both for the effects of EU membership and single market participation in the estimates.
compare the trade of euro area members with the outsiders. To use terminology borrowed from medical
research, they test whether trade that has been given a “euro treatment” is higher in a given year than trade
that has not received such treatment. The timing of the euro effect is obviously crucial here, as the “euro effect”
should not normally occur before 1999.11

The results are shown in the chart above. When compared with 10 non-euro area OECD countries,
intra-euro area trade was found to rise substantially and immediately after the launch of the single currency
(dark blue bars in the chart). When comparing the average of 2002–05 with the average of 1995–98, the authors
find a 26% increase in intra-euro area trade that can be accounted for by the single currency alone.

Trade between euro area countries and the other OECD countries also grew noticeably from 1999
onwards (in both directions), relative to trade between non-euro countries. Exports from non-members to the
euro area were 13% higher in 2002–05 relative to 1995–98 as a direct result of the euro. Outward exports from
the euro area were 12% higher. While only half the size of the intra-euro area trade effect, these increases are
still surprisingly large from the point of view of traditional currency union theory.

All estimates for trade within, to or from the euro area members are significant either at the 1 or 5%
level soon after 1999 (in a few cases only at the 10% level until 2001). The authors thus conclude that there is
solid evidence for substantial trade effect of the euro, both within the euro area and in trade with outside
countries. They are not surprised to find effects already in 1999 as decisions on euro adoption were taken in
early 1998.12

2. What effect has the introduction of the Euro had on the functioning of European capital markets?

One of the main channels through which the euro has affected European capital markets is by reducing
so-called “home bias” in asset portfolios. This has markedly improved risk sharing across Europe, allowing
investors to tap a much larger home currency pool of savings. This has, in turn, led to notable expansion of
euro denominated securities markets.

2.1 Home bias at the global level

Finance theory has shown that in a fully integrated world where purchasing power parity holds, all
investors should in equilibrium hold the same world market portfolio of financial assets. This portfolio should
consist of assets from different countries (or currency areas) in proportion to their market capitalisation, as
illustrated in the chart below (although this chart is only indicative as not all capital markets are included).

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11 The decision on EMU membership was taken in the spring of 1998, which suggests that 1999 should be the first year for which the
trade effect is visible.
12 The authors also produced a separate estimate of the euro’s trade effects when the control group is limited to the three EU-15 countries
that have not yet adopted the euro. Also in this case there is a substantial (21%) jump in intra-euro area trade relative to the control
group. However, the small size of the control group is problematic and no significant euro effect is detected on trade between the euro
area and non-member countries.
2.1.2 With the exception of the United States, whose large capitalisation share warrants a large share of domestic assets in the optimal portfolio, investors in most countries should, according to this theory, hold mostly foreign assets. The smaller the home country capital market, the larger the foreign asset share in the optimal portfolio. Even in the largest European countries, domestic securities should not account for more than 5–6% of the investment portfolio.

2.1.3 The strict assumptions of this theory typically do not hold in practice, however. Purchasing power parity certainly does not hold except possibly in the very long run. Nor is the world fully integrated. As a result of these factors, actual investment portfolios tend to be characterised by notable “home bias”, which can be broadly defined as a tendency of investors to hold a much larger share of domestic assets than suggested by market capitalisation shares.

2.1.4 This is changing. As observed by the IMF in its September 2005 Global Financial Stability Report, there has been a pronounced increase in the acceptance of foreign assets among developed country investors. The general trend towards more internationally diversified portfolios is observable for most developed countries included in the IMF study, though there is a notable difference between equities and bonds. In equity portfolios, the share of foreign assets has risen in all countries studied. In bonds, however, the international diversification is primarily concentrated to euro area countries.

2.2 Reduction of home bias in the euro area: influence of the single currency

2.2.1 The IMF study does not focus on the impact of the euro on the reduction in home bias. Still, the observation, that much of the global decline in home bias in bond portfolios is driven by euro area countries does suggest that it has played a key role. Several recent papers seem to confirm this conclusion.

2.2.2 Setting the stage for this research, the two charts below are suggestive of the impact of the euro on asset portfolios in very general terms. They show the share of non-domestic EMU assets in the debt and equity portfolios of different country groupings. The share of assets from other EMU countries has increased notably in the portfolios of EMU countries and—to a slightly lesser extent—in the three non-EMU countries of the old EU-15. In non-EU countries, on the other hand, EMU asset shares have not changed dramatically. There is no marked difference in this respect between equity and debt.
2.3 EMU substantially reduced home bias, especially in bond portfolios

2.3.1 New empirical evidence suggests that, indeed, home bias has fallen more in the euro area than in the rest of the world. A new study by De Santis and Gérard (2006) computes home bias in the traditional way, as the difference between the actual and optimal share of foreign assets, divided by the optimal share. Hence, the home bias is 100% if there are no foreign assets in the portfolio and 0 if the actual foreign asset share is the same as the “optimal” share, as defined by capitalisation shares. The ECB study draws several conclusions from its results. Three key observations are worth emphasising (as shown in the two charts below). First, the reduction in home bias is indeed much more pronounced in euro area countries than elsewhere. Second, the reduction in home bias of euro area investors has been much more pronounced in bonds than in equities. Third, while there has also been a marginal reduction in the home bias of other EU countries, there is little to suggest that this is a global trend, supporting conclusions made by the IMF that observed home bias is typically consistent with “optimal” portfolio diversification given current market conditions.

2.3.2 Also, when excluding assets from other EMU countries, the decline in home bias in euro area bond portfolios was notably smaller (far-right bars in the charts). This supports the conclusion that the reduction in home bias in euro area countries was primarily euro driven, and not part of financial integration at the global level. From a currency perspective, the home bias of euro area investors is thus not so much reduced as replaced with a “euro area home bias”.

2.4 Concluding remarks

2.4.1 Growing cross-border asset holdings within the euro area and the reduced home bias of euro area investors are indicative of the much larger capital market that individual issuers in euros can now tap. This increases the liquidity of the capital market, which has contributed to the steadily growing share of large bond issues, and of longer maturity.

2 April 2007

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The introduction of the Euro does not seem to have affected the dynamics of the Euro area's exports

Over the eight-year period 1999–2006, the growth of the volume of total exports (of goods and services) of the Euro area was slower than in the preceding decade (1989–99)—and also as compared to other advanced economies. Total exports of the Euro area rose by about 5.1% per annum in real terms, while those of all advanced countries (and the UK) by 5.5%.

Moreover, the average 5.1% growth of the Euro area conceals large differences across the individual Euro countries. German exports were rising at about 7.5%; the French and Spanish at about 4.4–4.5%; while the Italian at close to a mere 1%.

Trade (in goods) within the Eurozone has been even less dynamic than the Eurozone’s trade with the rest of the world.

These are the facts. They do not necessarily mean that it is the Euro itself which is responsible for the relative weakness of trade (both internal as well as external) of the Euro area. Other factors may have been at work (ie the differentials in overall economic growth between the Euro area and the rest of the world, as well as between individual Euro countries, real appreciation of the Euro vs. other currencies, etc). But, given the facts, it would seem rather extravagant to claim that the Euro has been conducive to a stronger trade performance.

The Euro area capital market remains largely fragmented

The common currency has had important consequences. The yields on long-term government debt has practically converged throughout the Euro area. Also, the spreads between interest rates on commercial loans charged across the Euro area have narrowed substantially. The convergence of yields on government debt has clearly benefited the high-debt countries (eg Italy). Moreover, the Euro-denominated corporate bond market has been growing rapidly since 1999. No doubt the cross-country transactions have become much more frequent than before. Whether the latter development is due to the common currency is debatable because other factors may have been equally important (such as intensified privatisation across the Continent). All in all, a single Euro area capital market is yet to emerge. Banks, subject to diverse national traditions (and regulations), continue to play a dominant role in continental Europe’s capital markets. Despite the elimination of the exchange rate risk, the impact of the Euro on the Euro area capital market is still considered fairly limited.

The Stability and Growth Pact: less of a nuisance, currently

The interpretation of the Growth and Stability Pact agreed upon in June 2005 provides for the necessary flexibility vis-à-vis the circumstances such as a prolonged stagnation. Moreover, the governments can now defend “deficit spending” by urgent needs (such as on health system reforms or infrastructure). All this is reasonable. But the rhetoric of the EU Commission and of the European Central Bank is still rather annoying. Apparently, “Brussels” continues to believe in the SGP. In due time (eg as the German government manages to eliminate its “excess deficit”), one may expect a tendency to return to a more rigid interpretation of the Pact.

The Euro’s losers and winners

The single monetary policy (conducted by the ECB) is at least partly responsible for the diverging performances of individual Eurozone members. The ECB’s single interest rate has had radically different consequences throughout the Eurozone. While in low-inflation countries (such as Germany) the ECB rate has implied quite high real market interest rates, in higher-inflation countries (say, Ireland or Spain) the same ECB rate implies low (or even negative) real market interest rates. The perverse consequence of this is that the same monetary policy which is actually too restrictive in low-inflation (and hence usually also low-growth) countries, is at the same time too lax in high-inflation (and, sometimes, also high-growth) countries. Thus, the ECB mechanism is actually a destabilising force, amplifying rather than reducing cyclical movements in individual member states. Of course, stagnation (and high unemployment) in Germany have had negative consequences for the whole of the European Union (and even more so for its major partners in the Euro area). The German stagnation released a tendency to suppress wages (initially in Germany itself). This further depressed German domestic demand—and further increased the competitiveness of German exports. In effect Germany’s problems have been spilling over to other countries (eg Italy) losing out on competitiveness/trade.
The ECB policy has been too restrictive

The ECB “implicit inflation target” (less than 2%) is certainly too restrictive. Other major inflation-targeting central banks (such as the Bank of England, Sweden’s Riksbank) have a 2% central target, with a +/-1% tolerance band. Numbers aside, the ECB is simply too inflation-averse. It sees signs of impending inflation where almost nobody else does.

The impacts of Euro area enlargement: next to nothing

Slovenia, recently admitted into the Euro club, is a tiny economy compared with the rest of the Club. Its money (M3) stock is about 0.2% of the Euro area’s M3. Moreover, the Slovenian economy is in a fairly good shape. All in all the enlargement is unlikely to disrupt, in any imaginable way, the functioning of the Eurozone economy. Also, it will not affect the management of the monetary policy. Things might be different should Poland, Hungary or the Czech Republic accede the Euro area. But this is unlikely to happen anytime soon. None of these countries qualifies. Moreover, they are not eager to accede at all—at least for the time being.

3 April 2007

Memorandum by Professor Pedro Schwartz and Juan Castañeda

Question 1: What contribution has the introduction of the Euro made to levels of trade within the Euro zone and the rest of the world?

1.1 Currencies are said to affect trade in two ways: their number can multiply transaction costs and vice versa; their volatility can reduce the volume of trade and upset the balance of payments. But the foreign exchange market is so large and sophisticated that the costs of using it have fallen to levels not too removed from money transfers in the same denomination. Also, a prima facie case can be presented that flexible exchange rates have not impeded the extraordinary growth of world trade in the last quarter century. From 1950–71, the Bretton Woods fixed exchange rate period, world exports corrected for GDP growth multiplied a mere 1.79 times. But from 1972, when Bretton Woods broke down, to 1993, they multiplied three times; and from the same 1972–2005, no less than 14.1 times.

1.2 For trade in goods and services what matters is the real exchange rate, that is to say, the nominal rate divided by the price of the goods and services concerned (E / P). The monetary authorities cannot manage these terms of trade of the nominal exchange rate, except in the very short run by means of a “dirty float”. The real exchange rate between two monetary zones cannot be frozen: it moves even if the money rates are fixed via a currency board. A central bank that keeps the exchange rate of its currency artificially low is pricing imports artificially high; quite soon wages and other production costs will increase; and the bank will find it difficult to sterilise the reserves it thus accumulates. All this will lead to rises in the price level that will have the same effect as a revaluation.

1.3 A full answer to Question 1 would demand detailed econometric analysis. To our knowledge, one of the most telling instances of the small effect of nominal exchange rates on trade is when Eire and the UK broke 150 year monetary union in 1979. A sharp fall of trade from 1979–82 coincided with a contraction of the Irish economy and a strong and sustained appreciation of sterling. But trade soon recovered, showing no sign of being hurt by the separation between the punt and the pound. (See Graph 1)

Question 2: What effect has the introduction of the Euro had on the Functioning of European Capital Markets?

2.1 The effect has not been as great as was hoped. The Treasury Bond Market is still fragmented due to the insistence of some national Governments such as that of Spain to force traders to register with the Bank of Spain. However, mergers between European electronic exchanges are imminent and they might create Atlantic rather than European Exchanges.

2.2 The Mifid Directive will surely make for pan-European markets in shares and derivatives, whether within banks or through Stock Exchange mergers.

2.3 It is ironic that one of the principal effects of the introduction of the Euro has been the emergence of London as the premier financial market of the EU and one of the three world markets, with Tokyo and New York.
4.1 In 1997 the Stability and Growth Pact (SGP) was adopted to prevent Euro zone members from free riding on a sound Euro to finance large and persistent public deficits cheaply. Such behaviour would undermine the common currency, especially when the market knows that errant countries will in the end be bailed out. The 2005 reform weakened the SGP and was not appropriate with one exception. (See 4.5 below)

4.2 The original SGP imposed a clear limit (3% GDP) to fiscal deficits in the short run, while aiming at fiscal balance or even a surplus as the medium term fiscal target (the preventive arm of the Pact). If the EcoFin Council considered a deficit as excessive (above 3% GDP), the so-called corrective arm of the Pact became operative via Council recommendations, sanctions and, finally, fines (proportionate to the member’s GDP)—unless it was appreciated that the country suffered a “severe economic downturn” (-2% or more annually) or an event out of its control.

4.3 The 2005 reform reduced the effectiveness of the rule. Regarding the preventive arm, country specific targets have replaced the single medium term target for all the countries. Though the reform keeps the 3% maximum for public deficits, the evaluation of this new country specific target is over the cycle. This permits a looser fiscal adjustment when output is said to be under its potential and thus erodes the effectiveness of the target as an anchor for expectations in markets. Monitoring and control become more difficult.

4.4 The reform has created such a high degree of flexibility in the measures to be taken to reduce the deficit that the effectiveness of the corrective arm has virtually vanished. The new SGP contains a number of escape clauses to avoid the deficit procedure (see Morris et al., 2006). The original “severe economic downturn” clause has been relaxed; now, any negative GDP growth is taken as severe. “Other relevant factors” can be taken into account to stay the corrective measures; such as the existence of an “output gap” in the economy, or the increased financing of R + D investment, or the implementation of the Lisbon Agenda. Also, deadlines for excessive deficit procedures by the Council have been significantly extended.

4.5 A positive aspect of the reform is that it allows the sustainability of public finances to be taken into account, such as the structural reforms implemented to achieve a better fiscal position in the long run.

4.6 A much needed change in the SGP was passed over: errant members should not be allowed to vote in their own cause, since they are at present a part the EcoFin Council that adjudges on their deficit and the correcting measures to be imposed on them. (Buiter, 2006).

Question 3: Are there any lessons to be drawn from the changes in the Euro exchange rates since 1998?

3.1 Too much political meaning is attached to the international value of currencies. The exchange rate is not a symbol but a price.

3.2 There was much misplaced glee at the early fall of the Euro after its launch and now too much worry because of its high price in terms of dollars. The dollar has gone through 30% devaluation since then because of the deficit in the American basic balance, brought about by low savings rates and a large budget deficit. The re-equilibrating mechanism is working slowly.

3.3 The nominal rate of exchange is not important in the long term and the real exchange rate is not controllable by the monetary authorities. (See 1.2 above)

Question 4: Was the recent reform of the Stability and Growth Pact appropriate?

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Question 5: What effect has the introduction of the Euro had on individual member countries’ economic development?

5.1 The mere change of the nominal currency used does not of itself affect the economic development a country. Economic growth depends on real factors, such as proper institutions, technological progress and the increase of productive resources of the economy on a sustainable basis. However, the stability of the currency does contribute to economic development. Also, conditions of proper macroeconomic behaviour imposed on the countries using the Euro contribute indirectly to sustainable growth. The reduction in transaction costs from using the same currency can have a sizeable effect as well but it has to be backed by a lowering of barriers to financial transactions—something still pending in the Euro zone. In sum, the introduction of the Euro was on the whole positive for the countries concerned, especially for those that markets saw as being unreliable.

5.2 The large differences in economic growth among the nations of the Euro zone indicate that the euro is not of itself a decisive factor of economic health. At the time of joining, there will be a marked reduction in the insurance premium against devaluations included in the interest rates of smaller countries. There will also be an initial boost in direct investment coming from the rest of the EU as they are not subject to nominal exchange rate shocks. However, further sustained growth demands real reform: Ireland and Spain, for all the aid they received, took painful but necessary measures; Portugal has done so only belatedly; France and Italy have not:
the euro: evidence

hence the differences in growth rates. The case of Germany, where a strong currency has proved no barrier for industrial exports, is an answer to critics of “one size fits all” interest and exchange rates: macroeconomic reforms demanded by a stable currency have positive returns; countries can adapt to an appreciating currency when excellence and productivity are pursued.

5.3 These arguments in favour of creating stable currencies used over a large zone may lead one to overlook the advantages of monetary competition. The supply of more than one currency in the EU and the world has its advantages. Central bankers are not to be trusted. Investors must be able to switch currencies and combine a portfolio that minimises risk. This consideration overrules arguments in favour of having Sterling join the Euro. An advisable step towards increasing monetary competition would be the total abolition of legal tender.

Question 6: Has the ECB’s monetary policy been too restrictive?

6.1 In the short period of its existence, the ECB has slowly come to fulfil its main obligation to maintain price stability in the Euro zone in the medium term. Since monetary policy cannot be used to smooth the cycle or foster growth, the policy of the ECB has been just about right.

6.2 The ECB has defined price stability as increases of the Harmonised Index of Consumer Prices (HICP) of less than (but close to) 2% yearly; which taking into account the positive bias of current price indices, virtually amounts to price stability. After a rocky start the HICP has been kept around its upper mark throughout from 2003 on. (See graph 2) The revaluation of the Euro has partly protected the Euro zone from asset price inflation induced by the lenient behaviour of the Federal Reserve and the Bank of England.

6.3 Some critics have adduced that monetary policy can be used as a counter-cyclical instrument. According to this view, monetary policy can be managed to foster the real economy by reducing the official nominal interest rate to fit the economic conditions of a given area. However, both macroeconomic theory and the analyses of the expansionary policies of previous decades clearly indicate the undesirable effects of money used as a demand-managing tool. In the long run, a loose monetary policy does not contribute to real growth but leads only to increases in consumer and asset prices (Friedman, 2006). Even in the short run there is no way to know how much a reduction of the bank rate will go into inflation and how much into real interest rates and real growth. Loose monetary policies result in artificial and temporary output growth, followed by inflationary episodes and sharp real adjustments.

6.4 Accurate knowledge of economic structure of the economies in a monetary zone and of the lags associated with monetary policy-making are even more acute in the case of the ECB, since it has to conduct a single monetary policy for a new economic area. Rather than trying to second guess the short term real effects of its monetary decisions, the ECB has rightly tried to run a credible price-stabilising policy in the Euro area and successfully anchored market price expectations. It has thus inverted the advice of neo-Keynesians and has contributed to better resource allocation by forcing markets to adapt to stable money conditions rather than the other way round.

6.5 It is real money, constant value money (M/P), that individuals find a necessary transaction tool and an indispensable asset in an uncertain world. But when excessive issue pushes up P, the price level, the resulting real money supply may fall and cause stagnation. The object of monetary policy should be that of the ECB: keeping the value of money as stable as possible while supplying just enough of it to give the market the real liquidity it needs.

Question 7: What impact will the expected enlargement of the Euro zone have on the functioning of the Euro zone economy?

7.1 Of the 10 countries that joined the EU in 2004 Slovenia has joined the Euro and the rest still have to fulfil the Maastricht criteria. When all of them join, the ECB will have to take monetary policy decisions for a supranational monetary area of twenty two members. The fulfilment of those criteria will permit the convergence to the nominal standards of the members in terms of public finance, as well as a greater stability of nominal interest rates and exchange rates during the evaluation period. However, even though necessary these criteria do not guarantee the proper functioning of the new enlarged monetary area.

7.2 True, these countries will benefit from the running of a credible non-inflationary monetary policy by the ECB. But for a multi-country currency area to operate smoothly the free running of markets is the essential requisite: nominal exchange rates will have ceased to be policy instruments nor will country-based monetary policy be possible. In order to overcome ordinary demand and supply shocks, flexible markets for goods, services and labour are required, as well as easy labour and capital movement across countries. Under those conditions transversal shocks, ie, those affecting the new members singly, would result in nominal adjustments
of local wages and prices rather than in costly real adjustments of output and employment. The present performance of the twelve countries of the Euro zone does not afford much hope of successful avoidance of real adjustment costs,

...and the management of monetary policy in the Euro zone?

7.3 The management of a new enlarged monetary area is based on a “one size fits all” policy; that is, the running of a single monetary policy made based on the aggregate data of the whole zone. This is the case in the different regions of nation states, and it has also been the case of the current heterogeneous multi-country Euro zone. It is sometimes argued that fiscal transfers are needed in a large monetary area to soften the cost of reacting to transversal shocks. This is as may be, but transparent information and timely warnings by the ECB and more flexibility in the economies of the new Europe and the whole of the Eurozone will reduce the unwanted effects of running a monetarist policy such as that of the ECB.

7.4 12 new members of the ECB will pose the functional difficulties noted by Schwartz (2006) and Berger et al. (2006). To address these difficulties the Governing Council of the Bank proposed and the EU Council decreed that the six Executive Committee members have each one vote and the Central Bank Governors variously rotate for the other 15 votes. (ECB, 2003)

7 April 2007

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Graph 1

IRISH-BRITISH MONETARY SEPARATION AND ITS EFFECT ON TRADE

Chart 5.26: Irish trade with the UK

Log of volume of trade

Source: OECD, IMF and HM Treasury calculations


Note: After correcting for the continued fall of UK’s share of Irish trade from the 60s, in part due to the rapid growth of Eire and the trade diversion caused by EU economic union, the Study asserted that “the estimated impact of the Anglo-Irish currency regime on trade between the two countries appears insignificantly different from zero”. (Pg. 44)
1. What contribution has the introduction of the Euro made to the level of trade within the Euro zone, and between the Euro zone and the rest of the world?

Intra-Euro zone trade has been stimulated by the elimination of exchange rate risks and currency-related transaction costs as well as by more price transparency and competition. It is estimated by several studies that the Euro has boosted intra-Euro zone trade by 5 to 15% on average since 1999. The German Council of Economic experts estimated that there has been a Euro-induced surge in German exports of about 18%.

Euro area trade with the rest of the world has risen roughly in line with world trade in the past 10 years (5% pa). It is, however, dominated by buoyant growth in the US, Eastern Europe and in Asia. Interestingly, trade invoicing between the Euro zone and the rest of the world has notably increased in recent years (to over 60% on average) thus reducing the exchange rate risks for firms in the Euro area.

2. What effect has the introduction of the Euro had on the functioning of European capital markets?

The introduction of the Euro has strongly stimulated the integration of European capital markets. Debt markets—in particular the government and corporate bond markets—have reached a high level of integration both in terms of liquidity and the availability of instruments. By contrast, equity markets have shown a moderate speed and extent of integration mainly due to different national legal and tax systems. But even here the home bias has lost in importance. For instance, the euro area’s mutual fund industry has increased the share of non-domestic stock holdings from 40% in 1995 to 70% in 2003.

With the completion of the EMU, the integration of Europe’s financial markets became even more important as a policy objective. The EU’s Financial Services Action Plan has strongly contributed to the great progress towards more integrated and efficient financial markets, in particular in the field of securities. It is now imperative to implement the FSAP as agreed. However, the EU also needs selective new legislative and regulatory initiatives in the segments where market integration is lacking so far: eg retail markets, mortgages and asset management. New regulations must be set smoothly and not burden industry.
Integrated financial markets are not only to the benefit of customers and the financial industry but also strengthen the competitiveness and growth prospects of the economy as whole. Several economic studies have estimated the economic benefits of financial market integration with an estimated increase in terms of GDP between 0.5% and 1.1%.

3. Are there any lessons to be drawn from the changes in Euro exchange rates since 1998?

The euro exchange rate vis-à-vis the dollar experienced a phase of weakness until 2002 (with a lowest rate of 0.83 USD per EUR) followed by a multi-year upward trend until 2007 (to about 1.34 USD per EUR). However, the amplitudes of the fluctuation of the EUR/USD exchange rates since 1998 has been much lower than the amplitudes of DEM/USD rates from the start of the floating-exchange-rates system In 1973 to 1998. A main reason is that euro financial markets are much larger and more liquid than the relatively small DEM markets before 1999 and thus able to absorb substantial capital flows out of a weak dollar or into a strong dollar more smoothly. Thus, the euro introduction has reduced the adjustment pressure of a weak dollar on the Euro zone’s foreign trade sector.

Moreover, the launch of the euro has also eliminated the negative impact of a weak dollar exchange rate on the intra-European exchange rate pattern. A weak dollar did not only put pressure on Europe’s overseas exports but also used to triggered an up-valuation of the DEM and higher interest rates in Germany’s partner countries with negative impact on business activity in Europe as a whole as we witnessed, for instance, in 1992–93 and again in 1995. Assumed there would have been the pre-1999 exchange rate pattern until today it seems to be very likely that Europe would have suffered massive currency turbulence after events such 9/11 or the terrorist attacks in Madrid in 2004.

4. Was the recent reform of the Stability and Growth Pact appropriate?

The reform of the pact in 2005 was necessary given the fading ownership of the pact rules by France and Germany and the rising economic heterogeneity of the enlarged EU. The reform was appropriate as it enhanced the economic rationale and the flexibility of the budgetary rules over the cycle and took better account of (longer) periods of weak growth.

I appreciate the strengthening of the preventive part of the pact by calling for a minimum annual reduction of structural deficits by 0.5% of GDP p.a. and stronger focus on budget consolidation in good economic times.

By contrast, I criticised the changes in the corrective part of the pact insofar as a long list of mitigating country-specific factors can be brought forward when it comes to the assessment whether an excessive budget deficit over 3% of GDP exists. Indeed the pact bestows a great deal of flexibility on governments which might be abused to dilute the pact and undermine fiscal discipline. So far, governments with excessive budget deficits have dealt with the reform of the pact in a responsible manner. Admittedly, the upswing since 2006 has been very helpful for Germany’s fiscal position which was characterized by an excessive budget deficit from 2002–05.

It is positive that the new pact stresses fiscal sustainability. However, much more emphasis should be placed on the demographic challenge in the Euro area.

5. What effect has the introduction of the Euro had on individual member countries’ economic development?

The introduction of the Euro has provided low interest rates and a substantial fall in the borrowing costs, in particular in the former high-interest-rate countries. The ECB’s credible monetary policy has also contributed to this. Lower interest rates have stimulated the economy and supported investment and employment throughout the Euro area.

A disappointing feature of EMU was the poor growth performance between 2001 and 2005, not only in relation to the US but also in comparison with the non-EMU EU member states including the UK. The reason for this long period of weak growth in the Euro area was not, as many claim, due to macroeconomic policies but resonates with a lack of comprehensive structural reforms in several member countries, in particular with regard to the overregulated product and labour markets.
6. Has the ECB’s monetary policy been too restrictive?

No. Nominal interest rates have been lower than in pre-Euro times. Even Germany has benefited from the fact that interest rates have been lower since 1999 than during DEM times. This is justified insofar as the average inflation rate of the euro area from 1999–2006 (2.1%) has been lower than the inflation rate during DEM times from 1948–98 (about 2.8%). But even real interest rates were lower in Euro countries after the introduction of the single currency.

The argument brought forward in 2003–05 by some Anglo-American economists that the German economy would have suffered from too high real interest rates and borrowing cost is not valid. The corporate sector did not complain about a too restrictive monetary policy. Real interests, however, have remained even lower than during DEM times when the German economy embarked on a brisk upswing in 2006.

Nevertheless, the ECB has achieved, on average since 1999, an inflation rate only slightly above its definition of price stability (“below but close to 2%”). The policy yardstick of the ECB is “Harmonised Index of Consumer Prices” (HICP). Thus, the ECB has, by definition, a one-size-fits-all problem as it cannot take into account inflationary pressures of individual fast-growing countries such as Ireland. Special national inflationary problems must be addressed by national policy such as fiscal, structural and wage policies.

7. What impact will the expected enlargement of the Euro zone have on

a. The functioning of the Euro zone economy?

The enlargement of the euro zone will further promote trade integration as such a step will eliminate the exchange rate risks and exchange-related transaction costs between the euro area and the new EMU member states. This will make it easier for the Euro zone economy to continue to benefit from the strong growth in the new EU member states.

The impact on the functioning of the Euro zone economy will, however, be limited for the time being given the fact that the overall economic size of the 11 new EU member states (Slovenia is EMU member state since 2007) is only about 7% of the euro zone’s GDP and the bigger countries such as Poland, Hungary and the Czech Republic are only expected to join EMU after 2010.

b. The management of monetary policy in the Euro zone?

Euro zone enlargement affects the ECB in various ways. The ECB has established a close cooperation with new EU member states in order to prepare them for EMU membership. The cooperation comprises areas such as monetary policy, banking supervision and payment systems. The ECB will also be party to the agreement on entering the ERM II in the pending cases of the abovementioned three bigger countries as well as Romania and Bulgaria.

The basis of ECB’s monetary policy will be little affected given the relatively small economic weight of the new EU member states. However, the voting procedure in the Governing Council of the ECB will have to be adapted as the governors of new EMU member states will also become members. The Governing Council is already rather big (six members of the Executive Board plus 13 national central bank governors). In order to deal with the problem of an efficient decision-making in a growing Euro zone, a rotation system was agreed in 2003 implying that all Governing Council members are allowed to attend all meetings but, as soon as EMU has more than 15 members, voting rights will rotate among national central bank governors. The rotation system has, however, some serious disadvantages, though, as it is very complicated and intransparent. A further weakness is that Germany and France would no longer have a permanent voting right.

Further Reading of Deutsche Bank Research Publications on the Euro

— Norbert Walter, Werner Becker, Marion Mühliberger (2006), Estonia, Lithuania, Slovenia: Poised to adopt the euro, Views on medium and long-term convergence, EU Monitor, Reports on European integration, No. 33.
— Werner Becker (2005), Reform of the stability pact—a license to run up debt, EU Monitor, Reports on European integration, No. 23.


— Norbert Walter (2000), The euro: second to (n)one, American Institute for Contemporary German Studies, German Issues 23.

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