

Further Considerations on EMU

It will create instability and destroy employment

WALTER ELTIS





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INTRODUCTION

GORDON BROWN HAS DECLARED that, 'The decision on a single currency must be determined by a hard-headed assessment of Britain's economic interests'.¹

This paper argues that there are fundamental *economic* obstacles to British membership which will need to be taken into account, even if convergence with the European economies is apparently achieved. In particular, it demonstrates that:

- The UK economy is and will remain, far more sensitive to interest rate fluctuations than the economies of continental Europe. In addition, the UK will often require different interest rates.
- The UK economy has a very different structure of production from continental Europe. UK exchange rates therefore need to be at rates which are sensitive to fluctuations in the dollar and the yen as well as the euro.
- Despite widespread apprehension to the contrary, the supremacy of the City of London as the financial centre of Europe will not be damaged if the UK stays out of EMU:

¹ *UK Membership of a Single Currency: an Assessment of the Five Economic Tests*, October 1997, HM Treasury, Preface by the Rt. Hon Gordon Brown MP, Chancellor of the Exchequer.

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its comparative international efficiency will ensure that it will prosper at least to the same degree as Switzerland whether or not the UK continues to maintain an independent currency.

- The euro will be especially vulnerable to financial strains during the transition period. International markets will be able to buy and sell bills and bonds denominated in national currencies (where the responsibility for them is unambiguously tied to their issuer). Interest rate differentials will widen if any country is evidently finding its membership uncomfortable, imposing additional costs on its government.
- European governments have so far found no solution to the underlying problem of growing unemployment.
- The pressure on governments to find a solution for their growing unemployment may impose unsustainable strains on EMU. The countries with the most intractable unemployment difficulties will question the constraints of EMU membership.
- The UK should therefore avoid joining EMU.

CHAPTER ONE

THE UK IS MORE SENSITIVE TO CHANGES IN INTEREST RATES

IN THE UK, A LARGE NUMBER of banks and building societies compete to take deposits and to lend. In consequence any British company or family which can offer adequate security can obtain all the finance it requires at interest rates close to the rate the Bank of England establishes. Because of the intense competition in the market for finance in the UK, this is allocated according to who can afford to pay the market rate of interest and not through administrative decisions by those who control particular banks.

In much of continental Europe, families obtain finance for home-ownership or for personal consumption far less readily. Since would-be borrowers have a more limited range of banks and building societies to turn to, they are far more often denied loans. Families cannot finance 90% of the cost of home-ownership as in Britain. In consequence aggregate mortgage debt is 60% of GDP in the UK but only 40% in Germany, 25% in France and less than 10% in Italy. The interest rates paid on these lower levels of personal debt are also less flexible than in the UK. The variable interest rate liabilities of the UK personal sector total 64% of GDP. They are only 16% in France, 3% in Germany and 2% in Italy.² Aggregate continental European bank and building society lending therefore rises and falls far less when interest rates change, both because there is less of it and because it is less sensitive to the rate of interest.

² *The EMU Collection: what the EMU means for Europe*, Dresdner Kleinwort Benson Research, March 1998, p.132.

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This also means that in these countries the rate of growth of the money supply is considerably less sensitive to the rate of interest.

An independent committee chaired by Rupert Pennant-Rae, whose membership included Sir Peter Gregson, Sir Tim Lankester, David Begg, Charles Bean, David Miles, Richard Portes and Martin Wolf, reported in May 1997 that, 'Simulations on macroeconomic models run by national central banks suggest that, for the UK, the impact of an interest rate change on domestic demand after two years is four times the EU average'.³ They continue:

The implication of this is clear. Unless UK balance sheets become more European, inside EMU the UK would be more sensitive to changes in short-term interest rates. The impact of any change in European monetary policy would therefore be disproportionately channelled through the UK. As a result the UK economy would be disproportionately volatile.

The UK's share of the EU's GDP is 15% in 1998. If the impact of an interest rate change is four times as great within the UK as in the remaining six-sevenths of the EU, approximately two-fifths of the total EU-wide impact on aggregate spending of a change in the rate of interest would arise within the UK and the remaining three-fifths in continental Europe. The UK would then become the EU's principal regulator of effective demand, with highly damaging consequences for its financial stability.

Past disasters when UK interest rates were over-closely tied to those in Frankfurt are familiar. In 1987-89 Nigel Lawson's policy of shadowing the D-Mark had the consequence that London interest rates were inappropriately low. At these bargain rates the UK personal and small business sectors rushed to borrow, and bank and building society lending exploded with the consequence

³ *The Ostrich and the EMU: Policy Choices Facing the UK*, Centre for Economic Policy Research, 9 May 1997, p.17.

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that house prices soared. Shortages of every kind of labour associated with construction developed, and pay accelerated first in construction and then in the remainder of the economy. Inappropriately-low interest rates raised the rate of inflation in the UK from 4¼% in 1987 to 9½% in 1989. There was no comparable acceleration of inflation in continental Europe.

In 1989-92, as a consequence of ERM membership, Chancellors John Major and Norman Lamont were again obliged to pursue a policy of shadowing Frankfurt interest rates. These proved inappropriately high for UK conditions in the aftermath of German reunification. Bank and building society lending collapsed together with house prices and the liquidity of small businesses. Bankruptcies and housing repossessions soared, and the consequent recession proved far deeper in Britain than in continental Europe.

In these episodes the UK economy built up steam when the engine drivers in Frankfurt decided that the European boiler needed to be stoked up, while it had to be run down when Frankfurt decided that the European economy was overheating. Within EMU, the Governor or Deputy-Governor of the Bank of England would become one of the European Central Bank's six principal directors, but one vote out of six would be insufficient to ensure that European interest rates were appropriate for UK conditions.

If, when EMU begins in 1999, UK interest rates actually had to come down to the prospective European rate of around 4%, those in the UK who wished to move up-market in housing would rush to take advantage of an apparently unique opportunity to move into more expensive property. Bank and building society lending would explode and inflation would soar in relation to continental Europe, thereby undermining the competitiveness of UK based production and make Britain a high-cost area within the new monetary union.

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The UK would of course time its entry to coincide with a convergence of interest rates so that it would temporarily appear that the interest rates judged appropriate for Frankfurt and Paris were also right for London. But subsequent divergences would arise. When they did, the UK would rediscover that it had been condemned to fluctuate disproportionately in relation to Europe in the manner that the Pennant-Rae committee predicted.

Some believe that the underlying structure of British and continental balance sheets is moving closer together and that these may converge. More British borrowing is now at fixed rates than used to be the case. There is none the less a fundamental difference in the finances of British and continental families. The UK personal sector holds far more extensive financial assets, 288% of GDP against 186% in France, 140% in Germany and 162% in Italy. The extra UK personal assets mainly consist of greater holdings of equity shares. Far more UK pensions provision is arranged through the private sector. UK governments have correspondingly less liability to finance future pensions. The OECD estimates that in 1997 the net present value of France's future pension and social security liabilities exceeded the UK's by 176% of its GDP, that Germany's exceeded the UK's by 206% of GDP and Italy's by 259% of GDP. Since personally-controlled UK wealth is more extensive, private expenditures will remain far more sensitive to interest rates. In addition to their direct effect on housing finance, they have a large and immediate influence on the equity market which will continue to have a disproportionate impact on consumer spending in comparison with continental Europe.

There is therefore no realistic prospect of significant convergence between financial balance sheets in Britain and Europe. Within the single currency, the British economy would be destabilised from time to time by property booms and slumps induced by inappropriate interest rates.

CHAPTER TWO

THE UK WILL OFTEN REQUIRE A DIFFERENT DOLLAR EXCHANGE RATE

MEMBERSHIP OF EMU WOULD fix the sterling exchange rate in relation to the European currencies, but not with regard to the dollar and the yen. Fixing sterling with respect to the D-Mark and the franc would increase its volatility in relation to the dollar and the yen. In the 1980s and the 1990s, whenever the dollar has risen in relation to the D-Mark, sterling has risen with it. When the dollar has fallen in Frankfurt, sterling has also fallen. Fixing the UK exchange rate with continental Europe would actually increase its volatility with regard to the rest of the world.

There are fundamental reasons why the sterling exchange rate moves partly with the dollar and partly with the D-Mark. The UK, like the US but unlike any other EU country, is a significant oil producer. The UK also resembles the US in the extent of its high-tech industries such as biochemicals, aircraft, scientific instruments and telecommunications. In these the principal international competition comes from the US and Japan.

The UK has a higher ratio of high-tech production than France, Germany and Italy. The details are set out in Table 1. France, Germany and Italy excel in the mid-tech manufacture of motor vehicles, washing machines, refrigerators, and mechanical engineering products. The UK excels in original research with far more Nobel Prizes than any country except the US: but it generally requires others to help it to manufacture what it brilliantly designs and develops.

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TABLE 1

Shares of High-Tech and Information Technology (1993-1996)

	High-Tech as % of Manufacturing (1993-94)		IT as % of GDP (1996)
	Value-Added	Exports	Expenditure
United States	24.2	37.3	4.08
Japan	22.2	36.7	2.51
UK	22.2	32.6	3.24
France	18.7	24.2	2.41
Germany	20.1	21.4	2.10
Italy	12.9	15.3	1.44
Spain	13.7	14.3	1.34
Sweden	17.7	21.9	3.36

Sources: OECD and Morgan Stanley for High-tech ratios.
European International Technology Observatory for IT data.

In the high-tech industries such as pharmaceuticals where the UK has some of the world's largest and most efficient companies, success in research and development is far more significant than skill in the mechanics of production, and the UK has established a large comparative advantage. France and Germany in contrast enjoy a considerable comparative advantage in the mid-tech industries where production skills are paramount. For UK high-tech production, the sterling-dollar exchange rate matters most.

It is often supposed that because between 50% and 60% of UK trade is with other EU members, and only 15% with the US, sterling's exchange rate with the US matters little in relation to its exchange rates with France and Germany. What such calculations ignore is that where the UK exports high-tech products to Europe its principal competition *within Europe* will often come from US companies. A recent Morgan Stanley survey of

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companies which enjoyed world-class competitive advantage found that more of these are located in the UK than in France and Germany combined.⁴ When such companies sell in Europe, their principal competitors are often equally large and competitive US and Japanese companies.

With EMU membership, the UK's exchange rate would be locked into France's and Germany's, and the interests of UK high-tech production would become subordinate to the influences which determine the appropriate exchange rate for the predominantly mid-tech products of continental Europe.

The advantage of sterling's present flexibility with regard to both the dollar and the European currencies is that foreign exchange markets can take both kinds of influence into account. They do so in general by raising sterling less than the D-Mark when the D-Mark rises, and by reducing it less when the D-Mark falls. That takes account of the particular need to sustain the competitiveness of UK high-tech production. Between April 1996 and May 1998, sterling rose 27% in relation to the continental currencies, but only 9% in relation to the dollar, so the competitiveness of high-tech trade was far less undermined.

With a different structure of production from continental Europe, the UK often needs a different combination of exchange rates. The present flexibility of the sterling rate with regard to both the D-Mark and the dollar delivers this.

⁴ Stephen S. Roach et al, *The Economics of Competitive Advantage*, Morgan Stanley (London), November 1996.

CHAPTER THREE

THE CITY OF LONDON WILL RETAIN THE SAME ADVANTAGES AS SWITZERLAND

THERE IS SOME APPREHENSION by those who fail to recognise its comparative efficiency that the City of London will be damaged if the UK stays out of EMU. They assume that monetary union will produce a continental European zone of stability and economic strength: this is far from clear. They also fail to recognise the extent of the City of London's world-wide business. Frankfurt and Paris cannot match London's domination of international financial transactions.

The City of London has vastly more international financial business than Frankfurt or Paris. In 1995, the year of the last comparative Bank of England survey (there will be another during 1998), daily foreign exchange market turnover exceeded \$450 billion in the UK when it was less than \$100 billion in Germany.⁵ Derivatives turnover was almost twice as great in the UK as in France and Germany combined.⁶ In 1992 marine insurance was almost twice as great in Britain as in France and Germany combined, while aviation insurance was more than seven times as great.⁷ In 1995 cross-border bank lending was greater in London than in France and Germany combined, and equity turnover was one-and-one-half times as great, while

⁵ *Bank of England Quarterly Bulletin*, November 1995, p.363.

⁶ 'Key Statistics on Financial Activity in UK, France and Germany', City Competitiveness Group, Bank of England.

⁷ Corporation of Lloyds.

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turnover in foreign equities was almost thirty times as great: markets for these scarcely existed in Frankfurt and Paris.⁸

Much of this business is independent of whether or not Britain is part of a single currency area, and London's greater market share underlines its superior efficiency. This could be weakened if banking regulations made in Frankfurt reflected continental rather than UK interests. For example, larger capital adequacy ratios of the kind proposed in Germany would in effect tax the UK's already well-regulated banks.

Switzerland offers an example of a country which does not maintain exchange rate stability with the currency of any other country, yet none the less maintains a highly prosperous and competitive financial centre. The comparative international efficiency of the City of London would ensure that it would prosper similarly if the UK continued to maintain an independent currency.

⁸ 'Country shares in Selected International Markets', City Competitiveness Group, Bank of England.

CHAPTER FOUR

EMU'S VULNERABILITY

THOSE WHO ARGUE THAT Britain should join EMU believe that it will offer membership of a large new currency area of strength and stability. But doubts have been expressed about its sustainability if countries are included which have converged insufficiently with Germany. In September 1996 Professor Allan Meltzer told a United States Conference, 'I have very little doubt that they will go ahead on January 1 1999. My question is, Will they still be there in 2001?'⁹ His apprehension is even shared by Hans Tietmeyer, the President of the Bundesbank who told a Karlsruhe audience on 13 October 1997 that, 'sustaining the monetary union may need perhaps more solidarity than beginning it'.

The European Commission has been aware of EMU's vulnerability and it has anticipated and sought to prevent a speculative attack of the kind I described in my 1997 Centre for Policy Studies paper, *The Creation and Destruction of EMU*. In July 1997 the Commission announced that from January 1999 until January 2002, the D-Marks, French francs, Italian liras and Spanish pesetas which still circulate will be regarded as subdivisions of the euro, and defined as quantities of euro cents, to be determined as soon as the irrevocably fixed exchange rates are

⁹ Jeffrey Gedmin (ed.), *A Single European Currency*, Washington DC: American Enterprise Institute, 1997, p. 40.

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established.¹⁰ If the world's banks sell liras on an enormous scale and buy D-Marks in the manner I described in 1997, they will be selling euros and buying euros, and end up with exactly the quantity of euros they started with. If the euro breaks, the component currencies will not necessarily emerge with their former legal identities because these will all have become sub-units of the euro. That is the European Commission's defence against the potential threat of speculation.

This defence relies on conformity by the Bundesbank with obligations which require it to print unlimited euro-D-Marks in exchange for euro-liras. If it is slow to do this for any reason – such as a belief by those who control it that the German government is replacing the D-Mark with the euro through an illegitimate political process – a *de facto* premium of the euro-D-Mark over the euro-lira would emerge. Well-informed observers are convinced that the Bundesbank will not hesitate in its obligation to print euro-D-Marks in exchange for euro-liras, and that it will then hold these in its balance sheet, or else convey them to the new European Central Bank.

But no defence can be absolute, and even if the Bundesbank acts in the manner most now assume, EMU will still be open to pressure in the markets for bonds and bills: a significant element in my 1997 account of its vulnerability. Interest-bearing bonds and bills are always specific to the country or company which issues them. Canada has a common currency, but interest rate differentials between the bonds issued by the Canadian provincial governments have been as high as 150 basis points because of their different credit ratings.

¹⁰ Resolution of the European Council of 7 July 1997 'on the legal framework for the introduction of the Euro'. (97/C 236/04).

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TABLE 2

The Credit Ratings of EMU's Founder Members (January 1998)

	Moody	Standard and Poor's
Germany	Aaa	AAA
France	Aaa	AAA
Netherlands	Aaa	AAA
Luxembourg	Aaa	AAA
Belgium	Aa1	AA+
Ireland	Aa1	AA
Finland	Aa1	AA
Portugal	Aa3	AA-
Spain	Aa2	AA
Italy	Aa3	AA

The ratings (in January 1998) of the eleven EMU starters are set out above. Variations in these will remain, as they do between the Canadian provinces. How they develop will influence the differentials between the long-term interest rates each has to pay.

Alberta has no responsibility to service Quebec's debt, and the German government will accept no responsibility for debt incurred by the Italian, Spanish and Portuguese governments: these will continue to be their own legal responsibility. If there is any suspicion of the Italian government's ability to service its debt, whether in liras or euros, its Moody's rating and its Standard and Poor's rating will fall and the comparative long-term interest rate it has to pay will rise correspondingly.

If EMU breaks, it is likely that German and Italian government debt will again be denominated in D-Marks and liras. But if what emerges from the collapse of the euro is to be New-D-Marks and New-liras, there is no doubt that the ratio of the New-D-Mark to the New-lira will exceed that of the Old-D-Mark to the Old-lira which initially entered the euro. If there is any break-up, those

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who hold bonds for which German companies or the German government are responsible will gain to whatever degree the ratio, New-D-Mark/New-lira exceeds the Old-D-Mark/Old-lira ratio. Hence if EMU breaks and Italy in effect devalues by 20% in relation to Germany, those who hold any German bill or bond will gain 20% relative to those who hold any Italian bill or bond.

This will be a one-way bet because the post-EMU Italian-German exchange rate can only move in one direction. In comparison, speculating against sterling within the ERM was risky. If sterling had survived in September 1992, it would have risen from the 2.78 D-Marks at which George Soros sold £1 billion to 2.85 D-Marks. Soros would have lost nearly £30 million.

Most of those who anticipate an EMU break-up will prefer to deal in bills or very short-term bonds so that their potential exchange rate gain will be maximised in relation to other influences. Many bills and bonds issued in the private sector will remain denominated in their present national currencies throughout the three year transition. Holding these will involve no shift into and then out of the euro. The proposed regulations which the European Commission published in July 1997 state that during the transition period between 1999 and 2002, 'Acts to be performed ... stipulating the use of or denominated in a national currency unit shall be performed in that national currency unit,' and it is only in 2002 that 'where reference is made to national currency units, these references shall be read as referring to the euro unit'.

Those who wish to take advantage of a possible break-up and a new exchange rate structure will find no difficulty in discovering bonds and bills which have a continuing legal existence in D-Marks and liras throughout the transition period. They will not buy and sell cash as in recent waves of speculation because the European Commission appears to have removed the separate element between cash balances in different European currencies;

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but the Commission cannot succeed in the same way with bills and bonds where the responsibility to service them is unambiguously and inseparably tied to their issuer.

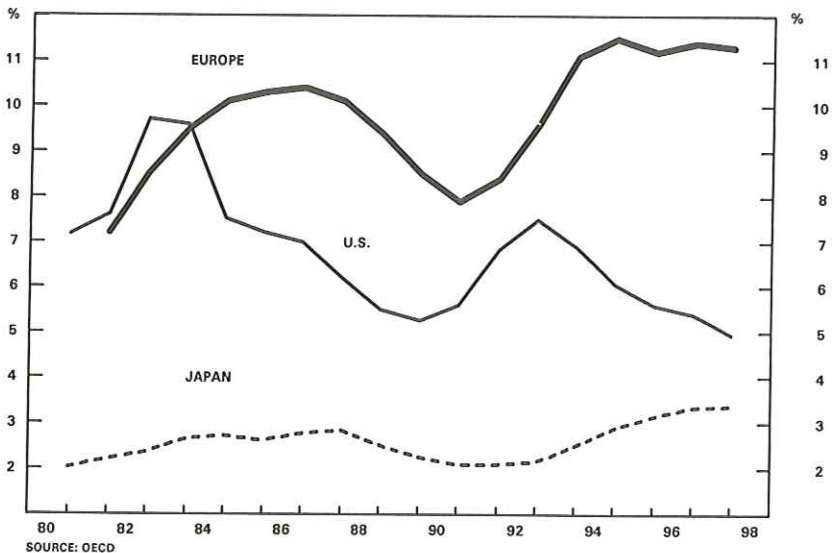
Hence, if there is an EMU crisis, the financial community will move heavily into bond and bill markets with the consequence that interest rate differentials will widen. Italian public debt is 120% of the Italian national income and it is mostly in short maturities. Each percentage point increase in the interest differential against Italy will raise the cost of financing Italian public debt and therefore Italy's budget deficit by about 1¼% of GDP. This will further weaken the market's perception of Italy's public finances, and throw additional costs onto employment in Italy.

CHAPTER FIVE

THE THREAT TO EMU FROM EUROPE'S GROWING UNEMPLOYMENT

IF THERE IS A CRISIS which threatens EMU's continuation it is likely, as George Soros has intimated, to centre on the inability of the leading European economies to prevent unemployment from rising. Europe's employment problems are at the heart of scepticism about prospects for the single currency. Unemployment within the EU has risen from 7% in 1980 to an estimated 11% in 1998. In 1980 unemployment was similar in the US and Europe. In 1998 unemployment in the US has come down to 5% while European unemployment has risen to 11%.

Unemployment Rates in Europe, USA & Japan, 1980-98

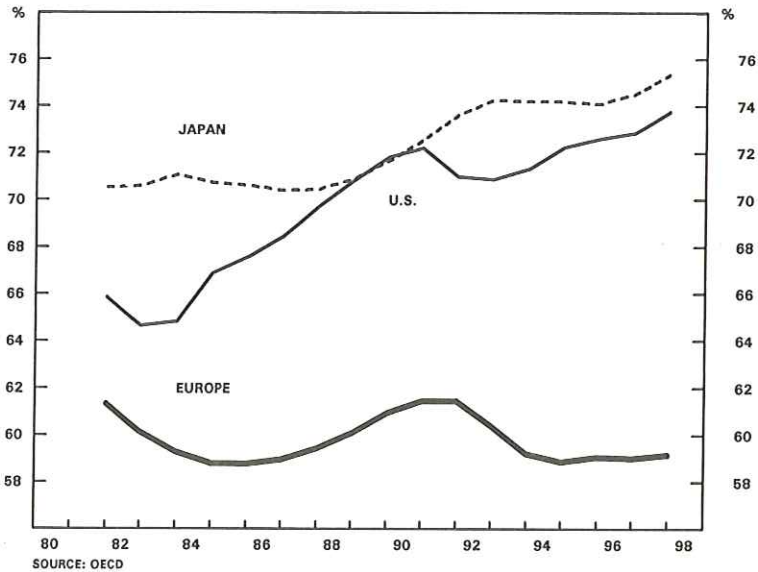


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More than 20% of European men and women under the age of 25 who wish to work are unemployed. As unemployment rises towards 12% and above, with youth unemployment averaging more than 20%, and with still higher unemployment among racial minorities and in inner-city areas, there will be growing threats to law and order in formerly stable societies.

The proportion of Europeans *with* jobs compares unfavourably with the US and Japan. In 1998 fewer than 60% of Europeans were employed, while more than 74% of US and Japanese men and women were in paid employment.

Employment Participation Rates in Europe, USA & Japan, 1980-98

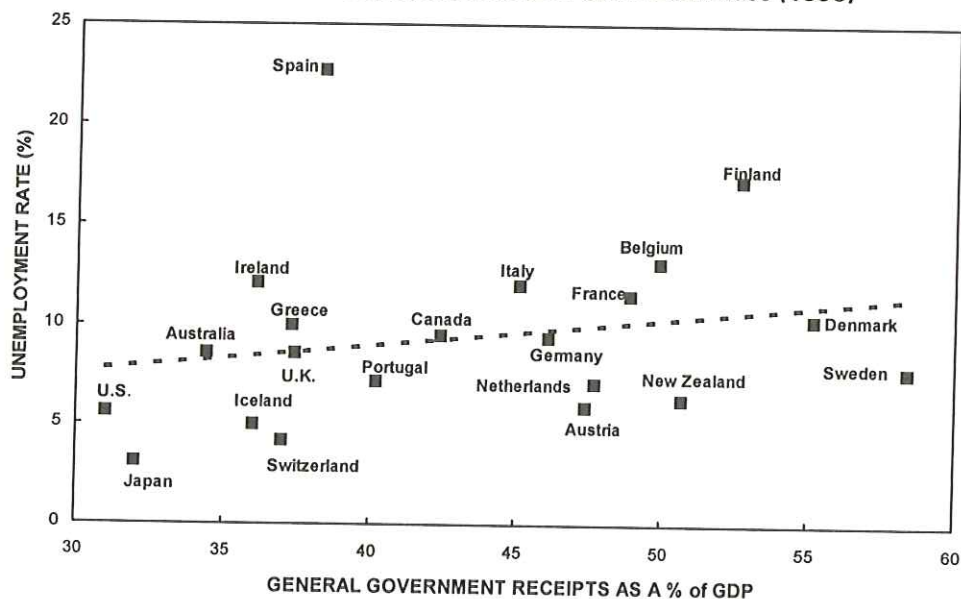


Europe's private sectors have created no jobs (in the aggregate) since 1970; such job creation as has occurred has been by government. In each economic cycle, no European jobs are created in the expansion phase, and this is followed by job destruction in the subsequent recession. From 1990 to 1993 when

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recession predominated, 4.4 million EU jobs were lost. From 1993 to 1997 when European economies expanded at a rate of 2.4% per annum, average unemployment remained stuck at 11%. With this trend, unemployment will rise to more than 13% in the next recession which could come as soon as the deterioration of Asian markets weakens Europe's exports, or else when the world's stock exchanges suffer a significant correction of historically high price-earnings ratios. French and Italian unemployment is 1½% above the European average, so if this rises from 11% to 13% in the next recession unemployment in France and Italy will approach 15%.

Taxation and Unemployment Rates in OECD economies (1995)



There is an explanation for the failure of the EU economies to create jobs even in periods of economic expansion. European taxation was only slightly above the US level in the 1960s, but since then it has risen sharply, and it now exceeds taxation in the

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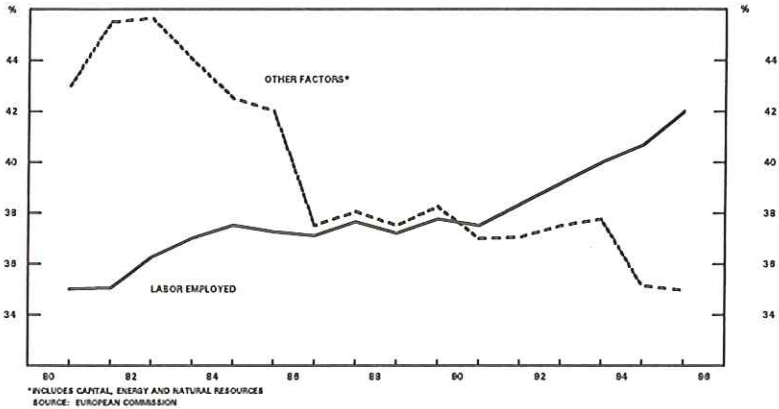
US and Japan by 14% of GDP. Steven Englander of Smith Barney has produced a cross-country study of unemployment and taxation in OECD economies: it suggests that each extra percentage point on taxation in GDP is associated with extra unemployment of 0.3%.

The explanation is the principle of the wedge. Taxation of virtually any kind creates a wedge between the sales value which workers and companies create and the wages and profits they receive. The wedge reduces the extent to which they are rewarded for producing. Europe's tax wedge now exceeds that in the US and Japan by 14% of GDP.

Herbert Giersch, the first chairman of Germany's council of economic experts which Ludwig Ehrhardt established in 1963, has suggested an elaboration. Because taxation raises the real cost of labour, it leads to a substitution of capital for labour with the result that new technology acquires a labour-saving bias.¹¹

European Implicit Tax Rates

The following chart shows how average European taxation on labour employed has risen from 35% to 42% while the taxation of capital and energy has fallen from 43% to 35%



¹¹ Herbert Giersch, 'Eurosclerosis' in *The World Economy in Perspective*, Aldershot: Edward Elgar, 1991.

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Since the 1970s, taxation has greatly raised the cost of labour in Europe in relation to other factors of production. This helps to explain why European investment expenditures, which considerably exceed those in the US as a share of GDP, create virtually no jobs.

In the US 35% of all new investment in durable equipment is now concerned with information processing where Europe invests considerably less. Since 1980 the real cost of IT equipment has fallen 90% in relation to the cost of equipment in general, so workers who have the skills to exploit these new technologies can be equipped extremely cheaply. This has had a favourable impact on job creation in the US. Europe has handicapped its potential to exploit the new technologies with tariffs on the principal IT components such as semi-conductors to protect its own manufacturers (such as Siemens). Such tariffs and anti-dumping duties are only now being removed. European users of IT have hitherto been denied the opportunity to buy the latest equipment as cheaply as purchasers in the US and Japan. This has placed a brake on investment in high-tech which has proved to have the greatest international job-creating potential.¹² Instead European producers invest mainly in the older technologies where, with high real labour costs, investment has often had an employment-displacing bias.

The principal diagnosis of the European Commission is that European unemployment rises at economic growth rates of less than 2%.¹³ But overall unemployment remained stuck at 11% between 1993 and 1997 when growth averaged 2.4%. Part of the explanation is that faster growth has been accompanied by an

¹² Walter Eltis, *The IT Revolution and European Employment*, Foundation for Manufacturing and Industry, June 1998.

¹³ Commission of the European Community, *Employment in Europe, 1997*, Brussels, October 1997, COM (97) 479, p.6.

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accelerated level of labour-displacing investment of the kind which Herbert Giersch described.

European employment also suffers from labour market rigidities. The IMF refers to studies which indicate that real wage flexibility in Europe is only half that in the US.¹⁴ The IMF has also estimated that in 1997 of Europe's 11% unemployment, between 8% and 9% was structural, especially associated with 'elaborate job and income protection arrangements that raise the cost of labour (including... high taxes needed to finance social safety nets), discourage job creation and job search, and favor substitution of capital for labour'.¹⁵

The European Commission produced two charts in 1996 to illustrate the adverse impact of labour market rigidities. The Employment and Social Affairs Directorate in Brussels objected to their publication, but the Financial Times nonetheless obtained copies and published the Commission's charts under the heading, 'The Charts they tried to suppress'. They illustrate how, across Europe, less flexible labour markets and higher costs of making workers redundant are associated with higher unemployment. The countries with the highest unemployment have made no effort to address these rigidities.

Many of Europe's larger companies, especially in Germany, are restructuring in order to improve their global competitiveness. Typically this results in major job losses. A similar process occurred in the US, but without negative effects on overall employment. The main explanation is that the US has a vibrant and entrepreneurial small business sector which created millions of new jobs in the 1980s and the 1990s. Continental

¹⁴ IMF, 'EMU and the World Economy', *World Economic Outlook*, October 1997, Washington D.C., p.64.

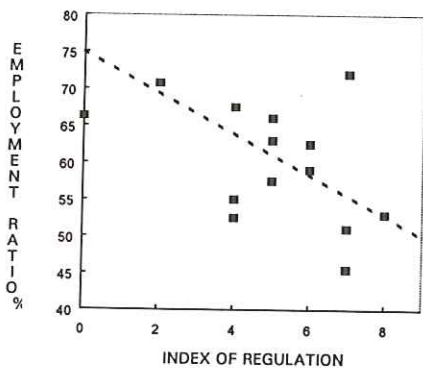
¹⁵ IMF, 'International Economic Outlook: Enhancing Labor Market Flexibility in Europe', *World Economic Outlook*, October 1997, pp.11-13

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Europe does not have this benefit so insufficient new jobs are created to replace those lost through corporate restructuring.

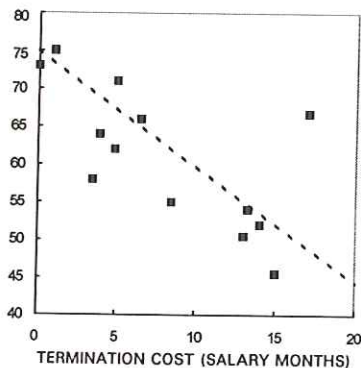
THE CHARTS THEY TRIED TO SUPPRESS

Trade-Off Between Employment And Regulation in EUR 14 1994



SOURCE: EUROPEAN COMMISSION

Trade-Off between Employment and Termination Cost In OECD 1994



The creation of new businesses is central to the achievement of growth in private sector employment, and this is especially inhibited by taxation and the labour market rigidities which proliferate in continental Europe. Jobs are crowded out by uneconomic minimum wages, especially for the young. In addition, as a result of the difficulty of making workers redundant, employers are reluctant to offer new jobs. France is replete with firms which limit their employment to 9 or 49 in order to escape the additional regulations which apply to firms with more than 10 and more than 50 employees. Small service sector firms in France are beginning to register in the UK to reduce their tax liabilities. The total number of small firms rose by more than 1 million in the UK in the 1980s, and the self-employed increased by nearly 1½ million between 1979 and 1995. France and Germany will require similar developments if the employment they lose through corporate restructuring is to be made good by additional job-creation in small businesses.

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The leading continental European economies are desperate to find solutions; but those they are actually implementing will add to unemployment. The former Communists on whom both the French and Italian governments rely for their parliamentary majorities do not countenance fundamental labour market reforms, while the French and Italian trade unions cling to hard-won privileges which add to the rigidity of labour markets, and they have never been defeated in a significant conflict with government.

In Germany there is little influence from former Communists, but there is similarly virtually no effort to reduce labour market rigidities. Unions insist on national pay scales so workers in areas of high unemployment cannot be priced into jobs, and the protection of the rights of those who already have jobs, the 'insiders', cannot be diluted. Hence those in work prosper, while the 'outsiders' without employment cannot be brought in. Employers have no desire to extend the insiders' privileges to additional workers. Moreover, it is in Germany that the relative cost of labour is highest and the bias towards labour-economising technologies is greatest.

Europe's private sector employment would be assisted if overall taxation could be reduced, and the tax-wedge diminished; but there is no likelihood of reducing the ratio of public expenditure to GDP. The domestic policies of all the leading European countries have a tendency to raise public expenditure, and demographic trends, together with the manner in which the leading continental European economies are failing to fund their future pensions liabilities will massively increase public expenditure and hence the need to raise taxation in the early decades of the next century. It has been estimated that to finance these, French taxes will need to rise by 6.6% of GDP, German by 8.8% and Italian by 10.2% over the next three decades.¹⁶

Faced by apparently intractable obstacles to orthodox economic solutions, some continental European governments have re-

¹⁶ *The EMU Collection*, (op. cit), p. 135.

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discovered the 'lump of labour' theory based on the notion that the amount of employment an economy provides is given, so that there will be jobs for more people if the hours each works is reduced. The IMF shows how such policies 'exacerbate structural problems':

Labour market policies have often sought to mask the underlying problems by promoting early retirement or work sharing. Such measures appear to be intended to reduce open unemployment not by increasing the demand for labor but by reducing labor supply. But with unreformed labor markets, such measures tend to improve the bargaining position of insiders and raise their real wages, with little benefit to outsiders who are likely to remain unemployed. (*Economic Outlook*, October 1997, p.12)

The most striking example is the decision by the French and Italian governments to reduce the working week from 39 to 35 hours with no reduction in pay. This will evidently raise the real cost of labour by 11% and so destroy marginal employment; but higher pay per hour for insiders will evidently price workers out of jobs. There is some French recognition of the laws of economics, because the 35 hour week is to be implemented in the private but not the public sector: the government recognises that it cannot afford its inflationary consequences.

The 35 hour week is actually a reversion to the economics of *Das Kapital*, first published in 1867. The former Communists who became ministers in France in 1996 will know it extremely well. It shows how income distribution between profits and wages is determined by an economy's 'rate of exploitation' which Marx defined as the number of hours in which workers work for capitalists divided by the hours in which they work for themselves. Any reduction in the working week cuts the hours employees work for capitalists without reducing those in which they work to produce their own wages. There are numerous and extensive

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passages in *Das Kapital* which show how frequently the nineteenth century class struggle took the form of efforts by workers to reduce the working week, and so diminish the rate of exploitation and the share of profits.¹⁷ Industrial workers produce vastly more than their wages throughout Marx's writings so higher pay never prices them out of jobs. The marginal revolution only entered economics in the 1870s, a decade after the publication of *Das Kapital*.

That probably explains why former Communists attach such priority to the achievement of a shorter working week; but the acquiescence of the brilliant *énarques* who control the French Socialist party in this reversion to the economics of 1867 is more difficult to understand. It is doubtless a price they have had to pay for a parliamentary majority. Dominique Strauss-Kahn, France's Finance Minister in 1998 perceptively described the 35 hour week as 'economic madness'; but Lionel Jospin, France's Prime Minister, told a Socialist party meeting on 24 January 1998 that cutting the working week is 'a symbol of the workers' struggle which has been going on since the nineteenth century.'

It may be a symbol, but it underlines the irrelevance of the policies which are actually being addressed to Europe's unemployment crisis. The same is true of public sector make-work schemes for the young in both France and Germany consisting of work with no economic function. These may have a temporary cosmetic influence on the unemployment rate, but they will increase public expenditure and therefore overall taxation, raise the 'tax wedge' and render the creation of private sector jobs still more difficult. President Chirac understood this completely when he said in 1998, 'It is the private sector which creates jobs and wealth: all the rest is nonsense.'

¹⁷ The Index of Karl Marx, *Capital*, vol. 1 (Progress Publishers, 1970) has references to 'workers' struggle for shorter working-day' on pp. 171-2, 219-20, 225, 241, 257-8, 265, 268-9, 274-77, 385-6; and to 'the prolongation of working-day and magnitude of surplus-value' on pp.486-96 and 513-4.

CHAPTER SIX

EMU'S PROSPECTIVE INSTABILITY

FACED BY GROWING POLITICAL DISCONTENT, European governments will be desperate to find solutions. Yet within EMU they will be able to do little or nothing to reduce unemployment. Fiscal expansion will be ruled out by the stability pact which only permits budget deficits of up to 3% of GDP. Most of the eleven EMU starters will enter 1999 with deficits already at that level, so the rules will permit no further fiscal expansion. Within EMU, individual countries will be unable to reduce interest or exchange rates. The EU budget is limited to 1.8% of GDP and this is already absorbed by previous commitments (in particular, agricultural subsidies, so there is no scope for fiscal transfers to individual countries in particular difficulty).

After the large further rise in unemployment which is to be expected in the next recession, Europe's electorates and the politicians who represent them will become desperate. If they are unable to face the realities of labour market rigidities and rising taxation, they may thrash around for false solutions and insist on the adoption of macroeconomic policies which are likely to undermine the authority of Europe's new Central Bank and the stability of the euro.

In theory, the euro will be controlled by some of Europe's most distinguished central bankers, but will governments actually stand aside and leave the principal macro-economic decisions to Wim Duisenberg, Otmar Issing, Jean-Claude Trichet and their similarly

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thinking colleagues? Europe's politicians will have an immediate means to influence the decisions of the European Central Bank. It has the responsibility to determine interest rates, but exchange rate policy remains with national governments. In theory these can seek exchange rates between the euro, the dollar and the yen which would oblige the European Central Bank to adopt inappropriate interest rates. In 1987, when Nigel Lawson decided that the pound would shadow the D-Mark, it followed that London interest rates had to be set at inappropriately low levels to hold sterling down. If EMU's eleven founder-governments decide that the euro should not rise in relation to the dollar, perhaps in another Plaza Hotel-like agreement, the European Central Bank could be obliged to set interest rates accordingly.

The machinery for such intervention will lie in the Euro-X Committee of finance ministers of the EMU members: France has insisted on this as a counterweight to the otherwise dominant and legally independent bankers. Spokesmen to represent the eleven may fly to Washington and Tokyo to demonstrate their continuing relevance to the ever-pressing problem of Europe's unemployed. Whether the bankers who control the new European Central Bank will actually be over-ridden will remain an open question while Europe's unemployment crisis persists.

But with the EU's overall ratio of taxation in GDP of 50% and its continuing tendency to rise, and the introduction of new flat-earth rigidities in France and Italy, private-sector job creation will not revive. New government attempts to create employment will raise taxation further and accentuate the labour-displacing tendency of investment in the private sector. European governments will therefore prove powerless to prevent the next step jump in unemployment.

Even if they agree to implement policies to reduce labour market rigidities, despite the uncompromising opposition of trade

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unions and unreformed Socialist ministers, the UK example suggests that it takes up to ten years for such reforms to make significant inroads into the overall level of structural unemployment.

Governments unable to satisfy their electorates are unlikely to preside for long over a stable economic environment. Desperate for action, some will press for the abandonment of the stability pact and some will indulge in creative accounting to circumvent it. Some will press for increases in the EU budget to finance Europe-wide job-creation schemes. This would increase the fiscal burden on Germany which is already paying heavily to absorb the former East Germany. In addition, Gerhardt Schroeder, the probable next Chancellor, has signalled a more German and less European view of Germany's interests than Helmut Kohl's. Germany will undoubtedly resist proposals which require additional spending to support Mediterranean employment: the leakages to a corrupt infrastructure which would accompany this are alien to the manner in which Germany and Austria are now governed. Germany and Austria will also resist pressures to remove EMU restraints.

With this continuing impasse, politicians in the countries where rising unemployment appears most intractable will begin to question the constraints of EMU membership. The world's financial community will note any speeches by potential future ministers regretting EMU membership. It will do so by avoiding bills and bonds issued by companies and governments in countries where there are such speeches against EMU. This will increase the interest differential against these countries. That will accentuate their financial difficulties in the manner which has been described. This is one scenario, close to the one which David Lascelles of the Centre for the Study of Financial Institutions has

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outlined¹⁸, and to George Soros's 1996 account of EMU's vulnerability.¹⁹ There are many others.

General von Moltke, who presided over Germany's victory over France at Sedan, used to say that 'the enemy has three alternatives, and of these he will choose the fourth.' The ways in which EMU may founder are equally various.

The UK should continue to keep clear of these developments. It is at last beginning to succeed in the independent management of its monetary policy. Even if EMU prospers, the UK will often require higher or lower interest rates than those in continental Europe. Outside a successful EMU, the City of London will enjoy the advantages which have made Switzerland a great financial centre. If EMU fails for whatever reason, it will prove to be greatly in the UK's interests if it has continued to keep its distance from arrangements which expensively fall apart.

¹⁸ David Lascelles, *The Crash of 2003. An EMU Fairy Tale*, CSFI, 1996.

¹⁹ George Soros, 'Can Europe Work', *Foreign Affairs*, vol. 75(5), September-October 1996.