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CentrePiece

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EUROPE SPECIAL

ENLARGEMENT & REGIONAL POLICY

THE NEW EUROPE

YOUTH UNEMPLOYMENT

Emu gets ready to fly

WILL IT RECOGNISE THE NEW EUROPE?

Austin Mitchell and Edwina Currie
BRITAIN AND EUROPE

Alan Walters
THE ERM

Danny Quah
THE WEIGHTLESS ECONOMY

Editor's Note

Don't be fooled: the joke on our front cover does not mark the dumbing down of CentrePiece. This bumper issue of the magazine addresses serious topics in a serious way, in keeping with the standards established from the start. But adopting a serious approach doesn't mean we have to abandon our sense of humour; nor should it prevent us from trying to reach a wider audience. Indeed, one of the principal aims of CentrePiece is to make the work of those at the Centre for Economic Performance accessible to many more people than might usually be inclined to read about economics. If an eye-catching front cover attracts new readers, it will be worthwhile.

Besides raising a smile (we hope) our cover emu advertises the fact that this is a special issue on Europe. With economic and monetary union due to start in little over a year; with negotiations on enlarging the European Union getting under way next year; and with many countries in Europe still struggling to get themselves on the path towards political stability and economic prosperity, we've brought together a range of contributors to explore these issues.

Michael Emerson offers some provocative thoughts about the new Europe, while Richard Jackman sounds a note of caution about monetary union. Diego Puga examines the challenge facing the EU as it works to reform its regional policy: finding more effective ways of helping the poorer member states – and regions – catch up with the more prosperous, while preparing the way for an ambitious enlargement of the Union.

Youth unemployment is not, of course, a Europe-specific problem. But it is such an important topic that I wanted to include it in this special issue, especially given that the authors, David Blanchflower and Richard Freeman, both associates of the CEP, are so well-known for their ground-breaking work in this area.

For this special issue we have three outside contributors. Two leading British politicians, Austin Mitchell, Labour MP for Grimsby, and Edwina Currie, a Conservative MP until the last election, offer their thoughts on Britain's future in Europe. Sir Alan Walters, formerly economic adviser to Margaret Thatcher, writes about Black Wednesday five years on.

In his regular column, Danny Quah looks at the potential long-term impact on Europe's boundaries of economic weightlessness.

All in all, then, another issue which underlines the breadth of the Centre's expertise and the quality of the work done here. The pieces in this extended issue are longer in response to feedback which we've had – and which is always welcome. Tell us if we are making the work of the Centre for Economic Performance more accessible: if we're not, tell us why not. Planning is already well advanced for next year's issues – so get writing!

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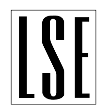

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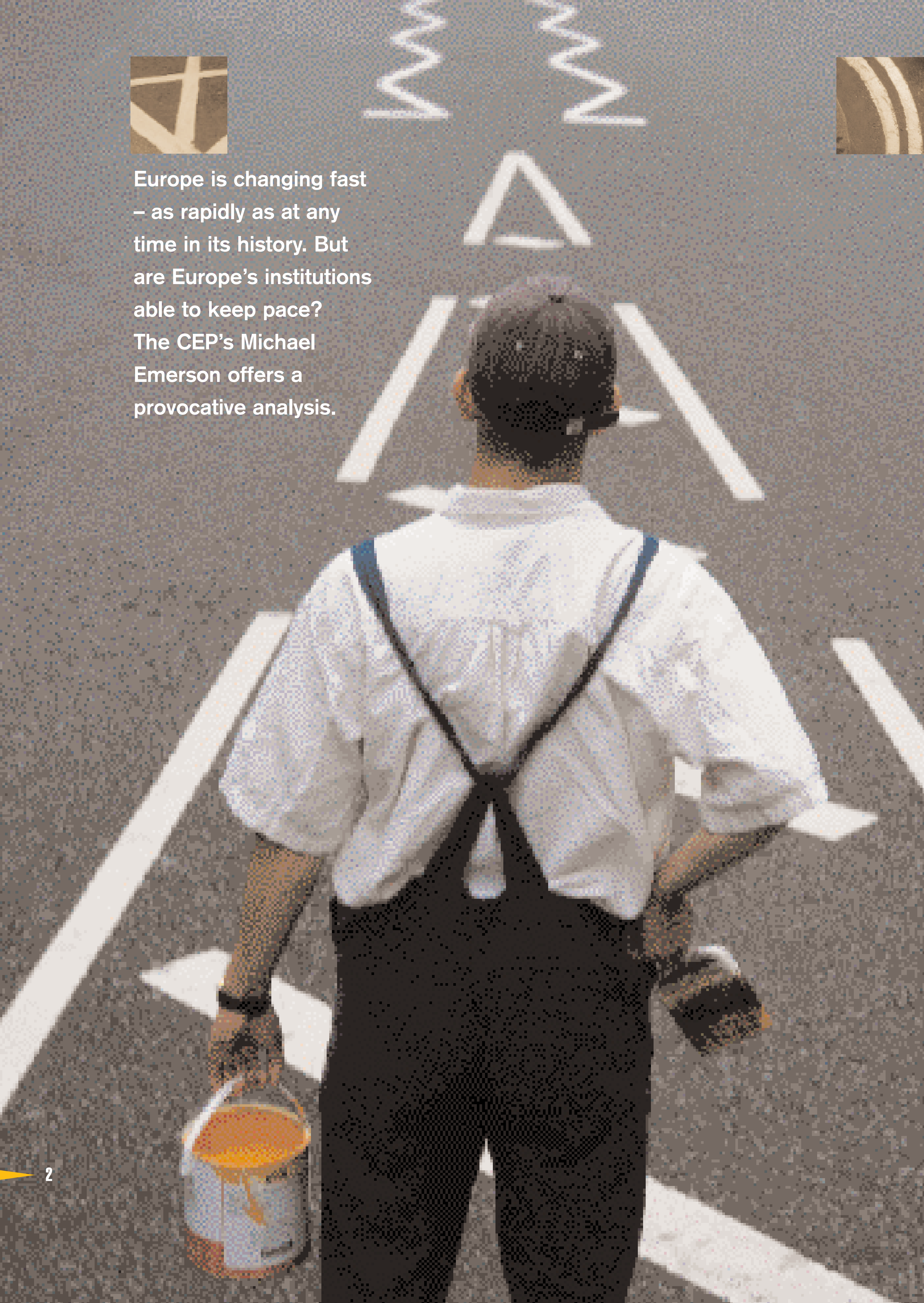


Europe is changing fast – as rapidly as at any time in its history. But are Europe's institutions able to keep pace? The CEP's Michael Emerson offers a provocative analysis.

by Michael Emerson

Mapping the new European structure

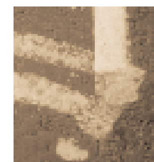
The summer of 1997 saw a series of crucial summit meetings – in Amsterdam, Madrid and Denver – all concerned with the shaping of the Europe of the twenty-first century. The coincidence of the collapse of Communism in Europe and the drive towards closer integration within the European Union has concentrated minds on the need to adapt institutional and political structures for the next century. The speed of change can often seem painfully slow. That might be less important if those forcing change through were always clear about the direction they were moving in; and those changes commanded widespread approval. Where is Europe heading?

The deadly past

The map of Europe has been redrawn with remarkable frequency over the past thousand years, and particularly the last century. As Europe enters the new millennium the challenge is clear: to break with tradition by bringing about change peacefully, without involuntary changes in frontiers.

Europe holds the world record for violent conflict. In the twentieth century, the continent accounted for more than two thirds of the one hundred and ten million war-related deaths; a further fifty four million civilians fell victim to Stalin's regime in the Soviet Union. And Europe continues to demonstrate an extraordinary capacity for its peoples to switch between rich multi-cultural integration and savage inter-ethnic conflict. There are more than a hundred instances of significant ethnic groups living as minorities in their own countries. The defeat of Communism unleashed pent-up demands for minority rights; but Northern Ireland, the Basque province of Spain, and Cyprus are all reminders that the problem is pan-European.

The cost is not measured solely in terms of lives lost. World wars and local conflicts cause devastating economic damage for the regions affected. More than half the entire capital stock was lost in Bosnia and Chechnya: GNP fell by 80% at the height of these conflicts. Public spending in Northern Ireland is 60% higher than in the rest of the UK; Turkish-occupied Cyprus is an underdeveloped territory, while the southern Republic has a GNP per capita comparable to Spain.



The Maastricht criteria, in particular limits on budget deficits and national debt, are already influencing the domestic economic policies of EU members, even those unlikely or unwilling to join EMU in the first wave.

Security and economics hand in hand

All this underlines the extent to which security questions in Europe have an economic dimension, and the extent to which the different sets of institutional relationships in Europe inevitably – and rightly – overlap. In the wake of the transition from Communism in such a large part of Europe, economists now recognise how much more than the right economic policy prescription is needed to ensure economic progress. There is the need to provide credible prospects for prosperity through democracy and the rule of law, in order to quash latent propensities for inter-ethnic conflicts. Just in economic terms, this is essential to avoid the costly episodes of destruction seen in the recent past.

But there is, increasingly, a second requirement: to offer clear rewards for civic behaviour and sound corporate governance in order to overcome the endemic corruption and criminality in some of the still-newly liberated countries of Eastern Europe. At stake here is the difference between continuing economic stagnation and a growth rate sufficient to catch up with average European living standards within, say, twenty years.

Institutional maps

Several institutions are involved in the process of change: their powers often overlap; and they all have an increasing tendency to work with flexible groups of participants. The European Union is currently pushing ahead with plans to introduce a single currency among most, but not all, of its fifteen members in 1999. At the same time, it is embarking on perhaps the most ambitious enlargement programme in its history; negotiations start with several countries next year, raising the prospect of a Union of twenty or more members early in the next century. The EU is also planning to extend its spheres of operation to various aspects of security policy. Yet one of the key developments in this area, the Schengen Group, does not count every EU state among its members and allows some non-EU states to opt in.

Meanwhile, NATO – which some thought would become obsolete with the end of the Cold War – is itself developing radically, and rapidly. The invitation to join NATO, extended to several former Warsaw Pact nations at the 1997 Madrid summit meeting, was coupled with closer cooperation with Russia – not itself on the list of new members. And new functions have been acquired along the way – a role in lesser, intra-regional conflicts, with a new capability, the Combined Joint Task Force (CJTF), to carry it out. But the CJTF can operate as part of NATO or leased to the Western European Union.

And then there are the two organisations with wider spheres of membership: the Organisation for Security and Cooperation in Europe (OSCE) and the Council of Europe. These bodies are addressing fundamental questions of security and civil society. But their areas of competence are confused and overlapping; and they only have modest powers.

The rules of civil society: political...

The distribution of powers is illustrated below. The various European institutions are, in effect, concerned with what we might call the eight sets of rules for European civil society. Four of these are political, four economic. Some are closely defined, others less so.

Curiously, the most fundamental set of rules, governing democracy, is also the least well-defined in officialdom. The Council of Europe monitors democratic institutions, and both the EU and NATO make democracy an absolute pre-condition of membership, which provides powerful leverage on applicant countries. Apparently one can recognise democracy when one sees it.

Human rights, by contrast, are codified with great precision in the European Convention on Human Rights and Fundamental Freedoms. This has been successful in large measure because of the enforcement activity of the European Court for Human Rights. Codified rights for

EIGHT SETS OF RULES FOR A EUROPEAN CIVIL SOCIETY

Political, security

1. **Democratic institutions** Council of Europe, EU

2. **Individual human rights** Council of Europe, EU

3. **National minorities** OSCE, Council of Europe, EU

4. **Inter-state behaviour** UN, OSCE, NATO, WEU, EU

Economic, social

5. **Market for products and factors** WTO, EU

6. **Macroeconomics** IMF, EU/Euro

7. **Social model** Council of Europe, EU

8. **Corporate governance** EBRD

In the transition economies issues of corporate governance are of increasing concern: an acceptable business culture does not necessarily accompany the freeing of markets, and in its absence, corruption and criminality hamper economic progress.

minorities also exist both in the Council of Europe and the OCSE. Both human rights and minority rights are given extra weight because of the importance attached to them by the EU in relations with applicant countries and others.

Principles of inter-state behaviour, stressing the inviolability of national frontiers, have been enshrined in the OCSE. They also lie at the heart of the mutual defence guarantees of NATO and the WEU.

...and economic

Trade is the most precisely codified set of relationships between countries in the economic sphere; specifically, the provision for free movement of goods and services, labour and capital within the EU and the partner countries in the European Economic Area. Accession to the EU is conditional upon applicant countries meeting these rules – over three hundred linked to the operation of the single market, for instance. But almost all European countries (the rest soon will be) are also covered by the rules of the World Trade Organisation (WTO), which provide an important benchmark for the newer transition economies, as well as setting ground rules for trade between industrial countries.

The imminence of economic and monetary union between some EU member states has also led to much more closely defined rules for macroeconomic policy and coordination right across the EU. The Maastricht criteria, in particular limits on budget deficits and national debt, are already influencing the domestic economic policies of EU members, even those unlikely or unwilling to join EMU in the first wave. And, of course, the IMF's standards for monetary and budgetary policy are influential right across central and eastern Europe.

Less clearly codified – and much more controversial – are the attempts both in the EU and the Council of Europe to define a European social model – covering labour market and social security law. This all sits uneasily with the unresolved problem of high unemployment in many parts of Europe. But the demands to include this area of activity in an integrating Europe remain strong.

Last but not least are the rules of corporate governance – minimally codified in Western Europe, but only because a culture of relatively high business standards has developed its own momentum over the centuries. In the transition economies, however, issues of corporate governance are of increasing concern: an acceptable business culture does not necessarily accompany the freeing of markets, and in its absence, corruption and criminality hamper economic progress. The European Bank for Reconstruction and Development (EBRD) has therefore established detailed guidelines which it seeks to impose as a condition of the provision of financial help.

Joining the right club

One obvious solution to the apparent chaos is to open membership of all the institutions to everyone in Europe. But this would be to go too far or too fast, riding roughshod over the determinants of integration. So how do countries decide which clubs they want to *join*? And how do those clubs decide whom they want to *admit*?

History is important here: the affinity of peoples and their willingness to share responsibility with others is linked to their proximity, language and cultural links. This is clear from the nature of EU enlargement over the years. Currently, the EU applies objective economic and political criteria to its candidates for accession. It turns out that certain states – variously Baltic, Catholic Slav and former states of the Austro-Hungarian empire – qualify; whereas some others – Orthodox Slav and Muslim countries – have more difficulty. France led its Latin neighbours in NATO to push for Romanian membership, while the Anglo-Saxon countries remained unpersuaded.

Economic calculations about integration start from the issue of market openness: proximity is again an important factor here. Monetary integration imposes more demanding restrictions: economic convergence is more important, as is assurance that new entrants are not likely to debase the currency.

Political assessments may be influenced in the first instance by the extent to which states share common political values. But elites will also be sensitive to gains or losses of political power as integration progresses – for example some large states may ally to achieve leadership, subject to constraints from small states which may have disproportionate voting power. The calculation of security gains and losses is becoming more complex in a Europe which has no obvious external enemy, but which is concerned about political instability within the former Eastern bloc.

The process is less complicated than it first appears, however. Core groups with shared interests and values have formed – the two principal ones being the EU itself, and Russia with a group of neighbouring states. *Domino dynamics* then tends to push peripheral countries to judge that exclusion from the core is riskier than compromising some interests by joining it. Coupled with this is a process of *disequilibrium dynamics*, at least within the EU: certain moves toward closer integration generate more momentum, making still further steps necessary if systemic failure is to be avoided. Thus, the single market led in turn to the drive towards economic and monetary union, which in turn will

The traditional nation-state remains the focus of national loyalties. But its role is changing beyond recognition, with many of its old functions devolved upwards or downwards.

increase the demand for democratic legitimacy at the European level.

Mapping this process

None of this tells us what the Europe of the next century will look like. The figure on the right is a stylised attempt to set out three different configurations. *Political Europe* identifies two core groupings: the EU and Russia, with the rest of Europe gravitating to one or the other. But while this might appear the most natural evolution from an historical perspective it has serious drawbacks. First, it recreates the divided Europe of the Cold War. And second, the Russian bloc – the Commonwealth of Independent States – risks being disconnected from the rules of civil society by tempting its natural leader to behave in old-style hegemonic fashion.

Security Europe brings almost everyone together, including North America and Central Asia, and has the advantage of the confidence building approach of the OSCE. But as a general mechanism for integration, it is too large; and one key element, NATO, is again divisive. Attempts by NATO to balance Eastern enlargement with closer cooperation with Russia have not been wholly convincing.

Civil Europe is based on the potential membership of the Council of Europe, and includes both Russia and Turkey. It excludes North America and Central Asia for quite different reasons (the US subscribes to most of the rules but Congress would not accept European jurisdiction; Central Asia is not seriously interested in democracy for the time being). The idea of making this area the focus of all the rules of a European civil society is attractive in theory. But the mechanisms are weak in practice. Reinforcement could be provided through an All-European Free Trade Area, with prospects later of an All-European Single Market, along with expanded investment in trans-European networks. Then there could be greater empowerment of the political rules through linkage to the economic.

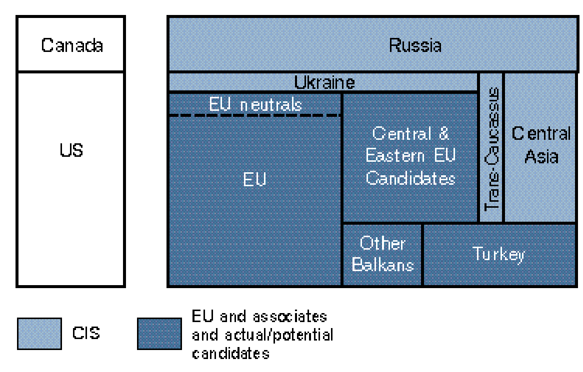
Sub-federal and post-modern paradigms

The overlapping maps still beg the question – is it not time to bring fresh order into these confusing structures? After all, the modern state brings together a whole range of vital functions within a single national jurisdiction; a federal state can, similarly, have a top level jurisdiction – the US is the pre-eminent example of the latter.

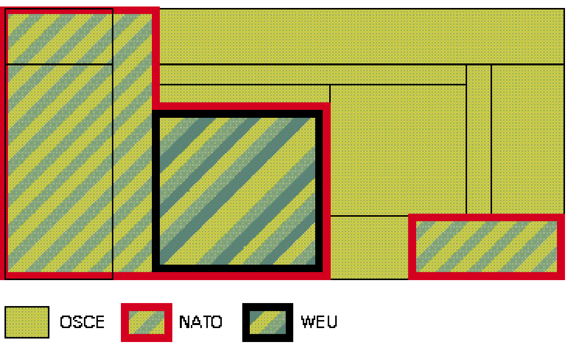
Many in the EU envisage it progressing on federal lines –

STRATEGIC MAPS OF EUROPE, 1997

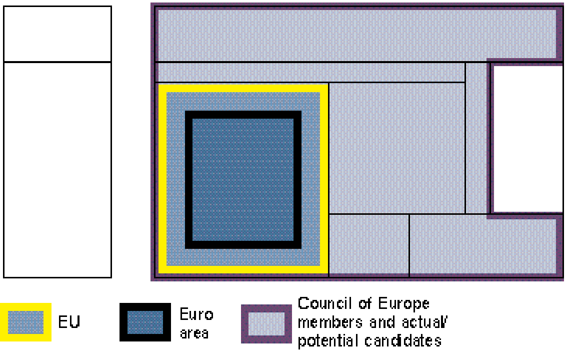
Political Europe



Security Europe



Civil Europe



The two biggest economic and security issues facing Europe today are all about the shallowness of the widest Europe. They are first, whether the transition economies can get onto a durable fast track towards economic prosperity, and second, whether they can achieve political stability.

though since no-one seriously supports the idea of France and Germany becoming like Texas and California, it might be better to call this a *sub-federal* model. The aim of this approach would be to bring together a range of powers – money, markets, external and some internal security – under one jurisdiction. But the role of the member state in the EU Council would remain fundamentally different from that of a state in the United States.

By contrast, the *post-modern* approach rejects the idea that great centres of state power need be concentrated at any one level. Instead, rules and codes are defined and enforced at a range of national and supra-national levels, largely, at least in theory, displacing the need for super-power states. The post-modern state marks the obsolescence of the old moral frontiers – between the internal control of law and morality on the one hand and the external acceptance of realpolitik on the other. This coincides with the increasing obsolescence of physical frontiers in the weightless economy. The traditional nation-state remains the focus of national loyalties. But its role is changing beyond recognition, with many of its old functions devolved upwards or downwards. Its national nominees, however, are represented at these other levels of jurisdiction, and they will behave more like shareholders of multinational corporations. New communications technologies make it easier for these objectives to be pursued. One can foresee the use of multi-media video-conferencing of many a multilateral meeting, with greater ease of switching issues onto the agenda of different institutions in search of resolution.

The post-modern system offers several advantages. It reduces the risk of monopolistic bureaucratic structures, which are more likely to make mistakes or encourage hegemonic tendencies. It encourages competition, albeit restrained, among jurisdictions. It is flexible; but the operation of *domino dynamics* – the incentive to avoid exclusion from the core – still prevents undue fragmentation.

Widening and deepening...

All this prompts a fresh look at the twin concepts of widening and deepening in Europe. The EU and NATO have already embarked on a process of widening; but not without causing uncertainty and friction. The EU's new single currency marks a deepening of the links between the participating member states; but its advent will in turn create other profound issues which will need to be addressed. The widest manifestations of Europe exist in the Council of Europe and the OCSE: but they are shallow and weak organisations.

Yet the two biggest economic and security issues facing Europe today are all about the shallowness of the widest Europe. They are first, whether the transition economies can get onto a durable fast track towards economic prosperity, and second, whether they can achieve political stability. Both these issues would be best addressed by ensuring the extension of the eight sets of rules for civil society right across Europe.

The most plausible routes for achieving this may be by widening the deep European map – the EU; and by deepening the wide map – the Council of Europe. Over time, therefore, these two maps would move closer together – prompting the question of whether the one might merge into the other at some point in the first part of the twenty first century. It is possible: although this might strike some as a rather tame evolutionary approach for a radically new situation.

...or *tabula rasa?*

Perhaps a more radical approach would be justified. What would happen if one were to look at a *tabula rasa*, forgetting all the present institutions accumulated as a jumble, each the product of a specific political moment, with no real attempt to maintain systemic coherence? The *tabula rasa* approach would probably assign all eight sets of rules, wholly or in part, to the all-European level, ie European Civil Society should be the 'basic' Europe.

Only two functions would need to remain restricted to a core group of countries which would need to be highly convergent in all relevant respects – monetary union, and defence union; although this would not exclude rules relating to monetary and defence cooperation having a wider European application. This core group would then justify the name European Federal Union.

Of course, this would turn Europe upside down, or inside out. It would be far too clear-cut. But as Europe, as seems more likely, proceeds with its hesitant widenings, and flexible deepenings in a messier way, those involved should bear in mind that the underlying market pressures – in both political and economic markets – are pushing for a *tabula rasa*. Only this explains what is really going on.

Michael Emerson is a senior research fellow at the CEP, and former EU Ambassador to Moscow.

Emu: convergence or divergence?

Economic and monetary union – the European single currency – is due to start in January 1999 for the first wave of countries able and wanting to join. Richard Jackman of the CEP questions whether the current plan is the best way of achieving greater economic integration in Europe.

There are of course enormous benefits to be had from greater European economic integration, and clear gains from projects like the European single market. Ultimately, complete economic integration in Europe will benefit from a single European currency, just as there would be benefits from a single European language, or a single European driving licence. The gains from a single currency are of course very much less than those from a single language: indeed, technical progress is already forcing down the costs of maintaining separate national currencies to minimal levels – credit cards, for example can be used without regard to national currencies. While these costs may be small and getting smaller, in an ideal world they need not exist at all.

Yes – but when?

But accepting that a single European currency is in some respects desirable in principle, or indeed at some stage inevitable in practice, is not to say that it should happen now. The movement towards economic integration has not meant doing everything together and instantaneously. The vital tactical questions are of speed and sequencing. A single currency removes a vital dimension of national economic policy at a stage when in many other respects the nation states of Europe retain distinct economic identities. It is the locking together of one element of the economy while others remain free to move independently that can lead to problems.

A single currency is of course much more than a technical advance in the operation of a single market. It involves the renunciation by the nation state of autonomy in a fundamental area of economic policy, namely the control of the nation's money, and the transfer of responsibility for monetary policy from the nation state to a European institution. Historically, a national money has been a defining feature of a nation state, and control over monetary matters a key responsibility of a national government. It is interesting now to look back on the American debate after independence as to whether there should be a national currency in America or whether each state should issue its own money. The 'Federalists' (Hamilton) triumphed over the advocates of States' Rights (Jefferson), and few would dispute that the position of the Federal government was greatly strengthened as a result. A single currency in Europe could likewise be expected to strengthen the powers of European institutions relative to national governments. This is therefore as much a 'constitutional' as an economic issue, and a question where progress should depend on the support of the people, as well as of political leaders, in the countries concerned.

Why not ask the people?

Despite the importance of the constitutional questions involved, the Maastricht Treaty made no provision for consulting the people. The absence of any democratic criteria for accession to the single currency stands in sharp contrast to the very precise specification of the financial criteria. This seems a bad start: constitutional changes

by Richard Jackman

surely require the support of electorates, not just of governments (a point explicitly recognised by the 'triple hurdle' commitment of the new UK government, which makes accession to the single currency dependent on the support of the Cabinet, Parliament and the people in a referendum).

If one were to set up a consensual procedure for moving to a monetary union, the first step would surely be to ensure that it has the support of the people in all the countries concerned. Only then should the union go ahead. A union is by definition a collective decision; it cannot exist if some countries opt out. The Maastricht proposals are however not for consensual monetary union, but rather for a greater deutschemark zone, which other countries can join if they are willing to sign up to the monetary policies and practices of the Bundesbank. These are the issues identified at Maastricht: in particular, stable prices, fiscal responsibility and central bank independence.

In or out?

It's thus striking, though perhaps not surprising, that among the bigger European countries, enthusiasm for EMU tends to be inversely related to the perceived competence of the national government in monetary management, with the Italians the greatest enthusiasts. Equally unsurprisingly, the countries keenest to join are those least likely to be allowed in. Membership of EMU thus offers low inflation and financial stability to countries which can prove they have these things already.

One reason why there is not greater enthusiasm for the single currency, particularly amongst the growing ranks of Europe's unemployed, is that these preconditions have imposed excessively deflationary policies on the aspiring member states. The Maastricht convergence criteria require not only fixed exchange rates, thus imposing the Bundesbank's restrictive monetary policies across Europe, but also the now famous 3% limit on budget deficits, which has ensured that in most countries fiscal deflation accompanies monetary. The depressed economic conditions have reduced tax revenues and thus further increased fiscal deficits; this in turn has required further cuts in government spending (or tax increases) to meet the 3% deficit ceiling. As a result, millions of people have been thrown out of work in Europe for no good reason, with only countries like the UK and Denmark, which have negotiated the right to opt out of the single currency and have therefore been able to run their economies in the light of domestic economic conditions, escaping the general malaise.

Ironically, the recoveries now forecast for France and Germany are being driven by the sharp falls in the franc and deutschemark exchange rates relative to the US dollar and pound sterling – the very flexibility which a fixed exchange rate system would remove.

This rather depressing start of the process towards the single currency has in fact served to highlight its most serious drawback. Under EMU, monetary policy cannot be set separately in each country with regard to its economic circumstances, but rather must be set uniformly for all member countries irrespective of their individual needs. Some economists argue that independent national monetary policies are unnecessary because wages and prices are flexible and can achieve the same effect. But recent evidence does not support this view.

The ERM experience

It is remarkable that those economies whose currencies fell within, or were pushed out of, the Exchange Rate Mechanism in 1992 have enjoyed not only more rapid growth but also a continuing decline in inflation (see table overleaf). The currency crises of autumn 1992 and 1993 led to five other countries either leaving the ERM (the United Kingdom and Italy), or devaluing (Spain and Portugal) or breaking their link with the mechanism (Sweden). These countries suffered falls in their exchange rates averaging over 30%. By contrast, the five countries remaining within the ERM or who maintained the parity of their currency with the deutschemark (Austria, Belgium, France, the Netherlands and Switzerland) were rewarded with a significantly slower growth rate and a smaller decline in inflation than the countries which left the ERM.

The Maastricht proposals are not for consensual monetary union, but rather for a greater deutschemark zone, which other countries can join if they are willing to sign up to the monetary policies and practices of the Bundesbank.

Research at the CEP attempting to explain these developments* suggests that the traditional ('Phillips Curve') theory that high unemployment leads to falling inflation is still valid, but that once inflation rates have fallen to very low levels, even very high unemployment will not cause inflation to fall any further. In other words, at very low rates of inflation the Phillips Curve becomes flat. So if an economy is in deep recession, one cannot rely on falling wages and prices to lead the economy back to full employment. What is needed is an increase in demand, and this of course implies that the government must be free to set its own monetary (and fiscal) policy.

The franc fort and Swedish monetarism

The clearest case has been the French economy. In 1983, France adopted the *franc fort* policy, which involved fixing the value of the exchange rate within the European Monetary system, and giving exchange rate stabilisation priority over domestic policy objectives. As a result, inflation in France fell sharply (from 9.5% in 1983 to 2.5% in 1986) and unemployment rose from 8% to 10%. But, over the ten years since 1986, inflation has remained low while unemployment has continued to rise. Persistently high unemployment has not brought further falls in inflation (it seems to have bottomed out at around 1.5%); yet low inflation has not of itself led to a resurgence of demand. The French economy had to wait for the weakness of the deutschemark in 1997 to enable it to begin to recover its competitiveness.

Matters have been made worse in France because the economic unpopularity of the persistent unemployment caused by the franc fort policy has made it more difficult for the government to introduce unpopular reforms in other areas, in particular in the labour market. France thus remains one of the most heavily regulated, and heavily taxed, labour markets in Europe; and, as the election victory of the new Socialist Prime Minister Lionel Jospin demonstrates, looks set to stay that way.

More dramatically, in 1990 Sweden abandoned its traditional commitment to full employment in favour of monetary orthodoxy. The policy has been very successful in reducing the Swedish inflation rate, which actually became negative at the end of 1996, but the unemployment rate shot up from less than 2% in 1990 to 9.5% by 1993, and, despite massive training and job creation programmes for the unemployed, shows no sign of a decline.

Economists often argue that a fully anticipated inflation rate of 1% is no different from a fully anticipated inflation rate of 5% or 7% once everyone has adjusted to it, and there is thus no reason why countries should not speedily adjust to any monetary regime.

But the evidence appears more consistent with the view that there is a limit to how low inflation can be pushed in any economy without having real economic effects. Some economies appear able to function effectively even with an inflation rate of less than 1% – essentially with stable prices

Change in effective exchange rates, and growth rates of real GDP, and GDP deflator, 1992-96
Five appreciating countries and five depreciating countries

	Appreciating countries	Depreciating countries	Difference between depreciating and appreciating
Effective nominal exchange rate			
1992: Q2	99.5	99.1	-0.4
1996: Q2	102.9	86.3	-16.6
1996-1992	3.4	-12.8	-16.2
Per cent change in real GDP			
1992: Q2	1.7	0.2	-1.5
1996: Q2	1.4	1.8	0.4
1996-1992	-0.3	1.6	1.9
Per cent change in GDP deflator			
1992: Q2	2.5	4.8	2.3
1996: Q2	1.8	3.1	1.3
1996-1992	-0.7	-1.7	-1.0

Notes: Appreciating countries are Austria, Belgium, France, the Netherlands and Switzerland. Depreciating countries are Italy, Portugal, Spain, Sweden and the United Kingdom. All data are aggregated using 1985 Summers-Heston GDP weights.

Source: 1992 figures: *Macroeconomic Policies and Structural Reform*, OECD Proceedings, 1996. 1996 figures: GDP and GDP deflator growth rates are from *IMF World Economic Outlook*, October 1996, tables A2 and A9. Effective nominal exchange rate index from IMF International Financial Statistics, 1997.

* R. Jackman '*EU labour markets inside and outside the Monetary Union*' paper prepared for Conference on European Monetary Union: Transition, International Aspects and Policy Options', Potsdam, April, 1996.

Accepting that a single European currency is in some respects desirable in principle, or indeed at some stage inevitable in practice, is not to say that it should happen now. The movement towards economic integration has not meant doing everything together and instantaneously.

– but others may function better with inflation in the range 2–3%, or even 4–5%. Low but positive rates of inflation facilitate the adjustment of relative prices and wages, provide a low but useful tax on wealth, and erode the burdens of past debt on current enterprise. Of course, inflation also has costs, and in advanced economies with sophisticated financial systems these surely overwhelm the benefits long before inflation gets into double digits. Nevertheless, where there are financial and institutional rigidities the optimal rate of inflation is not necessarily zero, nor necessarily the same for all countries.

The experiences of France and Sweden suggest that where a government forces upon an economy too severe a monetary regime, inflation can indeed be held down, but only at the expense of long periods of high unemployment. In the UK, it could be argued – and, indeed, has been by many – that the restrictive monetarist policies introduced by the Thatcher government in 1979 led to at least a decade of mass unemployment.

Of course, it could also be argued that long periods of high unemployment are the only way of achieving lower inflation and if governments think that a price worth paying, there is no more to be said. EMU is then simply providing a pretext for painful policies which are recognised to be necessary anyway. But the evidence suggests that monetary orthodoxy can always and easily bring down inflation, the problem is to avoid the after-effect of persistent mass unemployment. And in this respect, a monetary straitjacket, be it internally or externally imposed, can prevent the adoption of appropriate demand management policies to support an economic recovery.

Worse to come?

But a prolonged period of high unemployment may not simply be the entry price for joining EMU. Unfortunately, there are risks ahead in addition to the problems immediately apparent. One is the possibility of wage emulation: that within a single currency area workers will compare their wages to those of workers doing similar jobs in other countries, and seek to match them. Productivity differences between such groups will then lead to permanent structural unemployment, akin to the regional unemployment problems which characterise a number of European economies. Second, there is the likelihood that the European Central Bank (ECB) will adopt monetary targets which, given the uncertainty over the demand for the new Euro, could turn out to be excessively contractionary. And third, a single currency reduces the capacity of individual economies to adjust to shocks.

There are basically only two ways in which an economy can adjust to external shocks. One is through changes in its prices relative to other countries, either through changes in the exchange rate or through variations in money wages. In the case of a single currency, the former is, of course, ruled out; the latter made very difficult by the low inflation regime likely to be imposed by the ECB. The second is through changes in quantities, that is to say by the movement of labour from depressed to prosperous areas. In this latter respect Europe is most unlike that great example of a successful single currency area, the United States of America. In Europe, there is little mobility of labour within, and virtually no mobility between, countries. An expansionary shock, such as the current building society windfalls in the UK, can with independent monetary policy be offset by temporarily higher interest rates and a consequential temporary appreciation of the exchange rate. With a single currency, excess demand would push up wages and prices, but once the expansionary effects of the shock fade away wages and prices would not fall back, because they are less flexible than the exchange rate, but rather would remain at an uncompetitive level.

Costs versus benefits

The employment costs of EMU could thus be very substantial indeed; while the benefits, principally reduced transactions costs, are clearly minimal. Why then should any country, other than one with a hopelessly irresponsible or incompetent national government, wish to join? In the 1980s, there was a fear that the European ideal would collapse unless there were major new European initiatives. The single currency was conceived as the next step following the completion of the single market project in 1992. But the disintegration of the ERM in 1992 and 1993 suggests that this sequence was perhaps misjudged, and that a greater degree of institutional harmonisation would need to precede the successful adoption of a single currency. And the collapse of communism at the end of the 1980s means that the EU has very much more important issues, such as the accession of the countries of Eastern Europe, to concern itself with.

But as problems with the single currency have mounted, the political commitment of those associated with the proposal from the beginning has become stronger. The more EMU becomes an article of faith, rather than a matter of economic reasoning, the greater the sacrifices that it may be deemed to justify. The more pragmatic approach to economic policy currently adopted in the UK and in the Scandinavian countries may emphasise the policy differences with those countries aiming to join the single currency at the start. The attempt to achieve greater union in Europe could then lead instead to political division.

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Recipe for reform:

regional policy for an enlarging European Union

With the single currency deadline approaching fast, the European Union's regional policy is seen by many outside as less significant and less contentious. But as the CEP's Diego Puga explains, reform of this key area of European policy is an essential prerequisite of the ambitious enlargement programme about to get under way.

by Diego Puga

Economic and monetary union may be grabbing the headlines at present, but it is increasingly clear that the plans for enlarging the European Union will have at least as great an impact on its future development. The European Commission has now recommended that accession negotiations start in 1998 with five of the ten countries that have applied for EU membership: Hungary, Poland, Estonia, the Czech Republic and Slovenia. Negotiations will also start next year with Cyprus whose application was viewed favourably by the Commission in 1993. Such negotiations, and the prospect of twenty plus members of the EU within the next few years, will present a huge challenge for the EU's regional policy at a time when it faces greater pressures than ever before from within the existing Union.

Until recently, regional policy had accounted for only a small proportion of the EU budget. But, with growing concern about reducing regional disparities, the Structural Funds (the main instrument of regional policy) are the fastest-growing component of the EU Budget. These funds have been allocated 200 billion ecus (at 1997 prices) for the period 1994–1999 – thus accounting for one third of total EU spending, double the proportion for 1988, and about 0.4% of total EU GNP. The current arrangements for the Structural Funds expire in 1999: at that point they will need to be reformed in order to provide an effective regional policy for the EU until at least 2006.

The scale of the challenge

It is difficult to exaggerate the problems posed for regional policy by the applicant countries. Those with whom negotiations are likely to begin next year have a GDP per capita which is only 30% of the EU average, measured at purchasing power parity. By contrast, the GDP per capita of Greece, the poorest member of the current union, is 63% of the EU average. (See table overleaf.)

The resource transfer implications are huge. At present, more than two thirds of all Structural Funds money goes to promote the 'development and structural adjustment of regions whose development is lagging behind'; these are known as *Objective One Regions*. Providing Objective One money for the applicant countries would cost 25 billion ecus a year – compared with the 19 billion ecus earmarked for 1999 for all Objective One regions in the EU.

The European Commission, in its Agenda 2000 has already recommended that, to avoid placing intolerable strain on the EU Budget, total spending on regional policies will remain pegged at 0.46% of EU GNP beyond 1999; that includes the Structural Funds and also the Cohesion Fund, which covers countries with less than 90% of the average EU GNP per person – at present Ireland, Spain, Portugal and Greece. At the same time, funds for any one country would be limited to 4% of its GDP. These limits would also ease potentially serious absorption problems, since recipient countries must themselves meet some of the cost of projects financed by the Structural Funds. On this basis, it is expected that the Structural Funds and the Cohesion Fund will together be allocated around 275 billion ecus in the 6 years from 2000. 45 billion ecus of that will go to the applicant countries, 7 billion of which could be provided before they actually join.

But deciding the allocation for the Funds is only the first step. The main unresolved question is how to adapt the EU's regional policy instruments for the future in view of the challenge of enlargement. It is particularly important to try to coordinate assistance for the applicant countries with other elements of the pre-accession strategy to ensure that they catch up rapidly with the living standards of current members.

The challenge from within

Prospective enlargement highlights the gap between EU member states and the applicant countries. But the EU's regional policy must also address the profound regional income disparities within the Union. One quarter of the

Prospective enlargement highlights the gap between EU member states and the applicant countries. But the EU's regional policy must also address the profound regional income disparities within the Union.

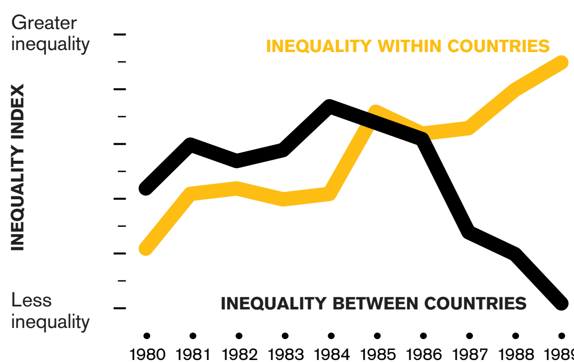
Improvements in transport infrastructure also make it easier for firms in richer regions to supply poorer regions at a distance, and can thus harm the industrialisation prospects of less developed areas.

INCOME DISPARITY: EU MEMBERS AND APPLICANTS

	GDP per person at purchasing power parity in 1993 (EU=100)	Population in 1995 (millions)
Current EU Member States	**100**	**371**
Luxembourg	160	0.4
Belgium	115	10
Denmark	113	5
Austria	112	8
France	109	58
Germany	108	82
Netherlands	104	15
Italy	103	57
United Kingdom	99	59
Sweden	98	9
Finland	90	5
Ireland	82	4
Spain	77	39
Portugal	68	10
Greece	63	10
Applicants with favourable opinion from EU Commission	**30**	**61**
Cyprus	63*	0.7
Slovenia	54	2
Czech Republic	49	10
Hungary	35	10
Poland	27	39
Estonia	22	1
Applicants without favourable opinion from EU Commission	**21**	**43**
Slovak Republic	34	5
Bulgaria	25	8
Romania	21	23
Lithuania	21	4
Latvia	18	3

Sources: Eurostat and World Bank.
* For Cyprus, GNP per person in 1987.

INEQUALITY IN THE EUROPEAN UNION



Source: Joan Maria Esteban based on Theil's index of regional inequality for the EU, 1980–89.

European Union's citizens live in 'Objective One' regions, where GDP per capita is less than three quarters of the EU average. If a similar measure were used for the United States, only two states, Mississippi and West Virginia, containing between them only 2% of the population of the US, would qualify.

Over the past fifteen years income differences across member states have fallen, but inequalities between regions within each member state have risen (see chart). At the same time, regional problems have, in spatial terms, become less clearly identified as large disadvantaged regions and more as concentrated pockets of poverty and unemployment; this is particularly true in central and northern member states. Over the same period, there has been an intense process of regional specialisation in different sectors in the EU. The picture is further complicated by the persistent failure of some regions to catch up in spite of continuing resource transfers. All these issues need to be addressed.

The European Commission has already made a start, by announcing changes to simplify the operation of the Structural Funds; instead of seven different objectives, there will be only three. But presentational changes could also have an important role in improving public awareness of regional policy. Instead of assigning each objecting a number – meaningless to outsiders – the Funds could be given titles which explain their function – such as regional development, social and economic adaptation, and human resource formation.

Spending the money effectively

As with the funds for applicant countries, a key question is which projects will be financed under these different objectives. To choose appropriately between projects it is important to understand their full impact on regional inequalities. Take infrastructure provision. What are the effects of a road project connecting regions with different levels of industrialisation? Some growth economists would regard infrastructure as merely another input into production and the road project as an addition to the infrastructure stock of affected regions which would help them grow. But this approach excludes the role of transport infrastructure in facilitating the movement of goods and people across space.

A cost-benefit analyst would go into the fine detail of the project, but would probably not go very far in quantifying its impact. Traditional cost-benefit analysis would look at the direct

impact of the project through reductions in transport costs, and also at its induced effect through changes in the number of journeys undertaken. But that is enough only if two conditions are met: that distortions and market failures are not significant; and that only those activities closely related to the project are much affected by it. However, there has been an increasing realisation throughout economics that wide ranges of economic activities may be affected by market failure and distortions; and spatial spillovers, both positive and negative, can amplify rather than dampen the effects of a project as they spread through the economy.

On the positive side, for instance, better communications can make a less developed region a more attractive location for firms by providing improved access to the inputs and markets of more developed regions. A rise in the level of activity of one industry in that region can in turn induce another supplying industry to produce at a more efficient scale, and so on. Cumulative causation can provide the road project with positive effects for less favoured regions, wider and stronger than its direct impact. Similarly, on the negative side, improvements in transport infrastructure also make it easier for firms in richer regions to supply poorer regions at a distance, and can thus harm the industrialisation prospects of less developed areas.

It is therefore important to complement traditional cost-benefit analysis with a quantification of these wider effects to assess accurately the impact of projects. Recently developed location theories provide the tools – at the CEP, Anthony Venables and Michael Gasiorek have already used them to assess the impact of several projects financed by the Cohesion Fund. Such theories suggest that the overall impact of a project depends not only on the nature of the project itself but also on the economic environment. For instance, the combination of minimal inter-regional migration with wage setting at the national sectoral level has arguably led infrastructure improvements to worsen the convergence prospects of the Italian Mezzogiorno. Lacking the industrial base and market size of northern Italian regions, but having similar factor costs, local firms there have lost to northern competitors as better communications have lowered the natural protection they enjoyed.

Gains from enlargement

The interaction between regional spending and economic environment also underlines the importance of coordinating the Structural Funds with other aspects of the pre-accession strategy for Central and Eastern European countries. The applicants lack the industrial base and expenditure levels of richer EU member states. Yet in many cases their geographical proximity to central EU markets, along with their comparatively low costs and skilled labour force, help to compensate for their disadvantages and have allowed them to attract large inward investment flows. Over the next few years more firms can be expected to settle in the Central and Eastern European countries, creating positive externalities that will attract further investments; and the applicants will see their incomes rise towards the levels of existing EU members as new opportunities for firms and consumers bring benefits to both East and West. In the April 1997 issue of *Economic Policy*, Richard Baldwin, Joseph Francois and Richard Portes estimate such gains to be large for the applicants, and small but unevenly distributed for current member states – Germany alone would get about one third of the total gain, and France and the UK would together get about another third. This, of course, has important budgetary implications. Given that it will gain most from enlargement, Germany will find it hard to convince its partners to accept a reduction in its contribution to the EU budget, as recently demanded by senior German politicians. The economic costs and benefits of EU membership cannot be narrowed to the difference between each country's contribution to, and receipts from, the EU budget. And, particularly with Eastwards enlargement, even the full economic gains are likely to be dwarfed by the political benefits of a more stable and democratic Europe.

But caution is needed

Two risks could undermine this ideal scenario. An enlargement which involved too large a gap in wage levels between new and existing members could drain the newcomers of their more skilled workers if full labour mobility across the larger union were introduced straightaway. But while it might therefore be tempting to try to force applicant country wage levels close to those of the EU as rapidly as possible, such a process should not be rushed. German reunification provides a clear example of how integration can homogenise

Given that it will gain most from enlargement, Germany will find it hard to convince its partners to accept a reduction in its contribution to the EU budget, as recently demanded by senior German politicians.

Uncontrolled competition between regions to influence firms' choice of location can bid up levels of regional aid as public authorities come under pressure to match or surpass the aid level available in other regions.

wages across regions offering very different degrees of attraction to firms. Between the first quarter of 1990 and October of the same year wages in the former Eastern Germany rose by 42%. Half that increase was accounted for by the harmonisation of social security contributions alone.

While EU membership must ultimately involve the same status for entrants as for existing members, different aspects of membership will need to be phased in at different speeds. A long transition period before full labour mobility would be preferable to unjustified wage increases in the new entrants – resulting either from the harmonisation of labour market regulations or from other reasons – which would push the objective of a more cohesive Union further away.

Who knows best?

For current member states, regional inequalities are increasingly within rather than across countries. This has led the European Commission to propose decentralising the administration of Structural Funds to local governments, on the basis that they have better information on local needs and the costs of addressing them. On the face of it, this argument makes sense, but regional governments are unlikely to assess accurately and then internalise pecuniary externalities created by local activities which have effects beyond regional political boundaries. The optimal degree of decentralisation therefore is a compromise: between exploiting better information on local conditions by delegating the decision to a small local jurisdiction; and taking proper account of broader repercussions by delegating powers to a larger jurisdiction.

The issue of decentralisation is also affected by location theories which suggest that the spatial distribution of economic activities is just one of many possible equilibrium configurations. The progress towards any one outcome is punctuated by critical points at which just a small difference can determine which region gets which industrial sector. This could justify subsidising activity; it also highlights one of the main dangers of such subsidy.

Attaining a critical mass of industrial activity in a less developed region can enable it to take off. Subsidies are one possible device by which industrial production can be developed to that level. But subsidies do not come without dangers, which go beyond possible production inefficiencies. While specialisation implies that not all regions will – or should – have production in the same sectors, subsidies give regional governments incentives to compete for sectors which they regard as particularly attractive, regardless of their wider economic desirability.

All of this suggests that funds that can be used to attract particular investments should be administered centrally and subject to clear rules. Otherwise we are likely to see firms shopping for aid while regional governments compete for activities they consider particularly important. That would not only be inefficient, it would undermine the credibility of European regional policy.

State aid matters too

But controlling the use of European regional funds is not sufficient. Subsidies offered to firms usually adopt the form of aid from individual member states. State aid to enterprises in the EU amounted to 2% of Community GDP annually between 1988 and 1990. That represents 4.3% of total government expenditure, more than the revenue generated from direct taxation of enterprises. Uncontrolled competition between regions to influence firms' choice of location can bid up levels of regional aid as public authori-

ties come under pressure to match or surpass the aid level available in other regions. In such a contest the more prosperous member states can take advantage of their deeper pockets to outbid less prosperous ones. The EU has set differential ceilings on state aid; in practice, though, the less prosperous states face more restrictive budgetary constraints of their own. State aid levels tend, therefore, to be roughly proportional to GDP levels. Unless tighter ceilings are introduced for wealthier states, a tool justified as a means of helping less developed regions escape from underdevelopment traps could end up by trapping them all the more firmly.

Adapting to industrial change

Further European integration is likely to intensify the process of regional specialisation in the EU, as firms move closer to other firms in related activities in order to exploit positive externalities; and move away from firms in unrelated activities to avoid having to compete with them for immobile factors and non-tradeable goods and services. But even if specialisation yields large gains overall, workers employed by locally declining sectors will suffer as regions adapt. Given the low propensity of European workers to migrate, adjustment will have to take place mainly through the movement of workers between sectors within each region rather than through the movement of workers between regions within each sector. The EU already finances programmes that help workers adapt to industrial change, but such programmes are still relatively small. Greater regional specialisation will increase the need for schemes designed to enable workers to move from locally declining to locally expanding sectors. It will also increase the general need for funding for regions in difficulties because of the nature of their sectoral specialisation, under what is currently known as *Objective Two* of the Structural Funds.

Sharing the risk

While the owners of factors employed by locally declining sectors will be adversely hit by industrial specialisation, owners of factors employed by locally expanding sectors will benefit. However, the latter will also be exposed to increasing risk. In a more specialised Europe, sector-specific shocks will become increasingly region-specific shocks. Human capital, unlike physical capital, cannot easily be diversified. Regional policy could provide insurance to workers by establishing contingent transfers from the relatively fortunate to the relatively unfortunate.

However, unlike the US, the EU has no automatic mechanism for shifting resources across regions in the face of asymmetric shocks. When a region's income falls in the US, 40% of the fall is absorbed by the federal government (34% through lower taxes going out of a region, the rest from larger transfers coming in); in Europe only 0.5% of a fall in a country's income is absorbed by the rest of the Union. The small size of the EU budget means that national governments are better placed to provide insurance against transitory shocks for individual regions than EU regional policy. But if the fiscal constraints attached to the formation of EMU are too tough, it may be increasingly difficult even for national governments to do that job.

This is yet another illustration of the extent to which the twin challenges facing the EU in the run-up to the millennium are inextricably interlinked. Regional policy has a vital part to play in the preparations and implementation of the most radical enlargement the EU has yet faced. Its role in the process of economic integration within the existing Union is no less crucial.

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POLITICS SPECIAL: Britain and Europe

It's five years since Black Wednesday when the pound was forced out of the Exchange Rate Mechanism, an event which had a profound impact on political debate about Britain and Europe.

Putting Britain First

by Austin Mitchell

British Euro-enthusiasts dream that Tony Blair will interpose himself between France and Germany to lead Europe in a new direction, carefully left undefined. Sadly, as long as monetary union is the only game in the European Union (EU) this dream is blocked as effectively as everything else. However great its goodwill, Labour can't play it without breaking undertakings and party unity. Why should we, when the determination of the EU elite to press on, against both economic sense and the wishes of the people, ensures four years of floundering disarray? New Labour is about success, not failure, and a British government compelled to grapple with the domestic consequences of Europe's folly can't lead the EU out of its DIY mess.

Monetary union is a political process of Europe-building, mis-sold as bringing economic benefits. It builds union from the top down without popular consent, but using the currency as a political instrument distorts its economic role of insulating the domestic economy. Floating currencies allow shocks to be taken on the exchange rate and so clear the market by letting the rate change with the circumstances. If all this is ruled out, damage to the weaker economies (including Britain) is the inevitable result, though this is currently obscured by the immediate agonies resulting from the monetarist convergence criteria. The deflation and cuts necessary to get down to an arbitrary 3% budget deficit have turned Europe into a low growth, high unemployment blackspot and trapped its economies in self-reinforcing deflation. As demand is cut, unemployment rises, tax receipts decline, so spending and deficits grow. Q.E.D.

The consequences for Britain are like those for neighbouring tribes when New Guinea natives abandoned cultivation to pursue cargo cults. The most damaging is the effect on our exchange rate as speculative flows flee the uncertainty of other European currencies for our high interest rates, forcing up the pound. This will lead to yet another industrial blood-letting next year. It was a mistake to give the Bank of England control over interest rates at any time. To do it when Europe's folly pushes up the pound is disastrous.

Speculative pressures are currently on us and will remain strong. Yet as union approaches they spread across the Channel. Maintaining existing parities, followed by a three-year lock on currency relationships from 1999 to the Euro in 2002, recreates the scenario which gave speculators so much fun and profit under the old Exchange Rate Mechanism (ERM). Requiring central banks to reward speculators by buying back currency at official rates guarantees years of turmoil as economic realities and fixed rates diverge.

Monetary union is a collective leap from the Eiffel Tower, promising not only to design the parachute on the way down, but also to get agreement on whether the landing should be hard or soft. Germany wants a hard Euro. Yet the deutschemark has been falling. With domestic deflation this is the only escape route for German industry, so it could become addictive. Also the ultimate decision on admissions is political. With Germany itself in danger failing to meet the criteria it cannot preach strict compliance to France, Italy or even Spain. If they are in, the Euro is soft.

New Labour's strategy is not Euro-leadership but better Euro-PR, talk the language of Maastricht and hang loose until the next election. Yet EMU's impact on our exchange rates makes that difficult. The pound is up 24% against the deutschemark and the franc. Britain's balance of payments with Europe will gape. Manufacturing will shrink and shed jobs (again). Foreign investment (as distinct from funny money) will seek more profitable and competitive bases elsewhere. So unless the pound comes down and we manage the rate for competitiveness, major difficulties lie ahead for the self-trussed British turkey. With a soft Euro they become more acute and are indefinitely prolonged.

Europe's obsession with the single currency, and ours with 'Bankernomics', make for a gloomy scenario. The speculators who saved us from the ERM are now working the other way while Europe will probably

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As economic and monetary integration in Europe approaches a new era, CentrePiece invited two British politicians to give us their very different views on the future of Britain in Europe.

Europe: Five years on

by Edwina Currie

Had the question of Britain's role in Europe been put at any time before the May 1997 general election the answer would have been clear. Britain did not appear to have – or want – much of a role. Other than carping, criticising, and blaming 'Europe' for self-inflicted wounds, the then UK government seemed neither to understand the workings of the modern European Union, nor how to make it function in the interests of its own people.

That ignorance and confusion was reflected in voters' opinions. To the alarm of pro-European activists in the European Movement, confusion and argument over Black Wednesday, the Maastricht Treaty and the single European currency saw support for British membership of the EU begin to fall away, until, in one poll, only one third of voters were in favour; one third were against, with one third throwing up their hands in despair as 'don't knows'. But the main plea was for more information. The active hostility of the Tory fringe was rare.

Black Wednesday was not, in retrospect, quite the economic disaster it first appeared – but nor was it the successful economic revolution claimed by Norman Lamont and others. A floating exchange rate was not the sole reason for Britain's recovery in the period since then: flexible *labour* markets and the hefty inward investment of the late eighties were also significant, highlighting the contrast with the continuing recession in continental Europe.

Attitudes remain confused, though marginally less xenophobic, under the Blair administration. To my disappointment, we will not yet be swapping sterling for the Euro: membership in the first wave has been ruled out. George Soros can sleep soundly in his bed: the see-sawing foreign exchanges in London will keep him in lucrative business for some years yet.

The Maastricht criteria which are causing so much grief elsewhere do not seem to be having the same effect here. Blair and his Chancellor, Gordon Brown, have adopted sound money principles as if born to them. An independent central bank is already a reality. The electorate in Britain, having contemplated the delights of higher taxation, have opted instead for tight control of public spending. Maybe there is a lesson here for politicians in other countries?

Yet, by contrast, the Social Chapter of the Maastricht Treaty is about to become UK law. A future Chancellor will also have to explain to irate inquirers how families are expected to benefit as the minimum wage, to be introduced next year, makes their low paid jobs illegal. The answer, of course, is that the black economy is alive and well throughout Europe. Berlin is being re-built by non-German workers, willing to defy both the EU Working Time Directive and laws on social security. The main gainers from the Social Chapter are those who laugh and ignore it.

It's in this area that Britain has an important role in European integration, if only the over-cautious ninnies in Whitehall could see it. We can demonstrate to our partners how sustained economic growth is achieved. Free trade, privatisation and an end to government subsidies for business have served us well, as New Labour willingly acknowledges. Cheap and flexible labour forces can compete effectively with rivals in Japan, America and the tiger economies. Keeping their products (like Japanese-made cars) out of our markets artificially is not the wisest response.

Big shifts of policy are needed by all Europe's governments. *Courage mes braves!* Enlargement of the European Union poses dramatic problems and worries, not least over the potential for huge – and unpopular – transfer payments to the would-be new members. Yet with flexibility, these countries could compete. We should bite the bullet of the most antiquated budget of all, the Common Agricultural Policy (CAP), and abolish it. The funds released could be better used for infrastructure, preservation of the environment and farm modernisation. Then Poland, for example, could once again be the breadbasket of Europe, instead of a

continued on p32

A raw deal for the young

Unemployment has long been one of Europe's biggest economic headaches: the experience in most European countries differs markedly from that of the United States. Yet, as David Blanchflower and Richard Freeman, both associates of the CEP, explain, the employment problems of young people in Europe have much in common with those in other industrial countries. Their research suggests there are no quick fixes on offer.

One of the most striking features of the job market in the 1990s is the scale of the problems which young people face. In spite of more young people staying on in education, and, indeed, more working and getting education at the same time, employment prospects for the young right across the industrial world are getting worse. Such developments have important consequences for society. The question, ultimately, is whether public policy can influence the future prospects for young people.

Differences – and similarities

Of course, the exact nature of the problems faced differs across countries, just as the way young people move from school to work differs among the OECD economies. In some countries, youths begin working while in school, shop around in the job market after they graduate, and then settle into a relatively permanent position. In the US, for instance, a typical young person will have worked at seven or eight jobs between the age of sixteen and twenty five, switching among jobs in school, and making further changes after leaving school. Elsewhere, there is a more structured transition from school to work; and youths take fewer jobs to reach 'permanent employment'. In Germany, Austria, and Switzerland, apprenticeships move youths from school to the industry in which they will find permanent work without an extended period of time in other sectors. In Japan, firms tend to recruit from particular colleges and universities or from specific high schools; workers remain with their first employer for long periods of time. In yet other countries, youths rarely work while in school and are often jobless for a long period after leaving school before obtaining a first job. Their first job, though, is a relatively permanent one. Italy and Spain – prior to the latter's introduction of temporary contracts – are examples of this pattern.

Throughout the OECD, young people have had greater problems in the job market in the 1990s than their predecessors had in earlier decades. In some countries, this shows up in relatively high unemployment rates and low ratios of employment to population. In others it takes the form largely of reduced wages for young workers. Table 1 (page 22) shows that for young men aged eighteen employment participation rates have tended to fall and rates of unemployment have risen in most countries. The trends are similar for older age groups and for women, although the levels are rather different.

At the same time, the proportion of young persons in educa-

Why youth unemployment will be hard to reduce

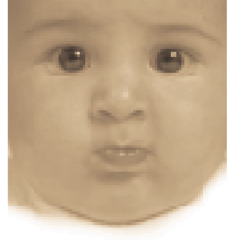
by David Blanchflower and Richard Freeman

tion (this includes schools, colleges and universities) has increased. This is illustrated in Table 2 (overleaf). It is noticeable that the UK has by far the lowest proportion of young people in school than in any of the countries reported here. It's also worth noting that a considerably higher proportion of those reported as being in education are likely to be in school in Europe than is the case in the USA. Ultimately, fewer of these people will obtain qualifications, especially degrees. Table 3 (on page 23) shows another interesting recent development. There has been an increase in all countries in the proportion of the employed who are simultaneously working and receiving some education. Once again the trends are similar for women although the levels are rather different.

It's not difficult to come up with explanations as to why youth employment prospects have deteriorated; the challenge is to find the right answer, since only then will the implications for government policies be clear.

Too many young people?

Three explanations fall in the supply-side category. The first is what was the predominant explanation of the job problems of young people in the 1970s. As the baby boom generation



Men at the top of the pay range saw virtually no drop in their rates of pay and were able to increase their earnings by working longer hours...

Table 1 Changes in labour market status for 18 year old males

	Activity rate		Employment/ Population rate		Unemployment rate %	
Country	**1984**	**1994**	**1984**	**1994**	**1984**	**1994**
Australia	83.2	70.0	66.0	53.7	20.7	23.3
Belgium	26.3	14.5	18.2	9.8	30.9	32.1
Canada	60.3	52.9	44.0	43.3	27.0	18.1
Denmark	74.3	69.5	66.3	63.7	10.7	8.3
France	42.5	16.9	27.2	11.1	36.0	33.9
Germany	66.7	57.8	61.8	53.6	7.4	7.2
Greece	40.5	27.1	33.4	21.2	17.6	21.8
Ireland	61.8	39.8	43.5	28.4	29.7	28.7
Italy	43.0	27.8	30.8	18.7	28.4	32.6
Luxembourg	54.1	27.5	50.5	22.5	6.6	18.3
Netherlands*	36.9	52.0	26.3	44.0	28.7	15.4
Portugal**	69.7	44.1	57.9	39.6	17.0	10.1
Spain**	49.6	36.7	25.8	20.9	48.0	43.2
UK	80.0	71.1	56.0	57.4	26.2	19.3
US***	59.9	54.9	46.7	43.8	22.0	20.3
OECD average	56.6	44.2	43.6	35.4	23.8	22.2

Note: OECD average is unweighted.
*1983 **1986 ***1993.
Source: Blanchflower and Freeman: *Growing into work* (CEP Discussion Paper No. 296, 1996).

reached working age, the supply of young workers increased relative to the supply of older workers, with what seemed to be classical market effects on wages and or employment. The large influx of young workers depressed the opportunities for a typical entering worker, causing either the wages or chances of employment for young people to fall.

This explanation has no relevance to the 1990s. In the past two decades, the youth share of the population has fallen noticeably in most OECD countries, as the baby boomers aged and were replaced by smaller generations. If everything else had stayed the same, the large drop in the size of youth cohorts in the 1980s and 1990s should have raised their employment or wages, or both, just as the large increase in the size of youth cohorts in the 1970s lowered wages and employment. It did not. The concordance of declining employment to population rates and relative youth wages, implies that everything else was not the same in the 1980s and 1990s. Detailed analysis of the link between the relative number of youths and their economic position relative to older workers up to the 1990s shows at most weak effects of demographic variables on the employment-population rate of youths. Perhaps the relatively smaller cohorts of young people eased their labour market difficulties, but not by enough to offset the other forces that were at work in the youth job market.

Table 2 Changes in the proportion of young men in education

	Age 18		Age 22	
Country	**1984**	**1994**	**1984**	**1994**
Australia	44.5	53.5	18.0	21.5
Belgium	72.0	78.3	35.4	34.3
Canada	58.3	76.0	23.2	33.1
Denmark	39.4	64.2	16.3	31.7
France	47.4	79.9	10.1	36.0
Germany	36.0	45.0	23.0	25.1
Greece	56.0	69.1	21.9	29.7
Ireland	41.0	59.7	11.3	20.7
Italy	55.1	66.5	23.2	27.5
Luxembourg	43.7	67.5	15.7	18.8
Netherlands*	66.9	75.0	33.2	43.3
Portugal**	34.8	59.8	19.6	31.5
Spain**	49.3	64.3	18.5	34.2
UK	26.7	31.7	11.3	12.8
US***	61.6	64.7	19.7	23.5
OECD average	48.8	63.7	20.0	28.2

Notes: OECD average is unweighted. *1983 **1986 ***1993.
Source: Blanchflower and Freeman (1996).

Underqualified?

The claim that the education system is failing young people is an often-heard explanation for youth job market problems. But it does not fly. Young people in the 1990s have more education than earlier generations had. Using data that traces two age cohorts through time, those aged 16 in 1983 and those aged 16 in 1988, we have analysed school to work transitions within countries through time. In most countries the percentage participating in education at every age for the 1988 cohort lies above the percentage for the 1983 cohort, implying that years in school are increasing. In the US, where post-secondary education increased earlier than elsewhere, the figures imply a stable proportion enrolled in school as their major activity in the periods covered. This evidence is consistent with data that show increased enrolments in higher education in most countries, including the US. The young today are likely to be more educated than earlier generations who had lower unemployment rates.

...but the ten per cent of men on the lowest rates of pay experienced a double whammy – cuts in the real rates of pay per hour and in the number of hours worked.

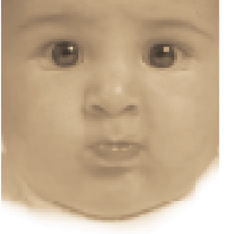


Table 3 Changes in the proportion of employed young men who are in school

	Age 18		Age 22		Age 26	
	1984	1994	1984	1994	1984	1994
Australia	41.7	43.9	14.9	18.0	12.6	12.8
Belgium	7.1	11.5	4.9	3.8	6.9	3.0
Canada	46.1	68.1	14.0	22.8	7.0	12.2
Denmark	23.9	50.8	6.4	15.9	5.1	7.0
France	1.9	15.6	1.9	9.4	1.7	6.9
Germany	5.8	12.0	2.0	5.8	2.0	6.7
Greece	5.8	5.1	2.0	2.7	1.1	1.7
Italy	2.1	2.6	2.4	3.0	2.2	1.7
Luxembourg	0.9	5.6	1.6	1.4	1.0	0.9
Netherlands*	23.7	55.1	13.7	25.6	12.5	7.4
Portugal**	10.2	16.6	7.9	10.2	2.1	8.7
Spain**	2.0	11.3	0.6	6.6	0.2	6.5
UK	14.6	21.9	6.6	7.9	3.9	5.1
US*	43.8	46.3	9.2	12.0	2.1	2.1
OECD average	15.7	25.1	6.1	9.9	4.2	5.6

Notes: as for Table 1.
Source: Blanchflower and Freeman (1996).

Are young people not flexible enough?

Another supply side explanation commonly advanced is that young people are not flexible enough in their job search. The wages they demand are too high and they are unwilling to take low skill starting jobs and then shift to better jobs later. We do not find much support for this explanation either.

The school-to-work transition can take the form of youths entering the job market and obtaining relatively long-term jobs; or it can be more of a job matching and shopping process, in which youths enter and engage in a lengthy period of search before settling down. Germany and Japan are exemplars of labour markets in which young persons enter the market and obtain relatively permanent jobs without much job-switching or working during school. In the US and Canada youths enter the market and change jobs readily before settling down, and many youths work during school and in summer vacations. There are advantages and disadvantages to both models. But whichever is better, there is no evidence in either of reduced mobility among youths, nor of increased reservation wages that would suggest that the young are unwilling to work. In the US, attachment to firms has, if anything, fallen among young less skilled men, implying greater – possibly too great – mobility. And young workers in virtually all countries are more mobile than older workers.

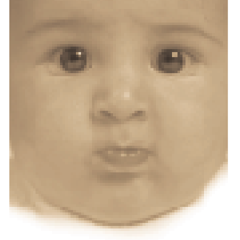
Sectoral decline?

If you can't explain something on the supply side, you don't have to be too much of an economist to know that you ought to try the demand side of the market. There are three demand side factors that might help explain youth job market problems. One hypothesis is that the sectors of the economy in which young people tend to work are in decline.

Has this been the case? In most countries youths work in different economic sectors than adults; it's not difficult to calculate which sectors are youth-intensive. Youths are disproportionately represented in hotels and restaurants and wholesale, retail trade, and repair: all these sectors are huge employers of young people. In Germany and France, for instance, the two sectors employed 39% of all young workers in 1994. When the youth workforce is disaggregated by sex, two other industries are highly youth intensive: construction, for men; and health, for women. Indeed analysis shows that recently among men, there has been an increased concentration of young men in 'youth intensive' industries. In this sense, the 1980s and 1990s have seen the development of a more bifurcated labour market by age.

The uniformity of these patterns across countries is striking and suggests that, differences in school-to-work transition patterns notwithstanding, what happens to the youth labour market depends critically on developments in a limited set of sectors in all countries. Since in most countries youths work in a distinct set of industries, it could be that some of their labour market problems might be due to structural shifts in the composition of employment against those industries. If the share of employment in hotels and restaurants and wholesale and retail trade, where young workers are found in disproportionate numbers, were falling, this would adversely affect the movement of youths into job markets. But in nearly all of the countries employment in these sectors grew relative to total employment.

Analysis shows that in all of the EU countries except Belgium, as well as in the US, Canada and Japan, the net effect of changes in the share of employment across industries has been to raise, not lower, the demand for young workers. Since changes in industry mix should have improved the employment prospects of youths, they offer no help in explaining the observed worsening of outcomes for youths.



School and job prospects are critical in the lives of young people. So it is not perhaps surprising that the worsening youth job market in the 1980s and 1990s brought unwelcome social consequences.

Too much pay?

When any group of workers is unemployed, economists naturally ask whether their wages have recently risen, getting out of line with their productivity. This is particularly the case for young workers or others whose pay is low and might be affected by minimum wages. So have youth wages risen relative to adult wages? Do rising minimum wages explain the worsened youth employment position?

There is a clear and uniform story about changes in youth wages over time. In virtually all OECD countries workers in both the 16–19 and 20–24 age groups have experienced declines in their earnings relative to older workers throughout the 1990s. The magnitude and timing of the fall differs across countries; but the direction of the change does not.

Of course, it may be that youth wages did not fall enough because of minimum wage interventions. This question has been most extensively examined in the US, where the real minimum wage fell sharply during the Reagan Presidency and then increased modestly under Presidents Bush and Clinton. The evidence suggests that even the large reductions in the relative pay of lower wage workers in the US were not been sufficient to improve their employment position. On the contrary, the amount of time worked by lower paid workers has fallen rather than risen. We have examined the relation between pay and employment for workers aged 25–29 using the US Census of Population. Men at the top of the pay range saw virtually no drop in their rates of pay and were able to increase their earnings by working longer hours. But the 10% of men on the lowest rates of pay experienced a double whammy – cuts in the real rates of pay per hour and in the number of hours worked. Women fared better: right across the earnings range, the number of hours worked rose, and the cuts in real hourly earnings were small compared with those of men. So despite substantial reductions in pay the amount of time worked by young men has not increased. For women, increases in hours worked do not appear to have been brought about by cuts in real earnings.

Consistent with these results is the growing literature on the relation between youth employment and minimum wages in the US, UK, and France which show at most modest job losses in response to mandated increases in the minimum. In many cases researchers are unable to find any loss of employment; and some have even found job gains. The fact that the relative pay of youths fell across countries at the same time that youth employment rates also fell tells a similar story. One possible interpretation of all of these results is that the data reflect a massively declining demand for young workers. Nevertheless, there is little in the evidence we have found to indicate that even greater relative wage reductions would have significantly improved the availability of work for the young.

The real explanation?

Since none of the explanations we've looked at so far helps us much in explaining youth unemployment, solutions based on tackling them – wage subsidies, extra training, encouraging young people to stay out of the labour market by carrying on with education – are unlikely to make great headway. A more traditional explanation is that youth unemployment is the 'squeaky wheel' in the job market: that the young are at the margin and thus especially sensitive to changes in the economy as a whole.

The effect of fluctuations in the aggregate economy on youths has long been an issue in analyses of the youth labour market. The standard generalisation is that youth employment or unemployment is exceptionally sensitive to aggregate economic fluctuations. No such clear generalisation has emerged about the effect of the aggregate economy on youth enrolment in school. We examined the impact of aggregate economic forces on three overlapping classifications: the percentage in school (regardless of employment status); the

Table 4 Death rates by suicide and self-inflicted injuries for men.
(Death Rates per 100,000 persons)

Country		Age 15-19	20-24	25-54
Australia	1970	8.4	16.7	26.2
	1992	19.6	34.6	26.3
Austria	1970	21.0	32.9	43.7
	1992	15.7	31.2	35.6
Canada	1970	10.1	21.9	24.6
	1992	20.1	29.0	27.3
France	1970	6.7	12.1	25.7
	1992	6.7	20.7	37.5
Italy	1970	2.6	4.5	7.9
	1990	3.3	8.3	10.5
Japan	1970	8.7	18.8	19.4
	1992	5.3	15.3	25.9
Netherlands	1970	3.3	8.1	10.7
	1992	4.6	12.5	17.0
New Zealand	1970	9.0	15.6	19.0
	1992	27.7	52.2	28.7
Norway	1970	1.3	9.2	17.2
	1992	18.0	37.2	24.3
Sweden	1970	10.2	25.4	41.3
	1992	5.4	14.4	27.5
UK	1970	3.0	8.5	11.5
	1992	6.4	16.9	17.8
US	1970	8.9	19.0	23.1
	1991	18.0	25.4	24.0
West Germany	1970	15.7	24.6	34.0
	1990	9.6	18.6	23.8

Source: World Health Organisation Statistical Database.

Unless overall rates of unemployment are reduced, there is little likelihood of an improvement in the job prospects for young people.

percentage employed (regardless of school status); and the percentage unemployed. Using data on 17 OECD countries, we estimated the effect of aggregate demand on the distribution of youths among each of the three states in turn. Pooling all of the countries together, schooling is positively related to unemployment, implying that increases in unemployment lead to increased enrolments, but the diverse country results gainsay any broad generalization.

By contrast, there is no ambiguity in the effect of aggregate economic conditions on the proportion of an age group working or unemployed. When we pooled all the OECD countries for which we had data, we found that an increase in aggregate unemployment by 1 percentage point reduces the employment rate of youths by 1.13 percentage points. This implies that a 1 percentage point increase in unemployment reduces the probability that a young person is employed by more than one point. Interestingly, the UK has one of the highest impacts with an increase in aggregate unemployment of 1% leading to a 1.8% fall in the employment rate of youths and an enormous 2.4% increase in unemployment of male youth. We found that as young people get older, the proportion employed or unemployed becomes less sensitive to aggregate economic conditions. This supports the generalisation that youth employment is exceptionally sensitive to aggregate conditions.

The social consquences

School and job prospects are critical in the lives of young people. So it is not perhaps surprising that the worsening youth job market in the 1980s and 1990s brought unwelcome social consequences. First, suicide rates increased. Table 4 (left) reveals a striking regularity in the rise of suicides among young men in English-speaking countries: the US, Canada, UK, Australia, New Zealand, and Eire. These countries have had relatively large increases in earnings inequality and have lower social safety nets than many other countries, although any causal linkage is speculative. Rates of suicide among young men have also risen in Norway, where earnings inequality is small and the social safety net high. Only in Japan, Austria, Sweden and West Germany did suicide rates for both of the groups of young men reported in the table decline: in these countries, unemployment rates over the period in question were very low.

Crime also increased. Most crimes are committed by the young. So a good indicator is thus the rate of crime per person in the crime-prone young age group, say 16–29. While there are major problems in the crime statistics of all countries, as far as it's possible to be certain, crime rates have risen in the past twenty to thirty years in most advanced countries. Across countries, rates of crime tend to be higher in the US than in Western Europe or Japan. But the US-Europe differences are largely the result of higher rates of violent crime in the US. Property crime rates differ only modestly among advanced countries with, for instance, car thefts higher in France or England and Wales than in the US in 1984.

What does differ across countries is the incarceration rate. An extraordinary proportion of young men in the US are in prison or jail. In 1993, 10% of 25–34 year old American men were 'under the supervision of the criminal justice system', meaning that they were in prison, or had been convicted and given probation, or were on parole from prison. In 1993 one man was incarcerated for every 50 men in the workforce, a rate of 2%. Even in the UK, which has one of the highest rates in western Europe, the figures were much lower: 60,000 men were in prison in 1996, 0.4% of the workforce.

The difference in the size of the prison population reflects two different ways of dealing with the decline in demand for low skilled labour which has characterized most OECD countries in the past two decades. In the US there are few benefits for unemployed or poor men; real pay for low skill work has fallen by 20% or so; jobs are scarce even at low wages, and society deals with these lost souls through the criminal justice system. In most EU countries there are substantial unemployment or social safety net benefits, and wages have not fallen, so that it pays to wait for a job.

Searching for a solution

Governments around the world have tried to mitigate the impact of adverse labour market conditions by developing 'training' programs that have frequently been targeted on the young. Examples include programs developed under the Job Training Partnership Act (JTPA) in the US and the Youth Opportunities Programme and Young Training Scheme in the UK. Until recently, however, there has been little effort to evaluate their effectiveness; and most attempts which have been made have largely been confined to the US. Where evaluation has been done appropriately – allowing for the possibility that participants might well have succeeded without the programme – the results have not been encouraging. Large scale government training programmes do not appear to work and hence the tendency to scale them down in the 1990s. No solution here.

Unless overall rates of unemployment are reduced, there is little likelihood of an improvement in the job prospects for young people. The most likely cause of youth unemployment is the high overall rate of unemployment: unless that is reduced, which may require faster economic growth than most countries seem willing to accept, the position of youths in the job market is unlikely to change in the near future.

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Their Discussion Paper *Growing into work* (1996, No. 296) is available from the CEP, price £5.

Black Wednesday: five years on

On September 16, 1992, less than two years after Britain joined the exchange rate mechanism of the European Monetary System, the pound was forced out amidst unprecedented turbulence on the foreign exchange markets. Guest Columnist Sir Alan Walters, economic adviser to Margaret Thatcher during much of the 1980s, reflects on the lessons of the crisis five years on.

As Talleyrand would have said about Britain's entry into the Exchange Rate Mechanism (ERM), it was worse than a crisis, it was a crime.

Purpose and practice

The ERM was part of the European Monetary System agreed between German Chancellor Helmut Schmidt and French President Valèry Giscard d'Estaing in 1978. Both saw it as an essential first step towards a monetary union of one sort or another. The French, as always the most skilled negotiators in the EC, saw this as one way in which they could achieve 'symetrie', which one translates as French control over German monetary policy.

The ERM itself was widely interpreted as a 'fixed' exchange rate system. It was thought to herald a 'sea of stability' in the floating rates of the 1970s. But from its inception exchange rates were 'pegged' rather than fixed: they were said to be, in an obvious oxymoron, 'fixed but flexible'. Exchange rates were permitted to wobble in a band of plus or minus 2.25% (6% in the case of Italy and, later, the UK) around a central value. But if there was a fundamental disequilibrium, the central value could, with the nominal agreement of the participating governments and the presumption of support, also be moved.

So much for the intent. The reality was that governments were reluctant to recognise fundamental disequilibria, just as they were under the aegis of Bretton Woods. With enormous private capital movements, it was quite impossible to have a considered devaluation or revaluation. The market could calculate as well as treasuries and central banks whether the parity was sustainable. And traders did not have to wait for the bureaucratic processes of assessment and decision.

The signs were enough: the rate of erosion of reserves, sky-high interest rates to discourage capital flight, and so on. Active traders would anticipate any move to make a killing. This, of course, exacerbated the flight.

The founding fathers of the ERM never anticipated the enormously disruptive private capital flows, partly because until 1990 there were effective controls on capital movements. With their dirigiste financial sectors, Germany and France believed that the central banks could maintain their chosen parities. But as international private capital flows burgeoned, and capital controls were reduced and eventually, in 1990, eliminated, so exchange rate policy became more and more a game of cat and mouse... and the speculating cat was almost always ahead of the mandarin's mouse.

The founding fathers also sought 'symetrie'. As in all institutions of the EC and the EU, they sought an equality between nation states. But it was clear from the beginning that Germany would dominate all other countries; the deutschemark would rule o'er all.

The decision to stay out

Throughout the 1980s, although Britain was in the European Monetary System, it did not participate in the ERM. Various reasons were given; the common thread was that Britain needed the flexibility accorded by a floating rate and should not lash itself to the deutschemark mast. It was argued that if there were shocks (such as a rise in oil prices) and one needed to change the overall price level and the differential between tradeable and non-tradeable goods, then it was a good idea to allow one price, the exchange rate, to move rather than go through the hassle and expense of negotiating virtually all prices individually. At various stages in the past (notably 1926, 1965 and 1973) governments had tried to negotiate restrictions on money wages and had failed and fallen. The Thatcher government was anxious to avoid that trap.

But the overwhelming reason for staying out of the ERM was that, with Britain's open and highly liquid capital markets, there would be destabilising capital flows which would be costly to deal with, through sterilised intervention, and which would result in perverse monetary policies and, ultimately, a collapse of the parity. On a personal note I should like to record that I wrote a seven page brief on these issues for the Prime Minister in November 1981. The argument in that brief became known as the 'Walters critique'.*

A caricature of the process is as follows:

> *Consider country G (for Germany) which enjoys zero inflation and country B (Britain) that suffers from 10% inflation. Let G's interest rate be 3% and B's 13%. The exchange rate is 3 deutschemarks to the pound, and sterling is depreciating at 10% a year. Now form an ERM by pegging the exchange rate at 3DM, and suppose this holds for a full year. At the prevailing interest rates, the yield in B is 10% more than in G for maturities of less than one year. So for these short maturities, capital will flow to B from G. This will depress interest rates in B and raise them in G. In principle, this flow from G to B will continue until interest rates in B and G are the same – say 6% for short term capital.*
>
> *We note the essential perversity of monetary policy in both B and G. B with her 10% inflation has negative real short term interest rates (minus 4%) and receives an enormous expansion in the money supply through injection of foreign money. G has higher real rates (plus 6%) and the flight of capital to B puts downward pressure on the money supply.*
>
> *But as the end of the year approaches, these capital flows are reversed. Traders anticipate the inevitable devaluation of B's currency. In order to hold sterling over the year's end, they need to be compensated for the expected 10% devaluation. So sterling interest rates over the end of the year rise, and G's fall, as we see typically where there is an imminent devaluation.*
>
> *This whole process will not lead to lower inflation in B. But it will induce great instability. After the devaluation, with sterling at 2.7DM, there is no reason why the process should not be repeated. It is inherently a destabilising process.*

There are many variations on this general theme – one could incorporate, for example, the fact that we do not know when the devaluation is to take place, the use of bands for parity tolerance, and so on. All these considerations are, however, variations around the theme. The basic perversity and destabilising forms do not change.

The British experience from 1987 to 1992 does not discredit this analysis of events. Recall that in January 1987, the then Chancellor, Nigel Lawson, pursued a policy of shadowing the deutschemark at a parity of 3DM to the pound. Since British interest rates were considerably above German rates, there was a flood of money into London... so much so that in February and March 1998, sterling went through its roof. Interest rates were reduced to a low of 7.5% in mid-1988, in spite of the mounting evidence of massive growth in the money supply. By shadowing the mark, the Chancellor hoped to ease Britain into the ERM; all he did, however, was to generate a substantial inflation ('headline' inflation peaked at over 10%) which, in 1989–90, required interest rates of 15% and a recession to subdue it.

Going in...

The ERM enthusiasts argued, or at least asserted, that Britain would not have got into the 1989–90 pickle if they had been firmly locked into the ERM. The media columnists, the CBI, most Ministers and virtually all Conservative

* See Palgrave's Dictionary of Money and Finance.

members of Parliament clamoured for Mrs Thatcher to enter the ERM forthwith.

Although I was still adamant about the dangers of joining such a club, one had to recognise political realities. As adviser to the Prime Minister, I tried to do this in a brief on the position to be taken at the Madrid meeting of the European Council on June 15, 1989. I suggested that we should join the ERM on certain conditions: first, there needed to be a considerable reduction in inflation; second, our European partners should eliminate both overt and covert exchange controls; and finally, the single European market should be completed. Although it was clear that wholesale achievement of these conditions would not deal with the fundamentals of capital flows and their destabilising effects, I thought that it was the best sort of deal that could be done.

Of course, none of these conditions were realised when, on October 5, 1990, Mrs Thatcher yielded at last to the pressures from the Chancellor, then John Major, her Cabinet and the howling banshees of the media. We entered at a central rate of 2.95DM, with 6% bands. Immediately the problems of the ERM became apparent. We in Britain were still deep in recession and required low interest rates to generate recovery. In Germany, however, interest rates were high as the Federal Republic aborbed the erstwhile German Democratic Republic. So of course British interest rates had to stay even higher. Germany really did call the tune of monetary policy.

...turned sour

After a brief honeymoon period, by the summer of 1992 the steady drip of the capital drain had persuaded many a portfolio holder that this would soon become a flood. The credibility of a central value of 2.95DM was severely dented by the recession-related expansion of the budget deficit, the very large increase in taxes and, in spite of high interest rates, the capital flight and massive shorting of sterling against the mark and the dollar. From various indicators, I calculated that sterling would be bounced out of the ERM on August 22. I did not, however, reckon with the enormously costly defence of the indefensible: and so Chancellor Lamont, with the agreement of the Prime Minister, John Major, delivered our billions of reserves to those speculators and fundholders who shorted sterling. The final curtain came down on September 16, when all hell, and sterling, broke loose. It was 'decided' to float rather than devalue to a new central rate.

(The confusion of the Major ministers and the Bank of England, the U-turns clumsily performed, are all the stuff of common knowledge. The common boast of the Conservative Party that they were far better at managing public finances and the economy than the opposition was at least open to question. I suspect this was still a major factor in the election of 1997.)

Apologists for the ERM argued that Britain entered at the wrong rate (and Sir Kit McMahon, a former Deputy Governor of the Bank of England argued, for example 'at the wrong time and for the wrong reasons'). All would have been well, it is said, if the rate had been lower – say 2.6DM. I doubt this. As a counter example, when sterling shadowed the mark in 1987–88 at 3DM, the rate was clearly too low. It pushed through the ceiling from March 1988 onwards. Informed opinion, in the shape of Sir Samuel Brittan, suggested that the appropriate rate at the time was around 3.2 or 3.3DM. Many learned calculations of the fundamental real equilibrium exchange rate came up with figures of that order. Certainly one can agree that entry at a lower rate would have changed the timing of subsequent events; but with the differentials in inflation so large, the inevitable capital flows would have done their damage.

There is no doubt that Black Wednesday played a large role in reversing opinion on the sustainability and desirability of the ERM type of 'stability.' Even more evidence poured in with the crisis of the French franc and other currencies in July 1993. True, with enormous German support and covert exchange controls exerted by the banks, the French held their parity: but that has had the effect of producing a severe recession which continues to this day.

Since these two European crises, there have been a number of examples of pegged exchange rate systems succumbing to capital flows. Mexico in 1994, Thailand and the Philippines in 1997, are the obvious examples. They can be understood in terms of the simple analysis of my critique. What cannot be predicted is the timing – but that is the Achilles heel of much economic analysis.

It is now generally accepted that exchange rates should either float or be absolutely fixed. As EMU lumbers ahead, the governments involved are anxious to avoid another Black Wednesday. From April 1998 onwards, they are likely to choose 'irrevocably' fixed rates. But that, of course, is just the word of politicians. We shall see what credibility the market attaches to it...

The common boast of the Conservative Party that they were far better at managing public finances and the economy than the opposition was at least open to question.

Sir Alan Walters was Cassel Professor of Economics, LSE 1968–70 and personal economic adviser to Margaret Thatcher, 1981–84 and 1989.

Danny Tyson Quah

Europe in the weightless economy

The weightless economy threatens the traditional nation state and is rife with positive externalities for economic growth. Is this the signal for government intervention? In the third instalment of his regular column, Danny Tyson Quah looks at some European experiences.

Just as on the Internet no one can tell if you're a dog, in the weightless economy no one should care if you earn your living logged in from Dulwich. Or from Silicon Valley for that matter. In the modern weightless economy, economic activity should disrespect location, geography, and distance. And, mathematically, the traditional nation state is just a topological deformation of physical distance. Pop journalism is rife with stories of how the twin forces of technology and globalisation have fed off each other and undermined the sovereignty of traditional nation states. In appropriate circumstances, it is natural and right for the traditional nation state to fight back – as it would be for any other player in the modern economy.

Moreover, characteristics of the weightless economy previously described in this column and elsewhere veer close towards standard notions of public goods. Indeed, in another guise, early versions of these ideas were linked to endogenous growth from spillovers and externalities – then, private actions of profit-seeking agents would lead to under-investment and slower growth than optimal. Shouldn't that give intervention-minded European governments yet further weight to step in?

The nation state and its economic geography

Sure, there was a time when economics bowed to geography. Farmers having grown their leeks (or corn or rice or soy) could not rely on neighbours buying all their produce. Even the most intrepid, after all, eat only so many leeks a year. Thus, leeks had to be transported from wherever they had just been produced to wherever they would ultimately be consumed. Given transportation costs, someone – whether it be the farmer, the consumer, or the automagical workings of the marketplace – will need to ensure that the distribution of economic activity across geographical space is deliberate and efficient. Location matters.

Swap 'industrialists' for 'farmers' and 'earth-moving, chemicals-processing, fabric-weaving, car-assembling, house-building machinery' – heavy metal – for 'leeks', and the location

From an economic perspective, as long as distance, trade tariffs, and other barriers keep the world from being one seamless web, they also help define what nation states are and what nation states can do. Taxes on a citizenry extend only as far as where those citizens can be found, and no further.

problem simply scales up. For the producer, there always remains the tension between settling on the fertile land, or near the coal mines or waterways, and locating near the customer or the distributors. For the consumer, there always remains the tension between working where one is most appreciated and living where one most appreciates. When economic activity was less specialised and one produced only for the consumption of one's family and fellow villagers, such tensions were correspondingly less pronounced. But then, as economies grew and technology allowed specialisation, opposing forces in the balance grew differentially in strength. The economic landscape changed accordingly.

This is a simple story, but it helps us understand the evolution of locational geography from Nebuchadnezzar and the Sumerians in the Tigris-Euphrates basin all the way up through shopping malls and industrial zones in the late twentieth century. Large empires were cobbled together and fought over, canals built and continents separated, to make an economic landscape just so. In the US, first railways and then automobiles and highways profoundly influenced the economics and the culture of American society.

In this simple analysis, when we recognise that being close to customers means different things depending, say, on ruggedness and inaccessibility of the surrounding terrain, we factor into the calculation the idea that relevant economic distance means something a little more subtle than that distance as the crow flies. From there, it is a small step to consider trade tariffs and trade barriers across nation states – on top of road-kilometres or air-miles – as also forming part of a sensible definition of economic distance.

But it is a two-way street when a nation state's policy actions directly influence distance and geography. From an economic perspective, as long as distance, trade tariffs, and other barriers keep the world from being one seamless web, they also help define what nation states are and what nation states can do. Taxes on a citizenry extend only as far as where those citizens can be found, and no further. Without free trade and mobile capital and labour, factor-price equalization fails, and the effective minimum wage in one nation state will differ from that in the next. Without the possibility of cross-country swapping of financial instruments, disparities in risk-adjusted interest rates across nation states need not be arbitraged away. Collecting revenues for the state is easiest and most efficient when tax officials can just wander on down to the closest port of entry, and sit there counting the bales of cotton or casks of wine that trundle from ship to dock.

Whither the nation state?

To continue the story, now replace 'leeks' with software, mathematical algorithms, designs, and database content. How do these travel?

The flip answer of course is very well, thank you. Converted into logic bits of zeroes and ones, these products scurry across the globe practically instantaneously. In package-switched transit, they are indistinguishable from any other zeroes and ones also zipping through the networks. And, without knowing how they are to be put back together again, those zeroes and ones that we sent are completely meaningless to the unsuspecting on-looking third party. However, when reconstituted into their error-checked manifestations at the receiver's end, they comprise exact copies of what had been originally transmitted. These commodities are not icebergs that melt along the way in transportation. Neither are they objects that a fiscal authority can easily tote up and impose a fiscal burden on – to tax just digital bits, independent of what value those bits carry, violates every sensible principle of public finance I know.

It is a naïve but natural extension of this reasoning to conclude from this that the nation state will wither away. In this reasoning, the nation state, as we know it, will soon become neither necessary nor viable.

Stories abound, some probably apocryphal, of how modern communications technology has altered power relations between governments and those they control. A 2400-baud modem or two, judicially distributed around Czechoslovokia, surely helped to communicate, organise, and coordinate in 1989 – with the heavy hand of the Communist state too unhip to understand how those instruments of new technology might matter.

Now, if anything, the nation state pokes its head into everything having to do with new technology. The US government auctioned off the radio spectrum (someone had to), and – after consulting the best economists in the business on how to do this – actually did a pretty good job, all agree. Drawing on the example of the government's success at building national highways, the federal government has also looked into constructing analogous pipeways for transmitting those digital bits of information.

It is unclear that private enterprise could not do by itself a pretty good job on this. Building highways when only national governments had the clout to amass the necessary resources is one thing. Crowding out what profit-seeking private agents can now do quite willingly is another. Already it is a private consortium that provides much of the world's satellite communications services via high-altitude geostationary orbit. Separately, Motorola and Teledesic (the latter in collaboration with Microsoft and Boeing) have been working on putting in place alternative low-orbit satellite service for video and voice communications. Having a global range, as any such operation must do, involves the delicate task of getting the approval of a sufficiently large coalition of different sovereign countries. It is informative that the bloc unified in favour of these operations comprised mostly the poorer emerging countries,

Why, when the new technology is geography-blind, do places like Silicon Valley, Massachusetts and Utah's software concentration between Salt Lake City and Provo succeed so spectacularly, while others – with arguably better financial support and government backing – fail?

arrayed against the Europeans and Japanese. Half the world's population still live in countries with less than one telephone per 100 inhabitants – there are more telephone lines in Tokyo alone than in all of the African continent. Here, profit-seeking private enterprise might well do a good job of bringing high-tech to the poor – indeed, in this regard, why should high-tech be different from anything else?

However, in the US the outstanding example of nation state intervention in these matters has been on the issue of privacy of those logic bits whizzing around communications channels. Debate surrounding the Clipper Chip – key-escrow encryption technology – has been heated, with the federal government seeking to retain the technical ability to decrypt every conceivable communication, whether it be by voice phone or data transmission. Opponents credibly organised against big-brother government. The right to free (i.e., uncensored) communication is always tricky for a government to challenge, even if the challenge is more imagined than real.

Where does Europe slot into the Net?

Governments could, of course, do worse. European information society initiatives (the Information Society being the EU counterpart to the US National Information Infrastructure, or to the less nationalistic and thus more universal 'information superhighway') abound, and some of these projects will probably do good. Now that 80% of the new jobs created in Europe in the last five years have been recognised as information-related, here's where someone might think European government resources could go on pump-priming stimulus, killing two birds – furthering modern technology and smoothing out sluggish, premodern, Eurosclerotic labour markets – with one stone.

Everyone should, of course, welcome any reallocation of resources into what are clearly growth sectors and away from moribund declining economic activities. But private agents do that well. Why get in their way and take away entrepreneurial opportunity? Such government interventions are in sharp contrast to, say, the US where, after early war-related beginnings, all high-tech development valued by consumers has been carried forward by profit-seeking private enterprise. Being contrary is, of course, no guarantee of error, but then neither does it assure success.

In the early 1990s, the French government and the European Community poured US$120m into the Advanced Computer Research Institute (ACRI), newly established in Lyons. One goal, presumably, was to try to grow some of that same creative fire igniting California's Silicon Valley. The ACRI paid top prices to hire managers, scientists, and engineers quickly. Staff surplus to requirement were taken on, partly because ESPRIT funding (ESPRIT was the European Union's principal programme for information-technology Research and Development subsidies) was based on staffing targets – but surely over-manning could do no harm. And it's an easy way to create jobs.

The ACRI project went nowhere. No product ever came to market; the Institute went bankrupt in six years. Its closest global competitor, Convex Supercomputer in the US, brought out its own machine in half the time and for a quarter of what ACRI spent.

This example is instructive. Why, when the new technology is geography-blind, do places like Silicon Valley, Massachusetts and Utah's software concentration between Salt Lake City and Provo succeed so spectacularly, while others – with arguably better financial support and government backing to boot – fail?

First, all those successful regions in the US are close to top universities churning out highly-motivated, success-driven software and hardware engineers; industry in the new technology relentlessly feeds off this creativity and brainpower. By contrast, in a 1996 survey, 50% of France's youth said they wanted to be civil servants. Sure, it doesn't matter that you're in Bangalore, India, bouncing off a satellite your code destined for a software house in California – but you have to want to do it, and someone had to find you as you were graduating from university in the first place.

Second, all the successes began lean, mean, and hungry. No one had a luxurious direct line to an ongoing supply of resources with which you could buy unneeded equipment and people. If you don't give people what they want, you're out of the game. Start over.

The binding constraint in this business is the shortage of human capital – whether it is for providing artistic design and content or for cutting code or for laying tracks on silicon. This is why in the 1990s in the US real wages have risen 13–20% for programmers, while the median wage has instead fallen; why US high-tech headhunters scour the globe for skilled software engineers; and why high-tech companies consider the shortage of human talent the greatest potential threat to successful, ongoing growth in their industry – more than any problem on the demand side for their products.

Unleashed, European private industry does very well in the global competitive weightless-economy market place. Nokia in Finland and Ericsson in Sweden continue to dominate the world in cellular global telephony. It might, of course, seem strange to think of 'Ericsson of Sweden' since Ericsson employs 17,000 engineers in 40 research centres distributed across 20 countries in the world. It has 90,000 employees in total, active in over 130 countries. After designers in Australia and England have worked to their

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satisfaction on an Ericsson blueprint, that design plan is simply and transparently made available to a factory in China for final production. The logic chips in their excellent telephones are just as likely to be designed in Nice using software tools developed by Ericsson in Houston, produced in Japan and Dallas, and tested in Taiwan. But, unquestionably, Ericsson remains a Swedish company. Similarly, 'Nokia of Finland' employs more than 34,000 people in 45 countries.

Psion in the UK is widely recognised to make the world's best handheld computers. About 40% of the world's most successful video games have been written and designed by British programmers. The same kind of freewheeling creative genius that made Douglas Adams's *Hitch-hiker's Guide to the Galaxy* such a runaway success will probably carry over to his *The Digital Village*, exploring online entertainment. In France, Gemplus, founded by engineers out of Thomson Semiconductor, developed the first microprocessor-equipped smart card and, in the process, launched a billion-dollar industry, of which it still owns more than a third. Over 90% of the world's smart cards are currently in use in Europe, although estimates are that US consumption of them will grow dramatically in the coming decade.

European governments, like all others, must recognize that success in the weightless economy comes from letting winners emerge, and getting out of their way when they do so. It's the same silver bullet as in the regular economy. Even if no one cares that you're logged in from Dulwich, what you're doing had better be useful and valued.

Danny Tyson Quah is Director of the CEP's National Economic Performance Programme, and Professor of Economics at the LSE.
http://econ.lse.ac.uk/~dquah/

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Austin Mitchell

persevere in its EMU folly, because postponement means chaos and the investment in misery has been too great to suddenly admit that it's all been the terrible mistake it really is.

How should Britain respond? *Schadenfreude* is permitted after years of excessive budget contributions, gaping trade deficits and losing jobs and business to Europe while being lectured as bad Europeans. Yet it must be supplemented by the determined pursuit of our own interests. Two decades of dear money and overvaluation have shrunk an industrial base on which all still depends. Only cheap money and a competitive exchange rate can repair the damage, boost growth and make production profitable in this country. We pursue that or we fail.

Europe's problem is what it can rescue from self-inflicted folly. To involve ourselves in that, or try to lead them out of it, is to abandon British substance for Euro-shadow. New Labour's job, however selfish or *uncommunautaire*, is to rebuild an economy which can pay its way in the world, generate the jobs and economic growth its people need, and maximise their living standards. All else is distraction.

Austin Mitchell is Labour MP for Grimsby.

Edwina Currie

poor supplicant for our largesse.

Rather than resist change – as the victory of Lionel Jospin suggests the French electorate wants to do – the process of adjustment needs to be speeded up. If the British began to push effectively, there would be allies. Our experience is that a lightly-regulated market economy brings the greatest gain to its people. Our politicians should become missionaries. Mr Blair paraded his admiration of Margaret Thatcher to the voters and won: now he should promote her ideas to a wider audience. However he might dress them up, he would find a ready audience in Europe.

Edwina Currie was Conservative MP for Derbyshire South. She is now a writer and broadcaster.

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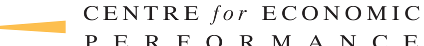

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