Britain's Future and the Euro

An Economic or Political Question?

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Chairman's Introduction

The original intention of this study was to examine the implications of a number of time-related assumptions about UK membership, or non-membership, of the euro during the next 5 to 15 years. The main emphasis was to be an economic one. As work progressed, however, the study took on a broader dimension.

First, the context in which the study started has changed. The euro itself is no longer the main focus of debate. The Government has announced a referendum on the new European Constitution, which, on the evidence of UK voting in the recent European Parliamentary elections, could well develop in practice into a vote on UK membership of the EU itself. Second, as work on the study progressed, it became clearer that a much wider range of issues than the purely economic ones concerning Britain's role in relation both to the EU and the world of the future more generally were involved. In a sense, membership of the euro became a proxy for whether Britain really wishes to commit its future wholeheartedly to membership of the EU, or to remain a semi committed member on the sidelines.

The study is not intended as a lobbying document in relation either to the proposed Constitutional referendum or to a referendum on the euro if there is one. After seeking to describe the possible effects on future European and world developments of a number of key driving forces (technology, demography, globalisation etc), it summarises in four main scenarios how Britain might fare in such a world both as a member and non-member of the eurozone, and depending on whether the eurozone performs well or badly. As such we hope the study will help to inform the broader debate on Britain's future role in an uncertain and complex world, which is likely to be dominated increasingly by three main economic groupings – the USA, the EU and the rising economies of China, India and East Asia.

The report does not express a single opinion on the purely economic arguments for UK euro membership. It discusses the conduct of macro-economic policy in the EU, and possible ways of improving it, and sets out in a balanced way both the opportunities and risks facing the UK. In the short term much depends on whether the eurozone economy performs well or badly, which in turn will be affected by whether the UK is a member or not. Will the political will that, in the face of much scepticism, drove the introduction of the euro in January 1999 and its establishment in a remarkably short time as the world's second currency succeed in delivering better economic performance than the disappointing experience of the recent past? I personally believe that it will and that the prospect of success would be greater with UK membership, and that, in the world we foresee, it is in the UK's broader long-term interest to be within the eurozone rather than outside it. But the purpose of this report is to help the reader reach their own conclusions on this vital issue for the future of our country. The debate goes much wider and deeper than simple prediction of direct economic benefits or disbenefits in the short term.

It remains for me to thank the Federal Trust for initiating and supporting this study, and to express my warm thanks to the members of the study group for all the time they have given in participating in the discussions leading to the production of this report.

Sir Brian Unwin

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Executive Summary

This study examines four different scenarios, designed to throw into sharper focus the salient issues in Britain's evolving relationship with the euro and the eurozone. The scenarios illustrate what might be the consequences of the following hypotheses:

1. The UK joins a eurozone that is performing well;
2. The UK joins a eurozone that has failed to achieve sustainable growth and welfare;
3. The UK stays out of a eurozone that is performing well;
4. The UK stays out of a eurozone that has failed to achieve sustainable growth and welfare.

Our analysis begins by identifying the most significant driving forces which are likely to condition and frame the circumstances in which the UK will have to compete in the coming decade. Our underlying objective is to consider what difference, if any, membership, or non-membership of the euro in the four scenarios posited could make for the UK's position and role in the European Union (EU), in Europe as a whole and in the world.

The Pressures of Globalisation

The Group foresees two possible paths for the driving force of globalisation, the first the (more likely) continuation of present patterns, the second (less likely) the reversal of recent developments and greater economic isolationism, on a national or regional basis. In either of these cases, we believe that being a fully participating member of a regional trade bloc will help the individual members of that trade bloc. There is at least a prima facie case for applying that same logic to membership of a regional single currency.

Technological Advance and Innovation.

Technological advance and innovation, where the EU still lags well behind the US, are perhaps the most important driving forces directly affecting economic performance. However, it is not simply the scale or rate of technological advance which matters; it is also critically the commercial and social application of such advances within modern economies, and the availability of entrepreneurs to exploit them.

The question is whether UK membership of the eurozone would be a help or a hindrance in its continuing efforts to invent, innovate and apply the results of technological advance. British membership of the eurozone would deepen and broaden the European capital markets, which would assist innovation both in our partners' jurisdiction and in our own. But even outside the eurozone the UK's record on innovation bears comparison with any others in the EU.

Distinctive Social Preferences in Europe

We have identified European social preferences as a driving force, which will increasingly influence British decision about its relationship with the euro and the eurozone. Traditionally social preferences on the continent have differed from those in the UK, which in certain aspects resemble more the US liberal model where the emphasis on freedom of choice and entrepreneurship take priority over equality and public welfare.

Europe still has positive choices for the future, whether in emphasising public-private partnerships or light touch state intervention at the local level, which is sometimes described as the 'new regionalism'. The EU countries are nevertheless slowly moving closer to an efficient trade-off between social insurance and economic efficiency.

Changing Demography and Migration

Throughout human history changes in demography have been among the most significant driving forces in human affairs. Indeed, demographic factors seem to have become more influential as the poor outside Europe produce more children, the affluent live longer, national borders become more permeable and modern transport makes travel easier for many people.

The latest United Nations demographic forecasts suggest that by 2050 the population of the world will be well on the way towards reaching 9 billion. Within the global total it is expected that the European population is expected to experience an absolute decline of 10 per cent and develop an ageing profile which is likely to increase the dependency ratio. These demographic trends, if they materialise, can be presumed to require higher public expenditure on social services for the elderly, health services and pensions; essential public services may be left short-staffed and desperate to

recruit competent labour from any available quarter, including abroad. This raises important and politically sensitive issues of immigration policy.

These trends will probably serve to reduce the rate of economic growth not only through rising expenditure pressures upon national budgets, but also through effects upon corporate profitability, private savings behaviour, labour market developments, total factor productivity and the balance between taxation and borrowing at a macroeconomic level. EU member states are unlikely to agree in the foreseeable future a common policy to resolve these problems at European level, since social security remains predominantly a national responsibility. The UK, however, with a marginally younger population and lower dependency ratio than most other EU states is relatively better placed to deal with them.

Towards a More Democratic EU

A frequent criticism of the EU and its institutional governance is that it lacks democratic legitimacy and accountability. Following enlargement, there is now increased pressure on the EU to improve and streamline its governance, to make it more transparent, open and genuinely accountable. This pressure is particularly relevant for the UK in relation to the euro, since joining the euro would entail handing over the control of monetary policy to the ECB, an important further sharing of sovereignty.

The Impact of EU Enlargement

The accession of ten new member states has changed for ever the EU. Although the benefits for Europe's political stability arising from enlargement are undisputed, the economic case for enlargement is less straightforward. While the recently enlarged EU has gained 20 per cent in terms of population, the increase in overall GDP is only 5 per cent.

Enlargement will change the dynamics of EU decision making. Recently tense discussions on the Constitution are a worrying indication that the enlarged EU may find it much harder to reach consensual decisions in the future.

Future extension of the eurozone is closely connected to the British debate on the euro. Some of the new member states have already applied for the Exchange Rate Mechanism 2 (ERM2) membership and most of them have expressed their wish to join EMU as soon as possible. If successful in their ERM2 participation record and fulfilment of other convergence criteria, the 10 new EU member states might join the eurozone in 2007. This would leave the UK in a tiny minority outside the EMU, even if Denmark and Sweden do not join the euro.

The Euro and Macro-economic Management

Macro-economic management, taking into account also structural policies in the EU, and of course in the eurozone in particular will continue to be of profound importance for the development of the UK economy.

Opportunities for the UK

There will continue to be arguments about how far Britain is convergent with the euro zone. These should not be allowed to obscure the strong case for entry that the British Treasury, drawing on the work of outside economists, put forward in its report on the five economic tests in June 2003. The case can be broken down into effects on transactions costs, prices, competition, trade, foreign direct investment and economic growth.

Risks

It is widely recognised that were the UK to join the euro at a time when interest rates were not well aligned and/or the sterling exchange rate was not close to an equilibrium level against the euro, the costs of entry to the economy could be considerable.

In general, there is some reason to believe that broad economic developments may, at least initially, impact the UK differently from the rest of the euro zone. But the ECB, watching its Europe-wide indices, would find it difficult to cut interest rates to the extent required solely for the UK. In these circumstances, the resulting downturns in the UK could therefore be deeper and more prolonged within the euro area than they would have been outside it.

If and when Britain does join the eurozone, it will be for the government to ensure that it joins at as economically propitious a moment as possible.

Improving the Governance of the Eurozone

The recently agreed EU Constitution does not address the question how effective macro-economic policy co-ordination is to be achieved, and it is unlikely that this difficult issue could be the subject of far-reaching decisions in the near future. It will be difficult to override the national preferences of the larger member states about the size of the public sector and the

sustainable level of taxation. Rigid institutional arrangements, and majority voting, are most unlikely to work in this area, but an independent advisory group (analogous to an extent to the US Congressional Budget Office) might usefully inform the debate about both the size and the distribution of the deficit.

The impact of Financial Integration

There have been profound changes in European and global financial markets in the last decade, driven by globalisation, the impact of information technology and now the introduction of the euro which has transformed the continental capital market. A new regulatory framework is emerging in Europe through the Financial Services Action Plan.

The City is already a world-wide and not just a European financial centre. However, if the UK joined the euro, the City's role might be further enhanced. The benefits of a more integrated capital market could result in a somewhat lower cost of capital for UK business. At the heart of the business case for the euro is the greater predictability it would bring for long-term investment by eliminating the exchange rate risk with the eurozone economies.

Scenario Conclusions

The effects of the driving forces self evidently differ according to the degree of certainty that can be attached to them. It is therefore impossible to predict with certainty how Britain would perform under the four stylised scenarios presented. Nevertheless we regard it as a useful exercise to produce these stylised scenarios, which provide an indication of the most important factors which may determine possible outcomes in an increasingly complicated world.

I: UK joins the eurozone that is performing well

Possible implications for the eurozone

1. Deep and wide ranging reforms have been taking place in Europe, driven by reforms in financial and product markets, and in turn leading to pressure for reform in the labour markets. These reforms are picking up against the background of an upturn linked initially to the boost given by enlargement and ICT development. The result is that the tackling of structural problems in the labour markets has started to pay off with wages beginning to reflect productivity differentials, thus leading to rising employment levels.

2. Euro-pessimism proves to be overdone, both politically and economically. The European Constitution is adopted and improves decision-making in the enlarged EU and over time begins to generate greater public confidence in and identification with the EU's institutions. Further progress in reforming the Common Agricultural Policy provides a greater flexibility within the European budget. The 2004 enlargement has settled down well. As a result of these developments, towards the end of the first decade of the 21st century, output growth gets back to level pegging between Europe and the United States.

3. An EU-wide policy on immigration and asylum provides a framework of robust rules and procedures which prevents each member state from undermining the policy objectives and social imperatives of the others. The result is that net immigration makes a positive contribution to economic dynamism and so helps to counteract the otherwise deleterious effects of an ageing society.

4. Increasing aggregate investment in ICT technology combined with the liberalising of markets and encouragement of innovation and entrepreneurship, particularly among SMEs, has positive effects on the eurozone's productivity growth and through its secondary effects on employment rates. The European economy becomes increasingly adept at the reorganisation and reinvention of existing businesses.

5. The increasing international role of the euro makes it a real competitor with the dollar in the financing of world trade and in use as a reserve currency. A gradual diversification of investments into European assets makes the US economy increasingly vulnerable to a downturn, leading to higher interest rates and reduced scope for reductions in taxation and continuation of the previously high levels of personal consumption and public spending. While the EU does not aspire to rival the United States of America in the possession and use of military power, its global financial outreach substantially reinforces its ability to play a leading role in the deployment of 'soft' political power.

Possible implications for the UK

1. As a 'fully paid up' member of the eurozone, with nearly two thirds of its trade now with the EU, the UK benefits generally from the eurozone's improved performance. The UK's high ranking in competitiveness (globally and within the EU) enables it to make particular gains from the European single currency, which attain and even surpass the upper range of the Treasury estimates in 2003. The dynamic effects are

particularly important for SMEs, the main source of innovation and jobs, who have been deterred from entering the export market in the past by exchange rate costs.

2. UK price levels that have in general been higher than in the eurozone face downward pressure through enhanced competition in the eurozone. The already good record of the UK on inflation benefits as a result. Further monetary stability is injected into the British economy as a result of measures encouraging more British homeowners to follow the predominantly continental European pattern of long-term, fixed-rate mortgages. This reduces over time the traditional volatility of the British housing market and the vulnerability of mortgage borrowers to changes in short-term interest rates.

3. The positioning of the UK within the eurozone, coupled with its existing traditional advantages, enables the UK once again to attract a growing if not predominant share of Foreign Direct Investment, based primarily on a better long-term predictability of investment outcomes from participation in the single currency. This brings higher quality jobs, with better pay and higher output per person. Increased FDI doubly benefits the UK, both by enhancing its intra-European exports and by improving the country's fixed and human capital stock.

4. The UK is protected by its membership in the euro from the uncertainty to which sterling, as a relatively small independent currency, would have been exposed to by the increasing volatility of the dollar. This stability in turn promotes growth, employment and investment within the United Kingdom.

5. Within EMU, and now genuinely 'at the heart' of Europe, Britain's influence over the political and economic development of the euro and EU policies more generally has increased. In particular, it is better placed to promote a more balanced overall mix of fiscal and monetary policies by the ECB (where it now has a place on the Governing Council) and national governments, as well as a more vigorous pursuit of structural economic reforms in the EU.

II: UK joins the eurozone that has failed to achieve sustainable growth

Possible implications for the eurozone

1. Under this scenario, with continuing failure to make progress on governance and institutional reform, the eurozone has failed to implement the required structural reforms. Labour market rigidities remain, particularly in France and Germany, resulting in continued high unemployment. Little further progress has been made in changing the CAP, thus maintaining severe budgetary pressures and stultifying progress on the Doha Round; and no sensible agreement has been reached on reforming the Stability and Growth Pact or on the overall conduct of macro-economic management.

2. The 'Rhineland model', which propelled the German economy in 'catching up growth' with the USA in the post war years, is coming under increasing pressure. It was based on relatively cheap long-term finance which in turn permitted job security and high welfare benefits for their workers. That model has become dysfunctional as European growth becomes increasingly based on innovation that calls for new relationships between firms, their banks and their workers.

3. By contrast, despite the generally poor overall economic performance, the Nordic countries, the Netherlands, and Ireland have all been relatively successful in deregulating their labour and product markets to compete in the age of ICT technology and globalisation, but the disparate nature of the eurozone creates problems for the ECB in setting an interest rate and monetary policy that is appropriate for the whole of the eurozone. These tensions are reflected in further moves towards variable geometry, both in the economic and other spheres.

4. Germany and to a lesser extent France are subject to deflationary pressures as investment levels and the growth of consumer spending remain low, especially in comparison to the Asian and NAFTA economies.

5. Despite considerable achievements by some of the new member states, most of them continue to suffer from high unemployment and high levels of social exclusion. In the near stagnation climate in the two largest continental European countries, the free movement of people from the new to the old EU remains restricted, and in the absence of agreement on an overall immigration policy, the deficit of young and productive workers in an ageing and diminishing EU population is not made good by the necessary inflow of immigrant workers.

Possible implications for the UK

1. Differing growth rates within the eurozone create increasing policy dilemmas for the ECB in the setting of interest rates. These dilemmas are often resolved in a way that is not appropriate to the circumstances of the UK, sometimes causing deflation and constraining its potential for growth and

sometimes provoking inflation, in both cases posing difficult problems for the conduct of domestic UK fiscal policy.

2. If the UK has entered EMU at what subsequently turns out to be an inappropriate exchange rate the problems of euro membership are especially severe. Entering at an over-valued rate causes industrial production and GDP to fall below the levels that would otherwise have been expected. The option of cutting interest rates and thus seeking to reduce the exchange rate, with the aim of stimulating economic activity in the UK, is no longer available.

3. British gains from increased intra-European trade are limited by the low economic growth elsewhere in the eurozone. The relative competitiveness of the British economy within the unreformed eurozone to some extent offsets this limitation; even when growing slowly, the eurozone remains a large and prosperous market. The United Kingdom in any event benefits from the dynamic effects of a growing share of FDI into Europe.

4. Britain's political and economic leverage as the best-performing large economy in Europe is enhanced as a member of the euro. In particular, it is better placed to argue persuasively for liberalising reform to tackle the causes of stagnation in the rest of the eurozone. On the other hand, the poor performance of the eurozone, and the feeling that it is 'dragging Britain down', increases domestic political pressure to revise the decision to join the euro, however impractical this may now be.

III: UK stays out of the eurozone that is performing well

Possible implications for the Eurozone

[As in scenario one]

Possible implications for the UK

1. The UK looks to play the role of niche player and semi-detached participant in the European economy. Although not a full member of the trading and currency block provided by the euro, it seeks to derive benefit from the European single market to which it has access, while remaining a global player in the small but significant number of service and manufacturing areas where it enjoys a comparative advantage. Success in this endeavour depends not merely upon the UK's economic flexibility and resourcefulness, but also on the willingness of other members of the EU to allow a Britain outside the euro largely unrestricted access to the European single market. This cannot be taken for granted, and although the UK's formal position is protected by the Treaties, there is increasing resentment at what is seen as the UK's wish to be a free rider and have it both ways. This begins to affect co-operation with the UK in other areas.

2. In a world now dominated by three broadly comparable currencies (the dollar, the euro and the yen) sterling suffers fluctuations of a kind which tends to befall any commodity which is traded in a marginal market. British interest rates remain higher than those of the eurozone, not least because of the essentially short-term nature of its housing finance, linked to high levels of consumer borrowing.

3. Although the UK retains many of its traditional attractions for investors, it does not attain again the peak levels of FDI before 1999. Its access to FDI accordingly remains below average eurozone levels. This makes it more difficult for the UK to close the gap in terms of capital intensity with the other major players in the EU. Both Frankfurt and Paris improve their relative standing as financial centres, although the City retains its predominant position in Europe. The UK, however, has progressively less influence on the rules and regulations governing EU financial markets.

4. Staying outside the eurozone symbolically reinforces Britain's current position within the American political orbit. This reaffirmation of the 'special relationship' of itself makes the establishment of a 'core Europe,' with enhanced economic and security co-operation among its members (particularly the Franco-German relationship), more likely. Britain finds itself uncomfortably torn between this evolving 'core Europe' and the United States of America, the unilateralist instincts of which arouse increasing antipathy in the United Kingdom, whether the questions at issue are environmental, trade-related, jurisdictional or economic.

IV: Britain stays outside the eurozone that has failed to achieve sustainable growth

Possible implications for the Eurozone

[As in scenario two]

Possible implications for the UK

1. Because of the poor performance and mediocre economic prospects in the EU, there is little public pressure to join the euro and a general belief that Britain made the right decision by staying out. There is growing political and economic

estrangement from what is seen to be a failing political and economic project.

2. Because its rate of growth is superior to that of continental Europe as a whole, Britain attracts a disproportionately large share of FDI. However, it still does not reach the highest levels achieved in the 1990s.

3. Low growth in the EU creates pressures for the creation of 'Fortress Europe'. If this is combined with simultaneously increasing protectionism in the United States (which could possibly happen as the result of an American currency crisis), Britain needs to develop new markets outside its traditional economic partners.

4. Britain's capacity to develop these new markets is, however, highly dependent upon the political and economic situation of such markets as India, China, Japan, the rest of Asia and South America. Already within both Asia and South America, there are significant moves toward the establishment of regional economic and political blocs. It must at least be questionable whether the United Kingdom can establish favourable trading relationships with these new trading areas.

5. Remaining outside a failing eurozone, in which poor economic performance increasingly lends to friction among members states in policy areas, pushes the UK even more closely into the American political orbit.

I Introduction

This study will examine four different scenarios, which are designed to throw into sharper focus the salient issues in Britain's evolving relationship with the euro and the eurozone. The scenarios could be regarded as four different pictures of the future, which illustrate what might be the consequences of the following hypotheses:

1. The UK joins a eurozone that is performing well;
2. The UK joins a eurozone that has failed to achieve sustainable growth and welfare;
3. The UK stays out of a eurozone that is performing well;
4. The UK stays out of a eurozone that has failed to achieve sustainable growth and welfare.

Scenarios are essentially stylised, heuristic devices to help decision-makers and others to confront some of the difficult, but fascinating, 'what if?' questions and to explore the likely consequences of different courses of action.

Our method of approach is to begin by identifying the most significant driving forces which are likely to condition and frame the circumstances in which the UK will have to compete in the coming decade. We have identified eight driving forces, which we believe are the most significant factors affecting outcomes. While some of these driving forces are internally generated, such as distinctive European social preferences, macro-economic management and democratic aspirations, others such as globalisation, technology, innovation and financial integration are generated largely outside the European context. These are not the only driving forces which could be identified; they are not free standing and there are important connections and overlaps between them. Nevertheless, we believe that they provide an adequately robust backdrop to our scenario building exercise.

Our underlying objective is to consider what difference, if any, membership, or non-membership of the euro in the four scenarios posited could make for the UK's position and role in the European Union (EU), in Europe as a whole and in the world. The key question we have tried to address is whether UK membership of the euro is the best preparation for meeting the challenges that will emerge. In other words, if the adoption of the euro brings additional risk or rather offers new opportunities.

Of course, all predictions about Britain's possible role in Europe would need revision if the British public voted 'No' in a referendum on the recently agreed European Constitution. But all scenario building must take as its basis the present state of knowledge and plausible projections about the future. Our simple goal is to throw more light upon whether and in what circumstances Britain's membership of the eurozone would be in this country's interests and, indeed, in the interests of the rest of the EU. In doing so, we hope to contribute to the continuing public debate about one of the most important economic and political issues of our time.

II Driving Forces

The Pressures of Globalisation

We have started with this driving force because we believe it is perhaps the single most important factor for the years ahead. Globalisation has three prime components: technological, political and economic. They initiate a process by which the importance of geographic distance is reduced as a factor in the establishment and sustenance of economic, political and socio-cultural relations. As geography becomes less important, national borders become less relevant and national characteristics less distinctive than they were throughout much of the twentieth century. As Thomas Friedman has suggested, globalisation has replaced the binary divide of the Cold War with an international system of integration and interdependence.[1] The common ground on which many (though not all) states and individuals are now content to stand is essentially based upon a combination of free-market capitalism (with various forms of regulation designed to limit or redress market failures) and ever-advancing information and communication technology (ICT). The most natural assumption is that this process will continue and even accelerate over the foreseeable future. This assumption may, of course, be disproved by events. In our attempts to describe different worlds in which the UK will have to position itself, we shall not therefore lose sight of the possibility that the process of economic and political globalisation could be reversed. De-globalisation is not an impossible event, if political and economic shocks are strong enough.

On the assumption that global developments will continue and lead to a shrinking world of progressive interdependence, free trade, liberalised capital flows and increasing cross-border production and consumption, membership of a large and stable single market will surely be at a premium for the UK and its European neighbours. It is difficult to imagine that in anything other than the very long term the world will become a single trading bloc or one single market.

In terms of global economic power, the EU accounts for almost a fifth of world exports of goods and almost one quarter of world exports of services. It is the world's leading source of foreign direct investment and the second largest destination for foreign investment (after the US). International trade accounted for over 14 per cent of its GDP in 2000, more than for the US (12 per cent) or Japan (11 per cent).[2] Following enlargement, intra-EU25 trade is expected to account for two thirds of the total trade of the EU25, accompanied by substantial simultaneous growth in extra-EU trade.[3]

The UK is the world's sixth largest exporter of goods with a 4.3 per cent share of world trade and the third largest exporter of services with a 5.2 per cent share of world exports in services (both including intra-EU trade).[4] It has a 13 per cent share in the total of extra-EU exports in goods and an encouraging 19 per cent share in services. Nevertheless, between 2001 and 2002, the UK faced a 60 per cent decline in investment inflows,[5] although these inflows are forecast to grow again in 2004 and 2005. Given lower capital intensity in the UK than in other EU member states, Britain is particularly dependent upon high levels of foreign direct investment (FDI).[6]

In order to remove problems of exchange rate volatility that could endanger the functioning of its single market, the EU opted in the early 1990s to establish in time for the new century a single currency bloc. From the external perspective, the main benefits of such a currency bloc are three, namely reduced exposure to external economic shocks, lower transaction costs in the single market and the establishment of a stronger position in global financial and capital markets.

The euro has already become a major new factor in the progress of globalisation. The eurozone economy is second only to that of the US in terms of its economic strength. The present euro area has a population of 305 million, which is slightly larger than the 270 million of the US, and a GDP of 5,773 billion euros (7,592 billion euros for the US). The euro area is a more open economy than the US. EU trade defined as the sum of exports and imports of goods and services, amounts to 33 per cent of GDP, while in the US the corresponding figure is approximately 24 per cent. From the very beginning, the euro established itself as the second most important currency in the world[7] as a medium of exchange (a 'vehicle' currency) as well as a currency of denomination (unit of account). The successful introduction of the euro is considered by many analysts to have enabled the eurozone in the late 1990s to withstand with comparative ease a series of global financial shocks, which could have destabilised some of the previous national currencies if they had not adopted the euro. For example, Spain was able to ride out currency crises originating in South America, where Spanish banks were heavily exposed.

It remains an open question whether the euro will be able eventually to challenge the US dollar as an international

currency. For this to happen, the eurozone would need to lower transaction costs yet further and place more emphasis on growth in its monetary policy.[8] The ECB would need in particular to take into greater account its second objective of 'economic and social progress, a high level of employment and balanced and sustainable development,' as laid down in Article 2 of its Protocol.[9] But as once the US dollar displaced the pound, the international currency of the 19th century, so there is no intrinsic reason why the euro should not become at least a serious international rival to the US dollar, the international pre-eminence of which is built on distinctly rickety foundations. US private and public debt accumulation has put the stability of the US currency at risk.[10] The East Asian countries which have accumulated massive dollar denominated reserves, thereby financing the growing US deficits, have already begun to diversify their foreign exchange reserves into euros. The enormous and growing US current account deficit and low level of national savings might well lead at some point in the relatively near future to an international financial crisis. This in its turn could lead not only to the euro partly replacing the dollar's dominant international role, but also to an increase in US protectionism and a consequent slow-down of global economic activity. The existing level of global economic integration would make it very difficult for individual countries to isolate themselves from the consequences of such a reversal.

Pressures of globalisation have affected the realm of foreign and security policy as much as, if not more than, the realm of international economics. For the best part of the 20th century since it entered the First World War in 1917, the United States has played a leading, if sometimes intermittent, role in foreign and security matters across the globe. Superior in technology and the capacity to deploy military force, the US has been the superpower of proactive diplomacy and a pre-emptive military approach.[11] Conversely, there has been a clear gap between the high economic and the relatively limited political role which the EU's member states have been able to secure for themselves in international relations, a gap all the more striking in view of the EU's position as the world's leading donor of development aid. Since the Maastricht Treaty of 1992, the EU has been seeking to strengthen its foreign, security and defence policies. The European Constitution, with its proposal to establish a 'European Foreign Minister,' is the most recent expression of this hitherto only partly realised aspiration.

Security issues are no longer limited simply to military capacity and defence. They include also the negative aspects of globalisation[12], such as money laundering, the impact of environmental degradation on security, trafficking in human beings, international organised crime, the proliferation of weapons of mass destruction, failed states and above all the recent wave of terrorism preceding and following the invasion of Iraq. In all these areas a nation state is no longer sufficient unto itself. Administrative resources and above all information need to be pooled and shared.

A key issue for the EU as a whole, and the UK in particular, is the relationship with the US. Although in terms of trade and investment the transatlantic relationship remains of the utmost importance for the US and the EU, the former has adopted a varied spectrum of approaches to the EU (and the UK). It has for example shown unilateralism in its pre-emptive policy towards Iraq and its policy on environmental issues relating to the Kyoto agreement. It has also appeared to pursue a 'divide and rule' attitude towards the EU, reflected in Rumsfeld's well-publicised distinction between 'old' and 'new' Europeans. In the context of Iraq and the ever-present threat of terrorism, the US has seemed to wish to use the UK as a bridge to the EU but also as a Trojan Horse. The decision of the UK to participate as the main partner in the US's invasion of Iraq clearly caused a major political rift within the EU and was a serious setback in the UK's relationship with France and Germany. In the area of monetary policy, the generally cool US attitude to the euro shows that the US has started to perceive it as at least a potential rival to the US dollar. There is also major uncertainty, in the short to medium term, associated with the possible reactions by the oil producing countries to US unilateralist policies.

Globalisation is not just a market driven process, but has been underpinned by a predominant US neo-liberal ideology, with its emphasis on mass-production and consumption. Exporting values, ideas and principles is as important in this context as exporting goods and services. Although the pressures of globalisation seem likely to operate for many years to come, the largely North American values and assumptions of globalisation could either wax or wane, depending upon the development of the American economy and the willingness or ability of decision makers and opinion formers in other countries to challenge what a number of them see as little more than American economic and cultural hegemony. Some European intellectuals have argued that globalisation creates an imperative for European and other nations to resist the American model of globalisation, expressed particularly through the dissemination of American popular culture in its broadest sense. The long-standing drive

for economic and political integration in Europe has become in many ways a rational response to the threat or 'challenge' from the United States. In a world where the projection of 'soft power' – i.e. cultural, social and psychological forces which attract millions of people around the world, and especially the young, into adopting American life-styles, American attitudes and the American language – is often more effective than the use of military might or technological supremacy, it has seemed logical to many in the governing and opinion-forming circles of Europe (and indeed other parts of the world) to want to deepen their integration with like-minded counterparts as a bastion against invasion by the least attentive manifestations of American globalisation.

The Group foresees two possible paths for the driving force of globalisation, the first the (likely) continuation of present patterns, the second (less likely) the reversal of recent developments and greater economic isolationism, on a national or regional basis. In either of these cases, we believe that being a fully participating member of a regional trade bloc will help the individual members of that trade bloc. There is at least a prima facie case for applying that same logic to membership of a regional single currency.

Technological Advance and Innovation

Technological advance and innovation are perhaps the most important driving forces directly affecting economic performance in the modern world and we have already observed in the previous section their vital role in the process of globalisation. However, it is not simply the scale or rate of technological advance which matters; it is also critically the commercial and social application of such advances within modern economies. On this criterion the United States (and often Japan) has tended to do better than Europe for many years and seems likely to outperform Britain and her European partners for the near future.

Since 1995 the growth of US productivity has accelerated while that of the EU has slowed, reversing the relationship of the previous 25 years when the European economy grew at more than 2 per cent a year while the USA advanced at only 1.4 per cent a year. The US surge since the mid-1990s has been largely attributable to its strength in computer hardware, software and the commercial application of both. On the other hand, if we look at the 'communications' element of ICT, the EU countries have outperformed the United States, especially in relation to the use of mobile phones following the adoption of a common GSM standard. This success has been reflected in the performance of Nokia and Ericsson, although in the most recent times even these two star European performers have experienced setbacks.

In its reports on this subject the OECD has distinguished between two different effects of the application of ICT to economic growth. Firstly, investment in ICT adds to a nation's capital stock. For example, between 1995 and 2001 the USA and Holland did well by this measure and significantly better than the UK, Germany, France or Italy. Secondly, the commercial application of ICT throughout the value chain of businesses large and small can have the effect of reorganising or even reinventing business practices in ways that facilitate change and innovation. This helps companies to develop new products and services or maintain a competitive edge with existing products and services.

Sixty years ago Joseph Schumpeter argued that economic performance could be portrayed in long cycles (evoking so-called 'Kondratiev waves') each of which was triggered by periodic surges in scientific and technological innovation. The present long cycle based upon ICT in which the advanced economies are said to find themselves began in the early 1970s with the arrival of microchips. The first half of the cycle was characterised by fierce competition between the relevant companies, resulting in the emergence of commercial winners such as Intel and Microsoft by the late 1980s. The second half of the cycle has been characterised by the wider commercial application of the technology across the economy, culminating in the dot.com investment boom and bust at the turn of the century. By contrast, the earlier long cycle based upon mass production manufacturing of big ticket consumer goods benefited the Western European economies once the best examples of those manufacturing technologies had been spread to this side of the Atlantic partly from US based multi-nationals seeking to enlarge their global markets by locating in Western Europe.

The question for the nations of the enlarged EU is whether they can now, thirty years later, engineer another positive step change in technological innovation and, crucially, its application to both business and consumer markets. The Lisbon strategy has called for greater corporate spending on research and development by companies large and small alike, especially within geographically concentrated clusters of related businesses. The intention is to create economies of scale through better co-ordination of the various national efforts in the field. On the other hand, at the political level the French, German and British Governments rejected in 2003 a proposal by the Italian Presidency of the EU for a programme of further substantial infrastructure spending on both transport and

telecommunications. These governments were reluctant to envisage any significant increase in current agreed levels of EU spending, levels which will come under even greater pressure in the wake of enlargement. Far-sighted companies will no doubt continue to invest heavily in technological innovation and in the human capital which goes with it. National governments, on the other hand, are always likely to have many other competing claims upon the financial resources available to them.

Usage of IT and the role of physical infrastructure

Europe has failed to achieve accelerated productivity growth in those sectors that are intensive users of IT. 80 per cent of the entire difference in productivity growth rates between Europe and the US has been due to slow growth in retailing and wholesale at around 1 per cent annually in Europe and 6 per cent in the US. The 6 per cent share of the IT-producing sector in EU GDP has been only slightly smaller than that of the US (7.3 per cent). A number of European countries exceed the US in this respect with over 10 per cent (Ireland, Finland). Despite achieving relatively fast growth in IT production, European use of IT in the services sector has remained relatively low.[13] Additional factors favouring US success in retail and wholesale services are the easy availability of land and highly developed infrastructure. US retail productivity has been largely achieved in new stores built since 1990. Big new stores on greenfield sites achieve huge productivity improvements from the use of IT, by exploiting the advantages of large site operations, bar code systems that cut inventory levels and back-of-store unloading. Adair Turner[14] has argued that this has not happened in Europe because large out-of-town new entry is inapplicable in the dense urban environment. Planning restrictions reflect consumer preferences for preserved countryside and the type of urban communities found in more densely populated Western European countries.

At this point in the discussion it is important to note that technological advance on its own cannot guarantee economic and social progress. That depends upon the purpose and quality of the innovation and the availability of entrepreneurs and venture capital to exploit it. A crucial question, therefore, for the member states of the EU is whether they can establish an entrepreneurial culture which is conducive to the application of new technology throughout all sectors of the economy, and will encourage young people of high quality and innovative skills to remain or settle in the EU. Venture capital at the outset and continuing access to capital at a later stage are both necessary conditions for success. However, the attraction and retention of talented, mobile people is probably even more vital and in this respect (despite some success, notably in mobile telephones), much of the EU lags well behind the technological and innovation 'hot spots' in the United States.

Lisbon Agenda

On 23 and 24 March 2000, the European Council held a special meeting in Lisbon to agree a new strategic goal for the EU 'to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion'.[15] The agreed measures could, according to the Commission, increase the EU's underlying annual growth rate by up to 0.75 per cent over the following decade. Such goals are based on an overall strategy aimed at:

1. Transition to a knowledge-based economy and society by better policies for the information society and R&D, as well as by stepping up the process of structural reform for competitiveness and innovation and by completing the internal market.
2. Modernising the European social model, investing in people and combating social exclusion.
3. Sustaining the healthy economic outlook and favourable growth prospects by applying an appropriate macro-economic policy mix.

Every March, the European Council at its Spring Summit reviews progress on achieving the Lisbon goals, on the basis of a report submitted by the European Commission. In 2004, the Spring Council concluded that four years later the picture is a mixed one.[16] Investment in human and physical capital needs to be increased to complement structural reform and realise the EU's growth potential. Completion of the internal market, better regulation and stronger business investment in R&D must be achieved to enhance competitiveness and productivity. Implementation of the employment strategy has not been satisfactory in all member states. More progress towards more and better jobs must be made over the coming year.

The Centre for European Reform published its fourth edition of the Lisbon Scorecard[17] just before the 2004 Spring Summit, marking progress by the member states over the last year as 'mediocre'. The report nevertheless showed that some EU countries have already met or even exceeded the Lisbon goals. Denmark, Sweden and Finland outperform the US on many indicators of innovation, entrepreneurship and employment, even while keeping their traditional high levels of social security. Britain, Ireland, Spain and the Netherlands perform well on many measures, with France, Germany and Italy as reform laggards. Italy has an especially poor record on innovation and entrepreneurship as well as low employment levels.

The question to be posed now, therefore, is whether, if the UK were to join the eurozone, it would be a help or a hindrance in its continuing efforts to invent, innovate and apply the results of technological advance. British membership of the eurozone would deepen and broaden the European capital markets, which would assist innovation both in our partners' jurisdiction and in our own. But it should be recalled that with the UK outside the eurozone, as it is now, the British

record on innovation – notably in sectors such as pharmaceuticals, bio-technology and high performance cars – bears comparison with any others in the EU. It will be primarily for individual national governments to implement (or not) the Lisbon 2000 agenda. The British government's desire and capacity to implement that agenda in its domestic legislation will not be greatly affected by its participation or not in the euro. On the other hand, the UK outside the euro might find itself less able to influence its European partners to follow the same path.

Distinctive Social Preferences in Europe

European integration has been a collectively shared preference of European citizens that emerged from the painful historic experiences of the two World Wars. It has been based on the ideas of reconciliation, democracy and mutual respect. According to its founding father, Jean Monnet, the purpose was not to create coalitions among states but to unite human beings. The principal driver of this process of unification was the development of a free market economy, which created a network of interconnections between individuals across Europe and presented opportunities to learn from each other. This process has profoundly transformed previously existing attitudes, social preferences and models in different parts of Europe. This is relevant for our subject, because social preferences on the continent have differed over time from those in the UK, which in certain aspects resemble more the US liberal model than the different variations of the European social democratic state. We have identified European social preferences as a driving force which does and will increasingly influence the British decision about its relationship with the euro and the eurozone.

Distinctive social preferences tend to condition the economic and political decisions made by the member states and tend to set the EU generally apart from many opinion formers and policy makers in the UK and virtually all in the United States. But even on the continent there are significant differences between social models. For example between the social democratic countries in Scandinavia and the more traditional and corporatist model in central Europe. Choices of different distributional systems have profound impact on levels and pattern of productivity and economic growth. However, not only social systems, but also the prevailing working culture in a society, changing value systems of knowledge-based societies and geopolitical positioning, together with availability of infrastructure, have influenced European economic performance.

Firstly, the corporatist continental model, also called the 'Rhineland' model of capitalism existing in Germany, France, Benelux, Austria and to some degree in Italy, combines market dynamics with hierarchical interferences in the name of collective interest. In some countries this collective interest is mainly represented by the state, as in France, and in others, like Germany, it is primarily organised in professional associations or regional organisations reflecting the federal structure of the state. It posits a mixed economy model, which is fairly evenly balanced between the public and private sectors. This is reflected in the fact that the core countries at the heart of the EU are prepared to allocate 40 per cent and more of national income to public goods of some sort, financed mainly by taxation, with the state retaining a significant role as provider as well as regulator of most core social services, such as health, education and pensions. A similar phenomenon can be observed in social democratic Scandinavian countries, although their welfare model follows a different logic. While the corporatist model is based on old hierarchical structures of status, which affect the financing of social security or pensions unequally, social democratic countries focus more on the equality of citizens and use the state as the guarantor of free choice and equal opportunity. As a consequence, they provide not only high social benefits but also have a high share of employment in public services financed by even higher tax levels than in the Rhineland model. This contrasts with the liberal models of the UK, Ireland or the USA, where the emphasis on freedom of choice and entrepreneurship has taken priority over equality of outcome, and the economic role of the democratic state has been shrunk.

Secondly, due to their emphasis on social responsibility, both the conservative Rhineland and the Scandinavian social-democratic models put considerable weight upon the value of stakeholder capitalism in which company management sees itself as responsible to a variety of different interests ranging from shareholders to individual employees and from local communities to national trade unions. In Germany, this is called Social Market Economy; and great value has been attached in the past to Works Councils and the principle of *Mitbestimmung* (co-decision), which have contributed to running the economy in a consensual rather than a confrontational spirit with impressive results for productivity. However, since German unification the model has come under significant pressure as the equality of living conditions and nominal pay across Germany did not reflect the low levels of efficiency and productivity in East Germany. This led to a steep rise in unemployment and huge transfers from the

productive part of the economy to the East.[18] However, in other countries, like Austria or the Netherlands, the social market economy is still producing good results, while the more confrontational industrial relations in France are a major handicap in that country.

Thirdly, most continental Europeans believe that there should be an adequate social dimension to the running of a liberal market economy – an idea which strongly appealed to and was put into practice by Jacques Delors when he was President of the European Commission (1985-95). Effectively, this idea has since found expression in significant extensions of workers' social rights at the European level, which are steadily being codified into EU law under the general rubric of the Social Charter. The hope is that by creating a level playing field, negative externalities can be avoided and the overall performance of the economy improved. This social psychology runs deep in continental European political thought and has affinities, for example, with the related ideals of *Gemeinschaft*, *Solidarnosz* and *Fraternité*, all of which have influenced European social history.

The contemporary manifestations of these well-established social and political preferences are mixed and seem to produce unequal results. In general it seems that the liberal and the social democratic models have both fared well, while the conservative/corporatist model is in crisis. The hierarchical model has difficulties in integrating women into the economy, and in dealing with the challenge of an ageing society and financing comprehensive health protection. There is a pronounced leisure preference reflected in some of the most generous paid holiday and other employee arrangements. The main difficulty seems to be unwillingness to give up privileges linked to status and custom. In this context the universality of some form of proportional representation throughout the continental EU is both part of the political response to potentially dangerous heterogeneity and part of the political problem, since it can give rise to relative political immobility when new policy departures are needed.

The UK has largely adopted the US system, but with variations. It developed its own version of the liberal welfare state, the so-called 'Beveridge' welfare regime with universal benefits and services, setting general standards of care to which everybody is entitled. However, the UK welfare regime has led to rationing of services (bottleneck effects) in combination with a lesser availability of choices for benefits provided by the market, as in the US-style minimal welfare state.[19] Although the UK has avoided rigid policies that cause 'welfare without work', it has experienced a phenomenon of large numbers of 'working poor' at the low end of the labour market. As a consequence, the UK has in the past years been following the US example of 'in-work benefits' (employment subsidies for low-wage workers).[20]

Contemporary classifications of EU systems see Mediterranean countries as a separate category, different from either the Rhineland or the Scandinavian model. The late transition from fascist dictatorial regimes has ossified some conservative and hierarchical structures in certain Mediterranean countries, although they are now changing rapidly. The structures are largely based on the supportive welfare role of the family and owe much of their economic success of the past two decades to the 'cohorts of superwomen'. These have combined their non-paid household activities with their increasing paid professional activities, a phenomenon that manifests itself in all social groups and classes. The role played by 'superwomen' within households has been very important in the catching up aspirations of Mediterranean countries and their convergence with the rest of the EU countries.[21] It is too early to say towards which model the new member states in central and eastern Europe will converge.

In terms of the macro-economic effects of these distinctive social preferences there seems to be a major shift in the relative economic performance of the Rhineland model on the one hand and the Anglo-American and social democratic Scandinavian economy on the other. Unemployment and public deficits are high in the first, but low in the two others. At the EU level the figures seem to suggest that the Europe of 15 or 25 member states will continue to grow in terms of GDP per hour worked as fast as the United States, but because Europeans generally choose to work fewer hours than their US counterparts, the actual growth of the European economy, with a static if not ageing population, will not match that of the younger and more dynamic US economy. GDP per hour worked increased much faster in Europe than in the US between 1970 and 2000. In 2000 it achieved 91 per cent of the US level, with some countries such as France even exceeding the US. Nonetheless, the gap between the US and the EU in relative income per capita is expected to remain if Europeans continue to choose working fewer hours than their American counterparts.[22]

Social cohesion after welfare transfers may be stronger on the continent, and it is uncertain whether this will be a handicap or an advantage for growth over the long run. The latest European Commission review of the Lisbon 2000 strategy suggested that there was no necessary incompatibility

between those member states with strong and expensive welfare states and good performance in terms of technological innovation and its entrepreneurial application, since Sweden, Finland and Denmark all scored highly in the latter respects. Even France, with the shortest working week in the EU – and maybe because of it – has maintained relatively high levels of labour productivity and capital intensity in its economy.

Europe still has positive choices for the future, whether in emphasising public-private partnerships or in promoting light touch state intervention at the local level, which is sometimes described as the 'new regionalism'. The difficulties are likely to be found in relative market rigidities, for example, in the German approach to insurance or the French attitude to public utilities or the Italian way of dealing with pension costs. EU countries are nevertheless slowly moving closer to an efficient trade-off between social insurance and economic efficiency, but they are converging to a more efficient European model rather than the US model.[23] Mutual learning is an important source for improving and reforming the habits. Although it seems likely that the NAFTA member states and, indeed, the Asian Giants, such as China and India, will grow faster than Europe for the foreseeable future, but with relatively low level of welfare protection, the European economies will have to respond to their own environments, economically, intellectually and politically. The strategic question for Britain, as so often before, is to which wagon we need to hitch our caravan, or whether we can enjoy the best of these various models without any definitive choice between them.

Changing Demography and Migration

Throughout human history, changes in demography, both in the aggregate and in the balance between the generations, as well as the compounding effects of human migration – whether voluntary or forced – have been among the most significant driving forces in human affairs. The contemporary world is no exception. Indeed, demographic factors seem to have become more influential as the poor outside Europe produce more children, the affluent live longer, national borders become more permeable and modern transport makes travel easier for many people.

The latest United Nations demographic forecasts suggest that by 2050 the population of the world will be well on the way towards reaching 9 billion – roughly a four-fold increase on where it stood at the beginning of the twentieth century. Within the global total it is expected that the population of Africa will grow by 150 per cent, Asia by 50 per cent and North America by 42 per cent, whereas the European population is expected to fall by 10 per cent.[24] As well as experiencing an atypical absolute decline, the population of Europe will develop an ageing profile which is likely to reduce the proportion of people who are gainfully employed and increase the proportion of people who are dependent upon their savings or the financial support of younger age groups. Within the EU of fifteen, the UK is forecast in the shorter term (by 2010) to have a proportion of people over 60 which remains at its current level of 24 per cent, whereas the equivalent figure for the EU as a whole is projected to rise to 27 per cent and assumed to continue rising thereafter. These demographic trends, if they materialise, can be presumed to require higher public expenditure on social services for the elderly, health services and pensions – unless of course there is a significant shift to private provision within a relatively refined timescale or a widespread social acceptance of growing poverty in old age. Such trends may also leave these essential public services short-staffed and desperate to recruit competent labour from any available quarter, including abroad.

The effects of immigration upon the ageing population in the EU and on the dependency ratio (defined as the number of people either too young or too old to be in the labour market who have to be supported by those who are in it) have been examined in a recent report by the EU Commission.[25] It suggests that net immigration (within politically tolerable limits) cannot be expected to make up for low fertility rates in the EU, where the current average birth rate is 1.4 children per female compared with the needed replacement rate of 2.1 children per female. In the view of the experts, a significant growth in EU population could only be achieved by an increase in fertility rates from 1.4 to 1.8 children per female, combined with a net immigration into the EU of at least 1.2 million a year, compared with the actual figure of 680,000 in the year 2000.

Contrary to much of its rhetoric, the UK Government has in practice adopted a more liberal position than most other member states in the EU 15 on the movement of labour from the ten new accession states, since it has only required some limited restrictions on social benefits for new arrivals and has not insisted upon a long transition period before the normal EU rights of free movement apply. However, our immigration rules for nationals from non-EU countries remain strict, and work permits are only issued for certain skills and professions in short supply in this country. The interaction between international migration and the labour market is crucial to all these policy considerations. By and large, the fewer vacancies

offered by employers to those seeking work, the more the Government feels obliged to heed the opposition of parts of the media and public opinion to any apparently open-door policy on immigration. On the other hand, with Britain's existing position of about 500,000 unfilled job vacancies currently notified and emerging difficulties for many employers in the public and private sectors seeking suitably qualified and motivated labour, the rational and political case for letting in larger numbers of migrant workers is considerably strengthened, and is supported by the CBI.

The UK has a relatively high participation rate in the labour market for both men and women and many of those in work tend to work longer hours per week for lower wages than their counterparts on the continent. In the year 2000 the UK figures showed that 78 per cent of men and 65 per cent of women were in paid work, compared with 73 per cent and 54 per cent respectively in the EU as a whole. Equally, national unemployment rates have tended to be lower in the UK, at 4.7 per cent currently, compared with a euro area average of 8 per cent – a well established position which derives from our more flexible labour market and a lighter burden of requirements upon potential employers. One important consequence of this is that, with a higher proportion of female and older workers in our labour force than on the continent, we are likely to find it somewhat easier to meet the financial and social needs of an ageing population.

There is now widespread recognition that future pension costs in the EU will put increasing strain upon national budgets and upon the generality of taxpayers in all member states, except the Netherlands and the UK. (This is not a reason for the latter group to be complacent. Their preferred solution of funded private pension schemes has the effect of shifting a good deal of the financial burden on to companies and individuals.) A working group of the Economic Policy Committee in Brussels has estimated that these pension problems derived from Europe's ageing population will increase national public expenditure over the coming decades in most member states by the equivalent of between 3 per cent and 7 per cent of GDP, with expenditure on pensions rising by between 3 per cent and 5 per cent of GDP. By contrast, the figures for the UK were projected to be an increase of only 0.6 per cent of GDP for public expenditure overall, made up of lower public spending on pensions and education (because of relatively fewer dependants) matched by small increases in spending on health and long-term care.[26]

Europe's shrinking and ageing population will probably serve to reduce the rate of economic growth (below what it would otherwise have been) not only through rising expenditure pressures upon national budgets, but also through effects upon corporate profitability, private savings behaviour, labour market developments, total factor productivity and the balance between taxation and borrowing at a macro-economic level. The EU Commission has put forward various ambitious plans to tackle some of these problems, ranging from limitations upon early retirement schemes to the gradual harmonisation of national pension policies. There have been calls for a credible and comprehensive European policy to deal with the consequences of an ageing population and particularly its effects upon public revenues and the labour market. However, there is little likelihood that EU member states will be able or even willing to agree in the foreseeable future upon such a policy or the means to finance it at European level, since social security remains predominantly a national responsibility under the principle of subsidiarity. The EU Budget is in any case over-stretched by commitments in other sectors of policy.

We have already pointed out the inescapable connections between demographic change of this order and mass immigration. In the case of continental Europe for the coming years, the likely formula will probably involve a mix of pro-natalist policies (as already in France and Italy) coupled with judicious use of immigrant labour to fill the jobs and to pay the taxes not paid by the indigenous (and ageing) population. The social problems potentially posed by such a dual approach will hinge as much upon the likely origins (North African and Middle Eastern) of most of the immigrants coming into the EU as upon the extent of the sometimes xenophobic attitudes of the already established populations. It may in particular be difficult for mainly poor Islamic immigrants to integrate into the host societies. In fact, this whole debate raises fundamental issues of political and philosophical importance about the changing nature of identity, citizenship and nationhood which we cannot further explore in any detail in the context of a publication on Britain and the eurozone.

Difficult as it may be to establish clear connections between these particular driving forces in British and European politics and the question of Britain's optimal approach towards joining (or not joining) the eurozone, we need to offer some summary of what current developments in this whole policy area are likely to mean for our scenarios.

Firstly, on the basis of present demographic trends and forecasts, net immigration into the UK and the rest of the EU

(preferably of talented and energetic people) could well make a positive contribution to economic dynamism and so help to counteract the otherwise deleterious effects of an ageing society.

Secondly, the UK seems to be relatively better placed on many key criteria to cope with these intersecting problems than most of the other member states in the EU 15. This is because we have a marginally younger population than they do, which stems largely from our multi-cultural society in which fertility rates are somewhat higher and the ageing tendency is somewhat weaker, thus contributing to a slightly less alarming dependency ratio and hence sounder economic prospects. Nevertheless, reforms of the pension system that were necessary to ensure its financial sustainability have also greatly increased the risk of a large proportion of the British population living one day in relative poverty.

Thirdly, if the European political class collectively comes to the conclusion that these matters cannot be managed successfully along current lines, then alternative policies are likely to include pro-natalist measures to encourage larger family formation in Europe and greatly increased economic support for the Islamic societies of North Africa and the Middle East. This enhanced economic support would be directed towards improving economic conditions in North Africa and the Middle East, thus making Europe a relatively less attractive goal for emigration.

Towards a More Democratic EU

A frequent criticism of the EU and its institutional governance is that it lacks democratic legitimacy and accountability. This criticism is particularly often heard in the UK, but it was manifested elsewhere in the generally low turn-out, particularly in the new member states, in the recent European Parliamentary elections. There is a strong undercurrent of scepticism about the EU among European electors generally, giving rise to such phenomena as the United Kingdom Independence Party which won 16 per cent of the vote in the recent election. Especially in the light of enlargement, there is now increased pressure on the EU to improve and streamline its governance, to make it more transparent, open and genuinely accountable. This pressure is particularly relevant for the UK in relation to the euro, since joining the euro would entail handing over the control of monetary policy to the ECB, an important further sharing of sovereignty.

The problems with which we are faced are to be found somewhere between identity, democracy, accountability, citizenship and legitimacy. Firstly, there is the issue of what really constitutes a European identity and how it combines with or cuts across the other identities which are meaningful to the various peoples of a very diverse EU. The question is complicated by the fact that most people have multiple identities which to them may seem equally valid or which may be ranked according to personal preference. One may feel that he is a Glaswegian, a Scot, a European and a British citizen in that order. Another may see herself first as a Parisian, then a global citizen, and only then as a French citizen.

Secondly, there is the issue of democracy in Europe or, more precisely, whether the institutions of the EU are sufficiently democratic to satisfy modern expectations and to bridge what has been described ever since the 1970s as a 'democratic deficit' in the EU.

Thirdly, there is the issue of accountability, which has been present in the political and public debate especially in the UK, Denmark and Sweden, for many years past. The degree to which different electors care about this issue seems to depend upon the particular political culture in which they have been reared.

Fourthly, there is the related broader issue of democratic legitimacy, which is, in a sense, the most fundamental aspect of the entire debate about how to construct and defend a more democratic political Union in Europe.

There is a widespread perception that the governance of the EU is less democratic and legitimate than that of the member states. In 2004 the Ministerial Council of the EU still meets in secret, accountability to national parliaments is mainly retrospective and often perfunctory; and the Commission is perceived as an undemocratic and a centralised 'head office' usually expressed simply as 'Brussels', despite being subjected to performance assessment by national governments after every five-year mandate.

On the other hand, the nomination of the President of the Commission and its Commissioners is in the hands of the democratically elected national governments, and the Commission as a collective body need to be approved by the European Parliament (EP) in a so-called 'Investiture Procedure'. Moreover, the Commission's legislative initiatives only become European law if they meet with the approval of the Council, which comprises ministers of each of the member states who are accountable to their national Parliaments, and of the EP. The Commission is also under ongoing scrutiny by the EP that reviews its annual working programme and confirms foreseen budgetary expenditures for implementation of Commission's policies and programmes.

As a delegated, technical executive body, the Commission certainly needs to increase the transparency, proportionality and legal certainty of its procedures. It could do more in the systematic development of open communication at all stages where the views of affected actors should be actively sought and valued.

Another delegated supranational body, the ECB, has been trying to increase transparency by monthly reports, regular press conferences and hearings of interested societal and business groups. Relevant to the ECB and its role and function is the fact that monetary authorities are as a rule deliberately vested with power from elected governments with the mandate to act independently, free from political influence, but at the same time accountable to the government, legislature and the people through their performance. The granting of such a form of independence to the Bank of England in 1997 was regarded as a great step forward in economic governance and one of the principal achievements of the present British government. In principle the ECB is to a limited extent politically accountable to the EP and the Council of Economic and Finance Ministers (Ecofin). This means that its expertise and output efficiency are regularly evaluated. The ECB President is required to defend the ECB policy in the EP plenary annually, and more often in the Economic and Monetary Affairs Committee (EMAC). However, no real sanctions exist in this procedure. Ecofin may present the ECB with recommendations, but has no real power of influencing its decisions.

The legitimacy of the EU cannot be judged only by a direct comparison of its institutions with those of national constitutional democracies. The EU is a mixture of different modes of governance, from intergovernmental to supranational or multilevel governance. Therefore sources of legitimacy are various and through their interaction result in a matrix of direct and indirect forms of legitimacy.[27] This indirect legitimacy rests on authorisation by the member states and is embodied in the Council of the EU and contrasts with the direct legitimacy of the member states' governments elected as a result of the ballot box. The Council, by contrast, is composed of ministerial representatives of governments with their legitimacy based on the votes of their own citizens, and the general elections through which their electorates hold their governments accountable. Parliamentary legitimacy at the EU level is based on the EU-wide elections to the EP, with its members at least in principle accountable to the EU citizens, as MEPs seek to take into account their voters' preferences. Co-decision[28] between the EP and the Council is becoming the principal legislative procedure of the EU. In its turn, the Commission increasingly implements European legislation in conjunction with the member states. All of these forms of legitimacy overlap and interact. It is therefore not only the legitimacy of the institutions, but also the patterns of their involvement in policy making and legislative procedures, that can eventually ensure democratic accountability.

However, the competencies and powers of the EU institutions still lack endorsement by European society as a whole. Common public perception does not seem to take account of the points raised in the previous paragraph. The acceptance by British society of national institutions such as the Bank of England has not yet been achieved for the European institutions. It was partly at least for this reason that the principle of subsidiarity was enshrined in Article 3b of the 1992 Maastricht Treaty. The principle of subsidiarity posits that European powers should be exercised in a proportional way at the most appropriate level of governance for the task in hand. The powers can be exercised at the supranational level only if there is no better or more efficient way for them to be exerted at the national or sub-national levels of government.

In the multilevel governance of the EU there is not one simple solution to the question of legitimacy and political accountability. The Constitution, though a modest step forward in adapting the government of the EU more effectively to the needs of a community of 25, has not entirely resolved the problem. The proposals for the greater involvement of the EP in choosing the President of the European Commission will be, if fully implemented, a step in the right direction. But until there is an established European party system active at the European level, political groups in the EP will remain to a greater or lesser extent attached to and creatures of their national parties. More transparency and openness, together with moves towards common European awareness, are necessary before citizens will be able to accept majority decisions as the standard way of making decisions in a Union of 25 plus.

The Impact of EU Enlargement

The collapse of communism and ultimate demise of the former Soviet Union led in the early 1990s to a process of EU enlargement, initially by the accession of Austria, Finland and Sweden and most recently in May 2004 of a further ten new member states (with the prospect of further new members later this decade).- This enlargement has changed for ever the EU and its likely future course. Since 1990 the UK has been at the heart of this process as a keen supporter of broadening the Union.

Although the benefits for Europe's political stability arising from enlargement are undisputed, the economic case for enlargement is less straightforward. While the recently enlarged EU has gained 20 per cent in terms of population, the increase in overall GDP is only 5 per cent. The average unemployment rate in the new EU has also experienced an upward shift.[29] The legislative adoption of the acquis communautaire will not, in itself, guarantee growth and prosperity.

Even so, the recent enlargement of the EU has further increased the single market for intra-EU trade in goods and services and for further capital movements in search of new investment opportunities. Although investment opportunities arising from privatisation have largely been exhausted, existing investors are looking for further openings through expansion and modernisation. First-time investors continue to consider that the new member states offer a cheaper and more flexible workforce than many countries in 'old Europe'. Smaller companies, which may have been reluctant to invest before the accession actually took place, may now look again at the opportunities available. In addition, the new member states will also offer doors to other new markets further east and south where they have the advantage of local knowledge. Especially in the field of trade, the enlarged EU must ensure that it is trade creating for the countries outside the EU as well.[30]

European Constitution: Improvements regarding legitimacy of EU

Increased Transparency: Council will met in public when acting as legislator (Article I.49.2)

Increased accessibility of the European Treaties (by consolidation of Treaties, simplification of Union acts and legislative procedures, Title V)

Legitimacy through efficiency (extension of QMV, creation of a European Foreign Minister (Article I.27) and a long-term Chairman of the European Council (Article I.21), streamlining of Council formations and rotations (Article I.23))

Incorporation of the Charter of Fundamental Rights (Part II)

Democracy:

- Enhanced role of national parliaments in scrutiny of governments when acting at EU level
- Parliaments' right to monitor application of subsidiarity (Protocol on Subsidiarity)
- Strengthening of the European Parliament
- EP will vote on the European Council's proposal for Commission President (Article 26.1)
- Greater weight to population in EU decision making through the introduction of a double majority system (Article 24)
- Introduction of the citizens' initiative (Article I. 46.4)
- Future revision of Treaties through the Convention method

In capital markets and financial services, the new member states have potential as future customers of diversified retail banking and insurance products, especially loans and pensions. Whilst their equity markets have been outperforming their EU neighbours, generally they remain shallow and illiquid. Their governments will have to adapt to debt management on a larger scale and their companies will have to look for other sources of financing than bank loans and self finance, this representing a move away from the dominant German/ Austrian structures. Whilst in most cases the Stock Exchanges in new member states are too small to survive independently,[31] they are understood to be currently discussing various mergers.

Underdeveloped structures in financial services and capital markets have offered new business opportunities for counterparts in the 'old' EU members in the past years, as indicated by the level of foreign ownership of banks, albeit with only a small British participation. The majority of this ownership represents investment from existing EU banks keen to seize the opportunity of the single financial market encompassing the banking, insurance, pensions and securities sectors. In the new member states the average size of the banking sector as measured by assets/GDP is around 80 per cent whilst stock market capitalisation ranges from 7.7 per cent to 34 per cent of GDP with an average of 16 per cent. This latter figure compares to the EU 15 average of 58.5 per cent according to 2002 data.[32]

Because of previous state/'social' ownership and because of hurried privatisation, carried through without proper regulatory structures in place, corporate governance in most of the EU new member states is weak. The initial post-communist approach was that all regulation must be set out in detail in legislation, an approach which sometimes has allowed the exploitation of minority shareholders.[33] In some countries, notably the Czech Republic, this unsatisfactory regulatory environment led to a flight of international investment which, in turn, brought about the devaluation of the currency. This precipitated the reform of the regulation of the financial markets and the creation of an independent financial market regulator. Similar experiences occurred elsewhere to a greater or lesser extent. The judiciary and regulators in several of the new member states have come to recognise the value of the UK focus on voluntary codes and disclosure on a 'comply and explain basis' and this was endorsed on an EU basis in the EU Action Plan and Communiqué of 2003 following the recommendations of the Winter Report. Thus all new member states have now either adopted, or are in the process of so doing, a corporate

governance code based on the 1999 OECD Principles and are amending the listing rules of their domestic stock exchanges to require compliance of issuers on the main markets as described above. It is anticipated that this will considerably improve the transparency of issuers. There is, however, a considerable amount of further work to be done to extend the code to issuers not listed on the main market.

Despite their generally impressive economic achievements, most of the new member states still suffer from high unemployment, high levels of social exclusion, ageing population and in some cases increasing crime figures. Further investment in social and economic policies is needed to prevent social disruption and mass migration from rural areas of inefficient semi-subsistence farms to urban centres. The new member states therefore need more public investment, which might lead to difficulties in their underlying fiscal positions. Apart from potential worries about sustainability of economic growth after accession, there are further concerns arising from enlargement, including the cost of EU structural and agricultural funding, the efficiency of decision-making procedures in the EU and the prospect of widespread migration of cheaper labour, both skilled and unskilled.

The newly enlarged EU will have a population of 450 million, second only to China and India. The current European rules have ensured that shopping for welfare benefits is impossible within EU territory, but new member states, which themselves also have declining and ageing populations, may well find themselves confronted with outward migration of their educated younger population. Fears of a brain drain from the new accession countries are well founded. Neither the existing member states nor the accession countries can be satisfied with the arrangements in place for the gradual extension of free movement of labour throughout the EU.

Aggregate price levels in new member states, lower than in the EU15, are slowly converging and fears of competition from low prices in the new member states seem exaggerated. Most of their low priced products are locally distributed and based on input of local cheap labour (e.g. hairdressing or bakeries). The enlargement may even deliver downward pressure on the prices of some tradable goods and services in the new member states as a result of more efficient economic structures.

Enlargement will also change the dynamics of EU decision-making with the larger number of member states rendering procedures more complex. The problems experienced in reaching agreement on the first-ever Constitution for the EU are a worrying indication that the enlarged EU may find it much harder to reach consensual decisions in the future. Existing differences on economic, political and institutional questions have apparently been exacerbated by ten additional member states, as different among themselves as are the present 15 members. Anyone with experience of the often prolonged and tedious decision making procedures of the Council of 15 member states, together with the Commission and other Council participants, will realise how difficult it will be to reach consensual decisions in a Council of 25 or more.

Future extension of the eurozone is closely connected to the British debate on the euro. Some of the new member states have already applied for the Exchange Rate Mechanism 2 (ERM2) membership and most of them have expressed their wish to join EMU as soon as possible. Given higher growth rates and need for intensive public investment, their monetary and fiscal policy preferences might well turn to be different from those of existing eurozone members. If successful in their ERM2 participation record and fulfilment of other convergence criteria, the 10 new EU member states might join the eurozone in 2007, raising its membership up to 22. This would leave the UK in a tiny minority outside EMU, even if Denmark and Sweden do not join the euro.

Finally, there is another enlargement scheduled for 2007 with Bulgaria and Romania (and possibly Croatia). More applicants are waiting to start accession negotiations, including Turkey, with a population of some 80 million, and Western Balkan countries. They are nations with turbulent pasts of ethnic and religious conflicts and human rights abuses, which rightly, perceive the EU as a guarantee for political stability and economic prosperity. Some of the present EU member states may be inclined however to see in these potential new members increasing budgetary costs and threats to their own political stability and cultural unity rather than new trade and investment opportunities.

The Euro and Macroeconomic Management

This chapter considers: (i) the current relationship between the UK and the eurozone, and the present set of arrangements for managing the zone; (ii) the ways in which the performance of the UK economy could be affected were the UK to join the eurozone – both positive and negative; and (iii) ways in which the economic governance of the eurozone might be improved, thus affecting the balance of the economic arguments relating to UK entry.

(i) The UK and the eurozone at present

Macro-economic management in the eurozone, which accounts for 77 per cent of EU GDP, taking into account also structural policies in the EU, and of course, will continue to be of profound importance for the development of the UK economy. Although extra-EU exports of goods and services account for a higher proportion of UK GDP than of other member states, UK exports to the rest of the EU have continued to rise as a proportion of GDP, and the UK has not escaped an adverse impact from the recent sluggish performance of the major eurozone economies.

The UK economy has been growing more quickly than the economies of most of the other major EU countries for at least a decade. While per capita income had stagnated at below 70 per cent of the eurozone average during the 1970 and 80s, it has been catching up since 1992, largely because of higher employment rates. Productivity grew less in the UK than in the eurozone during the 60s and 70s, and remained stagnant at a level below 60 per cent of the average in the 1980s and early 1990s. Only in the late 1990s, especially with the more stable macro-economic policy mix after the Bank of England became independent, did productivity and per capita income catch up with the rest of eurozone.

This partly reflects the rapid growth of domestic consumption, private and public, while consumers in Germany, France and Italy have remained cautious, and the resulting savings have not fed through into productive investment. There is however no room for complacency about the UK performance: UK GDP per head is still below the European average and UK output per hour remains some 20 per cent lower than in Germany, France and Italy, compensated for by longer working hours and a much higher labour force participation rate. Moreover, the UK share of EU inward investment has fallen over this period, and the UK external deficit is continuing to increase.

For the eurozone the single monetary policy is in the hands of the European Central Bank (ECB) which targets a rate of inflation not exceeding 2 per cent, with macro-economic policies in the hands of governments and co-ordinated by the Council and the Commission. Fiscal policy is in principle governed by the rules of the Stability and Growth Pact (SGP), which puts a ceiling of 3 per cent of GDP on the public sector deficit that any country may run without being exposed to financial sanctions proposed by the Commission and approved by the Council.

Technically, in terms of achieving its principal statutory objective, the ECB's operations have been successful: inflation has been below the ceiling; the ECB did not resist the initial fall in the euro exchange rate against the dollar, thereby helping to support economic activity through the trade balance; and the integration of financial markets has proceeded, with an explosion of corporate bond issues. The impact of monetary policy as set by the ECB of course spreads beyond the eurozone, and its effect is the greater the more closely a country's currency is tied to the euro. In the case of Denmark, which has kept its exchange rate steady against the euro despite having rejected its adoption, its monetary policy is effectively determined by the ECB. If the ECB is exposed to criticism, it is the lack of greater transparency in its decision-making, and its very cautious stance in any wider discussion about the mix of fiscal and monetary policy.

Without sustainable convergence of the UK economy with the eurozone, any hazard to the UK coming from adopting the euro could be compounded by the ECB's inflation objective. On past performance, UK business cycles have

Economic Policy Co-ordination in the EU

EMU displays a novel and sui generis economic policy framework with a single monetary policy in the sole competence of an independent central bank, whilst other economic policies (budgetary and structural policy and wage determination) remain in the hands of national actors.

'Economic policy co-ordination' is used as an umbrella term, encompassing the entire spectrum of interaction between monetary authority, national fiscal authorities and the European Commission. The key objective for policy co-ordination is to take account of spillover effects of national policies due to the strong interdependence of European economies. In the eurozone the average inflation rate and exchange rate have become common goods and national policy action thus affects these variables. Similar considerations apply to fiscal balances in the eurozone, where it has been plausibly argued that the eurozone's overall budgetary position must be close to balance or in surplus to maintain the euro's stability.

While budgetary and structural policies related to the European internal market are to some extent co-ordinated at the European level, interaction between the ECB as monetary authority, national governments and the Commission remains weak. The annual economic policy co-ordination process is conducted under the umbrella of Broad Economic Policy Guidelines (BEPGs) that provide general guidance and streamlining of several more specialised procedures like the SGP, the Luxembourg process of employment guidelines, the Cardiff process on economic reform of product and capital markets and the Cologne macroeconomic dialogue to promote responsible wage developments.

European Commission, Euro Papers, Number 45.

not always followed the typical pattern of the eurozone's members. Certain structural differences of the British economy are also potential risk factors for the achievement of convergence.[34] These considerations are further explored in the next section.

(ii) Opportunities for the UK

There will continue to be arguments about how far Britain is convergent with the eurozone, particularly in terms of interest rates, and whether there is enough wage and price flexibility. These should not be allowed to obscure the strong case for entry that the British Treasury, drawing on the work of outside economists, put forward in its report on the five economic tests in June 2003, particularly as regards trade, investment and growth. The case can be broken down into effects on transaction costs, prices, competition, trade, foreign direct investment and economic growth.

There will be savings in the transaction costs of trade because it will be unnecessary to buy euros with sterling, or to hedge against a change in the exchange rate between the two. For a large country such as the UK, these have been estimated at up to 0.1-0.2 per cent of GDP, or £1-2 billion, and are a once-for-all saving. Such costs are negligible for large companies, but often put small companies off entering foreign trade altogether. The capitalised value of this stream of savings is probably not hugely greater than the estimated changeover cost required to produce them, although it must be recalled that large companies in particular anyway regularly update their IT systems.

However, the dynamic effects of removing transactions costs will be greater than the direct savings. They are the outcome of exchange rate stability – or rather absence of exchange rates – over the whole eurozone. The result is potentially to lower costs and prices of exports to the eurozone to domestic levels, thus making them cheaper and increasing demand for them. This advantage, however, will be fully realised only when banks reduce the cost of euro money transfers across borders to what it is within borders, as the EU Commission has demanded.

This is not to deny that prices are already converging across the euro area for reasons which run wider than the simple abolition of transactions costs. But the transparency gained by expressing prices across eurozone national markets in the same currency puts downward pressure on high prices, even if some low prices are rounded up. The convergence of prices is occurring first in easily transportable big-ticket standard items such as cars. The UK price level is higher than the eurozone average, so there will be downwards pressure of the kind that is already taking place for many manufactured goods exported from China. Differences in indirect tax rates and divergent consumer tastes may hold up this process, but cannot prevent it happening. The huge differences in excise tax between the UK and France will be under still greater pressure to narrow once both countries are using the euro, as those differences are already being eroded by cross-Channel shopping.

UK entry into the euro should make the economy even more inflation-proof than it already is. The price of manufactured goods and internationally traded services may even fall for a time, offsetting the rise in the prices of domestically based services, which seems likely to continue. The net result should be as close to zero inflation as one can get, while avoiding the danger of outright deflation.

Price convergence will go hand in hand with stronger competition. Where a handful of big companies dominate a sector – such as retailing in the UK – foreign entrants will establish themselves in the UK market, just as Tesco is entering some EU national markets. A competitor which dominates the UK market will have a relatively small share of the wider euro market, but will still be able to expand and lower costs and prices thanks to the economies of scale. Not only does one market require one money, but one money is needed to make the market one. Greater competition will advantage some companies and disadvantage others, but all consumers will benefit from lower prices and a wider range of goods and services. It is true that in the UK, which has less cross-border shopping than for instance France and Germany, imports are purchased mainly by businesses, which find it easier to understand prices expressed in different currencies. But even for businesses, under pressure from consumers with increasing access to comparative prices through the Internet, price convergence can only be encouraged by the single European currency.

Transactions costs and national currency prices are a non-tariff barrier to trade. Their removal will stimulate trade across borders within the eurozone, without diverting it away from countries outside the area. There has already been an increase in trade within the eurozone of up to 20 per cent since 1999, when the euro came into being, while the UK's trade with the area has stagnated. While the evidence for an increase in trade due to fixed exchange rates is ambiguous, the effect of a common currency is much stronger and more clear-cut. UK trade – exports plus imports – with the eurozone

is now about 28 per cent of GDP, half of total external trade. The Treasury estimates that joining the euro would increase this by between 5 and 50 per cent, with a higher probability for the higher figure. So the result of joining the euro might be to increase trade with the eurozone by a headline figure of up to 14 per cent of GDP.

This would not all be an increase in GDP, because some of it would replace domestic production. About one-third to two-thirds of each percentage point increase in trade as a proportion of GDP would come through as additional GDP. If the higher figure is again taken, euro membership might raise UK GDP by about 9 per cent. The Treasury uses the assumption that it would take 30 years for the full effects to materialise. The addition to the UK's annual growth rate would then be 0.3 per cent, a significant addition to the present long-run growth rate of about 2.5 per cent. The increase would be all the more welcome because the projected rise of 0.5 per cent a year in the population of working age is expected to come to an end after 2010 as a result of the demographics of the ageing society.

It is noticeable that the EU countries with the highest standards of living are all small, with high percentages of external trade to GDP; Luxembourg, Ireland, Denmark, Netherlands, Austria, Belgium and Finland. The UK has done relatively well to rise to eighth place, just ahead of France, Germany and Italy. All these large countries could use the euro to stimulate a new phase of economic growth. The mechanism by which this happens is foreign direct investment (FDI). The advantage attracting foreign companies to the eurozone is that of exchange rate stability, which they use to even greater advantage than domestic companies, because they are seeking a base of expansion to the whole eurozone. As long as it was thought that the UK was about to join the euro, FDI flowed in, responding also to other attractions, such as cheap labour and the English language. In 1998, the UK got 28 per cent of FDI flows into the EU, but by 2002 this had fallen to 6 per cent, as against 10 per cent for Germany and 13 per cent for France. US and Japanese multinationals are now switching their attention from Britain to other EU countries.

There is controversy about the directness of the link between the recent decline in FDI and Britain's failure to adopt the new currency. There are counter-arguments against those who would see the one as directly following from the other. One counter-argument is the huge inflow of foreign investment into Britain all through the late 1980s and 1990s, when the UK's flexible exchange rate was clearly not a major factor in investors' minds, although they may have assumed that Britain would eventually join the euro. Another is that the lion's share of FDI into Britain (about two-thirds) is American. American firms have many motives for wishing to locate in Britain, not least a more familiar business culture, in the context of which exchange rate considerations may not be decisive. Moreover, the drop in FDI since 2000 was not surprising in the context of the American downturn, and may go into reverse as American business starts to invest again.

But to the extent that FDI is linked to euro membership, it certainly constitutes an argument for entry. Foreign companies export a higher proportion of their output than domestic companies. FDI also increases economic growth because foreign companies have higher productivity than British ones. It may help to remedy the under-capitalisation of British industry, and improve productivity and pay per employee by bringing in newer and more modern capital equipment. It may not bring more jobs, which are relatively numerous in the UK, but it would be likely to bring higher quality jobs, with better pay and higher output per person. Britain's closest neighbour, the Republic of Ireland, has conspicuously benefited from a long period of high foreign investment. For Ireland, FDI provided the linkage between increased trade and accelerating economic growth.

The case for joining the euro applies to a large part of the UK economy, covering not only traded, but tradable goods and services. Ironically, the only one of the Treasury's five tests that was passed in 2003 was that which demanded that the City's financial services should benefit, even though the City's view is that it will continue to do well in or out of the euro. The City is already a worldwide and not just a European financial centre. On the other hand, if the UK does join the euro, the City's role might be further reinforced at the expense of continental financial centres. There may be more opportunity for the City to carry competition into the retail financial markets of the eurozone, which have been relatively closed, but are due to open up under the EU Financial Services Action Plan. The benefits of a more integrated capital market could result in a somewhat lower cost of capital for UK business. The Treasury recognised the benefit of lower costs of finance in its analysis and a number of studies have suggested that more efficient European capital markets could add as much as 0.1 per cent to British GDP each year for a number of years.

Inside the euro, the City would have the advantage of using its own domestic currency as a base for its worldwide operations, thus reducing foreign exchange exposure risk. The addition of sterling would significantly increase the euro's share

of international financial markets vis-à-vis the dollar. Euro bonds and notes outstanding overtook those denominated in US dollars at the end of 2003. The impact of the pound's entry would be to increase the euro's share of bonds and notes from 44 to 51 per cent, compared with the dollar's 40 per cent. The effect on international bank loans would be to boost the euro's share from 39 to 45 per cent, just ahead of the dollar's share of 43 per cent. The London equity market's valuation is half that of the whole eurozone, so the wider euro equity market would jump from 16 to 24 per cent of the world total, forming half rather than only a third of the dollar's 50 per cent share. The UK would surely benefit from being part of a world currency at last rivalling the dollar. The implications of such a role are political as well as economic.

(iii) Risks

The Chancellor's statement on euro entry in June 2003 suggested that the benefits were as listed above, 'subject to convergence'. It is widely recognised that were the UK to join the euro at a time when interest rates were not well aligned and/or the sterling exchange rate was not close to an equilibrium level against the euro, the costs of entry to the economy could be considerable. For example, modelling by Oxford Economic Forecasting has suggested that entering at an exchange rate which was 10 per cent overvalued would cause GDP to fall around 4 per cent, and industrial production about 5 per cent, below the levels which would otherwise have been expected – falls which would be deeper and longer lasting than those associated with a high pound at present, because the opportunity to counter the impact of an over-strong exchange rate by cutting UK interest rates would no longer be available.

In general, there is some reason to believe that broad economic developments may, at least initially, impact the UK differently from the rest of the eurozone. Renewed recession in the US, a rise in the euro against the dollar, further global falls in equity prices, or a purely domestic development such as a downturn in the housing market and consumer borrowing – any of these could hit the UK harder than the eurozone generally. But the ECB, watching its Europe-wide indices, would find it difficult to cut interest rates to the extent required solely for the UK. Britain's representative on the Governing Council of the ECB could not always guarantee an ideal interest rate regime for British economic conditions. In these circumstances, the resulting downturns in the UK could therefore be deeper and more prolonged within the eurozone than they would have been outside it.

If a country diverges from the 'euro-norm' in a downward direction, recovery may take a number of years. When interest rates and the exchange rate are fixed, the only monetary technique left for a country to restore competitiveness and growth once it has fallen into recession is for inflation to be contained below the rate prevailing in the rest of the zone. This requires a period of very slow growth. As an adjustment mechanism, it is a slow-working and painful process.

There is at least a possibility that the UK could find itself exposed to this danger. For instance, an inappropriately high euro interest rate associated with a possible housing market crash after Britain joined the system would achieve that result, and we would be left with an economy in recession for as long as it took deflation to do its work. The specific benefits of euro membership which have been identified should therefore be weighed against the potential costs which would arise if the UK found itself burdened with inappropriate interest rates and a fixed exchange rate, and without the ability to influence either. In such a conceivable (but of course not inevitable) case, the losses involved could amount to several percentage points of GDP over a period of years.

There is a further Treasury argument against entry at present. Leaving aside shocks of the type discussed, the UK's stability could be damaged in the eurozone in the absence of reform of our system of housing finance. The stock of variable rate debt is substantially higher in the UK than in the eurozone countries. As a result, as the ECB raises and lowers euro interest rates in pursuit of its euro-inflation target in the normal way over the cycle, the impact of those interest rate changes can be expected to have a much greater impact on the UK than on other members of the zone. Interest rates varied to stabilise the eurozone as a whole could be de-stabilising for the UK.

The Treasury has argued that it is critical to reform housing finance and produce a major switch to fixed rate mortgages in order to avoid the destabilisation of the economy which may be associated with changes in the common euro interest rate. One possibility which has been canvassed would be to establish a European Mortgage Financing Agency and a secondary market in mortgage securities along the lines of the systems in the US, Canada, Hong Kong and several other countries. This would also make an important contribution to the further integration of European mortgage financial markets and reduce the vulnerability of mortgage borrowers to interest rate changes.

Another way to achieve this would be for the Treasury to offer tax relief on fixed rate mortgages. It must, however,

be recalled that not all analysts share the Treasury's fears regarding the housing market. The UK housing market is unlikely to be in the same overheated condition as it is now – or in a slump – if and when Britain joins the euro.

In short, if the above concerns are justified there is a possibility that the UK would experience a relatively less stable economic environment inside the eurozone than outside it. As Britain integrated itself more firmly within the eurozone, this problem would certainly diminish, particularly if Britain had been able to ensure that it entered the single currency at the appropriate exchange rate. It is not the view of the Working Group that Britain should never join the euro. Britain has a long record of joining late and on sub-optimal terms those European projects which it first rejected and later saw no option but to enter. It must, nevertheless, be accepted that there are significant risks in addition to the likely benefits arising from British membership of the single currency. If and when Britain does join the eurozone, it will be for the government to ensure that it joins at as economically propitious a moment as possible.

Are there institutional changes which could change the balance of benefits and costs in regard to British entry into the euro? In terms of this analysis, progress would be helpful on two main fronts. It would clearly be advantageous for the UK to retain the capacity to mitigate economic shocks of the type discussed, and compensate for the impact on the economy of the common euro interest rate to the extent that it is inappropriate for the UK. One response to this problem, as the Treasury has argued, would be to reform the current Stability and Growth Pact (SGP) to allow member states to pursue effective counter-cyclical fiscal policies. For example, new rules might relate allowable fiscal deficits to the size of a country's 'output gap'. It would then be possible for countries to exceed the present 3 per cent of GDP limits on deficits without waiting for negative GDP growth figures, as under the present Pact. The possibilities for reform are discussed in the section below.

(iv) Improving the Governance of the eurozone

The original objective of the existing SGP, strongly insisted on by the then CDU-led German Government, was to remove any risk that the burden of financing deficits run by profligate governments elsewhere in the EU would fall on the German economy. It is ironic that the country which insisted most strongly on the Pact should have been the first to refuse to be bound by its terms. It was, however, recognised at an early stage in the introduction of the euro that the SGP, together with the overall monetary policy of the ECB, would not be sufficient in themselves to deliver growth as well as stability. Thus the Lisbon summit in the spring of 2000 agreed on an ambitious structural reform programme – applicable to all 15 EU countries – with the objective of closing the productivity gap with the USA. This involved making labour markets more flexible, entrepreneurs spending more on research and development, and completing the Single Market. The Commission estimated that completion of this programme could add 0.75 per cent to the EU's annual economic growth rate.

Only slow progress has been made in implementing the Lisbon programme: labour market liberalisation has been very limited, more needs to be done to reduce the burden of pensions and social charges, and the EU has continued to fall behind the USA, a trend which is forecast to continue in 2004 despite some improvement in EU growth prospects. The Broad Economic Policy Guidelines (BEPG) applicable to all 15 countries (proposed by the Commission for approval by Ecofin) have not so far constituted a sufficient and effective method of macro-economic policy co-ordination. Such co-ordination requires, in place of a universally applicable maximum deficit, separate consideration – in the light of the ECB's monetary stance – of the fiscal stance and mix of structural policies appropriate for each EU economy, taking into account such factors as its cyclical position and the relative returns on new investment, public and private.

Constitution and Economic Governance

Although the Constitution did not adopt any substantive changes in the field of economic governance, the following significant changes have been introduced:

- A separate protocol on the euro group that calls for regular meetings of the group, but stresses its informal character.
- The group shall elect a president for two and a half years by majority of its members.
- The elevation of the ECB to the status of institution (rather than financial body).
- Setting a specific link between co-ordination of economic and employment policies.

The recently agreed EU Constitution does not address the question how effective macro-economic policy co-ordination is to be achieved, and it is unlikely that this difficult issue could be the subject of far-reaching decisions in the near future. As the experience of the SGP showed, it will be difficult to override the national preferences of the larger member

states about the size of the public sector and the sustainable level of taxation. Some collective consideration will be needed of the appropriate fiscal stance for the eurozone as a whole – or, indeed, for the whole EU of twenty-five – and some degree of common understanding will need to be reached as to how the overall sustainable deficit should be shared out among members of the group. Rigid institutional arrangements, and majority voting, are most unlikely to work in this area, but an independent advisory group (analogous to an extent to the US Congressional Budget Office) might usefully inform the debate about both the size and the distribution of the deficit. Provision could be made for consultation with both the European and national Parliaments before decisions were taken in a forum (perhaps an adapted Ecofin) in which the ECB would need to be a full participant.

Given the general recognition of the weakness of the SGP, there is now little risk that it could be used to impose an inappropriate and unsustainable fiscal stance on any EU member. But, in light of the above discussion of the opportunities and risks associated with euro membership, the UK will need to continue its efforts to promote a better overall mix of fiscal and monetary policies across the EU as a whole, and a more vigorous pursuit of structural economic reforms. Since the non-members of the eurozone are subject to the economic climate within the zone to almost the same extent as the current twelve countries, discussions should involve all twenty-five members. (However, in practice there must be a risk that effective macro-economic policy co-ordination will take place exclusively among the twelve, or even within a subset of major players.) Ideas for reforming the SGP, which could improve the balance of the economic arguments in favour of UK entry by reducing the possibility that an inappropriate macro-economic policy may be imposed on the country, are set out in the following box.

The euro is one of a number of driving forces which are likely to have an impact on the UK's growth rate and on its position in the world. Others include globalisation, technological progress, demography, and social preferences. Each of these forces could have an impact of the same order of magnitude as the euro for the UK and for Europe as a whole. The size and even the direction of the impact could vary considerably from one country to another. The UK differs from other major European countries, but not by more than they differ from each other. British efforts to reform the euro may have a better chance from inside than from outside. That will be a judgement for the next Chancellor of the Exchequer after the 2005 general election.

Re-thinking of the SGP

Since its creation, the SGP has been widely criticised for being too rigid and suffering from pro-cyclical bias, for making only a limited contribution to medium and long-term growth and for lack of flexibility. It has also failed to enforce its rules, not least because other budgetary sinners have been included in the voting procedure against a country in breach of the rules. On the other hand, it has delivered benefits to the EU economy by maintaining interest rates at low levels, even for high debt countries, and by encouraging, if only indirectly, the adoption of major reforms in labour markets and in pension systems in several eurozone countries.

Possible solutions to replace the SGP in its current form:

1. National fiscal policies as part of soft policy co-ordination in the form of the BEPGs rather than hard sanctions, including criteria of good finance rule (similar to the UK's golden rule) and other voluntary performance standards.

2. Achieving horizontal flexibility of an overall balanced fiscal stance in the eurozone with the Commission as a technical body recommending allocations of permitted overdrafts to the member states according to the strength of their economies and their position within their economic cycle. The final decision would be adopted by the Council with the allocation function of public finance remaining in the hands of national governments.

3. Establishment of a new independent technical authority, a Fiscal Committee or Fiscal Sustainability Council, supported by a monitoring role of the European Commission or national fiscal policy committees. When allocating permissible deficits, the Fiscal Committee would also take into account a country's public debt levels and quality of public spending.

4. Countries would be allowed to trade rights to deficit creation after the aggregate policy stance and initial distribution of permits corresponding to GDP shares had been agreed. The European Commission or a Fiscal Committee would define the total ceiling of tradable deficit rights and the EP vote would set the legal volume of deficit permits to each member state.

The Impact of Financial Integration

The UK, in the City of London, has the most sophisticated financial centre in Europe but a generally lower level of capital intensity than its major competitors in the EU. In 1999, capital per hour worked in Germany was nearly 50 per cent higher and in France it was over 75 per cent higher. UK productivity has been held back by bad management and labour productivity and a legacy of long-term under-investment caused in the past by macro-economic instability that has discouraged UK firms from investing for the long term. The City has been criticised in particular for adopting short-term criteria when assessing prospects of companies.

There have been profound changes in European and global financial markets in the last decade, driven by globalisation, the impact of information technology and now the introduction of the euro. The impact of information

technology has reduced the cost of trading, encouraging financial product innovation and precipitating the demise of the Glass Steagall Act in the US. This has allowed consolidation of the market and precipitated the creation of large financial conglomerates both in the US elsewhere. The removal of exchange rate risk in the eurozone has given a huge impetus to European financial markets to move further down the road of integration, leading to a reshaping of European securities markets and stock exchanges.

These changes are posing considerable challenges for European financial regulators, who are responding both by adopting the single financial market regulatory structure and the risk based regulatory approach favoured by the UK. It has been accepted that the obstacles to integration arising from differences in the various jurisdictions of the EU must be removed. Moreover, European regulation needs to keep up with the rapid rate of technological change, while ensuring proper investor protection and stability throughout the financial system.

The European Commission's response towards improving the single market in financial services was the Financial Services Action Plan (FSAP) endorsed by the Lisbon Council in March 2000, which set a deadline for the first phase to be completed in 2005. There has been considerable progress, but it is a complicated and immensely detailed process. The hope is that the agreement between the Commission and the EP to unlock the fast-track procedures proposed in the Lamfalussy Report will ensure that the 2005 deadline is met. In any event, the process has placed due emphasis on the consultative approach of involving market participants, thus reflecting UK practice.

Although there are some major elements of the FSAP that still have to be put in place, as indicated in the above box, the financial landscape of the EU has been transformed as a result of the single currency. Until 1 January 1999, investors could invest only a small amount outside their domestic currency, since they were bound by prudential practice, or by regulation, into matching their currency assets and liabilities. For the fixed interest part of the portfolio that meant effectively government debt because of the lack of an array of corporate debt. The result was that most European continental corporations had a much higher proportion of relatively expensive bank borrowing than was the case in North America.

The advent of the euro has transformed the situation. In two years the euro-denominated corporate debt market exploded from 476 billion euro at the end of 1998 to 1.3 trillion at the end of 2003. On the equity side, the Anglo-Saxon culture has grown in Frankfurt and Paris with share listings up 49 per cent and 47 per cent respectively in ten years. And equity volumes have been growing as well. It is not only the euro that influenced such developments, but it certainly helped to stimulate development of the continental capital market through increased need for capital for cross-border operations and better ratings that enabled companies to raise money by issuing bonds and securities. As regards company financing, the Financial Integration Monitor 2004 notes that alternatives to bank credits, which are still the dominant source of external financing for the EU private sector, have developed considerably. Even so, the growth of the EU corporate bond market since the introduction of the euro has not fundamentally altered the balance between market financing and bank loans in total companies' financing.[36]

In the boom phase up to 2000, both equity and debt securities issuance grew in importance in company financing. Equity markets in particular became an attractive source of finance (the number of Initial Public Offerings ('IPOs') increased steadily from 50 in 1995 to 288 in 2000) as market valuations rose strongly in the period to end-2000 (80 per cent). When market conditions turned for the worse, equity-finance became considerably more expensive and uncertain

The Financial Services Action Plan (FSAP) was adopted by the European Commission on 11 May 1999. A series of policy objectives and specific measures to improve the single market for financial services over the next five years (2000-2005), the FSAP suggests indicative priorities and time-scales for legislative and other measures to tackle three strategic objectives: completing a single market for wholesale financial services, developing open and secure financial services and retail markets and establishing EU regulatory safeguards to ensure stability of prudential rules and supervision for financial markets

According to the Commission's report on FSAP progress of November 2003,[35] results on progress in adoption of the main Directives in the set timeframe are mixed. The Directive on investment services, to be adopted in the first quarter of 2004, is still awaiting the EP 2nd reading. The re-drafted Company Law Directive on cross-border mergers was put forward by the Commission only in November 2003 and has missed the target of the first quarter of 2004. The Directive on Takeover Bids was agreed by the EP in December 2003.

The EU Financial Services Committee report, endorsed by the Ecofin Council on 2 April 2004, called for the EU to focus on wholesale financial markets and to give priority to rationalisation of the many clearing and settlements systems in the member states, complete an EU payments area, agree on capital adequacy rules for banks and financial companies and update solvency rules for the insurance sector. Tax harmonisation and financial supervision rules have remained intact.

(the number of IPOs plummeted to 9 in 2003) as market valuations and capitalisation collapsed in the period to early 2003, and the share of bank loans rose again.

UK corporate governance standards have generally been higher than elsewhere in Europe, both through greater adherence to voluntary codes and an active institutional investment community. In the second phase of the FSAP, the UK will be faced with defending its 'light regulatory touch' based on principles rather than rules in the field of corporate governance and thus fighting against a Directive on corporate governance as part of the FSAP. Consumer protection will also come into the focus in the second phase of the FSAP. Although some of the EP party groups demand high level of customer protection across financial services legislation, the UK will wish to stick to its light approach.

Retail financial services are particularly vulnerable to regulatory differences. Portfolios can be hedged to match assets and liabilities by currency but there are economies of scale in portfolio management. British institutions seem likely to focus on sterling customers and their products will be difficult to market in Paris or Berlin. If Britain remains out of the euro, the UK will have less influence on the regulatory harmonisation necessary to eliminate the national barriers.

The latest statistics from the Bank of International Settlements show that euro bonds and notes outstanding overtook those denominated in US dollars at the end of 2003. The impact of the pound's entry would be to boost the euro's share ahead of the dollar share in international bank loans yet further. The City of London and the UK would benefit from being part of a world currency rivalling the dollar, especially if the euro is increasingly held in other Central Bank reserves.

In terms of the impact of the euro on markets it is possible that the best is still to come. The volume of share trading in New York at nearly £21 trillion a year compares with £7.2 trillion if London, Paris and Frankfurt are added together. If the eurozone financial markets grow to resemble New York in depth, liquidity and size, the European securities markets over the next few years could treble in turnover. A leap forward of this proportion would substantially increase the efficiency of continental capital markets in allocating savings into investment. It would reduce transactions costs and increase market liquidity. Until recently, European investors have been paying seven times as much in clearing and settlement charges as in the US. If European funds could grow in size, they would thereby reduce administrative costs and improve net returns for investors. Until the introduction of the euro, the average real return on private pension funds was 10.5 per cent in the US and 6.3 per cent in those EU countries where funds faced severe investment restrictions.[37] Finally, investors will be able to diversify their portfolios and spread their risks, thus permitting the opening up of a more dynamic and widespread venture capital market and a more entrepreneurial culture, which in the US has been crucial in the development of innovation clusters such as Silicon Valley.

The City is already a worldwide and not just a European financial centre. However, if the UK joined the euro, the City's role might be further reinforced at the expense of continental financial centres. There may be more opportunity for the City to carry competition into the retail financial markets of the eurozone, which have been relatively closed, but are due to open up under the EU Financial Services Action Plan. The benefits of a more integrated capital market could result in a somewhat lower cost of capital for UK business.

At the heart of the business case for the euro is the greater predictability it would bring for long-term investment by eliminating the exchange rate risk with the eurozone economies. The Treasury have also pointed out that EMU entry would reduce the cost of capital for UK firms if long term interest rates fall further inside the eurozone and if membership of a larger financial market reduces the cost of finance. This could be especially important for SMEs as a result of enhanced competition in retail banking services.

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III. Scenario Conclusions

This final section of the report sketches four scenarios describing possible outcomes for Britain and the euro, taking account of the driving forces outlined in the first part of the report. The effects of the driving forces self evidently differ according to the degree of certainty that can be attached to them. We cannot in any case derive precise logical consequences from them. It is therefore impossible to predict with certainty how Britain would perform under the four stylised scenarios presented. Nevertheless we regard it as a useful exercise to produce these stylised scenarios, which provide an indication of the most important factors which may determine possible outcomes in an increasingly complicated world.

The four scenarios we have taken are UK membership of a eurozone performing well; UK membership of a eurozone that is performing badly (i.e. has failed to achieve sustained economic growth); and continued UK exclusion from a eurozone under these two assumptions about its performance. Clearly UK membership or exclusion would itself have implications for the performance of the eurozone, and we have tried to take this into account also in these summary conclusions.

I – UK joins the eurozone that is performing well

Possible implications for the eurozone

1. Deep and wide ranging reforms have been taking place in Europe, driven by reforms in financial and product markets, and in turn leading to pressure for reform in the labour markets. These reforms have been slow in the recessionary years but are picking up against the background of an upturn linked initially to the boost given by enlargement and extended in the medium term by Europe's catching up with the US, India and China in the ICT revolution. The result is that the tackling of structural problems in the labour markets has started to pay off with wages beginning to reflect productivity differentials, thus leading to rising employment levels.

2. Euro-pessimism proves to be overdone, both politically and economically. The European Constitution adopted at the Intergovernmental conference in June 2004 has improved decision-making in the enlarged EU and over time begins to generate greater public confidence in and identification with the EP and other key decision-making institutions. There has been further progress in reforming the Common Agricultural Policy, which in turn has made important progress in the Doha round and world trade negotiations possible, and provided a greater flexibility within the European budget. After initial teething problems, the 2004 enlargement has settled down well, with most new member states showing signs of improvement in economic performance and in their institutional structures. As a result of these developments, after fifteen years in which American output growth outstripped that of the EU, towards the end of the first decade of the 21st century, output growth gets back to level pegging between Europe and the United States. Europe has used some of the increase in productivity to increase leisure rather than income while the US has done the opposite.

3. An EU-wide policy on immigration and asylum provides a framework of robust rules and procedures which prevents each member state from undermining the policy objectives and social imperatives of the others. The result is that net immigration makes a positive contribution to economic dynamism and so helps to counteract the otherwise deleterious effects of an ageing society. Once again, 'Brussels' takes the blame, whereas the member states benefit from the overall benefits of a pooling of sovereignty.

4. Increasing aggregate investment in ICT technology combined with the liberalising of markets and encouragement of innovation and entrepreneurship, particularly among SMEs, has positive effects on the eurozone's productivity growth and through its secondary effects on employment rates. As in the third quarter of the 20th century, Europe benefits from the advantages which accrue to 'second generation' applications of new technology. The European economy becomes increasingly adept at the reorganisation and reinvention of existing businesses, and there is a marked shift of European economic activity towards the service sector.

5. The increasing international role of the euro makes it a real competitor with the dollar in the financing of world trade and in use as a reserve currency. This development is particularly important in relation to the large current account surpluses of East and South Asia which have traditionally been invested and held in dollars, and have in effect financed the high level of public and private spending, and low levels of saving in the US. A gradual diversification of investments into European assets makes the US economy increasingly vulnerable to a downturn, leading to higher interest rates and reduced scope for reductions in taxation and continuation of the previously high levels of personal consumption and public spending. While the EU does not aspire to rival the United States of America in the possession and use of military power, its global financial outreach substantially reinforces its ability to play a leading role in the deployment of 'soft' political power.

Possible implications for the UK

1. As a 'fully paid up' member of the eurozone, with nearly two thirds of its trade now with the EU, the UK benefits generally from the eurozone's improved performance. The UK's high ranking in competitiveness (globally and within the EU) enables it to make particular gains from the European single currency, which attain and even surpass the upper range of the Treasury estimates in 2003. The dynamic effects are particularly important for SMEs, the main source of innovation and jobs, who have been deterred from entering the export market in the past by exchange rate costs.

2. UK price levels that have in general been higher than in the eurozone face downward pressure through enhanced competition in the eurozone. The already good record of the UK on inflation benefits as a result. Further monetary stability is injected into the British economy as a result of measures encouraging more British homeowners to follow the predominantly continental European pattern of long-term, fixed-rate mortgages. This reduces over time the traditional volatility of the British housing market and the vulnerability of mortgage borrowers to changes in short term interest rates.

3. The positioning of the UK within the eurozone, coupled with its existing traditional advantages, enables the UK once again to attract a growing if not predominant share of Foreign Direct Investment, based primarily on a better long-term predictability of investment outcomes from participation in the single currency. This brings higher quality jobs, with better pay and higher output per person. Increased FDI doubly benefits the UK, both by enhancing its intra-European exports and by improving the country's fixed and human capital stock.

4. The UK is protected by its membership in the euro from the uncertainty to which sterling, as a relatively small independent currency, would have been exposed to by the increasing volatility of the dollar. This stability in turn promotes growth, employment and investment within the United Kingdom.

5. Within EMU, and now genuinely 'at the heart' of Europe, Britain's influence over the political and economic development of the euro and EU policies more generally has increased. In particular, it is better placed to promote a more balanced overall mix of fiscal and monetary policies by the ECB (where it now has a place on the Governing Council) and national governments, as well as a more vigorous pursuit of structural economic reforms in the EU.

II – UK joins the eurozone that has failed to achieve sustained growth

Possible implications for the eurozone

1. Under this scenario, with continuing failure to make progress on governance and institutional reform, the eurozone has failed to implement the required structural reforms. Labour market rigidities remain, particularly in France and Germany, resulting in continued high unemployment. Little further progress has been made in changing the CAP, thus maintaining severe budgetary pressures and stultifying progress on the Doha Round; and no sensible agreement has been reached on reforming the Stability and Growth Pact or on the overall conduct of macro-economic management.

2. The 'Rhineland model', which propelled the German economy in 'catching up growth' with the USA in the post war years, is coming under increasing pressure. It was based on relatively cheap long-term finance which in turn permitted job security and high welfare benefits for their workers. That model has become dysfunctional as European growth becomes increasingly based on innovation that calls for new relationships between firms, their banks and their workers.

3. By contrast, despite the generally poor overall economic performance, the Nordic countries, the Netherlands, and Ireland have all been relatively successful in deregulating their labour and product markets to compete in the age of ICT technology and globalisation. The disparate nature of the eurozone creates however problems for the ECB in setting an interest rate and monetary policy that is appropriate for the whole of the eurozone. These tensions are reflected in further moves towards variable geometry, both in the economic and other spheres.

4. Germany and to a lesser extent France are subject to deflationary pressures as investment levels and the growth of consumer spending remain low, especially in comparison to the Asian and NAFTA economies.

5. Despite considerable achievements by some of the new member states, most of them continue to suffer from high unemployment and high levels of social exclusion. In the near stagnation climate in the two largest continental European countries, the free movement of people from the new to the old EU remains restricted, and in the absence of agreement on an overall immigration policy, the deficit of young and productive workers in an ageing and diminishing EU population is not made good by the necessary inflow of immigrant workers.

Possible implications for the UK

1. Differing growth rates within the eurozone create increasing policy dilemmas for the ECB in the setting of interest rates. These dilemmas are often resolved in a way that is not appropriate to the circumstances of the UK, sometimes causing deflation and constraining its potential for growth and sometimes provoking inflation, in both cases posing difficult problems for the conduct of domestic UK fiscal policy.

2. If the UK has entered EMU at what subsequently turns out to be an inappropriate exchange rate the problems of euro membership are especially severe. Entering at an over-valued rate causes industrial production and GDP to fall below the levels that would otherwise have been expected. The option of cutting interest rates and thus seeking to reduce the exchange rate, with the aim of stimulating economic activity in the UK, is no longer available.

3. British gains from increased intra-European trade are limited by the low economic growth elsewhere in the eurozone. The relative competitiveness of the British economy within the unreformed eurozone to some extent offsets this limitation; even when growing slowly, the eurozone remains a large and prosperous market. The United Kingdom in any event benefits from the dynamic effects of a growing share of FDI into Europe.

4. Britain's political and economic leverage as the best-performing large economy in Europe is enhanced as a member of the euro. In particular, it is better placed to argue persuasively for liberalising reform to tackle the causes of stagnation in the rest of the eurozone. On the other hand, the poor performance of the eurozone, and the feeling that it is 'dragging Britain down', increases domestic political pressure to revise the decision to join the euro, however impractical this may now be.

III – UK stays out of the eurozone that is performing well

Possible implications for the eurozone

[As in scenario I]

Possible implications for the UK

1. The UK looks to play the role of niche player and semi-detached participant in the European economy. Although not a full member of the trading and currency block provided by the euro, it seeks to derive benefit from the European single market to which it has access, while remaining a global player in the small but significant number of service and manufacturing areas where it enjoys a comparative advantage. Success in this endeavour depends not merely upon the UK's economic flexibility and resourcefulness, but also on the willingness of other members of the EU to allow a Britain outside the euro largely unrestricted access to the European single market. This cannot be taken for granted, and although the UK's formal position is protected by the Treaties, there is increasing resentment at what is seen as the UK's wish to be a free rider and have it both ways. This begins to affect co-operation with the UK in other areas.

2. In a world now dominated by three broadly comparable currencies (the dollar, the euro and the yen) sterling suffers fluctuations of a kind which tends to befall any commodity which is traded in a marginal market. British interest rates remain higher than those of the eurozone, not least because of the essentially short-term nature of its housing finance, linked to high levels of consumer borrowing do.

3. Although the UK retains many of its traditional attractions for investors, it does not attain again the peak levels of FDI before 1999. This makes it more difficult for the UK to close the gap in terms of capital intensity with the other major players in the EU. Both Frankfurt and Paris improve their relative standing as financial centres, although the City retains its predominant position in Europe. The UK, however, has progressively less influence on the rules and regulations governing EU financial markets.

4. Staying outside the eurozone symbolically reinforces Britain's current position within the American political orbit. This reaffirmation of the 'special relationship' of itself makes the establishment of a 'core Europe,' with enhanced economic and security co-operation among its members (particularly the Franco-German relationship), more likely. Britain finds itself uncomfortably torn between this evolving 'core Europe' and the United States of America, the unilateralist instincts of which arouse increasing antipathy in the United Kingdom, whether the questions at issue are environmental, trade-related, jurisdictional or economic.

IV – Britain stays outside the eurozone that has failed to achieve sustained growth

Possible implications for the eurozone

[As in scenario II]

Possible implications for the UK

1. Because of the poor performance and mediocre economic prospects in the EU, there is little public pressure to join the euro and a general belief that Britain made the right decision by staying out. There is growing political and economic estrangement from what is seen to be a failing political and economic project.

2. Because its rate of growth is superior to that of continental Europe as a whole, Britain attracts a disproportionately large share of FDI. However, it still does not reach the highest levels achieved in the 1990s.

3. Low growth in the EU creates pressures for the creation of 'Fortress Europe'. If this is combined with simultaneously increasing protectionism in the United States (which could possibly happen as the result of an American currency crisis), Britain needs to develop new markets outside its traditional economic partners.

4. Britain's capacity to develop these new markets is, however, highly dependent upon the political and economic situation of such markets as India, China, Japan, the rest of Asia and South America. Already within both Asia and South America, there are significant moves toward the establishment of regional economic and political blocs. It must at least be questionable whether the United Kingdom can establish favourable trading relationships with these new trading areas.

5. Remaining outside a failing eurozone, in which poor economic performance increasingly lends to friction among member states in policy areas, pushes the UK even more closely into the American political orbit.

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Glossary

BEPG	Broad Economic Policy Guidelines
BIS	Bank for International Settlements
CAP	Common Agricultural Policy
CFSP	Common Foreign and Security Policy
ECB	European Central Bank
EMU	Economic and Monetary Union
EP	European Parliament
EU	European Union
eurozone	12 Member States of the EMU
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IGC	Inter-Governmental Conference
ISD	Investment Services Directive
JHA	Justice and Home Affairs
OECD	Organisation for Economic Co-operation and Development
QMV	Qualified Majority Voting
R&D	Research and Development
SGP	Stability and Growth Pact
SMEs	Small and Medium Sized Enterprises
WTO	World Trade Organisation

In late 2003 the Federal Trust convened a high-level Working Group under the chairmanship of Sir Brian Unwin, honorary President of the European Investment Bank. Its remit was to examine the implications of a number of assumptions about UK membership, or non-membership, of the euro during the next 5 to 15 years.

This report, the outcome of the Group's deliberations, seeks to describe the possible effects on future European and world developments of a number of key driving forces such as technology, demography and globalisation. Their analysis concludes with a summary of four main scenarios of how Britain might fare in such a world both as a member and non-member of the eurozone, and depending on whether the eurozone performs well or badly.

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