Submissions on EMU from leading academics

EMU study

HM TREASURY

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This study has been compiled by HM Treasury to inform the assessment of the five economic tests

The content and conclusions of the submissions in this study are those of the authors.

This is one of a set of detailed studies accompanying HM Treasury's assessment of the five economic tests. The tests provide the framework for analysing the UK Government's decision on membership of Economic and Monetary Union (EMU). The studies have been undertaken and commissioned by the Treasury.

These studies and the five economic tests assessment are available on the Treasury website at:

www.hm-treasury.gov.uk

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Introduction

1 To inform the preliminary and technical work for the assessment of the five economic tests, HM Treasury has approached a number of leading academics since summer 2002 to request an update of work which they had previously undertaken on the economics of monetary unions. 46 academics were approached, whose work has spanned the range of economic issues covered in the Treasury's preliminary and technical work. This volume brings together 23 submissions from those academics who were able to provide a contribution. Annex A lists all the academics approached.

2 In each case, the Treasury requested a short note of around 4,000 words in length which revisited the conclusions reached in the earlier piece of work, in the light of developments both in the economic literature and in the euro area since the original piece was written. In many cases, the request was based around a specific paper and quotation of particular relevance to the preliminary and technical work. In other cases, the request was based around a relevant body of work.

3 The contributions brought together in this volume have proved extremely valuable to the Treasury. The insights and analysis which they provide have fed extensively into the Treasury's work on the EMU studies and the five tests assessment. The Treasury would like to thank all the academics who have taken part in this exercise for their high quality contributions.

THE SUBMISSIONS IN THIS VOLUME

4 The 23 submissions in this volume are ordered alphabetically by author:

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Professor Willem H. Buiter and Dr. Clemens Grafe, European Bank for Reconstruction and Development, London and Birkbeck College, University of London.

Professor Lars Calmfors, Institute for International Economic Studies, Stockholm University, Sweden.

Professor Wendy Carlin and Dr. Andrew Glyn, University College London and Corpus Christi College, Oxford University.

Professor Paul De Grauwe, Katholieke Universiteit Leuven, Belgium.

Professor Jean Dermine, INSEAD, Fontainebleau, France.

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Professor Jacques Mélitz, University of Strathclyde.

Professor Patrick Minford, Cardiff Business School.

Professor John Muellbauer, Nuffield College, Oxford University.

Professor Robert Mundell, Columbia University, New York, USA.

Professor Andrew K. Rose, Haas School of Business, University of California, Berkeley, USA.

Professor George S. Tavlas, Bank of Greece, Athens, Greece.

Professor Charles Wyplosz, Graduate Institute of International Studies, Geneva, Switzerland.

RAY BARRELL: MONETARY AND FISCAL FRAMEWORKS IN EUROPE – ASSESSING AND CHOOSING MONETARY AND FISCAL POLICY RULES

January 2003

HM Treasury invited Ray Barrell to revisit his work on the EMU monetary and fiscal framework in papers such as 'Choosing the Regime: Macroeconomic Effects of UK entry into EMU' (2000), 'Monetary and Fiscal Policy in Europe' (2000) and 'The UK and EMU: Choosing the Regime' (2002).[1]

INTRODUCTION

1. Over the last decade or so politicians and economists have turned away from designing individual optimal responses to specific unexpected events and have begun to consider the construction of optimal frameworks that will cope with these events in a robust and predictable way. In the process we have moved through frameworks with rule guided behaviour toward a structure where day to day policy is set by an independent institution. These changes have been driven by dissatisfaction with frequent regime shifts as politicians re-optimised, as well as by the recognition that short term political necessity was not a good reason for making policy innovations with far reaching consequences. Optimal (and opportunistic) responses in the short run and optimal frameworks for the longer term may be in conflict, and longer term issues are more important for sustaining economic welfare.

2. Policy makers in the UK moved to an inflation targeting framework for monetary policy in 1993, and this was strengthened with the declaration of the independence of the Bank of England in 1997. The current members of the Euro Area have been through a sequence of monetary frameworks, starting with the Exchange Rate Mechanism (ERM) and progressing to full Monetary Union (EMU). Monetary policy was increasingly put in the hands of independent monetary institutions as exchange rates became more fixed. The ERM was designed to induce convergence on low and stable inflation rates in Europe as a preliminary to full Monetary Union, and on the whole it succeeded. Fiscal frameworks came into the European debate later, and they have not proceeded all the way to institutional independence. After a decade or more of large deficits and increasing debt stocks in Europe, in 1991 the Maastricht Treaty embedded a set of fiscal rules that were designed to limit borrowing and control debt in the run up to EMU. This framework was successful in part, and was changed in 1997 with the introduction of the Stability and Growth Pact (SGP). The SGP contained clearer guidelines for fiscal policy, and used sanctions to ensure that deficits were to be kept within reasonable bounds. The UK government also introduced a new fiscal framework in the late 1990s, setting out policies for the prudent management of the public sector.

[1] Barrell, R. and Dury, K. (2000) 'Choosing the Regime: Macroeconomic Effects of UK entry into EMU', *Journal of Common Market Studies* Vol. 38(4) pp. 625-644; Barrell, R. and Pain, N. (2000) 'Monetary and Fiscal Policy in Europe', *National Institute Economic Review* No. 174, October pp. 63-67; Barrell, R. (2002) 'The UK and EMU: Choosing the Regime', *National Institute Economic Review* No. 180, April pp. 54-71.

3. Policy frameworks are assessed in various ways, and it is common in the economics literature to look at their clarity, transparency and their credibility. Clearly these features are important, but must be subsidiary to an assessment of whether a framework has been successful in achieving its targets and enhancing welfare, and whether it is expected to continue to do so. The Chancellor's five tests make it clear that the assessment of the case for joining EMU depends on the ability of the framework to enhance output, employment and welfare, and our discussion is designed to throw light on the choice the UK must make.

ASSESSING MONETARY AND FISCAL FRAMEWORKS[2]

4. Monetary and fiscal frameworks should clearly help control the level of output and inflation. These variables are of immediate concern to the polity, and excessive cycles in output or unduly high (or low) levels of inflation are not desirable. However, when designing frameworks we should not only concern ourselves with cycles in economic activity, but also with the equilibrium level of economic activity. This will depend upon the size of the effective labour force, the skills of the workforce, the capital and technologies available to use in production, and the effectiveness with which these factors are used. The level of output, and of other economic variables can always be decomposed into what people expected to happen, and the remainder. The size and volatility of the unexpected components will have a direct bearing on perceptions of uncertainty in the economy. In a more uncertain world the level of investment in the stock of capital assets (knowledge, skills and structures and equipment) is likely to be lower, and they will be used less effectively. As a result the equilibrium level of output will be lower if the economic environment is expected to be more uncertain.

5. The macroeconomic framework will affect expectations of the future and perceptions of uncertainty and will therefore affect the behaviour of individual optimising agents and the equilibrium level of output. The choice of a framework for policy should depend on its impact on uncertainty and output as well as on its effectiveness in achieving short term targets for output and inflation. Discretionary monetary and fiscal policy in the 1970s and 1980s in Europe did not seem very effective at stabilising the mean and variance of output and inflation. The case against discretion, and especially against fine tuning, is now widely accepted,[3] and monetary and fiscal frameworks are built on commitments to policy targets.

6. Monetary frameworks can help stabilise the economy by reducing over-active policies and stopping politically motivated interventions. The effectiveness of the framework depends on the design of the regime and the reputation of the authority implementing it. It is important to assess the extent to which these allow the monetary authority to make credible commitments, as this will increase the effectiveness of the framework. Different frameworks will have different impacts on uncertainty even with the same targets for inflation and other variables.[4] Stronger and more binding rules as well as ones that are more credible will

[2] Many of the issues concerning the choice of policy regime, and in particular comments on the Euro Area framework, follow on from Barrell and Pain (2000) and Barrell and Dury (2000a).

[3] The Pre-Budget Report in November 2002 included as supporting document a useful discussion of the issues surrounding discretion and commitment. See HM Treasury (2002).

[4] Controlling economic systems is generally more difficult than controlling physical ones, but insights from control engineering can be useful nonetheless. If one wishes to control a variable, for instance inflation or the budget deficit, one can attempt to do so by writing down a feedback rule which changes a relevant instrument in order to correct a deviation of the targeted variable from its target value. It is generally the case that including the integral of the targeted variable will increase the efficiency of the targeting strategy and in an uncertain world it is often the case that this will reduce the volatility of the targeted variable. Fortunately the integral of the inflation rate (the price level) and of the budget deficit (debt stocks) are perfectly sensible economic variables to include in a targeting rule. Proportionate and integral controllers punish persistent target misses in an increasingly severe way, making them more effective and potentially more credible.

potentially reduce the volatility of inflation and hence change the expected volatility of inflation. For instance the inclusion of a price level target into an inflation targeting regime may help reduce the volatility of inflation and of output.[5] Hence the design of a monetary framework can affect the evolution of potential output as an increase in anticipated stability will induce changes in investment that will increase output.

7. Discretionary fiscal policy may be an effective tool for stabilising the economy, albeit a weak one, but the longer run effects of using it may include reductions in the sustainable level of output. Conditional experimental estimates of the effects of fiscal policy[6] suggest that the multiplier effect from an intentional fiscal impulse is likely to be less than one. We can therefore conclude that fiscal policy can have a limited role in helping stabilise the economy when needed. However, for much of the post Bretton Woods period in Europe innovations and changes in the fiscal stance have not been primarily directed at stabilisation, and they have not particularly achieved it.[7] The existence of the fiscal tool bag has probably had little impact on perceptions of the stability of the economy as a result, and the use of discretionary policy has had other undesirable consequences. Debt stocks grew rapidly in both the UK and the Euro Area countries into the mid 1990s, putting upward pressure on the long term real interest rates facing private investors. Higher real interest rates reduce the capital stock and hence the potential level of output. Fiscal frameworks that put effective upper bounds on the debt stock should reduce the volatility of deficits in the future, and hold down perceived real interest rates in future periods. They will therefore help reduce the level of long term real interest rates now as well as their volatility, and would lead to higher potential output.

8. The UK fiscal framework was developed independently when it became clear that the UK would not be in the first round of EMU countries.[8] Although it sets targets for debts and deficits, it is not clear how binding these might be, and there appear to be no sanctions if targets are not met. Although the lack of sanctions may reduce the credibility of the framework, it is hard to see how they can be introduced into it in an effective way. It is the tradition in the UK that institutions evolve, and it is clearly the case that the UK framework could be strengthened further in its process of evolution.

9. The Euro Area fiscal framework began with the Maastricht Treaty in 1991 with limits on the debt stock as well as on deficits, with the effective sanction that failure to attempt to meet the obligations in the Treaty would mean exclusion from Monetary Union. The subsequent fiscal framework agreed at the Amsterdam European Council in 1998 put rather more emphasis on deficits, but included clear pecuniary sanctions and penalties if targets were not met. Sanctions and penalties are easier to design and implement in a Treaty based framework, and if the structure survives its teething problems these features should enhance its credibility. Recent reform proposals shift the emphasis back to debt stocks and asset positions.[9]

[5] Gaspar and Smets (2000) discuss this extended inflation targeting version of a two pillar strategy, and suggest that in a more inertial economy, such as that of the Euro Area as compared to the USA, it may be better than pure inflation targeting at stabilising inflation.

[6] Representative estimates of multipliers using large scale calibrated and estimated macro models can be found in Röger and in't Veld (2002) and Barrell, Hurst and Pina (2003). The latter paper also discusses the impact of a permanent change in the deficit on the debt stock, the real interest rate and the level of sustainable output.

[7] Melitz (2000) suggests that fiscal policy has had a very small countercyclical effect.

[8] The UK framework for fiscal policy would probably have been developed even if EMU had not been on the horizon in 1997, as it was an important part of a shift to a medium term, rule-guided approach to macro policy adopted by the Labour government in 1997.

[9] The final, official version of the well flagged set of proposals is in European Commission (2002).

10. Successful institutions are not necessarily the best mould to follow when building new institutions. Good institutions need to be credible, and a history of success can significantly enhance current credibility. The Federal Reserve does not have an explicit inflation target, and Mankiw (2001) suggests that its policy can be described as covert inflation targeting around 3.0 percent leaving it room for a degree of discretion that would have been impossible with an explicit target. The Federal Reserve has been successful in keeping inflation low and has built up significant credibility as a result. This left it room to be less explicit about its target, and hence target misses would have less damaging effects on credibility. The Bundesbank was at the core of European monetary policy during the 1980s and 1990s, and its reputation rested on its record of success in keeping inflation low.[10] Germany had the lowest average inflation of all major economies in the post Bretton Woods pre EMU era, and hence its central bank was credible, with responses that were understood by markets and bargainers. Neither the European Central Bank (ECB) in 1999 nor the Bank of England in 1997 (or especially 1993) could gain the same degree of credibility just by speaking with a similar voice to the Federal Reserve or the German central bank.[11] Both needed to be significantly clearer about their objectives and noticeably more transparent and predictable in their actions than the two established central banks had been, at least whilst they established their reputations.

THE CURRENT UK FRAMEWORK

11. The UK monetary and fiscal frameworks were both designed to ensure transparency and clarity in decision making. The monetary framework was changed markedly in 1993 with the establishment of an inflation target and a panel of independent experts advising the Chancellor, and the creation of an independent central bank was a continuation of that successful move.[12] The success of the new framework between 1993 and 1997 was important for enhancing the Bank's reputation when it became independent. The fiscal policy framework was more innovative, and set targets for deficits and debts that were meant to re-assure people that tax burdens would not be shifted over time. A clear change in stance was needed in order to reduce the excessive deficits that had emerged especially in the 1990s with their associated impact on real interest rates and hence the sustainable level of output in the longer term. Barrell and Weale (2003) give an assessment of the impact of policy in the UK. They conclude that the current frameworks have increased stability and should be helping to set the basis for a stronger economy. However, they conclude, as we do here, that there remains room for improvement, and that there are lessons to be learnt from failures as well as successes.

12. The Monetary Policy Committee (MPC), largely a panel of independent experts appointed by the Chancellor, was set up at the same time as the Bank of England was made independent in May 1997, and it reaches majority decisions on the setting of interest rates each month. Decision making is independent, but the target for which the Committee aims is set by the Chancellor, and it can be changed by Parliament. The process is transparent and accountable, but sometimes it is not clear why decisions have been made. More importantly it is difficult, within the rotating independent expert framework, to ascertain what the MPC's response function is, and hence expectation formation must be fuzzier than under a system with a clear institutional response. The independent expert framework is unusual, and difficult to replicate except where there were few sectional or regional interests to reflect.

[10] The importance of success in building the Bundesbank's reputation is stressed by Blinder (2000), reflecting on experience as a central banker as well as on the academic literature on central banking.

[11] Guthrie and Wright (2000) discuss the benefits of 'open mouth operations'. Transparency and clarity are important for such policies to succeed.

[12] Giving the Bank independence clearly increased the credibility of monetary policy, and inflation expectations (from the difference between indexed and non-indexed government stocks) fell by half a point on the announcement.

13. Setting clear targets for a recognisable indicator linked directly to the objective of stabilising the economy was a very wise course of action at the inception of the new frameworks in the UK. Success in achieving its inflation target has made the Bank credible, and gives us space to improve on the current framework. It is possible to develop inflation targeting regimes in order that room for more discretionary action is available, as for the US Federal Reserve, whilst ensuring that the goal of price level stability in the medium term is achieved. The volatility of inflation can be reduced by targeting both the inflation rate and the price level, and discussions of inflation targeting in high inflation developing economies reflect this.[13] In addition setting a price level target as a back-up to the inflation target assures people that deflation will be reversed, and hence puts a floor on the amount of deflation they can expect.[14] An obvious extension of the current framework would be to request the Bank to achieve its inflation target on average over the life of the Parliament, ensuring that if there were significant overruns these would be reversed, at least in part. This would introduce a 'second pillar' into an inflation targeting strategy and recent literature suggests it would help reduce the perceived volatility of inflation and hence help raise the sustainable level of output.

14. The UK fiscal framework is designed to allow space for government investment whilst keeping the debt stock within sensible bounds. The objectives of the framework are clear, transparent and wise, but experience suggests that the mechanism for implementing the strategy could be reconstructed to make it more credible. A more credible framework would indicate that deficits would be more likely to be kept in bounds, and hence would mean that debt stocks would be expected to be lower in the medium term future. A lower level of expected debt would mean lower real interest rates would be expected for the future. Hence the long term real interest rate used in investment decisions now would be reduced, and output and the capital stock would grow more rapidly.

15. The intention of the UK fiscal framework is that the government current account should be in balance or surplus over the cycle, without any particular constraint in any one year. Hence the timing of the beginning and end of the cycle have to be determined in order to assess the longer term fiscal stance. Both points are essentially arbitrary, and even with a clear technical description in terms of output movements the end of the current cycle must always be in the forecast period, not the past. If it is considered that the current account will be in deficit over the cycle the government should react, but it is not clear how binding the requirement to respond might be. The UK fiscal framework also suffers from the weakness that action is not required if the deficit target is not met once the cycle is complete.[15] At minimum it would be useful to impose on the Chancellor a statutory duty to explain to Parliament why the rule had not been met. An independent, and responsible, fiscal authority assessing the cycle or even setting deficit targets might be a useful adjunct to this strategy.[16]

[13] See Mishkin (2000) for a discussion of inflation targeting regimes as they moved from simple attempts to remove hyper inflation to mechanisms for ensuring price stability in the medium term.

[14] Svensson (2000) discusses this in the context of Japan.

[15] Action may be needed if the debt target had been exceeded.

[16] Wyplosz (2002) for instance discusses this suggestion.

MONETARY AND FISCAL POLICY IN THE EURO AREA

16. The UK arrangements can be contrasted with the constitution of the ECB, which is more genuinely independent than are other central banks.[17] The ECB has a remit of maintaining price stability in the medium term, and it is allowed its own interpretation of this objective. As a new institution it lacked reputation, and at its inception the construction of a clear framework that was clearly explained was essential. A clear framework needs to have a simple pattern for decision making, a widely available information set for informing decisions, and a technical description of its targets that connects directly to its objectives. Inheriting the mantle of the Bundesbank was not a possibility, and the initial framework should have been an important bridge on the road to credibility built on success.[18]

17. The ECB's Governing Council meets and considers expert opinion, but its decision making process is not made public. The Bank is frequently criticised for this lack of transparency, but it is not always clear that greater transparency in decision making improves the certainty with which expectations are held. There are more significant criticisms of the initial framework for the two pillar strategy which was perhaps too close to the Bundesbank's public statements. The Bank sets itself a target range of 0 to 2 percent for Euro Area inflation, and also takes account of a medium term reference value for a broad money aggregate. It is acceptable for a successful central bank not to give up mentioning monetary targeting even though it has become largely irrelevant to its actions and success. It was perhaps not wise for a new central bank to take on an intermediate target that was difficult to interpret and had little relevance to its ultimate goal. This lack of clarity in the framework has made it harder for the ECB to build a reputation, and hence has left policy less credible.

18. The Euro Area needs a clearer fiscal framework than does the UK in part because it is a new breed involving a number of sovereign states controlling fiscal policy within a monetary union, and there are no established patterns for such constitutional hybrids. As long as the ECB remains credible and firm minded there is little risk that a burgeoning of the debt stock would result in inflationary policies being used to erode debt, but increasing debt remains a problem. If some of the independent fiscal authorities decide to 'free ride' on the low inflation strategy of the ECB debt stocks will rise, and this will push up the real interest rate in the Euro Area, reducing the level of private sector investment and its productive capital stock. This would reduce the sustainable level of output in the economy unless the public sector borrowing had been used to finance investment that was very productive or had significant spillovers to the rest of the economy. There is little evidence that debt has in the past been issued solely for these purposes, and we should not expect it to happen in the future.

19. Fiscal frameworks with enforcement rules are important in the new constitutional framework in the Euro Area. However, flexibility in the face of economic shocks is also of value, and the Stability and Growth Pact gives this, as no penalties are payable until the deficit has been greater than 3 percent for 2 years without a good excuse based on slow growth.[19] Members can ignore temporary shocks to the deficit and concentrate on more permanent events; this should give the flexibility needed to cope with genuinely cyclical components to any deficits. If they breach the Pact then they face fines, but these are progressive, and are designed to induce changes in behaviour. However, the 3 percent target is essentially arbitrary and is much easier for some countries to meet than for others. As a result although the structure and intentions of the Pact are good, it has not had a particularly easy beginning.

[17] Creel and Fitoussi (2002) suggest that this degree of independence detracts from the ECB's efficiency, as the lack of ultimate democratic control (except through Treaty revision) may alienate the polity from the institution, giving its voice less authority and effectiveness.

[18] Creel and Fitoussi (2002) suggest that the ECB has been perhaps more restrictive than the Bundesbank would have been in the circumstances, and this will help it build a reputation, albeit slowly.

[19] Dury and Pina (2003) calculate that breaches of the SGP would be rare if governments had stuck to their fiscal plans and had consolidated the fiscal stance during the upturn in the Euro Area economy.

PROPOSALS FOR REFORM IN THE STRUCTURE OF EUROPEAN INSTITUTIONS

20. European fiscal and monetary policy institutions are under continual pressure for reform especially as they adapt to their new environment. The European Commission has produced suggestions for the reform of the SGP that will move it in the direction of the current UK framework, emphasising in particular the importance of assessing the cycle when making judgements on fiscal positions.[20] The ECB has acknowledged that it needs to reform its management and decision making in the process of expansion of the EU. It has also accepted that it needs to review it strategy, and especially the pillar that is meant to rest on a medium term evaluation of the prospects for the economy. This should allow it to produce a set of targets that make it clear that it is focussing on its primary objective of price stability in the medium term.[21] It will of course be politically difficult for it to move away from a two-pillar strategy, and if it did so this could damage its credibility. Hence we cannot expect it to decide to adopt simple inflation targeting, but anyway we would suggest it should not do so. More sophisticated versions of inflation targeting, including some response to sustained deviations of inflation from target, would both maintain the two pillar framework and also be more effective.

21. The problems the Stability and Growth Pact has faced come from a combination of sources. The failure to consolidate fiscal policy during the upturn in France and Germany in particular was clearly bound to cause problems for the Pact. This failure on the part of the German Government may reflect the new situation where central bank responses to fiscal profligacy are less direct. Up until the formation of EMU the Bundesbank would have responded to a loose fiscal stance by raising interest rates and slowing the economy (its response to German unification reflects this pattern). Politicians would have been constrained by this potential and fully understood response, and would have had to respond quickly to pressure to consolidate the public finances. As there is now less monetary reaction to German fiscal (in)activity politicians will feel less pressure to react and fiscal policy rules perhaps need to be stronger than they were in the run up to the formation of EMU.[22]

22. The decision by the Commission to set targets that were perhaps too tight, and were not required by the Treaty of Amsterdam that set up the framework[23] reduced room for manoeuvre, and the new framework currently under discussion should introduce more flexibility. There is clearly room to reform the Pact, and in particular to redefine the target deficits at its core. In the recent proposals it is suggested that these should be reinterpreted to allow members to borrow more to finance investment in their inadequate public sector infrastructure[24] as long as their public sector debts and pension liabilities were limited. Buti, Eijffinger and Franco (2002) argue that the Pact is transparent, and because it has clear penalties, it is credible, but is in need of a number of internal reforms. This view may be optimistic, but it is clear that the Euro Area requires an enforceable pact with penalties to ensure that credibility, prudence and fairness are maintained in all countries in EMU.

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[20] See European Commission (2002) for a discussion of the new proposals.

[21] See ECB (2002a) for a discussion of the possible revision to the two-pillar strategy and ECB (2002b) for its proposals on a new three tier structure for the governing board. The former document has to be read in combination with statements to the press by members of the board after it was issued.

[22] It is not possible to explain the weakness of the French government's response to fiscal deficits in the same way, however.

[23] Barrell and Pain (2001) discuss the complexities of the European fiscal constitution.

[24] These changes give space for the UK to fit into the fiscal framework without changing the fiscal stance, and are also particularly useful for the potential Transition Economy members.

23. Small open economies operating independent policies, such as the UK, face difficult problems in choosing their regimes, because their optimal frameworks depend much more on the external environment than does the best framework for a large relatively closed economy such as the Euro Area. If policy responses to shocks change in the Euro Area and the USA then the UK may find that it has to adopt a different monetary (and fiscal) framework in order to cope with changes in the external environment. For instance a shift to a much more aggressive set of policy responses in the Euro Area would make the UK external environment potentially more uncertain. Introducing a medium-term price level objective into the existing inflation targeting framework could then ensure that it was more robust. Changes in the structure of the Euro Area economies would also impact on the choice of optimal policy framework for the UK, with an increase in inertia in labour markets in Europe shifting the balance of argument away from inflation targeting toward a nominal GDP target[25] for the UK. The Euro Area is able to make a much more robust choice of framework (and hopefully it will do so) than can the UK acting on its own, and hence, like the USA it has much more chance of building up credibility for that framework than does the UK. If we remain outside it will be optimal to continue to change monetary and fiscal rules and targets, and hence harder to build reputation.

WHAT DO MONETARY AND FISCAL REGIMES ACHIEVE?

24. The Euro Area economies are discussing the reform of their monetary and fiscal frameworks at a time when the UK is assessing the case for joining monetary union. The longer term benefits of joining monetary union are discussed in Barrell (2002) and in Barrell, Hurst and Kirsanova (2003), but they are at least in part conditional on having monetary and fiscal frameworks that enhance stability and ensure that the level of private sector investment is not held back by high real interest rates that result from high public sector debt. It would be hoped that the Euro Area frameworks could enhance the stability of the UK economy, and active participation in the discussion of their redesign would be of value. There are a number of issues that need to be discussed when we compare regimes.

25. *Solvency and Good Housekeeping*. Fiscal frameworks help reduce the volatility and level of real interest rates and the more credible they are the lower the long term real interest rate. The existence of even minimum penalties can make a framework more credible as long as the possibility of implementing sanctions is itself credible. It is often claimed that fiscal frameworks reduce the ability of governments to use automatic fiscal stabilisers, but Barrell and Pina (2003) argue that this is not the case, at least if budget deficit targets are set sufficiently far from the penalty inducing floor. It is also important when assessing frameworks to be clear about the signal we may extract from a declining budgetary position. Many of the fluctuations we observe in budget deficits are driven by purely random shifts in tax receipts or elements of spending not immediately under the control of the government. If such shifts occur good housekeeping requires that either they are rectified or that other taxes are changed to compensate for shifts in revenues. Changes in taxes in such circumstances are seldom destabilising. A worsening of the budget deficit is at least as likely to come from a

[25] These issues are discussed in Barrell and Dury (2003).

random reduction in the tax take that would leave individuals with higher incomes and more spending capacity as from a slowdown in economic activity.[26] Setting and implementing a budget target in these circumstances can stabilise output volatility as well as the budget deficit. Good housekeeping requires a fiscal pact even in a country that runs its own policy frameworks, and the more binding the pact the more credible the commitment to low debt and low interest rates.

26. *Output and Uncertainty.* Different policy frameworks with different targets and feedbacks make different economic indicators more stable, with some making inflation more stable whilst others might impact more on output or the real exchange rate. The choice of framework should depend on the potential impact of the choice on the economy and the level of output. The evidence on the importance of volatility in the economy is wide and various, but it is clear from work reviewed in Pain (2002) and from Byrne and Davis (2002) that real exchange rate volatility does impact on investment and output. It is less immediately clear that the volatility of output impacts on decision makers, although higher volatility probably does reduce welfare. Inflation volatility, especially through its impacts on the real rate of interest, is also thought to be significant. Choosing the best framework for a country requires that we can decide which volatilities matter most and which framework reduces those volatilities at least cost. If the volatility of the real exchange rate driving trade in goods and services is the most important variable to consider then joining EMU may be the best framework for enhancing the prospects for output growth in the UK.

27. Monetary and fiscal regimes have significant effects on the future course of output and welfare, and they should be chosen in the light of these impacts. Stabilising intermediate targets such as inflation is only a good thing if it enhances output and welfare. There are other outcomes on which regimes should be judged, and the discussion of the choice of regime in the UK should focus on the ultimate objective of policy, and not intermediate indicators of it. We should also accept that frameworks should change as the world changes, and as reputations are built. Suggesting reforms to the UK's fiscal and monetary regime may reflect the need to acknowledge the fact that the world can change and that our understanding of it can improve.

[26] Barrell, Hurst and Kirsanova (2002) show that this is the case for the Euro Area countries. A similar result holds for the UK and for Japan.

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IAIN BEGG: THE SPATIAL DISTRIBUTION OF FINANCIAL SERVICES ACTIVITY IN THE EU

February 2003

HM Treasury invited Iain Begg to revisit his 1992 paper 'The Spatial Impact of Completion of the EC Internal Market for Financial Services',[1] with particular reference to the conclusions: "the benefits of…the internal market…will accrue disproportionately to existing financial centres" and "London, Frankfurt and Paris are currently seen as the centres most likely to receive the largest benefits because of their strong competitive position" and that cost pressures might "decentralise back office functions to regional offices, providing opportunities for lower cost regions." (pp. 345-346).

1. As the EU has become more integrated, both formally (the Treaty on European Union and the various legally binding directives agreed at EU level) and as a result of market-led changes in industry structure, there has been a gradual, though persistent trend towards integration of EU financial markets. Although technological change and deregulation have reinforced these trends, intensifying competition at the European level, an observation about the development of euro area financial services is that the pace of change has been slow (Begg and Horrell, 2002; Heinemann and Jopp, 2002). One reason is that the measures to integrate markets take time to work and need to accumulate before the overall impact comes through. Wholesale markets, as has been evident for some time, have integrated far more than retail markets (White, 1998; Danthine *et al.*, 1999; Begg and Altunbas, 2002). Cross-border mergers and penetration of national retail markets by competitors from other EU Member States have been conspicuous more by their absence than by their frequency.

2. Financial and, more so, business services have proved to be among the best performing sectors of economic activity in recent years and the UK has, on the whole, been one of the most successful Member States in these industries. In the mid-1990s, the financial and business services industries (defined as classifications j-k of the Standard Industry Classification) overtook manufacturing in terms of jobs and have since continued to be net creators of employment, whereas manufacturing employment has stagnated. Data for 2002 show that there are now some 47 per cent more jobs in financial and business services (hereafter, FSBS) in the UK than in manufacturing.

3. This pattern has, broadly, been emulated in other mature 'industrial' [sic] economies, although few others have had the extent of the structural shift witnessed in the UK. At sub-national level within the EU, the relative importance of FSBS as a contributor to economic activity varies substantially. Few regions have above average activity in these industries and it remains the case that the least prosperous countries and regions of the EU often have very low proportions of FSBS activity.

4. In the UK, by contrast, although FSBS are often associated, quintessentially, with the City of London, the geographical spread of activity across the country has been considerable. In part this is because of dispersion forces that have led to certain functions within the sector being decentralised away from London, driven by a combination of cost reduction strategies by companies, competitive imperatives and labour shortages in financial centres. But it also reflects both the spread of consumer demand and active targeting of FSBS activity in local economic development strategies.

[1] Begg, I. (1992) 'The Spatial Impact of Completion of the EC Internal Market for Financial Services', *Journal of Regional Studies* 26 (4) pp. 333-347.

5. This note revisits some of the conclusions drawn by the author in a paper published ten years ago (Begg, 1992). Two main propositions are examined afresh:

- First, that financial integration will tend to concentrate FSBS in 'core' financial centres across the EU with London retaining its position as the leading financial centre in Europe; and
- Second, that trends towards dispersion of FSBS activity through such mechanisms as the pushing out of routine processing of information to back offices will ensure that the benefits of the UK's competitive strength in financial services[2] (especially) will be widely spread geographically.

6. The next section examines the evidence on the UK's overall competitiveness in financial services, and draws on a range of sources to reaffirm the competitive strength of the UK. This is followed by a brief look at other financial centres in the EU, then at the sub-national pattern in Britain. Concluding remarks complete the paper.

THE UK'S COMPETITIVE ADVANTAGE IN FINANCIAL AND BUSINESS SERVICES

7. The UK's competitive advantage in financial services is visible both in the macroeconomic sense of the healthy balance of payments surplus on financial services, and in a range of quantitative and qualitative microeconomic indicators. Table 1 shows elements of the current account of the balance of payments. It can be seen that although the balance of trade in goods has been substantially in deficit in every year since 1991, rising to £33.5 billion in 2001, traded financial and business services have been consistently and increasingly in surplus. UK competitiveness and the structural shift in the economy can also both be seen from a comparison of traded services and traded goods. Exports of all FSBS relative to goods have nearly doubled over the last decade, and now amount to 25 per cent of exports of goods. In the same period, the weight of finance and insurance exports, again relative to goods, also doubled.

Table 1: UK Balance of payments on current account

	Trade balance, £mn			Exports of services as a proportion of exports of goods, per cent		
Year	Goods and all Services	Financial and business services	Goods	Financial and insurance	All financial and business	All services
1991	-6121	7412	-10223	4.5	13.0	30.8
1992	-7568	9383	-13050	5.1	15.4	33.6
1993	-6485	10296	-13066	5.5	15.4	33.9
1994	-4747	11936	-11126	5.7	16.3	33.6
1995	-3542	12479	-12023	5.2	15.3	32.5
1996	-4125	15001	-13722	5.5	16.9	33.4
1997	186	18825	-12342	6.6	18.2	34.7
1998	-9147	20770	-21813	6.9	21.5	39.5
1999	-15578	24187	-27372	8.4	24.7	42.4
2000	-18488	26516	-30326	8.9	24.6	41.1
2001	-22309	28411	-33609	8.7	25.3	40.9

Source: ONS

[2] Banking, insurance, securities and related businesses involving financial intermediation, as opposed to the broader range of business services which also embrace activities as diverse as accountancy, contract cleaning, employment agencies and legal services.

8. The reasons for the UK's strong position in FSBS have been explored in a number of recent studies and reports, most of which tend to point to similar factors. A first competitive advantage is the character of the financial system which, as a direct result of having been very open and relatively deregulated, has first-mover advantage in many of the segments of the emerging Europeanised financial market most open to cross-border activity. This particularly applies to areas such as securities trading (equities and both the public and private bond markets) and the range of investment banking functions. London, alone, has double the foreign exchange trading of the US and in many segments of the managed funds markets has increased its market share since the late 1980s.

9. Second, the accumulated benefits of agglomeration – notably the diversity of professional services on offer in the City, but also now in regional financial centres – confer a great advantage on the UK. Survey after survey confirms these advantages. Other factors reinforce these agglomeration benefits, such as the English language, the reputation of London as a 'clean' financial centre and, with the glaring exception of rail and other local transport, good communications and air transport infrastructure (Bank of England, 2002). Moreover, the advantages of agglomeration will almost certainly be given a further boost by the euro. In a recent report, the EU's Economic and Financial Committee (2002) came to the view that 'the principal channels for delivering the benefits of integration will be enhanced efficiency provided by larger and more liquid financial markets and greater competition among financial service providers.' With great pressure from successive European Councils to accelerate the pace of integration, this manifestly augurs well for London because of its leading position and the fact that it already has the most liquid markets in the EU.

10. Third is the revealed preference of non-EU financial intermedaries (FIs) to locate in the UK. A study of EU banking by the European Central Bank (ECB, 2002) shows that, in 2001 (i.e. three years into the single currency), the number of branches of non-European Economic Area (EEA) banks in the UK is as high as in the other 14 EU Member States put together. The assets of these branches are on average very much higher – by a factor of about ten – in the UK, further emphasising the UK dominance. Only Luxembourg, relative to the size of its economy, comes close to the UK as a magnet for these funds, but then only in relatively specialised segments of the market. Moreover, although the numbers fell everywhere, the UK's overwhelming lead in this regard had been maintained since 1997. The figures are not so pronounced for subsidiaries of non-EEA FIs, but still show a large UK lead.

11. A survey conducted by Chrystal et al. (2002) examined the factors that matter most for the location of investment banking – arguably, the most 'footloose' financial activity. They find that London continues to score highly on several of the factors that matter most which they sum up thus: 'London's relative strengths distil down to a high concentration of activities and skills, i.e. an excellent catchment area of skilled labour and positive externalities of scope and scale'. High costs and infrastructure deficiencies (especially transport) are the main drawbacks. The survey findings confirm London's continuing lead over Frankfurt and Paris. Possible regulatory changes are seen as a minor threat and there is some concern that the euro area members will favour a regulatory style less suited to the City if the UK stays out.

TRENDS IN OTHER MEMBER STATES

12. Competition between financial centres across the EU has resulted in a relative concentration of activity in two other leading centres apart from London: Paris and Frankfurt. Amsterdam, Milan, Madrid, Brussels amongst the other national financial capitals, as well as the second tier cities in the larger Member States, have a lesser role in which the principal activity relates to national FSBS or a narrow specialisation (for example Madrid's links with Latin America), with relatively modest amounts of international business.

13. Two small EU Member States have carved out niche roles through a combination of light regulation, adept market positioning and favourable tax rules: Luxembourg, building on its ability to offer favourable terms to Belgian and German investors; and Ireland which adopted an aggressive strategy from the late 1980s onwards to develop itself as a financial services centre specialising in fund management. There have also been piecemeal attempts to enhance the ability of selected centres (or groups of centres) to achieve dominance in selected market segments. The efforts led by Walter Seifert on behalf of the Frankfurt stock exchange (Seifert *et al*. 2000), or the Euronext initiative are good examples.

14. In a careful review of banking in the euro area, Belaisch et al. (2001) show that leading banks in the larger euro area countries have high costs and their profitability is generally lower than in the UK or the US. Regional and savings banks – often protected or insulated from competition – have better profitability, but their sheer number (Germany is the most striking in this regard) suggests that consolidation is likely in the medium-term, especially if the measures to integrate the internal market for financial services continue apace. The financial system in most Member States is still bank dominated, but Belaisch *et al.* find evidence of a growing trend towards disintermediation and greater resort to other forms of financing, drawing on the capital markets. They argue that the advent of the single currency has quickened the pace of capital market development, although here again the underlying trends probably have more to do with change in FSBS than the euro *per se*.

15. Reform has not been as rapid as might have been expected. A major constraint on continental banks has been their timid approach to labour cost cutting – partly because of social constraints. As a result, a large majority of continental financial intermediaries generally do not have favourable cost-income ratios compared with their UK counterparts.

16. Another facet of financial modernisation explicitly linked to EMU is discussed in a study by Peree and Steinherr (2001) who found that although France had taken steps relatively early to increase the attractiveness to investors of its public issuance of bond, Germany and Italy had been slow to do so, and even so London has been the leading centre for trading these bonds.

17. Estimates published in an assessment commissioned by the Corporation of London (2003) suggest that in 2002 the UK accounted 'for 57% of all investment banking and related activity in the EU, and is well over three times the size of the EU's second biggest market, Germany.'

18. Overall, there is no direct competition for London as the EU's primary financial services centre. Indeed, the Corporation of London (2003) found that there were strong complementarities between financial services activity in London and business elsewhere in the EU. According to the report, because of London's strength as a 'global financial centre, annual EU GDP is €33 billion higher, and employment 193,000 higher, than it would otherwise be'. Another claim in the report is that up to 30% of 'city-type operations' could be lost to 'other continents' without the agglomeration of such business in London. These strikingly high figures are based on somewhat generous assumptions, but even if they were scaled down substantially, the impact of the City on the EU economy would still be shown to be impressive.

PROSPECTS

19. Looking to the future, although all eyes are on the UK decision on participation in the euro, important changes are taking place in the regulatory environment through the EU's *Financial Services Action Plan* and the *Risk Capital Action Plan*. Studies done for the Commission tend to the view that these twin initiatives to further the integration of EU financial markets will favour the established financial centres and see consolidation of activity. The expected gains from EU financial integration for established centres are confirmed in one such study by Gianetti *et al.* (2002) who argue that the anticipated integration of the EU market and the renewed impetus given to it by the FSAP will have the outcome that 'in countries that are less financially developed, the financial sector stands to lose market shares and profits....In financially developed countries, the situation is likely be reversed. The financial sector will gain from integration.'

20. Chrystal *et al.* (2002) find that banks are deliberately adopting a neutral stance towards euro membership, but that they find the uncertainty regrettable. The principal competitive fear articulated by retail banks is that there will be long-term disadvantages from being outside the eurozone, with the effects coming from isolation from 'mainstream EU decision-making' and from a risk of clients opting for a service provider that is 'in'. The same study also examines investment banking and concludes that eurozone membership is well down the list of factors likely to affect business prospects. On balance, membership would be expected to increase the size of London offices because it would make sense to consolidate some euro-related activity (such as treasury functions or corporate finance and advisory activities) in London, but these gains could be offset by the disappearance of some foreign exchange dealing.

21. Nevertheless, the second-order impact of eurozone membership is summed up in the conclusion drawn by Chrystal *et al.* that 'there seem to be some benefits for London as an international financial centres if the UK adopts the euro, but no major threats if the UK stays outside the eurozone'. The inference to draw, however, is that the City would increase its EU market share and that, as the EU financial market becomes increasingly integrated, there would be benefits for users of financial intermediation services.

THE OUTLOOK FOR OTHER UK REGIONS

22. The spread of FSBS employment across British regions has tended to increase over the years, partly because of the overall success of the sector generally in the UK, but partly also because of changes in industry organisation.

23. The relationship between City success and the outlook for financial services elsewhere in the UK works through a number of channels.

- The first is that as the big City institutions focus predominantly on international business – in services such as accountancy or corporate law as well as investment banking – firms in regional centres within the UK are able to expand their client base among domestic firms. There is good evidence that clusters of firms develop on this basis, for example lawyers in Leeds. This market segmentation is evident from trends in the last twenty years.

- The second mechanism is reorganisation within financial institutions, driven by a combination of technological opportunities and cost imperatives. The back-office as a mere paper shuffling operation has been superseded by much more developed centres that provide a range of services to bank or insurance company customers. Call centres, computing facilities and various settlement

functions fit into this category[3]. Although the bulk of this activity relates to domestic retail financial services, some of the success of British financial services globally does spill over into these complementary activities.

- Third, there has been continuing growth in demand across the UK. There is a relatively greater reliance on private provision of what in other countries of the EU is 'social' protection and compared with other Member States, UK residents make more use of banks and of card services.

24. Together, these three trends have seen geographically widespread job creation in FSBS. London has a third of British employment in mainstream financial services (banking and insurance), over two-thirds of those working in financial markets, security broking and fund management, and half of those in other specialised financial services. But as Table 2 shows, there is a broad regional spread of FSBS. Arithmetically, the dominance of London necessarily means that other regions have below average proportions of FSBS, but even the region with the lowest share – Wales, with 12.1% of national employment – has over 60% of the national average. Even in the short period from mid-1998 to the end of 2000, the share of financial and business services in total employment rose in every region, with Scotland and Yorkshire and the Humber posting the biggest rises.

Table 2: Employment by region in manufacturing and FSBR

(Share of the sector in total employment, December 2000, per cent)

Region	Manufacturing	Financial and business services
North East	18.2	12.6
North West	17.6	15.9
Yorkshire and the Humber	18.4	15.2
East Midlands	22.1	14.3
West Midlands	21.6	15.5
East	15.0	19.5
London	7.1	33.6
South East	12.0	22.9
South West	15.0	16.3
England	15.1	20.4
Wales	18.6	12.1
Scotland	13.6	16.8
Great Britain	15.1	19.7

Source: ONS

25. Parr and Budd (2000) identify some financial functions where London is overwhelmingly dominant within the UK, a further five which it shares in differing degrees with four domestic rival cities, and a third tier of five more functions where eight other centres compete with London. This shows that there is, indeed, a broad base of financial capacity in what could be considered 'export-base' activities across the UK. Moreover, as the Bank of England (2002) emphasises, a specific strength is the fund management business located in Glasgow and Edinburgh which, with an estimated £326bn of assets under management places Scotland in the first rank of such specialist centres in the EU.

[3] An illustration of the emergence of these types of downstream activity is the call centre. A recent study shows that they are concentrated in the conurbations of Scotland and the North-West, but are also found in a number of smaller urban centres in the South-East (Bristow *et al.* (2002). Labour supply, especially of reasonably well-trained and flexible female workers, is a key location factor.

26. In other Member States, the geographical spread of the higher level financial services is not so great, with the possible exception of Germany where Munich – the home of Allianz and Munich Re, the insurance market leaders – is a rival to Frankfurt and other regional centres such as Hamburg owe a marked presence in financial services to a combination of the regionalised banking system and specific attributes. In time, the trends just identified for the UK are likely to produce a similar dispersion of some of the 'lesser' financial functions in other Member States, but there no obvious reason to expect this to be at the expense of UK regions, because these tend to be complementary functions.

CONCLUDING COMMENTS

27. The UK financial services industry is the best developed, most diversified and, arguably, most competitive in the EU. It has the manifest advantages of the City of London in its role as Europe's one global financial centre, and of having a regulatory environment that has encouraged innovation and helped to sustain competitive advantage.

28. The spread of financial services activity across the UK has also continued, with signs that it is developing into more than just dependent processing functions. These assessments have not changed materially in the last decade and, if anything, the UK's position has improved.

29. On its own, the euro membership decision, according to the study by Chrystal *et al.* (2002), will be of little salience to the strategic decisions of UK retail banks compared with major shaping factors which are identified as 'competition, consolidation, M&A, regulation, Internet and technology, demographics and macroeconomic trends'. Other evidence supports their sanguine view that euro membership would pose few threats but might well lead to opportunities.

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