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H M TREASURY
ECONOMIC AND MONETARY POLICY: CALL FOR EVIDENCE
REVIEW OF THE BALANCE OF COMPETENCES

Submission by John Chown¹

INTRODUCTION

We are asked to deal with any or all of the questions set out. Briefly I do not think that the current government structure (Question 4) that we have the right balance and for reasons explained in more detail below, this may become a serious issue. There is (Question 6) some evidence of indirect impact, and I make a major point below under “pensions”. Dealing with Question 8, this is the main continuing danger.

The crisis and the way it has been handled has damaged the economy not only of the Eurozone but of the European Union as a whole. More importantly, though, the further steps that will surely be needed will inevitably risk impacting on the ‘outs’. The main part of my discussion will relate to Question 13. “What are the key challenges in terms of implications for the UK of likely future developments in these areas?” and here I will have to go back into the early history and some broad issues to show what is likely to happen again, and what we need specifically to guard against.

This paper is written from a broadly informed point of view. Although I made my career and reputation in international tax I began as, and remain, a monetary economist, having won the Adam Smith Prize at Cambridge for a dissertation on fixed versus floating exchange rates. More recently, I published “A History of Monetary Unions”² and as a general supporter of the European Union was an active member of Christopher Johnson’s “Association of Monetary Union in Europe” where my accepted role was to prepare a detailed analysis of the economic problems, in the hope that we could find solutions.

EVENTS

We, and others concerned had hoped that that the long awaited 1995 Green Paper would provide sensible answers to these questions. It didn’t and was an economically illiterate, entirely political, document and we predicted that if it went ahead on that basis, it would be a disaster waiting to happen. All went well to begin with although once the rates

¹ Chown Dewhurst LLP, 51 Lafone Street, London SE1 2LX.

² “A History of Monetary Unions”, John Chown, Routledge, 2004.

were fixed the euro fell sharply against other currencies. There was also inevitably some rounding up of prices when euro bank notes replaced domestic ones.

One of my main reasons for opposing UK membership of the Eurozone in that form was the inevitable risk of a fiscal union and having to bail out countries where pensions were an unfunded liability of the government.

In 2001, Eurostat published projections of the impact of what percentage of GDP each of the Member governments would have to finance to meet these pension obligations on 'unchanged policies' which were far worse than even I had expected. Based on these figures, I gave a talk to the Chatham House Economics Group: "Will the Pensions Time Bomb Blow Apart Monetary Union?" pointing out that unless steps were taken in time the "disaster" would hit by around 2020. (Eurostat and I both hoped that these figures would be taken as a warning rather than as a forecast.) The figures were later updated going out to 2060 and taking account of the, by then, 27 members. These show little improvement and although there have been changes in recent years, these do not go far enough particularly in France. Appendix 2 gives more detail on this issue which has not gone away, will remain, and is a problem.

Meanwhile, the crisis (originating outside the EU) had intervened and when the EU aspect became clear, I assumed that some or all of the weaker countries notably including Greece would leave the Eurozone, perhaps with the opportunity of rejoining a properly thought out version, at a more sensible exchange rate. This would be accompanied by an orderly debt write down leaving the core countries in a workable Monetary Union. Several people had suggested that I entered for the Wolfson Prize to which I replied that any sensible proposals would only work if they carried out in utmost secrecy. Interestingly, both the winner and the runner up in excellent entries pointed out that their proposals would also require secrecy. (Incompatible with publication.) There was and is clearly a huge political will behind the Euro project and many steps were taken but there was a danger that an obsession with this might finish up wrecking the European Union as a whole. The outcome, so far, seems to have worked well, but the Eurozone probably could not survive another shock (possibly the pension fund by the end of the decade but more likely something else) without moving closer to a fiscal, and maybe a Federal Union. Absent this, the very existence of the European Union could be threatened.

Because the European political class were reluctant to admit that the Euro experiment had failed, they have proved desperate in their attempts to preserve it at any cost. This cost already been high: the Greek "non-default" in a much smaller country cost twice as much as the previous record (Argentina) which in turn was twice as expensive as Russia in 1998. (I followed the latter particularly closely as I was in Moscow advising on the taxation of capital markets six times during that year.) Cyprus, an even smaller country, was a near disaster and the next such incident would surely be the end.

A couple of years ago, it seemed to be generally accepted that the Eurozone, or at least a core of its members, will have to move in the direction of a "Genuine Economic and

Monetary Union” on the lines suggested in the November 2012 Blueprint.³ This claimed the introduction of the euro as “one of the most far-reaching achievements” of European Union but (correctly) says that “EMU is unique” in combining centralised monetary policy with decentralised other economic policies, and this clearly envisages a move towards a fiscal and transfer union the implications of which it discusses at length. The language is a little inconsistent on whether it is referring to the “Eurozone” or the “EU” perhaps because its authors were not particularly interested in the second question. For instance, the opening paragraph of section 3.3 says “the European Union should move towards a full banking union, a full fiscal union and a full economic union” but goes on to refer to the creation of an EMU Treasury. I gave invited evidence to the House of Lords Committee⁴. There now seems to be an assumption that all is well and that the crisis is over. I doubt it.

The danger is that governments under pressure sometimes adopt a solution without considering the “law of unintended consequences”: solving one problem can, and often does, create others. Problems need to be solved, but first they must be recognised, acknowledged and analysed in depth. Both history and economic analysis suggest that a monetary union cannot survive without eventually becoming a political union. This itself raises problems for the Eurozone members themselves, one of which what is to be done about the weaker members or those who are, at this stage, candidates. More important for the United Kingdom and other ‘outs’ is whether and how this can be achieved without prejudice to the independence of non Eurozone members such as ourselves. Would this mean a total revision of the Treaty or would they attempt to do this under the Enhanced Cooperation Procedure? Either way, there are serious issues we would have to address. Indeed, the attempt could be an opportunity as well as a problem. The Eurozone, as is generally agreed, would have to ensure:

- effective arrangements for ensuring that each country maintains fiscal discipline.
- absolutely clear provisions that (as with long-standing and fully fledged Federal Unions) each State is responsible for its own debts. “No bail out”.
- adequate arrangements for emergency inter-state transfers – with IMF type safeguards and conditions - as happened in the days of Bretton Woods.

The second bullet should be no problem. We would be perfectly happy with no bail out and it is in our interest that it should be imposed on others. The first and the third are another matter. Yes, we want fiscal discipline within the Eurozone but this must not be used as an excuse for meddling by Brussels in our internal finances, including of course taxation which at present is meant to be protected. Neither must there be any obligation, moral or legal, to participate in any transfer arrangements. On this point, pensions is the most serious of many dangers.

³ “A Blue Print for a Deep and Genuine Economic and Monetary Union”, 28 November 2012.

⁴ The House of Lords EU Sub-Committee on Economic and Financial Affairs: EU "Genuine Economic and Monetary Union" and its implications for the UK. 2013

PART 2

We now need superb diplomacy untrammelled by short-term political considerations and liaise closely with our fellow EU members. Many of them, to my knowledge, have their own concerns and that discussions may help us to achieve our ends. Negotiation, after all, involves give and take and we need to consider carefully what points we can give up, and where it would be helpful to support changes which do not directly concern us on a reciprocal basis.

We need a positive approach to a free trade in services. The main advantage of an economic union is to make sure that each country can build on the benefit of its comparative advantages for the benefit of consumers as well as producers of such services. The EU has given great value on facilitating trade in goods even though some countries still try to promote and protect 'national champions' to defend themselves against competition. An interesting question, which I do not discuss, is whether we should encourage or discourage EU wide banking regulation. From a competitive point of view, it could benefit us, but an inappropriate attempt could be damaging.

If the Eurozone decides, or is forced, to move more closely in its tax and other economic arrangements, we may be able to treat this as an opportunity rather than as a problem. It is, or should be made to be, impossible to achieve this without either a Treaty or the use of the Enhanced Cooperation Procedure. The latter is intended to make it possible for a group of Member states to make arrangements between themselves provided that that this does not impinge on other Members. (See Appendix 1.)

EARLIER HISTORY

It is fascinating to see what has happened before and we now have information about earlier attempts to create a Monetary Union. These have lessons for us. Harold James ("Making the European Monetary Union"), which I reviewed in the February 2013 issue of Central Banking, had had access to archives covering the period to 1993 – Werner and the Snake, and Delors and the ERM. It was fascinating to have a detailed account of the really informed discussions which then took place about the key questions: does a monetary union need a comprehensive fiscal and economic union, a central fund to support the currency of countries in trouble, a central authority to coordinate banking regulation and overall control of the budgets of participating countries? Some participants thought these changes were inevitable while others regarded them as grounds for rejecting the proposals. The book obviously discusses which countries took which view. There are no surprises and these are precisely the issues which appear to have been ignored by those responsible for creating and now attempting to save the Eurozone, but we may have to wait 20 years to find out. There is certainly plenty of evidence to show that economic views were ignored. Those who had been working on that project defend themselves by saying "it was a political decision".

Something is revealed in a recent book "Alexandre Lamfalussy: The Wise Man of the Euro". He clearly recognised that monetary union need to be accompanied by a closer fiscal union but supported the efforts of Delors who clearly saw monetary union as being a first step towards forcing a level of union which could not have been negotiated in a politically acceptable way.

APPENDIX 1:

FINANCIAL TRANSACTIONS TAX

When the Commission first proposed a Financial Transactions Tax, (for the EU as a whole) I was appointed the 'expert' on the subject by Lord Lawson and was horrified (as I am sure James Tobin would have been) when I read the whole document. I decided to take a very active part in the opposition to this, including giving evidence to a House of Lords Committee.⁵ This having been rejected, it was re-introduced by a group of countries that signed up to it under the Enhanced Cooperation Procedure. This proposal was endorsed by the European Parliament but all of us, including signatories (!) had to wait some months before any of us actually saw what the proposal entailed. They were virtually unchanged from the original proposals.

Although this should obviously apply only to the participating countries, Commissioner Semeta said he plans to impose it on "financial transactions carried out by financial institutions established in the EU wherever they intervene in these transactions" meaning, he added, "to put it simply one would have to abandon their entire EU client base to escape the tax"! His attitude to information sharing, and other subsequent events, confirms that he was determined to get this nonsense through by means fair or foul. (He may of course no longer be the Commissioner by the end of the year.)

An initial challenge before the European Court of Justice was rejected on the grounds that there was too little information. If, and when, such information is available, the challenge will certainly be repeated. To uphold the tax, the ECJ would have to assert two things. First, that something called a tax, the intended result of which is the transfer of money from taxpaying businesses to tax collectors, is not a tax, changes in which cannot be imposed by the Commission without the consent of all Member states. Second, it would have to claim that provisions of Articles 326 and 327 which are intended to ensure that these (for example) "respect the competencies, rights and obligations of those Member States who do not participate in it". Both are surely impossible tasks, but perhaps not beyond the ingenuity of the European Court of Justice.

⁵ The Select Committee on the European Union, Economic and Financial Affairs and International Trade (Sub-Committee A) Inquiry on Financial Transaction Tax. 2011.

APPENDIX 2

PENSIONS

Pensions for ageing populations is everywhere a major policy issue. Being aware of this and knowing that this would have very different impacts of different countries, I had been concerned about it without having done any serious research. In 2001, Eurostat published figures which really bring out the differences between the funded and Bismarckian countries. The next promised, but delayed, update only included the demographic information, Eurostat having been instructed to omit the figures on the financial consequences to the various countries. The 2009 Ageing Report covered all 27 European Union members with the full figures out to 2060. What we, and they, were saying were not intended as predictions but as warnings of the urgent need for policy changes.

Their estimate of public pension expenditure as a percentage of GDP for 27 EU members shows, unsurprisingly, that the 'funded' countries, the United Kingdom, Denmark, the Netherlands and Sweden do far better.

The difference is of course mainly due to the size of private pension assets. We also have figures of the size of national independent pension funds alongside GDP and the percentage comparison. Interestingly, the Commission fairly recently suggested that the UK pension system was underfunded (true) and that we should do something about it. They failed to mention that our pensions were backed by about €1 trillion of independently held assets while the very similar obligations of the French, which are, as it happens, almost identical to those available in the UK, are simply an unfunded off balance sheet liability of the French government.

Versions of the Chatham House paper were updated from time to time and widely discussed. (Detailed figures can be made available with or without some minor updates.)