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Wage inflation on the rise

American and European central bankers forget an old lesson

Unemployment beneath the natural rate associated with ever-rising inflation

The heart of the post-monetarist policy consensus is that macroeconomic policies should not be used actively to reduce unemployment. The reason is well-known. There is only one rate of unemployment, the so-called "natural rate", at which the demand for and supply of labour are in balance, and the rate of wage increases is stable. If governments drive unemployment beneath the natural rate, the excess demand for labour causes an increase in pay growth (from, say, 3% to 4%) in year one. The higher rate of pay growth leads to a higher rate of price increases, which affects expectations of future inflation. When these expectations are incorporated in pay bargaining in year two, continuing excess demand for labour leads to another increase in pay growth to 5%. If unemployment stays beneath the natural rate, pay growth rises to 6% in year three, 7% in year four and so on. Low unemployment is not associated with stable high inflation (as Phillips believed with his famous "curve" in the 1950s), but with ever-rising inflation (as Friedman explained to the American Economic Association in 1967).

Unwise to cut interest rates when unemployment is beneath the natural rate

The application to this theory to policy-making is awkward, because the natural rate of unemployment cannot be directly observed. It has to be estimated by econometric techniques of debatable reliability. At any rate, central banks need to watch the data and ensure that pay growth is fairly stable. If pay growth has been rising for several quarters, a fair deduction is that unemployment is beneath the natural rate. If so, a major easing of monetary policy would be dangerous. To lower interest rates when unemployment is beneath the natural rate may cause a further fall in unemployment, which would entrench inflation expectations, aggravate the rise in pay growth and lead to yet higher inflation.

Unemployment is beneath the natural rate in the USA and the Eurozone, but the Fed (and perhaps the ECB) are easing policy

What, then, has been happening to pay growth in the leading industrial nations? In the USA the annual rate of increase in business sector compensation per hour was 5.0% in 2000, after 4.6% in 1999, 5.3% in 1998, 3.1% in 1997, 3.2% in 1996 and 2.1% in 1995. In other words, pay growth increased from about 2% in the mid-1990s to about 5% in the late 1990s. The clear implication that the rate of unemployment went beneath the natural rate at some point in 1996 or 1997, and at 4.2% it must still be so. In the Euro-zone the data do not go back so far, but Euro-zone "labour cost indices" are now published in Table 5.4 of the European Central Bank's *Monthly Report.* The annual increases in the total index were 3.4% in 1996, 2.5% in 1997, 1.8% in 1998 and 2.3% in 1999. The quarterly number for the annual increase had reached 2.7% in Q4 1999, and advanced to 3.4% in Q1 2000, 3.7% in Q2 and 3.8% in Q3. On the face of it, the Euro-zone unemployment rate dropped below the natural rate sometime in mid- or late 1999, when it was about 9 1/2% - 10% compared with the current unemployment figure of 8.8%. The data therefore hint strongly that unemployment is beneath the natural rate in both the USA and the Euro-zone, and imply that the current policy easing will be followed by rising inflation over the next few quarters.

Professor Tim Congdon 30th March, 2001

Summary of paper on

"The euro: a currency without a country"

Purpose of the paper

This year a referendum on British adoption of the euro may follow the general election. A key question - at the heart of Lord Lamont's recent speech to a Lombard Street Research/Capital Economics conference - is, "does monetary union need a political union for it to work properly?".

Main points

* **The introduction of the euro has had both advantages and disadvantages. One favourable development has been an improvement in European public finances. (See p. 6.) But the weakness of the euro is difficult to understand and may be due a "fatal flaw in the concept" (p.7). One possible explanation is that "the euro lacks a government behind it".**

* **The lack of a unified European government may have increased the European Central Bank's independence, but in other respects it is a weakness. The ECB cannot expect pan-European labour market reform and it does not have political accountability.**

* **The one-size-fits-all monetary policy has led to inappropriate interest rates in some European countries, notably Ireland and (since January 2001) Greece. (See pp. 8 - 9.) Both the level of Euroland inflation and the standard deviation of the 12 Euroland inflation rates have increased since January 1999. (See p. 10.)**

* **Economically, the euro "will not have been fully tested until it has been through a recession" (p. 14). But "the euro is a political question as much as an economic one".**

* **"The main drawback of Europe as a political entity is simply that it doesn't work." (p. 14) Its workings depend on "bureaucratic intergovernmentalism" (p. 15), not democratic consent. This leads to lack of accountability and - ultimately - to corruption.**

* **Democracy in Europe is "essential" (p. 14), but people identify with their nations, not with Europe. Until people identify with Europe rather than their own nations, Europe will not have a government and the euro will not work.**

Lord Lamont's speech was given on 28th February at Gibson's Hall in London, at the first Annual Economics Conference held jointly by Lombard Street Research and Capital Economics. Charts and lay-out were prepared by Lombard Street Research's UK Service.

The euro: a currency without a country

Lord Lamont's lecture to the first Annual Economics Conference, held jointly by Lombard Street Research and Capital Economics

The euro – a currency without a country – can that work?

It seems a long time since that heady day on lst January 1999 when a large crowd was assembled in Brussels to drink champagne and on cue wave their blue flags with twelve yellow stars. To cheers a European Union spokesman portentously announced to the world "At last Europe has a currency to stare the dollar in the face". "In the knee" might have been a more appropriate description, as the new currency failed to live up to its hype and reached ever new lows, reaching rock bottom at 82 cents, last October. However since then the euro has staged something of a partial recovery, and now stands at 92 cents, 15% up from its floor, but still well below the launch point of $1.17 to the euro.

A summary of the arguments for and against

It was always wrong for Eurosceptics to make so much of the fall in the euro. If you wish to defend national currencies because you think a country needs exchange rate flexibility you cannot attack Europe for using that same flexibility. Whether the weakness of the euro reflects concerns about the whole concept of the euro is a question, which I will address. But there are many other criteria by which the euro might be judged.

The arguments in favour of the European single currency are easily summarised:-

> Savings on transaction costs, greater price transparency, price stability, and most important of all increased economic and financial integration, thus increasing trade and investment.

The arguments against the single currency are equally easily summarised:-

> the problems of a "one size for all" monetary policy, the risks in abandoning flexible exchange rates, the need for flexible labour markets, the dangers of tax harmonisation, and further political integration leading to a European state.

It is easy to list the arguments on both sides. What is more difficult is to balance one against the other. How can one trade off the loss of exchange rate flexibility against the potential gain of further economic and financial integration?

Euro's introduction spurred improvement in fiscal policies

Let me start by saying something positive about the euro. The preparation for the euro has clearly had beneficial consequences. The convergence criteria embodied in the Maastricht Treaty were undoubtedly sound ones. Low inflation, low budget deficits and low borrowing are in themselves good. The prospect of the single currency led many countries in Euroland with unsound fiscal policies to put their house in order so that they would not be left out of the project. The preparation for the euro has undoubtedly made Euroland so far into a zone of stability and low inflation. But one might wonder, would it have been even better to have travelled hopefully than to have arrived?"

Euro weak since inception

Depreciation of over 20% against dollar since 1st January 1999

Chart shows daily exchange rates of the euro against the U.S. dollar and the pound sterling. Values pre-1999 relate to a weighted synthetic euro constructed from national currencies of member nations.

Source: European Central Bank

Lowest Euro quotation against $	0.8252 (26th October 2000)
Lowest Euro quotation against £	0.5707 (3rd May 2000)
Fall against $ from 1st January to 26th October, 2000	29.3%
Fall against £ from 1st January to 3rd May, 2000	19.1%

The public finances of the countries of Euroland since January 1999 have continued to be strong, even though there remain concerns that countries like Italy, having qualified for the euro, might not continue with fiscal discipline. In general, however, the strong recent growth of GDP and the sharp fall in unemployment have brought smaller deficits and bigger surpluses. On a cyclically adjusted basis the deficit for Euroland last year was overall 0.9% of GDP ranging from a surplus of 3.3% in Finland to a deficit of 1.2% in Austria.

The single currency has had a big impact on the European financial markets. The single unit of account has standardised prices of financial products producing savings in transaction costs, making markets more transparent and helping to develop a European capital market. Increasingly investors don't just look at countries but weight their portfolios by industries on a Euroland-wide basis. There has been an increase in international mergers and takeovers in financial services both within the euro zone and also between Euroland and the United States. Perhaps the most striking effect has been the growth in the euro denominated bond market, which is now larger than that of America.

The Euroland economy: growing but not because of the euro

But the most important criterion for judging the euro must be Euroland itself. In the long run the euro will be judged by the performance of the economy. After a long period of semi-recession and sluggish growth, Euroland is again growing relatively strongly. The real rate of growth of GDP increased from 2.1% per annum in the second quarter of 1999 to 3.4% last year. Unemployment has also fallen from 10.9% in 1998 to around 9%. Some of the countries with the highest unemployment rates have seen significant falls, particularly Spain and Ireland. This year Europe's economy is expected to grow faster than that of the USA but the corks should remain firmly in the champagne bottles because Europe's growth will still slow to 2.5%-3%. However too much should not be read into these figures. It is impossible to disentangle the economic consequences of the single currency from economic developments which are a consequence of the cyclical recovery in European economies.

Why has the euro been weak?

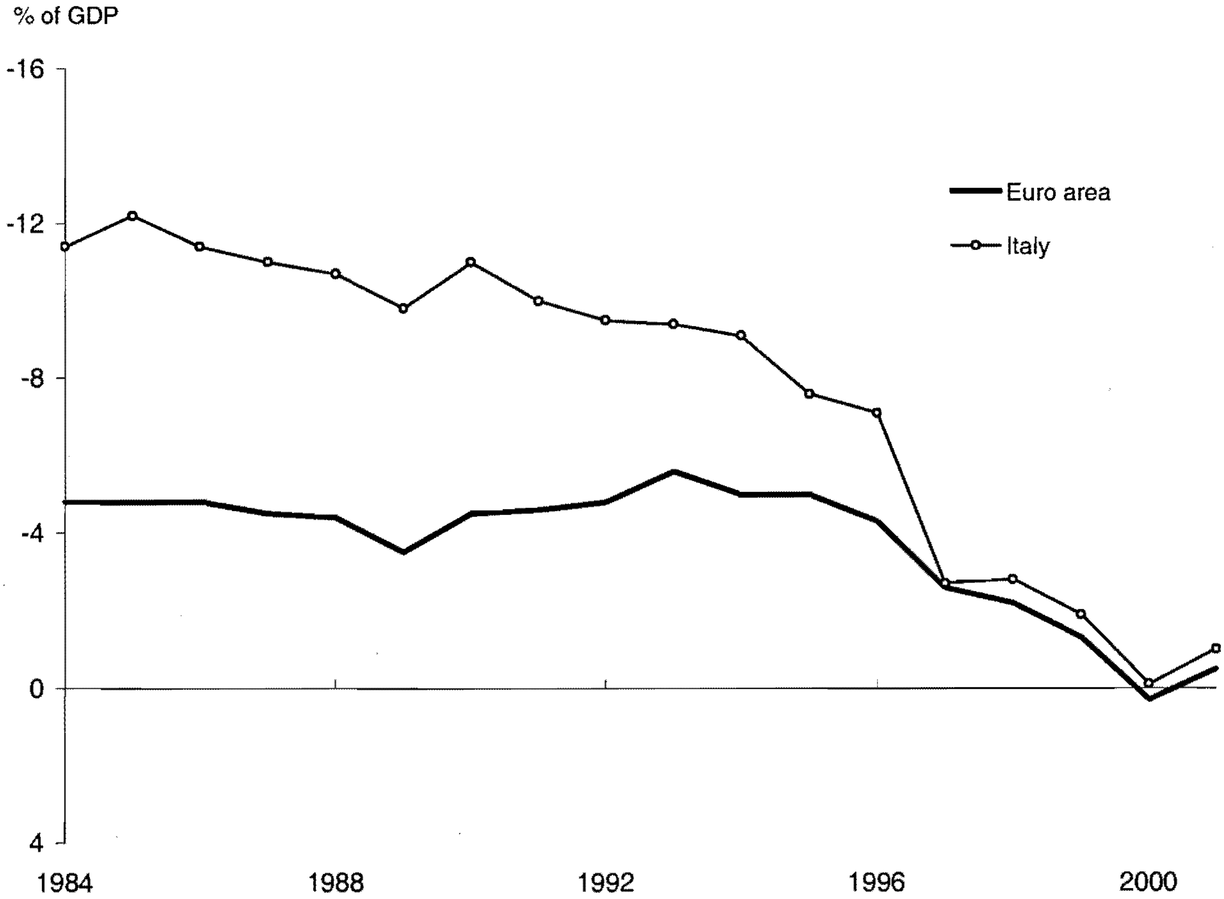
The initial weakness of the euro has caught the headlines, but what has happened is not particularly unusual compared with past exchange rate movements. Over the 20 years to 2000 the exchange rate between the US dollar and the ecu and then the euro has gone from as high as US$ 1.40 to as low as US$ 0.65. The fall in the euro against the US dollar between 1st January 1999 and 1st October 2000 was less than the fall in the ecu between 1990 and 1995.

Nevertheless, the weakness was embarrassing in the light of previous statements. At times apologists seemed to be running out of excuses. The most widely given reason for the weakness of the euro was that it reflected the capital outflows from Europe to the United States. With the benefit of hindsight this does appear to have been a significant factor: official figures now show there was an outflow of 133b. euros from the EU in the first 11 months of last year. Viewed in this light weakness of the euro has reflected the superior returns of the USA which have been an irresistible magnet to investors.

The benefits of the convergence criteria

Euroland countries achieve budgetary discipline

Chart shows general government financial balances as a percentage of GDP for Italy and the euro area as a whole. Figures are annual.



Source: OECD *Economic Outlook*

Control over public finances was regarded by the Bundesbank as essential to the successful introduction of the euro, when the single currency was first broached in the late 1980s. The chart shows that the public finances of the Euroland nations improved substantially before the euro's creation on 1st January 1999, but the improvement was very uneven over time. Hardly any progress was made before 1995, when Italy had a crippling foreign exchange crisis. But Italy then embarked on radical fiscal retrenchment, while the prospect of euro membership led to a sudden decline in interest rates and so in the heavy interest cost of Italy's public debt. Italy has been the big winner from the single currency project, but its deficit remains above the Euroland average.

The American economy is now slowing rapidly, may well face recession and this has led to weakness in the dollar. Looking at it this way the partial recovery in the euro seems to have had less to do with the euro, and more to do with the US economy and stockmarket. However, as long as there remains a great difference in profitability and productivity this will always be something of a shadow over the euro. If this is the real explanation for the performance of the euro it makes even more urgent the need for European structural reform. All European central bankers including Mr. Duisenberg keep saying that the performance of the euro has not reflected economic fundamentals. That is not unknown. Markets often do not reflect fundamentals. But it is worth asking the question. If the euro does not reflect the economic fundamentals of the economies of Euroland, is it reflecting something else? Is there some fatal flaw in the concept?

Does the euro need a Government?

It is worth looking at a number of alternative explanations for the euro's weakness. One is that the euro lacks a Government behind it. The European Central Bank has no political counterpart. Interestingly the argument that you couldn't have a single currency without political union, and by implication a Government, was one put forward by the Bundesbank twice in statements in 1990 and in 1992. Significantly also Chancellor Kohl a few weeks before the Maastricht Treaty was signed in December 1991 threatened that Germany would not give up the deutschemark unless there was a commitment to political union in Europe.

A unified Government might undermine ECB independence

Why should the markets worry about the absence of a Government, which would be likely to interfere? Indeed, the very fact that the European Central Bank is firmly put beyond the reach of any Government was rightly perceived as one of its strengths. The whole framework in the Maastricht Treaty was designed to make the European Central Bank the most independent in the world. The absence of a European Government guarantees that independence.

However, the fact that a single government does not stand behind the euro may be important in other ways. The Bundesbank may yet have a point. If there were a European government there might be a greater chance of European-wide labour market reform that many rightly see as crucial. Political union does not guarantee labour market flexibility, but a European Government could make it more likely. I shall return to this point later.

A weakness in the European Central Bank is that its votes take place in secret. This is in marked contrast to the "glasnost" of the Bank of England begun by myself where Minutes are published regularly and everyone can see which way individual members of the Monetary Committee have voted. The European Central Bank (ECB) refuses to reveal how individual Central Bank Governors have voted and this fuels suspicion that they have been voting along national lines.

Ireland: a success story endangered by the euro

The irony is that such problems as the Irish economy has stem largely from their membership of the euro. From the very moment Ireland joined things started to go off track. Ireland was forced to halve interest rates when it joined the euro, precisely at the time it should have been raising rates. The result was inflation rose from under 2% to nearly 7%, the highest level for over a decade. The situation, of course, was exacerbated by the weak euro. Outside the euro zone the punt would have been stronger and inflation therefore more constrained. Measured Irish inflation has since fallen back to a more acceptable headline rate of 4.6%. But this apparent improvement is not all that it might seem, since it was assisted by a 1% cut in VAT. Clearly inflationary pressures remain strong.

The growth in the Irish economy shows all the classic symptoms of a boom out of control. Bank credit has been rising by over 30% per annum, house prices are rising very sharply. This state of affairs remains surprisingly popular in Ireland. One is tempted to quote a remark once attributed to an Irishman "reality is an illusion caused by the absence of alcohol". The Irish Government can do little because they cannot put up interest rates, which is what is needed. Maurice O'Connell, the governor of the Bank of Ireland has said, "I keep telling everyone it can't go on – I sound like Cassandra. But there's nothing we can do".

Easing of Irish fiscal policy controversial

One consequence of continuing high inflation will be pressure on wage agreements, which have been central to Irish economic policy in the past. It is because of the importance they attach to wage restraint that the Government chose to cut both income tax and VAT in the budget. This has been the point of disagreement with the Commission, which felt that fiscal policy should have been tightened. The point is certainly arguable. But even if the Commission are right it seems extraordinary that they should have been so inept, and so keen to prove one of the claims of the Eurosceptics, namely that - under a single currency - countries will not be allowed to pursue their own economic policy.

The Irish economy is in many ways unique. It has greater mobility of labour than any other European economy. In recent years it has experienced both large-scale inward investment, and also the return of Irish emigrants from the USA. Further back in the past Ireland has shown an ability to export some of its unemployment to Britain so Ireland has the characteristics of a remarkably flexible labour market.

Circumstances may bring about a soft landing in Ireland. First the American slowdown is important for Ireland which now exports more to the USA than to the UK. Secondly, there has been a downturn in the market for technology products, of which Ireland is now a major manufacturer. Thirdly, the slight rise in the euro is also helping. But there is still a risk the boom will be followed by one of the biggest busts that Ireland has ever experienced. Clearly, one interest rate does not fit all Euro economies, any more than one drug would suit all patients with divergent medical conditions. If Ireland escapes without pain, it will owe as much to luck as policy.

The consequences of a "one size fit all" interest rate: widening inflation rates

Since the beginning of the year the euro zone has been joined by Greece, which threatens to become a second Ireland. Just like Ireland, Greece has had to slash its interest rates by 6 points so that they would converge with those of the European Central Bank. In December, Greece's headline inflation rate was 3.9%, almost twice the ECB's target upper limit. Greece was allowed to join the euro despite having forecast inflation would be 3%, and despite having a debt to GDP ratio of 103% well above the Maastricht limit of 60%. Greece, like Ireland, will be helped by falling oil prices, and the modest recovery in the euro. But clearly Greek interest rates are also not designed for their own circumstances. The same, to a greater or lesser degree, is also true of Spain and Portugal.

The euro was above all meant to bring monetary stability and indeed the short-term effect has been that. Inflation rates are much closer together than they were over a decade ago, and are also lower. Whether a "one size fit all" interest rate will permit this to continue is a different question. Ironically, the consequence of the single interest rate may be to bring back instability. The single currency will widen the inflation differences between countries, and simultaneously remove from countries the means to iron out those divergences, and thus make booms and busts more pronounced.

Euroland's convergence in terms of inflation has been achieved by divergent means. The inflation rate required by the Maastricht Treaty has been brought about by different countries having different interest rates. It required a much higher short-term rate of interest for Italy to deliver inflation of under 2% than it did for Germany or Holland. The question is whether a single interest rate will produce similar results in Italy, Germany and Holland. Or will there be a propensity to higher inflation in Italy?

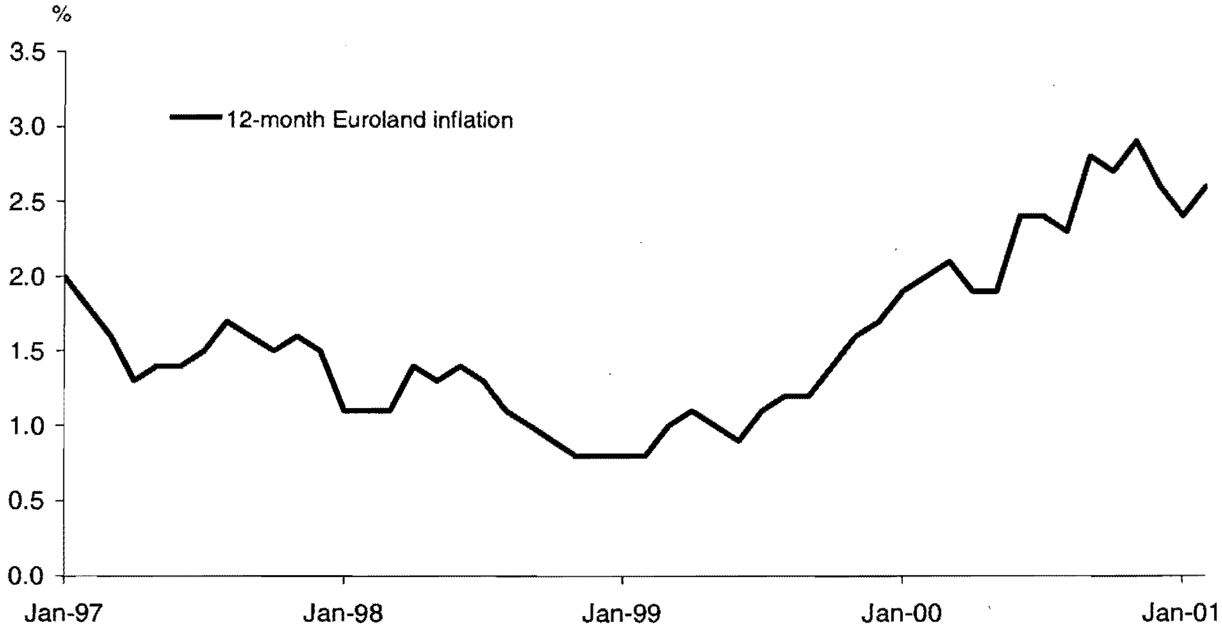
We can already see what is happening. In Euroland overall differences in inflation rates have widened. In the first quarter of 1999 country inflation rates ranged from 2.6% in Finland to 0.1% in Luxembourg. At the end of 2000 they ranged from over 6% in Ireland to 1.6% in France. These differentials may appear slight, but the worrying feature is that they have appeared relatively quickly. (See chart on p.10.) In theory, a single currency should in the long run, narrow inflation rates because goods will be transparently traded in a single market place. But this takes time. Differences in inflation may sound harmless enough but they tend to lead to differences in unemployment.

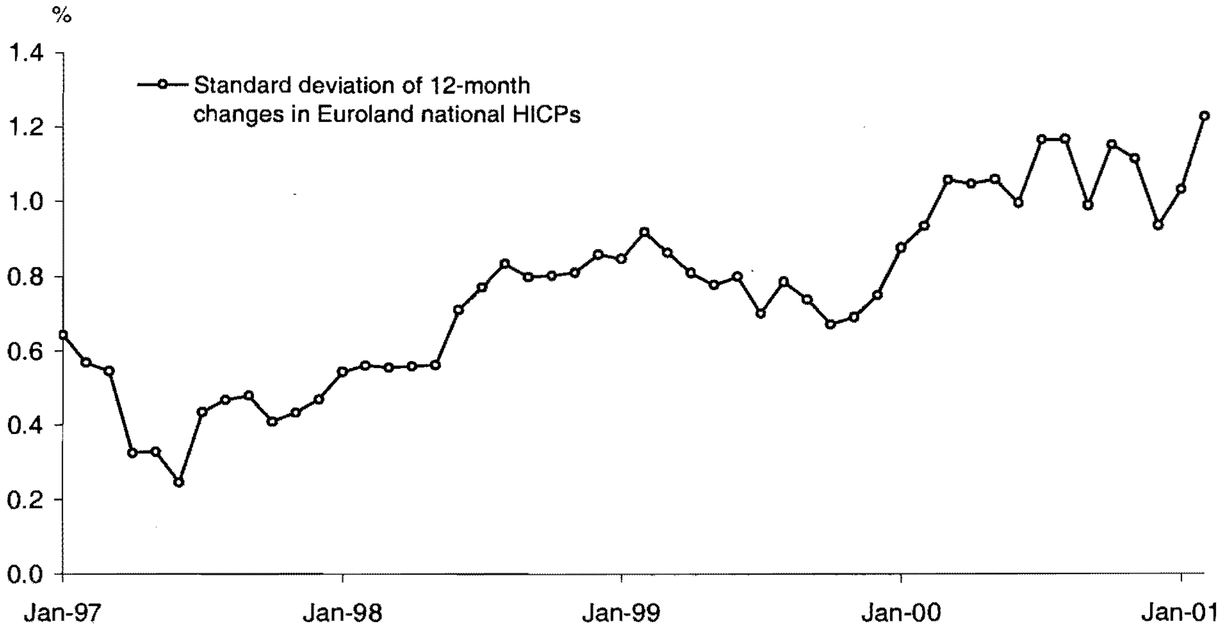
Defenders of the euro tend to point out that in the single currency area of the United States there are significant regional differences in inflation, and unemployment. It is surprising how the same people who make this point, at the same time deny the single currency will lead to Europe becoming one country. But it is easier for differences in inflation and unemployment to be tolerated within one country. And if there are sharp differences in employment will that be so easily tolerated by the citizens of the country which is suffering?

Is one-size-fits-all working?

Euroland sees widening inflation divergences, as price pressures increase

Top chart shows 12-month percentage changes in the Euroland harmonised index of consumer prices. Lower chart shows the standard deviation of 12-month percentage changes in the national HICPs of Euroland economies. (It is not weighted for the sizes of the different economies.) Note that Greece and Luxembourg were excluded from the standard deviation calculation based on their lack of convergence on inflation with the rest of Euroland in the early stages of the euro, and bearing in mind their relatively small GDPs.





Sources: European Central Bank, national sources and Bloomberg

If one has an average rate of interest rather than one designed for each country's needs, the risk is that inflation will be exacerbated in countries that have an inflationary problem, or growth slowed further in countries already growing sluggishly. If one had had a simple interest rate between Germany and Britain in the early 90s what would it have been? At that time Germany was beginning to experience some inflation following the reunification boom. Britain at that time was stuck in a recession as a consequence of the high interest rates that had been necessary to deal with the inflationary problem of the late 1980s. If high German interest rates had been applied in Britain the effect would be to prolong recession. If on the other hand lower British interest rates had been applied in Germany the effect would be to increase inflation. If an average rate of interest were applied in both countries, the effect would have been to prolong recession in Britain and increase inflation in Germany.

How the euro threatens stability

There are other reasons why Euroland's economy may become more volatile with a single currency. The removal of the exchange rate between countries removes an important safety valve. When an economy is booming a rise in the exchange rate can help to take the froth off the economy, as it would have done so for Ireland had it been outside the euro.

Britain's experience in the Exchange Rate Mechanism is illustrative here. In the early 1990s the ERM broke up because of fundamental strains in the European economy. After 1992 the value of sterling fell sharply. But if the exchange rate had not been able to depreciate then the strain would have continued to be borne by the real economy in jobs and asset prices. In a monetary union the abolition of the exchange rate does not remove volatility; it merely suppresses it or transfers it elsewhere. As Vaclav Klaus put it more theoretically, "It is not possible to convert a variable into a constant without paying an inevitable price, or without provoking movements of some other variable or variables." Even the common assumption that a single euro exchange rate will be more stable than national exchange rates seems highly suspect. A few years ago Mr. Paul Volcker, former Chairman of The Federal Reserve Board pointed to the dangers of a world in which there were fewer currencies but those currencies were more volatile against each other. The last two years gives support to that view.

One of the most trenchant critics of the euro has been the Harvard Nobel Prize-winning economist, Martin Feldstein, who has even gone so far as to say that the euro might cause war in Western Europe. This no doubt seems a little exaggerated, indeed, even to me, it is highly exaggerated. Nonetheless he repeated his point in Paris the other day. But the point Professor Feldstein is making is that the euro will inevitably increase tensions between different countries because different countries will have different and irreconcilable expectations from a single institution, the European Central Bank.

This is not just a question of interest rates, but might also encompass the exchange rate. If the euro shot up way above its $1.17 launching price that might be intolerable for certain countries, but not for others. It is often pointed out that for Euroland, as for the US, the ratio of trade to GDP is relatively small, a touch over 10%. For this reason the exchange rate is supposed to matter little. But the figures for external trade mask real differences. Germany's exposure to extra European trade is very different from Spain's. A sharp rise in the euro might be an asymmetric shock affecting Germany and Italy much more than France or Spain. A strong rise in the euro could put the ECB under pressure from Germany to cut rates when that was not appropriate for other countries.

The issue of asymmetric economic shocks is a key one. An asymmetric shock is an economic event, which affects different countries in different ways. For example German reunification, which had huge consequences for Germany and entirely different consequences for other countries. Clearly again the exchange rate would be one means of adjustment which is removed for individual countries in Euroland. Another response would be a change in budgetary policy. The fiscal deficit could be allowed to rise to help to stabilise the economy. However, the Stability and Growth Pact, which was added as an afterthought to the arrangements agreed at Maastricht puts limits on the extent to which budget deficits can be increased in order to cope with economic shocks. Many people have argued that these rules would be too rigid in a recessionary situation. Since in the last 26 months Europe has been in a cyclical recovery it is impossible to judge whether the budgetary rules are too inflexible.

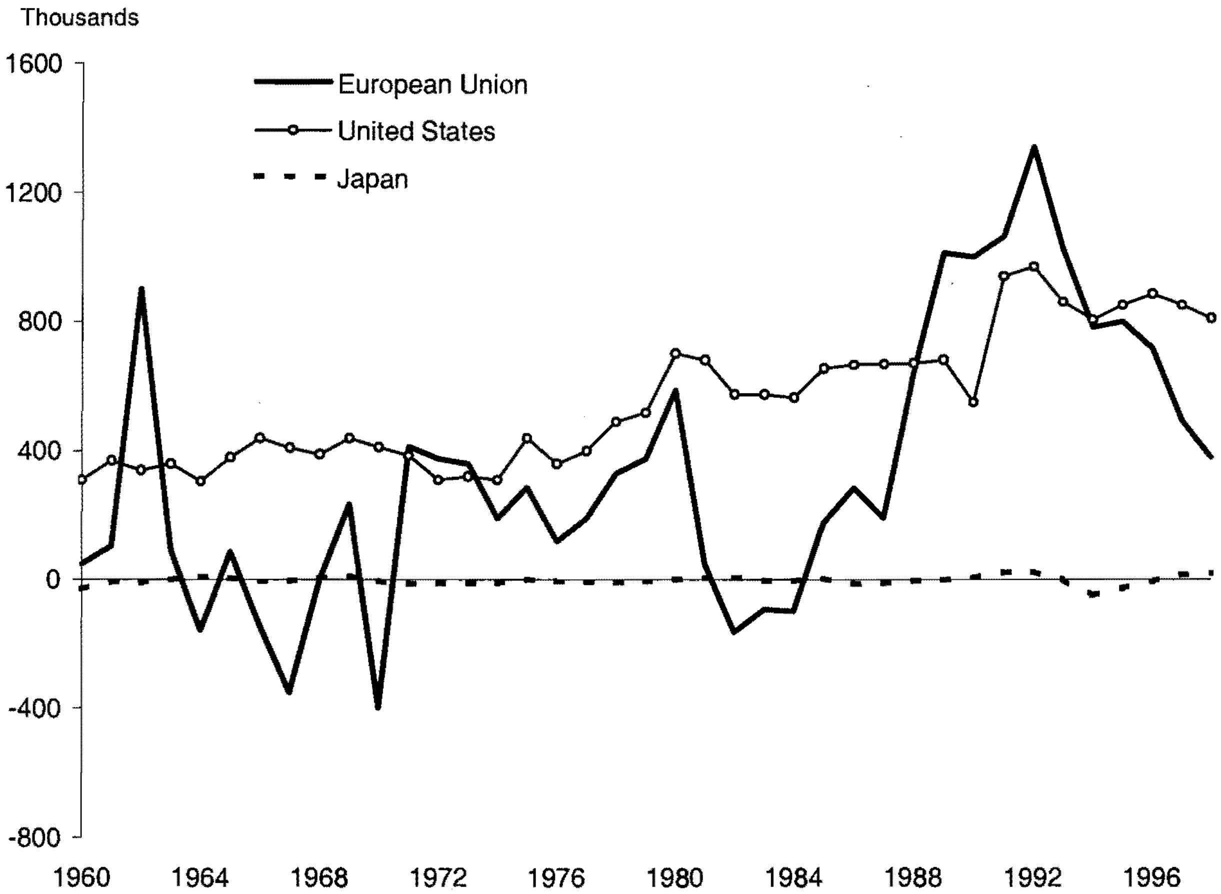
European labour markets: reform still needed

The American economist, Robert Mundell in a famous article in the American Economic Review in 1961 invented the concept of "optimal currency area". In order to qualify as an optimal currency area certain criteria have to be satisfied particularly a broadly conterminous single labour market. Only if countries met the criteria for an optimal currency area will the costs associated with the loss of exchange rate flexibility be more than offset by the benefits of trade without the obstacles of exchange costs and exchange risks. Few people think that Euroland corresponds to an optimal currency area, and fewer still people think that Britain plus Euroland corresponds to one either. Euroland is notable for its absence of labour mobility. Compared with the USA, there is little mobility within Euroland countries, and even less between them. A single currency will produce different unemployment rates in different countries. The options then are wage reductions, or migration to areas where there are more jobs, if not the areas of unemployment will become permanent pockets of joblessness. This is a weakness in Euroland. Euroland is completely different from the United States. If a steel worker loses his job in Pennsylvania he may move to another state in the same country where people speak the same language, where he may have relatives, and where his social security, and pension entitlements will still be the same. In Europe these incentives to mobility do not exist.

Euroland, like the USA, a magnet for immigrants

But internal mobility of labour greater in the U.S.

Chart shows net migration in Japan, the EU and the USA. Net migration is measured as the difference between the total population on 1 January and 31 December for a given calendar year, minus the difference between births and deaths.



Source: OECD *Economic Outlook*

Workers are more reluctant to move around Europe than around the USA, partly because of language differences between European countries and partly because social security and tax systems, and professional qualifications, are on a national basis. The relative immobility of labour is often cited as one reason that neither Euroland nor the European Union as a whole constitutes an "optimal currency area". However, the chart shows that inward migration in the 1990s was not much less for the European Union than the USA. The heavy influx in the early 1990s followed the collapse of communism and the consequent flow of people from Eastern Europe, but restrictions have subsequently been imposed to slow immigration. The immobility of Europe's labour market should not be exaggerated. Ireland saw heavy emigration in in the 1970s and 1980s, and even larger immigration in the late 1990s.

Will the euro last?

It is too early to make a definitive judgement on the euro. It, of course, will not have been fully tested until it has been through a recession. It is one thing to hold together in global good times. It would be much more difficult in a downturn. The euro has made an uncertain debut on the foreign exchange markets. But the more important problems are the cumulative ones, the strains of the "one size doesn't fit all" interest rate. Whatever the future may hold, the euro will not be broken by the markets in the way the ERM was and is unlikely to be easily abandoned by politicians. Huge amounts of political capital have been invested in it. There is a determination to press on with the project almost regardless. But as the problems increase this will be met by more calls from Europe's politicians for more integration in an ever more desperate attempt to make the euro work better. There will inevitably be more unnecessary tax harmonisation, and co-ordination of fiscal policy. We have seen it with the Stability Pact, the Broad Economic Guidelines, and the warning to Ireland. Mr. Welteke, the President of the Bundesbank said the other day "a single currency does not require a single Government, but a single Government will follow. That is my conviction."

The euro is a political question as much as an economic one. The British Government initially sought to portray the euro as purely an economic question. "If it's in Britain's interest then we must join." Then it sought to imply that although there were constitutional considerations they were not overwhelming. Without a word being said the Government decided it had resolved the constitutional issues. The political question is whether further political integration is desirable and is it possible? At the very least one would have thought that for it to be argued that further political integration was desirable it would have to be shown that European institutions would work better than the national ones they would replace.

Europe doesn't work

The main drawback of Europe as a political entity is simply that it doesn't work. It's not the superstate that's the problem, it is the sheer dysfunctional nature of the European Union that's the problem. Europe is everything the tabloids say that it is: bureaucratic, inefficient, corrupt, undemocratic, and unaccountable. Harsh words indeed, but everyone in this room knows they are not exaggerated.

The real problem is even worse, and that is that the problem is insoluble. The defects of Europe are inherent in its structure, and methods of working. Corruption and waste stem from the lack of accountability. Lack of accountability comes from lack of democracy. Europe would be more efficient, and work better if it were a superstate and were more democratic. Democracy in Europe is essential, but is, as I will explain, impossible.

The curse of bureaucratic intergovernmentalism

What makes Europe unworkable is bureaucratic intergovernmentalism: almost every decision is the result of horse trading and bargaining between different countries' national interests. "So what?", it might be said, Politics at a national level is also the result of bargaining between different interest groups. But at a national level there is a greater sense of trying to reconcile different interests in order to answer a problem. European legislation is often enacted simply for the sake of having European legislation. Furthermore European legislation is almost impossible to reverse. Once a proposal has been implemented it becomes part of the "acquis communitaire"- the accumulated total body of EU law that is regarded as sacrosanct and reversible only by unanimity. Legislation in the EU is a one-way street. But democracy is not intended to be a one-way street. People expect to be able to vote against, and reverse measures they do not like.

Why do I say there is no answer to this? I can hear the Euro enthusiasts saying, "Fill the democratic deficit, elect the Commission, give more powers to the European Parliament." Far from increasing legitimacy, this would be seen as undermining it, and simply would not be accepted by public opinion in the nation states.

The democratic deficit cannot be removed by pan-European elections

Democracy is a system by which 49.9% of an electorate are persuaded to accept the will of 50.1% of the electorate. In Europe today we do not allow simple majority voting, even in the Council of Ministers, because national interests are still judged too important. So we have a system of qualified majority voting on some subjects, and unanimity on others. But if majority voting is unacceptable in the Council of Ministers, how much more unacceptable is it likely to be at the level of European public opinion. Could we really envisage a European President elected by popular vote as suggested by Mr. Fischer, the German Foreign Minister? One wonders what would happen if the result of the election was as close as in the recent US Presidential election? Would British voters be content to sit back, watch TV and accept the decisions of a Belgian court over disputed pregnant chads in the Louvain electoral district? Somehow I doubt it.

Real democracy in Europe would also mean not just more powers for the European Parliament, but the election of MEPs who did not seek to represent countries and did not belong to national parties, only European ones. The European Commission perceptively suggested before the Nice Inter-Governmental Conference that some MEPs should be elected on a European-wide list rather than on a national list. The proposals received little support other than from the euro-enthusiastic Benelux countries. The Commission's proposals were logical. But this is not the real word, if it ever will be. Since there is no such thing as a European demos, or European public opinion, so there are no European political parties. One might ask also, can one really have a European demos or a European democracy without a common language so that each citizen instinctively understands each other?

Democracy can only work in Europe if somehow a European demos can be created. Hence the proposals from the European Commission for European political parties with suitably politically correct European credentials. C. J. Shore quotes a Brussels official has saying "We have built Europe, now we have to create the European". But this is surely too mechanistic. The American was not created. He evolved in response to history and external threats. You cannot forcibly create a sense of identity by Brussels directives, hard as they try with their proposals for flags, for passports, for EU numberplates, and for a European film industry.

The euro needs a country

Some people see political unification in Europe to be inevitable, and comparable to American Federalism. But there are at least two crucial differences. The first is that the English colonists were closely tied by a common language, and secondly the American colonies themselves had never enjoyed complete sovereignty.

...but legitimacy remains in the nation state

One answer to these deep seated problems might be thought to be a federal constitution as advocated by Chris Patten. Specified powers would be divided between the nation state and Europe. But it is easier to outline the proposal than to fill in the detail. And what in the last analysis would it achieve? Even if there were a written constitution bureaucratic intergovernmentalism would continue. National self-awareness would continue to exist. Legitimacy would remain in the nation state.

The euro will not work effectively without political unification

There is no escaping the reality that people of Europe today still live their lives in nation states, and part of their identity is their nationality. They look to their governments to protect them, to fulfil certain tasks for them, and if they judge them to have failed they expect to be able to dismiss them. But the Bundesbank was right at the time of Maastricht. Mr Welteke, the present President of the Bundesbank, is right in 2001. The euro will not work effectively without real political unification. But the euro requires more than unification of institutions. It requires unification of peoples, and their minds. It requires that people no longer think of themselves as British, French or Belgian but as citizens of a country called Europe. Only then will there be a European demos and only them could there be European mobility of labour. Only when there is real European solidarity, to use a favourite European word, will higher unemployment in, say Germany, be regarded, including by Germans, as no more significant than unemployment in say California. The rub of course is the phrase "including by the Germans". Will countries regard their own unemployment as purely a regional phenomenon?

Little sense of European nationality

But until there is a real European culture people will continue to demand that the governments of their countries, be it the UK or Germany, protect their interests. We are still a long way from that world in which people think of themselves first as Europeans. Politicians have built Europe but they have not created the European. Until that happens, the euro will not work and will not be seen to work in the best interests of the people of Europe.