Monthly Economic Review

No. 182, August/September 2004

Contents **Page**

Money trends must be watched

Credit and money growing too fast for inflation target

Money growth in year to July not far from double-digit annual rate

In the year to July M4 increased by 8.9%. Small mercies are always welcome, and it is good to note that this is much less than the annual M4 growth rates of 22.8% in the third quarter of 1973, 18.5% in Q3 1978 and 17.8% in Q3 1988. (To the uninitiated these were the highest money supply growth rates in the booms in the last three boom-bust cycles.) Nevertheless, money supply growth over the last year has been too high. If the ratio of money to gross domestic product continues to rise by about 1½ % to 2% a year (as it has done for most of the last decade), a sustained money supply growth rate of about 9% implies a 7% to 7½ %-a-year increase in nominal GDP. No one sensible believes that the trend growth rate of the UK economy is more than 3% a year and a figure of 2½ % a year is more reasonable. It follows that - over time - a 7% to 7½ % rate of increase in nominal GDP would be accompanied by 4% - 5% inflation.

Interest rates have been raised, but not by enough

Of course, the Bank of England has raised interest rates in an attempt to pre-empt an outbreak of above-target inflation. The critical question is, "will the move from base rates of 3½ % to 4¾ % (and perhaps to 5¼ % in early 2005) be enough to dampen down the growth rates of credit and money to, say, 5% - 7%?". The monetary data over the next three to six months will need to be monitored closely, to get a handle on this question. New bank credit over the last few years has been dominated by mortgage lending (including loans to non-bank housing finance intermediaries, which then extend mortgage credit to households). As there is little doubt that mortgage credit is interest-rate-sensitive, the Bank's task is to set interest rates at a level which lower its growth rate to single digits. This task is likely to be more difficult than suggested by recent newspaper comment. The trouble is the starting-point. In the year to July lending to individuals climbed by 14.5%, while in the three months to July - when the deterrent effect of higher interest rates ought to have begun to work - the annualised rate of increase was still 14.0%. Mortgage approvals have dipped, with the July figure of under £24b. being usefully less than the peak numbers of £27b. - £28b. last autumn. But - because the mortgage boom had such momentum in early 2004 - a reasonable verdict is that base rates of 5% or so will not suffice. It needs to be remembered that the last mini-boom - in 1997 - had to be countered by base rates of 7½ % in June 1998.

Trends in mortgage credit will be critical

Central banks complacent about oil prices

The UK's inflation prospects will be affected not just by domestic monetary trends, but also by the world economy. Central banks could have reacted to the oil price surge by warning about the dangers of knock-on effects to pay bargaining and inflation expectations. Instead they have taken a mostly complacent view that the higher oil price will divert spending power to energy producers and dampen demand in the industrial world. This complacency is itself one reason to expect monetary policy to accommodate above-trend growth in demand and output in the world economy until at least early 2005.

Professor Tim Congdon **2nd September, 2004**

Summary of paper on

'On handbags, rebates and the future of Europe'

Purpose of the paper

At the next meeting of the European Council in December the financing of the EU's institutions from 2006 is likely to be discussed. This research paper reviews the facts and figures of the UK's rebate. It also considers whether German and French influence on the EU (and especially on the Common Agricultural Policy) will remain sustainable as their economic weight in the EU declines.

Main points

- The rebate negotiated by Mrs. Margaret (now Lady) Thatcher at the Fontainebleau summit in June 1984 has on average been worth 0.3% of gross domestic product. Its cumulative value in the 20 years to 2003 was £40b. in current prices (and much more in 2004 prices).

- A key part of the original case for the rebate was the UK's relative poverty in Europe. But in recent years the UK's GDP has overtaken France's and been only 20% or so lower than Germany's. Germany and France, and indeed other European nations, will press for the ending of the rebate.

- The UK's increased economic weight in the EU has been due, almost entirely, to a large real appreciation of the pound against the ecu/euro since the mid-1990s. The reasons for this large appreciation are not obvious, but the increased competitiveness of the UK's tradables industries may have been crucial.

- With the rebate the UK has made net contributions to the EU of, on average, 0.4% of GDP; without the rebate the UK's net contribution to EU institutions would in the last five years have been higher, as a % of GDP, than the net contributions of Germany and France.

- The Franco-German attack on the UK's rebate stems partly from their own budget difficulties. Because of adverse demographic trends, Germany and France will have difficulty reducing public expenditure and budget deficits in coming years, even though their deficits breach the Stability and Growth Pact.

- But Germany and France - who have been the EU's leading economic and financial powers over the last 40 years - are in relative economic decline. Their share in EU output fell from 47% in 1995 to under 40% in 2003. They may be less willing to finance the EU in future.

- The UK should be willing to lose its rebate only if it can extract major changes to the working of the EU. It should press for the abolition of the CAP as its price for surrendering the rebate.

This paper was written by Professor Tim Congdon

On handbags, rebates and the future of Europe

How much should member states pay to European Union institutions?

UK rebate likely to come under attack at next European Council meeting in December 2004

Rows about money are inevitable even in the happiest families. The European Union may not be exactly a happy family of nations, but it resembles one in having numerous squabbles about the housekeeping bills. The next meeting of the European Council in December is likely to be more than usually acrimonious, because Europe's leaders need to reach an understanding about the financing of EU institutions from 2006. At the heart of the debate will be the UK's rebate, negotiated by Mrs. (now Lady) Thatcher in 1984 and still going strong at its 20th anniversary. Other European nations – particularly Germany – will try to stop the rebate or, at any rate, to pursue a bargaining strategy in which it is much reduced. This research paper will set out economic background to the coming debate on the financing of the EU's institutions. Traditionally, the EU has been characterised by an imbalance of power, with Germany and France dominating the European economy, financing the key institutions and setting the agenda. The imbalance will not be so pronounced in future, because of a variety of economic and political developments. As Germany's weight in the EU economy declines, the attack on the UK's rebate seems certain to intensify. However, it is far from clear that Germany (or Germany and France acting together) will win the coming round of bargaining.

Background to negotiations leading to rebate in 1984

When the UK negotiated entry to the European Economic Community (or "Common Market", as it then was) in the early 1970s too much was conceded to the existing members. If nothing had been done, the UK would by the mid-1980s have been making a large net contribution even though – in terms of both output per head and total national income – it was behind Germany and France. At the Fontainebleau summit in June 1984 Thatcher lodged a strong protest. According to a media stereotype that has now become established, she swung her handbag in anger and by sheer bloody-mindedness secured an annual rebate "of about £2b.". (The relevant chapter in Thatcher's autobiography – chapter XVIII in *The Downing Street Years* – is entitled "Jeux sans Frontières". There is no reference to a handbag, although Community negotiations in December 1983 are said to have been "reduced...to the level of farce". The exchanges that led to the rebate – mostly between Thatcher, Mitterand and Kohl – are described on pp. 541 – 5. The rebate is in fact 66% of the VAT receipts that the UK would otherwise owe to the EU. For most countries the EU's "own resources" include VAT revenue up to a limit of 1% of GDP. The rebate therefore varies with VAT revenues and in the last few years has been much larger than £2b.)

Three observations need to be made about the origins of the rebate. The first is that a large part of the UK case was that it was relatively poor and, as a matter of distributive justice, it should not be a significant net contributor. The argument

UK's relative poverty

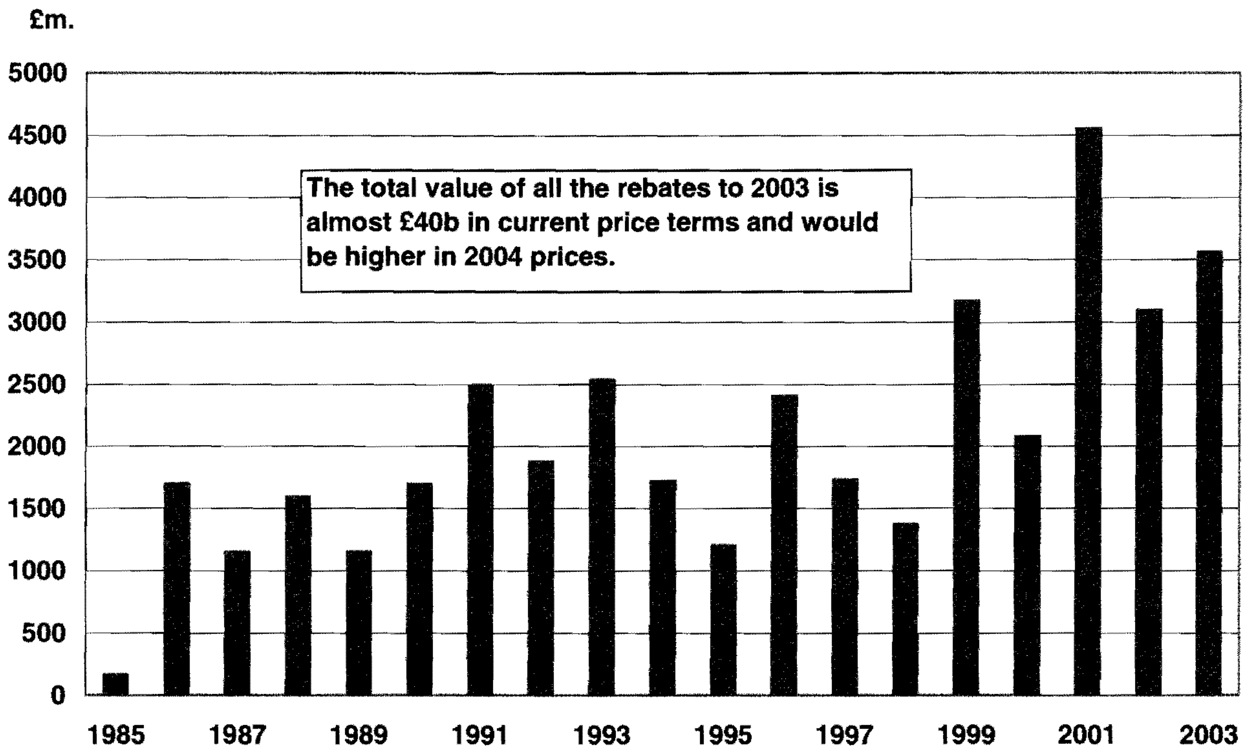
from relative poverty was reinforced by the importance of the Common Agricultural Policy in EU expenditure. The UK has always been hostile to the CAP, while – because of the efficiency of its farming industry – it has never been a major recipient of CAP money.

Franco-German financial contribution accompanied by political leadership

The second point is crucial in understanding the dynamics of the EEC, as it was in the mid-1980s, and the EU, as it has become. A fair comment is that Germany and France have been prepared to be magnanimous about the rebate, because their leaders have had a strong and continuous interest in the advancement of the EEC/EU. Crucially, they have believed themselves able to determine the European agenda. Since the 1950s Germany and France have held regular summits separate from the rest of the EEC/EU membership and reached decisions about the future direction of policy. These decisions have been – and still are – presented as virtual *faits accomplis* to the other members at the full sessions of the European Council. In the 1960s and 1970s Germany was the dominant net EU contributor, but in the last 20 or so years Germany and France have both played this role. There is an obvious logic in an arrangement whereby

Chart 1 **- The UK's rebate**

Chart shows UK's "abatement" as negotiated at June 1984 summit. Source is ONS Pink Book.



the nations that determine policy are also the nations with large net contributions.

Germany and France made net contributions partly in order to bribe smaller nations into accepting the integrationist agenda

The third point is related to the second. There is little doubt that Germany, often working with France, has told smaller EU member states that their net receipts from the EU depend on acceptance of the Franco-German agenda, which has been and remains integrationist. Because of the smallness of some nations' economies and their large farm sectors, their net receipts have in the past often been over 5% of national income. (Greece, Ireland and Portugal are examples.) In effect Franco/German influence over the smaller nations was obtained by a bribe intermediated through the EU. (Thatcher mentioned the smaller nations' susceptibility to hand-outs of this sort in *The Downing Street Years*, with a particularly acid comment on Greece. Noting that the weaker economies expected subsidies in exchange for supporting integrationist proposals [such as the single currency], she said that in 1989 and 1990 she became "all too used to a Greek chorus of support for whatever ambitious proposals Germany made." [p. 763]) Obviously, this pattern of European diplomacy has worked in the past because the two driving powers – Germany and France – have had sufficient economic power.

Data on different nations' EU contributions difficult to locate

How large are the sums of money at play in European Council discussions? Data on the size of different countries' gross and net contributions to the EU, and on the sources and uses of the funds, appear to be impossible to obtain from the European Commission. Fortunately, Europe's nations subscribe to international treaties on the publication of official statistics and, with a certain amount of detective work in national statistical websites, the key numbers can be found. (The UK's own *Pink Book* of balance-of-payments statistics is clear, thorough and easy to access on the Office of National Statistics' website.) Chart 1 shows the value of the rebate from 1985 to 2003. The cumulative total of all the rebates in the period was £39.3b. On average the rebate has been worth 0.3% of GDP.

UK net contribution to EU has - fairly consistently - been about 0.4% of GDP

However, the UK has been a consistent net contributor. The average net contribution in the decade to 2003 was virtually identical, at just over 0.4% of GDP, to the average net contribution in the decade to 1993. The surprise – in a comparison of Germany and the UK (see Chart 2 on p. 6) – is that Germany's importance in financing the EU has declined significantly from peaks in the mid-1990s. Whereas in the three years to 1995 Germany's net contribution was 0.9% of GDP, in the three years to 2003 it was under 0.6% of GDP. Chart 3 – which compares the actual net contributions (as a % of GDP) of Germany and France, and the UK's net contribution *plus the rebate* (i.e., what the UK's contribution would have been if there had been no rebate) – is an eye-opener. *Without the rebate the UK would over the last five full years have had the*

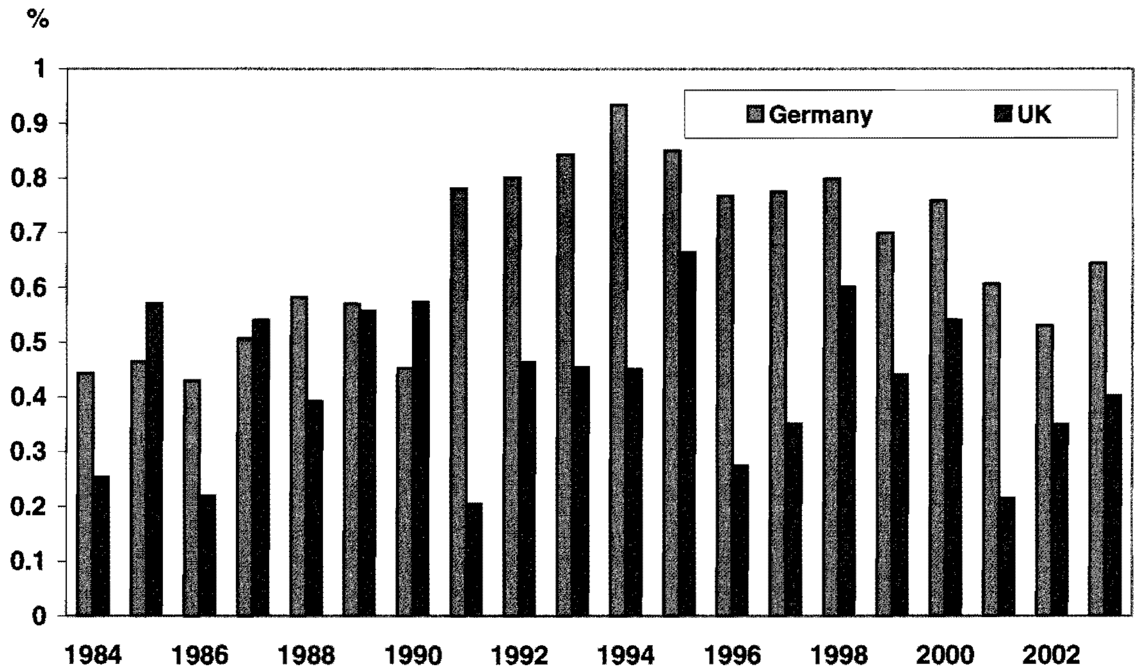
Without the rebate, UK's net contribution larger (as % of GDP) than Germany's or France's

largest net contribution, relative to GDP. Indeed, in absolute amount the UK's net contribution in 2003 would not have been much less than Germany's. (According to the *Pink Book*, the UK's net contribution was £4,429m. and the abatement was £3,560m., i.e., almost £8b. in total. According to the relevant table in the Bundesbank's *Monthly Report*, Germany's net contribution was 13,732m. euros which - using an exchange rate of 1.5 euros to the pound – is about £9b.) Moreover, if France's and the UK's actual net contributions are added together, they have exceeded Germany's in recent years. These numbers go some way to invalidate the traditional characterisation of Germany as "the paymaster of Europe". It remains the largest net contributor, but it is far from having the dominance it had in the first 20 years of the EEC/EU.

An important issue is raised by these figures, particularly for the British government and the UK Parliament ahead of the December summit. Why – in the absence of the rebate – would the UK almost have caught up with Germany in the size of its net contribution to EU institutions (and also, incidentally, far overtaken France)? The heart of the explanation is simple to describe, but quite

***Chart 2* - Actual net contributions to EU, as % of GDP**

Chart shows actual net contributions to EU institutions, as % of GDP, according to ONS Pink Book *and Bundesbank's* Monthly Report.



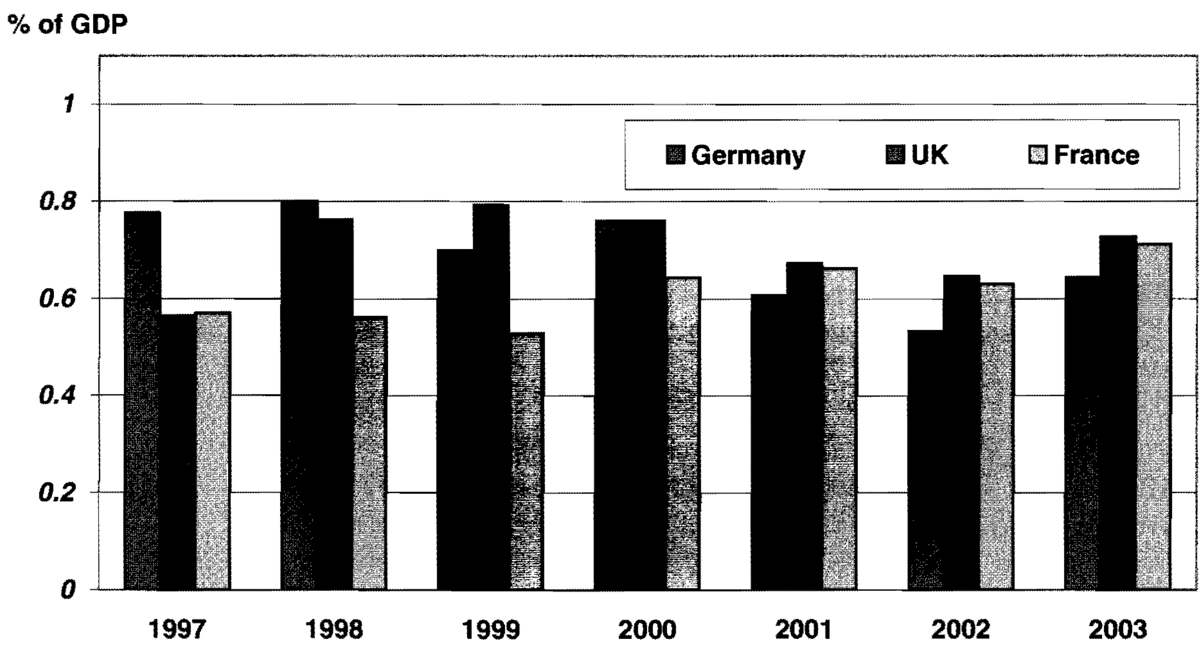
difficult to interpret. The reason that the UK's net contribution has been moving towards that of Germany and France is that its GDP has been gaining ground on theirs. As nations' contributions to the EU are most of their customs revenues and a proportion of VAT, and because these are correlated with GDP, net contributions to the EU are also correlated with GDPs.

UK's remarkable GDP catch-up

Chart 4 on p. 8 shows the relative sizes of the GDPs of Germany, the UK and France, where the GDPs are measured in terms of current prices and current exchange rates, and converted into a common currency (the US dollar). The story told by the chart is remarkable. Between 1983 and 1990 Germany had a larger GDP than France and France had a larger GDP than the UK. On re-unification in 1990 Germany moved further ahead, and in 1995 its GDP was over 60% larger than France's and more than double the UK's. But from 1996 onwards the UK has dramatically outpaced the two other large European economies. In recent years its GDP has been greater than France's and about 75% - 80% that of Germany's. How have the UK's workers and companies accomplished this apparently extraordinary catch-up in such a short period?

Chart 3 **- The contributions of the EU's "Big Three", without the UK rebate**

Chart shows net contributions to EU, as % of each nation'sGDP, actual for Germany and France, and notionally for the UK as if it had not received its rebate. Note that the bar for the UK is therefore not its actual *net contribution.*

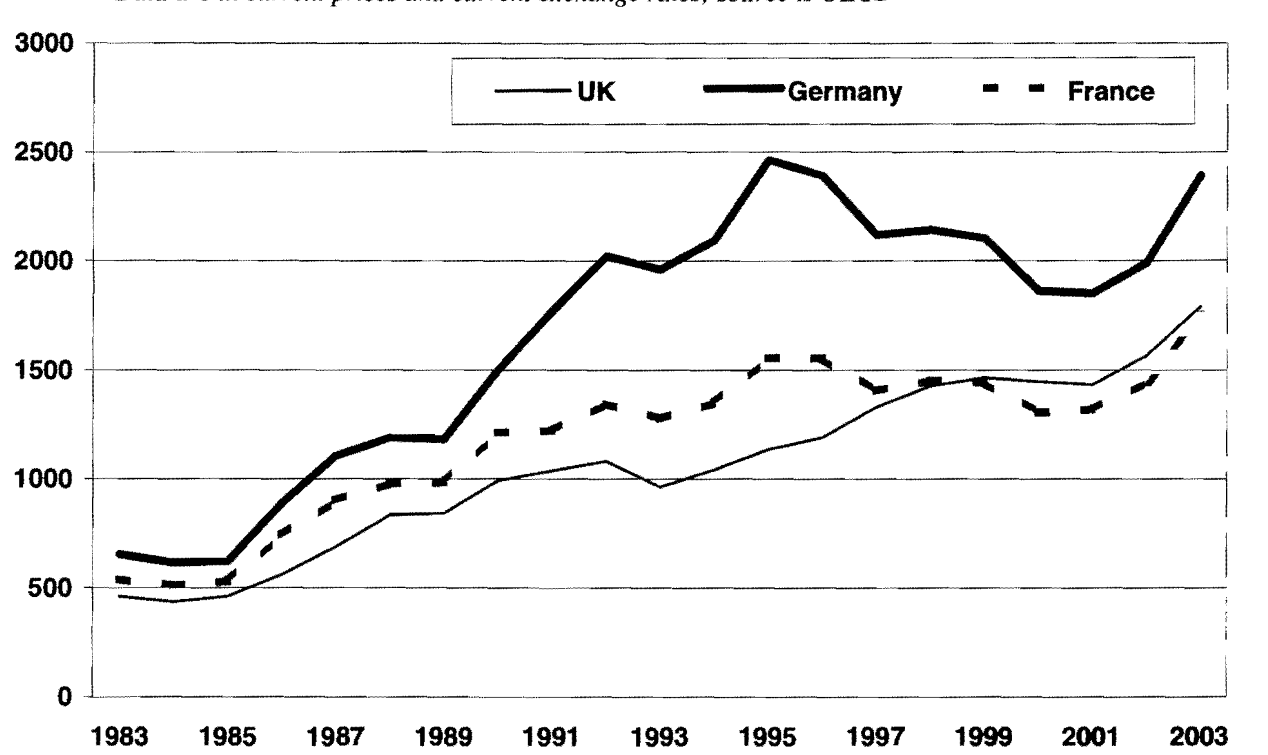


Part of the answer is that UK output has grown faster than German or French output since 1995, *where "output" is measured on a constant-price basis by official statisticians in the three countries.* But the gap between the UK's growth rate and either Germany's or France's is tiny and the data imply that this was only a small element in the catch-up. The main reason for the transformation in the UK's standing is the large appreciation of sterling in late 1996 and early 1997. The pound's effective exchange rate – which had been 83 to 84 in early 1996 (1990 = 100) – climbed from an average of 84.7 in August 1996 to 104.5 in July 1997, and has subsequently moved inside a 100 – 110 band with mostly modest month-by-month fluctuations. Against the ecu/euro the pound increased in value from an average of 1.21 in 1996 to an average of 1.52 in 1999. It has subsequently at least held the higher value or sometimes traded up into the 1.60 – 1.70 area. Roughly speaking, the pound appreciated by 30% against the euro in the year to mid-1997 and has stayed there. As a result, *when GDPs are measured "in current prices and current exchange rates"*, the UK has gained 30% compared with the position in 1995. This has eliminated all of the shortfall in output per head relative to Germany and France which was routinely reported in the 20 years to the mid-1990s.

Large sterling appreciation explains bulk of GDP catch-up

Chart 4 **- Comparative GDPs of the EU's three largest economies**

Data are in current prices and current exchange rates; source is OECD



The appreciation may have been due to the UK's pattern of specialisation

The next question is, "what happened to the UK economy to justify the large appreciation of its currency that occurred in 1996 and 1997?". Many economists have spent a good part of the last eight years saying that the pound is over-valued at the current euro/pound exchange rate and that a devaluation is inevitable at some point. (The author pleads guilty.) These warnings are wearing rather thin. The UK does have a larger current account deficit than in the mid-1990s, but – to judge from surveys of industrial opinion – its companies have adjusted to the higher exchange rate and are not complaining about a lack of competitiveness. In jargon, "the pound's equilibrium real exchange rate has appreciated (or, less ambitiously, seems to have appreciated) relative to the euro by between a quarter and a third compared with the mid-1990s". The UK's ability to cope with the higher real exchange rate may be due to its specialisation on complex, high-value-added services and manufacturing, whereas European nations have larger exposure to middle-technology industries (such as cars, consumer durable and chemicals) where they are vulnerable to low-cost Asian competition. Without a great deal of further research, the jump in the pound's equilibrium real exchange rate has to be described as a puzzle. Some observers might argue that it reflected the mostly sensible supply-side policies pursued under the 18 years of Conservative rule from 1979, but such claims would no doubt be regarded as partisan.

France and Germany have also lost economic weight relative to rest of EU, apart from UK

The UK's increased economic weight in the EU has gone a long way to undermine traditional Franco-German dominance. But other forces have reinforced the trend. The free flow of industrial products and factors of production within the EU have led to a marked equalisation of productivity and living standards, and this has inevitably reduced the productivity lead once enjoyed by Germany and France. Spain – in particular – has achieved much faster output growth than Germany and France over the last 20 years, while Ireland, Greece and Portugal have also outperformed the EU average. (Ireland – once a poor country by European standards – now has one of the highest incomes per head in the EU.) Chart 5 shows that in 1995 Germany and France together represented almost 47% of EU output, whereas in 2003 they accounted for under 40%. Germany and France lost share roughly equally to the UK and the rest of the EU.

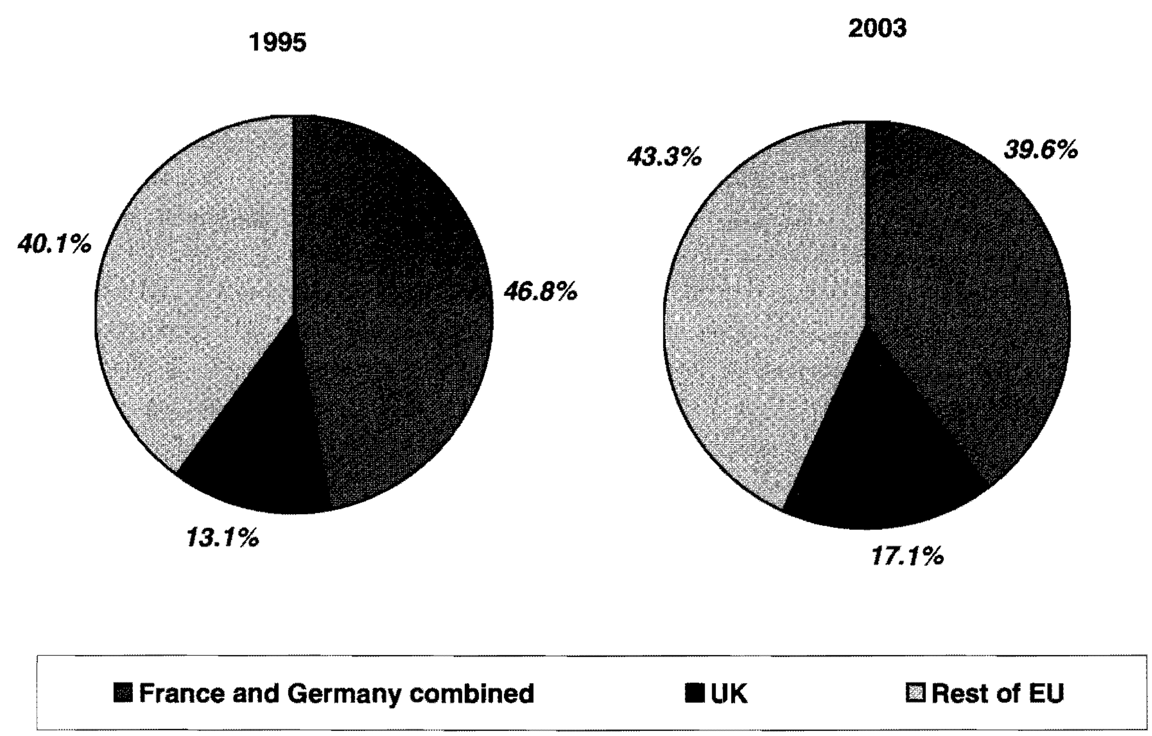
In 2004 the decline in Franco-German dominance has been given a further twist by the eastward expansion of the EU. The immediate effect is modest, because the ten new members have such small national outputs. In fact, the eastward expansion of the EU added only 5% to its output. However, the boost to population was much larger, from 382m. to 456m. or of almost 20%. Over time the same equalisation of productivity and living standards seen with Spain, Portugal, Ireland and Greece can be expected with the 10 accession countries. The shares of the EU nations in their combined output may never be exactly the same as their shares of the EU population, but a marked tendency in that direction is to be expected. The proportion of EU output attributable to Germany and France – still almost 40% today – will decline towards a third over the next 20 to 30 years. Indeed, a case could be made that Germany's position will be particularly difficult because, without heavy immigration, its working-age population will be falling by ½% - 1% a year in the 2010 – 2030 period. (The possibility of Turkey's accession to the EU must be mentioned here. Its population today is about 67m., compared with Germany's 82m. According to projections by the World Bank, Turkey's population in 2020 will be 81 1/2m., compared with Germany's 78 1/2m. If it were to join, it would be the most populous member of the EU. Assuming that the allocation of votes in the Council of Ministers were to correspond roughly with population, it would have at least as many votes as any of Germany, France, the UK and Italy.)

Further eastward expansion of EU would further weaken Franco / German position

The punch-line here is obvious. As the combined economic importance of

Chart 5 **- Shares in EU gross domestic product**

Chart is of shares of EU total GDP, at current prices and exchange rates



Germany and France in the EU declines, their willingness to provide the lion's share of EU financing will weaken. This would be true even if Germany and France were in a fiscally robust condition, but – as it happens – their public finances are strained. Both nations have budget deficits of about 4% of GDP, above the 3% maximum specified in the Stability and Growth Pact. Further, because of its demographics, Germany's fiscal crisis will intensify over the next 20 or 30 years. It will be difficult to prevent an increase in the ratios of government expenditure and tax to GDP, and it will therefore become harder to keep mobile labour and capital within Germany's borders. (The same comment does not apply with so much force to France, which has a relatively benign demographic outlook.)

Fiscal strains in Germany and France have prompted them to attack UK rebate

In these circumstances Germany and France will want to push the burden of EU financing towards other nations. In practice, that means particularly towards the UK. The sums involved in the rebate – roughly 0.3% of the UK's GDP and under a ¼% of Germany's – would not make a fundamental difference to the public finances of even the EU's largest economies, but they would still make a worthwhile difference relative to budget deficits that breach the rules by 1% - 1 ½% of GDP. The coming negotiations on the rebate and other aspects of EU financing will be acrimonious. Plainly, if Germany and France had output per head that were beneath – even if only slightly beneath – the EU average, and if they still had intense difficulties with their public finances, the large net contributions they make to the EU would come under very critical review by their national legislatures and electorates.

But he who doesn't pay the piper doesn't call the tune

On the other hand, if Germany and France cease to be major net EU contributors, they would no longer have the financial clout that has enabled them to bribe small member states and to promote the integrationist agenda. Newspaper reports that Germany and France wish to form a "federal core" within the EU, presumably with a separate set of institutions, need to be seen in this light. According to a report in *The Times* of 13th November 2003, Jean-Pierre Rafarin, the French prime minister, said, "If a Europe of 25 members fails, what will be left for France? The initiative of Franco-German *rapprochement.*" (The major diplomatic row over Iraq between, on the one hand, France and Germany, and, on the other, the UK and most of the rest of the EU has also to be interpreted in this context. France and Germany undoubtedly resent their inability to determine the EU's geopolitical direction, given their economic and financial leadership within the EU, and the sums of money they pay to maintain that leadership. Their reaction – or, at any rate, the reaction of their heads of state – has been to close ranks and hug each other more tightly.)

It seems unlikely that the UK will concede much ground on the rebate, unless massive changes are agreed to the EU's agenda. The major imponderable, and the central bargaining counter, is the future of the Common Agricultural Policy. Germany's continued preparedness to finance the CAP – which is hugely expensive to Europe's taxpayers and almost universally regarded as an economic monstrosity – may appear strange. The CAP is not and never has been in Germany's interests. Germany's support for the CAP can be understood only against the background of its tragic and peculiar history in the 20th century, and to the special bond it formed with France within the EU framework in the century's second half. But – if Germany cannot afford its traditional *largesse* towards the EU – it may become more flexible on the CAP. The task of Mr. Blair (and, to some extent, his more eurosceptic colleagues, Mr. Brown and Mr. Straw in their exchanges with EU counterparts) will be defend the rebate and give ground only if fundamental reform of the CAP is on offer.