

The Single Currency, and why Britain won't join the party

Ross Leonard – Junior Sophister

Ross Leonard begins this essay by exploring the history of Europe's single currency, the Euro. He then outlines the reasons for Britain's opposition to joining, as well as the arguments for and against a single currency. He concludes that Britain's reluctance to join is as much to do with British nationalism as economic arguments.

'If ever there was a bad idea, EMU is it.'

In such a way, Professor Rudi Dornbusch of MIT welcomed the Euro. However the successful introduction of Euro notes and coins at the beginning of 2002 throughout Europe is the culmination of an economic project begun in 1957 with the Treaty of Rome. This has seen the birth of one of the largest single markets in the world and the re-emergence of Europe as a massive economic power block. However, despite the initial progressions made through these developments, a number of countries have decided to remain outside the Euro-Area (including Britain). Euro-sceptics cry-fowl of the very thought that countries should give up their individual national currencies, and therefore at some level a degree of sovereignty. However there is much more to their argument than simple scare-mongering. In this essay, I shall attempt to outline the benefits and costs associated with joining the single currency. I shall then progress onto a discussion of the circumstances in Britain and issues surrounding the possibility that they will join at some point during this government's term of office. However, to allow some perspective, let us first explore the birth of the Euro.

The Birth of the Euro.

The Treaty of Rome, signed in 1957, involved the creation of a common market in Europe. This was followed by an agreement in 1969 that a Monetary Union was indeed desirable, and in 1970 the Werner Report was produced which provided a framework for such a Monetary Union. However it is not until 1978 that we see the first real indications of what was to come, when the Exchange Rate Mechanism (ERM) was introduced. This involved a system of fixed but adjustable exchange rate parities. The idea being that each currency was fixed to an imaginary currency, but adjustable by up to +/- 2.25%. As with the Euro, Britain did not join immediately. It did not join until 1990, and when it did join, it was generally believed to have joined at too high a rate. Thus in 1992/93, the ERM suffered massive speculative attacks (backed by George Soros among others) which eventually forced Britain to pull out

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and saw the dramatic collapse of the ERM.

However, this may not have been the disaster that it seemed like then. 1990 (the year Britain joined the ERM) is seen as the start-point for Stage 1 of the European Monetary Union (EMU). Stage 1 involved the full participation by all members in the EMS (the ill-fated exchange-rate mechanism), the liberalisation of Capital movements, increased policy co-ordination and finally, and perhaps most importantly, the completion of the single market. Despite the collapse of the ERM, Europe moved to Stage 2 of EMU with the signing of the Maastricht Treaty in 1992. This provided the basic blueprint for EMU and set out a range of criteria for membership including convergence criteria. While in 1994, the European Monetary Institute, the predecessor of the European Central Bank (ECB), was created. Thus finally, Europe moved to Stage 3 in 1999, with the introduction of the Euro in non-cash form and the locking of exchange rates for the twelve participants. And now, in 2002, for the first time since perhaps the Roman Empire, the vast majority of the citizens of Europe share the same tangible currency.

Why Euro?

Although the Euro is without direct precedent, monetary union and single currencies do exist today. The United States has an economy and population similar in magnitude to the euro-area, and runs the most successful economy with a single currency and monetary policy. Thus there must be some tangible benefits to a single currency. But what are they?

- *Increased Price Transparency and Competition.*
Increased price transparency allows easier price comparisons between countries, and make it harder for companies to get away with charging artificially high prices, thus reducing the overall level of prices and forcing companies to become more competitive and efficient.
- *Elimination of Foreign Exchange rate risk and associated hedging costs.*
The removal of foreign exchange risk will lead to an increase in the expected return on investments within the Eurozone. This will spur investment and lead to greater development and economic growth in the Eurozone.
- *Simpler accounting and treasury management systems.*
Simpler accounting and treasury systems will reduce costs of doing business in foreign countries, thereby increasing financial opportunities and allowing

exporters to compete more efficiently throughout the Eurozone. This is also true for Foreign Direct Investment, as multinationals operating in the Eurozone will no longer have twelve different currencies to deal with but one.

- *Lower interest rates in general.*

This lowers the cost of borrowing in both the public and private sector. The importance of lower interest rates in promoting economic activity is demonstrated by the aggressive rate cutting undertaken by the Federal Reserve, ECB and Bank of England over the last two years in order to stave off recession.

- *Stable Prices in the medium term.*

The ultimate objective for the ECB is price stability over the medium term, and given both France and Germany have enjoyed price stability over the past fifty years, it is reasonable to assume that this will continue. Therefore, such a situation is likely to be of greater benefit to countries like Spain and Italy. Price stability is important as it increases certainty and business confidence and therefore encourages economic activity.

Thus the overall effect of the single currency will be to promote economic activity and thereby increase growth and prosperity throughout the Eurozone. However if this were the only dimension in the debate, then all of Europe would have been racing to join, and since this is not the case, there must exist some costs or associated risks to joining the Euro. Britain certainly felt that the costs and risks were too substantial to commit themselves. Thus again, we must ask ourselves, what are these risks?

- *Loss of sovereignty.*

Many commentators appear to believe that a single currency is only a pre-cursor to even closer political union. This would then involve the loss of national identity, control over taxation, further fiscal restraints, and handing over the reigns of power to "Brussels Bureaucrats".

- *Loss of control of Monetary Policy.*

The loss of control over Monetary Policy is often seen as the main enemy in this debate. Joining the Euro means that nations may no longer set interest rates. This means that within the Eurozone, if a nation's economy is out of step with the rest of the Eurozone, then it will not have interest rates which are appropriate for its stage in the cycle, thereby impeding economic recovery, or

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exacerbating an overheating in the economy.

- *Loss of use of Devaluation as a means to stimulate economy.*

One of the key mechanisms for adjustment to economic shocks is a devaluation of a nation's currency. This allows exporters to compete more competitively on foreign markets, while making imports more expensive, thereby giving a boost to domestic producers too. Joining the Euro eliminates this instrument therefore severely restricting our ability to adjust to shocks.

So there you have it, the Euro is good or bad, depending fully on how you weigh up the benefits and costs. Let us now delve more deeply into the above issues. According to generally accepted theory, the means for readjustment to economic shocks are:

- Labour Mobility.
- Wage Flexibility.
- Income Distribution.
- Exchange Rate fluctuations.

In the case of the Euro, we have now given up the fourth instrument for adjustment, namely exchange rate fluctuations. Many economic commentators suggest that such a drastic measure should only be taken if the other three are particularly effective. Although this is certainly evident in the USA, it is not the case in Europe. Although labour is free to move within the Eurozone, there is little evidence to suggest that it actually does. In addition, due to the strong labour-protection laws and prominence of trade unions in much of the Eurozone, there is also little wage flexibility, and finally, although there is a European Community Budget, in the majority it goes to financing the Common Agricultural System (CAP) system of benefits. Thus, although it would appear that the Eurozone should have to rely heavily on exchange rate fluctuations to bring about readjustments, according to David Currie of HM Treasury, *'exchange rate flexibility provides a poor alternative'* and that this *'underlies the need for Europe to tackle the structural problems which create inflexibility in the first place.'* This suggests that elimination of exchange rate fluctuations as a means to boost an economy is a huge step forward for the lumbering dinosaur that is Europe. The theory being that devaluing one's currency in an attempt to boost the economy is a soft option anyway, allowing governments to

ignore their structural problems. Thus, the creation of the Euro will force governments to address the structural problems that plague Europe's economies.

A similar argument can also be applied to the use of interest rates to spur the economy. It has been noted that too often, the use of interest rates has been abused in the past, with governments manipulating Central Banks to achieve short-term gains rather than acting in the long-term interests of the national economy. Thus, by allowing the ECB (who will have the long term interests of all of Europe at heart) to take control of interest rates, far from damaging the economy, we are in fact ensuring the best chance that policies will be followed which will lead to more long-term growth and prosperity. Despite this, relinquishing control over interest rates can have serious effects on a nation's economic viability, and these effects should not be overlooked. The central issue here is as to whether the economies of the nations involved follow the same economic cycle. Such a problem developed here in 2000 and 2001, when the Irish economy was still booming compared to the sluggish growth of our European cousins. This meant that, because the Irish economy formed such a small part of the Eurozone in total, interest rates were set at a rate appropriate to countries experiencing low and sluggish growth. This led to a breakout of inflation in Ireland, which at one point reached 7%. Because Ireland is such a small part of the Eurozone, this was not seen as a major problem, however, were Germany and France to get out of step, this could cause massive problems for the setting of interest rates. This is one of the major obstacles to Britain joining the Euro, in that historically, the Eurozone and Britain have not followed the same economic cycle, however, more of this anon.

Another issue which is often quoted is the problem of free-riders, and the debt trap. This centres on excess borrowing by some governments, this would supposedly result in higher interest premiums on debt throughout the Eurozone, thereby forcing up the cost of borrowing for all members. However, conventional wisdom would seem to suggest that market forces would preclude such a situation from happening. After all, just because nations share a single currency, it does not mean that the market will judge them to have the same credit risk and therefore share the same risk premium. In this case, David Currie again expects to see that *'In EMU, different governments will be required to pay different rates of interest on their Euro debt, depending on their credit rating.'*

Thus, although there are credible benefits to the creation of the single currency, there are inherent risks and costs involved. For example, few commentators have mentioned that while the costs of changing to the new currency are shared by all

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businesses, it is only those that export that will see a direct benefit, thus the Euro can be seen as a once off redistribution of wealth, away from smaller regional operations to those who operate on the export market. That said, the introduction of the Euro has undoubtedly been a resounding success in the participating countries. Its introduction has been better received and run more smoothly than any officials could have hoped for. It has strengthened financial markets and led to the birth of what is now the largest overnight swap market in the world, the Euro overnight index average (EOINA) reference rate, the euro-bond market is now the second largest bond market in the world and new issues of euro-denominated bonds have even outstripped new issues of dollar-denominated bonds. The Euro has also become an important international currency, with it playing a role in the exchange rate regimes of more than 50 countries outside the Eurozone. The Euro is also listed as the second most held official reserve currency. Iran have announced that they are to issue its first bonds since the 1978 Islamic Revolution, and that they are to be issued in Euro, because the Iranian Central Bank deemed that the Euro would be easier to manage. These positive signals for the Euro have seen its supporters gain momentum. However, in recent polls, the majority of people in Britain would not vote for the Euro, and British commentators complain that any attempt to join the Euro will only end in a disaster similar to the ERM.

The British Perspective.

'EMU is portrayed as Alice in Wonderland economics, but risks creating Malice in Blunderland.'

(G Leach, 1999)

'EMU is not a narrow technical operation ... it has vast political implications.'

(Financial Times)

Thus the possibility of joining the EMU has been greeted by some in Britain. In fact, the Euro has become such a heated topic, that the Conservative Party even tried to run their election campaign as a "Save the Pound" campaign. When remembering Britain's previous experience with exchange rate programs with Europe (ERM), such attitudes are not surprising. However, perhaps they are misjudged and narrow, and then again, maybe they are not. Whether or not Britain joins the Euro will be the most important decision by the people of Britain in the next century. Both joining and remaining outside the Eurozone have massive consequences for the British economy and people. I hope that the previous section will have cleared up any doubts about the relative benefits and costs to joining the Euro, or indeed any such

monetary union. But what about the particular circumstances with regard to Britain.

The Five Tests.

To judge whether a referendum should take place on the Euro issue, the Chancellor of the Exchequer has devised a series of prerequisites, known imaginatively as the "five tests". Each test sparks its own debate, and indeed each test is sufficiently hazy as to make broad definitions possible. So let us now deal with each test in turn.

Would joining the economic and monetary union (EMU) create better conditions for firms making long-term decisions to invest in the United Kingdom?

This question relates to the implications on Foreign Direct Investment (FDI) of joining the EMU or staying outside. By joining the Euro there are obvious benefits to be had. In the last section, we mentioned that joining the single currency will lead to the elimination of exchange rate risk and associated hedging costs. Undoubtedly, joining the Euro will eliminate exchange rate risks and associated hedging costs for multinationals who use Britain as an export-base for Europe. Such multinationals will no longer have to buy currency hedges that safeguard their export earnings against currency movements against the Euro. It is quite possible that negative exchange rate fluctuations can erode profits significantly by reducing the value of goods and services that are exported. For example, assume the exchange rate between Britain and the euro is parity (i.e. one for one), a good (which cost GBP75 to make) is exported from Britain to the Eurozone where it is sold for EUR100, during the sales process the Sterling/Euro exchange fluctuates and at the time the good is sold, the exchange rate stands at GBP0.60 per Euro. Therefore, when the proceeds from the deal are repatriated to Britain, they are now worth only GBP60, meaning the exporter makes a loss of GBP15, instead of a profit of GBP25, if the exchange rate is fixed. Such an example is over-simplistic and includes an absolutely massive movement in the foreign currency markets, however it serves to illustrate the point that currency fluctuations can have massive implications on company accounts. Thus to have a system of fixed exchange rates would surely be beneficial to firms making long-term investment decisions to invest in the United Kingdom as it guarantees stability and transparency between Britain and the major market that is the Eurozone.

That said, Euro-sceptics point to the fact that since the birth of the Euro in 1999,

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Britain has continued significant FDI growth despite being outside the Eurozone. Statistics from the Office of National Statistics show that in the financial year of 2000/2001, there was a 36% increase in FDI in Britain year on year. Thus it would appear that membership of the Euro is having no effect on decisions to invest in Britain. In fact, FDI is attracted to Britain because of factors such as culture, language, a de-regulated, business-friendly environment and low levels of taxation and corruption. This argument is certainly not without sense. Certainly Britain, with its relatively lax labour legislation and pro-entrepreneurial government, is a prime destination for FDI for good reason. Euro-sceptics thus argue that joining the Euro would have no effect on decision-making in the long-term for Investments in Britain.

In conclusion, it is my opinion that joining the Euro would indeed create better conditions for firms making long-term decisions to invest in the United Kingdom. Euro-sceptics are merely scare-mongering when saying that the Euro will not add a new dimension to Britain. Although Britain may well remain a prime destination for FDI in the long-term without entering the Euro due to its pro-business stance, adding the dimension of the Euro to that can only further increase Britain's advantages in this area. Thus adding fixed exchange rate stability to cultural, language, de-regulated, business-friendly environment and low levels of taxation and corruption as reasons to invest in Britain.

How would adopting the single currency affect our financial services?

This question, we will take to mean would adopting the single currency affect the position of London as one of the pre-eminent financial centres in the world. Certainly London has lost out in one sense, in that London should have been the location for the ECB whereas it is now resident in Frankfurt. Thus in a manner, London has lost that further prestige which would have occurred had the second most powerful Central Bank in the world located in London. However the position of London as one of the major world financial centres has remained unchanged. In this case, it was the euro-philés who were guilty of scare-mongering. In fact according to the Guardian newspaper, Lord Levene, the Lord Mayor of London in 1999, used to warn about the threat to London, but the evidence was so overwhelming that he quickly changed tune. This is no surprise. The creation of the Euro, although it eliminated currency trading between the Eurozone's currencies, it created a surge in trade between the Euro and other currencies. In addition, as noted earlier, the creation of the Euro led to the establishment of what is now the largest overnight swap market in the

world, the EOINA reference rate, and the euro-bond market is now the second largest bond market in the world. New issues of euro-denominated bonds have even outstripped new issues of dollar-denominated bonds. In fact, recent figures show that Britain accounted for 19% of the global market for bank lending (France 8% and Germany 7%), 59% of foreign equity turnover (France 1% and Germany 2%), 32% of foreign exchange dealing (France 4% and Germany 5%), 36% of over the counter (OTC) derivatives turnover (France 9% and Germany 7%) and two thirds of the international bond market. Thus whether or not Britain joins the Euro, it should have little effect on the position of London as a leading financial centre. Which makes this test now irrelevant.

Are business cycles and economic structures compatible so that we and others in Europe could live comfortably with Euro interest rates on a permanent basis?

This is the key question as to whether Britain should join the Euro or not. There is no contention that historically, Britain's business cycle has indeed been out of step. In fact according to the International Monetary Fund's (IMF) World Economic Outlook, October 1997, during the period 1964-1990, the British economy had the lowest correlation coefficient with Germany, of any EU country. This heightens the possibility of asymmetric shocks. As explained in the previous section, an asymmetric shock, or the simple occurrence that an economy becomes out of step with the rest of the Eurozone has the effect that a nation will be subjected to a monetary policy that is completely inappropriate for its current situation, thereby exacerbating the problem. The IMF is not the only body to come out with evidence to suggest that the British business cycle has been out of step with that of Europe's. HM Treasury data show that during the 1980's and early 1990's, Britain had a negative correlation coefficient for GDP Growth with Germany. That means that whenever Britain needed higher relative interest rates to prevent overheating, Germany needed the opposite. On this basis, it would seem that Britain would never pass the test of having similar business cycles with Europe. However, a case can certainly be made that in the late 1990's and early 2000's, Britain's business cycle has indeed begun to become more in tune with that of Europe's. This is demonstrated by the global slowdown which begun in the US before spreading to Europe and Britain. The simple fact that Britain and Europe slowed at the same time and the reaction in each case was the aggressive rate cutting by both Central Banks perhaps points to a new era of convergence between Britain and Europe. In fact, this is one of the arguments by euro-philes, that joining the Euro would further this

phenomenon. In fact, when you aggregate quarterly growth (over an eight quarter period) for a selection of the Eurozone, you get an average figure of 0.6%, which is exactly the same as the figure for Britain. Thus perhaps Britain and Europe are indeed converging on the same business cycle as we head into the new Millennium.

This test also states that Britain should not join the single currency unless economic structures are compatible with those in Europe. In fact, once more this is an area where there are significant differences between Britain and Europe. For Example:

- Britain's unemployment rate, public sector spending levels and taxation levels are significantly below those of many Eurozone countries.
- High levels of pension fund assets mean that Britain is less exposed to the high levels of pension liabilities which face many Eurozone countries in the near future. For example, the Organisation for Economic Cooperation and Development (OECD) has estimated that the net present value of current pension arrangements to be 98% of GDP in France and 139% of GDP in Germany compared with 19% of GDP in Britain. Although these estimates are fraught with error and often subject to a very wide margin of error, it does highlight a glaring structural difference in the economies of the Eurozone and Britain.
- British households tend to be much more sensitive to changes in interest rates than their Eurozone counterparts. This is due to the high level of borrowings by households (mainly in the form of mortgage finance) which is mainly at a variable rate of interest, in comparison to German household's debt which is chiefly at a fixed rate of interest. Thus were Britain to join the EMU, interest rate changes would have a much larger effect on the British economy, and thus Britain would experience much stronger economic and business cycles relative to Germany, thereby undermining stability. In fact according to David Currie, *'this is a good argument for ... remaining outside EMU.'*

In fact according to Greame Leece (IoD, 1999) the differences do not stop there, but continue with facts such as Britain having the lowest share of gross public debt to GDP and the lowest share of public spending to GDP, among others. Thus it would appear that there are substantial differences in economic

structures between the Eurozone and Britain. However, the test asks not whether there are differences, but whether these difference in economic structures are so significant that Britain and others in Europe could not live comfortably with Euro interest rates on a permanent basis. To this the answer must certainly be, that if the business cycles of Europe and Britain are converging, then in time, so will their economic structures. After all, this is part of the point of the Euro. One of its latent benefits will be the structural reform of their economies, thereby most likely bringing them closer to the British economic structure or at least close enough that Britain and others in Europe could not live comfortably with Euro interest rates on a permanent basis.

If problems occur, is there sufficient flexibility to deal with them?

This question would appear to have occurred as a direct consequence of the failing of the ERM in 1993, and the subsequent forced policy reversal in Britain. However, the resolution of this test relies solely on your interpretation of "flexibility". Certainly the membership criteria of maximum budget deficits of 3% and maximum debt/GDP ratio's of 60% should indeed allow the flexibility to provide boosts to a flailing economy without undermining an economies long-term health. After all, these measures and restrictions were drafted so as to allow sufficient flexibility in economic downturns to stimulate the economy without over doing it. In addition, part of the reasons for the creation of the singly currency was to provide a better chance of the long-term economic growth and prosperity. Thus, such restrictions were created with such an objective in mind and therefore should, and do, provide the means for nations to respond to economic problems.

Will joining EMU help to promote higher growth, stability and a lasting increase in jobs?

In the previous section, we outlined the benefits of joining a single currency. All these benefits pointed to the ability of a single currency to promote higher growth, and a lasting increase in jobs. With respect to stability, the ECB's ultimate objective is price stability over the medium term and, if as it is generally assumed, the ECB has been founded on the principles of the Bundesbank, then Britain cannot argue over a record of maintaining price stability. Over the final forty years of its existence, the Bundesbank maintained an average yearly inflation rate of just over 3%, compared with an average yearly inflation rate of over 6% in Britain. Thus in terms of test 5, Britain

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should indeed join the Euro.

Thus ultimately, according to tests one, two, four and five, Britain should indeed join the single currency program. However, test three still has to be met, and perhaps more importantly, seen to be met. Certainly, there is a prevalent thought amongst commentators that this new millennium will see closer economic structures between Britain and the Eurozone, as well as closer business cycles. If this were to occur, than it would be an act of economic madness for Britain to "save the pound."

Is there a political dimension?

Of course there is a political dimension. To even mutter the words European Monetary Union without a thought for what part politics plays is laughable. However to suggest that a single currency means a single state is equally laughable. After all, there are many examples of countries who enjoyed a single currency without giving up national sovereignty. Ireland maintained a currency union with Britain between 1921 and 1979 without becoming part of Britain, and Belgium and Luxembourg have long enjoyed the benefits of a single currency without surrendering sovereignty. Thus if the debate over sovereignty is not that which should occupy the minds of British nationals what is it? Put simply, the debate centres upon what role does Britain see itself having in a future Europe. Time and time again, Britain has remained an outlier on European affairs only to join later anyway. This has meant that Britain's ability to shape the development of Europe has been severely restricted. For example, Britain did not join the European Economic Community until 1973, it was also a belated entrant to the ill-fated ERM, and already it is late to the party that is the Euro (Although perhaps with good reason, as discussed above). However if Britain is to have any say upon the future development of Europe it must get involved now. While remaining outside of the EMU, Britain is open to accusations of not being fully committed, to sneers that since it will not directly affect Britain, why should Europe take Britain's interests on board at all? Therefore, if Britain has an interest in the continuing development of Europe, then surely it must become involved in the single currency program as early as possible. On top of this, Britain is presently in a situation of possible great political influence. After all, Britain is led by a government which won a resounding victory in its last election. The Anglo-American economic model has proved itself to be far more successful than the EU model and Britain has succeeded in achieving productivity gains over the last few decades that Germany and France can only sniff at. In addition, Britain has appeared to be sounding out allies for its economic model

in Spain and Italy, both of whom are expected to post fast economic gains due to their increasingly open economic models.

Another factor is that Britain, Spain and Italy all have recently elected governments with considerable public support. Compare this with the situation in both Germany and France, whose economic models have resulted in their becoming economic dinosaurs. In addition, Germany and France's political leaders are now shortly facing into elections which are expected to be keenly contested. Thus, today, Britain is in a position of unparalleled historical ascendancy in terms of its domestic affairs when compared to the other major economic powers of Europe. Since the economic strife is forecast to continue in both Germany and France as they adjust to structural challenges, surely now is the time for Britain to step up to the plate, and become a major influence in the further shaping of Europe. This however, can only be achieved by further committing to Europe, and therefore joining the Euro. This brings us back to the original question, upon what role does Britain see itself having in a future Europe?

Concluding Remarks

'If the shoe fits, wear it'.

So Dr Willem F. Duisenberg spoke in a speech given in November 1999. At present for the Eurozone, the shoe does indeed fit, although perhaps a little uncomfortably. The same would be said of Britain were they to join the Euro too, but the real question for Britain is surely, do they want to wear it?

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