Evidence presented to the Treasury Committee of the House of Commons on the subject of Economic and Monetary Union by William Porter[1], writing in a private capacity. June 2000.

The evidence takes the form of a two-page discussion which makes two main arguments in a total of four points. Four Appendices (not congruent with the four points) expand the summarised arguments somewhat. A fifth Appendix describes the author. Paragraphs are numbered as requested in the Guide for Witnesses. The arguments are simple, but it is submitted that they are powerful and reasonably self-supporting. They are therefore presented briefly. Points that are poorly-presented or controversial can be expanded upon, by supply of supporting documentation, references, further written evidence or oral evidence, which the witness is available to give.

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[1] See Appendix E for information on the witness.

1 Conclusions:

The euro is unique. A currency is a legal construct. The boundaries of the euro uniquely do not coincide with those of a legal jurisdiction and of a political entity[2]. The euro therefore pools monetary sovereignty.

As a direct result of the unique nature of the euro, a decision to join EMU is irreversible, regardless of nominally-retained monetary sovereignty. In certain circumstances a new currency could be introduced and circulate in parallel, but the *status quo ante* can never be recovered.

There is widespread misunderstanding on this issue, even in expert circles. The possibility of voters misunderstanding is large.

The EMU debate must be conducted with no misunderstanding on this central point. Entering EMU under a misapprehension that it can be left should not be an option. Parliament has a key role to play in ensuring that any guidance that Parliament receives from a referendum is in the context of that understanding, perhaps achieved via the wording of the question.

Secondly, the unique nature of EMU leads to the current debate being coloured by assumed conclusions that EMU either must end or must lead to political union

Thinking through to those conclusions instead of assuming them creates corollaries.

Consideration of adopting the dollar instead, if only as a 'control thought experiment' as part of that process would put the issues into clearer relief.

2 Joining EMU is irreversible, in the sense that despite retaining monetary sovereignty a country cannot leave EMU by introducing a new currency and redenominating euro obligations into it. The proof is simple: see Appendix A for an expansion of the following summary. Currencies are a legal construct. A sovereign state retains monetary sovereignty. It can legislate the nature of all currency transactions within its borders and under *lex monetae* this precedent is respected by all other jurisdictions. Globally, the currency of the United Kingdom is what Parliament says it is, at whatever rate to the old currency Parliament decides. (1p = 2.4d, for a weak example). For all major currencies other than the euro, that is an end to the matter. This includes adoption of the euro.

3 But the precedent will be subordinate to another jurisdiction's own *lex monetae* if the two are in conflict. This issue is unique to the euro and makes it indissoluble. French-law contracts, for example, with private-sector counterparts in the leaving country, assumed not France, will be enforceable in euro in the French courts irrespective of the legislation of the leaving country. (The EU's being agreed to have taken monetary sovereignty would clearly put the issue beyond doubt.)

4 If the leaving country would have a weak currency (and this works in reverse), entities would have ample notice to ensure that their claims on the leaving country were, to the extent possible, in a surviving-country jurisdiction and the leaving country's claims were in the leaving country's jurisdiction. This would impose very large costs, which are likely to be prohibitive in light of the large cross-border flows and claims. The balance sheets of banks, for example, are inextricably mixed across jurisdictions. These costs will grow as all new trade is denominated to the detriment of the leaving country (for example, as simply as moving deposits from one branch to another of the same bank). If the currency leaving were weak, these costs would weaken it further, creating a negative spiral and economic meltdown.

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[2] See footnote to Appendix A

5 The decision to enter EMU is therefore permanent and irrevocable. The exception is the total, multilateral breakup of EMU, which alone reclaims de facto monetary sovereignty. A country can introduce a new currency to circulate in parallel but this will fail unless needed as escape from a total collapse of the system. The *status quo ante* is irrecoverable in all circumstances (See Appendix B).

6 Although EMU countries retain monetary sovereignty, this is illusory and, for all practical purposes, EMU entry is irreversible. The *status quo ante* can never be regained.

7 The point is clearly central to any consideration of the merits of the EMU case.

8 There is widespread misunderstanding on this central point, even in the most surprising circles. (See Appendix C for documentation. Further quotations can be provided, but for now the witness submits the assertion.) It is therefore likely that the vast majority of the voting public is capable of becoming confused on this point.

9 There is widespread, erroneous belief even in expert circles that EMU is reversible. This suggests the possibility of confusion on the subject among the electorate.

10 All elements of the debate should be conducted in the context that, as a matter of Parliamentary record, UK entry into EMU would be permanent and irrevocable.

11 The issue causes other forms of confusion. Those who, consciously or unconsciously, cannot accept the precedent of a currency whose boundaries do not coincide with a legal jurisdiction, tend to resolve the novelty either by considering EMU as being unilaterally revokable (monetary sovereignty thereby remains uncompromised, thus retaining boundaries coincident with those of the existing jurisdiction) or an inevitable step on the road to a European sovereign entity (for good or ill). Just as the first resolution is wrong, the second is an assumed conclusion.

12 Maybe the disconnection between currency and jurisdiction is indeed ultimately unsustainable, in which case the euro must be ended multilaterally, or Europe must become a sovereign State. But the possibility should at least be considered that an apolitical monetary union is possible. The debate should not be conducted with this important conclusion assumed, one way or the other.

13 There are important corollaries even to considering the question. If the possibility of the current arrangement being stable is rejected, then the EMU debate can be conducted on the basis of Economic, Monetary and Political Union. If not, the political evolution of Europe can be considered separately from EMU. And if monetary unions can exist independently of political union, then the UK's decision on whether to forgo monetary sovereignty need not be confined to the euro. Adoption of another currency can be considered. This improvement to the logic of the current debate is explored in Appendix D.

14 Those who feel or claim that EMU is apolitical and those who feel that it leads to an inevitable erosion of all sovereignty should both therefore consider the alternatives to both EMU and sterling. Essentially, dollarisation. See Appendix D.

15 More generally, the nature of the uniqueness of the euro must be understood in the debate.

Appendix A — **The irreversibility of a decision to join the euro**

A1 When Greece adopts the euro on 1st January 2001, all Greek drachma contracts globally will become euro contracts as a result of *lex monetae* being applied in all major jurisdictions[3]. For the Greek drachma, that is an end to the matter, as it is for any other currency being redenominated by its sovereign government. The exception is the euro.

A2 No law passed in Greece can affect the legal status of, for example, the German currency under German law. And no law passed in Germany can affect the legal status of the currency of any other sovereign nation, including Greece. Under treaties incorporated into the law of all participant nations, the currencies of Greece and Germany are 'non-decimal denominations' of a euro. Under the laws of all major jurisdictions (all participants and major non-participant jurisdictions, who have passed laws to the effect: see footnote), they are as interchangeable as silver and brass coins or five- and ten-pound notes. This interchangeability of currencies issued under different jurisdictions is unique to EMU[4] and complicates irretrievably the normal application of *lex monetae,* which is an essential component of monetary sovereignty.

A3 Let us say Germany 'leaves EMU' today. The German Parliament passes a law reintroducing the Deutschemark at the existing parity of DEM1.95583 to €1. The physical euro is never to be introduced, existing Deutschemark notes and coins are to be used for convenience, and existing euro debts are to be redenominated into Deutschemarks. Domestically, this causes minimum fuss: is imperceptible as, at one level, the introduction of the euro has been. But internationally, things are not that simple.

A4 French-law contracts, for example, between French parties and private-sector counterparts in Germany, will be enforceable in euro in the French courts. French courts will see even surviving references to the 'old' Deutschemark as a reference to 1/1.95583 of a euro, since this is enshrined in French law. Laws passed by the German Parliament which deem references to 'old' Deutschemarks as being references to 'new' Deutschemarks can therefore have no impact at French law. As nor can any attempt to deem references to one euro to be references to 1.95583 'new' Deutschemarks. The normal precedent of *lex monetae* is subordinate to the fact that French courts will not recognise the attempt of any foreign power to legislate over the domestic currency of France, still, for these purposes, most definitely a State with monetary sovereignty. (The EU's being agreed to have taken monetary sovereignty would clearly put the issue beyond doubt.) Entering the euro does not destroy monetary sovereignty but effectively pools it with other

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[3] At the outset of EMU, for the avoidance of doubt and given the complex nature of the project, many foreign jurisdictions passed special Acts covering continuity of contract etc. This is, however the exception and is not normally done. eg the Argentinian currency reforms of the late 20th century.

[4] This footnote is that referred to from the first conclusion. The pound sterling / Scottish pound parity is a partial counter-example and a useful illustration. The Treaty and Act of Union unified the government but not, completely, the legal systems. The familiar Scottish note issue, governed by the Bank Charter Act of 1844, is backed by holdings of Bank of England notes (held, for convenience, at the Bank of England in the form of specially-created £1million notes). The status of the Scottish pound is not dissimilar to that of a euro-constituent currency. But the Scottish pound is irrecoverably lost, even to a future sovereign Scotland. Scottish banks would hold a large part of their assets in Scottish law and a large part of their deposits in the law of England and Wales. An attempt to unscramble the two pounds would be doomed. What of the Englishman whose salary is paid into a London branch of a Scottish bank? A Glaswegian with a mortgage at Barclays London? Would the two, now sovereign, Parliaments cooperate in unscrambling the mess? Who would pay?

members' monetary sovereignty, at which point it is irretrievable unless by mutual agreement.

A5 The position at other jurisdictions is more complex, and much confusion is likely, there being no precedent (Scott, 1998)[5]

A6 If the leaving country has a weak currency (and this works in reverse), people would have ample notice to ensure that their claims on the leaving country were in a surviving-country jurisdiction and the leaving country's claims were in the leaving country's jurisdiction. This would impose very large costs, which are likely to be prohibitive in light of the large cross-border flows and claims. These costs will grow as all new transactions are denominated to the detriment of the leaving country (as easily as moving money between branches of the same bank). If the currency leaving were weak, these costs would weaken it further, creating a negative spiral and economic meltdown. An estimate of initial costs would be given by

$$\text{(GROSS annual cross-border flows of all types)} \times \text{(currency move)} \times \text{(lead period in years)} \times \text{(some fraction)} + \text{constant.}$$

A7 This can clearly reach many percent of GDP within a few months. As the costs mount and the currency falls, the cost mount until complete destruction of credit occurs.

A8 The decision to enter the euro is therefore permanent and irrevocable. The *status quo ante* can never be regained.

A9 This argument is referred to elsewhere in this evidence as ‘the main critique'.

A10 Appendix B explores the possibility of introducing a new currency to circulate alongside the euro, but that this is possible only in theory and will be ineffective. Appendix B also explores the fact that only the total, multilateral break-up of EMU reclaims de-facto monetary sovereignty.

A11 Although EMU countries retain monetary sovereignty, this is illusory and, for all practical purposes, EMU entry is irreversible. The *status quo ante* can never be regained.

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[5] ‘When the euro falls apart’ Hal S. Scott, Harvard Law School. International Finance 1:2 1998. The witness does not agree with many of the conclusions, as the paper's title might suggest, but this is an excellent survey of the legal issues.

Appendix B — **The theoretical ‘options’ of introducing of a new currency in parallel, dissolving EMU entirely or joining another currency**

B1 Introducing a new currency

B1a This is the preferred vehicle for arguing that EMU is reversible. The fact that monetary sovereignty, while pooled, is retained does indeed mean that a new, officially-legislated currency can be introduced to circulate in parallel. This cannot recover the *status quo ante*, but provides an opportunity to recreate monetary sovereignty effectively from scratch. This is likely to be very difficult, to the point of being unfeasible in most circumstances. Its importance in thinking that EMU is reversible should certainly not be exaggerated.

B1b Establishing a new currency, so that effective monetary sovereignty is recovered, requires its widespread adoption by the banking system and the government, including the redenomination of government debt. The main critique prevents the government legislating equivalence between the euro and the new currency. It can however redenominate its debt and demand use of the new currency for taxes. There is no way to extinguish domestic private-sector euro obligations. This establishes a situation where a foreign currency (the euro) is circulated very widely in competition with the domestic currency. In most countries, this has already occurred to some extent. In Deutschemark note form, the euro circulates widely in Eastern Europe. In Argentina, the peso is interchangeable with the US dollar. To regain actual monetary sovereignty, the new currency has to establish itself throughout the economy. Gresham's law does not apply: history suggests that foreign currencies circulate in response to a valueless local currency. (Scott 1998). There are three cases.

a) A new, weak currency. Were the euro still a strong currency, with a new weak currency to be introduced, the situation would resemble some of the history of Eastern Europe and the economy would remain effectively ‘euro-ised'. Redenomination of government debt would provide some short-term windfall gains to the public sector, in common with any such default, but would not gain monetary independence and would incur large costs. The country would be in breach of EU Treaties and would lose whatever say it has in euro monetary policy. Those owing overseas debts (and see main body: this is likely to include everyone transacting overseas) would still be on the hook. Would a sovereign (for rhetorical purposes) East Germany expect to gain from reintroducing the Östmark? Failure.

b) A new, currency and a chronically weak euro. Were the euro chronically weak, the new currency could establish itself. The original EMU would remain intact, but become irrelevant. This method has been used by former Soviet Republics in connection with the rouble. This indeed provides relief from the problem of a euro devaluing to worthlessness (taking the legacy currencies with it) but this scarcely constitutes reversibility of the decision to join.

c) A new, relatively stable currency and stable euro. The economy might have diverged from the remainder of the EU, leading the government to wish to regain monetary sovereignty. New claims and government debt could be accrued in the new currency, but old claims remain. Establishing the new currency requires widespread redenomination to take place voluntarily on

the part of the private sector. Either debtors or creditors will push for this, through the markets, depending on the reasons for introducing the new currency and the monetary policy being pursued within it. Debtors will seek to 'redenominate' through the markets into a weak, lower-interest-rate currency, creditors the opposite. With a very small natural base and with the whole private economy denominated in euro, this implies either a monetary policy exactly matched to that of the euro, or a quick degeneration to case (a), driven by the interests of debtors gaining the upper hand or a slower degeneration in the direction of case (b), driven by creditors. The latter is probably the most stable outcome. It implies the new currency being very strong. The economy will be faced with a choice of two monetary policies and an internally-floating exchange rate. A form of internal divergence is conceivable, with very sharp and sudden internal price moves between those parts of the economy that remain euro-ised and those that are not.

But, in addition to these problems, the situation is unstable in that any tendency to weakness on the part of the new currency degenerates into case a unless the currency has become very firmly established. Monetary sovereignty can therefore only be regained for as long as the new currency is needed to be strong. As soon as the need changes, case a occurs, leading to failure of the new currency. The only case in which it never does so is case b.

Thinking to a conclusion, therefore, it is highly unlikely that introducing a new, parallel currency can regain monetary sovereignty. However, it does provide a way to mange the euro becoming worthless.

B2 Dissolution of the ENTIRE system.

a) Post the EU assuming monetary sovereign status (if ever). The issues are much simpler and are those of any single sovereign State reforming its currency. The issue in the euro is the current disjoint between the currency area and sovereignty. Monetary sovereignty of the component States is of course lost and this is not a true exception.

b) Pre the EU assuming monetary sovereign status. The main critique concerns the creation and management of international claims in a way that harms the leaving country. Surviving countries' jurisdictions continue to recognise euro claims on the leaving country. But if all countries left, some mechanism could be agreed to destroy ALL euro claims in favour of, for example, a basket of new currencies — the reverse of EMU. *Lex monetae* would redenominate all euro claims globally to the basket, given that the laws of all ex-EMU countries would legislate that change. This would be an enormous project, but no more so than the creation of EMU itself. In extremis, it is just conceivable as a possibility.

Note that this mechanism is most unlikely to allow a country to leave EMU even by mutual agreement with all survivors. How could it be arranged? Could all claims on and by entities of the leaving country be agreed across all EMU member jurisdictions to be denominated in the new currency? This creates arbitrary transfers of wealth within the EU. Remaining countries are most unlikely to agree to this. Could a basket be agreed which made a 'new euro' and some fraction of a new (eg) Deutschemark out of a euro? Why should French companies endure this complication? And what of a euro claim by an EMU-country entity on a leaving-country entity under English or New York law? Creditors would

immediately seek to establish these claims, which could be argued to survive: this would be new legal ground. And non-EMU claims under non-EU law - claims of UK banks, for example - would remain in euro.

B3 Adoption of another major currency. This idea is controversial and, to the author's best knowledge, original. The witness has published it nowhere else.

B3a In a clumsy analogy, consider a frog on a lorry in a traffic jam at Spaghetti Junction. The frog suspects its lorry is going to London: the frog wants to go to Manchester. The frog has retained the right to hop. Hopping off in the general direction of Manchester, it is crushed. But it can hop onto another lorry that it believes is more likely to be going in the right direction.

B3b The leaving country's authorities could announce that on some certain date in the future, their currency was (to name the clear obvious example) the dollar with existing claims redenominated at then-prevailing market rates. *Lex monetae* is clear: claims in the law of the leaving country are in dollars, other claims in euro. The mechanism is broken whereby the market can accrue claims in the currency they know will be stronger. Even if a judgement is made as to the course of the dollar vs the euro and asymmetric claims build up against the leaving country, the eventual exchange is at market rates and involves no gain or loss (compare the ECU at the end of 1998). The main critique is neutralised.

B3c A key underlying assumption is that the destination currency is sufficiently robust to be able to absorb the impact of the incoming entity. The complicity of the destination-currency authorities is clearly highly desirable but is not indispensable in all circumstances[6]. Argentina and Hong Kong are actively considering adopting the dollar independently of the US authorities.

B3d One potential example is Ireland. Were the UK to stay permanently out of step with the euro economies and out of EMU but economically in step with Ireland, as is currently the case, it is argued by the witness to be theoretically feasible that Ireland could adopt sterling. Probably politically impossible, of course, but this evidence attempts to ignore politics to the extent possible.

B3e Interest-rate contracts of course create transfers of wealth in this process, to the extent the interest-rate structures are different in both currencies. This problem is manageable and was managed in the transition to EMU. New interest-rate transactions can be stopped or the law of new transactions can be chosen freely once the government's plans are known. This is a small problem compared to that imposed by the main critique. Therefore there are likely to be costs, but these are strictly determinate in contract to the indeterminate costs of creating a new currency. Domestically, wealth transfers will arise but the government has tools to offset these, eg through the tax system. These issues existed in the creation of euro. EMU ‘convergence’ occurred over a period of years but created very large wealth transfers, mainly away from the governments of high-interest-rate countries and in favour of bond-holders. The issues were manageable and managed.

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[6] A full study of the mechanics of adopting a foreign currency is beyond the scope here. Briefly, for the process to be sustainable, the adopting country has to accumulate enough of the target currency to retire the liabilities of the central bank in the retiring currency. A monetarily-sovereign State can achieve this unilaterally, given the right policies. While not essential, the assistance of the target currency's authorities is useful: this is how countries join EMU - the ‘Eurosystem’ assumes joint responsibility for the new member's central-bank liabilities. But these remain distinct. The process is more difficult for an existing EMU member adopting a foreign currency, but theoretically possible while still monetarily sovereign. In contrast to the indeterminate sums mentioned in the main critique, the liabilities of the central bank are strictly determinate. Transfer of EMU central banks' FX reserves to the ECB makes the process more expensive but the mechanism is intact.

B4 Note that true monetary ‘sovereignty’ can only be regained under option 2, for which the consent of others is required.

B5 **Exceptions are academic. Joining EMU involves effective loss of monetary sovereignty unless either the sovereignty pool is mutually dissolved, the euro becomes worthless or monetary sovereignty is transferred to the authorities of another currency.**

Appendix C — **Widespread misunderstanding of the irreversibility of EMU**

C1. Romano Prodi, the President of The European Union, was interviewed in the Spectator of 27th May 2000.

> *Q: did Mr Prodi believe that, if the Danes voted 'yes', they might later be allowed to change their minds?*
>
> *A: The President hesitated, hefting his words carefully. 'What I have said is that there is no provision in the treaty for withdrawal. This is stating the obvious. But, of course, in an extreme case, one could always foresee, for example, that Texas might leave the dollar. But this is not strictly in the US constitution*[7].
>
> *Q: …I pressed him for clarification: are you really saying that existing members of the euro might choose to opt out again?*
>
> *A: 'If there were exceptional circumstances, and provided it was not done in a way which was hostile to the European Union. It is impossible to foresee for certain.'*
>
> *Q:But, in theory, a country could go back to its old money while remaining a full member of the EU?*
>
> *A: 'Certainly, it's possible. There are countries today which are full members of the EU but are outside the euro.'*[8] *There has been no provision for Greenland to leave the EU, he added helpfully, but it had still happened*[9].

C2. In private correspondence and discussions with UK opinion-makers and officials, the witness has also noted widespread misunderstanding of the issues involved. A typical example is "You forget sovereignty. Just as a country can redenominate in Euro, so it can re-redenominate in DM and if it is a fait-accompli markets will react maturely". Precisely: sovereignty is inviolate, as argued. But the 'mature' market reaction, readily achieved, is to attack the bare throat of the leaving country, imposing prohibitive costs. The market is central to the main critque.

C3. There is a strong appetite for analysis on the subject among investors.

C4. The theoretical possibilities explored in Appendix B do not provide a method for reversing EMU, and are capable of being misunderstood - even, misrepresented.

C5. Further quotations can be provided, but the witness submits as proven the assertion that:

C6. There is widespread belief even in expert circles that EMU is reversible. Therefore the possibility exists of the electorate misunderstanding this central issue

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[7] ! Texas seceded from the United States on 23rd February 1861. The American Civil War started on 12th April 1861. Mr Prodi is correct in: the US Constitution was silent on the point of secession, in contrast to the Treaty on European Union, Article 6.2 "The Union shall respect the national identities of its Member States". But the Civil War clearly established the precedent that the American Union is indissoluble. The dollar resides in Federal law: Texas is a State with no monetary sovereignty. An illustration, perhaps, of the differences between Common-Law and non-Common-Law jurisdictions. - See Appendix D.

[8] But no ex-EMU members: this is a non-sequitur.

[9] Of nil relevance. A sovereign State can attempt to negotiate its way out of the Treaties, as Denmark did for Greenland. The inevitable, large costs of attempting to leave EMU explored herein are not incurred on leaving the EU. But any country leaving the EU would have to retain the euro.

Appendix D — **Misunderstandings of the nature of EMU confuse the debate.**

D1 *It is an intensely political act… However, just as the euro cannot be conceived of except politically, it cannot be made to work except economically. It is, after all, an economic union. Statement by Prime Minister Blair to the House of Commons 23 February 1999.*

D2 Considering EMU as a political act is disputable. "It is, after all, an economic union" is closer to the mark. The confusion of the euro decision with a political agenda, simply because all other major currency areas coincide with a political area, colours the debate irrecoverably. The euro is unique in being a currency that does not coincide with a political area. Maybe this is ultimately unsustainable, in which case the euro must be dissolved or Europe must become a sovereign State. But an open mind should at least consider the possibility that an apolitical monetary union is possible. If this possibility is rejected, then the EMU debate can be conducted on the basis of Economic, Monetary and Political Union. If not, the political evolution can be considered separately from EMU. In which case the UK's decision on whether to forgo monetary sovereignty need not be confined to the euro. Adoption of another currency can be considered.

D3 Those who feel that EMU is apolitical AND those who feel that it leads to an inevitable erosion of all sovereignty should therefore consider alternatives to both sterling and the euro. The obvious possible choice is the US dollar[10].

D4 Transforming the UK's monetary choice from the binary, sterling or euro, to the ternary, sterling euro or dollar, provides a ‘control experiment’ on whether the EMU debate and the European political debate can be separated. This would appear to be so: there is no serious suggestion on any part that Argentina or Hong Kong, if they adopt the dollar, would face inevitable political absorption into the US. Introducing the dollar as a third alternative actually clarifies the issues. The decision trees in D19 illustrate how the concept can enrich the debate.

D5 It also provides a ‘control experiment’ on the "Five Economic Tests". Quoting from the above-referenced statement by Prime Minister Blair:

> *...sustainable convergence between the UK and countries within the euro zone; flexibility to adapt to change in the UK and in continental Europe; the impact on investment and the UK financial services industry; and whether joining the single currency would be good for employment...*

D6 Without arguing the issues to conclusion here, a case can be made that the dollar fills the conditions more fully than currently does the euro.

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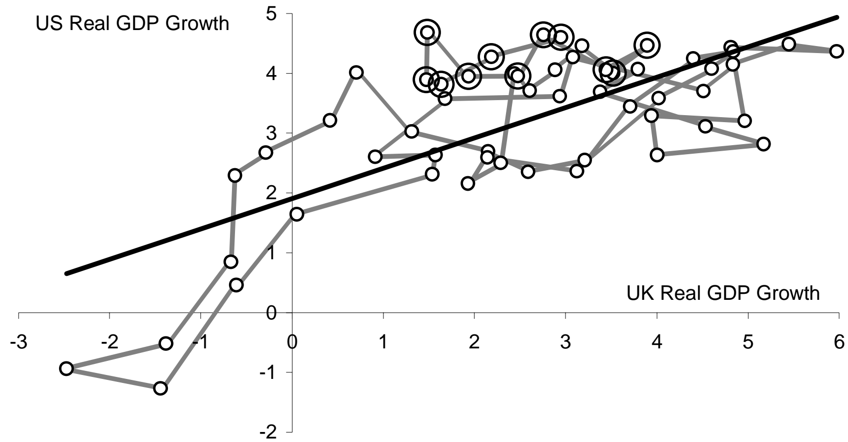
[10] See footnote to Appendix B. There is one essential difference between the adoption of the euro and the dollar. In the former case, UK views would be represented by a seat at the ECB Governing Council that sets euro monetary policy. This would be unlikely to be the case at the Fed. But better non-voting in a converged economy than being outvoted in an unconverged economy - see discussion in balance of this Appendix. cf Ireland, although the UK would be perhaps be more influential. Central Bank of Ireland Spring 2000 Bulletin "...Ireland’s inflation rate, at 4·6 per cent in February 2000, is now by far the highest among EU countries... With higher inflation, real interest rates are lower here than elsewhere... The Irish economy is just one percent of the total euro area economy. It follows that Irish experience will not greatly influence nor dictate policy... As monetary policy is no longer determined to suit Irish conditions, our economy is more vulnerable than before to overheating and the consequences of this — inflation and a loss of competitiveness."
There is also a clear legal difference: adopting a third currency would be against the spirit of the Treaties, although not the letter. Even the latter would of course not prevent at least considering the concept.

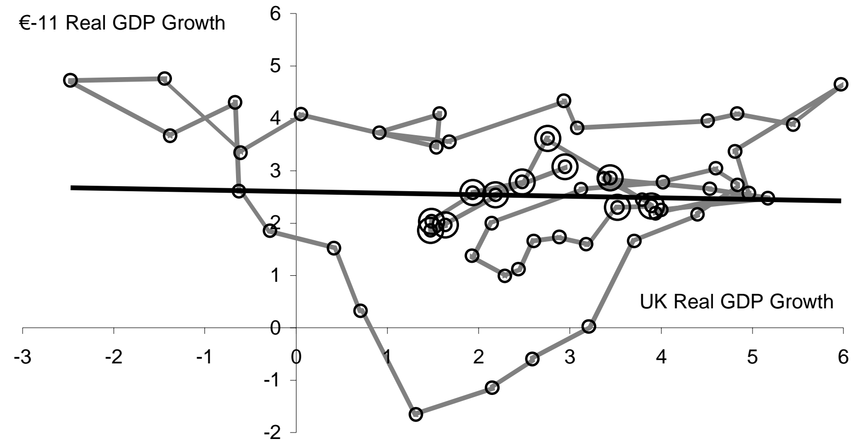
D7 Over the past 15 years, the correlation between monthly closes of sterling Base/Repo Rate and the US dollar Fed Funds target has been 73%. The below chart shows, in part, how this can be the case.

Chart: Quarterly year-on-year US real GDP growth, plotted against UK real GDP growth 1985 to present. Line of best fit shown. Ten most recent observations circled. Source: Datastream



D8 The correlation with the Bundesbank/ECB Discount rate is minus 26% over the period. See the below chart for a possible explanation.

Chart: Quarterly year-on-year euro-11 real GDP growth, plotted against UK real GDP growth 1985 to present. Line of best fit shown. Ten most recent observations circled. Source: Datastream



D9 It could be argued — perhaps rather bravely — that, based on the latest ten (circled) datapoints, recent data reflect better UK/euro-11 convergence. And that the longer data are unrepresentative due to eg German reunification. But the contrast with the US is striking. And note in particular how periods of greatest UK economic weakness coincided with greatest euro-11 strength but greatest US weakness.

D10 Modern economies are increasingly focussed on services, less on heavy industry. India is a major exporter of computer software development services. China has attracted significant criticism for failing to curtail software- and music piracy. Quoting again from PM Blair's statement to the House:

> *In the modern world, one has only to look around to see that technology, global finance, mass communication--to say nothing of travel and culture--are coming together. The world is moving together*

D11 Physical distance is becoming less important to trade than are distances of language, culture, training and legal system.

http://www.gwu.edu/~ibi/minerva/Spring1997/Luciano.Guimaraes/Luciano.Guimaraes.html Information Technology and its impact on modern society:

> *Manufacturing employment has declined to about 20%, and soon less than 10% of all workers should operate the industrial system. Industrial capacity will always remain essential, of course, just as agriculture continues to be important even now. However, today more and more of the U.S. workforce is in the production, transformation or storage of information (clerical workers, services agents, data-entry jobs, software programmers, investment brokers, etc.).*

D12 Again, a conclusion is not sought here but there is a case to answer that these considerations work in favour of dollarisation rather than joining EMU.

D13 Currencies being legal constructs, the common-law legal approach common to the UK and US is a further factor to be considered in these circumstances. It can at least be argued that the Internet is shrinking trade-routes in the emerging information industries faster than global cultural barriers are falling. Economic convergence is not just a matter of trade but is also strongly dependent on how similar economies respond to global stimuli compared to different economies. The UK economy can be argued to resemble the US

economy more than eg the French. This similarity has, for many years, dominated trade links reinforced by proximity, as shown by the above correlations. This dominance is arguably likely to increase.

D14 It could further be argued that the political effects of such a move would be desirable, although the move would obviously be controversial.

D15 PM Blair to the House 23rd February 1999

> *I want us in a Europe that at best is moving firmly in the same direction, rather than trying to hold us back. That is a vision that lets us adapt the European social model to the new realities of global commerce; a vision that binds the EU and America closer together and lets us learn from one another.*

D16 A risk to that process would be that Britain in EMU might become part of the perceived problem: dollarisation would reduce that risk. And (Appendix C) the euro could conceivably be adopted later. But, once surrendered in any direction, monetary sovereignty could not be regained.

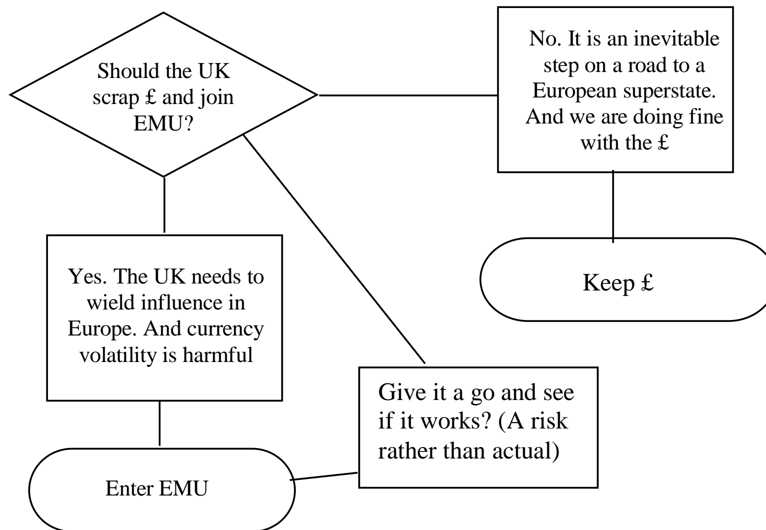
D17 A poor understanding of the unique nature of EMU leads to the current assumptions in many circles that EMU either must end or must lead to political union. Clearer understanding would improve the debate.

D18 The debate would be enriched by consideration of adopting the dollar, if only as a 'control thought experiment'.

D19 Exhibit to Appendix D **— Decision trees**

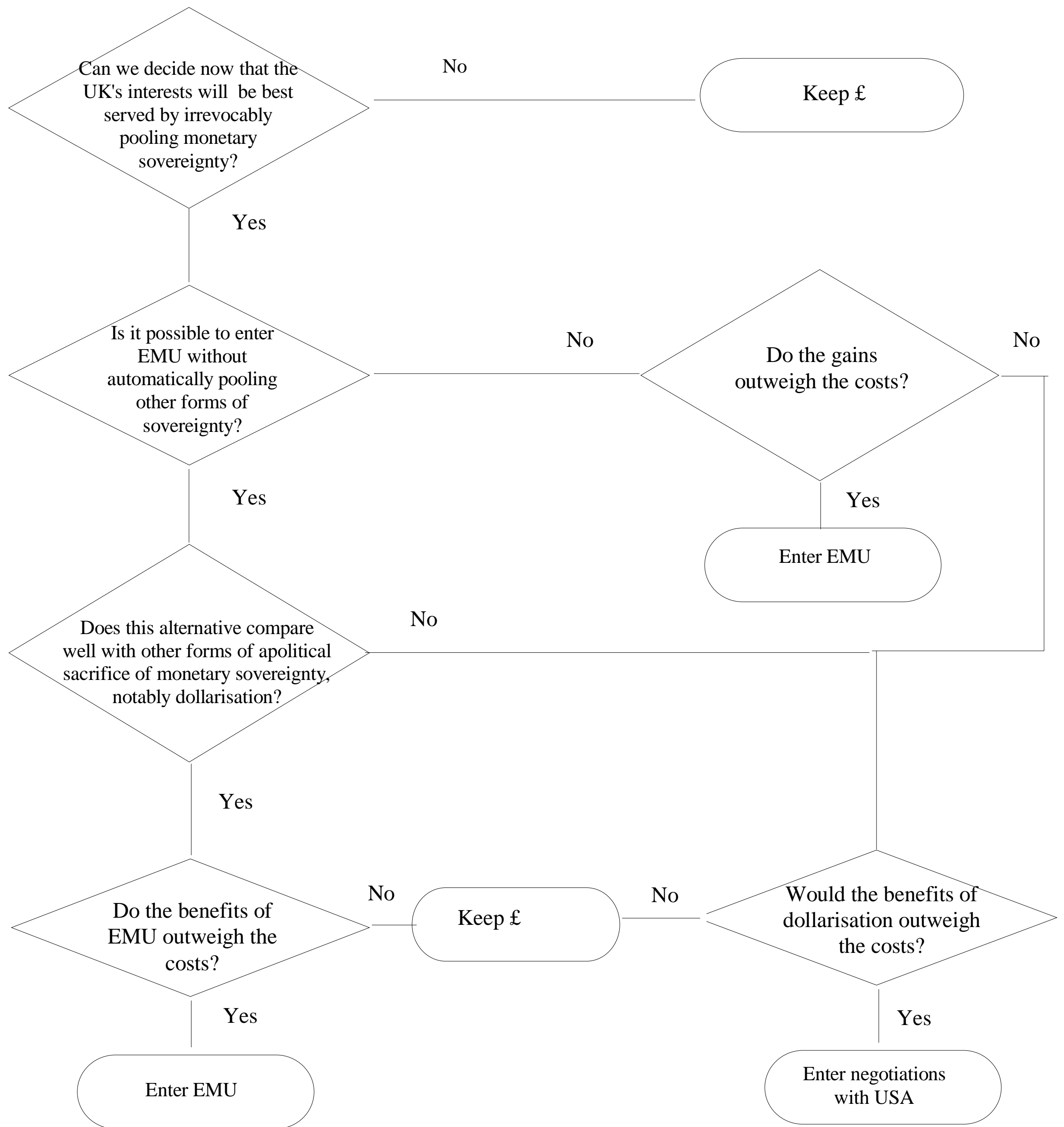
Accepting that, if EMU is apolitical, there is at least a case to answer that dollarisation should be considered, if only as a control experiment, clarifies and enriches the debate. The current decision tree may be stylised as below, while the second decision tree shows the much richer debate that should be held.

Current debate, stylised only mildly:



Full decision tree overleaf

Full decision tree:



Appendix E — **The Witness**

E1 William Porter is a bond-market analyst at an investment bank. He has wide experience in currency and interest-rate markets. This evidence is submitted in a purely individual capacity and these views are in no way connected with those of his employer. Some of the views are controversial within that firm. The witness is grateful, however, for the interesting discussions that he has on the subjects with colleagues and others: the issues raised are central to financial markets.

E2 His areas of study centre on central bank policy, where he has worked closely with officials of the Bank of England and the ECB, and on the effect of regulation such as the UK MFR on financial markets.

E3 The witness was actively involved in making EMU happen, through his work on creating the reference rates necessary for the functioning of financial markets in any currency. He is a member of the Euribor Steering Committee (Euribor is the euro equivalent of LIBOR) and, working with that committee and the ECB, created EONIA, the reference overnight rate used to settle financial transactions and, due to its success, now used by the ECB in formulating policy.

E4 The witness is British and has lived in the UK, USA and Japan. His 'EMU politics' are that currencies are economic tools. Similarly to Flag Carrier airlines a generation ago, they attract national pride that is unrlelated relative to the job they have going forward and which is a major drawback to their management. But they are tools that can be turned to political ends. He is therefore an EMU agnostic but thinks that any decision to retire irrevocably a currency that has served for 1082 years has to be got right, cannot be 'political' and must be made in an environment of general agreement on the underlying nature of the decision.

E5 The fact that the irrevocable decision is being made at a time of intense change increases the burden of proof yet further.

E6 The experience of the recreation of the only other currency zone of comparable size and diversity is relevant. Ingo Walter, at New York University, teaches that reconstruction of the South following the American Civil War was massively delayed by 'Economic and Monetary Reunion' (not his words). Through a monetary policy unsuited to its needs, the South largely missed out on the entire Industrial Revolution and only caught up as the 'rust belt' faded from the American economy. Only now, a century on, has the South 'converged'. It is therefore worrying that many people active in the debate miss some of the lessons to be learnt from the dollar and that US experience is not more widely quoted; indeed, is sometimes extraordinarily misquoted.