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EMU, the UK and their future?

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Introduction

Economic and Monetary Union will take place on 1st January 1999 between a core of 'rich' countries leaving a 'two-speed' Europe which will show increasing divergence between the rich and the poor. This problem will be further compounded by the expansion of the EU when the countries of Eastern Europe are admitted. This leaves the question of the how the UK fits into Europe; should it enter EMU with the core countries or would it be better off in the periphery? This paper assesses European Monetary Union, (EMU), giving the economic and political rationale behind it and the problems underlying the politically driven agenda. The scenario of a two-speed Europe is discussed at length and the implications for the UK of two speed monetary union are critically appraised.

The Background of EMU

Economies in Europe had been ravished by the Second World War and national currencies were not convertible. The Bretton Woods agreement in 1944 did not support international trade until 1958-59. The International Monetary Fund, (IMF), was established in 1945 and introduced a system of fixed exchange rates which linked all currencies to the US dollar and the US dollar to gold, (the Gold Standard). Changes in parities were only allowed in the case of a fundamental imbalance between government revenues and spending. In Europe, efforts to co-ordinate trade led Germany, France, Belgium, Holland, Luxembour and Italy to sign the Treaty of Rome in 1959 establishing the European Economic Community, (EEC). The main elements of the Treaty were the customs union, (the Common Market) and the Common Agricultural Policy, (CAP). The aspirations of the EEC went further; economic policy coordination and the balance of payments were dealt with in the Treaty. Further conjunctural policy and exchange rate policy were to be a matter of common concern. By the end of the 1960s the customs union had been completed and the CAP implemented ahead of schedule.

The Werner Report in 1970 detailed the way forward to EMU implying 'the total and irreversible, convertibility of currencies, the elimination of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital'. The Bretton Woods system broke down in the 1970s. In Europe inflation and unemployment rates grew but at different speeds. The European Monetary System, (EMS), was created at the end of the 1970s and included the Exchange Rate Mechanism (ERM) and the European Currency Unit (ECU). The ERM would allow currencies to fluctuate in ±2.25% bands, (with some exceptions), and parity adjustments were subject to mutual agreements between the parties concerned. The ECU was defined as a weighted basket of European currencies and was the accounting unit of the EMS. The EMS began operating in March 1979 but twelve realignments of currencies were required before the ERM could maintain stable parities in Europe. This was mainly due to the very slow recovery from the oil crisis. Further steps were taken towards EMU when the Delors Report of April 1989 set out the necessary criteria for EMU:

- total convertibility of currencies;
- complete liberalisation of capital flows and full integration of markets;
- irrevocable locking of exchange rates and the subsequent adoption of a single currency;

The European Council meeting in Maastricht in 1991 adopted the Delors Report and ratified amendments to the Treaty of Rome making monetary union binding. The Maastricht Treaty established:
the European Central Bank\(^1\), (ECB), responsible for handling the single currency; 
a specific timetable for EMU; and
for the European Community, (EC), to be renamed the European Union, (EU).

It also sets out five criteria that countries should fulfil before proceeding to EMU:

**price stability:** inflation of no more than \(1\%\) above the average of the best three performing economies over a period of one year;

**fiscal stability:** a government deficit to GDP ratio of no more than \(3\%\) and government debt to GDP ratio of no more than \(60\%\), both at market prices;

**exchange rate stability:** the currency must be operating within the normal bands of the ERM without any realignments for the last two years;

**nominal long term interest rates:** these should not be more than \(2\%\) above the average of the three countries with the lowest interest rates.

The Maastricht criteria are discussed fully below. For those moving towards EMU by 1st January 1999, national currencies will still prevail for three years but then substitution of national currencies by the Euro will take place in 2002. The Euro will still of course be subject to fluctuations against other currencies outside the EU but has the potential to be the largest reserve currency with the exception of the dollar. The economic rationale for a single currency is that it is a store of value, with the ECB maintaining tight monetary policy; it eliminates many of the transaction costs in EU trade; and by abolishing national currencies exchange rate uncertainty is avoided.

### Is Europe an optimal currency area?

Can countries afford to hand over their monetary instruments to the ECB to apply a common monetary policy? How should the fiscal tool be used in the absence of country specific monetary targets? Should countries coordinate their fiscal policy to avoid fiscal indiscipline or can they be allowed to cater for the country specificities especially in the absence of a monetary tool? The answers to these questions determine the extent to which Europe is an Optimal Currency Area, (OCA), i.e. an area in which a single currency will stimulate growth without imposing extra costs.

There are cultural reasons for not having a single currency, simply because the public identify with their own national currency and know what it represents. There are economic criteria however that explain existing financial borders which combined with sociological reasons define national currencies. The fulfilment of these criteria gives a level of homogeneity in economic structures that will sustain a single currency and optimise trade. If no common ground exists then the only sensible means of establishing exchange between countries is through national currencies. The criteria required for countries to be an OCA are:

- they have similar inflation rates
- there is a high degree of factor mobility between them with flexible wages and prices
- the economies are open to trade
- there is a high degree of product diversion
- they are hit by symmetric shocks

Whether Europe satisfies this criteria or not is a moot point but even currency unions like the US do not comply with all the theoretical conditions. The important point is that where a region diverges from average economic performance there is a mechanism that provides assistance and promotes recovery:

### Fiscal federalism

The US has a Federal budget which represents \(40\%\) of national income. Redistribution of funds to regions experiencing economic hardship requires a central fiscal authority, i.e. the National government. The two crucial factors are the freedom to take political decisions and a budget of an adequate size. Neither of these are present in Europe as it stands. The design of EMU is for fiscal policy to be operated domestically. In Europe only \(1.5\%\) is available for redistribution and this is almost entirely taken up by the CAP. The absence of such a buffer concentrates all the effort to trying to satisfy the OCA criteria as closely as possible in a determined effort to avoid fiscal redistribution at all costs. These efforts have failed for two principal reasons: firstly the efforts to achieve convergence required for the sustainability of a single currency can only go so far without imposing costs elsewhere i.e. in the real sector. Concentration on

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\(^1\)The ECB would be politically and economically independent but it would report to the institutions that are politically responsible.
inflation control over the past 15 years has had a negative effect on demand causing high unemployment and the underlying production structures have adapted to repressed demand generating high structural unemployment which is now hard to solve, (see Figure 5 and Table 1). Secondly, even if OCA criteria are satisfied, there will always be unforeseen shocks that affect individual countries asymmetrically. That requires a stabilisation tool equivalent to the redistributive mechanism of the US. Paradoxically, such a system is considered infeasible in Europe despite the general agreement that EMU is politically driven. This has resulted in the promotion of convergence in view of achieving as good an OCA as possible.

Convergence criteria and interpretation

The convergence criteria (see Figures 1-4) are outlined above and countries should satisfy them by either 1997 or 1999. An examination will take place in the Spring of 1998 and progress to EMU will be determined by qualified majority voting. It is therefore not simply a matter of meeting a set of agreed economic criteria but a political decision.

There are strong economic arguments to justify meeting the criteria but their fulfilment still poses a considerable adjustment burden on participating economies, Hughes Hallet, McAdam, (1996a, b, c). Common convergence to low and stable inflation is necessary for trade and demand stability; if countries entered EMU with markedly different inflation rates then there would be, in the immediate absence of offsetting factor movements, chronic unemployment and competitiveness problems. Stable exchange rates are an indicator of readiness for exchange rate locking and convergence on long term interest rates should automatically occur as monetary and fiscal policies converge while positive expectations are formed about the success and stability of the EMU. With perfect capital mobility borrowing rates should tend to equalise anyway - with the only outstanding difference being debt-default risk premia. The fiscal criteria are to make financial crises less likely in EMU and to avoid undermining the credibility and policy stance of the ECB.

The UK entered the ERM at too high a rate, £1=2.95DM, and also was unfortunate in entering when monetary conditions in Germany following re-unification led to high interest rates across the EU. Irrespective of its long-term commitment to the ERM, the UK would be a good candidate for EMU on the inflation and fiscal criteria. Progress on these targets for the rest of the EU has been difficult. The convergence criteria, particularly in France have hampered EU growth. In 1995 only three countries, (out of fifteen), meet the fiscal criteria, (Luxembourg, Denmark and Ireland), whilst only four meet the debt criteria, (the previous three plus Germany), with some wildly short of the EU target (notably Italy, Belgium, Greece, Ireland and Sweden). Inflation performance across the EU is promising with almost all passing the threshold. With Italy returning to the ERM the economic impetus towards EMU is higher now than it was two years ago. The outstanding problem remains that of fiscal convergence and the adjustment process will invariably be felt on the real side of the economy - on output and employment.

If EU countries do fulfil these criteria and reach EMU, (at whatever stage), the benefits of that regime are believed to be small. They are investment gains due to reduced interest rates; (diminished exchange rate uncertainty and risk premia), reduced transactions costs, stable prices and the improved bargaining powers of the EU. In quantifiable terms these gains are assumed to amount to annual growth effects of 0.4% (reduction in transaction costs); 0.3% (price transparency); and 0.7% (reduced exchange rate uncertainty), summing to 1.4% of EU GDP, (EC, 1990). Normally such an advantage is small and must be regarded as even smaller if only a core group of countries forms EMU. If this, (average), figure of 1.4% were to be larger we still know little about the robustness of the EMU regime. For example the partial withdrawal of fiscal policy running up to the convergence period, (and possibly beyond with the new 'stability pact'), seriously constrains policy in stabilising the economy around shocks and so risks prolonging and deepening those shocks - thus potentially making the EMU a highly unstable regime.

What are the possible scenarios for EMU?

There are three possible EMU scenarios, (excluding no EMU), and they are in order of increasing probability:

One speed EMU, broad membership on time:

This is the least likely scenario bringing about a much looser monetary union because there are...
difficulties in meeting the convergence criteria. It would appear that at least some participating economies have not converged enough to make the EMU a stable regime. It is the most likely to lead to a break up of a single currency.

One Speed EMU but delayed:

If the convergence criteria are not met by 1999 then the EMU creation date could be extended to some time in the near future to signal credibility to the markets and to offset the danger of a prolonged appreciation of the DM which will incur further adjustment costs. The main obstacle to delay is the huge political stimulus that EMU has been given to happen on time.

Two speed EMU, narrow membership on time:

This is almost certainly the most plausible outcome - EMU will take place on 1/1/99 and will include a narrow group of countries, Germany, France, Belgium, the Netherlands, Luxembourg, Austria and probably Ireland and Finland. Some countries for example Italy and Spain have not converged enough therefore have not signalled to their partners and financial markets that they have the appropriate monetary and fiscal discipline for EMU. Some countries - such as the UK and Denmark - have strong incentives to remain outside EMU.

A two-speed regime

The Maastricht Treaty requires that on the 1st of January 1999 there is a nucleus of a Monetary Union formed, composed of at least seven countries. That implies that only those countries that have managed to meet the convergence criteria will be allowed to adopt a single currency and more importantly will be able to make it a credible commitment. The remaining countries will still maintain use of their national monetary instruments till monetary convergence is attained. This is the two-speed EMU with the remaining countries forming a periphery which will be allowed to join as soon as they satisfy the criteria. In economic terms, the rationale for two-speeds is justified by the evidence that the core is closer to meeting the nominal criteria prescribed in the Maastricht Treaty and in that sense, stands a much better chance of being an OCA that would benefit from a single currency. However, the division of the EU into different groups, immediately casts doubt on the basis on which this division is made and challenges whether classifying countries in that particular way contributes towards the final goal. If unemployment and growth performance for example, were to be the criteria of choice instead, the set of countries forming the core group would be distinctively different. The choice of the current criteria is of course a reflection of what the ordering of relative priorities in the pursuit of European economic policies has been, with price stability claiming an exclusive place at the top. It is the pursuit of such rigid anti-inflationary policies that has proved very destructive for the real side of the European economies and ultimately for the nominal side as well, (break-up of the ERM). Even if we were to accept that the present group of convergence criteria is justified on economic grounds, the choice to differentiate between the 'ins' and 'outs' may still be deemed discriminatory.

The proposal made by the German CDU (1994) on the issue of 'multiple-speeds' and 'variable geometry' is perhaps the first official document which transforms the issue from theoretical speculation to strategic pragmatism. However, despite the very lucid German objectives and the economic case for the core forming a better OCA in comparison to the whole of the EU, there remains a distinct impression that policy makers have somehow managed to make a virtue out of a necessity without having done the appropriate cost-benefit analysis which would allow them to properly evaluate such a regime. This impression arises from the large number of questions left unanswered concerning how such a multiple speed regime will function and eventually attain its primary goal. There is a paradox, in the inevitability with which we are about to institutionalise a two-speed Monetary Union, when so little economic analysis has been done to illustrate its merits as a transitional arrangement to the adoption of a single currency. This leaves the discussion to be conducted on elusive and unfortunately speculative grounds.

To illustrate the point, some of the questions that need to be answered before proceeding with a two-speed arrangement are presented below.

• The Maastricht Treaty clearly indicates the 1st of January 1999, (originally 1997), as the first date for the adoption of a single currency. There remains however, a lot of uncertainty as to whether this will actually occur, arising from the markets' perception that countries (even some of the ones that would
traditionally form part of the core) will not have the economic structure needed to maintain it. This arises from the fact that satisfying the Maastricht criteria is now an increasingly difficult target to attain within the prescribed time.

- Equally uncertain is the number of countries that will participate. For those countries that perhaps satisfy the Maastricht criteria and can therefore form part of the core, they need to know what the implications will be if they choose not to participate (the UK being very much the case in point). On the other hand those countries that are not allowed to proceed immediately with a common currency, will want to be told what time scale they need to consider in their economic planning for these criteria to be fulfilled and more importantly how the core will assist them in the catching up process. Exclusion, either by choice or by necessity, must involve some costs that will provide the right incentives for Monetary Union to be formed. At the moment however, these costs are not obvious to the 'dissidents' or indeed to anybody else and even if they were they would not necessarily be counteracted by the risks implied by a badly designed Monetary Union. Unfortunately, the degree of transparency required to clarify all these points is still missing.

- More specifically it is important to know how the periphery will function in relation to the core. Will it form an interbloc ERM, float against the new currency formed, or will it explicitly coordinate without the framework of an ERM? Will the countries in the periphery cooperate amongst themselves and the core, or act as a competitive fringe?

- If the core is to adopt a leader's role, then how leading should it be? It is important to know how far the leading position of the core should be allowed to set the agenda for both the core and peripheral members. What system will show how the followers evolve from the periphery to the core and how will the leaders assist this process?

- This of course naturally leads to the question of the institutions required to support such an arrangement. The operations of the ECB are immediately affected by a two-speed framework. Although its original statute requires representatives from all countries in the EMU to carry out one single monetary policy, its activities will have to be limited to the monetary policy for the core, decided only by the core's representatives. This implies that the remaining countries will not be able to influence the decision process; in that respect policy makers of the peripheral countries will be left to their own devices to manage their monetary instrument. In fact Martin (1995) highlights this split of carrying out of monetary policy and suggests that with no explicit rules to either restrain their monetary policies or direct them towards the monetary objectives of the EMU countries, the periphery will manage to free-ride by competitively devaluing their own currencies thus threatening the function of the CAP and the Single Market.

- From the argument that the existence of a national currency gives ultimately the opportunity to the policy makers to use it, the lack of credibility that the ERM entailed, is automatically re-introduced. The perceived way of handling this is with unlimited intervention from the ECB to sustain the currencies that might potentially come under speculative attacks. However, although this is an effective way of solving the problem, the political will required for this to happen is non-existent.

- There is undoubtedly a political element in the choice to proceed in multiple speeds, which if it becomes part of EMU's design, may threaten the stability of a genuine Monetary Union for all. Examples of political interventions would be the inclusion of Belgium or Ireland in the core despite their official debt ratios, curtailing structural/cohesion funds before new members join, tightening the convergence criteria after the Treaty was agreed, redefining what counts in the budget or what counts as 'normal' fluctuations bands or what counts as 'sufficient progress' back towards the official criteria. It is not that the decision to form EMU will or indeed should be free of any political bias. However, it is very important to realise that actions taken need to be incentive compatible in order to generate the mechanism that will make the system sustainable.

- Lastly, it is of great relevance to the final outcome whether the system is divisive or conducive. In other words, if all countries of the European Union are to ultimately adopt a single currency, then we must ensure that a two-speed arrangement maintains a transitory character and during its operation it induces greater convergence by assisting the periphery. This is, without doubt, the most important point that the architects of this regime must address.

The UK and EMU

The UK has a choice: to participate in EMU on
time or to stay out. It is a dilemma rather than a choice and the response will be governed largely by what the government of the day sees as most advantageous to the UK. The decision to participate will be political not economic. The convergence criteria appear to be surplus to requirements which is ironic as the UK is in a position to meet most of these. The benefits are seen to be largely marginal and at the worst could be overturned into net costs.

The Conservatives view EMU with a great deal of scepticism as they value deregulated markets, privatisation, open trade, competition and free enterprise. They are probably reluctant supporters of EMU because they see it as a necessary condition for access to European markets and retaining some power in decision making. The Labour Party is concerned about the lack of consideration given to real variables particularly unemployment, redistribution of income and regional aid. They would also reluctantly support EMU because this would signal that they would embrace a credible monetary policy and pursue low inflation through the European Central Bank. Significant doubts still exist over the lack of a growth objective. Two thirds of the British public are against any further integration into Europe but business is divided, (Arrowsmith, Taylor 1996; Hughes Hallett 1996).

It is the asymmetries that exist between the UK and its European partners which mean that EMU would not be in the best interests of the UK. The UK is more sensitive to short term interest rate changes and asset values; to the business cycle which leads that of Europe; to world trade; to more flexible labour markets and has a preference for growth and employment policies rather than price stability per se. The economy is also more sensitive to changes in the oil price, North Sea oil production, output shocks in the US as well as being less sensitive to German monetary conditions. Asymmetric responses to common shocks are important as although they tend to be smaller, they are more frequent. It is the economic structure of the UK which makes these responses different from our European counterparts. The main difference is the labour market institutions and the mechanisms by which these shocks are transmitted to prices, output and employment. The fact that half of the UK trade is non EU, (Hughes Hallett, 1996), (more than any other EU country), also acts against EMU.

Our previous experience in the ERM where there was an inability to realign within the system caused major problems resulting in massive hikes in real interest rates before sterling actually left the ERM. Following the devaluation in 1992 the experience post ERM has been one of exceptional economic performance which most people are unwilling to give up. This may be a lesson; it appeared before to be a serious mistake to be outside the ERM so the UK joined but once in, leaving because it does not suit the country’s needs also appears to be traumatic. The fact that the UK did quite well may indicate that being outside EMU might not be that bad. So, the lesson is, ‘if it doesn’t suit your needs don’t get boxed in’. The position seems to be, not so much that the UK does not want to participate in EMU but more that the form of EMU on the menu is not to our taste. It is the very design of the system which we are unhappy with. However changing the design at this late stage appears to be a forlorn hope. Alain Juppé, the French Prime Minister, has called for unemployment to be included at some stage as a criteria of EMU. Other countries would also be happier if there were ‘real’ targets rather than the current concentration on price stability and financial targets.

It is widely accepted that the UK will be a peripheral country but this does not necessarily mean that the UK is to suffer second class economic performance. If it stays within the Maastricht criteria then it will ‘shadow’ the core countries and at times outperform them. It will not be a part of the ERM but is more likely to have slightly higher growth and more success at reducing unemployment. Further it has strong trading links with the US and the Commonwealth. The economy is an export oriented economy which must maintain its competitive position to be successful. EMU does not offer that at the moment. Any restriction on UK policies of output growth, wealth creation and employment generation would hamper economic progress. Sterling is not over/undervalued therefore a speculative attack is not an imminent threat.

London is unlikely to lose out as a financial centre. Its great advantage is that it straddles the US and Japanese time zones and that in itself is an immense asset. However when all government bonds for those countries in EMU are issued in 1999 then it is reasonable to suppose that the market will be in a member country, probably Frankfurt. If the primary market is there then large volumes of the secondary bond market may also move to Frankfurt.

The UK is a major recipient of inward investment in Europe. This is more important to Scotland, Wales, the North East and Northern Ireland. Capital flows into the UK are undoubtedly due to lower labour market costs, deregulated markets and a
skilled workforce. These investments are European plants designed with exports to Europe in mind. Any restrictions on growth, the labour market and competition would undoubtedly deter further investment. Both EMU and the Social Chapter threaten to increase labour costs. It is for this reason that the UK will wish to avoid these.

The UK has a relatively good fiscal position in Europe and it is improving. The UK should be concerned that with the ECB running monetary policy then the government would only have fiscal policy left as an instrument of policy control. Unpleasant decisions would therefore require tax increases or expenditure cuts. Using fiscal policy solely is not thought to be a good idea and political parties see the dangers of being boxed into a corner if budget deficits are not made good in the upturn. Another policy issue to be addressed is the lack of coordination between monetary and fiscal policy. This was seen in the ERM débâcle.

The UK has promoted growth and recovery believing that revenues will grow faster and the same outcomes can be achieved more quickly than by cutting expenditures which reduces growth. Faster deficit reductions will prove to be strongly deflationary. In EMU all fiscal issues appear to be driven by the debt level rather than deficits. Debt is harder to deal with than deficits. Any fiscal contraction to reduce debt will also reduce national income. There are some perverse problems here whereby if the fiscal multipliers are greater than one then the ratio will fall by a smaller amount than the rate at which absolute debt falls by. It is possible that it may even rise slightly. There is a large incentive to ignore the debt criteria as contractions will only have small impacts on the ratio while the large deflations necessary to make significant reduction in the ratio will be politically unacceptable. If the markets see no action being taken then interest rates will rise, again damaging growth.

Unemployment is low in the UK relative to Europe but not as low as the US. They have more flexible labour markets, higher labour mobility and higher wage differentials than the UK. The UK labour market operates more like that of the US rather than like European labour markets. Wage flexibility is small as are fiscal transfers in the UK. Unemployment disparities across Europe are considerable while mobility is low for cultural and linguistic reasons. Both locational competition and decentralised wage bargaining have helped to bring down relative wages in the UK. It is this competitive advantage that the UK does not want to surrender to Europe. The asymmetries between the UK and her European partners are significant obstacles to becoming a core member of EMU given its current design and objectives. The costs of exclusion from EMU are difficult to quantify but they do not appear to be prohibitive.

Conclusion

- EMU will take place on 1st January 1999 as a two-speed arrangement with Germany, France, the Netherlands, Belgium, Luxembourg, Austria, Ireland and Finland forming the core. There are many issues which remain unresolved but require to be addressed before a two-speed monetary union can proceed satisfactorily. The UK will remain on the periphery pursuing policies of output growth, wealth creation and employment generation but will live in coexistence with the core countries of EMU.

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Reference Value: 3%
Reference value: 60%
Inflation Rates 1995

Reference value: 2.7%
Figure 4

Long-Term Interest Rates, 1995

Reference value: 9.7
Figure 5

![European Unemployment Graph](image)

Table 1

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