

THE PROSPECTS FACING AN INDEPENDENT SCOTLAND IN THE EURO, WHILE THE REST OF UK STAYS OUT

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1. INTRODUCTION

This paper is concerned with the case where an independent Scotland is a member of the Euro zone, while the rest of the United Kingdom (denoted hereafter as RUK) stays out. There are two main aspects to this scenario. There are the transitional aspects, and there are also long-run implications: in particular, what sort of economic future could Scotland expect once the transitional phase was over. Both of these aspects are vitally important. There is a danger, however, that the difficulties associated with the transition phase (which would involve the problems of leaving one monetary and political union to join another monetary union) appear so overwhelming that they squeeze out consideration of what Scotland's long-run prospects would be, assuming the transition had been successfully completed.

To avoid this danger, the paper concentrates on the economic aspects of a scenario whereby Scotland might leave the UK monetary union, and translate into a fully fledged member of the Euro zone. However, the paper does not go into the complex legal and political difficulties which would be associated with this transition. This approach is justifiable on the grounds that only if there is a feasible economic transition route, and only if the long-run prospects looked inviting, would it be worthwhile embarking upon consideration of the legal and political difficulties of the transition.

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The structure of the paper is as follows:-

Section 2 discusses entry requirements. It notes that probably the key de-facto requirement is that Scotland enters the Euro zone at an exchange rate which is competitive. Two principal options are outlined for achieving this requirement. It is argued that the feasibility of the more attractive of these options hinges in large part on the likely future behaviour of the Sterling-to-Euro exchange rate. Accordingly, Section 3 considers the question of relative exchange rate fluctuations over the past 30 years, and prospects for the future. The conclusion drawn from this is that Scotland could have the opportunity to exploit Sterling-to-Euro volatility to make a successful direct transition from Sterling to the Euro. Section 4 is concerned with of the Irish experience of Euro entry. Although Ireland's experience is not an exact parallel, nevertheless there is a great deal to be learned from the latter stages of Ireland's transition to the Euro zone: both about the short-term opportunities which might be open to Scotland, and about the potential seeds of some longer term problems. Finally, Section 5 addresses the question of what opportunities and challenges the Scottish economy would face in the longer term: what responses would have to be made, and whether the longer run scenario would be viable. On this final point, it does not seem feasible to arrive at a clear-cut answer. What does seem clear is that the position of the Scottish economy would be a challenging one, highly exposed to international trade shocks, and far removed from the characteristics of a conventional optimal currency area. To thrive in such an environment, the Scottish economy would have to display great adaptability and flexibility.

2. ENTRY REQUIREMENTS

The formal entry criteria for Euro membership are set out in the accompanying paper by Hughes Hallett and Scott (2003). It is by no means clear whether Scotland could be deemed as qualifying on some or all of these criteria on the basis of the experience of the UK as a whole, or whether Scotland would have to establish its own track record on the various tests. On balance, however, it seems unlikely that Scotland would be regarded as such a special case that it could, in effect, translate instantaneously into full Euro membership. It seems much more likely that Scotland would have to establish the institutions and mechanisms to enable it to demonstrate that it qualified for the Euro in its own right. This would imply, in particular, the establishment of some form of separate Scottish currency, and the formation

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of a Scottish central bank. It also implies that the transition process would be lengthy- taking a minimum of several years to complete.

As well as the formal entry requirements, there are also de-facto requirements which are in many ways equally important. Perhaps the main one is that Scotland would have to enter the Euro zone at a suitably competitive initial exchange rate: entering at too high a rate risks triggering a recession, with loss of export markets, and damaging closure of firms – witness the kind of problems experienced by the UK economy when it entered the ERM at too high a rate in 1990. This requirement in turn interacts with the options open to Scotland for the form of intermediate currency it would have, between Sterling and the Euro. The question of intermediate currencies is discussed in more detail in the accompanying paper by Dow (2003), and a radical alternative is also postulated in the paper by Simpson (2003). It is not the intention to repeat here the more detailed discussion in either of these papers. For present purposes, there would appear to be two basic options available to the Scottish government:-

- Option A. A fully separate currency, which would float (hopefully in a managed fashion) relative to both Sterling and the Euro.
- Option B. A pegged currency: this would initially be pegged one-for-one against Sterling, but at some point would convert to a Euro peg, at the then current Sterling-Euro exchange rate.

As is made clear in the discussion by Dow, a significant danger with the former option is the risk of demonetisation: that is, that a fully separate Scottish currency could fail to achieve widespread acceptability, with consequent risk of instability. This option would also pose very much greater problems for Scotland's important financial sector. On the other hand, there are also significant problems with the second option: in particular, it would potentially demand greater reserves to maintain the currency pegs (failing which, it could be severely deflationary): it involves being subject to the vagaries of the Sterling exchange rate – until a suitable time occurs for the switch to the Euro peg: and it pre-supposes that, at some time in the foreseeable future, the Sterling-Euro exchange rate will reach a level which would provide a suitably competitive rate for Scotland's entry to the Euro zone. On balance, however, it seems that Option B would be preferable, assuming these conditions could be met.

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The following two questions are therefore very important. First, what is a competitive exchange rate for Scotland joining the Euro? Second, is Sterling likely, in the foreseeable future, to reach an exchange rate with the Euro which would be suitably competitive for Scotland's entry to the Euro zone?

As regards the first question, it seems clear (and has been argued at greater length elsewhere – for example, Cuthbert and Cuthbert (2002), and Cuthbert,(2003)), that Scotland is uncompetitive (that is, has an overvalued exchange rate), within the UK monetary union. There also appears to be a general consensus in the wider debate about UK entry to the Euro that, over much of the recent past, Sterling has been overvalued relative to the Euro, in the sense that the Sterling-Euro exchange rate would not have provided a competitive entry point for the UK as a whole. Taken together, these arguments imply that Sterling would require to depreciate significantly more relative to the Euro than would be required for UK Euro entry, in order to reach a competitive entry rate for Scotland to the Euro. For working purposes, it is assumed here that what might be required would be an entry rate some 5 to 10 percent lower than the sort of rate that would generally be regarded as acceptable for UK entry: it does not seem possible to be more precise than this, given the current lack of the required data on the Scottish economy.

To take a view on the second question, namely, the chances of achieving such a Sterling-Euro parity in the foreseeable future, it is necessary to look in more detail at the past history of the fluctuations between Sterling and the basket of currencies which became the Euro: this is the topic of the next section.

3. THE RELATIONSHIP BETWEEN STERLING AND THE EURO

Predicting the future movements of the Sterling-Euro exchange rate is extremely difficult, particularly given that the Euro is still a relatively new currency. However, some inferences can be drawn about the likely nature of the relative movements of the two currencies.

It is interesting first of all to look at historical evidence. A useful starting point is to consider a historical proxy Euro, formed by weighting together the twelve currencies which came together to form the present Euro. For the purposes of the present study, such a proxy Euro was constructed (weighting

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the constituent currencies together on the basis of GDP), starting in 1970, and linking with the Euro itself, so that a continuous series is available from 1970 up to the present.

Over the period, there have been large fluctuations in the proxy Euro-to-Sterling exchange rate. Sterling depreciated by almost 40% against the proxy Euro between 1970 and 1977: appreciated by almost 30% between 1977 and 1980: then followed a long period of Sterling depreciation (with some ups and downs) until 1995 – by almost 30%: this was followed by sharp Sterling appreciation, of almost 40%, up to 2000. In other words, the historical relationship between Sterling and the 'Euro' is characterised by repeated swings, taking place over an average 7 or 8 year period, when one currency appreciates or depreciates by the order of 30 or 40% relative to the other. Closer examination of the data suggests that Sterling contributed more volatility to the relationship than the proxy Euro did over the period.

Part of this historical instability may be related to the high rates of internal inflation which were experienced at times during the period examined: but it is interesting that the relationship continued to be highly unstable into the 1990's, even though by then inflation rates were much lower than they had been earlier. In addition, there are other reasons to suggest that future volatility is likely to be considerable. In particular:-

- there are technical reasons (Cohen 1997) for supposing that the Euro may be more unstable than the average of its constituents would have been. The core of Cohen's argument is that the Euro zone as a whole would be a less open economy to international trade than the individual member countries were before the establishment of the Euro. This means that monetary policy will be less constrained by trade disequilibria than before – hence making the Euro more volatile. This is consistent with the observed behaviour of the Euro to date.
- as the Euro becomes established as one of the world's major trading currencies, it will be held internationally in large quantities: this will open up the potential for large swings in value as sentiment changes between the dollar, the yen, and the Euro. (Witness, for example, the recent appreciation of the Euro against the dollar, due to worries about the US economy, even though this has been against the interests of exporters in the Euro zone's largest economy, Germany.)

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For all of these reasons, it seems likely that the future of the Sterling-to-Euro exchange rate will be characterised by continued swings – probably of a similar magnitude, or even larger, than those experienced in the past. What cannot be predicted, of course, is the timing of these swings.

The data on the proxy Euro were also used to examine the important topic of the tripartite relationship between the Euro, Sterling, and the dollar. Over the period since 1970, changes in the dollar have been strongly negatively correlated with changes in the Euro, with a correlation coefficient of -0.76: similarly, Sterling and the Euro are strongly negatively correlated, with a correlation coefficient of -0.79. The dollar and pound tend to move in the same direction – with a correlation coefficient of 0.22. This is interesting confirmation that the pound has tended to be an Atlanticist rather than a European currency.

The likelihood that there will continue to be major swings in the Sterling Euro exchange rate opens up the possibility that, if Scotland had a currency which was pegged to Sterling, it could wait for a suitable opportunity when Sterling had depreciated against the Euro to switch its currency peg from Sterling to the Euro, in preparation for full Euro entry. In other words, the likely volatility of the Sterling-Euro exchange rate offers Scotland the opportunity of adopting currency option B as outlined in section 2. If, after a suitable time period, the opportunity had not arisen to switch to a Euro peg at a competitive market rate, then Scotland would still have the option to float its currency, and seek to secure an appropriate devaluation before linking with the Euro.

If, however, Scotland did manage to switch its currency peg near the bottom of the currency swing, when Sterling had depreciated to near its maximum extent relative to the Euro, then, as the swing reversed, Scotland would receive a boost in competitiveness relative to RUK. This scenario would have important implications, both positive and negative, for the Scottish economy. To understand what some of these implications could be, it is useful to look at the final stages of the Irish transition to Euro membership.

4. IRELAND: A SUCCESSFUL TRANSITION?

The Irish Punt broke its one-for-one link with Sterling in 1979, at the same time joining the European monetary System (EMS), the pre-cursor of the

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Exchange rate Mechanism (ERM). The Irish economy then went through troubled waters in the early 1980s, with inflation peaking at over 20%, and a budget deficit rising to about 7% of GDP, before a balance of payments crisis in the mid 1980s. This prompted the Irish government to introduce a package of measures, including public expenditure control, together with an accord with the trade unions designed to restrict wage inflation, so that by the late 1980s inflation was reduced to around 3%. At the same time, the Punt devalued successively against the EMS and the ERM – in 1986 by 8%, and in 1993 by 10%. The performance of the Irish economy changed dramatically during the 1990s, with the emergence of the 'Celtic tiger', achieving the highest rate of growth in Europe (about 10% per annum in real terms in the late 1990s), and with Ireland successfully taking its place as a fully fledged member of the Euro at its inception.

It is relevant to note that, as late as the early 1990s, economic conditions in the UK were still so important for the Irish economy that Ireland could not avoid devaluing after the UK left the ERM in 1992. In the words of Connolly (1995), 'nemesis, [i.e., devaluation] had arrived in the most malevolent guise – the pull of the British economy, from whose orbit Ireland seemed doomed never to escape'. The Punt thus really only finally broke away from Sterling after the joint devaluations in 1992-3. Hence the period of the 1990s for the Irish economy is similar to what has been described here as an Option B currency transition. This is why, although the Irish experience is not an exact parallel, it is useful to look at it in some detail, to illustrate some of the potential advantages and pitfalls for Scotland.

One important indicator of the performance of the Irish economy is to consider its competitiveness relative to other economies like the UK, Germany, which one might regard as the core European economy, and the US. 'Competitiveness' is measured here by the real exchange rate. The real exchange rate between two countries, A and B, is, essentially, the number of standard baskets of goods which could be purchased in A for the price of one basket of goods in B. Competitiveness depends both on the internal prices in the two countries, and on the exchange rate between the two countries: if inflation in A is higher than in B, then A loses competitiveness, while if A devalues relative to B, A's competitiveness increases. If A and B are in a currency union, then the only thing that affects their relative competitiveness is their relative rates of internal inflation.

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Indicators of the competitiveness of Ireland relative to the UK, Germany, and the US were computed for the present study, using data on purchasing power parities and exchange rates published by the OECD: (OECD 2003). These indicators are shown in Chart 1, taking 1990 as base: note that the higher the value of the indicator, the more competitive Ireland is relative to the country in question. The picture is striking: Ireland increased its competitiveness against all of the other three countries up to the mid 1990s – by over 20% in the case of Germany, and almost 20% in the case of the US. There was then a decline in competitiveness against all three countries in 1996: but to levels that were still at or above those in 1990. From 1996, competitiveness then increased rapidly again until 2000 relative to the UK and the US. However, competitiveness against Germany continued to decline, falling, by 2001, to 15% below the 1990 level.

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chart 1 here

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chart 2 here

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chart 3 here

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It is also instructive to split down the overall index of competitiveness to show separately the components of the index due to relative exchange rate movements, and due to relative internal inflation. These are shown in Charts 2 and 3 respectively: note that the overall index of competitiveness is the product of these two components. The internal inflation component is the simpler to describe: Chart 3 shows that this component had the effect of increasing Irish competitiveness relative to the three other countries up to 1995: after 1995, however, this component acted to decrease Irish competitiveness against all three countries – but in particular against Germany. This effect relates to the relatively high inflation experienced in Ireland in the late 1990's, as the economy grew very fast.

As can be seen from Chart 2, movements in the exchange rate component are larger, and more complex. By devaluing with Sterling in 1992/93, Ireland increased competitiveness relative to Germany and the US – while later on, as it became locked into parity with Germany, it increased competitiveness relative to the UK by benefiting from the appreciation of Sterling. Throughout the period, competitiveness relative to the US increased because of the appreciating dollar.

This is not to say that these very beneficial exchange rate movements caused the development of the Celtic Tiger economy. The Irish economic success of the 1990's involved a large number of factors, including the investment which had been made in education, a very favourable tax regime for business, success in attracting foreign direct investment, the accord to control inflation, the ability to attract back highly skilled emigrants, and substantial structural fund subsidies from Europe. All of these factors, in a sense, came together successfully in the 1990's, to enable Ireland to exploit the opportunities afforded by the extremely favourable exchange rate changes it experienced, in order to achieve sustained real growth.

There are, however, other, perhaps less positive, aspects of the Irish experience, which are relevant. There are three of these in particular:-

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- As noted, Irish competitiveness relative to Germany has declined steadily and significantly since 1995. Of course, competitiveness as measured by this single indicator is not the whole story – Irish competitiveness may be greater than measured here for particular export goods, or specialist products. But in general, it would appear that Ireland is likely to have increasing problems exporting to core European markets, unless it is able to significantly reduce its internal inflation rate.
- Secondly, the large increase in competitiveness relative to the US and UK which Ireland experienced between 1990 and 2001 was brought about by a probable undervaluation of the Euro: Ireland is vulnerable if the Euro starts to appreciate relative to the pound and the dollar. Indeed, between 2000 and 2001, competitiveness relative to the UK started to decrease; and more recent appreciation of the Euro relative to both countries will have damaged Ireland's competitiveness.
- Finally, there is the effect which the relative competitiveness movements described here have had on Ireland's trade patterns. Given that Ireland has experienced a particular competitiveness advantage relative to the US and UK, it might be expected that Ireland's exports to these countries would have grown particularly fast: this is indeed the case. Between 1995 and 2002, Irish exports to the US and Canada increased by 437% in money terms, and by 150% to the UK: this compares with 124% to the Euro zone (EireStat 1993). This has meant that the percentage of Irish exports going to the Euro zone has been dropping – from 47% in 1995 to below 40% in 2002. In this respect, Ireland has actually been diverging, rather than converging, in the latter stages of its entry to the Euro zone. (It is also relevant to note that the proportion of Irish imports from the Euro zone did increase, but only very slowly, over this period – from 21.5% to 23.4%: so marked convergence has not taken place here either.) This is not to deny the very substantial progress which Ireland has made, over the longer term, in reducing its trade dependence on the UK: for example, the percentage of Irish exports going to the UK has reduced from almost 90% in 1955 to 24% by 2002. Nevertheless, Ireland is still very highly exposed to trade outwith the Euro zone, and recent movements in relative competitiveness have increased, rather than decreased, this exposure.

5. THE PROSPECTS FOR SCOTLAND

It has been argued earlier in this paper that the likely scale of currency fluctuations between Sterling and the Euro could offer the potential for a feasible transfer mechanism for Scotland to Euro membership, if Scotland were to switch currency pegs at the right time in the currency cycle. For the purposes of the section, it is assumed that Scotland has made such a transfer. This implies that Scotland has had the reserves (perhaps from oil) to fund the process: that the switch of currency pegs has been timed right, so that Scotland has benefited first of all relative to the Euro group by a significant depreciation of Sterling before the switch, and then relative to RUK (and the US) by Sterling and the dollar appreciating as the currency swing reverses: and that Scotland has been able to put in place the whole range of policies which has ensured that the initial honeymoon of high competitiveness has resulted in a real transformation of the economy. What then?

Some of the potential problems in these circumstances are clear from the preceding analysis: in particular:-

- Given the initial boost in competitiveness which, it has been argued, the Scottish economy would have experienced relative to RUK, Scotland's trade patterns are likely to be heavily weighted outside the Euro zone. At present, about half of Scotland's exports go to RUK. In the long term, given geographical proximity, historical links, and the likelihood that there will be successive periods when competitiveness increases relative to RUK due to currency swings, it seems inevitable that RUK will continue to be a major export market for Scotland.
- It has been argued that the Sterling-to-Euro exchange rate will be subject to continuing volatility, perhaps greater than that experienced in the past. This means that Scotland will be subject to large swings of competitiveness relative to RUK, which will continue to be both a major trading partner, and competitor. Further, given the tendency noted earlier for the pound and the dollar to move in parallel against the Euro, trading conditions in both the RUK and US markets are likely to get better or worse at the same times. In other words, the effect of the pound-dollar interaction will be to amplify, rather than damp, the resulting instability for the Scottish economy.

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- If Irish experience is a guide, then Scotland would emerge from the transition phase with competitiveness declining relative to the Euro zone core, because of higher internal inflation.
- In addition to currency fluctuations as a potential source of shocks to the Scottish economy, Scotland, as an oil producer, would suffer asymmetrically from oil shocks relative to the Euro core.

The prospects for the Scottish economy, under the scenario considered here, are therefore challenging. In particular, the Euro zone is likely to be very far from representing an optimal currency area (OCA) as far as the Scottish economy is concerned: (see the accompanying paper by Hughes Hallett and Scott (2003) for a discussion of the characteristics of OCAs). There are standard arguments which imply that, once the conditions for an OCA are met, then endogenous factors could ensure further convergence: these arguments will not apply in this case. This, however, may not be disastrous from Scotland's point of view. Even though the Euro zone may not be an optimal currency area for Scotland, there may still be a successful niche which the Scottish economy could exploit. How feasible is this, and what policies would Scotland have to pursue?

In a monetary union, any member state which does not have inherent natural resource advantages must retain its level of productivity growth close to or above the average for the union, or it is likely to suffer long-run relative economic decline. Leaving aside Scotland's oil (which is, after all, a finite resource), this applies equally to Scotland. But the additional complication for Scotland, under the scenario considered here, is that it can look forward to the repetition of positive and negative exchange rate shocks: the inflationary shocks, as Scotland's extra-Euro trade prospers, will tend to induce a loss of competitiveness within the Euro zone. Unless Scotland has the flexibility to restore this competitiveness rapidly when external trading conditions turn unfavourable, then it may experience such a severe downturn that its economic fabric is damaged, and it may not be able to benefit from the next favourable exchange rate swing when it comes along. In these circumstances, the prospects for Scotland are likely to be bleak. It would be essential, therefore, for Scotland to have the flexibility to be able to rapidly restore competitiveness relative to the core Euro economies, when external trading conditions turned unfavourable.

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Factors which Scotland could control, or at least influence, to give it the required flexibility, would include the following:

- It would be necessary to reduce any imperfections in the labour market, and to remove unnecessary price and wage rigidities. There are, of course, limitations on how far such a policy could go: an unconstrained labour market is inconsistent with a civilised society. But an economy which was in Scotland's position would have to exhibit a flexible labour market.
- Another important factor would be to encourage foreign direct investment. FDI is recognised as being an important driver in improving productivity in an economy – and is also important as a means of securing and retaining export markets. During those years of the currency cycle when Sterling and the dollar were strong relative to the Euro, it would be important for Scotland to try to sell its attractions to firms from the US and RUK as a foothold within the Euro zone for manufacturing and service provision, and for high-value activities for the local economy like R and D, and local headquarters location. The difficult trick, of course, would be to retain these businesses when they were most needed: that is, when the Euro was appreciating against Sterling and the dollar. In this respect, any measures which could encourage these firms to put down long term roots (like, for example, favourable tax treatment of profits, and of R and D expenditure) would be extremely important.
- It is also clear, however, that if Scotland is faced with the problem of increasing competitiveness relative to the Euro zone, at a time when general price pressures are against it, it would be of great assistance if Scotland was, in effect, a market maker, rather than simply a market taker, in specific sectors. In other words, it would be very beneficial if Scotland had its own equivalents of, say, Nokia, which could (within limits) sell on brand and technical leadership: or if Scotland was recognised as the world leader in some particular specialisms. There is no obvious recipe for creating market leadership like this: but Scotland does have some advantages, particularly its track record of world class academic research in some fields. It should in principle be able to exploit these advantages to create a suitable environment for growing market leading firms, and strong technological clusters of firms.

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None of the strategies identified in the preceding paragraph would be easy, or guaranteed of success. Scotland would, however, have certain advantages when trying to implement such policies. One of these would be the ability (within the constraints imposed by EU Harmonisation) to design specific tax and other policies. The other would be the ability, indeed, the requirement, to focus single mindedly on national economic imperatives. In 1959, Seán Lemass, shortly before becoming Irish Taoiseach, said that 'the historic task of this generation is to ensure the economic foundations of independence' (MacSharry and White 2000). The degree of focus implicit in this comment has been manifest in the development of Ireland's economic policies ever since. A similar degree of national economic and social focus would be a continuing requirement for Scotland under the scenario outlined here.

6. CONCLUSION

Would Scotland achieve lasting economic success under the circumstances outlined in this paper? It does not seem feasible to give a definitive answer. What this paper has attempted to do is to outline the nature of some of the opportunities and challenges, and some of the appropriate responses.

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