

PRELIMINARY AND TECHNICAL WORK TO PREPARE FOR THE ASSESSMENT OF THE FIVE TESTS FOR UK MEMBERSHIP OF THE SINGLE CURRENCY

1. This short paper restates Government policy on EMU and addresses issues of content and timing of the preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency.

Policy

2. In the Chancellor's Mansion House speech of 20 June 2001 he restated the Government's policy on membership of the single currency. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. The Government recognizes the constitutional issue as a factor in the decision, but the Government does not consider it a bar to entry if there is clear and unambiguous evidence of the economic benefits of joining, and if the people have the final say in a referendum.

Content

3. The five tests define whether a clear and unambiguous case can be made. In the Mansion House speech in June the Chancellor repeated the five economic tests set out in his October 1997 statement. The tests were set out in full in the document accompanying the statement made in October 1997¹. They are:

- (1) Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- (2) If problems emerge is there sufficient flexibility to deal with them?
- (3) Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

¹ HM Treasury (1997) "UK Membership of the Single Currency: An Assessment of the Five Economic Tests".

(4) What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?

(5) In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

4. The tests are the necessary economic pre-requisites for membership of a successful single currency. Indeed, the IMF² have commented recently that the five tests are:

“...consistent with the economic considerations that would be important for the decision to join a monetary union.”

5. In the Mansion House speech in June the Chancellor explained that before the assessment of the tests was started, the Treasury would:

“...continue to do the necessary preliminary work for our analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised.”

This makes clear that the preliminary work will inform the assessment.

6. The Chancellor has made clear that the Government will publish the assessment and ensure that it is rigorous and comprehensive. It is on this basis, taking account of all relevant information that the Government will decide whether to recommend membership to Parliament and then to the British people. The assessment has not yet started but the preliminary and technical analysis is underway.

7. The scope of the necessary preliminary and technical work was set out in the original October 1997 assessment. Although there have been new developments since the 1997 assessment, the underlying issues to be analysed remain the same and the five tests themselves remain unchanged. Some of the key parts of the preliminary and technical work are set out below although this is by no means an exhaustive list as the preliminary work continues to evolve to take account of the latest technical research and analysis.

² IMF Article IV Report on the UK economy (28 February 2001).

- Under the **convergence test** the preliminary and technical work will update the evidence presented in the 1997 assessment on the cyclical behaviour of the UK economy relative to that of the euro area countries and their relative responses to different shocks. The preliminary work will include collecting information on indicators like the output gap, inflation, interest rates and the real effective exchange rate, and will update and extend the analysis on issues of convergence.

As in the 1997 assessment, the preliminary and technical work will also consider the evidence on the sustainability and durability of convergence. As set out in the executive summary of the 1997 assessment,

“...sustainable and durable convergence is the touchstone and without it we cannot reap the benefits of a successful EMU.”

The executive summary went on to spell out that sustainable convergence means that the British economy:

- has converged with Europe;
- can demonstrably be shown to have converged;
- that this convergence is capable of being sustained; and
- that there is sufficient flexibility to adapt to change and unexpected economic events.

As in the 1997 assessment, in order to judge whether convergence is sustainable and durable, the preliminary work is studying key structural features of the UK and euro area economies that might be a source of asymmetric cyclical responses in the future. These include: analysis of trade and investment linkages; the behaviour of housing markets; and the sectoral composition of output; as well as analysis of financial structures of the studies of the monetary transmission mechanisms of the UK and euro area economies.

A forward looking-assessment of convergence also needs to consider the strength of the arguments that closer convergence will develop over time, such as through the operation of a common monetary policy, or through stronger trade and financial linkages. Background analysis of these issues is included as part of the technical and preliminary work.

- The second test concerns the **degree of flexibility** in the UK and euro area economies, and as the 1997 assessment made clear, it is closely related to the convergence test. The preliminary work is focussed on compiling evidence on evaluating the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work. A key area, as reflected in the 1997 assessment, is the behaviour of the labour market, including the degree of wage and employment flexibility. The work is looking again at the evidence for market flexibility in the UK economy as well as the position in other European countries following the drive to make progress on economic reform. The 1997 assessment also noted the importance of macro-economic policy alongside micro policies to achieving flexibility.
- As in the 1997 assessment, the preliminary work on the **investment** test considers both the general impact on investment and the impact on foreign direct investment. Key issues for analysis include the impact of the single currency on: the cost and availability of capital; macroeconomic stability and the stability of the real effective exchange rate; and the location, quantity and quality of private and public investment.
- As with the preliminary work for the other tests, the work on **financial services** will update the analysis in the 1997 assessment on this key sector to the UK economy. The 1997 assessment noted that EMU will affect the financial services industry more immediately and more profoundly than other sectors of the economy. As recognised in the 1997 assessment, the preliminary and technical work for the next assessment will have to include a detailed analysis of the changes that have already occurred in this sector in the UK and the euro area since the start of the single currency in 1999.
- As defined in the 1997 assessment the fifth test on **employment** will cover whether EMU will “promote higher growth, stability and a lasting increase in jobs.” The preliminary and technical analysis being undertaken for this test will, as in the 1997 assessment, analyse the potential benefits of EMU for the longer-term performance of the economy. This includes an update of the analysis of the potential impact of the single currency on trade, competition and productivity, and also its potential sectoral and regional impact.

Timing

8. The Budget 2001³ document set out the details on the timing of the assessment process. The Government has said that it will produce the assessment within two years of the start of the Parliament. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. The Government believes that, if a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people. The referendum would only occur if the five tests were met and the Government had made a decision to recommend joining.

HM Treasury, November 2001

³ HM Treasury 'Budget 2001' (March 2001) see box 2.2 on 'EMU and EMU preparations' on page 23.