UK membership of the single currency

An assessment of the five economic tests

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Executive Summary

GOVERNMENT POLICY ON EMU AND THE FIVE ECONOMIC TESTS

Government policy on EMU…

Government policy on EMU was originally set out by the Chancellor of the Exchequer in his statement to Parliament in October 1997 and is updated in the Government statement and decision on EMU membership, based on this assessment of the five economic tests.[1]

EMU stands for Economic and Monetary Union. Membership of EMU would mean that the UK would adopt the euro as its currency and UK interest rates would be set by the European Central Bank (ECB), on the basis of economic conditions in the euro area as a whole. The Government's decision on EMU membership reflects what it believes is best for the long-term economic interests of the British people and the performance of the UK economy.

…is founded on four key building blocks

When in 1997 the Government committed the UK to the principle of joining the single currency, the Chancellor stated that Government policy towards EMU is founded on four key building blocks:

- first, a successful single currency within a single European market would in principle be of **benefit** to Europe and to the UK: in terms of trade, transparency of costs and currency stability;
- second, the **constitutional** issue is a factor in the UK's decision but it is not an overriding one, so long as membership is in the national interest, the case is clear and unambiguous and there is popular consent;
- third, the basis for the decision as to whether there is a **clear and unambiguous** economic case for membership is the Treasury's comprehensive and rigorous assessment of the five economic tests; and
- fourth, whenever the decision to enter is taken by the Government, it should be put to a **referendum** of the British people.

The five economic tests

- **Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?**
- **If problems emerge is there sufficient flexibility to deal with them?**
- **Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?**
- **What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?**
- **In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?**

EMU in a global setting

EMU's development and the Government's policy towards it reflect global trends which are shaping economic policy worldwide. Globalisation is moving the world towards greater integration through increased trade and investment.

[1] All available on the HM Treasury website at www.hm-treasury.gov.uk.

The stronger integration brought by globalisation also brings added uncertainty. Changes in economic circumstances (shocks) in one sector, region or country are now transmitted more rapidly around the world economic system. This puts increased demands on the world's economies and the people and technologies which are the foundation of their success. To be successful in achieving high growth, employment and social inclusion, everyone who plays a role in the economy has to be adaptable both to shorter-term developments and longer-term change.

A world characterised by constant economic change and increasing uncertainty would not be good for growth, investment and jobs without the additional safeguard of stability. Stability anchors expectations and allows individuals and companies to plan ahead with confidence. Across the global economic system, there is a growing commitment to policies designed to deliver stability, and increasing evidence and recognition that this is best achieved through frameworks based on clear principles and objectives.

The UK in Europe

This is particularly the case across Europe, where there is increasingly a shared commitment to economic stability combined with wide-ranging economic reform designed to achieve full employment, high living standards and social cohesion. With more than half the UK's trade with the EU and increasing integration of product, labour and capital markets, the UK's economic interest is best pursued through a deepening cooperation with other European countries as part of the Government's commitment to a strong EU and a successful EMU. As the Prime Minister said in November 2002:

> "*We should have more self-confidence because we are a leading European power, always have been and always will be.*"[2]

The Government's objectives...

These global and European trends are mirrored in the Government's central economic objective for the UK to build a stronger, more enterprising economy and a fairer society, extending economic opportunity and supporting those most in need to ensure that rising national prosperity is shared by all.

...and strategy

Stability, productivity and employment opportunity are the foundations of the Government's economic strategy. Since 1997, the Government has taken tough decisions and introduced wide-ranging reforms to establish a platform of economic stability and to promote work and enterprise, tackle poverty and deliver sustained investment to modernise public services. The Government's decision on UK membership of the single currency must contribute to these objectives and this strategy.

The implications of EMU

EMU membership would mean significant changes to the operation of UK macroeconomic policy. The exchange rate between sterling and the euro would be fixed irrevocably and the euro would become the UK's national currency. The UK would be subject to the single interest rate set by the ECB for the euro area as a whole. And the UK would be required to comply fully with the terms of the EU's Stability and Growth Pact (SGP).

A long-term approach

The development of the UK economy following the introduction of the Government's monetary and fiscal policy frameworks since 1997 shows how stability has provided a foundation for a long-term improvement in the UK's economic performance. This demonstrates why the Government's decision on EMU membership focuses on what is right for the UK economy in the long term. A long-term approach is necessary because of the distinctive nature of the UK economy – a large economy in the EU with a global outlook – and the stop-go nature of the UK's economic history.

[2] '*A clear course for Europe*', speech by the Prime Minister, 28 November 2002.

The five economic tests… The Government's five economic tests for UK membership of EMU cover convergence, flexibility, investment, financial services, and growth, stability and employment.

…define whether a clear and unambiguous case can be made The five economic tests define whether a clear and unambiguous case for UK membership of EMU can be made. This sets a demanding standard, reflecting the long-term importance of the decision. The Government believes that to aim lower would fail to take full account of the particular nature and policy history of the UK economy, the irreversible nature of the decision and the constitutional issues which it raises.

Together, the assessment of the convergence and flexibility tests determines whether sustainable and durable convergence has been achieved between the UK and the euro area. Sustainable and durable convergence is the key precondition for realising the potential benefits that EMU membership offers.

The comprehensive and rigorous approach… To ensure that the assessment can support a decision of this importance, the Chancellor has said that: *"the assessment will be the most robust, rigorous and comprehensive work the Treasury has ever done"*.[3] To this end, extensive use has been made of the latest analytical modelling techniques and approaches and the latest economic literature, which has been influential in shaping the Treasury's analysis of the key issues. A major development since the 1997 assessment is that it is now possible to examine and analyse the experiences of the countries which have adopted the euro since 1999, enhancing the evidence base and the understanding of the operation of EMU.

…an assessment and 18 studies The assessment of the five economic tests is the work of the Treasury. 18 EMU studies are published alongside the assessment and inform it. Experts from outside the Treasury have produced four of the studies, developing new work in key areas. Other outside experts have assisted the Treasury, in a consultancy capacity, on the studies and provided new insights on previous academic work.

Costs and benefits It is important that the decision on whether to join EMU focuses on both the potential costs and benefits of joining at the present time. The potential benefits of membership have to be considered alongside an assessment of whether there is sustainable and durable convergence to enable the potential benefits to be secured.

The Treasury's 1997 assessment concluded that the UK was not convergent with the prospective euro area, that flexibility was insufficient and that the lack of sustainable and durable convergence meant that the risks of membership were such that the UK would not be in a position for some time to reap the potential benefits of EMU in terms of higher investment, growth and jobs.

Re-evaluating the 1997 decision To highlight the key issues which form the analytical backbone of the assessment, a stylised exercise has been conducted re-evaluating the 1997 assessment conclusions and EMU decision by considering 'what if' the UK economy had joined EMU in 1999, at the same time as the 11 'first wave' members. The exercise indicates that had the UK joined EMU in 1999, the UK economy could potentially have experienced greater economic instability than has actually been the case. However, since 1997 there has been significant progress made in addressing the issues raised in the 1997 statement.

[3] Mansion House Speech by the Chancellor of the Exchequer, 26 June 2002.

ASSESSMENT OF THE FIVE ECONOMIC TESTS

The assessment provides a detailed analysis of each of the Government's five economic tests for EMU entry.

When in 1997 the Government committed the UK to the principle of joining the single currency, the Chancellor stated that the advantages are lower transaction costs, less exchange rate volatility, more incentives for cross-border trade and investment, and potentially lower long-term interest rates. Part of the assessment is the finding that, with the euro, trade within the euro area has increased and that, inside the euro, UK trade with the euro area and UK national income could, over the long term, increase substantially.

The assessment shows that intra-euro area trade has increased strongly in recent years as a result of EMU, perhaps by as much as 3 to 20 per cent; that the UK could enjoy a significant boost to trade with the euro area of up to 50 per cent over 30 years; and that UK national income could rise over a 30-year period by between 5 and 9 per cent. A 9 per cent increase in national income would translate into a boost to potential output of around $^1/_4$ percentage point a year, sustained over a 30-year period.

The assessment addresses the necessity for sustainable and durable convergence as a precondition for successful membership of EMU at the present time and the risks and costs from delaying the benefits of joining. The assessment of the convergence and flexibility tests together determines whether sustainable and durable convergence has been achieved. This is the basis for assessing whether UK economic stability – one of the central objectives of Government policy, providing the platform for delivering high levels of growth and employment – could be maintained if the UK were to join EMU.

The conclusions on each of the tests are as follows:

Convergence

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

There has been significant progress on convergence since 1997, which marks a break with the UK's past history of divergence and reflects greater stability of the UK economy and global trends towards integration. Indeed, the UK now exhibits a greater degree of cyclical convergence than some EMU members demonstrated in the run-up to the start of EMU in 1999 and remains more convergent than a number of EMU countries today. The UK meets the EC Treaty convergence criteria for inflation, long-term interest rates and government deficits and debt. But there remain structural differences with the euro area, some of which are significant, such as in the housing market. Because of the risks these factors pose, and the fact that any dynamic changes would take time to come through, we cannot yet be confident that UK business cycles are sufficiently compatible with those of the euro area to allow the UK to live comfortably with euro area interest rates on a permanent basis. Overall, at the present time, while the extent of convergence with the euro area has significantly increased, the convergence test is not met. The Government is committed to building on the platform of stability and has announced a wide-ranging forward-looking policy agenda to deliver high levels of output and employment. This will help to make the economy more convergent with the euro area for the future.

Flexibility

If problems emerge is there sufficient flexibility to deal with them?

UK labour market flexibility has improved markedly since 1997. Significant falls in unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than in the US. While considerable progress has been made to reform labour, product and capital markets in the UK and the euro area, more can be done to ensure the UK economy is resilient to deal with the risks identified in the convergence test and the challenges of EMU membership. Inflation volatility is very likely to increase inside EMU. Greater flexibility in the UK and throughout the euro area would minimise output and employment instability, helping to ensure convergence was durable and that the potential benefits of EMU could be fully realised. This underlines the importance of maintaining progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy. Overall, at the present time, we cannot be confident that UK flexibility, while improved, is sufficient. Reflecting this, at the present time, the achievement of sustainable and durable convergence has not been demonstrated. But increased flexibility through the measures we set out will help to provide greater reassurance that the economy can meet the additional demands that EMU membership would pose and contribute to achieving sustainable and durable convergence.

Investment

Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

UK productivity has been held back by a legacy of long-term under-investment. EMU entry could reduce the cost of capital for UK firms if long-term interest rates fell further inside the euro area and if membership of a larger financial market reduced the cost of finance. These costs could fall for small and medium-sized enterprises (SMEs) in particular if joining EMU lowers the barriers which prevent SMEs accessing euro area financial markets and lowers the cost of bank lending. Over time, EMU is likely to boost cross-border investment flows and foreign direct investment (FDI) in the euro area. There has been a fall in the UK's share of total EU FDI flows coinciding with the start of EMU, and a corresponding increase in the share of the euro area. But against the backdrop of many other influences on FDI flows, it is difficult to say with confidence that EMU has boosted FDI within the euro area. There can, however, be confidence that a successfully operating EMU, and UK membership of it on the right basis, would boost FDI over the longer term. There is a risk that the longer membership of the euro is delayed, the longer the potential gains in terms of increased inward investment are postponed. If sustainable and durable convergence is achieved, then we can be confident that the quantity and quality of investment would increase ensuring that the investment test was met.

Financial services

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

Over the four years since the start of EMU, the UK has attracted a significant level of wholesale financial services business. The strength of the City in international wholesale financial services activity should mean that it continues to do so, whether inside or outside

EMU. EMU entry should enhance the already strong competitive position of the UK's wholesale financial services sector by offering some additional benefits. Again, while the UK's retail financial services sector should remain competitive either inside or outside the euro area, entry would offer greater potential to compete and capture the effects of greater EU integration that would arise from the single currency and other efforts to complete the Single Market, in particular the Financial Services Action Plan (FSAP) – benefits which are postponed while the UK is not in EMU. Overall, the financial services test is met.

Growth, stability and employment

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

EMU membership could significantly raise UK output and lead to a lasting increase in jobs in the long term. As noted above, the assessment shows that intra-euro area trade has increased strongly in recent years as a result of EMU, perhaps by as much as 3 to 20 per cent; that the UK could enjoy a significant boost to trade with the euro area of up to 50 per cent over 30 years; and that UK national income could rise over a 30-year period by between 5 and 9 per cent. A 9 per cent increase in national income would translate into a boost to potential output of around $^1/_4$ percentage point a year, sustained over a 30-year period. Despite the progress made since 1997, the lack of sustainable and durable convergence means that, for the UK, macroeconomic stability would be harder to maintain inside EMU than outside, were the UK to make a decision to join at the present time. The potential uncertainty created by the price stability objective of the European Central Bank (ECB) and the potential constraints on the use of fiscal policy for stabilisation under the current interpretation of the Stability and Growth Pact (SGP) increase the chances that output and employment would be less stable inside EMU. The Government supports the direction in which the EU macroeconomic framework is evolving. Enhancing the flexibility and dynamism of the European economy, building on the achievements of the economic reform programme agreed at Lisbon, will also be important if the full benefits of EMU are to be realised. Entering EMU on the basis of sustainable and durable convergence is essential so that the UK can benefit from the substantial increases in cross-border trade, investment, competition and productivity that EMU could provide. Lower prices would lead to a lower cost of living, a key potential benefit of EMU entry for households, but one that would only accrue if entry were on the basis of sustainable and durable convergence. Poorer households tend to spend a greater proportion of their income on goods and services, so lower prices could benefit such households relatively more than wealthier ones. Overall, we can be confident that the growth, stability and employment test would be met once sustainable and durable convergence has been achieved.

Overall the Treasury assessment is that since 1997 the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area. So, despite the risks and costs from delaying the benefits of joining, a clear and unambiguous case for UK membership of EMU has not at the present time been made and a decision to join now would not be in the national economic interest.

POLICY REQUIREMENTS

Therefore, because it is right for the British economy in any event and because it will contribute to achieving the sustainable and durable convergence we need to enable Britain to prosper inside the euro area, the Government is entering into a wide programme of economic reform.

Key elements of this policy agenda are as follows:

Maintaining stability: Government's inflation target

- In terms of macroeconomic policy, the Government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will improve the quality of the UK inflation target and will also help ensure inflation expectations in the UK remain in line with those of the euro area.

Enhancing stability and flexibility: housing

- To deliver a more settled platform of stability in the future and a higher degree of convergence, the Government is committed to a comprehensive programme to improve the functioning of the housing market. Building on the reforms to deliver a step change in planning policy, the Government is undertaking further significant changes in the planning system, supply of housing and housing finance to tackle market failures, increase the responsiveness of supply to demand and reduce national and regional price volatility. These measures are beneficial in their own right to improve the stability and flexibility of the UK housing market and wider economy, but will also increase the housing market's compatibility with the euro area, encouraging greater convergence over time.

- This means implementing quickly and decisively past reforms to housing supply and going further to address both supply and demand in the housing market and macroeconomic stabilisation more generally:

  - on the supply side, the Government is requiring new Regional Spatial Strategies to take account of volatility in the housing market and promote macroeconomic stability as part of delivering sustainable development; tough and credible measures, including intervention, where local authorities are not delivering housing numbers in high demand areas; and exploring whether, in the medium term, achieving the Government's objectives will require a system of binding local plans. The Government has also commissioned a review of issues affecting the elasticity of supply in the UK, in particular to look at the role of competition, capacity and the financing of the house building industry and possible fiscal instruments, and the interaction of these with the planning system and sustainable development objectives;

  - on the demand side, through a review of the UK mortgage market to establish why the share of fixed rate mortgages is so low in the UK compared to many other EU countries and to identify ways of encouraging the market for longer-term fixed rate mortgages; and

- at the macroeconomic level, given that housing is identified as a significant risk factor to the achievement of sustainable and durable convergence and, in the context of the Treasury discussion paper *Fiscal stabilisation and EMU*, to consider what additional reforms and measures might help deliver wider stability in the economy, including with reference to the housing market, to create the right conditions for convergence within EMU. The Government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will help ensure inflation expectations in the UK remain in line with those of the euro area.

Proposals for enhancing stabilisation: fiscal stabilisation

- The degree of fiscal stabilisation may need to increase inside EMU where the absence of a UK-specific monetary policy may cause the degree of macroeconomic volatility to increase. The Treasury discussion paper *Fiscal stabilisation and EMU* explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper considers the reforms to the institutional framework that EMU membership would require to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently and which policy levers are likely to prove most effective.

- Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure that the policy proposals deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.

UK flexibility: reform of markets

- Flexibility, the ability to respond to economic change efficiently and quickly in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes, ensures convergence is durable. Sufficient flexibility ensures shocks do not have long-lasting effects and that high levels of output and employment are maintained.

- In the labour market, the Government is continually working to enhance flexibility and is going further through a package of measures designed to increase wage flexibility in the public sector, improve skills, particularly at the basic and intermediate level, give greater local discretion in the delivery of employment policies and increase labour supply by helping more people to move from welfare to work and increasing cyclical economic migration.

- In the product market, the Government has announced the full independence of the UK competition authorities and is going further to enhance competition in specific markets, reform the planning system to make it work more efficiently and introduce a package of deregulatory reforms to ease the burden of regulation on small business.

- In the capital market, the Government will increase flexibility through reforms to improve access to finance for small enterprises with high growth potential and consultation on further reform to the corporation tax system.

STABILITY IN EUROPE – POLICY FRAMEWORKS

In Europe there is increasingly a shared commitment to economic stability combined with wide-ranging economic reform designed to achieve full employment, high living standards and social cohesion. With more than half the UK's trade with the EU and increasing integration of product, labour and capital markets, the UK's economic interest is best pursued through a deepening cooperation with other European countries as part of the Government's commitment to a strong EU and a successful EMU.

In its May 2003 review of monetary policy strategy, the ECB restated that: "*Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term*". The ECB review went on to state that: "*At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*". At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialised.

At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are '*exceptional and temporary*' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.

All European countries have embarked on an ambitious programme to reform labour, product and capital markets and the Government supports policies to strengthen competition in the EU and the Single Market. However, it is important to make more progress at the European level, in particular on employment flexibility, trade and the Single Market in financial services. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy.

Many of the issues being considered in the European Convention could have far-reaching consequences for the future performance of EU economies, whether they are part of the euro area or not. The Government will continue to work with other European countries to ensure outcomes that will bolster stability and enhance the ability of European economies to raise productivity and employment levels. It will oppose proposals that would lead to unnecessary rigidities.

Although ECOFIN remains the decision-making body for the EU in economic and financial policy, in EMU the UK would be a member of and attend all – and not some – meetings of the Eurogroup, thereby participating fully in euro area decision making.