

## ASSESSMENT OF THE FIVE ECONOMIC TESTS

**6.1** The previous five chapters provide a detailed analysis of each of the Government's five economic tests for EMU entry.

**6.2** 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.

**6.3** 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  $\frac{1}{4}$  percentage point a year, sustained over a 30-year period.

**6.4** 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.

**6.5** This chapter draws together the conclusions on each of the tests to present the Treasury's overall assessment of the five economic tests.

### 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  $\frac{1}{4}$  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.

**6.6** 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.