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TESTING TIMES FOR MR BROWN

DECISIONS ON THE ON THE UK AND EMU CANNOT BE DELAYED INDEFINITELY. IT'S TIME FOR A MORE OBJECTIVE AND INFORMED DEBATE , SAYS **JEREMY PEAT** OF THE ROYAL BANK OF SCOTLAND.

The euro issue cannot be avoided forever. At some stage soon the government will have to take a decision as to whether to proceed to a referendum on UK entry to EMU during the course of this Parliament. To date, options have been kept open and a definitive decision, one way or the other, avoided. The UK remains outside but can still be judged a 'pre-in' where that suits.

The EMU decision will be as important as any taken by the UK during my lifetime as an economist. Full participation in EMU would involve not only adopting the euro, via irrevocably locking our currency to the single European currency, but also handing over responsibility for monetary policy from the Bank of England to the European Central Bank (ECB). The ECB's responsibilities include the critical power to set short-term interest rates. We would have no independent flexibility on either our exchange rate or our key interest rate.

UNCERTAIN TIMES. Determining not to go ahead with a referendum during the course of this Parliament would have to be taken as a decision to remain outside EMU for the foreseeable future – especially if Sweden and Denmark were to hold referenda. That would imply continuing volatility and uncertainties so far as the sterling/euro exchange rate is concerned and, potentially, a significant change in our economic relationship with the eurozone and the EU *per se*. The timing of any referendum remains highly uncertain. However, two dates are clear.

First, the government is committed to completing by June next year an assessment of Chancellor Gordon Brown's famous five tests. Second, the next General Election is due by June 2006. Complex operational – including IT – change would be involved across the economy if the UK (see BBA article page 37) were to enter, as set out in the banking industry's recent blueprint. Consequently, a substantial period of time would be needed between decision and final retail conversion. The risks, for the financial sector and others, of a dash to conversion would be huge.

It is self-evident that views as to whether entry would or would not be in the UK's interests will involve political as well as economic factors. Nevertheless, Gordon Brown's five conditions are economic in nature and the government is committed to pressing for entry if these economic tests are satisfied.

THE FIVE 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 UK joining EMU promote **higher growth, stability and a lasting increase in jobs**?

The government is seeking a view that is 'clear and unambiguous'. That will never be achieved – no matter how full and rigorous the analysis, how expert the analysts, how lengthy the assessment process, at the end of the day a large dose of judgement will be required. The scope for 'experts' to disagree is evident from the assessments published to date by various protagonists from 'no' and 'yes' camps.

Even excluding the politics, the economics of UK and EMU is complex and inevitably uncertain. We are realistically talking about an assessment, based on sound analysis, of whether the risks associated with UK entry are greater or less than the risks of UK staying out. A more constructive approach would involve considering how UK and EU policies could be influenced so that the risks of entry could be minimised.

TEST 1: MONETARY CONVERGENCE. In practice, there are at least three components to the test. Is the 'neutral' level of UK interest rates now broadly similar to that in the eurozone? Could we adapt to the level of euro interest rates likely to apply at the time of entry? Would the subsequent trend in these rates suit our domestic economy?

Not so long ago, it could be argued that the UK needed some external anchor to secure stability in our domestic economy, because our policy regime lacked consistency and credibility. More

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FIGURE 1
UK AND EUROPEAN INTEREST RATES

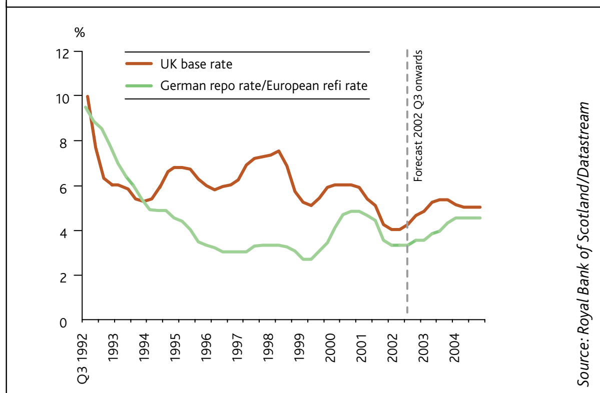
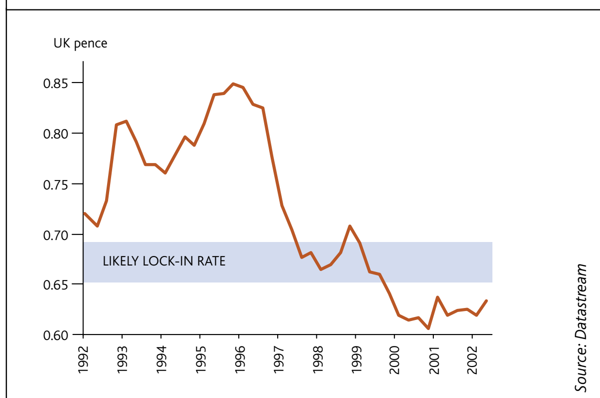


FIGURE 2
STERLING/EURO EXCHANGE RATE



volatility and higher inflation meant a tendency to higher interest rates. Credibility has now been attained, thanks to the policy improvements in the period pre- and post-creation of the Monetary Policy Committee (MPC). We have achieved embedded low inflation. One result is that the neutral level of nominal interest rates in the UK is now certainly closer to that prevailing in the eurozone (see *Figure 1*). The present gap between the 'repo' and the 'refi' is only 75 basis points. Nobody can be sure where either is heading in this period of increased macro-economic and market uncertainty. Nor can we know which direction the refi would be heading if/when we enter – or indeed where the repo would at that stage have been heading if we had stayed outside. But we can be sure that yielding up an independent monetary policy will have costs. The risks on this front are of substance.

TEST 2: SUFFICIENT FLEXIBILITY. In a monetary union, when independent action via the exchange rate or interest rates is not possible, other means of adjustment are essential when one component of that monetary union moves out of line with the remainder. The more that such adjustment can take place through fiscal policy and the 'supply side', the less that more painful adjustment via unemployment and real wage movements is necessitated. Full EMU participation does not mean tax harmonisation. To maximise flexibility, scope for independent tax adjustments must be maintained. However, the Stability and Growth Pact limits the extent to which overall fiscal policy can be used as an adjustment mechanism. Full EMU participation need not, and must not, mean any extra limits on a flexible labour market or reductions in flexibility for other components of our supply side. Within EMU such flexibility would be even more essential than now.

TEST 3: INVESTMENT IN THE UK. EMU entry would mean exchange rate certainty and reduced transaction costs for investors looking at broad eurozone markets. A decision to stay out would mean facing currency uncertainties for the duration and also uncertainties as to wider economic relationships with the expanding EU. Any signs that EMU entry implied reduced supply-side flexibility would be damaging to investment. Such flexibility is one of the reasons the UK has been a magnet for footloose investment. But entry on the 'right' basis should prove a plus for investment.

TEST 4: IMPACT ON FINANCIAL SERVICES. Government has effectively already agreed that this test is as good as passed. The competitive position of the wholesale and other markets is largely uncorrelated with the issue of UK and EMU.

TEST 5: HIGHER GROWTH, ENHANCED STABILITY AND MORE JOBS. This is not really a distinct test, more of a catch all – and a test that will never be clearly and unambiguously proven.

THE GIST, FOR AND AGAINST. While the economics of EMU are horrendously complex, the gist of the pros and cons can be summarised succinctly. Entry implies exchange rate certainty and lower transaction costs, to the benefit of traders and investors. Entry should increase transparency and competition, while confirming our stable economic relationship with our key economic partner. But it also means giving up both exchange rate flexibility and sovereignty over monetary policy, the risks of which must be seen as significant, especially if there are doubts about convergence and/or fears that other forms of flexibility would also be constrained.

Gordon Brown's tests are not all-embracing. Two key points are omitted. First is the little matter of the exchange rate at which locking would take place. Sterling has been overvalued against the euro for several years (see *Figure 2*). Locking at an overvalued rate would be highly damaging. Recent dollar-related developments have reduced, but not eliminated the degree of overvaluation. One crucial component of generating a convergence path will be the move to an acceptable entry rate.

Second, the extent we should worry about yielding up rights of monetary policy and accepting limits on fiscal policy and the like will be largely determined by our confidence in the institutions involved in the development and operation of European economic governance. For example: the ECB is not a perfect institution; reform is needed – and quite possibly achievable with the UK's constructive involvement; something similar to the Stability and Growth Pact is required; but the present arrangement is sub-optimal, and review is appropriate. Our involvement in EMU will be more likely to prove a success not only if *we* retain supply side flexibility, but also if the key countries at the core of the eurozone seriously enhance such flexibility; that debate must be pressed forward as a top priority.

All in all, UK entry to EMU would be distinctly risky, but so would UK opting to stay out. Let the debate continue!

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