Measuring the merits of UK entry to Emu

The Labour Government, should it be granted a second term, has its own plans for the UK and Emu. Jeremy Peat contributes with his own set of tests.

We have had the Budget and now await the next General Election. So what is next? The simple answer would appear to be a debate on the merits of UK entry to Emu. Tony Blair has stated that, if re-elected, his Government will press forward, within two years, to determine whether the time has come for that referendum on UK and Emu.

We have some indications of the possible phasing of UK entry from papers published by Government over the past couple of years. These, understandably, provide no indication of when the entry timetable might get underway. However, it appears reasonable to infer that a re-elected Labour Government would wish, if it works up the courage to press for UK entry, to have the whole process through to euro notes and coins done and dusted well before the subsequent General Election. On the basis of such information and inferences it is feasible to work out some plausible scenarios.

Blind dates

The most logical set of dates would appear to involve:

- January 2002 – notes and coins issue in 12 member states;
- late spring/early autumn 2002 – UK referendum.

Then, if 'yes' vote:

- early 2003 – formal Emu entry and irrevocable locking of sterling with the euro – transition of wholesale banking services only;
- early 2004 – full retail banking services available; or
- February 2005 – euro notes and coins issue in UK.

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All of this begs two key questions – apart from the Election result. First, will a new Labour Government determine to push for entry? Second, even if it does, will a referendum yield a 'yes' vote? Remember the Danish referendum outcome and that no EU member state has actually voted at a referendum for adopting the euro.

If, or when, the referendum campaign gets underway, there must be a firm basis for debating the complex economic issues. Formally, we have the five Maastricht criteria, which had to be 'met' by each of the existing 12 participating states.

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They require the achievement of inflation and, long-term interest rates comparable with the other Emu participants; along with low ratios of Government total debt and Government annual deficits to GDP. None of these cause any problem for the UK. There is also a requirement for exchange rate stability. Being deemed to meet this criterion would involve some discussion with our EU partners.

We also have Gordon Brown's own five tests set out as far back as 1997. Unlike the Maastricht five, these are qualitative rather than quantitative, and hence amenable far more to judgement than measurement. Brown's tests are fine, but it would not be grossly unfair to state that these can, by-and-large, be deemed met when that suits.

Time to add more tests

Neither set of tests appears to focus sufficiently on the economic pros and cons. Therefore, it is time to develop a further five tests, more closely related to the economic debate. In brief, the economic argument for entry revolves around achieving a combination of secure, full and unfettered, access to the market of our main trading partner, at a set exchange rate and at a time when that market should be becoming increasingly dynamic and openly competitive.

The economic downside relates to yielding independence on monetary policy as well as exchange rate flexibility. This implies considerable difficulties of adjustment to 'asymmetric' shocks: with heightened concern because of, first, doubts about economic governance in the Emu zone, and, second, a view that this is certainly not anything like an optimal currency area, with the UK exhibiting distinct structural differences from economies at the core of Europe.

Given the above, my five tests are as follows:

- entry should be at a time when there is a distinct degree of cyclical convergence between the largest economies in the eurozone and the UK;
- there should be a degree of confidence that the UK could adapt to the short-term interest rate set by the European Central Bank, at the time of entry and for a reasonable period thereafter;
- sterling should only be irrevocably locked to the euro at a rate bearing a fair approximation to an equilibrium rate – that is, much lower than now;
- a maximum degree of scope for adjustment should be retained via fiscal policy and on the supply side – no tightening of the stability and growth pact; no pressure to harmonise direct taxes; and no further EU wide restrictions on flexibility in either labour or product markets; and
- further progress towards transparency on the roles and operations of the Emu institutions, plus clear signs of progress towards supply side flexibility for the core EU states, all as a demonstration that this is a club from whose membership we could expect benefits.

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These tests are as qualitative as Gordon Brown's, and leave ample scope to disagree in the assessment. However, debating around these issues should attract the discussion to the key economic questions. ■

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