UK: still dragging its feet over adopting the euro

Joining the euro certainly appears to have its attractions. So why is the UK holding back? Steven Bell of Deutsche Asset Management looks at the downside.

The debate on sterling's membership of the euro has been extensive. Recent arguments have focussed on whether Britain's decision to stay out has caused the UK to lose manufacturing jobs. This is an issue for the many thousands of people who are employed by car manufacturing giants such as Ford and Nissan.

Yet there is another issue which would affect millions which is rarely mentioned. It relates to the strange shape of the UK yield curve and its interaction with our financial structure. Both would be radically changed if the UK were to join the euro. The effect would be to cut the cost of mortgages and raise annuity rates. As a result of staying out of the euro, people in the UK currently pay the highest mortgage rates and retire on the lowest annuity rates in Europe.

Figure 1 shows the swap curves for sterling and euros. UK mortgages are largely priced at the short end of the curve. Even fixed rate mortgages rarely extend beyond the five-year maturity. This part of the curve is significantly higher in sterling than in euros. If we were to join Emu, the sterling swap curve would converge towards the euro curve. We show the result as the theoretical EU and UK curve[1]. The immediate impact would be to cut the cost of providing mortgages in the UK by 80bp (basis points) to 100bp depending on their duration.

Of course, there is no guarantee that UK short rates would always be lower than those in euroland if sterling were to remain outside the euro. But history suggests that they do and the current gap occurs despite the UK having the lowest inflation in the EU – at least on the basis of the harmonised index of consumer prices.

At the same time as the heavily-mortgaged 30 to 50 year olds were benefiting from lower mortgage rates, so their parents would be able to enjoy higher annuity rates for their retirement. These, of course, are priced off the long end of the curve in government bonds.

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But long-term interest rates in the UK are lower than in euroland and the gap is particularly wide in government bonds (see *Figure* 2). If sterling were to join the euro today, annuity rates in the UK would rise by close to 80bps. Admittedly, this would do nothing for those who had already bought an annuity, but those yet to do so would benefit greatly.

Steven Bell

Benefits of joining the euro

It is difficult to understand why the pro-Emu camp has not made more of this argument. The reasons why mortgage rates would fall and annuity rates would rise are undoubtedly complex. But the effects can be translated into hard money. If we were to join the euro today:

- variable mortgage rates could fall by close to 80bp–100bps. This would reduce monthly payments on a 25-year £100,000 repayment mortgage by £64 (assuming a 100bp fall in rates from the 7.5% current); and
- long-term annuity rates would improve by 80bp. This means the cost of a second death annuity of £10,000 a year for a couple aged 60 would fall from £136,986 to £123,456, representing a saving of £13,530.

A cynic might argue that the pro-Emu camp is reluctant to point out these two obvious benefits because it would lead to discussion of two related drawbacks. When faced with the evidence that Emu would reduce annuity rates in the UK, the anti-Emu camp might ask "why are long-term rates higher in euroland?" and then answer "because their governments are an inferior credit."

Before Emu and unification Germany had one of the world's strongest currencies, a current account surplus, a fiscal surplus and a low ratio of government debt to GDP. Today, Germany's financial statistics have deteriorated, largely because it is fully united with the economically-depressed eastern region and shares a currency with some larger neighbours whose finances are even worse.

Meanwhile, the UK has enjoyed an unprecedented period of financial

FIGURE 1

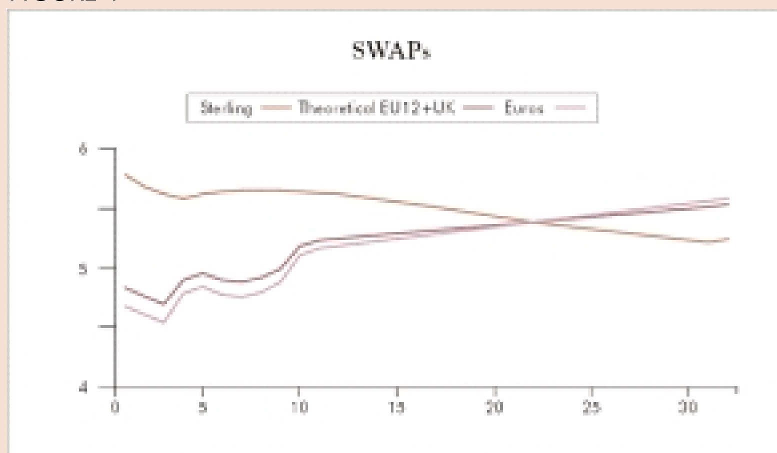
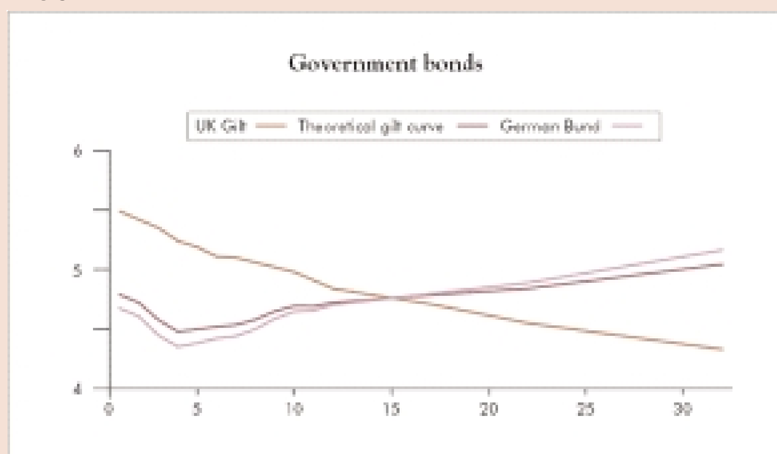


FIGURE 2



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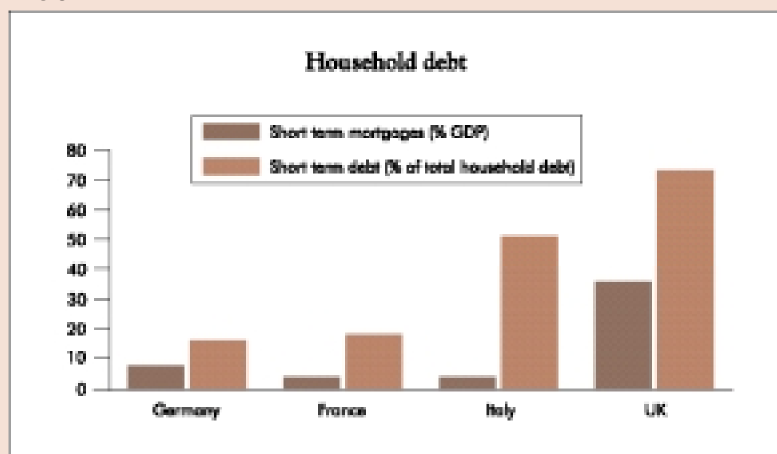

stability and fiscal surplus. Once the problem of dealing with unfunded pension liabilities in Europe is taken into account, the contrast becomes even greater.

Debt is a drawback

The second related drawback concerns the sensitivity of the UK to short term interest rates. UK consumers have far more floating rate debt than their European counterparts. Our mortgage debt is high, only a small proportion is financed at long-term fixed rates, and we have more non-mortgage debt than the rest of Europe.

Figure 3 gives some idea of the scale of the differences. This means that the UK is more sensitive to short-term rates. When a country joins a single currency, it must accept that interest rates, being set in relation to the whole region, will differ from the ideal level based on their local considerations alone. This is true for every country in euroland. But these differences are relatively unimportant for most Emu countries.

For the UK, they would matter much more. Certainly, the UK and euroland financial structures would move closer together if we joined the euro. But this would take time, probably decades, and in one important respect the gap has widened. By abolishing Miras, the current government has removed one shelter that UK consumers had against interest rates. This move has merits if we remain outside the euro – it means that the MPC can keep base rates at lower level – but it makes the UK less fit to join Emu.

What does all this mean for the corporate treasurer?

Beyond noting that the UK's yield curve is sensitive to the prospect of us joining the euro, there a few practical implications. If you have euro-denominated liabilities, borrowing in short-term euros is probably more attractive than short-term sterling. However, borrowing in euros to finance sterling liabilities would involve taking on board currency risk to achieve a lower interest cost.

This is not a gamble I would usually recommend: if you fancy the odds, you might as well borrow yen. If you are in the long-term debt market and your credit rating can stand it, sterling does look attractive relative to euros. But my advice has long been that, while it is probably inevitable that we will we join the euro some day, that day is many years away. One thing is certain, this debate will run and run. ■

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Note

[1] The two curves should converge to a weighted average. But the weights would favour the dominant curve, which is the euro. Sterling membership would shift the euro swap curve in its direction but only slightly. GDP weights suggest a 6:1 ratio which implies that euro (and so the UK) short rates would be 4.8% if sterling were to join.