IS THE CLOCK TICKING FOR THE UK'S ENTRY INTO EMU OR IS THE COUNTRY ON THE RIGHT TRACK TO MEETING IT'S 'FIVE ECONOMIC TESTS' CRITERIA? FOR UK CORPORATES, EMU MEMBERSHIP CAN BRING SEVERAL BENEFITS INCLUDING INCREASED TRADE, MORE INVESTMENT OPPORTUNITIES AND ACCESS TO CHEAPER CAPITAL – BUT ONLY IF THE TIMING IS RIGHT. BY **HM TREASURY.**

GETTING THE TIMING RIGHT

In October 1997, the Chancellor of the Exchequer said that in principle the UK government is in favour of UK membership of the single European currency, but in practice the economic conditions must be right. The determining factor was whether or not joining would be in the national economic interest; a clear and unambiguous case would have to be made.

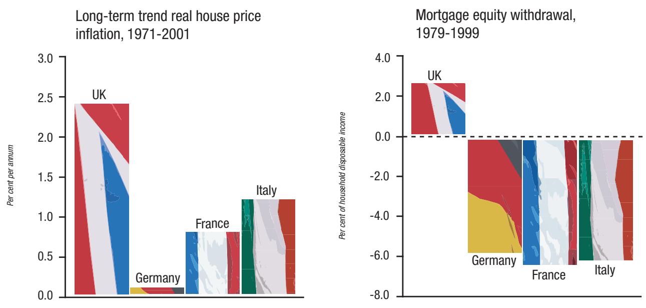
This necessitated looking widely at both the potential costs and benefits of monetary union. The UK Treasury's five tests provide the framework against which the case for entry could be made. A full assessment of the five tests was published in June 2003. It showed there are potentially very large gains from Economic Monetary Union membership due to lower transaction costs, increases in trade, and the potential to boost investment and productivity. Their attainment would, nevertheless depend on continued economic stability and the ability to prevent the UK from returning to the boom-bust cycles of old. The potential costs of joining EMU arise from the loss of an independent monetary policy, and the lack of flexibility to vary the exchange rate in line with other European partners as before.

"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," said the assessment. "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."

Figure 1. Convergence test – Housing: high-risk structural factor

In the UK, the link between house prices and consumer spending is stronger than in other EU countries.

Combination of real house price rises.... and ease of access to housing wealth.

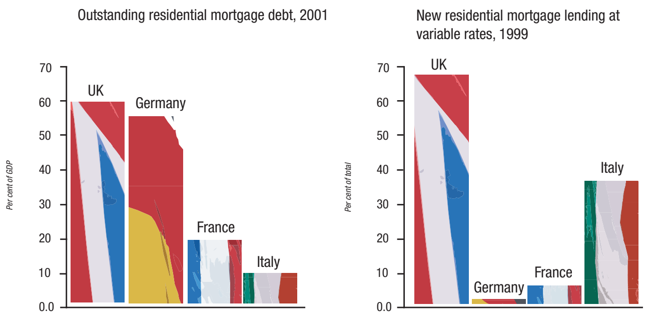


Source: HM Treasury

Figure 2. Convergence test – Housing: high-risk structural factor

UK household incomes are more sensitive to interest rate change.

High mortgage debt is financed predominantly at variable rates.



Source: HM Treasury

THE FIVE TESTS. The Treasury's five tests provide the framework against which the case for UK entry into EMU could be made. Specifically, they focus on economic convergence, flexibility, investment, financial services and growth stability and employment.

CONVERGENCE. The convergence analysis showed that the UK exhibited a greater degree of cyclical convergence – in terms of inflation, long-term interest rate trends and government debt - than some EMU members had demonstrated in the run-up to the start of EMU in 1999. However, there were substantial differences in policy settings. In particular, UK short-term interest rates had remained higher than euro zone rates over the last five years, reflecting the fact that the UK's consumption growth since 1997 has been nearly twice as high as in the euro zone. UK entry at this stage would have involved a marked fall in interest rates, with the consequent risk of a destabilising boom.

It was also vital to eliminate the risk of any divergence once inside EMU. The analysis hence looked at structural differences between the UK and the euro area including the UK housing market, which could be identified as a source of economic instability if common interest rates were adopted. Strong UK house price growth, driven partly by supply constraints, has helped underpin robust consumption growth (see *Figure 1*). Moreover, a high level of mortgage debt, financed at variable rates, has made UK households far more sensitive to interest rate changes (see *Figure 2*).

The assessment concluded it was not possible to be confident of UK business cycles being sufficiently compatible with those of the euro area.

FLEXIBILITY. The flexibility test asked how the UK and the euro area may respond to economic shocks such as a change in global demand for certain goods or commodities. Problems could arise if such a shock affects individual countries differently, bearing in mind that interest rates are set for the euro zone as a whole.

This test found that more could be done to ensure the UK economy is resilient to deal with the risks of EMU membership. To illustrate this, *Figure 3* shows how a fall in demand for labour impacts output and employment when both outside and inside EMU. Outside EMU, the adjustment process can be facilitated by amending UK interest rates and by movements in the sterling:euro exchange rate. If the UK was in EMU, these macroeconomic adjustments would not be possible.

Greater flexibility in the UK and throughout the euro area would be important to minimise output and employment instability. Overall, the assessment concluded that there was not sufficient flexibility – despite significant improvements in recent years – to reduce volatility in EMU.

INVESTMENT. The investment test (see *Figure 4*) was designed to assess whether recent improvements in business investment in the UK could be sustained in EMU. It found that 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. EMU membership could also boost cross-border investment flows and foreign direct investment (FDI). Indeed, there is already evidence that the single currency has yielded tangible benefits to euro zone members in terms of increased FDI.

The assessment, nevertheless, concluded that in the absence of greater convergence and improved flexibility, the investment test would not be met as a return to volatile economic conditions would make business planning difficult and threaten expected returns.

FINANCIAL SERVICES. UK financial services account for five per cent of GDP and over one million jobs. Back in 1997, it was suggested that if the UK did not join EMU, its financial institutions would risk losing business to Paris or Frankfurt. In practice, however, UK financial services have continued to illustrate substantial net overseas earnings (see *Figure 5*). In some areas, for example in the Eurobond business, the UK has continued to increase its market share. It is clear that the achievement of a comparative advantage in financial services derives from a range of factors, such as skills, location, and tradition, and that currency plays only a minor role. Nevertheless, the study showed how EMU might offer greater potential for financial services to compete and capitalise on the effects of greater EU integration such as lower costs on euro zone transactions, more optimal allocation of investment portfolios and potential economies of scale for investment funds.

GROWTH, STABILITY AND EMPLOYMENT. Successful adoption of the euro raises the possibility of substantial gains to UK growth and employment. A common currency eliminates a barrier to trade between countries, and hence joining EMU could boost UK trade with the euro area, and raise national income. The assessment found that intra-euro area trade has increased since the formation of EMU, without loss of trade with countries outside the euro area. It concluded that in the best case UK membership of EMU might lead to a significant boost in trade with the euro zone of up to 50 per cent over 30 years, provided entry was based on sustainable and durable convergence. This might correspond with a rise of 5-9% in UK national income over the same timeframe. But, in the absence of sustained convergence the potential gains to growth and trade could be negligible even in the long run.

In addition, the potential uncertainty created by the price stability objective of the European Central Bank, and the potential constraints on the use of fiscal policy for stabilisation, increased chances that output and employment would be less stable inside EMU.

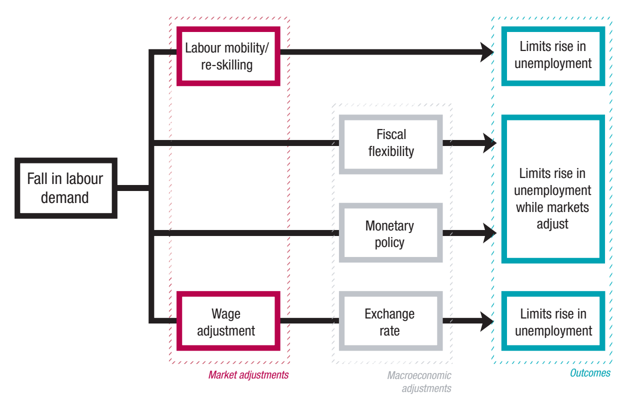
Overall, the final test found that growth, stability and employment could be met, but only once sustainable and durable convergence was achieved.

THE IMPLICATIONS FOR UK COMPANIES. The convergence and flexibility tests showed that joining EMU at the time of the assessment could lead to greater macroeconomic instability in the UK. It would also be damaging for UK companies and lead to greater uncertainty and reduced investment (domestic and foreign).

However, if sustainable and durable convergence were achieved, EMU would confer considerable benefits. Obviously, the extent to which the costs and benefits offset each other would depend on the business activity in which a company is involved. EMU is already promoting a deeper, broader and more integrated market for capital across the euro zone, which could lead to a reduction in the cost of capital for euro zone firms. The removal of currency transaction costs and risks allowed by EMU entry could increase access to this market for UK firms. Easier and cheaper access to euro area financing is likely to

'CONVERGENCE AND FLEXIBILITY TESTS SHOWED THAT JOINING THE EMU AT THE TIME COULD LEAD TO GREATER MACROECONOMIC INSTABILITY IN THE UK'

Figure 3. Flexibility test – adjustment to a negative shock



Source: HM Treasury

benefit larger SMEs that currently raise funds through domestic capital markets and are discouraged from tapping international markets by exchange rate costs.

EMU entry at this stage would also lead to a fall in UK short-term interest rates, but this would be likely to come at the cost of greater macroeconomic instability. A lower cost of capital through lower real and nominal interest rates has been a key economic benefit of EMU for many euro zone countries. However, over the medium to long-term, euro zone interest rates are not expected to be lower than those in the UK, reflecting the expectation that macroeconomic frameworks in both the UK and the euro area will maintain low and stable inflation.

EMU entry on the basis of sustainable and durable convergence once the five test are met would allow the UK to participate in a more active cross-border investment market and prompt greater FDI flows into the UK from the euro area.

It would also reduce nominal exchange rate volatility and lead to greater certainty about returns for firms doing business in the euro area.

FINANCIAL SERVICES INDUSTRY. Inside or outside EMU, the competitive strength of the City should mean that the UK continues to attract a significant level of wholesale financial services activity. Entry would remove any unease firms might have about locating in a financial centre outside the euro area. It could also improve the UK's ability to compete for the new, contestable business that can be expected to arise from EU enlargement, an ageing EU population and the continued development of euro financial markets. Changeover costs arising from entry for the sector would not be significant.

Entry into EMU could also improve the competitive position of the UK's retail financial services sector if other barriers were also removed. Such benefits include lower costs on euro area transactions, the possibility for a more optimal allocation of investment portfolios and potential economies of scale for investment funds. Assuming markets are competitive, these benefits should be passed on to consumers and offset the one-off changeover costs that would arise for the financial services sector.

The dynamic effects of the single currency are likely to be gradual. With other changes, the euro will encourage the integration of retail financial services in the single market over the longer term and, importantly, greater competition in the sector. For countries outside the euro zone, these effects will be more muted. The business case for greater cross-border merger and acquisition activity could strengthen as retail financial services firms seek to make the most of new opportunities in a single market with no currency barriers. Outside the euro area, these opportunities could be weaker.

POLICY SINCE THE ASSESSMENT. The assessment announced a policy agenda designed to bring about durable and sustainable convergence with the euro zone and increase the UK economy's flexibility in response to economic shocks. Many of the measures proposed since June 2003, particularly on flexibility, will benefit the UK economy, whether it is in EMU or not.

The 2004 Budget reported progress made on the government's reform agenda since the June 2003 assessment. The government's policy on membership of the single currency remains unchanged – in favour of joining in principle but in practice the economic conditions must be right.

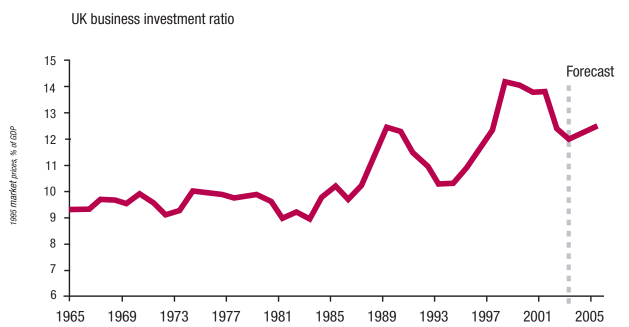
Addressing some of the structural problems associated with housing has formed the centrepiece of the government's agenda since the assessment. The Barker Review published at the time of the Budget identified the need for a substantial increase in housing supply in order to improve affordability and create greater stability in the housing market. It sets out a challenging set of reform proposals for central and local government and the house building industry.

The review of issues affecting the elasticity of supply in the housing market also focused on the role of competition, capacity and the financing of the house building industry, and the further use of fiscal instruments. The 2004 Budget also saw the publication of The Miles Review which looked at possible ways to improve the structure of housing finance by establishing why the share of fixed rate mortgages in the UK is so low compared to many other EU countries.

Budget 2005 will consider the extent of progress made and again determine whether to make a further assessment of the five tests. If this proves positive, it will allow the government at that time to put the issue before British people in a referendum.

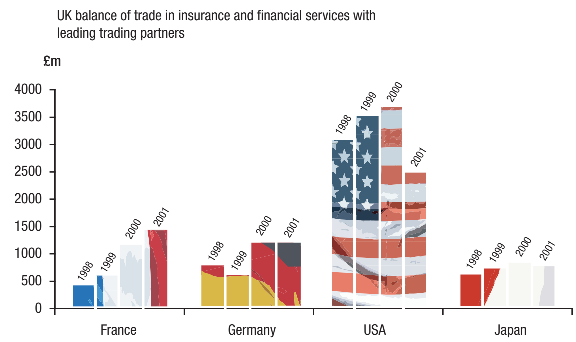
public.enquiries@hmtreasury.gov.uk
www.hm-treasury.gov.uk/

Figure 4. Investment test – Business investment



Source: HM Treasury

Figure 5. Financial services test – Importance to UK economy



Source: HM Treasury