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In or Out: The Choice for Britain

JIM ROLLO *European Economics, University of Sussex*

ABSTRACT

The choice facing British government about maintaining the status quo for sterling or joining the euro is a choice between long-term policy regimes. Short-term considerations such as the relative position of business cycles or the current level of the sterling-euro exchange rate have a bearing on the adjustment costs and the timing of entry. The article therefore examines the EMU framework versus the British framework for monetary policy; the performance of economic policy in Britain and in Euroland, and especially Germany as Euroland's main precursor; the relevance to the adjustment costs of membership to the Maastricht criteria and the Chancellor of the Exchequer's five economic tests for joining the euro; and whether or not Britain can qualify for joining EMU. The analysis is broadened to include supporting policies for monetary policy, especially fiscal, labour market and other structural policies where relevant.

The choice of a currency regime is the choice about how to set and manage domestic monetary policy. The alternatives are broadly: I) To set monetary policy targets domestically and achieve them by use of domestic interest rates and leave the exchange rate to float, OR ii) To fix the exchange rate (in the extreme, adopt another currency) and take the monetary consequences of this domestically. There are intermediate positions which range from managed floating, where the central bank intervenes to smooth the rate of change of the market rate with or without formal targets, through fixed but adjustable exchange rates which allow periodic adjustments of target rates to take account of emerging imbalances and quasi-permanent or irrevocable fixes such as currency boards or currency unions.

Opinion in the economics profession has a tendency to swing quite widely on the matter of preferred exchange rate regimes, depending on the currently most pressing macro-economic management problem. Following the ERM crises of 1992/3 and the Asia and Latin America crises of 1997/8, adjustable peg systems are deeply unpopular (Fischer 2001). The conventional wisdom now prescribes either floating or an

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irrevocable fix – currency boards, "dollarisation" or "euroisation" or membership of a monetary union with a country's main economic partners.

Swinging between extremes also reflects an underlying analytical insight that in the long-term there is no difference between a fix and a float. The essential point is that factor prices of capital and labour will adjust in such a way as to ensure that the real – as opposed to the nominal – exchange rate would tend to the same level under either regime. The adjustment paths are, however, quite different and depend crucially on labour market characteristics in a world of open capital markets if adjustment costs are to be minimised. Put crudely, under a floating rate regime, the exchange rate works to compensate for wage rate changes that are out of line with rest of the world. In a fixed rate regime, wages have to make the adjustment or the level of employment will have to fall, assuming that in most cases wages are flexible upwards but not downwards. In a world where wages are perfectly flexible the exchange rate does not matter and the case for a world currency is almost unimpeachable.

The choice of exchange rate regimes for Britain thus has two main dimensions. First, will the change to the Euro improve macro-economic policy outcomes – notably inflation and unemployment – and the shape of the economic cycle? Second, will it impose short to medium term adjustment costs on the real economy in terms of lower employment levels and lower growth rates? It follows that, provided there is some flexibility in labour markets, the choice of exchange rate regimes is about minimising the short term costs of reaching any set of macro-economic and real economy goals. The questions that any government contemplating the change of exchange regimes reconsidering include: Are the long-term objectives of the new regime better than the existing regime? Is the performance of the existing regime in achieving its objectives better or worse than the proposed regime and is any under performance structural?

If the answer to the first two questions are positive: How can a government minimize the cost of shifting from one currency regime to another?

I The long-term policy framework: EMU

For practical purposes the EMU Framework is made up of 3 elements, two determined by the terms of the Treaties of Maastricht and Amsterdam and one by non-treaty agreement.

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(i) Monetary policy

The Treaties grant the European Central Bank (ECB) total independence over both its targets and the instruments it uses to meet these targets. Given the difficulty of changing the Treaty once ratified, this independence may be taken to be complete in the short run and, as long as the ECB has supporters on the Council of Ministers, probably also in the long-term. The degree of formal independence granted to the ECB thus exceeds that of the German *Bundesbank*, the model for the ECB; it could in principle be abolished by an act of the German Parliament. The only objective the ECB is given is that of price stability. In operational terms this is quite difficult to define.

While zero inflation is consistent with price stability, the latter is not a zero inflation target for two reasons. The first is technical. Some measured price rises result from quality increases e.g. computers. The measurement of such quality increases is intrinsically difficult and such exercises as have been done suggest that quality improvements in the US have been equivalent to between 0.5 and 1.5 per cent growth in prices per year (Boskin et al., 1996). If true for the Euro zone, price stability would be consistent with inflation of around 1 per cent per annum on average. The ECB (1999: 47) argues that the measurement bias in European indices is lower than elsewhere but presents no direct evidence

The second issue is more complicated and is essentially dynamic. The question is what happens if there is a bout of inflation (or deflation), which leads the price level to rise or fall. If the target were zero inflation then the ECB would be back on track once inflation fell or increased after a deflation to zero again. But that means that the price level will be permanently higher or lower than the baseline price level. Thus, a zero inflation target by itself allows the price level to drift. A target of true price stability would require the ECB to continue deflating or inflating once inflation reached zero, that is, prices would need to fall or rise until the impact of the bout of inflation or deflation was removed from the price level. Only then could inflation return to zero and be consistent with price stability.

These considerations may seem arcane but they do give rise to potentially different policy responses as is the case with inflation targeting in Britain as against Euroland. They also gives rise to some confusion when comparing British and ECB monetary targets. Because of uncertainty about the definition of price stability the ECB announced its target as being inflation less than 2 per cent per annum on the common measure of inflation, the Harmonised Index of Consumer Prices

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(HICP) in the Euro area (ECB, 1999). The fact that this represents a price level target and not an inflation target explains why the target is not set in symmetrical terms. However, because there is no estimate of the effect of quality change it remains hard to know how low inflation could go without the price level falling. This suggests the possibility of a deflationary bias, a charge refuted by the ECB (1999: 47)

(ii) Fiscal policy

The Maastricht Treaty lays out the excessive budget deficits procedure (Article 104c) which, as in the Maastricht Criteria, puts an upper limit of 3 per cent of GDP on national government budget deficits and 60 per cent of GDP on government debt levels. These, in conjunction with the Broad Economic Guidelines (Article 103.2), try to define the policies of member states and those outside the Euro zone as well as those inside it as matters of common interest (Article 103.1). The excessive deficits procedures demand that member states agree budgetary plans to keep or bring deficit and debt levels below the upper limits and the broad economic guidelines suggest their deficit and debt levels should as far as possible be minimised. It is under the Broad Economic Guidelines that both Britain and Ireland have been criticised by the European Commission for expansionary fiscal policy. If a member state allows its budget deficit to exceed 3 per cent of GDP without the agreement of the Council of Economic and Finance Ministers and remains in this position there is the possibility of financial sanctions. For example, EU budget payments can be suspended.

The Stability and Growth Pact is outside the Treaty and is an agreement among the members of the Euro zone to pursue a set of fiscal policy objectives and subject to explicit sanctions if these objectives are missed. New members will be asked to sign up to the pact as a condition of membership. In essence, the Pact is an intensification of the excessive deficits procedure. Budget deficits are not allowed above 3 per cent of GDP in all but exceptional circumstances. This limit is defended both by explicit commitments by member states in the form of convergence plans (see below) and by draconian sanctions which can allow fines of up to $\frac{1}{2}$ per cent of GDP to be levied on recalcitrants. The revenue from these fines is paid to governments who are in line with their commitments.

The key difference between the Stability and Growth Pact and the excessive deficits procedure however is not the more draconian system of sanctions. It is rather that the Pact has a specific commitment to budget balance as the long-term objective. Convergence plans are thus the means for mapping out the path that member states can take to

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balance their budgets. It is divergence from these convergence plans which have brought German and French fiscal policy under explicit criticism from the European Commission.

(iii) What can Euro zone members expect?

If the ECB sticks to its definitions of price stability, then in the long run and without any shocks, inflation is likely to be around 1 to $1\frac{1}{2}$ per cent in core countries of the Euro zone, that is, meaning France, Germany, Benelux and perhaps Italy. It could be a bit higher in countries with higher productivity growth or in catch-up growth, e.g. Spain, Portugal, Greece, Ireland and above all in new member states in Central Europe. In these circumstances, short-run interest rates are likely to be in the range of 4 to 5 per cent and long run interest rates to be around 5 to $5\frac{1}{2}$ per cent.

On the fiscal side, over the long haul the Growth and Stability Pact should lead to a budget deficit of zero on average and a public debt stock that is also zero. These outcomes will only happen in circumstances where there are few shocks and in the very long run. They are very unlikely to be reached and the route would be uncomfortable Nonetheless, they represent the intention of the system

Monetary policy responses to shocks will be shared. To the extent that these are demand shocks and shared across the Euro zone, that will cause few problems. If there are asymmetric demand shocks or localised supply shocks, these will have to be managed by the independent fiscal policies. These fiscal responses will be constrained by the Stability and Growth Pact and the Excessive Deficits Procedure to the extent that they require deficits in excess of 3 per cent of GDP. There is some evidence based on past performance, experience and model simulations (Barrell and Dury 2001) that the headroom between the long run objective of zero budget balance and the 3 per cent maximum deficit is enough to manage the likely range of shocks. Note, however, that budget deficits can balloon very rapidly when monetary policy is too tight for specific circumstances. When Germany tightened monetary policy in response to the impact of unification in 1990–92, the impact on Britain, as a member of the exchange rate mechanism of the EMS – and already going into recession – was to increase the budget deficit to more than 8 per cent of GDP as activity fell and unemployment rose.

II The long-term British policy stance

The underlying assumption for the purposes of this paper is that Britain would sustain its current policy stance indefinitely if it remained

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outside the Euro zone. This might not be true. For example, shocks might encourage governments to raise inflation targets. The continuing failure of infrastructure to improve might raise public expenditure and perhaps borrowing if tax increases were politically difficult.

(i) Monetary policy

British monetary policy has three main elements: i) a target set by the government and specifically by the Chancellor of the Exchequer; ii) inflation targeting with a symmetrical range; iii) a Central Bank with instrument independence to achieve the target range. The institutional differences from the EMU system are substantial. The Central Bank is not fully independent. Elected politicians set the target for the Central Bank. The target is the inflation rate and not the price level. Because the target is symmetrical, this prevents the Bank being over-deflationary. The target range is $2\frac{1}{2}$% plus/minus 1%, as measured by the British Retail Price Index excluding mortgage interest rates. Since this is roughly equivalent to a target of 2% measured by the Harmonised Index of Consumer Prices used by the ECB, the British inflation target is aimed at delivering a higher rate of inflation than the ECB.

(ii) Fiscal policy

The fiscal policy system in the UK also differs significantly in intent from the EMU system. The policy follows the 'Golden Rule', which derives from the argument that current expenditure, and current revenue should be in balance but that it is justifiable to borrow to cover net public investment which has real economic payoffs. This approach was chosen against a background of perceived under-investment in public infrastructure and the need to rebuild that stock. The target chosen was that the budget deficit should average 1 per cent of GDP over the economic cycle and should represent net public investment.

(iii) Labour markets

As a result of twenty years of reforms, British labour markets are generally considered to be among the most flexible in the OECD. Wages are not controlled, hiring and firing is relatively easy, taxes on employment are low compared with many EU members, working hours are not closely controlled, and part-time work is generally encouraged (Nickell and Quintini, 2001). There is a minimum wage but it is set at a level

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below half the average adult male wage. The result is low levels of unemployment and high participation rates.

(iv) The long-run outcomes of British policy

On the monetary side, British inflation is likely to settle at around $2\frac{1}{2}$ per cent per annum on the chosen indicator or about 2 per cent on the ECB inflation indicator. This would be up to 1 per cent per annum higher than the likely core rate in the Euro zone. Short-term internal rates are likely therefore to be 5 to 6 per cent per annum and long-term rates about 6 per cent. These are higher than Euro zone rates in nominal terms but real rates are likely to be about the same.

The budget deficit will average 1 per cent of GDP. According to Barrell (2002), this is consistent with a debt stock of around 20 per cent of GDP, which is higher than under the Stability and Growth Pact. It is, however, about half the current level in the UK and a third of the limit under either the Maastricht Criteria or the Excessive Deficit Procedure and much below the average of existing members of the Euro zone or current members of the OECD.

Comparing the two systems shows differences in long-term outcomes (Table 1), but these differences are not especially large. British inflation would be one-half of a percent or one percent lower in EMU, while the tax burden would be higher under the Stability and Growth Pact by 1 per cent of GDP if the net public investment target remained the same. This is well within the fluctuations in the British tax burden in recent years, which has varied between 38 and 44 per cent of GDP between 1992 and 2001.

III Economic performance under EMU and the British framework

It is clear that the long-term intentions of the two systems are not very different so it might be inferred that there is no real objection to substituting one system for another. But actual performance may differ from intentions and point to frailties, technical or political, with either system. This comparison is, however, complicated by the short periods of time over which both systems have been in operation. The British

TABLE 1: *Long run equilibrium values for inflation and fiscal policy variables*

	EMU Framework	British Framework
Inflation (HICP) %	$1-1\frac{1}{2}$	2>
Budget Balance (% of GDP)	0	−1
Public Debt (% of GDP)	0	20

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system has been in operation only since 1997. Admittedly, the precursor to the system that operated after Britain's ejection from the ERM in 1992 bore some broad similarities in the sense that there was steady downward pressure on both inflation and on the deficit and debt. The Central Bank was a more obvious player in the system than previously but still did not have either target or instrument independence. But the emergence from the deepest recession in post war history after 1992 had such profound effects on inflation and economic activity and on budget revenue and expenditure that even as late as 1996 it is hard to disentangle the effects of policy from recovery from the recession.

Similarly, the Euro was introduced on 1 January 1999 and the Stability and Growth Pact has been in operation since mid 1997. Although it may be something of an exaggeration, it is possible to say that the policy framework under EMU was not new and untested, it can be argued that it is simply an extension of the framework under the European Monetary System and in particular during the run-in to EMU, which began in 1995. Essentially, the ERM imposed German monetary policy on its members. Thus, monetary policy was being run by an independent central bank with an objective of price stability in Germany. ERM member states could change their central rates if the pressure of keeping up with Germany was too difficult. Indeed, only the Benelux countries and Denmark sustained the same parity throughout the life of the ERM.

The fiscal framework was much less draconian. The Excessive Deficits Procedure made its first appearance along with the Maastricht Criteria in the Maastricht Treaty of 1992. The genesis of the precise values for deficit and debt levels is a little mysterious but it is relevant that neither France nor Germany had exceeded either value in the post war period. In other words, their historical fiscal stance was conservative even if government expenditure as a share of GDP grew throughout the period . The fiscal shock of unification soon put Germany under pressure to conform with the Maastricht fiscal criteria. The transmission of tight German monetary policy to France via the ERM also forced a relaxation of fiscal policy, so much so that when the first date for the formation of the EMU in 1997 approached, neither country was able to qualify.

Nonetheless, it is worthwhile examining British and Euro zone inflation as proxied by Germany over the long-term and forecasts for the post 2002 period based on inflation targets being met (Figure 1). This shows that apart from a few quarters in 1992/3 and since 2000, inflation in Britain has been above, and often substantially above, that in Germany.

Figure 2 shows that inflation in Britain has been below Euro zone

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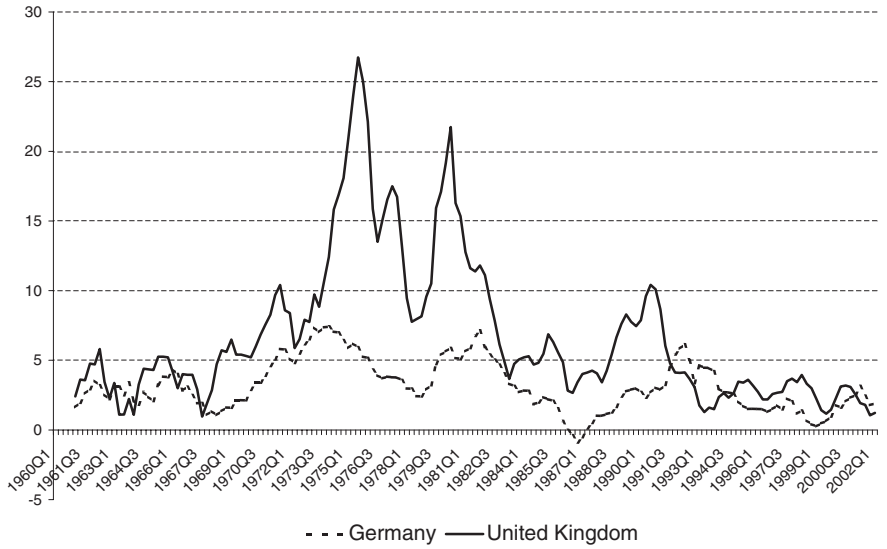


FIGURE 1: *Inflation in United Kingdom and Germany, 1960–2002*

levels as measured by HICP. Over the 36 months to May, 2002, the British Monetary Policy Committee has undershot its central target in all but 2 months, though it has not yet come close to the lower bound, whereas the ECB has constantly exceeded its target 2 per cent inflation since the beginning of 2000. Monetary policy typically has a lag of 12 to 24 months, and the British target is inflation 2 years ahead. These figures suggest that since the new policy came into place in 1997, the Bank of England has been conspicuously successful in meeting its brief. The performance of the ECB in the two years after January 1999 is less impressive.

Broadly viewed, economic performance has been less different. On growth rates in particular, the Euro zone picked up in 1999 and 2000 as the relaxation of monetary policy and the weakening Euro encouraged domestic and foreign demand. Unemployment levels, particularly in France and Germany, began to fall. This, however, has not yet caught up with the UK where, since 1992 growth has been consistently above trend and on any measure unemployment has fallen substantially. After 1997 growth, unemployment and inflation performance in the UK has been the best since at least the 1950s. Table 2 sets out comparable performance indicators since 1991, including EU Commission forecasts to 2002. The data suggest that in general British performance on inflation and growth is at least as good as the Euro zone average and that unemployment tends to be substantially lower than the Euro zone average.

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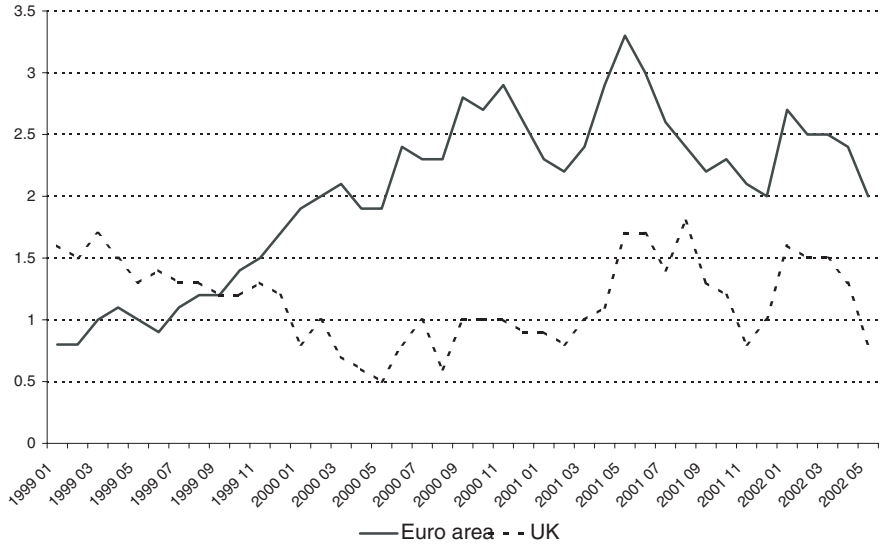


FIGURE 2: *Inflation in United Kingdom and Euro area, 1999–2002 (HICP)*

The major point of policy weakness in the British economy is the persistent trade and current account deficit. In part this may represent willingness by foreigners to buy productive assets in the UK which may relate to the apparent increase in trend growth values in recent years, and it has certainly been linked to the strength of sterling, notably against the Euro. This last point is partially undermined by the fact

TABLE 2: *Unemployment, GDP and Inflation 1991–2003*

	Unemployment rate		Real GDP growth[1]		Inflation[2]	
	Euro area	UK	Euro area	UK	Euro area	UK
1991	:	8,6	2,5	−1,4	4,9	6,6
1992	:	9,8	1,5	0,2	4,3	4
1993	10,6	10,2	−0,8	2,5	3,6	2,6
1994	11,3	9,4	2,3	4,7	2,8	1,4
1995	11,1	8,5	2,3	2,9	2,9	2,6
1996	11,3	8	1,4	2,6	2,1	3,3
1997	11,3	6,9	2,4	3,4	1,6	2,9
1998	10,7	6,2	2,9	3	1,7	2,9
1999	9,8	5,9	2,6	2,1	1,1	2,6
2000	8,8	5,4	3,4	3	1,3	1,7
2001	8,3	5,1	1,6	2,2	2,3	2,4
2002	8,5	5,3	1,4	2	2,0	2,5
2003	8,1	5,3	2,9	3	1,7	2,5

Source: European Commission
[1]GDP at 1995 market prices, annual percentage change.
[2]Price deflator GDP at market prices, annual percentage change.

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that according to UK statistics the trade deficit is largely with the rest of the world while trade with the EU is in broad balance. Nonetheless, traded goods industries, though not traded services, have complained about the strength of sterling and manufacturing growth has been low and even negative even when the rest of the economy was growing steadily.

Over all, this section suggests that UK comparative performance has been as good or better than Euro zone performance in recent years and the UK monetary policy framework has been better than the ECB at hitting targets. Taken over the last 30 years however, the Euro zone policy framework performed much better than the successive British ones. There is thus not a stark choice over long-term objectives nor is implementation likely to be much worse or better under one framework or the other. Britain may be getting better at macro-economic policy making but the jury is still out on whether this is sustainable. The continentals are not significantly worse at implementation than they were but long-term economic policy performance is decisively better than in Britain.

IV Can Britain quality for EMU?

Qualification for EMU membership depends on two sets of tests. First, are the Maastricht criteria, which are formally required to be met by any applicant state under the provisions of the treaty. The second are the five economic tests set in 19997 by the Chancellor of the Exchequer, Gordon Brown.

(a) The Maastricht Criteria

There are six Maastricht Criteria, of which four are tests of monetary integration and two of fiscal policy compatibility. Table 3 indicates that on the basic policy performance statistics, Britain is well within the range of the Criteria. Inflation would be among the best in the Euro zone as would fiscal performance. The two areas where the criteria are not met are essentially policy choices. The first is the creation of an independent central bank. This is not problematic once the choice to go into the EMU is taken, since an Act of Parliament could create an independent central bank in relatively short order.

Exchange rate stability is more problematic for essentially political reasons. First, the experience of the brief membership and ejection of sterling from the ERM was widely seen as having destroyed the credibility of the last Conservative administration only a few months after it had been re-elected. The memory of that makes British politicians

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TABLE 3: *Britain and the Maastricht Criteria*

	Fiscal Tests	Test Statistic	Most recent British performance (Q1 2002)
1.	Budget Deficit as % of GDP	Less than 3%	−1%
2.	Debt level as % of GDP	Less than 60%	40%
	Monetary Policy Tests		
3.	Independent Central Bank	YES	NO
4.	Inflation rate within $1\frac{1}{2}$% points of three best performers in the Euro zone (HIPC)	2.7%	1.5%
5.	Long-term interest rates within 2 % points of three best performers in Euro zone	7.10%	5.23%
6.	Stable exchange rate demonstrated by membership of the ERM of the EMS for at least 2 years	YES	NO

extremely hostile to membership at all. Second, a period of two years in the ERM on narrow margins before full membership of EMU is a potential purgatory, since many things could go wrong after a British referendum on membership is won. This fits with judgement of much of the economics profession that adjustable peg systems are accidents waiting to happen, and is reinforced politically by the British ERM experience. This may be exaggerated however. The experience of Italy and Greece suggest that if the commitment to EMU is credible the market rate will converge immediately on the chosen central rate and stay there. The third objection is technical, and in the eyes of many in the Euro zone, disingenuous. In the Treaty, the requirement is to be a member of the ERM on 'normal margins of fluctuation', which at the time the Maastricht Treaty was written, meant plus/minus 1.25% around the chosen central rate. After the crisis of 1992/93, the margins were extended to plus/minus 15%. This, it may be argued, is such a wide range that it has no relevance for a test based on the ability to defend a chosen central rate for two years. The ECB and the members of the Euro zone reject this argument. They demand that applicant members of EMU should enter the so-called ERM-II alongside Denmark, which once more demands margins of fluctuation of plus/minus 1.25%. The British argue that this was not in any of the Treaties they signed and that there is no legal basis to impose these conditions upon them.

This wrangle is an essentially political roadblock and there are a number of ways around it. Neither the Italians nor the Greeks spent 24 months on narrow margins in the ERM before entering EMU. So Britain could perhaps negotiate a shorter period based on its better than Euro zone economic performance in the years prior to entry.

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Over all therefore, the only one of the Maastricht Criteria that looks problematic is the exchange rate. That will require some form of political deal to minimise the risk of what happened to Britain during its membership of the ERM.

(b) The Five Tests

Ahead of the May 1997 election and in an attempt to sweep the issue of membership of EMU off the political board, the Labour Party offered a referendum on membership after the cabinet and parliament had agreed that membership was in Britain's economic interest. The Treasury is responsible for assessing whether or not British economic interest are met, and Gordon Brown has set out five tests (http://www.hm-Treasury.gov.uk/topics/topics_euro/topics_emu_index.cfm):

1. Whether there is sufficient *flexibility* to cope with economic change.
2. The effect on *investment*.
3. The impact on our *financial services* industry.
4. Whether it is good for *employment*.
5. Sustainable *convergence* between Britain and the economies of a single currency.

The tests have two purposes. First they have intrinsic merit as indicators that measure whether the long term interest of the British economy and people is met by membership and the size of short-term adjustment costs. Secondly, the process gives the Treasury and the Chancellor of the Exchequer an element of veto over the membership question. This is underlined when it is recognised that there is great room for manoeuvre in deciding whether any criterion is met unambiguously. Indeed on the convergence test, the Deputy Governor of the Bank of England has said that 'It is going to be difficult to prove that the British economy has ever achieved lasting convergence with 'Europe' (quoted in *The Guardian*, 25 February 2001).

Any assessment of the tests will be published and there are a number of organisations willing and able to carry out their own assessments. There is already a small industry assessing these (see (e.g. Ardy et al., 2002; Artis, 2000; Barrell, 2002; Bush, 2001; and Layard et al, 2000)). It will not be possible for the Treasury to stop debate simply by saying yes or no. Any assessment will need to be able to stand critical scrutiny. The Treasury, however, remains in charge of the timing of any move towards EMU membership and will have an important impact on the tenor of the debate.

The tests are relevant to both long-term and short-term considerations. Four are, superficially at least, predominantly long-term. These

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are those on flexibility, investment, the financial services industry and employment, although this last might also be thought to be a question about the level of the real exchange rate. These four tests are intrinsically very difficult to answer unambiguously. Arguments can be adduced on both sides of the question of whether joining EMU would improve or make the outcome worse.

(1) Economic flexibility

The flexibility criterion is extremely hard to operationalise, not least because of the range of its potential coverage. It not only includes the flexibility of labour markets, but also capital markets, goods and services markets and intrinsic qualities of human capital, notably education and R&D. These all bear on the ability of an economy to adjust to change.

From competition policy through the regulation of the financial services policy to the minimum wage and taxes in employment, the flexibility of the economy is in the government's power. The flexibility of the labour market is determined by government regulation, as is the flexibility of goods and capital markets. Education is in Britain largely determined by the state directly or is regulated in a way to deliver state determined outcomes. So the question is not how flexible is the economy? It is, given other economic and social objectives in the existing policy mix, is the choice of a fixed exchange regime with our closest trading partners going to generate better outcomes than sticking with the existing regime?

(2) Inward Investment

The issues of inward investment and the position of the City of London emerge from fears that staying out of EMU would both reduce investment inflows and undermine the position of the City as the prime international market in the European time zone. In both cases, there is an economic and a political aspect. The economic issue revolves around the question of whether unstable nominal exchange rates between Britain and the euro zone will encourage inward investors to shift to the euro zone. To date, there has been no sign that Britain is losing its place as a prime recipient of inward investment as a result of being outside the euro zone (Figure 3). To be sure, some existing foreign firms, notably in the auto industry, have complained about the strength of sterling. But that would not be solved simply by joining the Euro zone. It would require a fall in the value of sterling, which could happen

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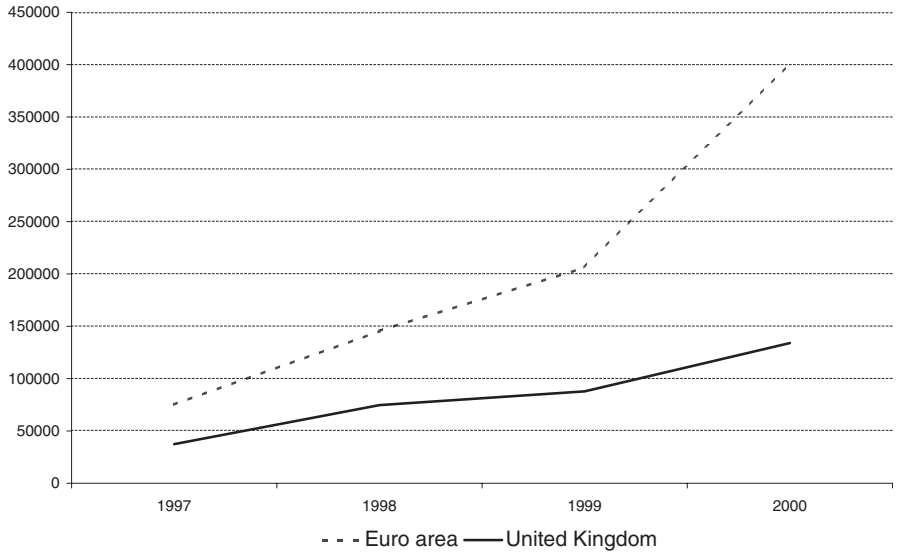


FIGURE 3: *Foreign Direct Investment: net inflows million*

despite staying out, as is demonstrated by the June 2002 hardening of the euro against both sterling and the dollar.

A more political and long-term reason for fearing an impact on inward investment is that if Britain stays out of it will be excluded from the decision-making process on the single market. As a result, foreign investors would locate inside the euro zone not only to increase market access but also to extend influence over governments actively engaged in crafting policy. As yet, there is no significant evidence of barriers emerging against Britain or a reduced British influence in the single market policy framework.

(3) The Financial Services Industry

There is no sign of significant business transferring from the City of London to the Euro zone as a result of British self-exclusion from EMU. There was scare about the derivatives markets moving to Frankfurt and over merging stock exchanges in continental Europe, but neither of these owed anything to membership of the Euro zone. They were driven by intrinsic weaknesses in the structure of the British derivatives market and by the problems faced by small stock exchanges on the Continent.

As with investment, proponents of entry express both economic and political fears. They see the eventual creation of an integrated euro

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zone bond market, potentially rivalling the United States, as posing a threat to the City's dominance. But as of yet this has not appeared. The loss of influence in the inner councils of the EU might lead to discrimination against the British financial services industry. The most obvious risk is harmonisation of withholding taxes. Germany in particular is pushing for this to prevent tax avoidance. So far Britain, assisted by Euro zone members Luxembourg and Ireland, has resisted this successfully, on the grounds that it would reduce the competitiveness of the respective international markets and move business offshore with no benefit to EU treasuries.

Long-term British absence from the Euro zone and any shift of decisions traditionally made in the Ecofin council to the unofficial committee of euro zone finance ministers *de facto* might leave the City of London vulnerable to regulatory exclusion from key continental markets. But once more there is, as yet no direct evidence that staying out would harm Britain (see Lascelles, 2001).

(4) Employment

The key employment test is essentially the entry rate into the system. If that is too high, then competitiveness will be reduced and, unless wages fall, unemployment will increase. Note the caveat however. Thus, the question becomes the consequent fall in real wages required to retain competitiveness can be brought about. A desire to do so via a fall in the exchange rate suggests a fear that labour markets are not flexible enough. Given that the exchange rate against the euro seems to be on a declining trend, this may now be a less pressing issue.

(5) Convergence

Convergence is the key question in relation to the likely short-term impact of membership and whether any costs can be minimised. In general terms, this can be thought of as matching the British economic cycle to the Euro zone cycle. That can be assessed by comparative economic indicators in the public domain. The easiest single statistic to comprehend is the output gap. This summarises the difference between actual output and trend output. If it is negative, then output could increase and monetary policy be relaxed to help promote convergence and the opposite if the gap is positive, and if output gaps are the same then a degree of convergence appears to be achieved. But this is not enough. This could, in the words of the Governor of the Bank of England, be no more than a case of "ships passing in the night". Broadly speaking, not only should the output gaps be similar, but they should

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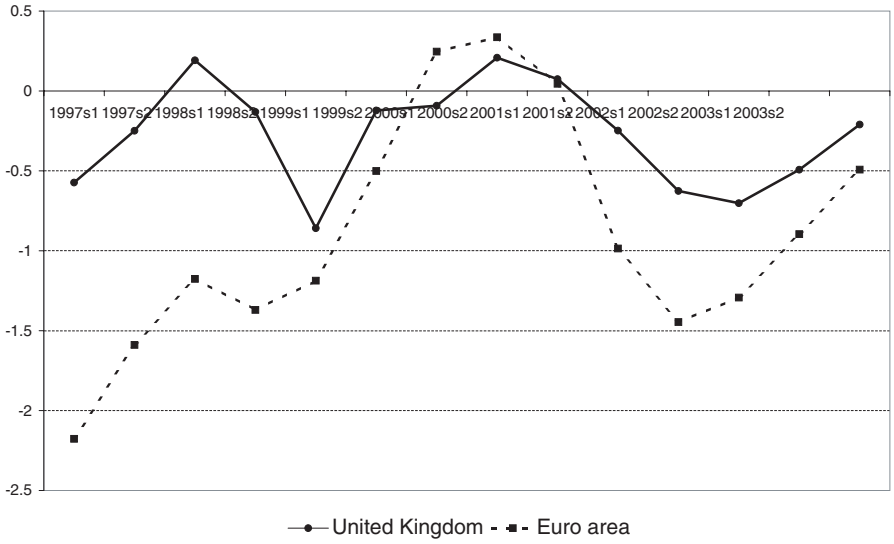


FIGURE 4: *Semi-Annual Output Gaps in Euro area and UK, 1997–2001*

also be moving together, so that monetary policy is acting in the same direction in both cases. Figure 4 suggests that the shape of the respective cycles are quite well matched since 1999 and that the gap between the UK and the euro zone is shrinking.

From a monetary policy outlook the picture is uncertain. As things stand at mid-2002, inflation is lower and short-term interest rates are higher in the UK than in the Euro zone. With Euro zone inflation above 2% the ECB's next move is likely to be an increase in interest rates. Paradoxically, the most likely next move in UK interest rates is also upwards in an attempt to curb consumer spending and the housing market pressures rather than goods or labour markets. Yet again the ECB may hold back on interest rate increases to see what impact the hardening of the euro may have on inflation. At the same time any further depreciation of sterling against the euro might increase inflationary pressures on Britain, further encouraging interest rate increases.

There is a case for British and euro zone interest rates to move together or in opposite directions during 2002. What is clear is that entering EMU at anything close to the mid-2002 economic situation would mean a fall in short-term interest rates and possibly an increase in inflation up towards current Euro zone levels. It would also mean fixing at an exchange rate which may be uncomfortably high, particularly for British manufacturing.

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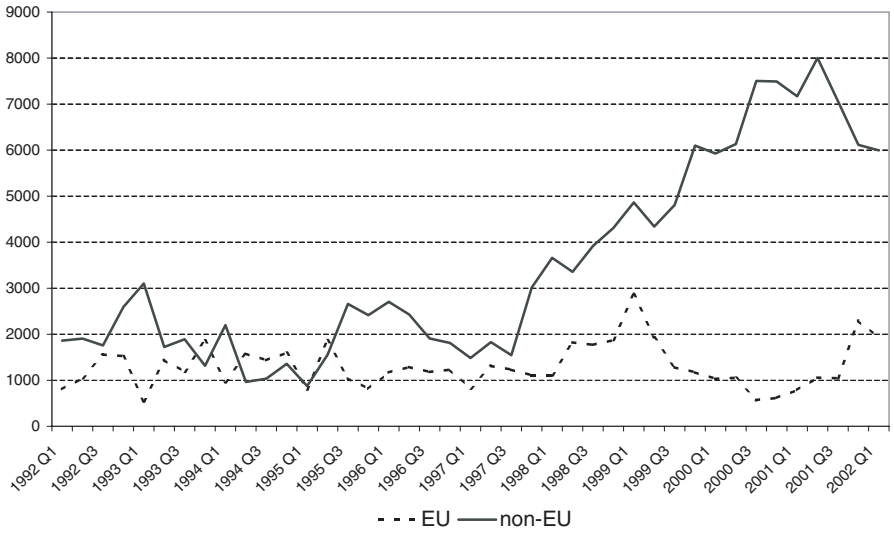


FIGURE 5: *UK Trade Deficit in Goods with EU and Non-EU Countries (£mn, seasonally adjusted)*

On convergence, there is potentially a quantitative test but the range for interpretation may be wide and hence any judgement controversial. The comment by the Deputy Governor of the Bank of England that perfect convergence might not happen in a thousand years along with the comment of the UK desk economist in the OECD Secretariat that the UK was more converged on the euro zone average than most member states (reported in *The Independent*, 2 May 2002) indicates the range of interpretation possible. The exchange rate is therefore is likely to provide an implicit sixth test.

(c) The Sixth Test: the Exchange Rate

After its exit from the ERM, sterling fell from its central rate of €1.45 (2.90DM) to under €1.10 in mid-1994. Since then, it has risen to a peak of €1.60 and by early July 2002 it stood at €1.55. This has meant a rough ride for the British traded sector. Manufacturing output in early 2002 has fallen below that at the beginning of 1995 and there is a deteriorating trade deficit (See Figure 5). This has led to calls for a loosening of monetary policy as a way of driving down the exchange rate.

There is, however, considerable controversy around what nominal

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exchange rate represents the long-run equilibrium rate. During the 1990s, conventional wisdom put the equilibrium exchange rate in the range of DM2.40 to 2.60 (€1= £0.83 to 0.77) or 20 to 30 per cent below mid 2002 levels. Some estimates put the equilibrium rate at €0.91 (Driver and Wren-Lewis (1998)). Barrell (2002) has suggested that the late 2001 rate of one euro equally £0.60 or close to it is sustainable. The recovery in manufacturing output despite the high exchange rate and the apparent fact that, according to British statistics, that trade in goods with the Euro-14 is in deficit by £4bn compared with an overall trade deficit of £32bn does give some credence to Barrell's estimates. The Confederation of British Industries suggests that parity around £0.67 is bearable while others would be happier if the euro was worth £0.70 or more (*Financial Times*, 26 June 2002).

The most likely entry rate will be the market rate close to the date that accession to EMU is agreed with EU partners. The experience of other EMU states is that once a rate is agreed and initially announced as the central rate in the ERM, the market rate will move to it and stay there until entry into EMU. This raises the question whether an entry parity, perhaps some distance from the market rate, could simply be announced and the credibility of entry after a short period in the ERM such as six months rather than two, would persuade markets to move the rate there immediately. The problem with this scenario is that Euro zone partners would have no interest in letting Britain join at a very competitive rate, especially if it differs much from the prevailing market rate. Indeed, if the rate in the market fell precipitously ahead of entry, for example, on expectations of lower interest rates, Euro zone members might ask for an entry rate higher than the prevailing rate.

Another potential problem is that the moment the United Kingdom enters the euro, the economic relationship with the United States dollar will be governed by the euro rate, which is generally expected to rise in future. On coming into existence, the Euro had a rate to the dollar of about $1.15. It subsequently fell to the region of $0.86, but by mid-2002 had risen to around $1.00. Past exchange rate cycles have shown very wide swings. Sterling has tended to move more closely with the dollar than the euro since January 1999. It depreciated by a maximum of 15 percent against the dollar since January 1999, during which time the euro fell a maximum of 36 percent at its last trough in June 2001. Even in mid July 2002 when the euro is testing parity it is still more than 15% below January 1999 levels. If the appreciation of the euro against the dollar continued at the point of UK entry to EMU, then sterling could face a situation in which it would suffer a greater appreciation against the dollar inside the Euro zone system than it would have experienced in a free float.

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V Exercising the choice

(a) The Maastricht Criteria

Unless something unexpected happens, there seems little doubt that the UK can meet the Maastricht monetary and fiscal criteria, since it has done so since 1999. Making the central bank independent should not be a significant obstacle if a referendum can be won. The key difficulty with the Maastricht Criteria is over the interpretation of the exchange rate stability criterion and whether and how long Britain would be required to stay in the ERM on narrow margins before entering EMU proper. The answer to this will be determined by how much the Euro zone members want Britain in and whether, after winning a referendum, this issue would be quite so politically neuralgic for the British government. It is likely that any British government would want full membership to begin as soon as possible after winning a referendum. That interval might be the most important determinant of how long sterling would remain in the purgatory of the ERM.

(b) The Five Economic Tests

These seem much more problematic. They are all open to wide interpretation and will generate significant controversy. The British economy is among the most flexible in the world and at least as flexible and capable of managing change as any in the euro zone. On two key tests, neither inward investment nor the financial services industry seem to have suffered any systematic damage as a result of being outside EMU. Investment has suffered from the continued strength of sterling (which raises the cost of acquiring assets to foreigners and reduces competitiveness) and that might have been avoided by entry to EMU in 1997 when Labour came to power. If sterling continues to depreciate against the euro and EMU entry locked in a more competitive parity then the attractiveness of the UK as platform for supplying the EU market might increase. The employment test is also about flexibility since if wages are flexible then employment will be sustained irrespective of exchange rate movements. It is also a question about the entry rate. The convergence criterion is highly contestable. Output gaps are unlikely to be the same at any point in time, and they diverge across the euro zone (Barrell, 2002)). Because of domestic or external imbalances in the UK or the euro zone, short-term considerations may argue for opposite monetary policy dynamics at the point when any assessment is made even if output gaps in both levels and expected changes are broadly matched.

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The first key issue for any Treasury assessment recommending entry to EMU would be to show convincingly that there will be little change in expected long-term outcomes except in a better direction. Lower inflation, lower costs of debt service, and perhaps a slightly higher growth rate as real long term interest rates fall are the main potential gains. Yet in any case, these gains could be obtained by simply changing the UK targets to inflation of 1.5 to 2% and budget balance over the cycle. Secondly, the Treasury will need to demonstrate that these advantages are not offset by significant short term adjustment costs.

In economic terms and in the long term, there is not much to choose between the British and the euro zone economic frameworks. Both aim to deliver low inflation and prudent fiscal policy. Inflation is likely to be lower and fiscal policy a little tighter in the euro zone and as a result real long term interest rates are likely to be lower and growth higher. But the differences in economic performance may be small. The euro zone policy mix model has a long history of success in Germany and within the European Monetary System. The British framework has be running since 1997. Nonetheless, the British system has arguably produced lower inflation than EMU membership would have done over that time period and fiscal management has been steady and effective. Nor have the first three years of EMU demonstrated that the European Central Bank has a sure touch in managing monetary policy or that the Growth and Stability Pact is as consistent in application as its proponents wish. For any British government recommending entry on economic grounds after more than five years of successful economic performance may appear to some as admitting that the British political system cannot be trusted to deliver good policy in the long term. That may be a difficult admission for any Chancellor of the Exchequer to make.

Apart from the economic considerations, there remain outstanding political questions: what is the likelihood that the Blair government could win the referendum vote necessary to secure British entry into EMU? And, given uncertainties whether the outcome would be defeat or victory, what degree of risk is the Blair government willing to run by calling a referendum on the euro? Any calculation about the outcome of a referendum must not only take into account the pros and cons of the economic arguments for entry and for Britain to be, in the prime minister's words, 'at the heart of Europe'. It must also include the popularity of the government at the time the referendum is called, and the readiness of voters to trust the judgement of its governors when asked to make a major change in regime with inevitably incomplete information.

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Jim Rollo
Director, Sussex European Institute
University of Sussex
Brighton BN1 9SH, United Kingdom
email: j.rollo@sussex.ac.uk

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