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The euro-zone: The early years & UK Convergence

The third Stage of Economic & Monetary Union [EMU], the creation of the euro-zone, began on 1 January 1999 and in January 2002 euro notes and coins were issued for the first time: the euro-zone is now complete. This Paper looks at the zone's economic performance since 1999 and at its institutions, in particular at the emerging role of the Growth & Stability Pact. It also considers whether there is evidence of economic convergence by the UK with the zone. Lastly, it summarises public opinion and attitudes towards the euro in both the euro-zone and the UK.

Timothy Edmonds

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Summary of main points

The creation of the euro-zone is now complete following the introduction of the euro currency and the removal of the legacy currencies.

Euro-zone economic growth has been slower than in the US, which has recently experienced something of a ‘golden age’, but has been reasonable by historical standards. Monetary conditions have remained stable and unemployment has declined. Widely divergent examples of economic performance have been recorded and look set to persist.

The euro as a currency has traded below its launch value for virtually the whole of its life. Since July 2001, however, it has first stabilised and then, since April 2002, risen sharply against the dollar and sterling.

The European Central Bank has faced criticism in its first years of existence. It has established a mixed relationship with the media and with the financial community. But the ECB has identifiable successes too. Its main economic aim of price stability within the euro-zone had largely been achieved and the almost flawless introduction of the new notes and coins in January 2002 was a major triumph. The ECB can also point to the fact that one, unsaid, political aim has been achieved, namely the maintenance of public unity amongst the national representatives on the Governing Council. The ECB has been a more passive institution than either the Federal Reserve or the Monetary Policy Committee.

The Stability and Growth Pact has emerged as a major influence on the economic decision making of some participant states, in particular Italy, France, Germany and Portugal.

On the question of UK convergence with the euro-zone and its performance against the ‘five tests’ views of economists vary considerably. By contrast the UK would appear to comfortably meet the convergence criteria established by the Treaty.

Public opinion in Europe is broadly in favour of the monetary union policy though support for the euro has increased since 1998 in only five of the twelve participants.

Opinion in the UK towards membership has varied considerably. Since 1999 the gap between the ‘pros’ and ‘antis’ has varied considerably. The ‘anti’ lead has varied from a high of 40 percentage points in November 2000 to a low of 18 on two occasions - January 1999 and January 2002. In contrast to equivalent European polls the number of ‘don’t knows’ is both high and showing no sign of decline.

CONTENTS

I Introduction 7

II Performance of the euro-zone 8

A. Economic Performance 8

1. The euro-zone: an outline 8
2. Growth 8
3. The euro 9
4. Inflation 11
5. Unemployment 16

B. Institutional Performance 17

1. European Central Bank 17
2. Stability & Growth Pact (SGP) 23

III Convergence? 29

A. Introduction 29

B. Intra-zone convergence 29

C. UK convergence 31

1. The Five Tests 32
2. The Maastricht tests 36

IV Attitudes towards the single currency 41

I Introduction[1]

> "This has been a historic moment for Europe, which has shown itself to be equal to the task. We have introduced the euro. Now a new era starts. We have to exploit the advantages of the euro to the full. The first task is to strengthen our economic policy co-ordination in order to accelerate structural reforms and further modernise our economies. It is imperative to increase the growth potential of the euro area if we are to emerge from the current slowdown even stronger than before. The warm response of the European people to the euro changeover shows that they are ready for change."[2]
>
> *Pedro Solbes, EU Commissioner for economic and monetary affairs*

For more than twenty years many European politicians and civil servants have harboured dreams of closer monetary integration between their respective national economies. Some were attracted by the idea of forming an alternative to the influence of the world's dominant currency, the US dollar. Some had been attracted by the advantages that a single currency would bestow. Others argued for it on the grounds of political symbolism, while yet others saw it as a way to import an economic model that had worked successfully in the major economy of Europe: Germany. Whatever the motivation the dream was finally realised on 1 January 2002 when euro notes and coins, authorised and issued by a pan-national authority, became the legal currency for 300 million people.

Of course notes and coins are just the visible expression of the irrevocable fixing of interest rates which took place three years before. Consequently it is now possible to begin to see if either the fears or claims made for the project have been realised or exaggerated. Furthermore, sufficient time has now passed to form a judgement on the constitutional framework within which EMU was devised and to examine the performance of its most important player, the European Central Bank.

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[1] References to EMU will refer to the political and constitutional process or event of monetary union. The area comprising the twelve participating member states will be referred to as the euro-zone. The official name of the new currency is the euro, abbreviated to eur (sub denomination cents) and the official symbol is €.

[2] EU Commission Europa website, Brussels, 7 January 2002, quoted at: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/02/16|0|RAPID&lg=EN&display=

II Performance of the euro-zone

A. Economic Performance

1. The euro-zone: an outline

The nearest economic comparator to the euro-zone in terms of size and economic development is the United States.

The euro-zone is slightly the larger of the two in terms of population (by about 10%), but rather smaller (about two thirds) in terms of GDP. The euro-zone is a more open economic area than the US, with exports from the euro-zone about 50% more significant in GDP terms than in the United States. The two areas have been at different stages of their economic cycle over much of the period between 1999 and 2002. Until mid 2001 the US appeared to be on an ever-upward path of a new economic paradigm. Now, however, it is near the bottom of its cycle. By contrast, much of the euro-zone is recovering from a period of slow growth and continuing labour market difficulty.

The tables below and on the following page give some basic data on the size and structure of the economies of the United States and the euro-zone.

Euro-Zone & United States Compared

Comparator		Period	Euro-zone	U.S
Population (000s)	(a)	2000	304,395	275,614
GDP (million pps)	(a)	2001	6,863	10,961
GDP per head (million pps, EU15=100)	(a)	2001	98.9	153.6
Exports of goods (% of GDP)	(a)	1991-2001	30%	11%
Labour				
Male participation rate	(b)	1998/2000	78%	85%
Female participation rate	(b)	1998/2001	57%	72%

Sources: (a) European Economy, no 72
(b) OECD, Main Economic Indicators, February 2002

2. Growth

Euro-zone (real) GDP growth compared with the UK and the United States is shown in the table below. Figures for France and Germany are also shown. The outcomes may come as something of a surprise given the prominence given to comments about 'sclerotic Europe'. Growth in the euro-zone, although slower than in the US, has not been that low by historical standards. In retrospect, the late 1990s may have been something of a recent golden age for the US economy. This had ended even before the events of September 11th and comparisons with Europe at this time may be somewhat distorted.

GDP Growth
Annual % change

		Euro-zone	UK	US	Germany	France
1997	Jan-Jun	2.0%	3.3%	4.3%	1.4%	1.3%
	Jul-Dec	2.7%	3.6%	4.5%	1.4%	2.5%
1998	Jan-Jun	3.3%	3.2%	4.3%	2.5%	3.7%
	Jul-Dec	2.4%	2.8%	4.3%	1.4%	3.2%
1999	Jan-Jun	2.1%	1.7%	4.0%	1.1%	2.6%
	Jul-Dec	3.2%	2.5%	4.2%	2.6%	3.3%
2000	Jan-Jun	3.8%	3.3%	4.7%	3.5%	3.7%
	Jul-Dec	3.1%	2.8%	3.6%	2.6%	3.4%
2001	Jan-Jun	2.1%	2.6%	1.9%	1.1%	2.6%
	Jul-Dec	1.0%	1.8%	0.5%	0.1%	1.5%
2002	Jan-Jun	0.8%	1.6%	1.6%	0.0%	1.1%
1999-2002, av'ge growth rate		*1.7%*	*1.8%*	*2.3%*	*1.1%*	*2.0%*

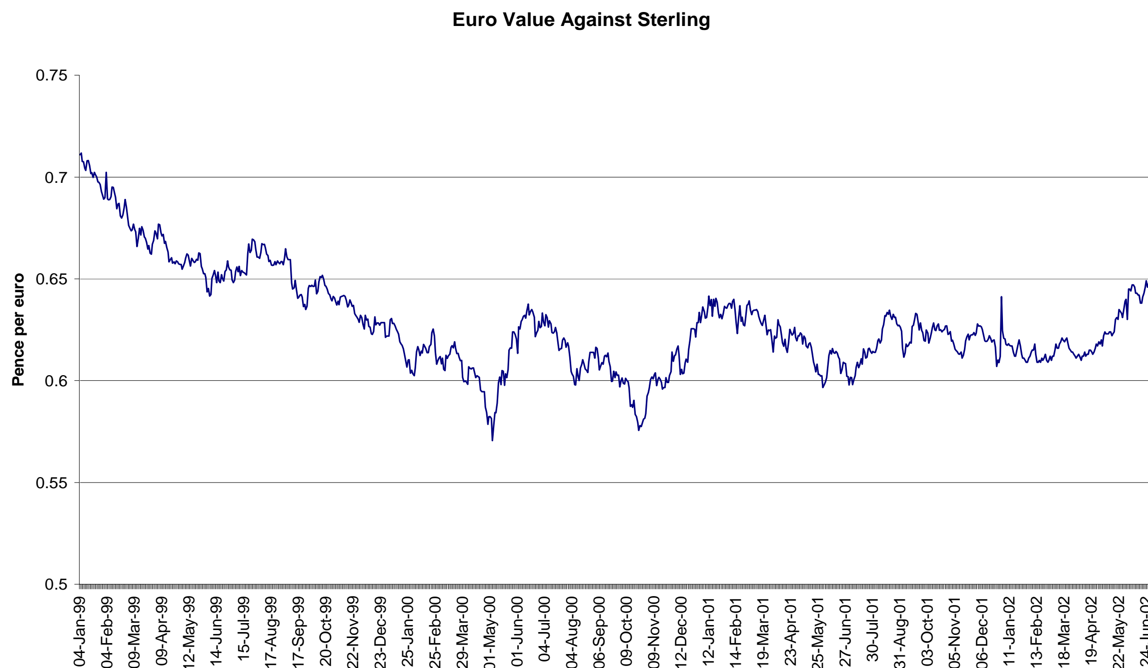
Source: OECD Main Economic Indicators

If the performance of the euro-zone is considered poor, the reason can be found in the performance of the German economy. Clearly if the largest economy in the euro-zone is growing slowly then it is hard for the euro-zone as a whole to grow much faster. As always, it will be easier to make a fair comparison between the US and the euro-zone with the passage of time and when the immediate effects of September 11th have worked themselves out.

3. The euro

The most commented-upon feature of the first years of the euro-zone has been the euro's decline in value. Apart from a brief period at the start of its life the euro has generally traded far below its opening value of €1.1743 to the dollar and €0.7058 to the pound. A chart showing the value of the euro against sterling between January 1999 and June 2002 is shown on the following page. The chart highlights various general phases of the euro's development.

1. Launch to spring 2000, general continual depreciation.
2. May 2000 to July 2001 instability, sharp appreciations followed by equally severe declines.
3. July 2001 to April 2002 settled into a range equivalent to a 10% to 12% depreciation against sterling.
4. April 2002 to date a sharp appreciation of about 8%.



Although many commentators have tried, there has not yet been an entirely satisfactory or complete explanation for the euro's poor performance. The Bank of England in its regular publication *Practical issues arising from the euro* noted:

> Market participants explain the euro's weakness in different ways. Some argue that, while uncertainty over the extent of the economic slowdown in the US has persisted, they now expect the slowdown to be relatively short lived and growth in the US to be robust in the medium term. And, at the same time, in the light of the most recent data for some euro-area countries, the market is beginning to question whether euro –area growth will be quite as strong this year as expected. Others argue that it is inevitably going to take time for the ECB to acquire fully the historic credibility of the Bundesbank; or that the communication of the ECB's monetary policy has not been as clear and transparent as they would have liked, even though they acknowledge that the ECB's interest rate decisions throughout its relatively short life have themselves been well founded. No single explanation is likely to suffice, and overall the euro's weakness remains something of a puzzle.[3]

Throughout 1999 and 2000 the authorities' expressions of dismay at the euro's value being at odds with economic fundamentals never persuaded markets to reassess their view of the euro. Various reasons were put forward to explain the outturn.

One reason for the weakness has undoubtedly been the exceptional performance of the US economy. In the late 1990s expectations of permanently higher rates of growth and

[3] Bank of England, *Practical issues arising from the euro*, June 2001, p12

productivity (and profit) improvement in the US economy were very high. Attracted by this story of high productivity growth (the 'New Economy') on the back of IT investment, direct investment (i.e. investment in physical assets and companies) flowed in substantial volume to the US. The expectations of higher profits spilled over into very strong performances on the US equity market supported by high levels of portfolio investment (equities) in the States. There was no similar story (at least on anything like on a similar scale) being told on mainland Europe, despite widespread consolidation of companies and markets in anticipation of 1999. In the simplest terms therefore, there was a lot more demand for US dollars than for European currencies.

Another facet to the explanation is the behaviour of the legacy currencies. The deutschmark was an important reserve currency, particularly in Eastern Europe and Asia. According to the Bundesbank about 1 in 3 deutschmarks circulated outside Germany in 1995.[4] The impending replacement with the euro persuaded deutschmark holders to switch into either other currencies or other assets. For example, in the run up to 2002 there were housing booms in desirable places such as Portugal and Spain financed by undeclared, 'black' money. Similarly the cash market for sports cars and yachts had seldom been so good. Even where the money was 'clean' what appears to have happened is that in the run up to the changeover those people who held deutschmarks as a store of value switched to another internationally acceptable store of value, the dollar, rather than the euro.

Another, financial, explanation for the euro's weakness lies in the fact that there was an enormous increase in the issuance of euro denominated debt after 1999. In the international debt market the percentage of instruments issued in euros was 25% - 30% before 1999 and 40% - 45% after the launch of the new currency.[5] There were several stimuli for the increase in bond issuance. The European corporate market went through a wave of mergers. The national financial markets merged to form pan-national European markets and there was the stimulus of a new, low interest rate, long term borrowing environment. The impact of this issuance is complex however; the euro debt could be seen as asset substitutes for holding actual currency.

4. Inflation

A low and stable level of inflation is the bedrock upon which many of the economic advantages of EMU are based.[6] Consequently, the success of the European Central Bank (ECB) to deliver on its constitutional imperative is crucial to the credibility of both the institution and the whole EMU project.

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4 Source: *Report on the European Economy 2002*, European Economic Advisory Group, p 31

5 Ibid, p 30

6 See for example, *One Market One Money,* European Commission*, European Economy 44, October 1990*

The ECB Governing Council in its inaugural *Annual Report* declared that the monetary policy strategy consisted of three main elements:

- A quantitative definition of the primary objective of the single monetary policy, namely price stability and the "two pillars" of the strategy used to achieve this objective were:
- a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate; and
- a broadly based assessment of the outlook for the future price developments and the risks to price stability in the euro area as a whole.[7]

The inflation target is defined thus:

> The primary objective of monetary policy, namely price stability, is defined as a year on year increase in the HICP[8] for the euro-area of below 2%.[9]

The prominent role for money is defined as an annual target of 4.5% growth in 'M3' or the broad money aggregate. The part reliance on a monetary target was somewhat surprising. Many national monetary authorities have abandoned monetary targeting as being too imprecise and difficult to control to be a reliable guide to policy. Of its importance the ECB state that

> The concept of a reference value does not entail a commitment on the part of the eurosystem to correct deviations of monetary growth from the reference value over the short term. Interest rates will not be changed "mechanistically" in response to such deviations in an attempt to return growth to the reference value.[10]

Annualised inflation, based on the harmonised index of consumer prices, for the euro-zone are shown below:

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[7] ECB *Monthly Bulletin*, January 1999, page 45-6
[8] Harmonised consumer price index
[9] ECB *Annual Report* 1998, page 8
[10] ECB *Monthly Bulletin*, January 1999, page 48

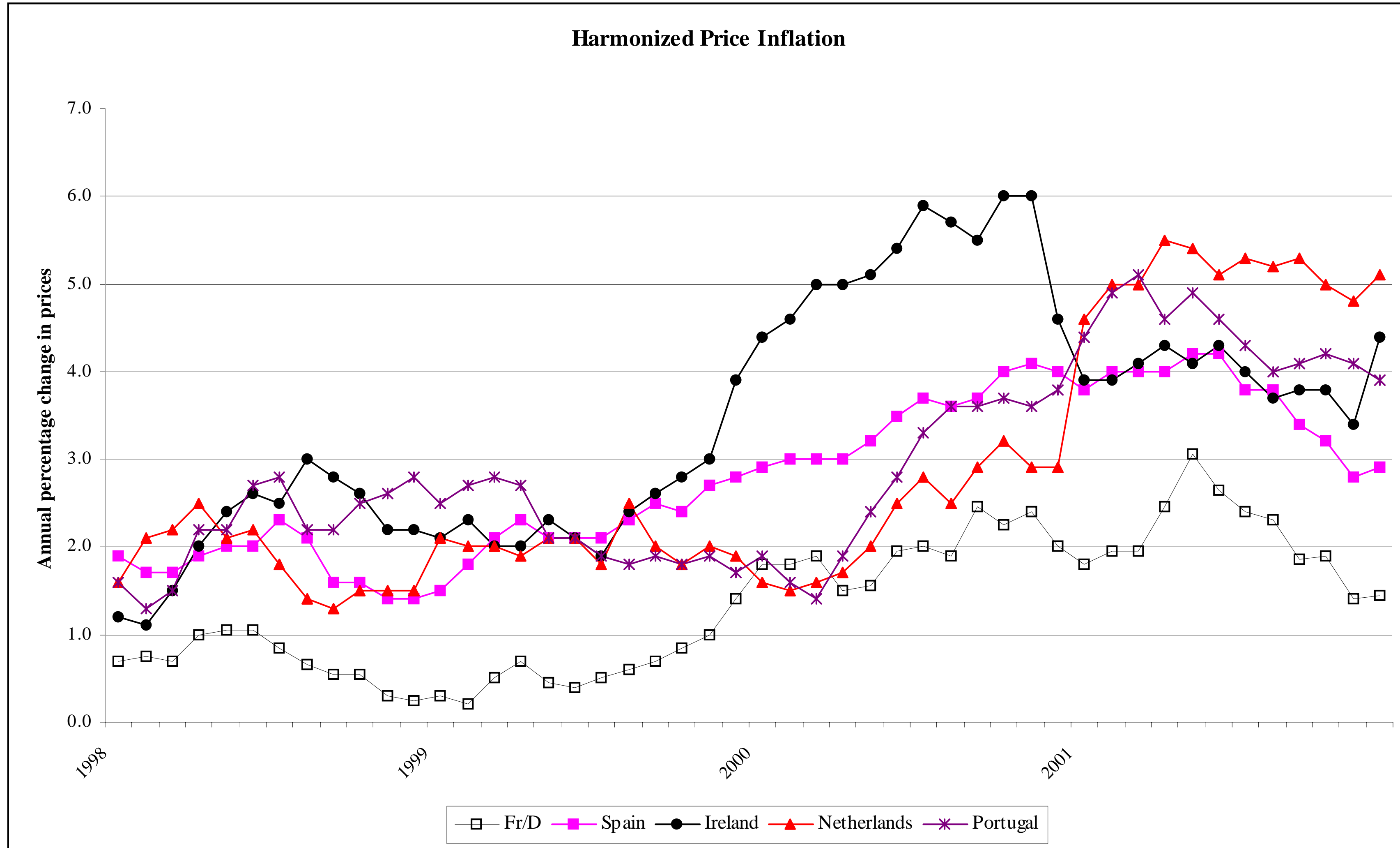
Harmonized Index of Consumer Prices

		% change on previous year		
		US[a]	Euro-zone[b]	UK
1998		1.6%	1.1%	1.6%
1999		2.2%	1.1%	1.3%
2000		3.4%	2.3%	0.8%
2001	Q1	3.4%	2.3%	0.9%
	Q2	3.4%	3.1%	1.5%
	Q3	2.7%	2.5%	1.5%
	Q4	1.9%	2.2%	1.0%
2002	Jan	1.1%	2.7%	1.6%
	Feb	1.1%	2.5%	1.5%
	Mar	1.5%	2.5%	1.5%
	Apr	1.6%	2.4%	1.3%
	May	na	2.0%	na

Note: a) National consumer price index
b) Information for euro-zone pre 2001 excludes Greece

Source: European Central Bank

The accession of Greece, traditionally an above average inflation state, in 2001 probably raised the inflation average for the whole zone, but, inflation in other member states, for example Ireland, has been far higher. Indeed a feature of the last two years has been the extent to which inflation amongst the participants has diverged. The graph on the following page illustrates inflation developments since 1998.


Harmonized Price Inflation
Annual percentage change in prices
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
1998
1999
2000
2001
Fr/D
Spain
Ireland
Netherlands
Portugal

Certain simplifications have been made to the data. The data shown are of those member states that either had the lowest or highest rates of inflation at the start or end of the period. Those participants that were mid range have been excluded. Because the inflation rates for France and Germany were so close for virtually all of the period (apart from a few months in 2001) a composite French German (Fr/D) rate has been calculated by way of a simple average of the two rates.

The graph is quite revealing. One year before the euro was introduced, inflation rates of the 12 member states varied by less than 1.5% (France, the lowest, was 0.6% and Italy and Spain 1.9% were the highest). For the next 18 months relative positions remained largely unaltered. However, from autumn 1999 inflation rates rose in most countries (including Germany and France). In particular, inflation doubled in Spain and trebled in Ireland. Six months later similar increases were recorded by Portugal and the Netherlands. By the end of 2001 the range of inflation rates from top to bottom has increased from the 1.3 percentage points in 1998 to about 3.5 percentage points.

Such an outcome was not entirely unexpected and it highlights the validity of one of the main criticisms of monetary union, namely that the 'one size fits all' policy produces problems. This argument states that the wider the area covered by a single interest rate the more likely it is that it will include areas for which the central rate is inappropriate. Within the UK economic conditions in the North East of England and London might be completely different but both have to live with one interest rate. The differences are more obvious in a monetary union where whole countries (with their own identifiable inflation rates) might be out of line with the central rate.

Work undertaken by the EU Commission and the UN Economic Commission for Europe estimated the difference between the optimal rate of interest for each member state and the rate of interest set by the European Central Bank (ECB) over the last two years. The results were determined by the size of each state's output and inflation gap.[11] The table is shown below.

One Size Fits All?

Required Interest Rate Change

		Percentage points	
		2000	2001
Interest rates too high	Germany	-0.5	-0.5
	France	-0.5	-0.5
	Portugal	1.0	1.0
	Finland	1.5	1.0
Interest rates too low	Netherlands	0.5	1.5
	Ireland	4.0	3.0

Source:Commission Services

[11] Difference between actual inflation and NAIRU and between output and trend growth rate output.

The calculations suggest that Ireland's interest rate regime was exceptionally loose for its circumstances. The ECB and EU Commission would point out that Ireland did very little to use what economic levers it retained (mainly tax policy) to rebalance its economy. In the normal run of things, high relative inflation in one country would lead to a depreciation of its exchange rate. This supports the domestic traded service sector but makes imports more expensive. Within monetary union of course the exchange rate is fixed between Ireland and her main trading partners. This implies that as Irish prices rise it will become harder for its export sector to compete. This will reduce demand in the economy and eventually bring it back to an equilibrium vis-a-vis the ECB interest rate. This illustrates the rather bald sounding economic argument that in the absence of flexible exchange rates economic adjustments have to be effected internally, either through wage rates or employment levels.

5. Unemployment

One of the most criticised features of the EU economy has been its failure to significantly reduce the level of unemployment in member states. On its creation the euro-zone, which excludes the better than average performing UK labour market, inherited an unemployment rate of 10.8% compared to a rate of 4.4% for the United States.[12] Summary figures for the period since 1997 are shown below:

Unemployment

	Euro-zone		United States
	Millions	% of total labour force	% of total labour force
1997	14.1	10.9%	4.5%
1998	13.3	10.3%	4.5%
1999	12.3	9.4%	4.2%
2000	11.2	8.4%	4.0%
2001	11.1	8.1%	4.8%
2001 Q1	11.1	8.1%	4.2%
Q2	11.0	8.0%	4.5%
Q3	11.1	8.0%	4.8%
Q4	11.2	8.1%	5.6%
2002 Q1	11.4	8.2%	5.6%

Source: ECB Monthly Report, June 2002

In some senses one can see a good story in these figures. Europe has closed the unemployment gap between it and the US by a significant margin (even more so considering that the figures include Greece from 2001). However, the negative aspect is that even after a period of four years' uninterrupted growth, some of which was above trend in many countries, unemployment fell by only 2% of the population and youth

[12] ECB *Monthly Bulletin*, January 1999

unemployment is currently double the overall rate.[13] Again it is too early to identify the impact the euro-zone has had on the labour market. About half of the fall in unemployment took place before the zone began, suggesting that if Europe is getting better at reducing unemployment factors, such as the creation of the single market have had as big a role as the new currency.

B. Institutional Performance

Monetary union was not just a new form of economic organisation, it also brought into being a new institutional structure. The most prominent new body was the European Central Bank (ECB). Less obvious in some respects, but now emerging as becoming increasingly influential in the determination of economic policy, is the 'virtual' institution of the Stability & Growth Pact (SGP).

1. European Central Bank

The ECB has faced criticism in its first years of existence. Part of this follows on from comparisons with the Monetary Policy Committee (MPC) in the UK. The UK economy has been perceived to have grown faster and been more dynamic than the euro-zone and, by association, some of the implied poor performance has rubbed off on the ECB. The ECB is less open an organisation than the MPC. The MPC has established a helpful relationship with the media and with the financial community whereas, at times, the ECB has been perceived to have been out of step and has committed the worst of financial markets crimes: springing surprises. Lastly, the euro has not achieved the hoped for function as a world currency to rival the US dollar.

But the ECB has identifiable successes too. On the economics front its main aim of price stability within the eurozone has largely been achieved, albeit not to the high standards that it has set itself. One should also count as one of the ECB's successes the almost flawless introduction of the new notes and coins in January 2002.

On the political front the ECB can point to the fact that one, unsaid, political aim has been to ensure the public unity of purpose and opinion of the national representatives on the Governing Council. There have not been, for example, Bundesbank briefings in favour of lower interest rates, or Irish complaints of laxity.

Furthermore, the issue of the weakness of the euro itself is countered by the simple fact that the ECB has never formally published a target range for the euro. However, the informal meetings and consultations in the summer of 2001 between the ECB and the central banks of G7 countries and the concerted market support operations for the euro which followed, undermines the studied air of nonchalance over its value.

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[13] ECB *Monthly Bulletin* June 2002

An excellent review of the way the ECB worked in its early years was published in a report *'How is the euro working?'* by the House of Lords Select Committee on the European Union.[14] The Committee's comments updated by later events and commentary from the basis of much of the analysis which follows.

The Report's framework suggests three areas of study for looking at the ECB:

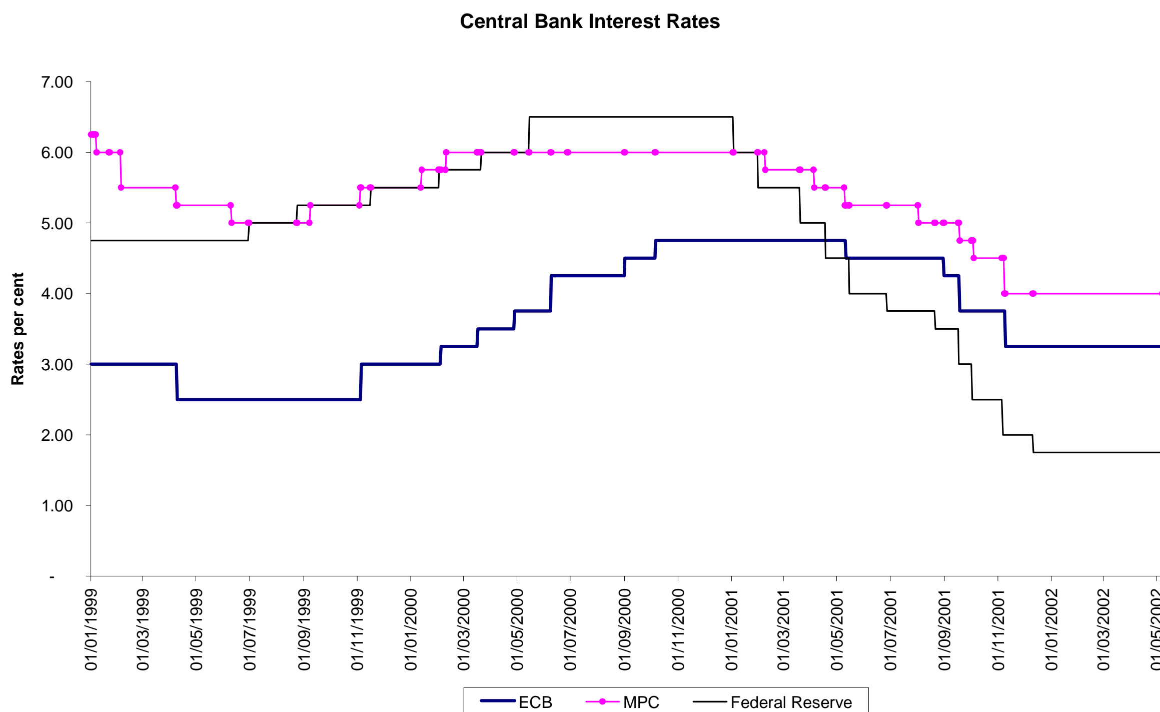
1. The interest rate decisions: i.e. has the ECB got it right?
2. Does the ECB have the right objectives and how should they be set: i.e. did the Treaty get it right?
3. Is the ECB sufficiently accountable and transparent?

a. ECB Interest Rate Decisions

It is very difficult to determine whether or not the ECB's interest rate decisions have been correct. Earlier in this Paper the point was made in the context of the 'one size fits all' criticism, that the interest rate for some countries was too low and for others too high. The corollary of this is that for a substantial number of members it was about right. Furthermore the ECB would argue that the only test that can be applied is that of the inflation target. This has largely been met, and, therefore the rate decisions must have been broadly appropriate. (The interaction between the rate and the objectives is discussed in the next section.)

Despite the difficulty in coming to an ultimate judgement on the appropriateness of the interest rate level some features of the ECB's decisions are worth noting. The graph below tracks interest rate levels set by the United States Federal Reserve (the Fed), the MPC and by the ECB.

[14] HL 124 1999/00



First, the ECB has made fewer changes to rates (twelve) over the period than either the Fed (seventeen) or the MPC (fifteen). Second, the range of interest rates set by the ECB (2.25 percentage points) has been much narrower than that of the Fed (4.25 percentage points) but identical to that of the MPC. Thirdly, the reaction of the Fed to the events of September 11th was much faster than either the ECB or the MPC. Between the attack and Christmas, US rates fell by 1.75 percentage points compared to but only by 1 percentage point in the eurozone and the UK. Between the attack and the start of November, rates had fallen twice as far in the US (one percentage point) as in the other two areas.

Thus the picture that emerges of the ECB in action is that despite the economic similarities between the monetary union of the United States and the eurozone, the ECB acts in a manner far closer to that of the MPC than the Fed. Whereas the Fed makes rapid changes in reflection of events, the ECB moves more slowly and less aggressively. This might be explained, in part, by the greater impact that world events has had on the US than on the euro-zone. However, the suspicion remains that, in contrast to the Fed, the ECB reacts more slowly in the face of quickly changing circumstances.

b. Does the ECB have the right objectives?

The ECB is the central body of a broader organisational structure: the European system of central banks [ESCB]. The Maastricht Treaty, as amended by the Amsterdam Treaty, sets out the governing legislation of the ESCB, supplemented by subsequent regulations. A brief resume of the institutional structure is useful before assessing the question of its objectives.

The Treaty outlines basic tasks to be carried out by the ESCB. These are:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations;
- to hold and manage the official foreign reserves of the Member States; and
- to promote the smooth operation of payment systems.

The primary objective of the ESCB is set out in Article 105 of the Treaty.

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 [promotion of harmonious, balanced and sustainable development of economic activities][15]

A recent publication, *Surviving the Slowdown: Monitoring the European Central Bank* [16] examines the dual objective question in the light of the economic slowdown that took place in 2001. The authors make the point that the ECB has got around the potential difficulty of having two objectives by conflating them into one. In the words of Wim Duisenberg, President of the ECB:

> We always maintain - and we still do - that the best contribution that monetary policy can give to fulfil the second task is to maintain price stability.[17]

According to the authors this statement is 'repeated tirelessly in almost every press conference'.

The term price stability has been defined by the ECB Governing Council to mean:

> Price stability shall be defined as a year on year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability according to this definition is to be maintained over the medium term.[18]

There has been some concern that this target embodies a deflationary bias to policy – that it does not admit the possibility of inflation being too low. However, this is refuted by the ECB. They comment that:

> The phrase below 2% clearly delineates the upper bound for the rate of measured inflation in the HICP which is consistent with price stability. At the same time, the use of the word "increase" in the definition clearly signals that deflation, i.e.

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15 Article 105 Treaty of Amsterdam Cm 3780
16 Centre for Economic Policy Research, February 2002
17 ibid p11
18 ECB Monthly Bulletin January 1999, p 46

> prolonged declines in the level of the HICP index, would not be deemed consistent with price stability.[19]

The combination of the supremacy of the inflation target over 'real economy' targets such as growth and the asymmetric (ceiling but no floor) nature of the target raises issues over the appropriateness of the ECB's mandate in deflationary times. What would prevent the ECB from maintaining inflation at well below its target rate in the absence of any countervailing upward influences?

c. Transparency & accountability

Transparency and accountability afford practical benefits to a new institution. Transparency or openness allows outside agents to see how decisions are reached, and the reasons for them. This allows for predictions to be made about the course of future decisions and aids policymaking. If it is known that the central authorities will react in a certain way to the movement of economic aggregates then, when economic conditions change, markets can react accordingly. For example, if a rise in a money supply aggregate of 5% is known to trigger a rise in bank rates, lenders can start to restructure their lending and borrowers can forecast their future liabilities before the actual rise takes place. Thus the economy has already started to react in the way that the central bank wants without it doing anything.

An institution that is accountable clearly has more authority and can demand greater public acceptance than one that is not. The pan-national nature of the ECB clearly magnifies the question of accountability. The most precious coinage of any central bank is credibility. Accountability and prestige reinforce that credibility and the ECB has been criticised on both counts.

With respect to the openness/transparency issue, the problem has been that markets and analysts working in them have never been certain which data set has most influenced the ECB's decision making. As stated earlier in this paper according to the ECB, monetary policy within the euro-zone has 'two pillars' an explicit inflation target of 2% and a reference rate for the growth of M3 of 4½%. The influence of this latter rate is described thus:

> The reference value will help to inform and present interest rate decisions aimed at maintaining price stability over the medium term. Therefore, in the first instance, a deviation of monetary growth from the reference value will prompt further analysis to identify and interpret the economic disturbance…The relationship between actual monetary growth and the reference value will therefore be regularly and thoroughly analysed by the Governing Council.[20]

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[19] ibid cit p 46

[20] ECB Monthly Bulletin January 1999 p 49

Other indicators which are assessed by the Council as they affect price developments include wages, the exchange rate, bond prices and the yield curve.

The dual pillar approach is difficult to interpret if one variable is moving too fast but the other too slowly. Similarly if the overall inflation target has been met but the monetary growth figure shows no inclination to conform to the guidelines it is not clear what the ECB will do.

A further criticism of the ECB has focused on the actions of its President Wim Duisenberg whose 'off the cuff' remarks have occasionally precipitated market rumours that proved foundless. Anxiety over the leadership of the ECB was expressed in October 2000 when Mr Duisenberg hinted that the ECB would never intervene in the currency markets to defend the euro. The result was a sharp decline in the euro's value. In March 2001 the President, speaking at the European Parliament, declared that "there are no convincing signs that the slowdown in the US economy is having significant lasting spill over effects on the euro area economy".[21] Even at the time this was a highly contentious statement. Growth in Germany had already slowed dramatically and other members of the ECB had made less optimistic statements. The upshot was that the rates were not cut at the March meeting. This led to headlines such as those in the Financial Times, 'ECB Surprises markets' and 'Conflicting Signals'.

The ECB defended itself in evidence to the House of Lords Committee, supported by the Governor of the Bank of England:

> Mr Trichet said that the ECB had always been "very, very keen on having as complete transparency as possible *vis-à-vis* public opinion and the markets". Its policy was to produce the evidence on which each decision on interest rates was based, and to hold a press conference to explain it "in real time", rather than several weeks later (Q 117). The ECB recognised that there had to be permanent communication, responding to "this unique challenge to explain the monetary policy in nine different languages to eleven different cultures" (Q 112). The Governor of the Bank of England agreed that the ECB did "try extremely hard" to explain itself:
>
> "I think if you compare it with the Bundesbank, its ancestor, as it were, it is just chalk and cheese … indeed all our media are absolutely full of the President of the ECB being too transparent and being too ready to speak".[22]

[21] Reported Financial Times 6 March 2001
[22] HL 124 1999/2000

2. Stability & Growth Pact (SGP)

The SGP is a virtual institution whose profile has risen as the impact of slow economic growth filters down to the bottom line of government finances.

Once established, members of a monetary union have a vested interest in a stable and orderly monetary area. One potential source of disorder could be excessive government spending by one member government. Excessive government spending in an independent national economy can generate external imbalances, weaken the exchange rate and cause inflation to rise. On the world's currency markets the government can be punished by a downgrading of its credit rating and, consequently, higher domestic interest rates.

Within a monetary union the link between the national fiscal stance of one member and the market reaction towards the whole area is less clear cut but the consequences will be in the same direction: higher inflation and a credit downgrading of the whole euro currency area implying higher interest rates for all member states. A way of trying to resolve the potential imbalance between national responsibility for fiscal policy and central monetary control has been the agreement, finalised at the Amsterdam Council (17 June 1997), of a "stability and growth pact".

The basis for the agreement was a Franco-German summit where various ideas for fiscal discipline were put forward. It was agreed that the pact would be based upon Article 99 and 104 of the Amsterdam Treaty. These articles had been the basis for the surveillance procedure and the excessive deficit procedure in stage 2 of EMU under the Maastricht Treaty, thus there was no need for negotiations on a new Treaty. The German/French plan was that member governments should have a continuing duty to present budget plans to other member states who, by a system of qualified majority voting, would decide whether an excessive deficit situation existed.

The pact as outlined in the Council Resolution of the Amsterdam Presidency conclusions requires member states to aim *for a medium term budgetary position of close to balance or in surplus*. At the heart of the pact is a series of steps designed to bring a member state back to the path of fiscal rectitude. These are not discussed in detail here but can be viewed on the 'frequently asked questions' pages of the Library's EMU website at http://hcl1.hclibrary.parliament.uk/emu/faq/stabil.htm. At the Barcelona council meeting in March 2002 it was decided with respect to the SGP that:

> Coordination of fiscal policies is anchored in the commitment to sound public finances and rules of play agreed in the Stability and Growth Pact. Member States will maintain or respect the medium term budgetary objective of close to balance or in surplus by 2004 at the latest. Automatic stabilisers should be allowed to play symmetrically, provided that the 3% of GDP limit is not breached in downturns. This means, in particular, that in expansionary phases growth dividends should be fully reaped. Member States could make use of discretionary fiscal policy only if they have created the necessary room for manoeuvre.

> The European Council invites the Council to continue to examine the long-term sustainability of public finances as part of its annual surveillance exercise, particularly in the light of the budgetary challenges of ageing.[23]

With respect to the current debate there are two requirements to keep in mind. First there is the requirement mentioned above that member states must aim *for a medium term budgetary position of close to balance or in surplus*. Secondly, if the actual or planned government deficit exceeds 3% of GDP then a series of penalties of an increasingly public and punitive nature are activated. It is the first of these requirements that the UK may be in danger of not meeting.[24] Member states are required to plan for their budgets to be broadly neutral in the medium term. The UK is not doing this. The 2002 Budget Redbook shows there to be a planned deficit between 2002/03 and 2006/07 of between 1% and 1.5% of GDP each year at a time when growth was at or around trend levels.[25] Anti euro activists argue that euro entry would therefore mean tax rises of £10 to £15 billion each year in order to comply with the SGP. The Government argues that it has adopted a 'prudent' interpretation of the SGP (though the use of the word 'prudent' has never been defined or explained) and that the excess does not count since it is solely due to investment in public services and infrastructure that will raise the productive capacity of the country. The issue was discussed at a meeting between the Chancellor and the head of ECOFIN and the issues reported in the following news article:

> Rodrigo Rato, the finance minister of Spain, which currently holds the EU's rotating presidency, told the Financial Times that the long-term health of Britain's public finances was "not an issue". He also said Britain's need for public investment and low levels of government debt should be taken into account in determining whether it complied with EU rules.
>
> His remarks followed a suggestion from a senior European Commission official this week that the UK's "unique" public finances might allow it more leeway if it were to join the eurozone.
>
> The chancellor has been arguing for what he calls a "prudent" interpretation of the pact, which would take into account the country's position in the economic cycle, the need for public investment and the size of the national debt.
>
> The importance of taking the economic cycle into account has largely been accepted across the EU, as a result of last year's slowdown. European governments agreed that if their commitments to cut borrowing were at risk because of falling tax revenues and rising benefit payments, putting up taxes or cutting spending to meet those targets would make the slowdown worse.

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[23] http://ue.eu.int/pressData/en/ec/71025.pdf

[24] It should be noted in this context that although the UK is not a member of the eurozone it is bound by the requirements of the SGP excluding those sanctions attendant upon a breach of the requirements.

[25] HC 592, 2001/02, table C5

> There is less consensus on Mr Brown's other arguments. A paper circulated by the European Commission this month said: "While the budget balance fluctuates over the cycle in nominal terms, it should be balanced in cyclically adjusted terms." However, Mr Rato appeared to suggest that Britain might for a time be allowed to continue to run a cyclically adjusted deficit.
>
> While stressing that there were no proposals and no appetite in the EU for rewriting the stability and growth pact, he pointed out that the pact made explicit reference to the need for public investment and the level of national debt relative to the size of the economy. He acknowledged that the European Commission might raise objections, but said it was ultimately up to EU governments to decide how the rules should be applied.
>
> But there is scope for disagreement over how long Britain's deficit might be allowed to persist. Mr Rato suggested he thought the UK would commit to bringing the budget back into balance eventually.[26]

The second SGP issue is the 3% of GDP limit on borrowing. This is impinging on the budgets of countries such as France, Germany and, particularly Portugal. The General Government Deficit position of 'at risk' member states is shown below:

General Government Balance
% of GDP

	Estimates as at Spring 2002			
	2000	2001	2002	2003
Germany	-1.3%	-2.7%	-2.8%	-2.1%
France	-1.3%	-1.5%	-2.0%	-1.8%
Italy	-1.7%	-1.4%	-1.3%	-1.3%
Portugal	-1.9%	-2.7%	-2.6%	-2.5%
Euro area	-0.8%	-1.3%	-1.5%	-1.2%

Source:European Commission Spring Economic Forecast

Little wonder that the SGP has grown in the consciousness of euro - zone watchers. The three largest euro area economies face short term imperatives of ensuring that deficits do not exceed 3% and a longer term requirement to balance them over the cycle. Herein lies a dilemma for the ECB. Inflation in the euro - zone is currently above the target rate and gradual world economic recovery would suggest that interest rates should start to rise. If the ECB raises interest rates this will damp down economic growth. Without economic growth the three largest countries in the zone will not be able to rebalance their public finances without internal economic 'pain'. Therefore, does the ECB raise rates and risk snuffing out the limited economic recovery taking place in, especially, Germany? The

[26] Financial Times, 18 May 2002

President of the ECB took a hard line on this topic when he addressed the European Parliament in May 2002.

> Mr Duisenberg told the European parliament's economic and monetary affairs committee that he wanted to "stress forcefully" that all eurozone states had to respect their commitment to eliminate public deficits by 2003 or 2004 to ensure that the pact worked and prevent further interest rises. He said he was not confident that the pact would be respected.
>
> He also indicated that he was concerned about the continued breach of the 2% inflation target. Inflation was 2.4% last month, driven up by increased food and oil costs, and Mr Duisenberg fears that it could affect wage rounds and lead to an inflationary spiral.
>
> He assured committee members that there was no immediate cause for alarm, saying that, for the moment, interest rates were "at an appropriate level".[27]

Meeting the SGP target has become a real issue in several member states. Portugal and France have been of particular interest.

In Portugal, the newly elected (March 2002) centre-right government held its socialist predecessor responsible for a soaring budget deficit. The finance minister, 'iron lady', Manuela Ferreira Leite stated that "Our economy is like a drowning man".[28] The government's austerity programme includes raising value-added tax from 17% to 19%, freezing civil service recruitment, closing or merging of dozens of state institutes and setting debt limits for municipalities.

The reason for the seriousness with which the new government has taken to the task is explained below:

> "We have seven months to bring a deficit heading inevitably towards 4.5 per cent of GDP to below 3 per cent," [Manuela Ferreira Leite] said in an interview. "If we fail, Portugal will be automatically barred from applying for new development funds. The effect on our economy would be devastating."
>
> Being denied further aid from the Cohesion Fund for the European Union's four poorest countries is the sanction Portugal fears most for failing to comply with the eurozone growth and stability pact, said Ms Ferreira Leite, who in the month since she took office has become known as the "iron lady" for her tough-minded approach to public finances.

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27 Daily Telegraph 22 May 2002
28 *Financial Times* 9 May 2002

> "The consequences of deviating from the pact are far more serious for Portugal, which needs Community funds to catch up with the rest of Europe, than for countries like Germany or France," she said. "We have to take drastic action because the threat of sanctions is very real."[29]

France appears to be another country in which opposition to the SGP has found political expression:

> From Berlin, Brussels and other European capitals, the message going to the French government this week could scarcely have been louder or clearer.
>
> Alarmed that President Jacques Chirac's budget proposals risk tearing apart the eurozone's rules for fiscal discipline, some of Europe's most influential policymakers are asking France to think again. "The French government cannot expect us to lift a finger to help soften the stability and growth pact," says Hans Eichel, Germany's finance minister, referring to the agreement that obliges eurozone governments to balance their budgets over the medium term. "It really is a matter of credibility," observes Jean-Claude Juncker, Luxembourg's prime minister.[30]

Another article expanded the point:

> The German finance minister, Hans Eichel, yesterday criticised Jacques Chirac's election plan to break France's commitment to bring its budget close to balance by 2004.
>
> In remarks likely to strain ties between Berlin and Paris, Mr Eichel said: "I don't understand how Mr Chirac can vote in favour (of the deadline at the EU summit) in Barcelona and say a few weeks later that this no longer applies."
>
> The French president, who faces parliamentary elections next month, has promised tax cuts and increased spending, which would delay France reaching a balanced budget until 2007. Mr Eichel, whose Social Democratic party is politically aligned with Mr Chirac's Socialist opponents, said he expected Mr Chirac to revise these plans.
>
> "I don't believe that his commitments will last," he said in comments to a conference in Berlin.
>
> Alain Lambert, French budget minister, said at the weekend that Paris would seek a dialogue with its European partners over its budget plans. A senior politician in Mr Chirac's Gaullist party said Germany and France should form a common front on the issue.

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[29] Ibid

[30] *Financial Times* 16 May 2002

> At the same conference, Laurent Fabius, a Socialist and France's former finance minister, said: "International responsibilities must be adhered to, with pragmatism but loyally. When a country thinks its budget deficit is too high, it shouldn't increase it further."[31]

It should be noted that the efforts to reign in public spending are, compared to the efforts to meet the Maastricht criteria before the start of the third stage of monetary union, hampered by three things. First, there is no obvious prize, like EMU entry, for successful administrations. Secondly, the economic background is worse than in the mid 1990s. Lastly, the effort has to take place against the background of unhelpful national electoral timetables:

> Yet policymakers accept that the budget problems in France - like those in Germany, Italy and Portugal**,** which are equally in the spotlight - come at a sensitive time. An unfortunate coincidence of Europe's electoral calendar and the world economic cycle has meant that the stability pact has been under strain for the past year from a combination of weak economic growth and the exigencies of electoral politics.
>
> By next September, when Germany elects a new parliament, all four countries will have experienced hard-fought electoral campaigns in the space of 16 months. Although all eurozone countries have suffered from economic slowdown, it is these four that have the highest budget deficits and are finding it hardest to meet their commitments to balance their books by 2004 at the latest.
>
> The crunch may come with next month's French parliamentary polls if Mr Chirac's interim centre-right government is victorious and sticks to its platform of tax cuts and higher spending on law and order. Although a French government spokesman promised yesterday that Paris would abide by the stability pact, he also said the tax cuts would go ahead.[32]

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[31] *Financial Times* 15 May 2002

[32] *Financial Times,* 16 May 2002

III Convergence?

A. Introduction

Convergence is a key issue and has two applications. First the issue of convergence is seen in respect of an entry test for new participants. Secondly, since the monetary and, increasingly, the fiscal stance too is the same for each member state, it is important that the underlying economic conditions are approximately similar in all member states if persistent imbalances, or impediments to growth, are to be avoided in any one state.

In either case a difficult but important distinction to make is between long term convergence and convergence at a point in time: the ships crossing at night analogy.[33]

This section looks first, at whether the constituent parts of the eurozone are converging and secondly at the two convergence tests (one established by Treaty and the other by the UK Chancellor) as they might apply to the UK in the lead up to an assessment of membership and possible application to join.

B. Intra-zone convergence

In the run up to 1999 all the participating economies had subjected themselves to the rigours of the Maastricht convergence procedure. Member states had had a period of between three to four years to effectively get their economies in a state to meet the criteria laid down in the Treaty.[34] With the incentive of membership ahead, several governments were able to take measures that would have been politically unacceptable in other circumstances. Whilst there is doubt as to some of the methods used to achieve the public sector finance improvements, for most applicants the build-up period to the 1998 assessment was a time when similar measures were being taken to reform the economy and to achieve shared aims. Consequently, 1999 might be expected to stand as a high water mark in convergence. Once the political imperative to meet the criteria passed one might expect traditional pressures and trends to reassert themselves.

In terms of the general macroeconomic conditions this paper, see page 15, has already drawn attention to the way in which inflation rates have diverged since 1999. Persistent low inflation in France and Germany can be compared to rates three to four times higher in the Netherlands and Ireland. However, if GDP growth is examined there is more evidence of convergence than divergence.

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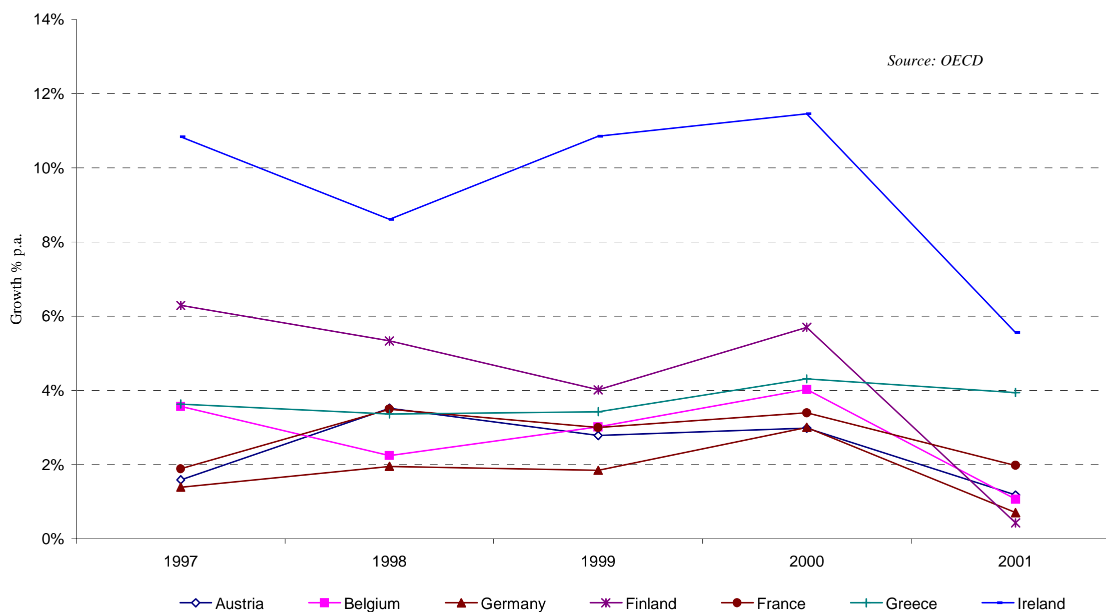
[33] This analogy is used to compare two countries whose relative positions in terms of, say, inflation may be very similar but whose medium term trends are highly divergent. For example, one country may be slowing down whereas the other is recovering from a period of slow growth.

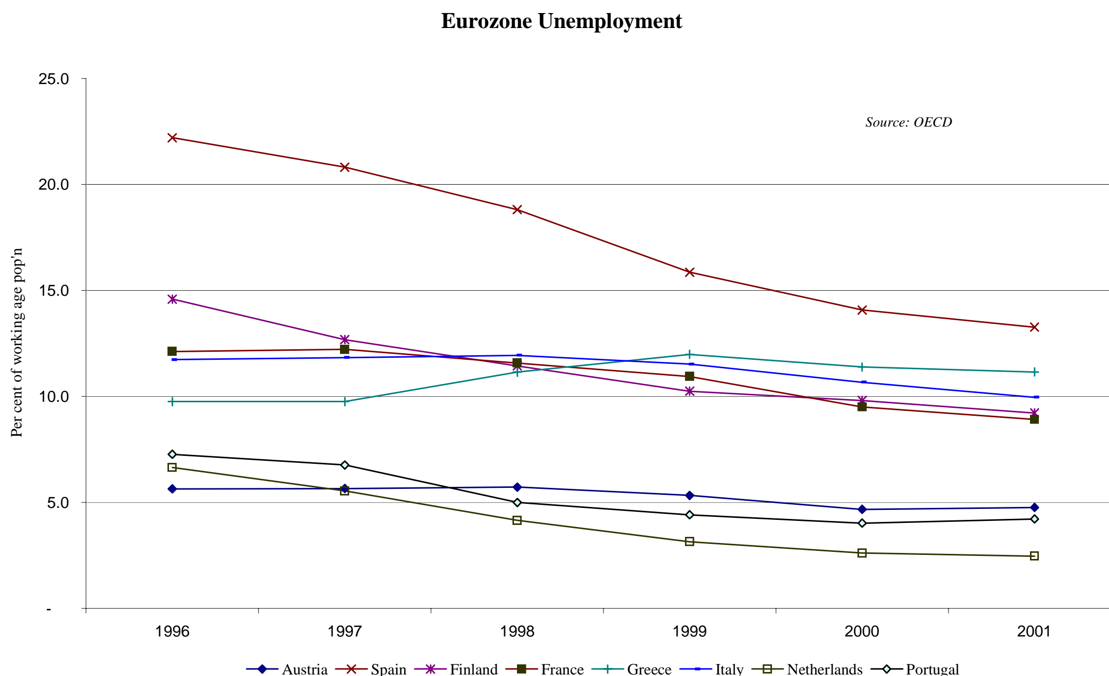
[34] The criteria are explained in greater detail later in this Paper.



Again the data have been simplified.[35] The graph shows the three slowest and fastest growing economies at both the start and end of the period. It is clear that there has been a marked convergence of growth rates over the period primarily due to a sharp slowdown in the growth of those which were growing the most strongly at the start - Ireland, and Finland. Whereas in 1997 the fastest member state was growing at 9.5 percentage points faster than the slowest, in 2001 the difference was just 5.2 percentage points. By the end of the period a clear bloc of three or four countries had growth rates within a percentage point of each other and had done so for almost two years. Over the last three years the three big economies in the zone, Germany, France and Italy, registered annual GDP growth rates within 1½ percentage points of each other.

A rather crude measure of the utilisation of the economic resources of each member state is the unemployment rate. Unemployment on a simplified basis is shown below:

[35] Note data for Luxembourg are generally excluded from all the analysis due to the small size of the Luxembourg economy



Unemployment rates have converged largely due to the substantial fall in the rate of the worst performing economy at the start of the period. Unemployment in Spain has fallen by almost 9 percentage ponts and this accounts for most of the reduction in the spread of rates from 16.6 percentage points to 10.8 percentage points. Ignoring the Spanish result the spread of rates has barely altered, although some of the relative positions have changed.

On the basis of the three measures, inflation, growth and capacity chosen above, a confused picture emerges. On two counts, measures reflecting 'real' economy developments show wide but narrowing differences between the eurozone partners. In both cases what nominal convergence has taken place has mainly occurred because one of the extreme performers (Ireland in the case of GDP growth and Spain in the case of unemployment) have sharply moved towards the average. Ignore these statistical outliers and the evidence for convergence is rather weaker. When one looks at the measure of the monetary conditions in the zone, inflation, there is no evidence to suggest that performance is converging. Inflation rates vary widely between members and show no obvious sign of converging on any average rate.

C. UK Convergence

With respect to the UK, convergence is seen as part of the test to see if the UK can and/or should join. There are two sets of convergence tests. First, there are the famous 'five tests' set out by the UK Chancellor in October 1997. These tests are designed to answer the question 'should the UK join'? The second set of tests is the Maastricht convergence criteria, administered by the European Commission and adjudicated upon by the European Council. This test answers the question 'can the UK join'?

1. The Five Tests

A full explanation of the circumstances surrounding the Chancellor's five tests can be found in previous Library Papers on EMU and on the Library's EMU webpage.[36]

There are different versions of the tests. The first was as described by the Chancellor in his speech in October 1997. It states:

- whether the UK has achieved sustainable convergence with the economies of the single currency;
- whether there is sufficient flexibility in the UK economy to adapt to change and other unexpected economic events;
- whether joining the single currency would create better conditions for business to make long-term decisions to invest in the UK;
- the impact membership would have on the UK financial services industry; and
- whether joining the single currency would be good for employment.[37]

A more recent and more formal version of the tests appeared in a Treasury document which described the technical work associated with the pre-assessment period. In this version the tests are:

- 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 joining EMU promote higher growth, stability and a lasting increase in jobs?[38]

It is not clear whether the Treasury has finished the preparatory work and started its assessment of the economy against these criteria. The Treasury website has, since the autumn of 2001, stated that:

> The assessment has not yet started, but the necessary preliminary analysis - technical work that is necessary to allow us to undertake the assessment within two years as promised - is underway.[39]

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[36] See: http://hcl1.hclibrary.parliament.uk/emu/faq/five tests.htm
[37] HC Deb 27 October 1997, c583
[38] Source HM Treasury November 2001, available at http://www.hm-treasury.gov.uk/mediastore/otherfiles/Preliminary and Technical work.pdf
[39] http://www.hm-treasury.gov.uk/documents/the_euro/euro_index_index.cfm

However, several economic experts and consultancies have carried out their own convergence assessment with mixed results. An article in *The Times* asked five economists for their views:

> Ray Barrell, National Institute of Economic and Social Research (NIESR)
> "I would argue that the Chancellor's five tests can be seen as being answered in the affirmative, and that the case for joining is clear. EMU would give more stable interest rates and inflation rates than we would see outside it. A more stable environment will increase output and growth."
> Mark out of 5: 5
>
> Ciaran Barr, Deutsche Bank
> "Clearly the five tests are very subjective. However, in 1997 it would have been difficult to make a strong argument that they had been met. Since then, changes to the economy, not least the independence of the Bank of England, mean that a robust case can now be made that the tests have been satisfied. We believe they no longer stand in the way if the Government wishes to join."
> Mark out of 5: 5
>
> John Hawksworth, PricewaterhouseCoopers (PwC)
> "I regard convergence (the Chancellor's first test) as the most important and the one that drives the assessment. Convergence is definitely closer - our growth cycles have been broadly similar - and there is a degree of sustainability. But there is not enough sustainability to prove the case decisively."
> Mark out of 5: 3
>
> Geoff Dicks, RBS Financial Markets
> "When I hear people saying that the cycles are converging, I regard that as superficial. We are as far away as ever from durable and sustainable convergence which requires us to live comfortably with low euro interest rates. UK and European consumers simply don't respond in the same way to low interest rates. When exposed to low interest rates, the UK consumer goes berserk."
> Mark out of 5: 2.5
>
> David Hillier, Barclays Capital
> "The UK fails what, for us, is the key test - that of structural alignment. This is not the basis for a successful monetary union as it implies a need for an independent monetary policy. The economic structures in the UK and euro area are not sufficiently compatible to allow the UK to live comfortably with euro interest rates."
> Mark out of 5: 1 [40]

[40] *The Times* 17 May 2002

Whilst the fact that five economists gave four answers to the same question may not surprise, the differences between, for example, the National Institute response and that from Barclays is startling.

a. The Institute's view

A more detailed critique of the National Institute's view can be found in an article published in a recent *Review* from which the following comments are drawn.[41]

The Institute use the output gap as a measure of 'sustainable convergence'. The output gap is the difference between what the economy, at a full (non-inflationary) employment of resources level, could produce and what it is actually producing.

Compared to 1997 (when the first Treasury assessment was carried out) the Institute found that:

> By 2001 cyclical positions were very similar; the UK had an output gap of -0.1%, the euro area -0.5%. The dispersion is less: Italy -1.9%, Germany -1.1% to Netherlands 0.3 and France 0.4.[42]

The 'key' point on this test "is whether the UK could live with European interest rates".[43] The institute says that any sub-optimality would be fairly short-lived. ECB interest rates are below the Bank of England rates but UK inflation is generally below eurozone levels too, hence the real rate of interest is approximately the same.

The second test concerns flexibility. The Institute accepts that the UK is probably a more flexible economy than the average EU economy. However, it notes that:

> The construction of the Broad Economic Policy Guidelines requires that each [EU] country agree an Employment Strategy with the Commission, and these are designed to produce a more flexible workforce and a more flexible economy[44]

These developments follow upon the decisions taken at the Lisbon summit, which aimed to raise EU productivity levels to world class. Clearly the Institute's view is based on the hope that the, as yet unfulfilled, promise of reforms are realised in the near future.

The third test, on investment, covers domestic and foreign direct investment (FDI) into Britain and the Institute can find nothing other than conflicting evidence on the impact of EMU on investment. A more stable macroeconomic climate should encourage higher levels of investment, but reduced exchange rate uncertainty can reduce levels of FDI.

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[41] *National Institute Economic Review*, 2/2002, "The UK and EMU, Choosing the right regime"
[42] Ibid p62
[43] Ibid p62
[44] Ibid p63

Similarly evidence on the fourth test, financial services, is conjectural rather than definitive:

> We can expect EMU to change European financial markets, making them more integrated, and producing a large and liquid EMU equity market.[45]

The argument used is that outside of the zone the UK will not be able to take advantage of these developments. Even so, the Institute will only go as far as saying that:

> There is a good chance that …staying out could be a major loss for the UK financial services industry.[46]

The final test focuses on growth, stability and output. The Institute accepts the established professional view that monetary unions have a positive effect on trade and that trade raises incomes. Furthermore, the other expected changes consequent upon the single currency; transparency of prices, lower exchange costs and greater macroeconomic stability, are all expected to operate in a positive direction and hence this test is seen as passed. Even though the gains may not be huge, they are gains.

b. Barclays Capital view

Although the main Barclays analysis was conducted in 2001 it is clear from the above comment that their views have not changed. The executive summary from that report is shown below:

> Our analysis suggests that only one of the tests is passed. This is the test on inward investment, where there are indications that the flow of money into the UK might be adversely affected if we were to decide not to join EMU (though there are no clear signs that the UK has been adversely affected by staying out). The fact that we do not appear to pass the other tests is obviously a very significant conclusion. But, just as important - perhaps more so - is the fact that our work also suggests that these tests will not be passed over the next five years.
>
> The main reason for that is that the UK fails what, for us, is the key test - that of structural alignment. All of our work suggests UK growth is poorly correlated with that of the euro area core (Germany) and that there is a high degree of variability in this correlation. This indicates that the economies have not been subject to the same shocks and/or that they have responded to shocks in different ways. This is not the basis for a successful monetary union as it implies a need for independent monetary policy.

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[45] Ibid, p63
[46] Ibid, p63

There are a number of reasons for the poor growth correlation. The structure of our exports is significantly different from that of the euro core, trade with the EU is less important, and fewer of our mortgages are subject to fixed interest rates. The key difference, however, is that the UK's product and labour markets are far more flexible than those in the euro area. Indeed, the OECD's labour and product market rankings imply that, overall, the UK is more flexible than the US. This has produced a superior earnings-employment trade-off versus the euro countries.

Put all of this together, and it should not be too much of a surprise to find that our economy responds differently to changes in interest rates from the five largest EMU countries. Indeed, econometric simulations for these countries suggest that a 1% change in rates has the largest output, but smallest inflation, impact in the UK. European interest rates have had a stronger relationship with UK rates since the UK started to target inflation. But our analysis shows US rates to be more important, and that almost 60% of the changes in UK rates could reflect UK-specific shocks that have required an independent monetary policy response.

Together, these factors suggest that economic structures in the UK and euro area are not sufficiently compatible to allow the UK to live comfortably with euro interest rates. The flexibility of our product and labour markets, and our (associated) heightened sensitivity to changes in interest rates, also suggest that if problems emerge (because of this incompatibility), then the effects will be magnified in the UK. As the superior flexibility of our markets has been developed over twenty years, this is not something that is going to unwind over the next five years.

Staying out of EMU does not appear to have damaged the competitive position of the City. London's equity market continues to outperform its key European competitors. London has also accounted for around 50% of euro-denominated eurobond issuance since 1999, and more cross-border euro payment flows than all countries except Germany - even though it is not an EMU member. Joining EMU would lead to the loss of sterling markets in which the City has a clear competitive advantage and which it uses to break into non-sterling markets.[47]

2. The Maastricht tests

The Maastricht convergence criteria have been covered in depth in previous Library Papers on EMU (see in particular RP 98/35 available on the internet http://www.parliament.uk/commons/lib/research/rp98/rp98-035.pdf). Consequently the actual criteria will be described only briefly here.

The criteria consist of four measures of absolute or relative economic and monetary performance designed to assess the long term compatibility of partners within an irrevocable union. Each measure appears in the Treaty but is then amplified in separate protocols from which the descriptions below are drawn.

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47 Barclays Capital, *Euro test special- still 'non',* 8 June 2001

a. Achievement of Price Stability

The protocol states:-

> The criterion on price stability referred to in the first indent of Article 109j(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.

Due to differences in national practices a common methodology was agreed upon and a harmonised index of consumer prices (HICPs) was constructed. The Commission decided that the reference level should be based on the unweighted arithmetic average of the inflation rate of the three member states with lowest inflation.

b. Government Deficits and Borrowing

The protocol states:-

> The criterion on the government budgetary position referred to in the second indent of Article 109j(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104c(6) of this Treaty that an excessive deficit exists.

It is important to remember that although there are two parts to the criterion the test is whether an excessive deficit position exists. This requires that both elements, deficits and debt, are considered in relation to each other. The Treaty allows some flexibility in assessing whether or not such an excessive deficit position exists. Article 104c(2) states that the basis of the two criteria is:

> (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless
> - either the ratio has declined substantially and continuously and reached a level that comes close to the reference level (3% of GDP);
> - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
> (b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value (60% of GDP) at a satisfactory pace.

c. Observance of Normal ERM Fluctuation Margins

The protocol states:-

> The criterion on participation in the Exchange Rate Mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

d. Convergence of Interest Rates

The protocol states:-

> The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long term government bonds or comparable securities, taking into account differences in national definitions.

e. Other Factors

In the final assessment of member states the Commission and the EMI (as was) also took into account other economic indicators of performance. These included: the development of the euro, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

f. The UK's performance

The UK comfortably passes most of these tests. The general government deficit ratio is projected to be 1% of GDP in 2002/03 and the debt ratio 36.9% in 2002/03.[48] The latest euro-zone inflation rate is under 2%; the UK rate for May 2002 is 0.8%. On interest rates the UK base rate is only 0.75% above the ECB rate. This leaves the membership of the ERM.

Whether or not the UK would have to spend two years in ERM II before membership has been the subject of debate between the UK government and the Commission.

During the second-Stage of EMU, the test of currency convergence was based around the existing system of exchange rate links - the ERM. This was a sensible and obvious decision and membership of the ERM was explicitly spelt out as part of the exchange rate

[48] HMT, *Budget 2002*, table C5, HC 592

section of the convergence criteria. The criterion, as amplified in the protocol on the convergence criteria states that:

> A Member State has respected the normal fluctuation margins provided by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

According to the Commission this meant, that the UK, which left the ERM in September 1992 would not be able to qualify for EMU unless it first rejoined the system for two years. By contrast the British government argued that the UK could stay out and still participate. This position was an important part of the then government's policy towards EMU. Rejoining the ERM was a hurdle that the government had no wish to jump amidst the charged political EMU debate of the 1990s.

This issue, however, has become somewhat clearer following the start of EMU in January 1999 since the ERM referred to in the Treaty ceased to exist from that date. In advance, and because of this, it was necessary to establish a new ERM arrangement. This supports the view that, should the UK wish to join EMU, it would not have to first join an intermediate body for a ‘probationary’ period. In a written answer on this subject the Prime Minister said:

> The new exchange rate mechanism will, like the existing mechanism, be established by an intergovernmental agreement, on a voluntary basis. The Resolution recognises this, stating explicitly that "participation in the exchange rate mechanism will be voluntary for member states outside the euro area." There is no Treaty obligation for Member States to put their currencies into an exchange rate mechanism.[49]

This has remained the Government’s view.

However, the resolution that established the new ERM, finalised at the Amsterdam Council meeting on 16 June 1997, was less clear cut than the Prime Minister implied in his answer as the following extract from the resolution shows:

> Participation in the exchange-rate mechanism will be voluntary for the Member States outside the euro area. Nevertheless, Member States with a derogation can be expected to join the mechanism. A Member State which does not participate from the outset in the exchange rate mechanism may participate at a later date.

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[49] HC Deb 26 June 1997 c 610w

In its latest review of the UK's convergence programme[50] (based upon data presented in 2001) the Commission found that:

> The convergence criteria on inflation, long-term interest rates and the public finances are comfortably met. While there are signs of reduced exchange rate volatility, it cannot be concluded that the pursued policy has delivered a sustainable stable exchange rate. It is therefore appropriate that the UK continue with its stability oriented policies with a view to securing exchange rate stability, which, in turn, should help re-enforce a stable economic environment.[51]

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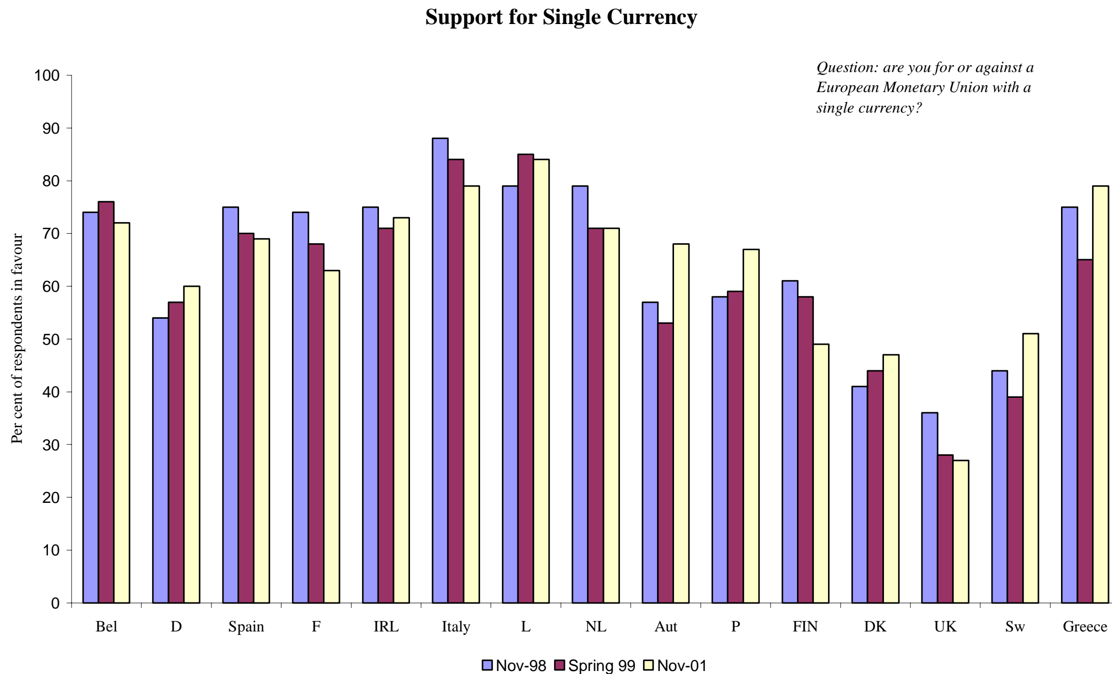
[50] The Stability and Growth Pact, adopted by the Amsterdam European Council in June 1997, requires countries not adopting the single currency to present, annually, updated convergence programmes to the Council and the Commission. The aim of these updated programmes is to provide information on how Member States intend to meet the objectives of the Pact, in particular, the medium-term requirement for public finances of a budget balance 'close to balance or in surplus'

[51] Source; EU Commission Rapid press service, available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?reslist

IV Attitudes towards the single currency

There are several long running surveys of attitudes towards the single currency. Some are undertaken for the Commission, whereas others are purely UK based. A graph illustrating attitudes across the member states is shown below:



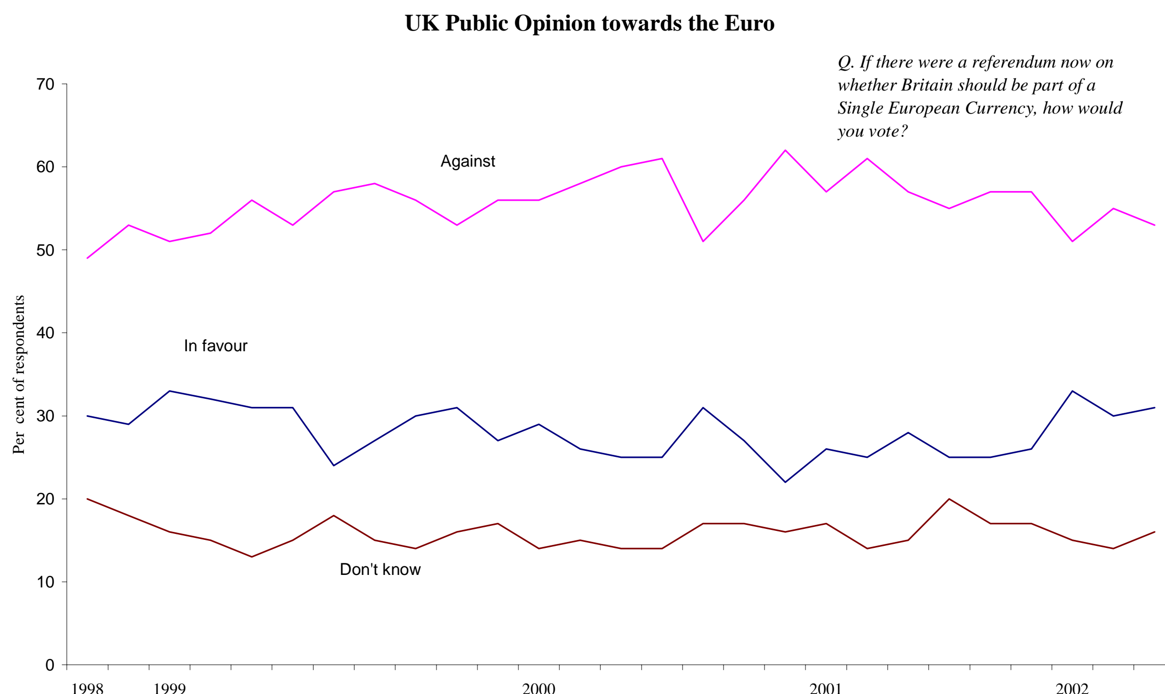
This 'eurobarometer' poll has asked the same question of about 2,000 citizens across the EU over a number of years. Although the next round will, in some ways, be the most interesting (asked after the introduction of notes and coins) reading the results over the past three years are interesting too. First, there is a simple majority in favour of the euro in all currently participating member states. Second, support for the euro has increased since 1998 in only five of the twelve participants; support is highest in Greece, the most recent member and lowest in Finland. Lastly, support for the euro has increased in two of the three pre-in countries (Sweden and Denmark) but fallen in the other (the UK).

There is no obvious explanation for the level or movement in support for the euro. High levels of support in Belgium and Luxembourg may reflect the number of EU institutions based in those countries. The relatively low level of support in Germany may reflect the attachment of Germans to the deutschmark and the relatively poor performance of the economy in that country. Concerns over the budgetary position of France and the action being taken to meet the Stability and Growth Pact (see above) may contribute to the French level of dissatisfaction. However, no such effect appears to have been felt in Portugal where the impact is even greater.

Opinion in the UK towards membership has varied considerably, thus giving both 'pro' and 'anti' camps encouragement and disappointment in equal measure. One very evident development is that there are far fewer 'don't knows' now than before. Typically in 1999

about a fifth of those questioned did not know which way they would vote in a referendum. It is more usual for only about a tenth to declare as undecided in recent polls.

In the UK the MORI organisation has asked the same question of voters about their intentions towards the single currency for several years.[52] The results are shown below:



The position over this period has been consistently against membership, however, there have been sharp swings in sentiment and the gap between the 'pros' and 'antis' has varied considerably. The 'anti' lead has varied from a high of 40 percentage points in November 2000 to a low of 18 on two occasions - January 1999 and January 2002. In contrast to the European poll the number of 'don't knows' is both high by European standards, and showing no sign of decline.

[52] Source:MORI, *British Public Opinion Newsletter*, various