

GOVERNMENT RESPONSE TO THE SIXTH REPORT OF THE TREASURY COMMITTEE, SESSION 2002-03 (HC 187)

THE UK AND THE EURO

The Treasury Committee published its report *The UK and the euro* on 28 April 2003. The Government response is set out below.

Government Response

On 9 June the Chancellor of the Exchequer made a statement to Parliament on UK membership of Economic and Monetary Union.

The Chancellor's statement and the assessment of the five tests show:

- The Government has strengthened its commitment to and support for the principle of joining the euro – showing that the gains to Britain are considerable;
- The five tests are our stability guarantee. To meet them would ensure that we will not put at risk our economy or our public services. At all times we will put stability and the national economic interest first. While there has been significant progress in achieving cyclical convergence, we still have to meet the two tests of sustainable convergence and flexibility. But, as the Chancellor said, with the achievement of sustainable convergence and flexibility, all five tests could and can be met;
- To achieve sustainable and durable convergence to meet the five tests, we have announced major reforms – including a new inflation target, reforms to housing, planning and to promote flexibility in the economy, and consultation on a new fiscal regime - to be implemented immediately and over the next year. It is a reform agenda - right for Britain's economic interest and right to help meet the five tests; a reform agenda on which we believe there is a realistic prospect of making significant progress over the next year;
- The Government will report on progress in the Budget next year. We can then consider the extent of progress and determine whether on the basis of it we make a further Treasury assessment of the five tests which - if positive next year - would allow us at that time to put the issue before the British people in a referendum;
- A modern, long-term, and deep seated pro-European consensus in Britain about Britain's role in Europe and Europe's role in the world can and will be built.

The third outline National Changeover Plan sets out in detail how the UK could achieve a smooth and cost-effective changeover to the euro. Practical preparations will be stepped up across the economy to ensure that the UK has a realistic option to join the euro, should the five economic tests be met.

The conclusions and recommendations set out by the Treasury Committee in its report are addressed in the Chancellor's statement; *UK membership of the single currency: An assessment of the five economic tests* (HM Treasury, Cm 5776 – hereafter referred to as 'the assessment of the five tests') published on 9 June 2003; and the eighteen detailed supporting studies and the third outline National Changeover Plan that were published alongside the five tests assessment.

Detail

This report

Recommendations (a) and (b)

The Government welcomes the report by the Treasury Select Committee, which is an important contribution to the debate. As the Chancellor said in his statement to the House of Commons on 9 June 2003: "I believe a modern long term and deep seated pro-European consensus in Britain about Britain's role in the world can and will be built."

The changeover process

Recommendation (c)

As stated in the EMU study *The five tests framework* (paragraph 4.9): "...The Treasury's sixth report on euro preparations and the third outline National Changeover Plan (HM Treasury, 2002c and 2003a) describe the key features of the changeover to the euro in the current euro area and the lessons that can be drawn. They conclude that the changeover to the euro was broadly smooth in all 12 euro area countries..."

Recommendation (d)

As stated in the EMU study *EMU and Prices* (paragraphs 2.6 and 2.9): "Data on changes to euro area prices since the establishment of the euro, and in particular the introduction of notes and coins, are still relatively scarce as such a short time has elapsed...The evidence suggests that, at the aggregate level, the immediate changeover effects associated with the introduction of the euro were only small. For the euro area as a whole, the rate of HICP (harmonised index of consumer prices) inflation for the first half of 2002 was broadly similar (at 1.4 per cent) to the rate for the first half of 2001. Eurostat analysis... suggests that almost all of the inflation that occurred in the first half of 2002 can be accounted for by factors other than the introduction of euro notes and coins. These factors included bad weather affecting fruit and vegetable prices and increases in car and energy prices."

European Central Bank

Recommendation (e)

As stated in the EMU study *Policy frameworks in the UK and EMU* (paragraphs 3.67 and 3.70): "...the ECB does not appear to follow monetary data dogmatically, but rather as a useful leading indicator, as indeed does the Bank of England...the ECB has been prepared to raise interest rates when monetary growth has been below the 4½ per cent reference value, and to cut them when it has been above it...Overall, the ECB appears to take a pragmatic approach to monetary growth in its actual decision making, suggesting that the role officially assigned to it in the framework is unlikely to make a substantial difference to outcomes. But it could make more of a difference in terms of effectively communicating the ECB's strategy to the outside world, potentially harming transparency and clarity. Gali (2001) observes that: '*The coexistence of two pillars, yielding potentially conflicting signals, can only introduce noise to the monetary policy process, making the communication of policy decisions less transparent, and leading to confusion among the public.*'"

Recommendation (f)

As stated in the EMU study *Policy frameworks in the UK and EMU* (paragraph 3.64): "Another difference between the frameworks is the extent to which the inflation level aimed for is explicitly symmetric. In the UK, the symmetry of the inflation target makes clear that deviations below target are taken as seriously as those above, ensuring that monetary policy is neither unnecessarily loose nor unnecessarily tight. An asymmetric target could provide policymakers with an incentive to drive inflation as low as possible to ensure they met their target comfortably, even if this had detrimental consequences for output and employment. Moreover, it might not provide sufficient incentives for fiscal consolidation or structural reforms, as the government does not know that its actions will be met by an easing of monetary policy...As Pisani-Ferry (2002) puts it, the ECB "*has not acknowledged that it follows an inflation targeting strategy and that it is willing to counter potentially deflationary shocks with the same energy as inflationary ones.*"...However...ECB President Duisenberg has recently suggested that the ECB would be as concerned about inflation below 1 per cent as about inflation above 2 per cent."

Recommendation (g)

As stated in the EMU study *Policy frameworks in the UK and EMU* (paragraph 3.30): "...The ECB has also developed two macroeconomic models which are used to produce projections in alternate quarters, and some details of which were published in June 2001: the 'area wide model', in which behavioural relationships are estimated at the euro area level; and (in conjunction with NCBs) the multi-country model, the projections from which (so-called 'staff' projections) have been published every June and December since December 2000. The ECB have made clear that these projections play an important but limited role in the ECB's monetary policy making, not least because they are always based on specific assumptions (for example, about oil prices or exchange rates) which can change rapidly, making the projections outdated."

Recommendation (h)

As stated in the EMU study *Policy frameworks in the UK and EMU* (paragraphs 3.31 and 3.81): "...Article 10 of the ESCB Statute provides for decisions to be taken by vote...In practice, the Governing Council appears to prefer to take decisions by consensus...The Bank of England is required to publish minutes of all MPC meetings, including members' voting records, but the ECB is not. The ESCB Statute explicitly protects the secrecy of ECB meetings, and it is up to the ECB to decide how much information to reveal. Thus far, it has decided not to publish minutes, even in an anonymised form. No record of voting patterns is made available. Other things equal, this could damage accountability and reduce credibility if the public fear that decisions are not being taken for the right reasons."

Recommendation (i)

As stated in the EMU study *Policy frameworks in the UK and EMU* (Box 3.5): "Favero *et al.* (2000) argue that accountability and legitimacy could be improved were the ECB's specific target to be set by ECOFIN and/or the European Parliament. They suggest that this would enable the ECB to focus on the technical task of meeting this target. It would also allow democratically elected representatives to change the monetary policy objectives if these differed from those of the public. Favero *et al.* claim that such a move would also 'contribute to fewer national tensions in policy-making and to less contentious appointments. ... The goal could be set at regular, say three-year intervals...'"

Recommendation (j)

As stated in the EMU study *Policy frameworks in the UK and EMU* (Box 3.2): "...Were all of the accession countries to join EMU, together with the existing EU members who are not currently members of EMU, the size of the Governing Council could expand from 18 to as many as 33 (27 NCB Governors and the six members of the Executive Board). The Treaty of Nice, ratified on 1 February 2003, paved the way for amendments to the operating procedures of the Governing Council in response to EU enlargement, through the addition of an 'enabling clause' to Article 10 of the ESCB Statute. On 3 February 2003, the ECB (2003) made proposals for such amendments...At the 2003 Spring European Council, Heads of State or Government agreed the change unanimously. The proposed amendments must be ratified by all Member States, in accordance with their respective constitutional and parliamentary requirements, before entering into force."

As stated in the Explanatory Memorandum submitted by HM Treasury to the House of Commons European Scrutiny Committee on the proposed amendments to the operating procedures of the ECB Governing Council (EM No 6163/03 and 6684/03 dated 8 March 2003): "The UK supports the existence of an effective decision-making body in the ECB."

Stability and Growth Pact

Recommendation (k)

As stated in the assessment of the five tests (paragraph 5.55): “At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are ‘exceptional and temporary’ circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.”

Recommendation (l)

As stated in the EMU study *Policy frameworks in the UK and EMU* (paragraph 4.49): “Statistical difficulties have also been highlighted...However, there have recently been useful moves to improve the reliability of statistics, including ECOFIN's adoption of a Code of Best Practice on compiling and reporting data in the context of the EDP on 18 February 2003.”

As stated in the assessment of the five tests (paragraph 5.55): “...The March 2003 European Council fully endorsed a report from ECOFIN on improved budgetary coordination and invited ECOFIN to implement its conclusions, which suggest...emphasis on the need to take into account country-specific circumstances when assessing the ‘close to balance or in surplus’ requirement of the SGP, including the long-term sustainability of public finances and allowance for the automatic stabilisers to operate fully without breaching the 3 per cent reference value.”

Recommendation (m)

As stated in the assessment of the five tests (paragraph 5.55): “At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are ‘exceptional and temporary’ circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.”

Performance of the eurozone economy

Recommendations (n) and (o)

As stated in the assessment of the five tests (paragraphs 2.6, 2.97 and 2.126): “A successful single currency within a successful single market is of benefit to Europe...The Government will continue to argue that employability, flexibility and stronger competition policies must be a top priority, so that EMU can be a sustained success. This will be particularly important as EMU expands to take in the new Member States joining the EU in 2004...It is now recognised across Europe that to realise the full benefits of EMU membership requires more progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. Europe as a whole, and especially the larger EU economies, needs to match the impressive flexibility record of some of the smaller EU Member States...The

Government reported earlier this year on progress on reforms in EU economies in Meeting the Challenge: Economic Reform in Europe. There have been substantial developments, including progress on the liberalisation of energy and communications markets, research and innovation initiatives, ongoing work on European competition policy and changes to the state aid regime. However, European economic performance in recent years has remained weaker on many counts than that of the US.”

Recommendation (p)

As stated in the assessment of the five tests (paragraphs 2.156 and 5.146): “Inside EMU, economic performance has varied considerably. Growth was initially stronger in Ireland and the Netherlands, generating overheating pressures in these countries. Growth has been weaker in Germany, which had a negative output gap in 1999 and again in 2002...The employment and productivity performance of an economy largely reflect policies which encourage its citizens to work, save, invest and innovate. These are the policies that will provide European countries with the flexibility and the dynamism that will ultimately determine whether the euro area can fulfil its potential and match the economic performance of more dynamic counterparts such as the US.”

Recommendation (q)

As stated in the assessment of the five tests (paragraphs 2.156 and 2.157): “Inside EMU, economic performance has varied considerably. Growth was initially stronger in Ireland and the Netherlands, generating overheating pressures in these countries. Growth has been weaker in Germany, which had a negative output gap in 1999 and again in 2002...Euro area economies had different experiences in the transition to EMU, as discussed in the assessment of the convergence test. In particular, Ireland's transition entailed a sharp reduction in interest rates immediately prior to joining EMU. This added to domestic overheating pressures in Ireland at the start of EMU.”

Experiences of UK companies so far

Recommendation (r)

As stated in the *third outline National Changeover Plan* (paragraphs 9.2 and 9.3): “The Government has continued to raise awareness amongst UK business as part of ongoing support on the practical issues involved in dealing with the euro as a foreign currency...Although significant numbers of UK businesses with trading links to the euro area have made preparations or put a strategy in place, others have not considered the implications of the euro for their business. These organisations need to consider the range of issues, including the effects of increased competition, changes to marketing and pricing, new methods of raising finance, price transparency and new market challenges, irrespective of whether or not the UK decides to join the euro...Consequently, the Government has made information available to help UK business consider these issues...”

The assessment process

Recommendation (s)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: “The five tests are our stability guarantee: to meet them would ensure that we will not put at risk our economy or our public services...it is because we will never put stability at risk that the tests we set were and are indeed high ones: namely to show a clear and unambiguous case for British membership.”

As stated in the assessment of the five tests (Introduction, paragraphs 15 and 16): “The five economic tests define whether a clear and unambiguous case for UK membership of EMU can be made. This sets a demanding standard, reflecting the long-term importance of the decision. The Government believes that to aim lower would fail to take full account of the particular nature and policy history of the UK economy, the irreversible nature of the decision and the constitutional issues which it raises...To ensure that the assessment can support a decision of this importance, the Chancellor also said...that: ‘the assessment will be the most robust, rigorous and comprehensive work the Treasury has ever done’. To this end, extensive use has been made of the latest analytical modelling techniques and approaches and the latest economic literature, which has been influential in shaping the Treasury's analysis of the key issues...”

Recommendation (t)

Parliament was explicitly informed through the Chancellor's 2003 Budget statement, in statements to the Treasury Select Committee, and in answers to Treasury Questions that the studies would be published alongside the assessment at the time of the Government's statement to Parliament on the euro. As stated in the assessment of the five tests (Introduction, paragraph 17): “18 EMU studies are published alongside the assessment and inform it”.

The five tests and the supporting studies

Recommendation (u)

As stated in the assessment of the five tests (paragraph 5.10): “...the decision on whether or not to join EMU needs to take full account of the costs and benefits both of joining and of not joining...”

As stated in and the EMU study *The five tests framework* (paragraph 4.4): “...A description and assessment of the options – the ‘counterfactuals’ – is central to ensuring that there is a *genuine* option to join EMU...”

Recommendation (v)

As stated in the assessment of the five tests (Introduction paragraph 16): “...A major development since the 1997 assessment is that it is now possible to examine and analyse the experiences of the countries which have adopted the euro since 1999, enhancing the evidence base and the understanding of the operation of EMU.”

Paragraph 54 of the Introduction to the assessment of the five tests adds that: "...EMU now means a real choice between policy frameworks. In 1997, the new UK macroeconomic framework was only just being established and the EMU framework had not been set up, so this was not a practical issue. Now that the UK has established a track record for delivering macroeconomic stability and sound public finances on the basis of a framework which has symmetry at its heart, the choice between the two potential routes to stability open to the UK economy is important..."

Convergence test

Recommendation (w)

As stated in the assessment of the five tests (paragraph 1.173): "There has been significant progress on convergence since 1997, which marks a break with the UK's past history of divergence and reflects greater stability of the UK economy and global trends towards integration. Indeed, the UK now exhibits a greater degree of cyclical convergence than some EMU members demonstrated in the run-up to the start of EMU in 1999 and remains more convergent than a number of EMU countries today. The UK meets the EC Treaty convergence criteria for inflation, long-term interest rates and government deficits and debt. But there remain structural differences with the euro area, some of which are significant, such as in the housing market. Because of the risks these factors pose, and the fact that any dynamic changes would take time to come through, we cannot yet be confident that UK business cycles are sufficiently compatible with those of the euro area to allow the UK to live comfortably with euro area interest rates on a permanent basis. Overall, at the present time, while the extent of convergence with the euro area has significantly increased, the convergence test is not met. The Government is committed to building on the platform of stability and has announced a wide-ranging forward-looking policy agenda to deliver high levels of output and employment. This will help to make the economy more convergent with the euro area for the future."

Recommendation (x)

As stated in the assessment of the five tests (paragraphs 1.106 and 1.107): "The transmission of monetary policy is complex in both theory and practice. The EMU study EMU and the monetary transmission mechanism takes a wide-ranging approach to consider both the workings of the transmission mechanism and the overall speed and strength of the UK transmission mechanism when compared to other countries...Monetary policy affects output and prices through a wide variety of channels and numerous structural factors will influence the speed and extent of the transmission mechanism through these channels. Analysis of these structures suggests that when compared to other countries, the UK may be more sensitive to monetary policy through some channels and less sensitive through others: the pass-through of interest rate changes from official rates to bank lending rates is faster in the UK, potentially making the UK more sensitive to monetary policy changes; the household sector in the UK may react more strongly to interest

rate changes than in euro area countries due to: higher levels of mortgage debt in the UK, combined with the dominance of variable rate mortgages; UK house prices being potentially more responsive to interest rate changes due to the low supply response of UK house building; and UK households being more sensitive to changes in housing and financial wealth; there is little to suggest the corporate sector in the UK will react more strongly than in the euro area. The structure of production is service intensive, whereas monetary policy has a stronger effect on investment and durable goods sectors which are more important in the German economy. UK banks are relatively large and firms use a range of financial products and so are less likely to face credit supply constraints at a time of monetary tightening; the UK is potentially more sensitive to monetary policy through its impact on the exchange rate as the UK has a larger stock of foreign assets and liabilities than major euro area countries; although this may be a reflection of the UK's role as an international financial centre and so have limited implications for the behaviour of consumption; and anticipating the analysis in the flexibility test chapter, the UK is seen to have relatively low levels of nominal wage rigidity. Nominal wage and price rigidity strengthens the impact of monetary policy on output (and temporarily reduces the impact on inflation)."

Recommendation (y)

As stated in the assessment of the five tests (paragraph 1.142 and 1.144): Getting the entry rate at the time of entry right is obviously a key factor in achieving sustainable convergence. But this is not straightforward because the medium-term sustainable exchange rate is not directly observed and because of the many uncertainties in estimating it, which are complicated by the significant movements in sterling and other exchange rates since 1996... Professor Wren-Lewis considers 1.37 €/£ to be the current medium-term sustainable sterling-euro exchange rate, a slightly higher rate for sterling than in his earlier work reflecting trends in recent years. On the basis of this, and reflecting the uncertainties inherent in calculations of this sort, the assessment is based upon a medium-term estimate of the sustainable sterling-euro exchange rate in a range around 1.37 €/£. But on different assumptions about the recent and future sustainable trade performance of the UK and other countries, equilibrium exchange rate estimates vary significantly."

Recommendation (z)

Issues relating to mortgages and the housing market are dealt with in the assessment of the five tests (Chapter 1: Convergence), and in the EMU study *Housing, consumption and EMU*. These issues will be considered further as part of the Miles Review; as the Chancellor said in his statement to the House of Commons on 9 June 2003: "And because Britain has had a different system of housing finance - just 7 per cent of mortgages in the UK are at long-term fixed rates - we are learning the lessons from other countries, where for example in America they securitise long-term fixed rate mortgages, and an independent review is now examining the structure of mortgage finance including the case for - and how we can help the development of - the long-term fixed rate mortgage market in the UK...". Professor Miles will deliver an

interim report by autumn and a comprehensive report and recommendations to the Chancellor by Budget 2004.

Flexibility test

Recommendation (aa)

As stated in the assessment of the five tests (Paragraph 2.223): “UK labour market flexibility has improved markedly since 1997. Significant falls in unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than in the US. While considerable progress has been made to reform labour, product and capital markets in the UK and the euro area, more can be done to ensure the UK economy is resilient to deal with the risks identified in the convergence test and the challenges of EMU membership. Inflation volatility is very likely to increase inside EMU. Greater flexibility in the UK and throughout the euro area would minimise output and employment instability, helping to ensure convergence was durable and that the potential benefits of EMU could be fully realised. This underlines the importance of maintaining progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy. Overall, at the present time, we cannot be confident that UK flexibility, while improved, is sufficient. Reflecting this, at the present time, the achievement of sustainable and durable convergence has not been demonstrated. But increased flexibility through the measures we set out will help to provide greater reassurance that the economy can meet the additional demands that EMU membership would pose and contribute to achieving sustainable and durable convergence. “

Recommendation (bb)

As stated in the assessment of the five tests (paragraphs 2.213 to 2.215): “Fiscal policy has the potential to support market adjustment mechanisms inside EMU. But enhanced stabilisation mechanisms would need to meet a range of criteria to ensure their worth and be implemented when the understanding of the mechanisms by which fiscal policy affects the real economy has increased... The degree of fiscal stabilisation may need to increase inside EMU where the absence of a UK-specific monetary policy may cause the degree of macroeconomic volatility to increase. The Treasury discussion paper *Fiscal stabilisation and EMU* explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper considers the reforms to the institutional framework that EMU membership would require to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently and which policy levers are likely to prove most effective... Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure that the policy

proposals deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.”

On tax harmonisation the assessment of the five tests (paragraphs 5.154 and 5.155) state: “Some argue that a successful single currency requires greater harmonisation of tax and social policies across Europe. The UK Government disagrees, believing that this would not promote dynamism and flexibility. Its approach to tax policy within the EU can be summarised as competition where possible, coordination where necessary...taxation is a matter for Member States, in keeping with the principle of subsidiarity. Tax is at the heart of economic policy, a key aspect of national sovereignty and a matter for national governments and parliaments...The Government therefore opposes unnecessary tax harmonisation which would constrain Member States' economic success. It does not accept that tax harmonisation is an inevitable consequence of EMU. EMU does not require, either in principle or in practice, the harmonisation of direct taxation. Indeed, countries inside a monetary union might need fewer rather than more constraints on variations in their individual tax rates and bases in order to aid adjustment to country-specific shocks.”

Investment test

Recommendation (cc)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: “The assessment shows that inside the euro there will be new opportunities for investment in particular foreign direct investment. And at all times by continuing to maintain macroeconomic stability and encouraging flexibility the Government will continue to ensure that the UK retains our position as a magnet for foreign direct investment. We have taken particular account of the views, the qualitative evidence from Japanese, other Asian, American and European investors many of whom have said membership would be beneficial and is important to them...”

As stated in the assessment of the five tests (paragraph 3.93): “UK productivity has been held back by a legacy of long-term under-investment. EMU entry could reduce the cost of capital for UK firms if long-term interest rates fell further inside the euro area and if membership of a larger financial market reduced the cost of finance. These costs could fall for SMEs in particular if joining EMU lowers the barriers which prevent SMEs accessing euro area financial markets and lowers the cost of bank lending. Over time, EMU is likely to boost cross-border investment flows and FDI in the euro area. There has been a fall in the UK's share of total EU FDI flows coinciding with the start of EMU, and a corresponding increase in the share of the euro area. But against the backdrop of many other influences on FDI flows, it is difficult to say with confidence that EMU has boosted FDI within the euro area. There can, however, be confidence that a successfully operating EMU, and UK membership of it on the right basis, would boost FDI over the longer term. There is a risk that the longer membership of the euro is delayed, the longer the potential gains in terms of increased inward investment are postponed. If

sustainable and durable convergence is achieved, then we can be confident that the quantity and quality of investment would increase ensuring that the investment test was met.”

Statistics on mergers and acquisitions can be found in the assessment of the five tests (chart 3.5 and paragraph 3.83): “FDI flows have been increasingly dominated by M&A activity in recent years and individual deals have been significant contributors to volatility. The decline in the UK's share of EU FDI flows also reflects Vodafone's acquisition of Mannesmann in 2000, an extremely large deal which boosted Germany's share of EU FDI. Other M&A deals also affected UK figures, including the purchase of Orange by France Telecom in 2000. While it is not possible, using official statistics, to extract M&A data directly from FDI data, the EMU study *EMU and business sectors* uses proxies for M&A activity and suggests that UK underlying FDI continued to grow in 2001, although it fell back in 2002 reflecting...specific factors...Of course, the introduction of the euro may itself be a factor in increased M&A activity in the euro area.”

Recommendation (dd)

These issues are dealt with in the assessment of the five tests (paragraphs 5.41 and 5.55): “The EU fiscal framework recognises, to some extent, the importance of public investment. For example, Article 104 of the EC Treaty states that assessment of whether a country's deficit is excessive needs to take into account 'whether the government deficit exceeds government investment expenditure'. But this recognition was not made explicit in the SGP and the medium-term objective that the budgetary position should be 'close to balance or in surplus' could be interpreted to mean that investment should be financed by current taxpayers, not by future ones, potentially harming inter-generational fairness...At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are 'exceptional and temporary' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.”

City and financial services test

Recommendation (ee)

As stated in the assessment of the five tests (paragraph 4.70): “Over the four years since the start of EMU, the UK has attracted a significant level of wholesale financial services business. The strength of the City in international wholesale financial services activity should mean that it continues to do so, whether inside or outside EMU. EMU entry should enhance the already strong competitive position of the UK's wholesale financial services sector by offering some additional benefits. Again, while the UK's retail financial services sector should remain competitive either inside or outside the euro area, entry would offer greater potential to compete and capture the effects of greater EU

integration that would arise from the single currency and other efforts to complete the Single Market, in particular the FSAP - benefits which are postponed while the UK is not in EMU. Overall, the financial services test is met.”

Paragraph 4.69 in the assessment of the five tests says: “The UK’s influence over EU financial services policy should remain strong whether inside or outside the euro area. Concerns prior to the start of EMU that the UK’s influence would diminish outside EMU have not been realised: the UK has had an influential say over EU financial services issues. In part because of the position of the City as the major international financial services centre in the EU and the transaction of a significant proportion of euro business in London, the UK’s influence should remain strong in or out of EMU. The Government is aware that it will need to be more vigilant in the face of any risks that might arise while the UK remains outside EMU and will be fully engaged in the debate about the future regulatory framework for EU financial services. Using its strong influence, the Government will work with the UK’s financial services sector to ensure that the UK’s competitive advantage in many retail and wholesale financial services activities is safeguarded and, wherever possible, enhanced.”

Recommendation (ff)

As stated in the *third outline National Changeover Plan* (paragraphs 4.2 and 4.3): Since the second outline National Changeover Plan, further planning has been undertaken to determine what organisations would do during each phase in a changeover, and to agree the products and services which would be offered to businesses and citizens. The work has drawn extensively on the changeover experience of the euro area and has enabled the timetable to be refined...After further consultation with the financial services sector, the Government has concluded that approximately twenty four months would be required to develop full euro payment systems’ capability to enable RT [retail transition] to begin. This work would begin at D [decision].

Chapter 8 of the *third outline National Changeover Plan* considers how the changeover timeline would be delivered for the financial services sector.

Growth, stability and jobs test

Recommendation (gg)

As stated in the assessment of the five tests (paragraph 5.8): “The assessment of the fifth test is a challenging task. Some benefits would only become apparent in the longer term and the single currency itself remains in its relative infancy. As in the rest of the assessment, some effects can be modelled and quantified within a range, such as the likely effects of EMU on international trade, while others require a more qualitative analysis. The analysis of this test focuses on the likely effects of EMU on the key variables of growth, stability and employment, but it also recognises areas where uncertainty remains. The test focuses on the potential benefits of EMU.”

Paragraph 6.6 of the assessment of the five tests states: "Overall the Treasury assessment is that since 1997 the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area. So, despite the risks and costs from delaying the benefits of joining, a clear and unambiguous case for UK membership of EMU has not at the present time been made and a decision to join now would not be in the national economic interest."

Recommendation (hh)

As stated in the assessment of the five tests (paragraph 5.175): "In its May 2003 review of monetary policy strategy, the ECB restated that: "*Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term*". The ECB review went on to state that: "*At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*". At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialised."

Maastricht criteria for entry

Recommendation (ii)

These issues are dealt with in the EMU study *Policy frameworks in UK and EMU* (paragraph 4.35): "A more difficult question is whether the 3 per cent of GDP limit for deficits would impact on policy. This has not been an issue for the UK to date. The golden rule and sustainable investment rule, operating together, have both allowed the automatic stabilisers to operate fully over the economic cycle, contributing to macroeconomic stability, and allowed the government to undertake much needed quality public investment, whilst staying within the 3 per cent nominal deficit limit...If the UK were to enter EMU, to the extent that the UK were subject to asymmetric shocks, there would be a case for an enhanced stabilisation role for fiscal policy. This might be expected to involve wider fluctuations in the deficit, either from the full operation of the automatic stabilisers alone or their combination with supplementary discretionary fiscal action. These issues are explored more fully in the EMU study by HM Treasury *Fiscal stabilisation and EMU*."

Exchange rate on entry

Recommendation (jj)

These issues are dealt with in the assessment of the five tests (paragraph 1.144): "Professor Wren-Lewis considers 1.37 €/£ to be the current medium-term sustainable sterling-euro exchange rate, a slightly higher rate for sterling than in his earlier work reflecting trends in recent years...But on different

assumptions about the recent and future sustainable trade performance of the UK and other countries, equilibrium exchange rate estimates vary significantly.”

Recommendation (kk)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: “We have said throughout that we do not believe it necessary or right to rejoin the ERM...We will report on progress [on the reform agenda] in the Budget next year. We can then consider the extent of progress and determine whether on the basis of it we make a further Treasury assessment of the five tests which - if positive next year - would allow us at that time to put the issue before the British people in a referendum.”

Influence of UK on reform

Recommendation (ll)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: “We will also continue to pursue our objective of a Stability and Growth Pact that takes into account the economic cycle, debt sustainability and public investment - and seek reform of the European Central Bank.”

These issues are also dealt with in the assessment of the five tests (paragraphs 5.54 and 5.55): “In its May 2003 review of monetary policy strategy, the ECB restated that: *“Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term”*. The ECB review went on to state that: *“At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term”*. At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialized...At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are 'exceptional and temporary' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.”

Paragraph 2.230 of the assessment of the five tests states: “All European countries have embarked on an ambitious programme to reform labour, product and capital markets and the Government supports policies to strengthen competition in the EU and the Single Market. However, it is important to make more progress at the European level, in particular on employment flexibility, trade and the Single Market in financial services. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy.”

The present options

Recommendation (mm)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: "And my conclusion is that if, on the basis of the five economic tests, membership of the euro is shown as good for sustaining British jobs, business and future prosperity then it is economically right and in the national economic interest to join."

Engaging the public: the challenge

Recommendation (nn)

As the Chancellor said in his statement to the House of Commons on 9 June 2003: "...I believe a modern long term and deep seated pro-European consensus in Britain about Britain's role in Europe and Europe's role in the world can and will be built."

Public interest and increasing public understanding Issues of concern to the public

Recommendations (oo) (pp) (qq) and (rr)

Recommendation (ss)

The Government will not pre-empt the decision on UK membership of EMU. As the Chancellor said in his statement to the House of Commons on 9 June 2003: "We will report on progress [on the reform agenda] in the Budget next year. We can then consider the extent of progress and determine whether on the basis of it we make a further Treasury assessment of the five tests which - if positive next year - would allow us at that time to put the issue before the British people in a referendum." In his 9 June statement the Chancellor also announced that the Government will publish a draft Referendum Bill this autumn.