

The UK and the euro

The five tests and their aftermath

- **The results of the five economic tests will be announced on 9 June.**
- **The euro verdict is likely to be 'not yet'.**
- **The verdict is likely to be accompanied by a plan to clear away remaining obstacles.**
- **The pound's exchange rate is no longer such a big obstacle.**
- **There are serious deficiencies in the economic policy framework in the euro area.**

Chancellor Gordon Brown will announce the results of the five tests? that will determine whether the economic case for the UK to join EMU and adopt the euro has been met on 9 June. If a decision to recommend joining were taken by the government, it would be put to a vote in Parliament and then to a referendum. The verdict in June is widely expected to be 'not yet' but how this is presented and whether clear plans are put forward to clear away the remaining obstacles is of crucial importance.

The decision to delay the announcement to the last possible minute suggests that the vigorous debate between Prime Minister Blair, in favour of early UK membership, and Chancellor Brown, who is more sceptical about the euro, is continuing.

The five tests, which were first outlined by Chancellor Brown in July 1997, provide a framework for judging whether the economic case for joining is clear and unambiguous. They focus on:

- Cyclical convergence
- Flexibility
- Investment
- Financial services
- Employment and growth

The first assessment by the Treasury in October 1997 found that neither flexibility nor convergence were sufficient for the UK to adopt the euro. The assessment envisaged that policies in both the UK

? The UK Treasury's five economic tests are separate from the five convergence criteria for EMU stipulated by the Maastricht treaty. The Maastricht criteria relate to inflation, long-term interest rates, the budget deficit, public sector debt, and membership of the exchange rate mechanism. The UK currently meets three of them, but does not satisfy those relating to inflation or membership of the ERM.

and Europe would increase flexibility and convergence, but concluded that it was likely to be some years before sustainable convergence could be demonstrated.

The second assessment was apparently completed in April when a comprehensive 2000-page report was delivered to Blair. There seems little doubt that the overall verdict will be 'not yet' but it remains unclear to what extent the new assessment will be more favourable towards the euro than the 1997 assessment. Crucial political discussions about how it will be presented are still under way.

The five economic tests:

- **Cyclical convergence**

Cyclical convergence examines whether business cycles and economic structures are compatible so that the UK live comfortably with euro interest rates on a permanent basis. The government's key requirement is that convergence must be sustainable and durable to provide a basis for successful membership of the single currency.

- **Flexibility**

If problems emerge, is there sufficient flexibility to deal with them? If the UK adopts the euro then it would lose autonomy over the exchange rate and interest rates that can be used to tackle economic problems such as a loss of export competitiveness. The main focus is likely to be on wage flexibility and employment flexibility.

- **Investment**

This focuses on whether adopting the euro would create better conditions for firms making long-term decisions to invest in the UK.

- **Financial services**

This looks at the impact of adopting the euro on the competitive position of the UK's financial services industry. It will probably reach a similar conclusion to the 1997 assessment that while the euro offers benefits to the UK financial sector whether the UK adopts it or not, these benefits and opportunities will probably be easier to tap from within the euro area.

- **Employment and growth**

This examines whether the single currency is

compatible with the government's key economic objectives of promoting higher growth, stability, and a lasting increase in jobs.

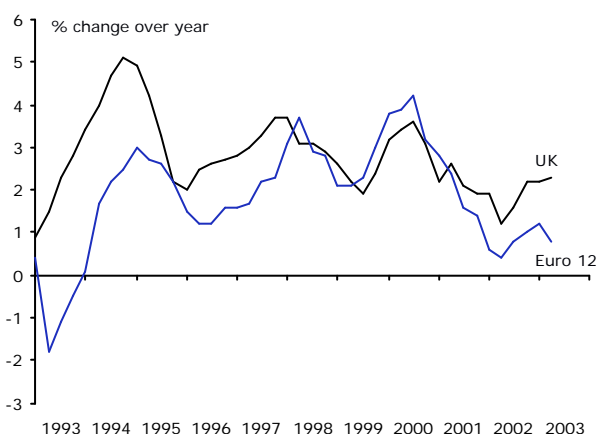
Economic obstacles to the UK's early adoption of the euro

There is clear overlap between the five economic tests and, without detailed research and analysis, it is not possible to identify the specific impediments that are likely to underpin the government's decision not to push for early euro entry. In broad terms, however, it is possible to highlight areas where impediments identified in 1997 have still not been overcome and other obstacles that need to be addressed.

Some progress but the UK has probably not achieved 'sustainable and durable' convergence

In terms of convergence, it is clear that in overall terms progress has been made.

Real GDP Growth



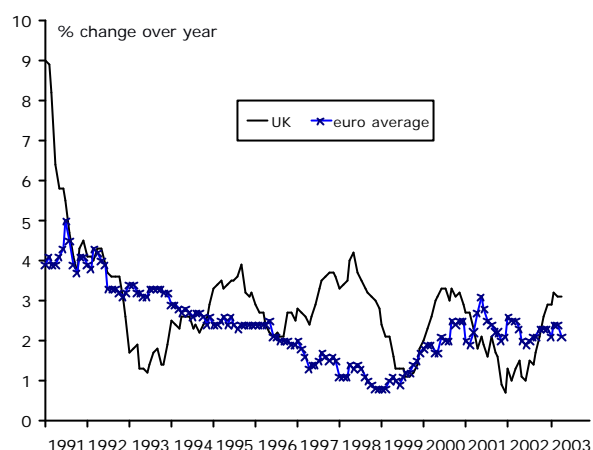
The gap between inflation and short-term interest rates has narrowed significantly over recent years, while GDP growth and the output gap are also closer. However, there are doubts about whether this apparent convergence will be sustained (indeed, the pattern of GDP growth has already begun to diverge anew). In addition, there are still several significant structural differences between the UK economy and other economies in Europe.

The 1997 assessment identified the smaller proportion of UK trade with its EU partners, higher home ownership and higher levels of household debt in the UK, the greater reliance of UK companies on equity finance and/or variable-rate loans than their European counterparts, and the UK's position as a significant oil producer and exporter.

Trade patterns have not changed significantly over

recent years. Comparing 2002 with 1995 shows that UK trade with the EU was unchanged at 52.5% of the total, the EU share rose from 61.9% to 63.3% in France, while the EU share declined slightly in Germany, from 55.9% to 53.2%, and in Italy, from 58.5% to 55%. The proportion of the UK's trade with the EU remains below that in the other major European economies, but in most instances the differences are not significant.

Headline Inflation



UK housing and housing finance

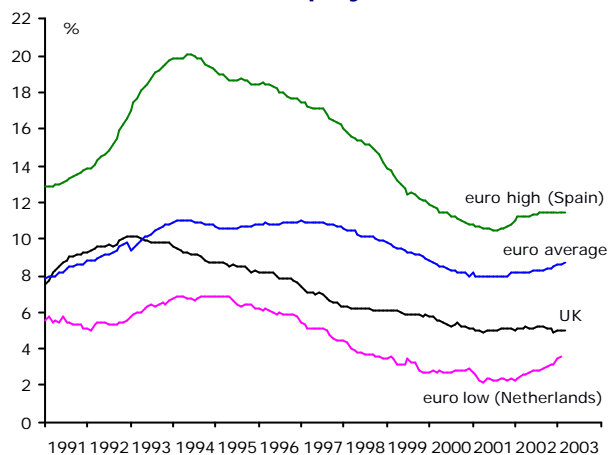
The Treasury has recently focused on the risks associated with the house price boom in the UK over recent years and on housing finance. If the boom were to be followed by a bust, there would be a significant adverse impact on consumer demand. At present the Bank of England could respond by lowering interest rates, but such independent action would not be possible once the UK adopts the euro; interest rates in the UK, as elsewhere in the euro area, would be set by the ECB based on its assessment of economic conditions across the euro area as a whole.

Concerns regarding housing finance reflect the relatively high proportion that is linked to short-term floating interest rates in the UK. In his April 2003 Budget, the Chancellor announced a review of why the share of fixed-rate mortgages in the UK is low compared with the US or other EU countries, but in the meantime the sensitivity of the finances of UK households to changes in short-term interest rates is likely to be highlighted as an area where the UK economy has not achieved convergence.

The decline in the UK unemployment rate from over 8% in 1995 to around 5% currently is encouraging, but of key importance in the Treasury's assessment is likely to be the extent to which this reflects increased wage flexibility, as opposed to general economic conditions, the

availability and scale of unemployment and social security benefits, or the degree of labour market flexibility.

Unemployment



The assessment is likely to identify a number of impediments to mobility of labour within the UK, such as big differences in house prices between regions, and language and cultural differences as obstacles to greater mobility between the UK and Continental Europe. In this area, however, the Treasury is likely to contrast the decline of unemployment within the UK with the higher euro area average and recent rise from 8.0% in 2000 to 8.7% in 2003. The Treasury is likely to be critical of restrictive labour market regulation in other EU countries and the slow progress in improving labour market flexibility despite the shortcomings in this area, and the need for reform, identified in Lisbon in 2000.

In considering the impact on investment, the main attributes of the single currency have long been recognised. It would remove exchange rate volatility and uncertainty between the UK and the euro area, and promote price transparency and competition within the single European market. This test examines not only whether there would be increased investment as a result of joining the euro, but whether investment is lost as a result of staying out.

Shortcomings of the economic policy framework in the euro area

The Chancellor is proud of the government's decision, immediately after taking office in 1997, of granting responsibility for setting interest rates to the Bank of England which has strengthened the prospect of economic stability in the UK. In 1997, the government was optimistic that the economic policy goals of the euro area would be consistent with those of the UK and that this would help promote investment. However, following a period of faster growth in 1998-2000, economic performance in the euro area has been disappointing.

While the ECB's anti-inflation credentials are strong, the recent record of economic growth in the euro area is unimpressive. To a significant extent, this poor growth performance reflects structural impediments in Continental Europe arising from inflexible labour markets and the high costs of generous social security and pension arrangements. There are several areas where the UK is likely to be critical of economic policies in the euro area. In addition to the failure to tackle structural rigidities referred to above, these are likely to include the damage inflicted on growth prospects by the EU's 'Stability and Growth Pact' and the ECB's formulation of monetary policy.

The Stability and Growth Pact is impeding economic growth in Europe

The stability and growth pact requires that individual countries should ensure that budget deficits are kept below 3% of GDP, except in exceptional circumstances. A number of countries, including Germany and France, are currently in breach of this requirement. Its existence is preventing fiscal policy being used to bolster flagging economic growth and thereby avoid a prolonged period of negligible or even negative growth. Although criticism of the pact is widespread, there is not yet any consensus among EU countries about whether it should be ditched, reformed, or suspended. Chancellor Brown considers his own 'golden rule' that specifies that 'over the economic cycle, the government will borrow only to invest and not to fund current spending' to be far superior to the stability and growth pact. The golden rule is met if, on average over a complete economic cycle, the current budget is in balance or surplus.

From the UK perspective, the stability and growth pact is not only a major constraint on economic policy at times when economic growth is faltering; it could also act as a long-term constraint on the UK government's plans to improve the quality of infrastructure in the UK which is generally lagging that of Europe.

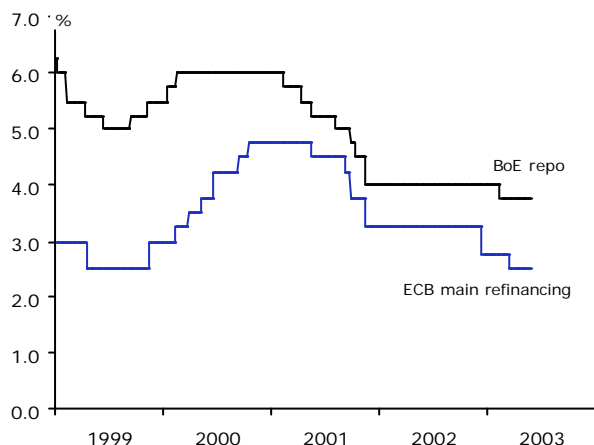
The UK government also considers its own monetary policy framework to be superior to that used by the ECB. The UK's monetary policy framework gives independence to the Bank of England to set interest rates to keep inflation in a band set by the government (1.5-3.5% since 1997). The ECB also has independence to set interest rates free of political interference to ensure price stability, but since its inception has aimed to keep inflation below 2%.

There are also problems with the ECB

While there has been widespread criticism of many

aspects of the ECB's monetary policy and how the ECB operates, the main concerns to the UK government are likely to be that the inflation target is too restrictive, and that the ECB has been too slow to head off the threat of economic slowdown.

Official interest rates



As fears of deflation spreading from Japan and other parts of Asia to the US and Europe have mounted over recent months, the ECB has clarified its inflation target in an attempt to reassure financial markets that it is alert to the risks of deflation. While it remains unwilling to adopt a new inflation target of, say, 1-2% or 1-3%, it says that its 'below 2%' target is not 0-2% but means 'close to 2%'. While some analysts consider this clarification to be inadequate, most accept that it is a step in the right direction.

The ECB does not accept that it has been too slow to act in the face of economic slowdown and points to its mandate which says that its primary objective is to maintain price stability. The UK government's retort might be that the ECB's inflation target is too restrictive in not allowing it to meet its secondary responsibility of supporting the EU's economic policies which include sustainable and non-inflationary growth. It considers that the broader, symmetrical, inflation target in the UK allows monetary policy to support the UK government's objective of high and stable levels of growth and employment.

The problems associated with the ECB's policy regime are set to increase as the EU expands from 15 to 25 countries in 2004 and as new EU countries adopt the euro, probably from 2006 or 2007 onwards. The enlargement of the euro area, however, is eventually likely to force further changes in the ECB's structure beyond the modest changes already envisaged.

Another area for criticism could be the failure to remove the remaining obstacles that impede the creation of a genuine single European market.

The exchange rate is no longer such a big obstacle

One of the major obstacles to UK membership of EMU has been sterling's overvalued exchange rate. While it is not possible in this short paper to determine what an appropriate and irrevocable conversion rate between the euro and the pound should be, it is clear that this obstacle has been substantially reduced as a result of the pronounced depreciation of sterling over recent months. The pound has fallen by more than 12% against the euro since October 2002.

The decision about the euro is political

The Treasury's examination of the 'five tests' will undoubtedly be thorough and insightful, but it has long been clear that the UK government's decision about whether the UK should adopt the euro will be determined by political considerations, not economic ones.

In addition, this far-reaching decision will not have been made following thorough discussion of the relevant issues within the government, but will largely be determined by the drawn-out and continuing power tussle between Prime Minister Blair and Chancellor Brown.

Blair is strongly pro-euro and considers that Britain should embrace the single currency in order to be at the heart of Europe. Brown has been careful to avoid accusations of being anti-euro, but he is not yet in favour of entry and, to date, has been unwilling to devise a strategy that would clear away remaining obstacles.

According to recent press reports, Blair and Brown agree that there should be no rush to call a referendum on euro membership this year. Such a decision would be sensible, as well as pragmatic, given the government's recent preoccupation with Iraq, the divisions and fall-out in the UK and Europe concerning the Iraq war and its aftermath, the uncertainties facing the world economy which are being exacerbated by the poor performance of the euro area, and the continuing opposition of public opinion to the idea of discarding the pound and adopting the euro.

There is growing criticism, however, from all sides of politics, about the folly of giving the Chancellor the sole power to determine whether the UK has satisfied the economic tests relating to membership of the single currency.

From the opposition Conservative party, calls are growing for an early referendum. Given continuing popular opposition to the euro and current divisions within the government, the Conservatives

are confident that the result would be a clear 'No' and that the prospect of the UK adopting the euro would disappear from the political agenda for many years.

The problem for Prime Minister Blair and supporters of the euro is that the economic tests are framed in such a general way that a cautious Chancellor and sceptical Treasury could continue to deliver 'not yet' verdicts indefinitely.

The way forward – a new road map

As the government has already determined that it is, in principle, in favour of UK membership, Blair and his pro-euro supporters in Cabinet want the 'not yet' verdict to be accompanied by a clear plan, or road-map, that details what needs to be done. They want economic and foreign policy to be directed to removing remaining obstacles so that the UK can join at the first suitable opportunity.

To underline the objective of joining as soon as possible, recent press reports suggest that Blair, while willing to rule out a referendum this year, wants to keep open that possibility for 2004 or 2005. If accurate, this seems a rather odd position to adopt.

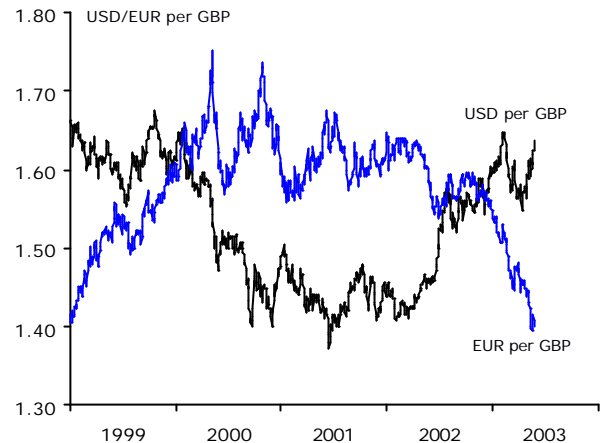
While the economic tests can be criticised for not providing precision regarding whether the economic case for the euro is met, the facts are that they exist, have a central role in the process, and give the Chancellor the role of final arbiter. The economic tests are big and broad enough to make it inconceivable that a 'not yet' verdict could be delivered in mid-2003 only to be overturned in 2004 or 2005. The continuing uncertainty about the government's attitude towards the euro would not be welcomed by business or the public and would deflect the government from making progress in its key political objective of improving the quality of public services and thereby reinforcing the prospect of its own re-election in 2005 or 2006.

A better option would be to accept that the consequence of a 'not yet' verdict would be to rule out the possibility of a referendum in the current parliamentary term, but to identify clearly and precisely what the remaining obstacles to membership are and, crucially, to make it the responsibility of the Treasury to tackle them.

Following its recent sharp decline against the euro, opinions are mixed about whether sterling is still significantly overvalued and whether the current exchange rate still represents a major obstacle to adopting the euro. Unless adoption of the euro were to be ruled out for many years, it would seem sensible to begin discussions with existing euro members about the appropriate conversion rate sooner rather than later.

It has been obvious since the pound was forced out of the Exchange Rate Mechanism in 1992 that the prospect of sterling ever rejoining the ERM was remote. Yet a period of two years within the ERM remains one of the conditions of entering the euro required by the Maastricht Treaty.

The pound has fallen sharply against the euro



Negotiations about removing this condition could accompany discussions about an appropriate conversion rate and the period prior to adoption of the euro deemed necessary to demonstrate that this exchange rate was sustainable.

It would also be appropriate for the UK government to discuss the parameters of fiscal and monetary policy with its EU partners. If such discussions were to be of value, it would be important to focus on substantive issues, such as the threat the stability and growth pact poses to the economic performance of the euro area, rather than getting bogged down in detailed debate about, say, the merits of the UK's inflation target compared to that adopted by the ECB.

The main point of such discussions would be to remove obstacles that could threaten the UK's economic prospects if it were to adopt the euro, rather than aim to fine-tune every aspect of economic policy in the euro area before deciding whether to participate.

If substantive progress were made in these areas over the next 2-3 years then there would be a much firmer basis for determining that adoption of the euro was clearly in Britain's interests and then, assuming it wins the next election, for the Labour government to make the determined political efforts that will be necessary to swing public opinion in favour of adopting the euro.

Barry Coulthurst
Economics@anz
 Email: coulthub@anz.com



ANZ is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

10th Floor 100 Queen Street, Melbourne 3000, Australia

Telephone +61 3 9273 6224

Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ACN 005 357 522

Minerva House, PO Box 7, Montague Close, London, SE1 9DH, United Kingdom

Telephone+ 44 207 378 2121

Fax+44 207 378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc.

(Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212-801-9160

Fax: +1 212-801-9163

NEW ZEALAND by:

ANZ Banking Group (New Zealand) Limited.

Level 10 215-229 Lambton Quay Wellington, New Zealand

Telephone +64 4 496 7000,

Fax +64 4 496 7360

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