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# **Joining the Fold**

**—the Question of UK entry into EMU—**

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## **INSTITUTE FOR INTERNATIONAL POLICY STUDIES**

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# Joining the Fold: the Question of UK entry into EMU

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**KIYOSHI TAKATA\***

*On 1 January 2002, 12 of the 15 Euroland countries began the physical circulation of the euro taking the Economic and Monetary Union (EMU) in Europe to new heights. A big issue still lurks however: The United Kingdom, which is a significant economy in the European Union (EU) with an important financial market in London, has yet to join. In the following article, IIPS Senior Research Fellow Kiyoshi Takata gives an outline of the economics and the changes in public opinion on the question of UK entry into EMU. Takata also reviews the business cycles and estimates the Trade Intensity Index of the UK to Euroland as an indicator of the level of integration of these economies.*

On 1 January 2002, the physical circulation of the European single currency, the “euro,” began. The euro became available not just in western Europe but all over the world. Three years previously on 1 January 1999, Europe had seen the birth of the Economic and Monetary Union (EMU), which to be precise, was the third (or final stage) of the European Union (EU). At that time, however, the euro had not been physically circulated and all the currencies of member countries, such as the D-mark for example, had remained legal tender as denominations of the euro.

The physical introduction of the euro has helped to create a greater sense of “Euroland”—the countries in the EMU—as the citizens of member countries benefit from the freedom of movement without cumbersome exchange rates. The impact of the euro is not just limited to Euroland however, but extends throughout the whole of EU, including the UK.

The success of the euro’s launch does not mean that Europe’s big experiment with the EMU has been completed: Member countries, all with differing policies, will have to bring their diverse economies under the umbrella of one single monetary policy. Another big issue is if, and when, those countries that are outside the EMU will join the fold. The United Kingdom is particularly significant being a large economy in the EU with an influential financial market in London. At the outset, Euroland was made up of 11 countries, which increased to 12 with the entry of Greece on 1 January 2001. The remaining 3 out of the 15 EU member countries—UK, Sweden and Denmark—however, have yet to join.

The EMU is not just an economic project but also a political one. Despite skepticism from many quarters, it was pushed through by the strong will of politicians and the ability of many member countries to cut their huge budget deficits in the mid-1990s. The UK has not joined the EMU citing economic reasons—including the divergence of business cycles—and political

objections such as the British public's attachment to the sterling and aversion to the euro. After all, Britain has never been the most enthusiastic supporter of the EU and managed to keep her distance from European integration for more than 50 years.

However this may be, in any discussion of the EMU it is not possible to leave out the question of UK entry and care is required when evaluating the impact, cost and benefits to British society and economy. If the benefits turn out to be greater than the cost of entry, the government should join the EMU and by mounting an effective information campaign explain to the British public of the necessity of its actions.

In this article, section 1 reviews the history of the EMU and the participation of the UK. Section 2 examines the five economic tests spelt out by the British chancellor of the exchequer, Gordon Brown, before entry into the EMU. Section 3 considers the economics of UK entry into the EMU. Section 4 reviews the UK's business cycles and estimates the Trade Intensity Index of the integration between the UK and Euroland. Section 5 concludes.

## **1. The history of EMU and UK participation**

### ***Delay in entry into the EMS***

The concept of the EMU has been around for over 30 years and has been the focus of many studies including the one by Gros and Thygesen which provides a detailed history.<sup>1</sup> In 1970, a study group produced "the Werner Report," (named after the chair, the then prime minister of Luxembourg, Pierre Werner) which introduced the idea of the EMU. In April 1972, the first step towards an exchange rate mechanism, the "snake system," was taken. This system was not effective, however, because of the collapse of the Bretton-Woods regime. The UK eventually joined the snake system in May of that year, only to withdraw the very next month. In 1979, the next step, the European Monetary System (EMS) was introduced which included the European Currency Unit (ECU) and continued till the launch of the EMU in January 1999. Initially, the UK did not take part in the EMS and was still outside at the time of the Delors Report in 1989.

### ***Delors Report and the UK***

In 1987, the member states agreed to the Single Market program. In 1989, the Delors Report (named after the chair, Jacques Delors, the president of the European Commission) was submitted to the council of ministers of economics and finance (ECOFIN) which gave an outline of the step-by-step process toward monetary union. This was incorporated into the Maastricht Treaty. The Conservative government in the UK at the time, could not however accept the conditions set in this report and proposed a counter parallel currency approach—the Hard ECU.

### ***Maastricht Treaty and exchange rate crisis***

As a result of several intergovernmental conferences held after the Delors Report, member states concluded the Maastricht Treaty in December 1991. This treaty deals with numerous issues, but in particular, the metamorphosis of the European Community into the European Union and establishing the Economic Monetary Union. This treaty set a target date—no later than 1999—for the EMU's launch and a list of Maastricht Criteria, to decide on member eligibility. The UK, negotiated the right to opt out of the EMU.

The path to EMU was not strewn with roses and the speculative exchange rate attacks in the autumn of 1992 and the summer of 1993 were two disastrous mines which eventually led to the transformation of the EMS into the EMU (although providing a wealth of research material for academics).<sup>2</sup> The British government could not remain in the EMS which it had only joined in 1990 and was forced to withdraw in September 1992. Since which time it has remained beyond the pale of the Exchange Rate Mechanism (ERM) and ERM II.

After the withdrawal, the British economy revived due to the sterling's depreciation. While the rest of the EU managed to converge their business cycles by the mid-1990s, the UK's business cycle remains out of sync with that of Euroland. It should also be noted that after the ignominious withdrawal, the UK may not meet the Maastricht criterion on entering the ERM within two years.

## **2. Five economic tests and starting EMU**

### ***Blair's new government and change of policy***

The May 1997 elections brought the British Labor party into power after more than a decade in opposition. Margaret Thatcher and her supporters in the Conservative Party had made a new art form of opposing European integration whilst John Major and his motley crew did not have a strong enough majority to press for change. The sticking point had been opposition to the EMU and the EU's Social Charter, which had been accepted by all other members in the treaty on the Maastricht European Council in 1991.

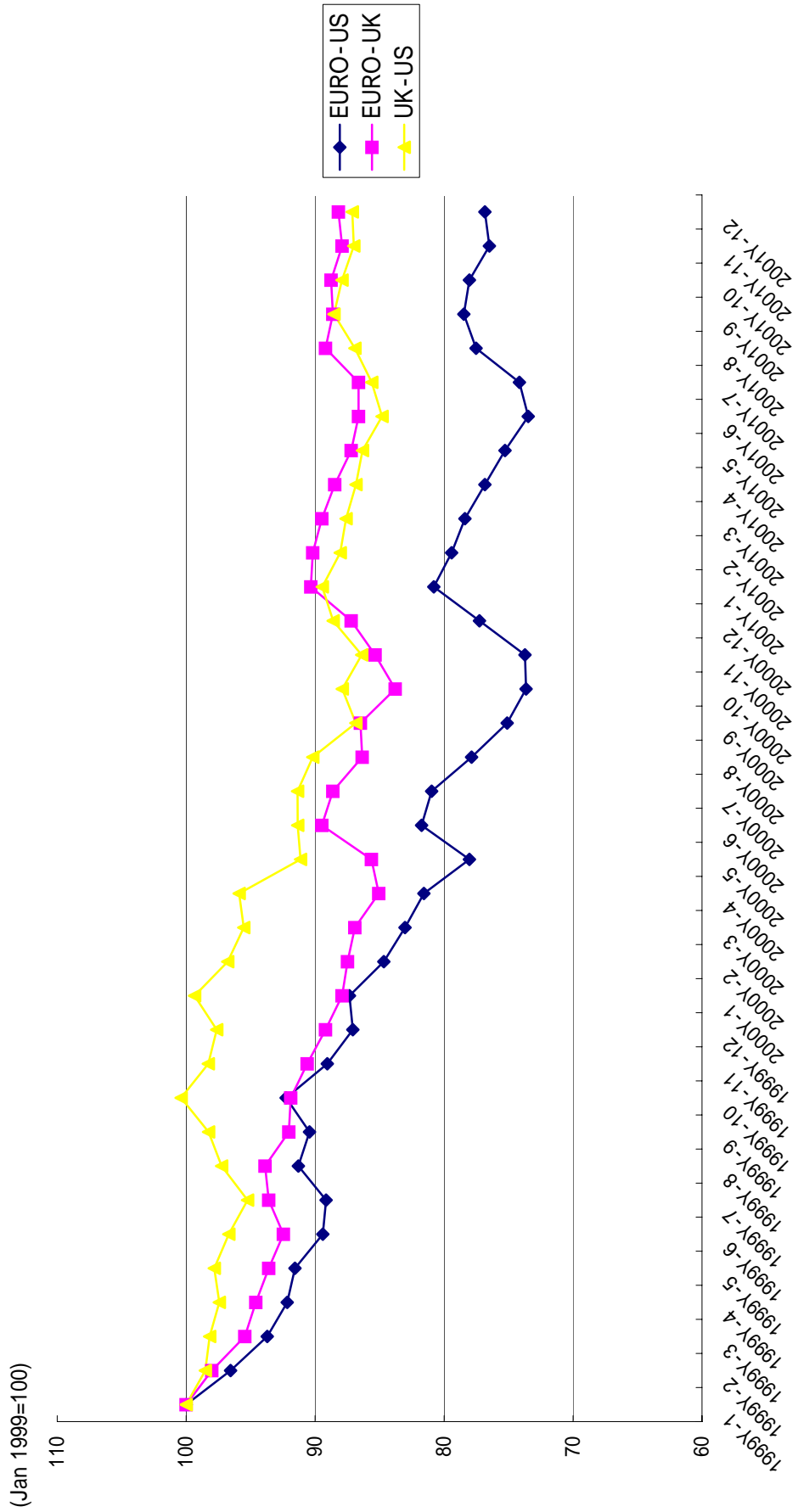
The new Labor government were more favorable towards Europe and Tony Blair's Cabinet accepted the new EU treaty, including the Social Charter, at the Amsterdam European Council in 1997.

### ***Five economic tests***

Joining the EMU is a crucial issue for the Labor government. In October 1997, the chancellor of the exchequer, Gordon Brown, released the "UK Membership of the Single Currency—An Assessment of the Five Economic Tests" report.<sup>3</sup> Like any government, the central economic objective is to achieve high and stable levels of growth and employment. Therefore, Britain's economic interests in the single currency need to be judged against this central objective. To make this assessment, Gordon Brown set out the following "five economic tests" which are the conditions that have to be met before Britain enters:

- a. Are business cycles and economic structures compatible so that we [British] and others could live comfortably with euro interest rates on a permanent basis?
- b. If problems emerge, is there sufficient flexibility to deal with them?
- c. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- d. What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- e. In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?<sup>4</sup>

Figure 2-1EURO-US-UK EXCHANGE RATE



Source: ECB Monthly Bulletin

The first two of the tests concern the theory of Optimum Currency Areas, reviewed below in section 3. The rest of the tests do not belong to any other particular framework of economical analysis.<sup>5</sup> As is often mentioned, the issue of UK entry in EMU is critical to inward investment but it is difficult to evaluate the overall effect on investment and employment in the UK.

On the basis of these five tests, the report examines the current state of the UK economy and concludes that neither flexibility nor convergence are sufficient to make joining EMU in the near future desirable.

### ***The birth of EMU in 1999 and depreciation of euro***

On 1 January 1999, the single European currency “euro” was introduced implementing the single monetary policy of the European Central Bank (ECB). This was the actual beginning of EMU. Euroland’s economy has been relatively sound since but the euro has depreciated against the dollar as well as the sterling and the yen (figure 2–1). From the UK’s point of view, this means the sterling has appreciated against the euro resulting in the loss of competitiveness of UK industry.

### ***Significance of British public opinion***

One of the primary reasons why the UK has not joined the EMU is the strong public antipathy towards a federal Europe. It is worth scrutinizing this hostility. In his study of EMU and European integration, John Curtice observes British sentiments by looking at several surveys: the 1998 Social and Community Planning Research (SCPR) British Social Attitudes (BSA) survey showed that more than half of those surveyed wanted to “keep the pound as the only currency for Britain,” although the ratio had decreased from previous surveys.<sup>6</sup> In contrast, less than 20 percent wanted to “replace the pound by a single currency.” A noticeable drop in support of EU membership was apparent in 1993 and 1996 after unfavorable publicity in the UK. The result in 1993 was taken six months after the September 1992 withdrawal from the ERM and in 1996, in the aftermath of the ban on British beef on the continent because of the bovine spongiform encephalopathy (BSE) crisis.

Although a vigorous study should not rely on the result of one survey alone, other surveys confirm this result. In a MORI (Market & Opinion Research International) poll, the ratio of people who were in favor on “if there were a referendum now on whether Britain should be part of a single currency” decreased from 1996 to 1997, but the ratio of the people who were against increased. After 1997, the ratio of those “in favor” increased to 30 percent, whilst the ratio of those against decreased to 50 percent. It is reasonable to suppose that positive news from Europe could reduce the aversion to the EMU.

Another survey by the European Commission in the spring of 2001 revealed that although there had been an overall fall, anti-EMU sentiment still hovered at nearly 60 percent and in contrast, the ratio of pro-EMU had increased but still only at 25 percent. The irrefutable conclusion is that more than half the British population are still against EMU.<sup>7</sup>

After the introduction of the banknotes and coins of the euro on 1 January 2002, a MORI survey<sup>8</sup> taken between 17 and 22 January shows the ratio of those “in favor” increased to 33 percent from 26 percent of the previous poll in October 2001 and those “against” decreased to

51 percent from 57 percent of the previous poll. After the introduction of the EMU the support for European integration fell but this has now risen back to the January 1999 level. While it is too early to judge the trend of opinion by this poll now, this result suggests that the introduction of banknotes and coins of the euro may change British opinion of the EMU.

### ***UK in Europe***

In his speech on “Britain’s role in Europe” to the European Research Institute at Birmingham University on 23 November 2001,<sup>9</sup> Tony Blair, the British prime minister, stated, “most of this [EU] market of 380 million people has a common currency...if the economic tests are met, political or constitutional barriers should not prevent us [from] joining,” giving an indication of his strong support for participation in EMU.

The majority of the British public had been hostile to the EMU when it was launched in 1999. Thus, the implications of making the euro legal tender in the UK has an important impact on UK entry in EMU.

## **3. Economics of UK joining EMU**

### ***Economics of the EMU—theory of the Optimum Currency Areas***

There have been many economic studies on joining EMU,<sup>10</sup> the most popular being the theory of Optimum Currency Areas (OCA) which was developed by Robert Mundell<sup>11</sup> and examined by others. Generally speaking, the OCA theory focuses on the costs and benefits of adopting a common currency in a specified area. If the gains from lower transaction costs, exchange risk, and greater price transparency surpass the additional costs of adjusting to asymmetric shocks and out-of-sync business cycles incurred by the loss of monetary and exchange rate policy instruments, participating countries will make up an OCA.

Critics of the OCA theory point out that a short term nominal depreciation may not always be consistent with long term real depreciation.<sup>12</sup> International financial mobility existed before the OCA theory had been developed and thus, monetary and exchange rate policies may not always adjust asymmetric shocks as traditional OCA theory would suggest. These criticisms go against the costs analysis of the OCA theory and give rise to the positive side of joining EMU.

### ***Costs and benefits of UK joining EMU***

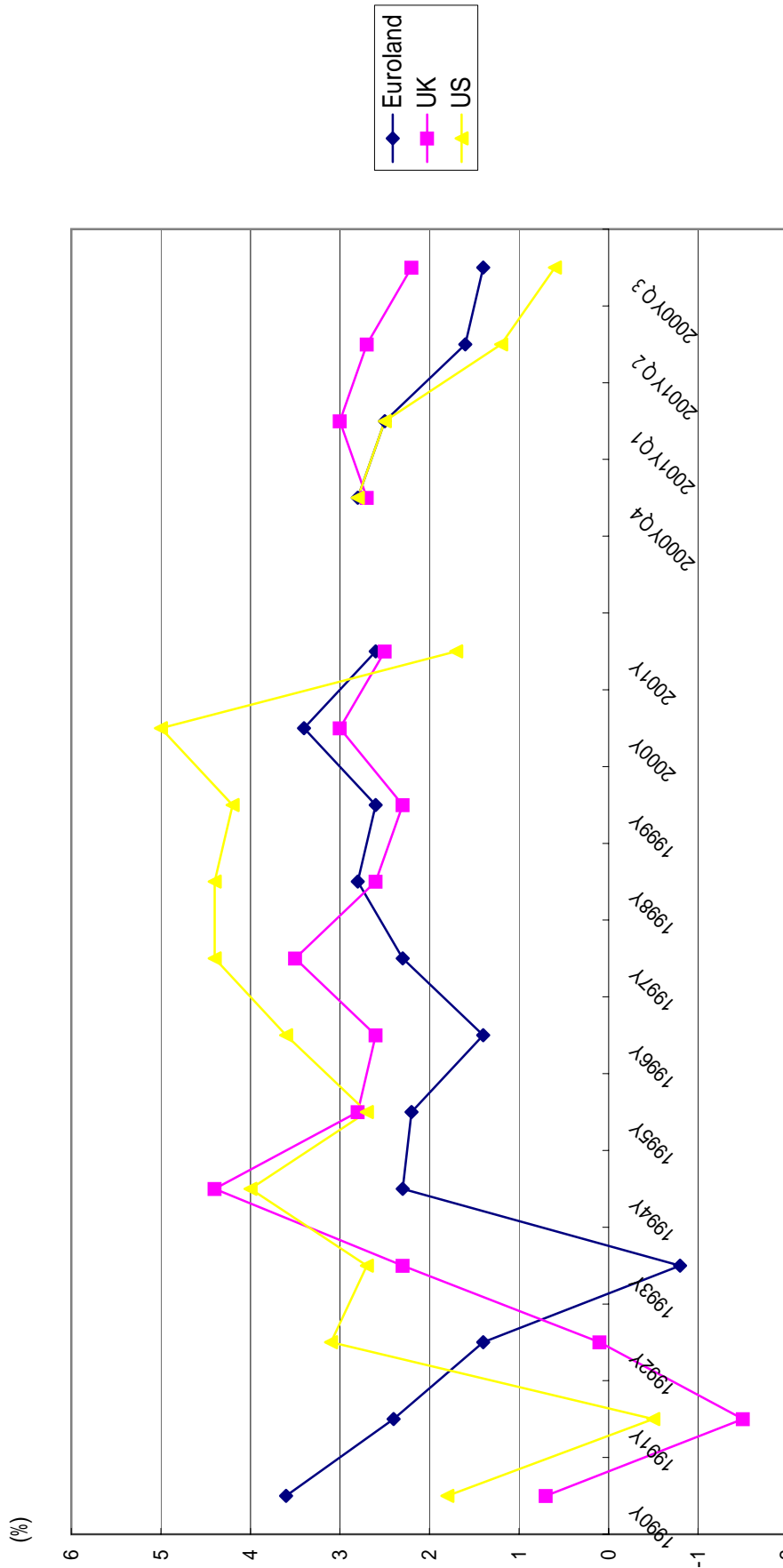
There are many studies on the pros and cons of joining EMU including on British participation,<sup>13</sup> but few empirical studies have focused exclusively on the UK .

According to European Commission estimates, overall transaction costs are predicted to be around 0.5 percent of GDP—a benefit of eliminating direct transaction costs.<sup>14</sup> This advantage may be less for the UK than that for the other 12 members, however, as the latter already have fixed currencies.<sup>15</sup>

In the long term, the elimination of exchange rate risk and transaction costs should lead to increased investment and growth. In the same study, the EC also estimates that there could be a substantial growth offered over the long run, accounting to perhaps 5 percent of GDP if EMU reduces the risk premium.<sup>16</sup> The benefits to the UK may be greater due to the big impact inward investment has on her economy.<sup>17</sup>



Figure 4-1 Euroland-UK-US Growth Rate



Source: Annual; OECD Economic Outlook 69, June 2001  
 Quarterly; Eurostat News Release No6/2002  
 (compared to the previous year)

Table 4-2 UK-Euroland-US Business Cycles

(Correlation Coefficient)

| Authors                         | Sample Period                             | Intra-Euroland     | UK-Euro land                   | UK-US                | Cycles     |
|---------------------------------|---|--------------------|--------------------------------|----------------------|------------|
| Angeloni and Delola 1999        | 79/2Q-85/4Q<br>86/1Q-92/4Q<br>93/1Q-97/1Q | 0.91(a)            | 0.55(c)<br>-0.46(c)<br>0.76(c) | 0.42<br>0.76<br>0.64 | GDP        |
| Artis 2000                      | 65/05-79/03<br>79/03-97/06                |                    | 0.64(c)<br>0.16(c)             | 0.75<br>0.35         | IP         |
| Backus and Kehoe 1992           | 50-83                                     |                    | 0.40(c)                        | 0.48                 | GDP        |
| Bayoumi and Eichengreen 1993    | 65-86                                     | 0.54(a)<br>0.35(a) | 0.11(c)<br>0.16(c)             |                      | (f)<br>(g) |
| Christodoulakis and others 1995 | 60-90                                     | 0.78(a)            | 0.50(c)                        |                      | GDP        |
| Danthine and Donaldson 1993     | 57/1Q-89/Q2                               | 0.61(a)            | 0.33(d)                        | 0.45                 | GDP        |
| Antoio Fatas 1998               | 61-96<br>79-96                            | 0.66(b)<br>0.56(b) | 0.43(e)<br>0.25(e)             |                      | GDP        |
| Imbs 2000                       | 59/Q1-93/Q4                               |                    | 0.40(c)                        | 0.52                 | GDP        |
| Kontolemis and Samiei 2000      | 60/Q1-97/Q4                               | 0.48(a)            | 0.38(d)                        | 0.58                 | GDP        |
| Wynne and Koo 2000              | 63-92                                     | 0.64(a)            | 0.45(c)                        | 0.67                 | GDP        |

## Remarks

## 1. Intra-Euroland

- (a) France-Germany
- (b) Average EU15 aggregate

## 2. UK-Euroland

- (c) UK-Gerrmany
- (d) UK-Euro11
- (e) UK-EU15 aggregate

## 3. Cycle

GDP: Gross Domestic Products

IP: Industrial Production

(f) Correlation coefficients measuring the association of supply shocks in Germany

(g) Correlation coefficients measuring the association of demand shocks in Germany

On the downside, empirical studies suggest that there is less labor mobility and fiscal transfer in Europe than in the US.<sup>18</sup> These results are often cited as examples of the costs of joining EMU—that Europe has few methods of dealing with asymmetric shocks without an adjustment in the exchange rate. These arguments back up the criticisms of OCA theory mentioned above.

As the business cycles of the UK and Euroland are not synchronized, it may be difficult to apply the single monetary policy on the British economy, which is another example of the cost of joining EMU. On the other hand, experts have pointed out that the ERM helped to convert the economies of other member countries. Thus, they argue that monetary union will synchronize business cycles because a single monetary policy will reduce the divergences caused by different monetary policies.<sup>19</sup> The Stability and Growth Pact (SGP), which restricts the fiscal policy of member countries, may also contribute to bring about this effect. In addition, Frankel and Rose argue that monetary union could promote trade and investment, and thus further economic integration.<sup>20</sup> They estimate that joining the EMU could increase the UK's GDP by 20 percent in the long term.<sup>21</sup> These arguments support the notion that in the long term, the benefits of joining EMU offset the costs.

The more integrated the economy, the easier it is to manage a single monetary policy and diminish the costs of joining EMU.

## **4. UK business cycles and the Trade Intensity Index**

### ***Business cycles***

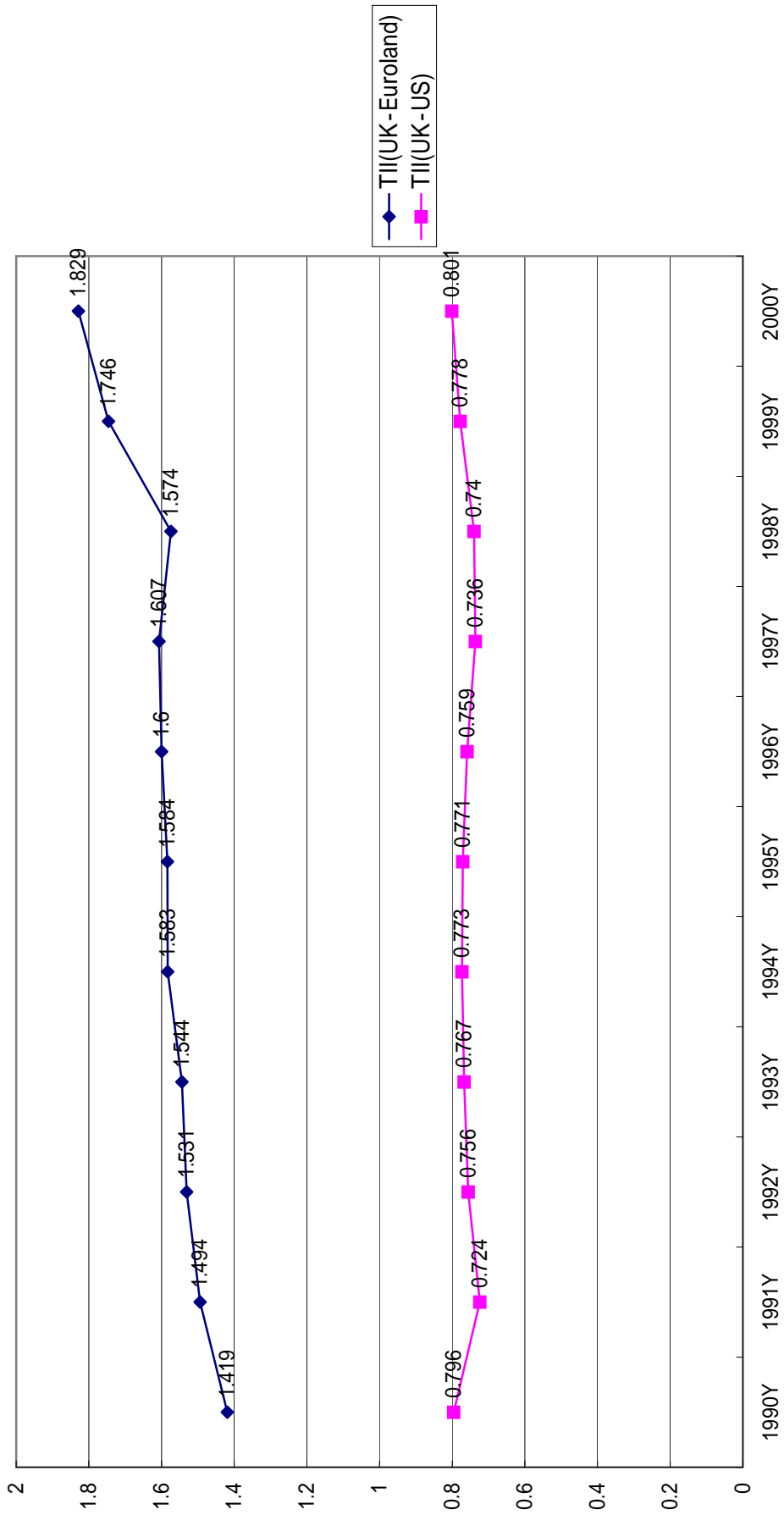
It is necessary to determine whether the correlation of business cycles between the UK and Euroland is critical to UK membership. Figure 4–1 shows the growth rate of real GDP in Euroland, the UK and the US. On first glance, the UK business cycle appears to have gradually converged to that of Euroland on an annual basis but in reality, as quarterly data does not sufficiently reflect the convergence, it is difficult to evaluate the correlation of business cycles using graphs. Thus, econometric research is necessary.

As can be seen in table 4–2, there are many studies on the business cycles between the UK and Euroland (continental countries) but not many on the correlation of their business cycles. Thus, the correlation between UK and Germany has been substituted for most cases in this table.

Although the sample period differs in all these studies and their purpose is not an evaluation of EMU, they do suggest that the correlation of business cycles between the UK and Euroland is not strong. Some show that the correlation of business cycles between the UK and Euroland is less than even that between the UK and the US.

Most of these studies were taken before the mid 1990's and the results may not include the effects of the Single Market Program, which was completed in the early 1990's. Angeloni and Delola's paper, based on estimates from 1993 to 1997, shows interestingly that the correlation of business cycles between the UK and Euroland (Germany) could increase.<sup>23</sup> As a refined estimate of business cycles may need longer sample periods for technical reasons, more research is clearly necessary.

Figure 4-3 Trade Intensity Index (UK-Euroland & US)



Source: IMF Direction of Trade Statistics Yearbook  
 Remarks: Euroland=12Euroland countries

### **Trade Intensity Index from UK to Euroland**

I estimate the trend of the Trade Intensity Index (TII), to evaluate the progress of economic integration between the UK and Euroland. The TII according to the Anderson and Norheim<sup>24</sup> definition could be described as:

$$TII = \frac{QAB^x / QAW^x}{QB^m / W^m}$$

Where  $QAB^x$  = share of country (or country group) A's exports going to country (or country group) B  
 $QAW^x$  = share of country (or country group) A's exports to the world  
 $QB^m$  = country B's total imports  
 $W^m$  = total world imports (net of country A's imports, since A cannot export to itself).

The TII is used as an indicator of the closeness of trade between countries. A high level of TII of country (or country group) A to country (or country group) B indicates a greater closeness between the two economies.

Figure 4–3 shows the TII from the UK to Euroland and the US. A comparison of the level of the TII *per se* in and of itself, is not important, but what is more relevant is the trend—whether it is increasing or decreasing. A careful assessment of the TII is needed because it could be affected by movements in the exchange rate, figure 4-3 shows that the trend of the TII from the UK to Euroland has been increasing whilst that from the UK to the US shows little change.

While economic integration should be assessed from various points and to just use the Trade Intensity Index is risky, this result suggests that in the last decade the economy of the UK has gradually converged to that of Euroland. It also gives a positive spin on UK joining EMU. More research is needed to evaluate a sufficient level of convergence between UK and Euroland to join EMU.

## **5. Conclusion**

While the circulation of banknotes and coins of the euro began on 1 January 2002, the European experiment with the EMU has not finished. The crucial issue which still looms large is the participation of the “outsiders:” whether those who are not in EMU such as the UK will join.

As may not have been obvious from the concentration on economic issues, EMU is not only an economic project but also a political one. Nevertheless, the economic issue of UK membership cannot be ignored. If the benefits of joining EMU exceed the costs, the UK should join. While most empirical studies focus on the negative results of joining EMU, there are some signs that the UK economy has become more integrated than before. More research on this subject is necessary.

Whether the hostile public perception will change after circulation of the euro is another factor determining entry into EMU.

## Notes

- \* The views expressed in this paper are those of the author and do not necessarily reflect those of the Institute for International Policy Studies or any other organization.
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