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The UK and Euroland -  
Ships passing in the night  
*IoD Economic Policy Paper*

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Graeme Leach

**This policy paper was written by Graeme Leach, Chief Economist. It was produced by Lucy Chard.**

**September 2000**

**ISBN 1 901580 458**

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Published by the Institute of Directors  
116 Pall Mall, London SW1Y 5ED.**

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**Director Publications  
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116 Pall Mall  
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# Summary

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- This paper explains why economic forces may yet stand in the way of UK participation in the euro. It shows that sustainable, as opposed to transient convergence, is a long way off.
- The IoD argues that economies can appear to be converged in much the same way as 'ships pass in the night'. Economies can at any point in time display similar rates of output growth, inflation or interest rates, but this tells us nothing about their future speed or direction.
- OECD estimates show the UK's output gap converging with Euroland's in 2001. This is shown to be the result of transient convergence because of divergence in monetary policy - higher interest rates and a high pound against the euro.
- A simple conceptual model is developed to show that sustainable convergence is not possible without convergence in:
  - (1) The structural unemployment rate or NAIRU - the unemployment rate at which inflationary pressures emerge.
  - (2) The monetary policy transmission mechanism - the response of consumers and companies to interest rate changes.
- Both (1) and (2) are crucial for sustainable convergence. For example, even if two countries had the same rates of structural unemployment, economic problems would emerge if they had different transmission mechanisms - the obvious example being where one country had a large exposure to variable rate debt and the other to fixed rate debt. Alternatively, even if the two countries had the same transmission mechanism, it could engage at different times or speeds if their structural unemployment rates differed. Inflationary pressures would emerge earlier in the economic cycle - and interest rates would need to rise - for the country with the higher structural unemployment rate.
- Euro participation and deeper EU integration risk higher structural unemployment and a lower GDP growth rate for the UK economy in the future.
- The UK has a significantly different monetary policy transmission mechanism to that of our key EU partners. This finding is based on single and multi-country econometric modelling, together with available evidence regarding the proportion of debt at variable versus fixed interest rates. The case against this view is based on a very small number of studies with empirical difficulties, with results highly sensitive to initial conditions.

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- The view that participation in the euro will bring about ex-post convergence is weakened by the impact of different legal systems on financial structure – for as long as the legal systems of EU countries differ, then so too might the impact of ECB interest rate changes.
  - Ex-post convergence may arise as a result of price convergence. However, thus far the evidence points towards price divergence as a result of the inappropriate one size fits all monetary policy being applied in countries such as Ireland. Since the introduction of the euro the UK has transformed from having an HICP inflation rate (EU harmonised index of consumer prices) double that in Euroland to one that is now less than half the Euroland rate and the lowest in the EU.
  - During the 1990s, prior to the start of the euro, the UK had a negative GDP correlation coefficient with Euroland. In other words, when the UK needed lower interest rates, Euroland needed higher interest rates - and vice versa.
  - Euro participation is not the solution to an overvalued sterling/euro exchange rate. Even if interest rates were to fall prior to joining the euro, there is no guarantee the exchange rate would reverse the appreciation of recent years. Participation could mean joining at an irrevocably fixed overvalued rate.
  - IoD estimates of the cumulative output gap suggest that if the UK had pursued a monetary policy appropriate to Euroland there would have been a reduction in potential output of at least £50 billion between 1992 and 1999. Euro participation risks more, not less volatility in the UK economic cycle.
  - EMU is ultimately a political project. Even if there was evidence of economic convergence, the decision as to whether to hold a referendum would depend on the strength of public opposition/support as measured in opinion polls. There is no evidence of any political convergence in support for the euro between the UK and other EU countries.
  - There is no guarantee that a long term strategy of adopting a ‘wait and see’ approach will result in a yes vote via ‘euro-creep’. Future UK political support is likely to diverge further as a result of the income tax rises required to maintain generational balance in the fiscal position of EU countries, though this is some years off and not in the immediate future. In other words, the electorate is likely to connect future monetary and fiscal policy harmonisation – with the former hastening the latter – as the price of euro participation.
  - The IoD’s proposed ‘**Convergence Contract**’ (CC) with the British people is reproduced in Annex 1. It shows that the only sensible way the UK economy can converge with Euroland is if Euroland itself changes towards an Anglo-American style system. This is highly unlikely to happen and explains why the IoD says the UK should stay outside the euro for the foreseeable future.

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# 1 Introduction

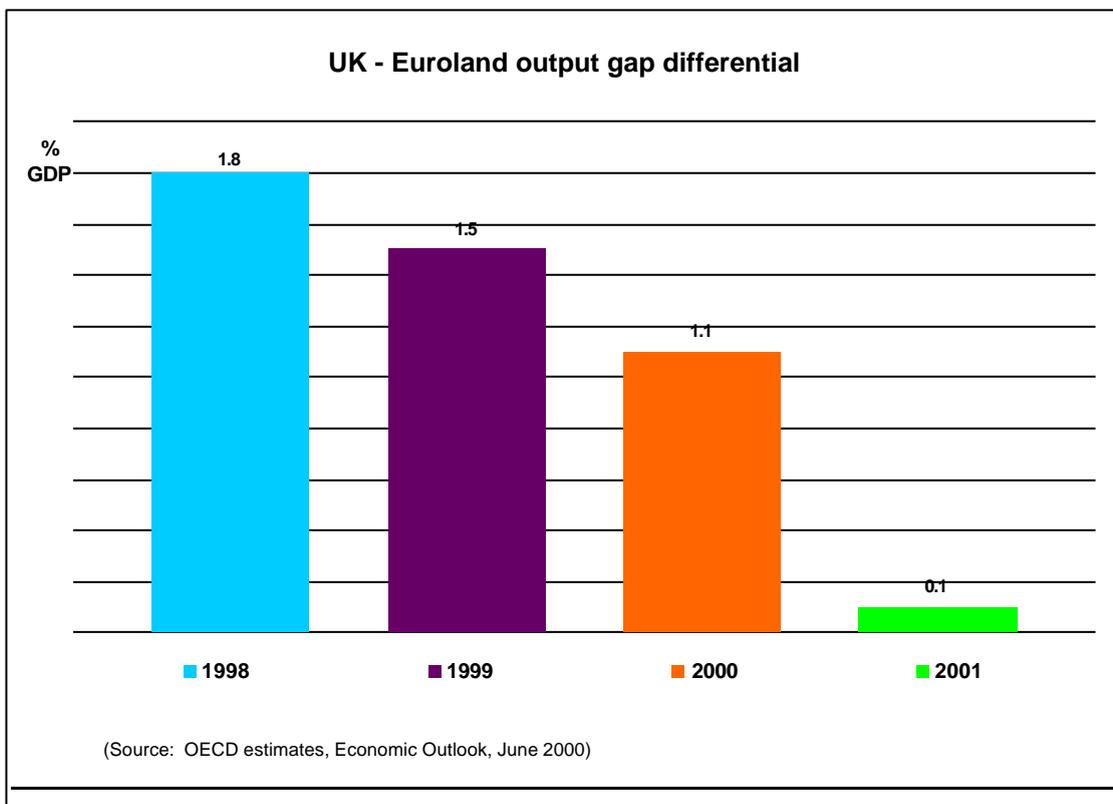
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*The Economist* has described the controversy over UK convergence with Euroland as “**the debate that will not die**”. The Government has stated that it will not consider joining the euro until the five economic tests (FET) have been satisfied. Any assessment of the FET is likely to follow the next General Election and to take place against the backdrop of a convergence in output gaps between the UK and Euroland. Recent projections from the OECD (*OECD Economic Outlook*, No. 67, June 2000) show the output gap differential falling to zero in 2001.

The received wisdom regarding the FET has been well summarised by David Walton of Goldman Sachs. Walton has stated that (*Financial Times*, 21<sup>st</sup> June 2000),

**“the Treasury can do some analysis but this is still a very political question ... these economic tests will provide a bit of cover: if the politics are not right then the Government can hide behind the economics. But if the politics are right, then the economics won’t stand in the way”.**

Figure 1.1



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This paper explains why economic forces may yet stand in the way of UK participation in the euro. It shows that sustainable, as opposed to transient convergence, is a long way off.

The IMF has supported the wait and see approach of the Government, arguing that it will take time to see whether concerns over economic convergence and wage flexibility can be met. The IMF state (*World Economic Outlook*, March 2000) that,

***“an over-riding case for or against entry could not be made at the present time”***

The IoD takes issue with this claim, arguing that an over-riding case against entry can be made at the present time.

## The five economic tests

To recap, the FET as set out by HM Treasury (*UK Membership of the Single Currency – An Assessment of the Five Economic Tests*, HMT, October 1997) are:

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

If one reads the HM Treasury report on the FET the scepticism of the most powerful department in Whitehall is all too clear. HM Treasury states very clearly that temporary convergence is insufficient and that there should be a ***“period of stability”***. Without convergence, HM Treasury states that the ***“resulting turbulence could cause considerable damage”*** and the UK economy needs to have displayed ***“sustainable convergence”***.

The language and tone of the October 1997 report on the FET strongly suggests that HMT caution regarding UK participation in the near term remains firm. Moreover, strong opposition can be found in Threadneedle Street as well.

The Governor of the Bank of England, Sir Eddie George, commented on his relief that Britain had not joined EMU in January 1999 because,

***“we could have been the elephant in the rowing boat”***.

Sir Eddie George went on to state that,

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***“if we had joined EMU from the start ... it is very difficult to envisage how we would have avoided another inflationary boom in this country”.***

More recently (*Financial Times*, 24<sup>th</sup> July 2000) the Governor has challenged the view of the ECB President that there is a ‘window of opportunity’ to join the euro. George stated that,

***“we must put the emphasis on sustainability rather than transient opportunity”.***

The emphasis on sustainable convergence reflects the fact that economies can appear to be converged in much the same way as ‘ships pass in the night’. In other words, economies can at any point in time display similar rates of output growth, inflation or interest rates, but this tells us nothing about the future direction and speed they are heading.

The House of Commons Treasury Select Committee 8<sup>th</sup> Report (July 2000), to which Ruth Lea, Head of the IoD Policy Unit, gave evidence, states that,

***“our witnesses agreed that sustainable convergence is the most critical of the five tests and that it should be more than a short term cyclical coincidence”.***

## **What is convergence?**

The standard dictionary definition of convergence is ‘to move towards’, but how a country moves towards in an economic sense is far less transparent. This lack of clarity and precise definition is apparent in the way in which ECB President Wim Duisenberg has been able to engineer a flip-flop in his views regarding UK convergence.

In a BBC Money Programme interview in early 2000 he stated,

***“if ever the UK were to decide to join, you are talking about a moment in time which is years from today, well it has to be, one of the pre-requisites for joining monetary union is to have demonstrated that your economic performance has converged [with the euro area]”.***

However, by June 2000 the ECB President had shifted his view (*Financial Times* 21<sup>st</sup> June 2000), stating that there was a window of opportunity and that,

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***“UK economic conditions in terms of inflation, in terms of budgetary policy, in terms of interest rates, more and more point in the direction of the UK joining forces with the euro area”.***

## **Which convergence test is best?**

The House of Commons Treasury Select Committee 8<sup>th</sup> Report (July 2000) has reported that,

***“there is broad agreement that the UK meets all the Maastricht criteria, bar that of exchange rate stability”.***

Nevertheless, what matters in the UK context is what the Government has decided will be the criteria for entry, namely the FET. As we show below, the concern of the IoD is that until there is far greater convergence in monetary policy transmission mechanisms, together with structural or natural rates of unemployment (the NAIRU), any convergence can only be seen as ephemeral.

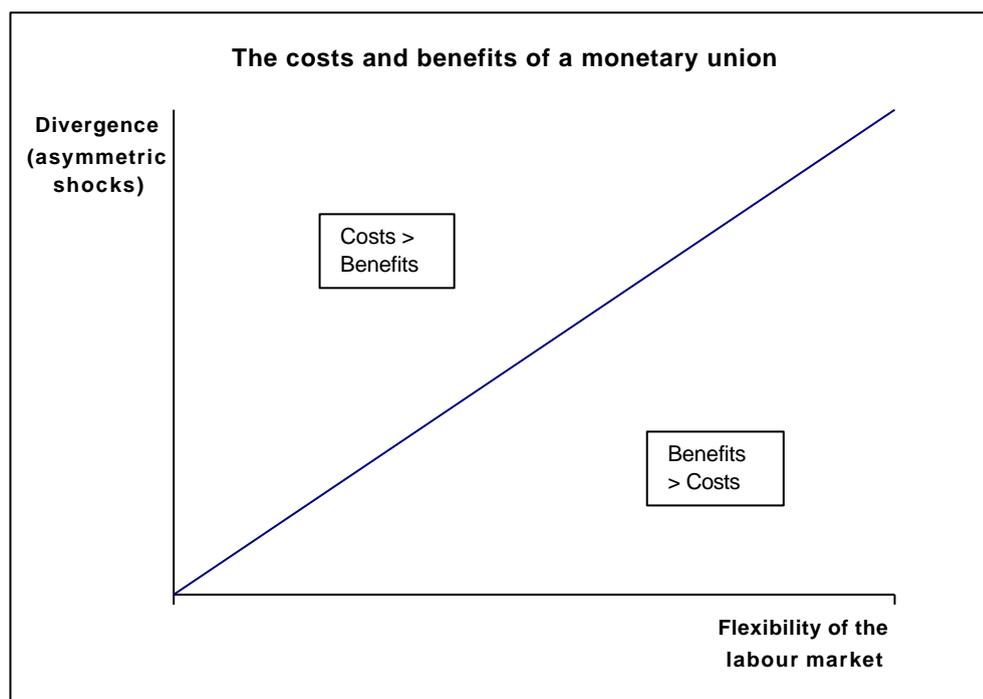
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## 2 Why sustainable convergence is crucial

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The costs and benefits of a monetary union are illustrated by the conceptual figure below. Real divergence is shown on one axis (the extent to which countries face asymmetric shocks) whilst the adjustment mechanism is shown on the horizontal axis. In simple terms, the more flexible the economy is, the less costly is the loss of national monetary policy. This paper aims to show that the UK economy is positioned above the line i.e. there are likely to be frequent asymmetric shocks. Moreover, deeper economic integration is likely to weaken the adjustment mechanisms by increasing labour market inflexibility.

Figure 2.1



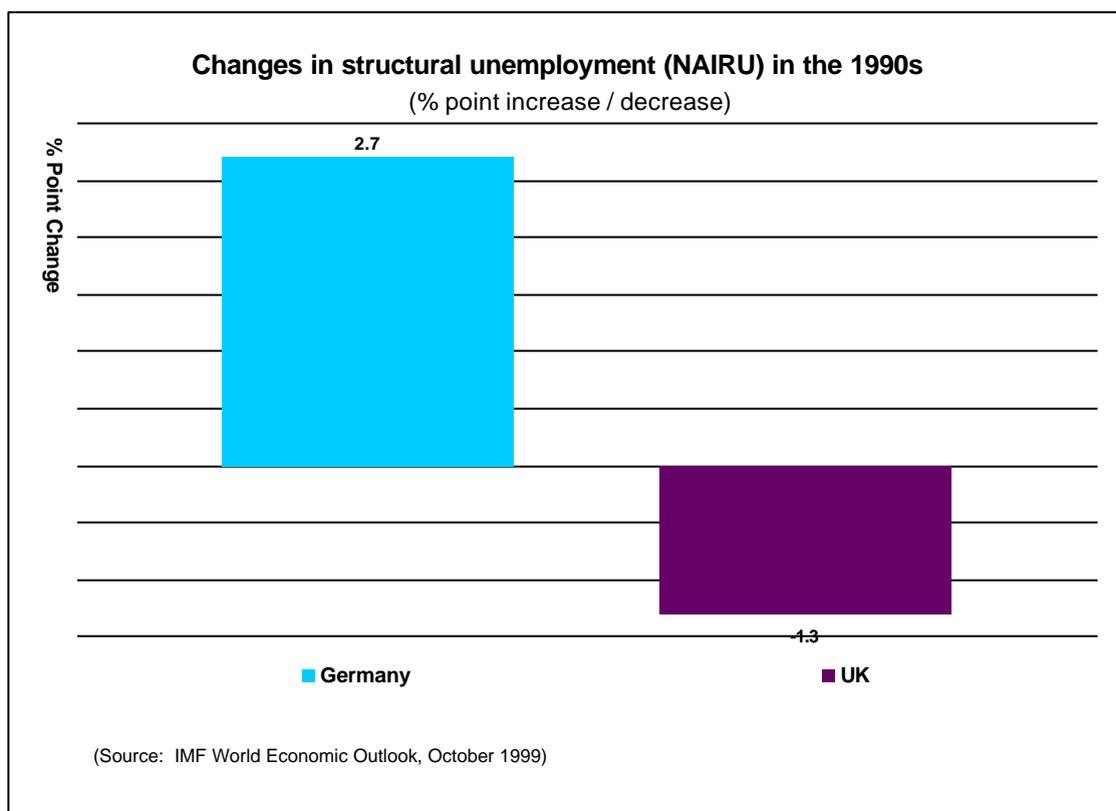
The first two economic tests which are concerned with economic cycles, structures and flexibility can be examined within the context of:

- The NAIRU (non-accelerating inflation rate of unemployment)
- The monetary policy transmission mechanism.

Both considerations are important in order to have an effective economic policy. For example, even if two countries were to have the same NAIRU, economic problems would still emerge if they had profoundly different transmission mechanisms in monetary policy - the obvious example being where one country had a large exposure to fixed rate debt whereas the other country was far more exposed to variable rate debt.

Alternatively, even if the two countries had the same transmission mechanism, it could engage at different times or speeds if their NAIRU differed. Inflationary pressures would emerge earlier in the economic cycle - and interest rates would need to rise - for the country with the higher NAIRU.

Figure 2.2



## The NAIRU

If different economies have a different NAIRU then inflationary pressures will emerge at different stages in the economic cycle – sooner or later depending on whether the NAIRU is higher or lower in the countries concerned.

Whilst the NAIRU has fallen during the 1990s in the UK, in the EU it has increased over the same period. Figure 2.2 shows IMF estimates that structural (NAIRU) unemployment fell by 1.3 percentage points in the UK in the 1990s whereas it rose by 2.7 percentage points in Germany over the same period.

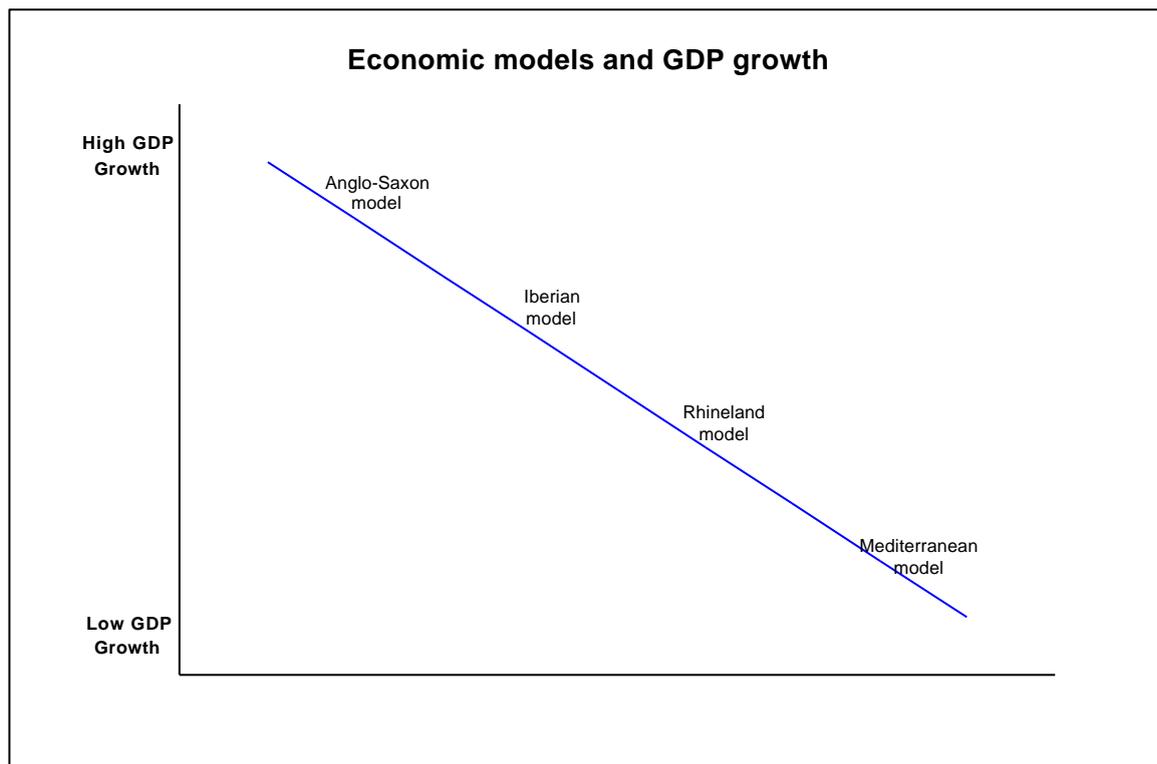
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A significant part of the explanation of different NAIRU estimates is the different labour and product market regulatory structures across the EU.

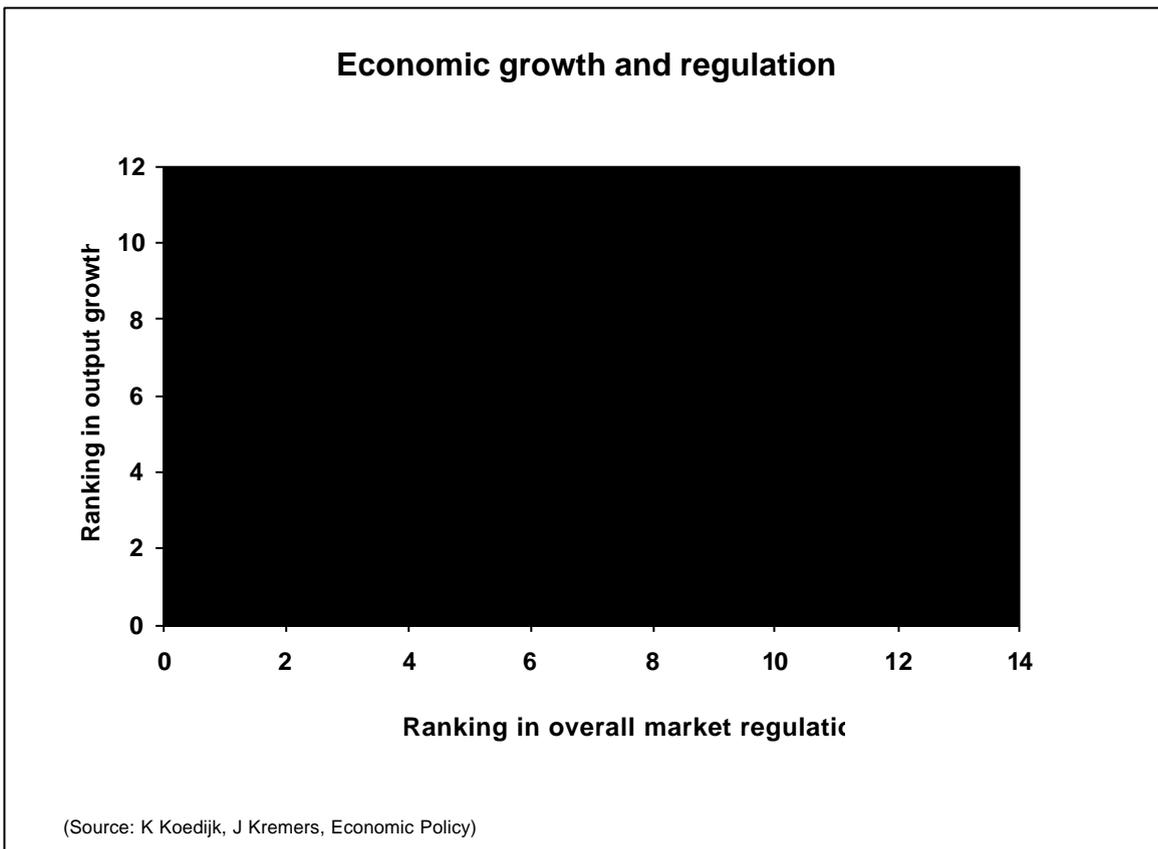
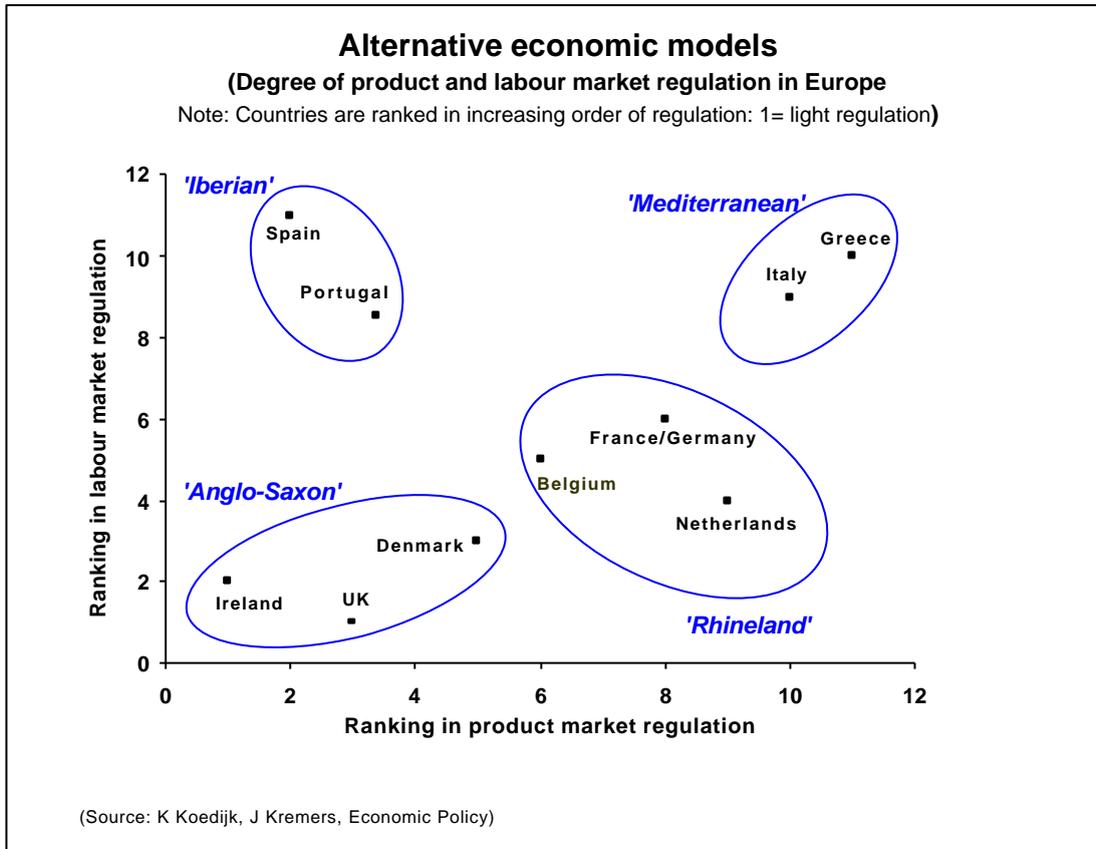
Research (*Market Opening Regulation and Growth*, K Koedijk and J Kremers, Economic Policy 23, October 1996) shows a powerful link between the degree of regulation in the economy and growth in output. Over recent decades de-regulation in the Anglo-Saxon economies has not been matched in the EU economies. The work of Koedijk and Kremers shows the UK has a high ranking – light regulation – in both product and labour markets. Koedijk and Kremers show there is a strong link between the degree of regulation and economic performance. Cluster analysis shows the alternative economic models in terms of their regulatory burden – Anglo-Saxon, Iberian, Rhineland and Mediterranean (see Figures 2.4 and 2.5).

These alternative models can also be grouped by GDP growth, with the least regulated economies displaying the fastest economic growth – and the smallest output gaps. Euro participation and deeper economic integration risks a higher NAIRU and lower GDP growth rate for the UK economy in the future.

Figure 2.3



Figures 2.4 and 2.5



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## Transmission mechanism

The importance of the monetary policy transmission mechanism can be seen in the various ways in which it can impact on an economy:

- An increase/decrease in interest rates leads directly to a decrease/increase in consumption and investment.
- An interest rate adjustment leads indirectly to a change in consumption via wealth effects emanating from equity and property markets – in accordance with the life cycle hypothesis of consumption.
- An interest rate adjustment leads indirectly to a change in investment via Tobin's Q – higher equity prices increase the value of Q (the ratio of a firm's market value to the replacement cost of capital) and make it easier to issue equity to finance investment.
- An interest rate adjustment leads to a movement in the exchange rate which changes the balance between domestic demand and imports.
- Interest rate movements alter the disposable (wages and income from saving) and discretionary (available income for spending after paying for mortgages and borrowing) income of consumers.
- Interest rate movements impact differentially depending on the proportion of liabilities and assets at fixed or variable rates of interest.
- Interest rate movements impact differentially depending on holdings of equities and bonds by consumers.
- Interest rate movements impact differentially depending on the population profile and generational holdings of saving and borrowing.

There is a considerable economic literature showing that interest rate movements have a different impact on the UK economy from Euroland. For example, Oxford Economic Forecasting model simulations (reported in *Strainspotting* HSBC James Capel Economics, November 1997),

***“show that the impact on UK GDP [from a rise in interest rates] is considerably higher than for other EU countries”.***

The CEPR, in reporting a number of studies (*The Ostrich and the EMU – policy choices facing the UK*, CEPR 1997) have reported that,

***“a country where changes in interest rates have effects similar to those in other EMU members will be a country that has less difficulty in living with a common monetary policy. The transmission***

*mechanism of monetary policy in the UK is however, far from average... unless UK balance sheets become more European, inside EMU, the UK would be more sensitive to changes in short term interest rates”.*

Figure 2.6

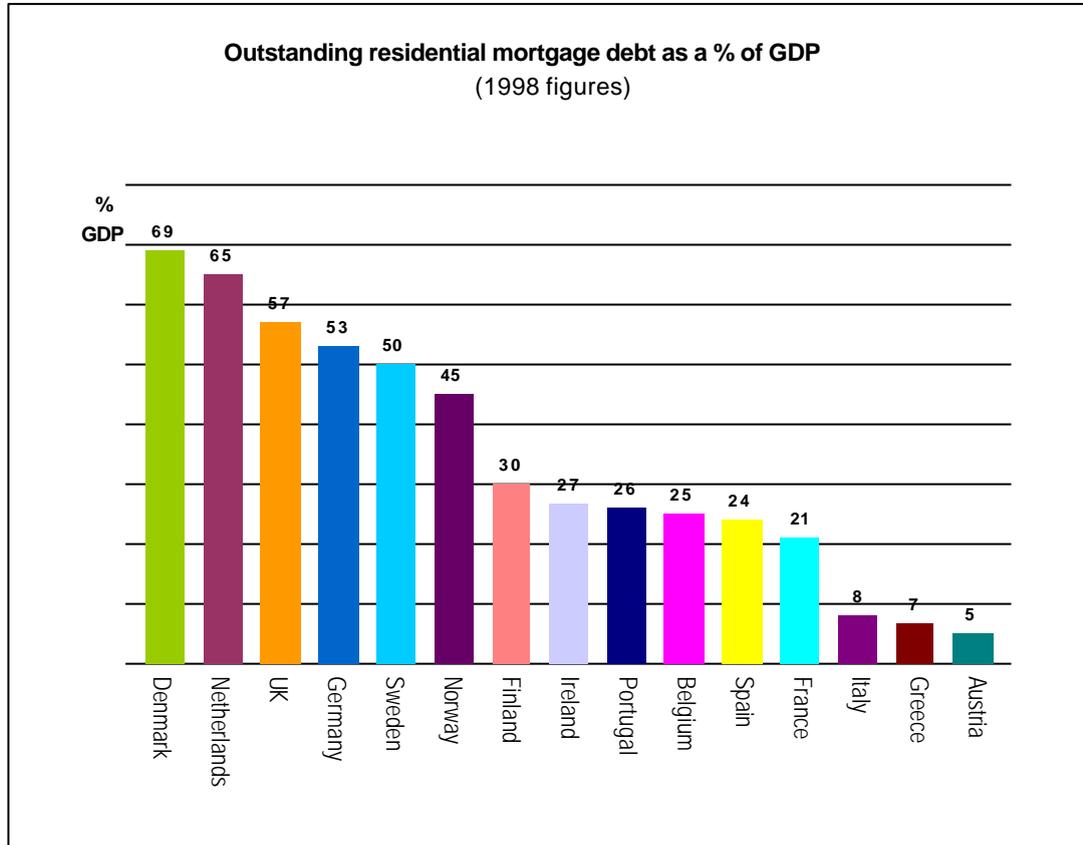
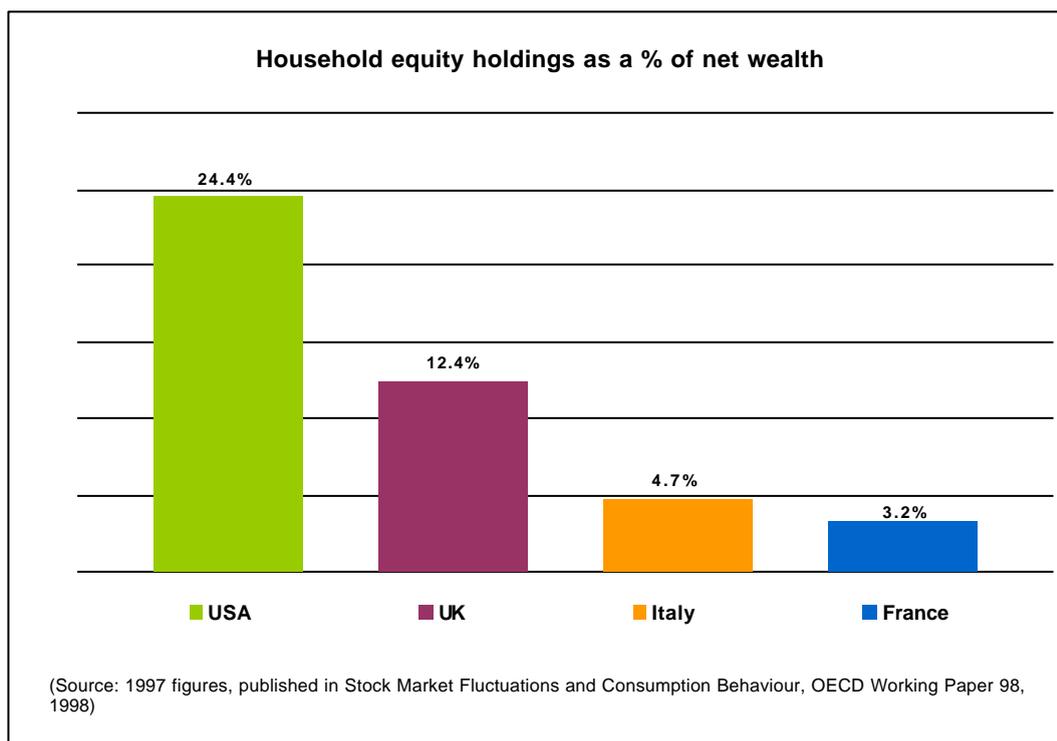


Figure 2.7



Recent research (*Asymmetries in housing and financial institutions and EMU*, Maclennan, Muellbauer and Stephens, Oxford Review of Economic Policy, Autumn 1998) analysed the contrasting nature of the UK housing market and how institutional characteristics influence asset prices and thereby produce,

***“substantially different responses to both interest rate changes and to world wide equity price changes”.***

Despite these findings, the empirical evidence is also characterised by other results which seem to make the picture less clear. Table 2.1 summarises the empirical evidence of the impact on output of changes in monetary policy. The findings for single and multi-country models do suggest significant differences for the UK economy. However, the findings from small structural, reduced form and VAR models tend to suggest that interest rate effects are weakest in the UK. This surprise finding suggests we should treat these results with caution. Maclennan et al state that,

***“simulations with large macromodels show large interest rate effects on output in the UK, consistent with economic reasoning The fact that research using VAR methodology has arrived at less conclusive results has persuaded some economists that these are minor issues ... however, research using VARs is seriously flawed”.***

Table 2.1

<b><u>The impact of monetary policy on output</u></b>				
<b>Study</b>	<b>France</b>	<b>Germany</b>	<b>Italy</b>	<b>UK</b>
Single Country Models (BIS, 1995)	-0.4	-0.4	-0.4	-0.9
Fed's Multi-country macro model: (BIS, 1995)	-0.7	-0.7	-0.3	-1.2
Small Structural Model (Britton and Whitley, 1997)	-0.5	-0.5	-	-0.3
Reduced form models (Dornbusch et al 1998, Cecchetti 1999)	-1.5 -1.3	-1.4 -1.2	-2.1 -0.6	-0.9 -0.5
Structural VAR model (Gerlach and Smeth, 1995)	-0.5	-1	-0.5	-0.7

(Source: Table 6.2, European Monetary and Fiscal Policy, CW Eiffinger and J De Haan, OUP, 2000)

The limitations of VAR modelling have also been highlighted by the European Commission (*Economic Policy in the EU – A study by the European Commission Services*, OUP 1998).

The thesis that the UK has a significantly different monetary policy transmission mechanism is therefore based on single and multi-country econometric modelling together with available evidence regarding the proportion of debt at variable versus fixed interest rates. The case against is based on a very small number of studies with serious empirical deficiencies, with results highly sensitive to initial conditions.

Table 2.2 shows that there are significant variations across the EU in the proportion of credit at adjustable interest rates, ranging from 25% in the Netherlands to 74% in Austria. With reference to households alone, the UK is far and away at the top of the league with 90% of borrowing at variable rates. UK consumers also have the highest proportion of household sector liabilities – as a % of disposable income – in the EU. Liabilities account for 111% of disposable income in the UK, compared with 79% in Germany, 75% in France and only 28% in Italy (*OECD Economic Outlook*, annex table 58, June 2000).

Table 2.2

<b>Credit at adjustable interest rates in the EU</b>			
(percentage of total credit)			
<b>Country</b>	<b>All Sectors</b>	<b>Households</b>	<b>Firms</b>
Austria	74	-	-
Belgium	44	18	67
Germany	39	36	40
France	44	13	56
Italy	73	56/59	77
Netherlands	25	8	37
Spain	43/64	-	-
Sweden	35	-	-
UK	73	90	48

(Source: BIS 1995)

Because the proportion of credit at variable rates is broadly comparable for the corporate sector between the UK, Germany and France, the result is that any one size fits all ECB monetary policy would have a disproportionate impact on the household sector in the UK – this is an important political lesson the Government should be aware of.

## Ex-post and ex-ante convergence

The previous section has explained in conceptual terms why convergence in NAIRU rates and monetary policy transmission mechanisms is fundamental to sustainable convergence – without both any convergence will only be transient. However, it must also be considered that a country might be more likely to satisfy the optimal currency area criteria for creating a monetary union *ex post* rather than *ex ante*. In other words, euro participation of itself might accelerate the convergence process via:

- Financial markets
- Price convergence

## Financial markets

We will first consider whether the introduction of the euro is of itself likely to have an endogenous effect on the future financial system. An obvious possibility arises from so called matching rules – when EU life insurance companies have had to match 80% of their assets to the currency of their liabilities. This has led to virtually all assets being held in national currencies. The euro clearly enables companies to diversify their portfolios across Euroland. However, there are also deep seated structural impediments to convergence in financial systems.

Table 2.3

<b><u>Differences in EU Legal Systems</u></b>			
<b>Country</b>	<b>Shareholder rights</b>	<b>Creditor rights</b>	<b>Enforcement</b>
Austria	2	3	10.00
Belgium	0	2	10.00
Denmark	3	3	10.00
Finland	2	1	10.00
France	2	0	8.98
Germany	1	3	9.23
Greece	1	1	6.18
Ireland	3	1	7.80
Italy	0	2	8.33
Netherlands	2	2	10.00
Portugal	2	1	8.68
Spain	2	2	7.80
Sweden	2	2	10.00
UK	4	4	8.57

(Source: La Porta et al, 1997)

One school of thought (see La Porta et al (1997) in *European Monetary and Fiscal Policy*; SCW Eijffinger and J De Haan, OUP 2000) suggests that the financial structure of a country reflects the legal system and so variation in financial intermediation is a consequence of dissimilar legal structures. If this is true, then for as long as the legal systems of EU countries differ, then so too will the impact of ECB interest rate changes. Table 2.3 shows an index where a higher number indicates: (1) It is less costly for shareholders to exert influence on managers (2) Creditors can more easily reorganise or liquidate a company. The central message of the table is that countries with a common

law system generally support the greatest investor protection and the most developed equity markets.

## Price convergence

Professor S. Hall (*Financial Times*, 5<sup>th</sup> July 2000) argues that the loss of an independent monetary policy is not the concern suggested by opponents of UK participation, because of the,

***“fundamentally different way that prices work inside a single currency zone Within a single currency area it is simply impossible for two regions to experience different inflation rates for a prolonged period of time”.***

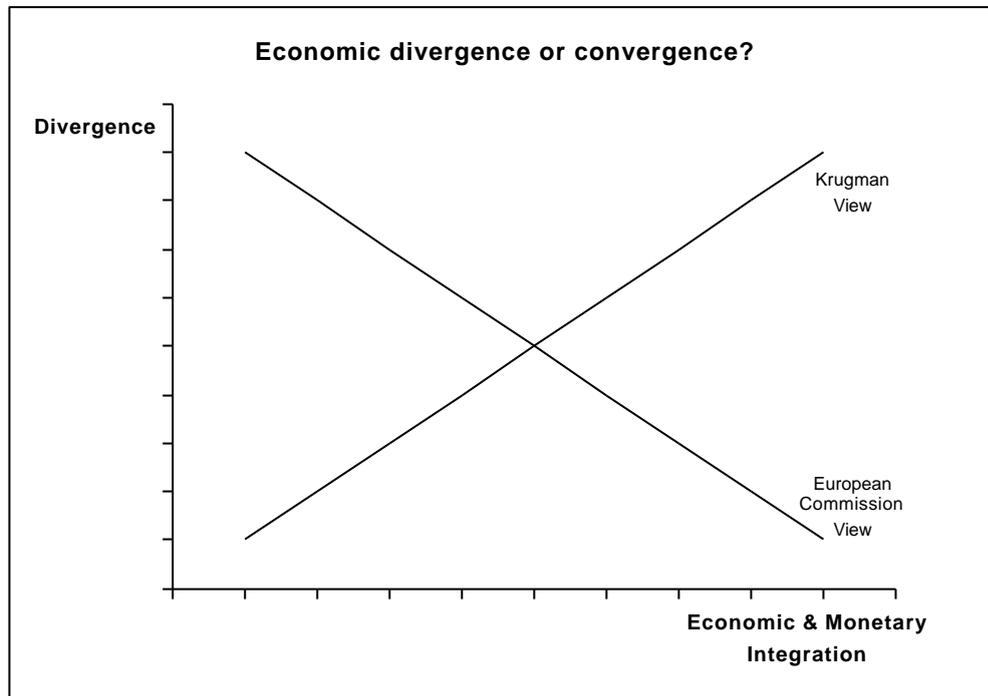
Hall makes the point that over the long term inflation rates will need to converge within the euro zone. Consequently, he asserts that,

***“this simple point is profoundly important for Mr Brown’s business cycle criteria. If inflation cannot be different across the euro zone, to any important degree, there is no need for an independent interest rate policy to control differential inflation pressures in the UK”.***

The essential argument is that wage and price convergence will involve labour market restructuring and a convergence in NAIRU rates. The difficulty with this approach is the time scale involved. At present there are very substantial differences in NAIRU rates and little evidence of convergence or de-regulation – witness the recent introduction of the 35 hour week in France. The theory also fails in the context of the monetary policy transmission mechanism - since the introduction of the euro there has been an increase in inflationary divergence across Euroland. Inappropriate monetary policy in Ireland, for example, has fuelled inflationary pressures. The European Commission (April 2000) has recently warned of the inflation threat and that five of the Euroland economies are in danger of overheating.

There are divergent views (see Figure 2.7) over the impact of the euro itself on economic convergence across Euroland. On one side lies the European Commission which argues that greater economic integration will lead to less divergence due to the promotion of intra-industry trade and income convergence - which is likely to reduce national specialisation.

Figure 2.7



In contrast, economists such as Professor Paul Krugman argue that the euro will lead to greater divergence as a result of regional specialisation (***Geography and Trade***, P Krugman, MIT Press, 1991). Krugman argues that the combination of a single market and a single currency will lead to greater vulnerability to region specific disturbances – although the ‘region’ in this sense may not necessarily coincide with the ‘country’. However, at the very least the existence of such a debate suggests the UK should proceed with great caution when considering participation in the euro.

Finally, it should also be pointed out that supporters of UK participation often argue that even though one size does not fit all at the Euroland level, neither does it within the UK – for example because of a north-south divide. In other words, Euroland is not an optimal currency area, but neither is the UK.

The obvious response to this has come from David Smith, Economics Editor of The Sunday Times (***Sunday Times***, July 2000) who has written that,

***“Some will say one size does not fit all in the UK and the MPC doesn’t set interest rates appropriate for the North East. That may be true but two wrongs don’t make a right”.***

The UK is closer to being an optimum currency area than is Euroland – within countries there is greater scope for migration and regional fiscal transfers. If an area such as Euroland is too big to be an optimum currency area, then making it bigger must make things worse.

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## 3 The five economic tests

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This chapter examines HM Government's five economic tests (FET) and whether or not they can expect to be satisfied over the coming years.

In HMTreasury (1997) the Government state that,

***“at present the UK's business cycle is not convergent with the rest of our European partners”.***

However, as we have seen, OECD output gap projections do at face value suggest the UK economy is converging with Euroland. In figure 1.1 OECD output gap projections showed the UK/Euroland differential falling from 1.8% of GDP in 1998 to zero in 2001. The 2001 figure is significant because this is the order of magnitude that HM Treasury are likely to use in any post General Election assessment of the FET.

Generally the OECD is very bullish about the UK's prospects for participation in the euro. The OECD has stated (*EMU One Year On*, OECD, February 2000) that,

***“on several scores, even as an ‘out’, the UK is projected to be as close or even closer to the economic centre of gravity of the euro than some of the ins”.***

Acknowledging that UK short term interest rates are higher than euro rates the OECD states that,

***“this would change should the prospect of joining become a reality”.***

In this chapter the IoD challenges the OECD view that the UK economy has converged with Euroland. Indeed, the reason that we have an element of convergence in GDP growth rates at present is primarily attributable to ***divergent*** monetary policy.

It is very obvious that countries which have previously followed divergent economic cycles, could converge with each other with very close rates of growth. However, this merely reflects 'ships passing in the night', it tells us nothing about:

- Whether the economies are sailing in the same direction - one might be slowing whilst the other accelerates.
- Whether the convergence is sustainable.

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We consider four key economic indicators which suggest that:

- (1) Any short term GDP convergence is transient and unlikely to reflect a sustainable trend.
- (2) Since the introduction of the euro inflation has diverged between the UK and Euroland.

The four indicators are:

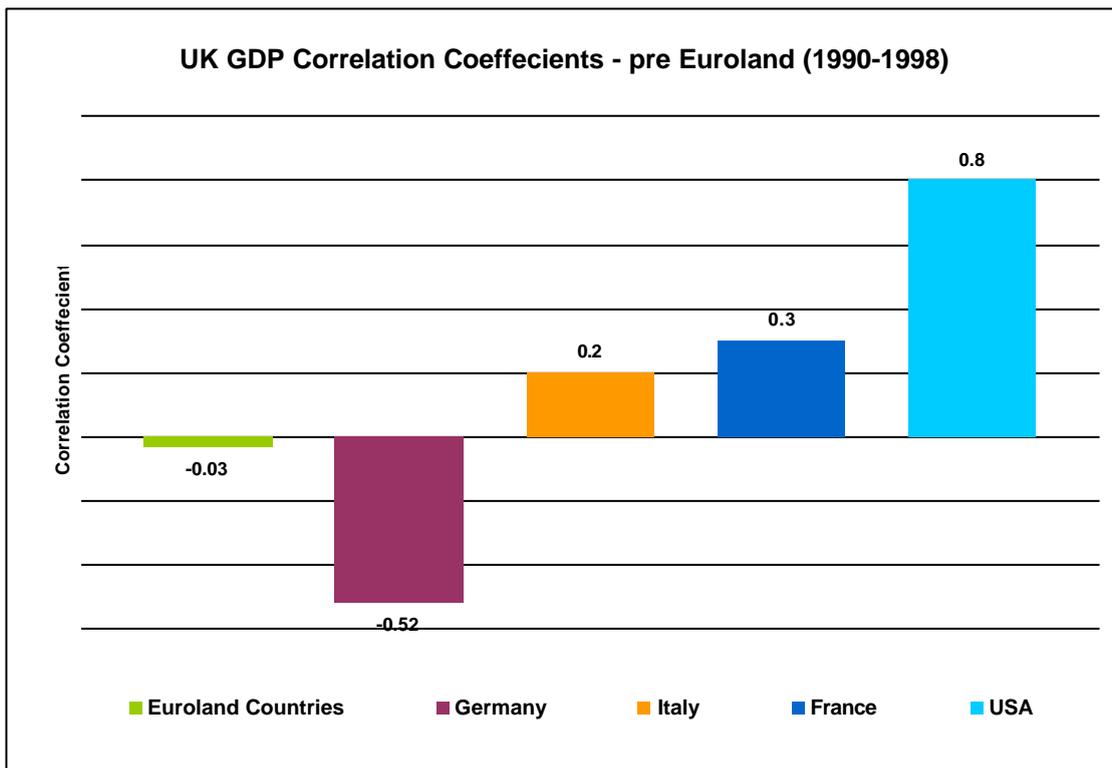
- GDP correlation coefficients
- Inflation rates
- Interest rates
- Output gaps

## GDP correlation coefficients

HMT (1997) highlighted the fact that over the 1982-1993 period UK and German GDP growth had a negative correlation coefficient. Moreover, HMT's correlation coefficient estimates show the de-synchronisation of UK and German GDP increasing over time.

More recent estimates by the IoD - over the 1990-98 period immediately prior to the introduction of the euro - show the UK's GDP correlation coefficient with Germany was  $-0.52$ , with France  $0.3$  and Italy  $0.2$ . With Euroland as a whole over the 1990-98 period the GDP correlation coefficient was  $-0.03$ . In contrast, the GDP correlation coefficient between the UK and the US over the same period was  $0.8$ .

Figure 3.1



UK GDP performance remains weakly associated with that on the continent. This has even prompted some to argue that divergent economic cycles are beneficial to the EU, since the UK can then perform a function as 'importer of the last resort' when GDP growth on the continent is poor.

## Inflation rates

Table 3.1 shows the relative inflation rate – harmonised index of consumer prices (HICP) measure – in January 1999 at the introduction of the euro, and latest data for June 2000. Table 3.1 shows that over the past 18 months the UK has transformed from having an inflation rate double that in Euroland to one that is less than half the average Euroland rate and the lowest in the EU – hardly synchronisation. Euroland data was only available up until June 2000 at the time of writing.

Table 3.1

<b>Inflation divergence (HICP measure)</b>					
(% change yr-yr)					
<b>Date</b>	<b>UK</b>	<b>EU15</b>	<b>Euroland</b>	<b>UK/EU gap</b>	<b>UK/ Euro gap</b>
January 1999	1.6	1.0	0.8	0.6	0.8
2000 Latest	1.0	2.1	2.4	-1.1	-1.4

(Source: ONS CPI June 2000 release)

The Irish economy was the fastest growing economy in the world at the end of the 1990s. Despite this, interest rates were reduced in order to squeeze inside the euro. The end result has been a housing boom, 20% plus growth in the money supply and a HICP inflation rate six times that in the UK - UK 1%, Ireland 6% inflation. Moreover, the inflationary pressures in Ireland have probably been muted by an exceptional boost to the labour supply from inward migration.

## Interest rates

In 1997 the gap between UK and German/French short term interest rates was around 4%. The gap between UK and euro short term rates was around 3%. This fell to 2.4% in 1999. Latest figures for the end of August 2000 show the differential at 1.5%.

Table 3.2

<b>Interest rate differentials - UK versus Euroland</b>									
(UK less Euroland rate)									
	1993	1994	1995	1996	1997	1998	1999	2000	2001
Short term rates	-2.7	-0.8	0.2	1.2	2.6	3.4	2.4	2.3	1.9
Long term rates	-0.5	0.2	-0.2	0.8	1.1	0.8	0.5	-0.2	-0.2

(Source: OECD Economic Outlook, June 2000)

However, the clear lesson of contemporary policy is that we have convergent economic cycles because of divergent monetary policy i.e. higher interest rates and a high pound. Without this divergent monetary policy UK growth would be very much higher in 2000.

The narrowing in the interest rate differential needs to be placed in context:

- The interest rate gap at the short end is still significant. If UK rates were to fall by 1.5% tomorrow, a boom-bust scenario for the housing market would become very possible.
- Falling interest rates could also herald a depreciation in the pound – in advance of euro membership – which accentuates inflationary pressures. Based on current indications, the MPC would wish to respond to any depreciation in the pound with higher interest rates. Instead, euro participation could facilitate lower interest rates and a lower pound against the background of an already tight labour market with claimant unemployment falling below the 1 million level.
- NIESR estimates of the FEER (fundamental equilibrium exchange rate) suggest the pound is more than 20% overvalued. There is no guarantee that an overvaluation of this magnitude can be reversed. Consequently we may be forced to join the euro at an overvalued exchange rate - which does not suggest sustainable convergence.

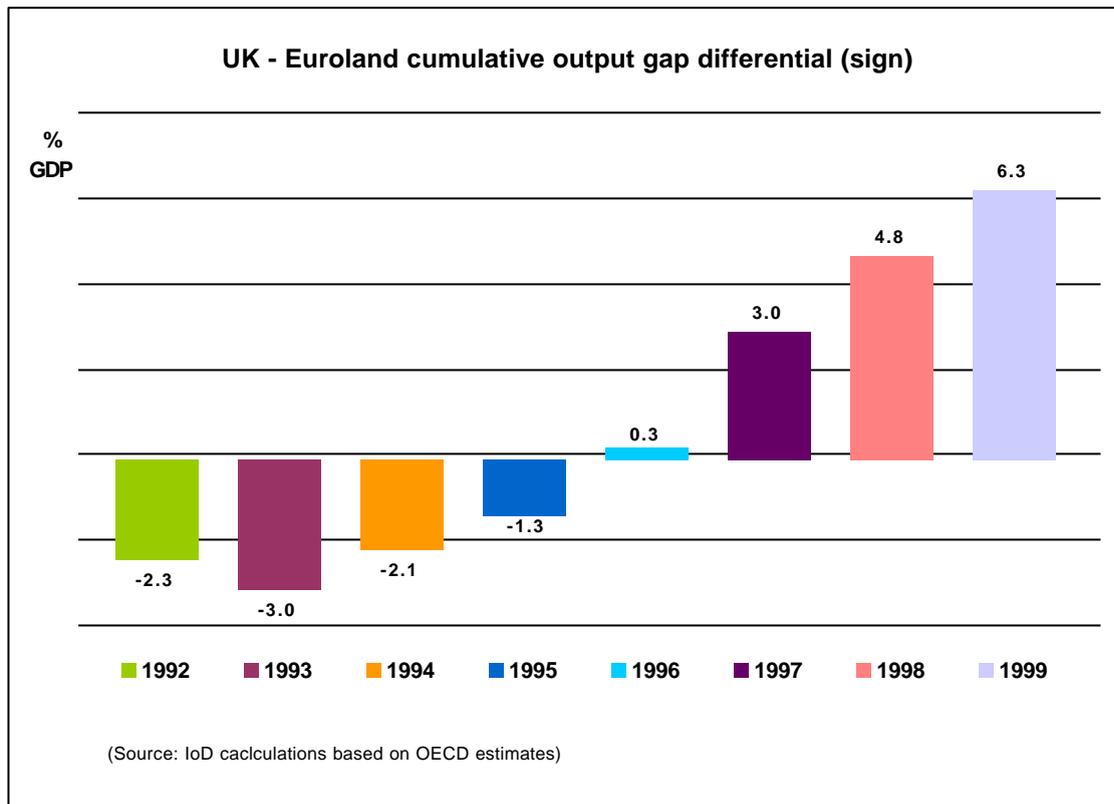
## Output gaps

According to OECD estimates (*OECD Economic Outlook*, No. 67, June 2000) output gaps in 2000, across the EU, ranged from plus 4% (4% of GDP above potential output) in Ireland to minus 1.7% in Italy (1.7% of GDP below potential output). The UK was estimated to have an output gap of plus 1%. Cross sectional comparisons such as this only partly describe the degree of sustainable convergence – or lack of it.

In order to assess sustainability, we need to examine the time series of output gaps. Figure 3.2 shows the cumulative output gap of the UK with Euroland. The cumulative output gap differential over the 1992-1999 period (when the UK was outside the ERM) amounts to over 6% of GDP. In other words, if the UK had pursued a monetary policy

appropriate to Euroland there would have been a reduction in potential output of the order of £50 billion.

Figure 3.2

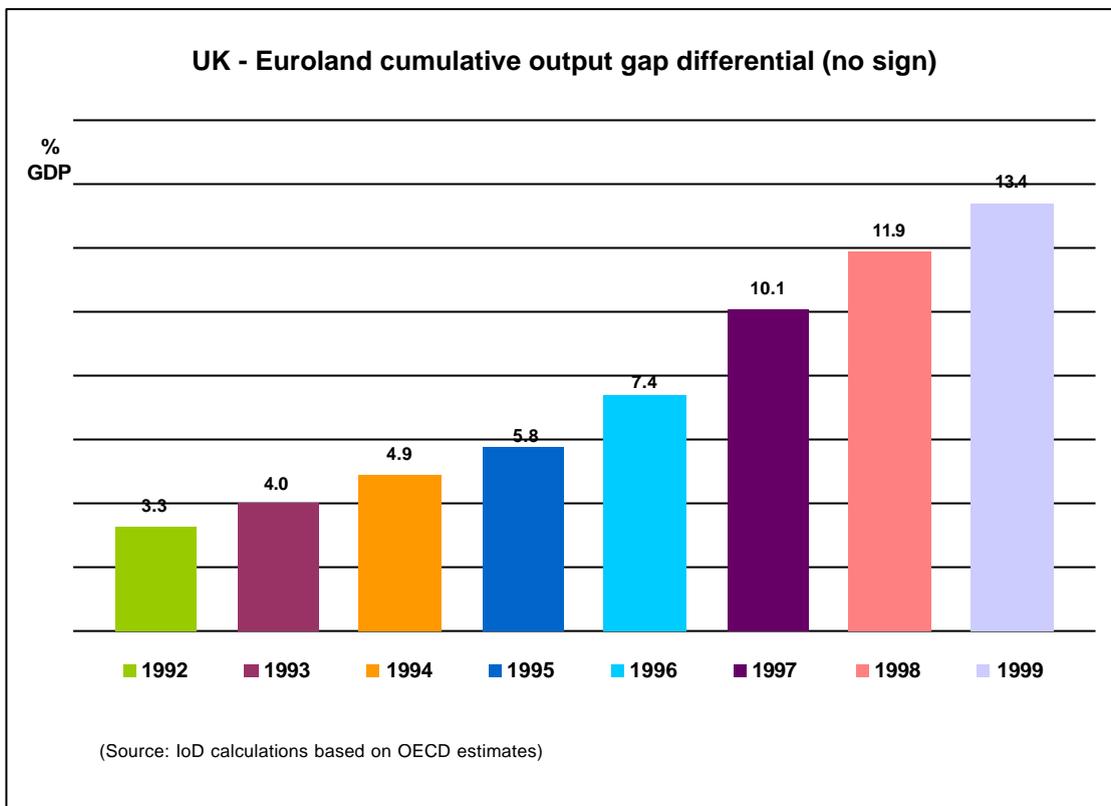


It is possible to argue that the Maastricht criteria unduly constrained EU output growth over this period. However, there is also a counter argument that looking at cumulative output gaps fails to capture the full impact of economic divergence – because of a lack of cyclical synchronisation.

For example, the cumulative output gap over a ten year period might be zero, because for half the period UK growth rate exceeded the EU rate by 5% and for the other years was less than the EU by the same amount. Obviously, in this example, the economies were always divergent and so it is more realistic to examine absolute measures of cumulative output gaps – ignoring positive and negative signs.

This analysis shows (see Figure 3.3) that the absolute cumulative output gap was over 13% of GDP. Note that the loss of potential output would not equate to the output gap in this example, because of both higher and lower relative growth. What the absolute measure shows is the potential for greater volatility in the UK economic cycle within Euroland.

Figure 3.3



## Inward investment

Previous IoD reports (*The UK and the euro – better out than in?*, IoD 1999) have argued that only a small proportion of FDI into the UK is dependent on the single market, and even less on the single currency. However, the debate over the impact on FDI of staying outside the euro shows no sign of abating. Drawing conclusions from individual corporate announcements is very difficult. At the same time that Toyota was instructing its suppliers to invoice in euros, Honda was announcing it is to double production in the UK. Just as the President of Matsuchita suggested that his company’s problems in the UK would be solved by joining the euro, the President of NEC stated that the UK and the euro “*is not so big an issue for us*” (reported in *Sunday Business*, 6<sup>th</sup> August 2000). The President of Matsuchita failed to mention that much of their TV production has already been moved to the Czech Republic – a low cost base outside not just Euroland but the EU as well!

Latest statistics from Invest UK (formerly IBB) show that the total stock of foreign assets in the UK continues to rise, reaching £252 billion in 2000 – an increase of £100 billion over the past five years. The number of inward investment projects has increased strongly, reaching 757 according to latest figures. Invest UK also reports that interest from potential investors remains strong (reported in *Financial Times*, 30<sup>th</sup> May 2000).

Figures from Dun & Bradstreet show the number of companies owned by foreign firms has increased by almost 24% over the past two years. The number of foreign owned companies doing business in the UK increased to 28,777 in 2000, from 25,802 in 1999 and 23,300 in 1998. Given the strength of sterling over this period, against the euro, this is a considerable vote of confidence in the UK.

Table 3.3

<b>Direct investment in UK</b>		
Total stock of foreign assets		
1995	Q4	£137.9 billion
1996	Q4	£147.6 billion
1997	Q4	£167.1 billion
1998	Q4	£192.8 billion
1999	Q4	£243.1 billion
2000	Q1	£252.4 billion

(Source: Invest UK)

Business surveys of FDI confidence by AT Kearney show the UK is only eclipsed by the US. The *Financial Times* has reported that “*Investors prefer UK despite euro uncertainty*” (*Financial Times*, 25<sup>th</sup> January 2000). The AT Kearney survey of chief executives shows

that the UK is the second most attractive location in the world for inward investment, after the US.

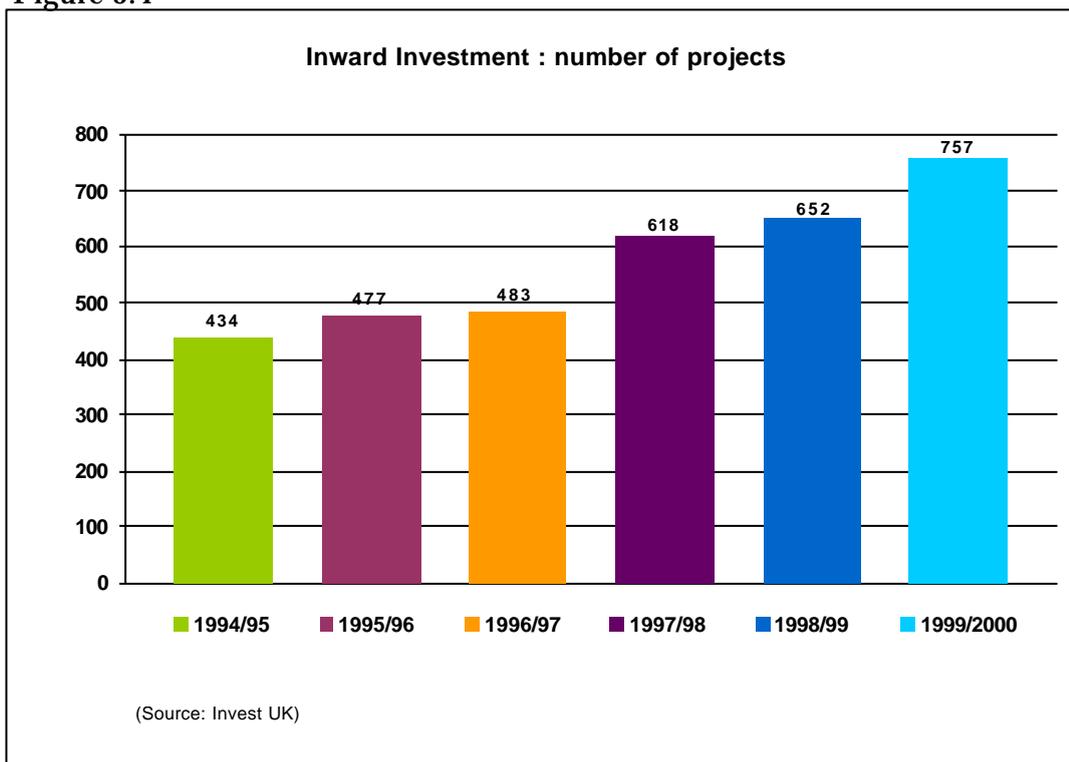
One study, by Ernst & Young, does suggest that the UK's market share of inward investment into Europe has fallen over recent years. Ernst & Young report that the UK's share of inward investment fell from 28% in 1998 to 24% in 1999 – these figures exclude mergers and acquisition activity. This report is out of line with surveys by Invest UK and the United Nations Conference on Trade and Development (UNCTAD). Moreover, even if the figures are correct, they say little about the cause of the fall in market share. It is quite plausible to argue that any loss of attraction for the UK could be attributable to the greater regulatory burden on business introduced in recent years.

Britain in Europe argues that because of long lead times, it will only be in the years to come that we will begin to see the impact on FDI of the UK staying outside the euro. Against this argument is evidence from the Invest UK that international interest remains high despite the fact that UK politics are likely to prevent participation for the foreseeable future. Moreover, the NIESR report that (NIESR Economic Review, No. 173, July 2000),

***“When FDI plans were struck there were certainly many people who believed that Britain would be a late entrant rather than a permanent non participant”.***

However, the NIESR assert this view without presenting any evidence. At present, much of the debate about the costs of being outside the euro is based on the weakness of the euro against sterling. Many of those who presently support UK participation are in reality arguing for a weaker exchange rate. Unfortunately, joining the euro does not necessarily mean that the pound will weaken substantially. Lower interest rates might bring about a limited depreciation against the euro, but the currency could still be irrevocably locked at an exchange rate ill suited to UK exporters.

Figure 3.4



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## The City

The IoD has reported elsewhere (see *Protecting the City* in *The UK and the Euro – better Out than In*, IoD, April 1999) that the City is just as likely to gain as it is to lose from being outside the euro. Since this report over a year ago no evidence has emerged to undermine that conclusion. Latest evidence re-affirms this view. The House of Commons Treasury select Committee 8<sup>th</sup> report (July 2000), concluded that,

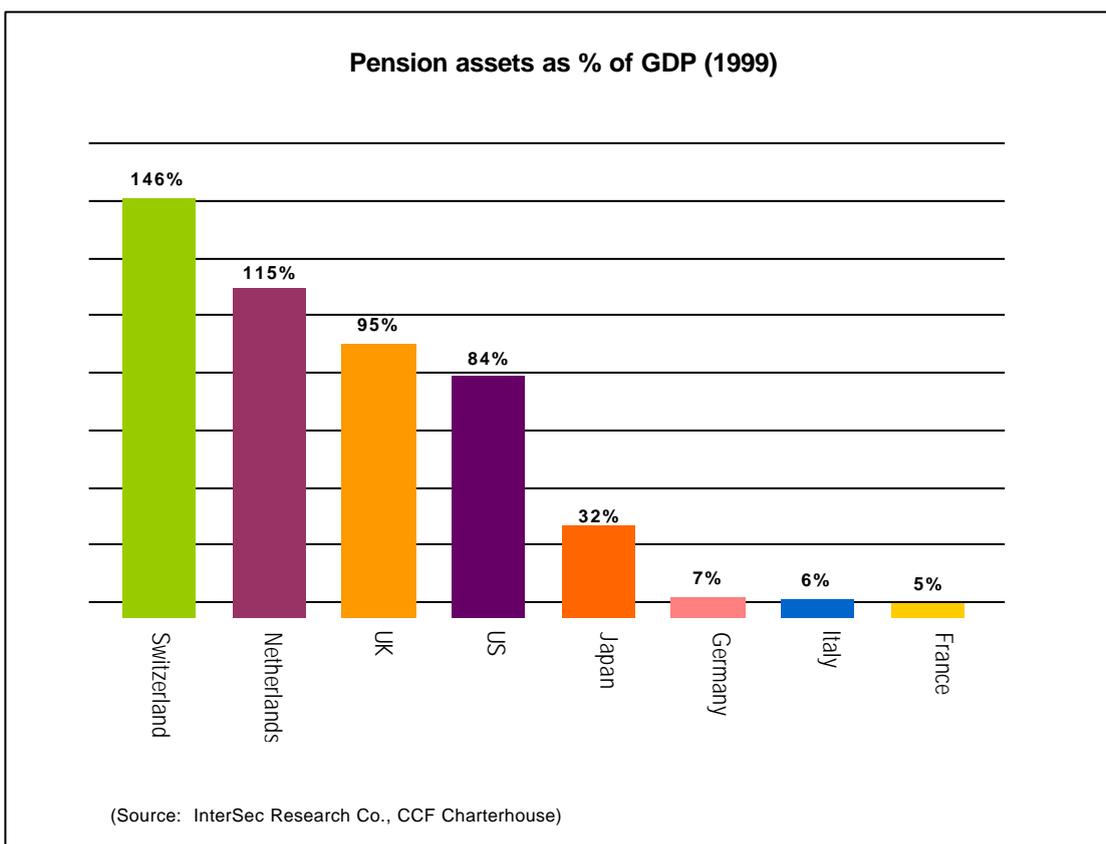
***“witnesses from the financial services sector were united in the opinion that they and in particular the City of London as a global financial centre, have not yet been adversely affected by the UK decision not to participate... we are of the view that the success of the City will not be much affected if the UK chooses to join the euro or stay outside”.***

In their evidence the British Bankers Association stated that,

***“There are no areas of business which have manifestly suffered and there are some which have manifestly grown since the euro was launched”.***

Across many products, from asset management to forex, from OTC derivatives to bond issuance, the City’s position is strong and improving (see *European Capital Markets* WG Seifert et al, Macmillan, 2000).

Figure 3.5



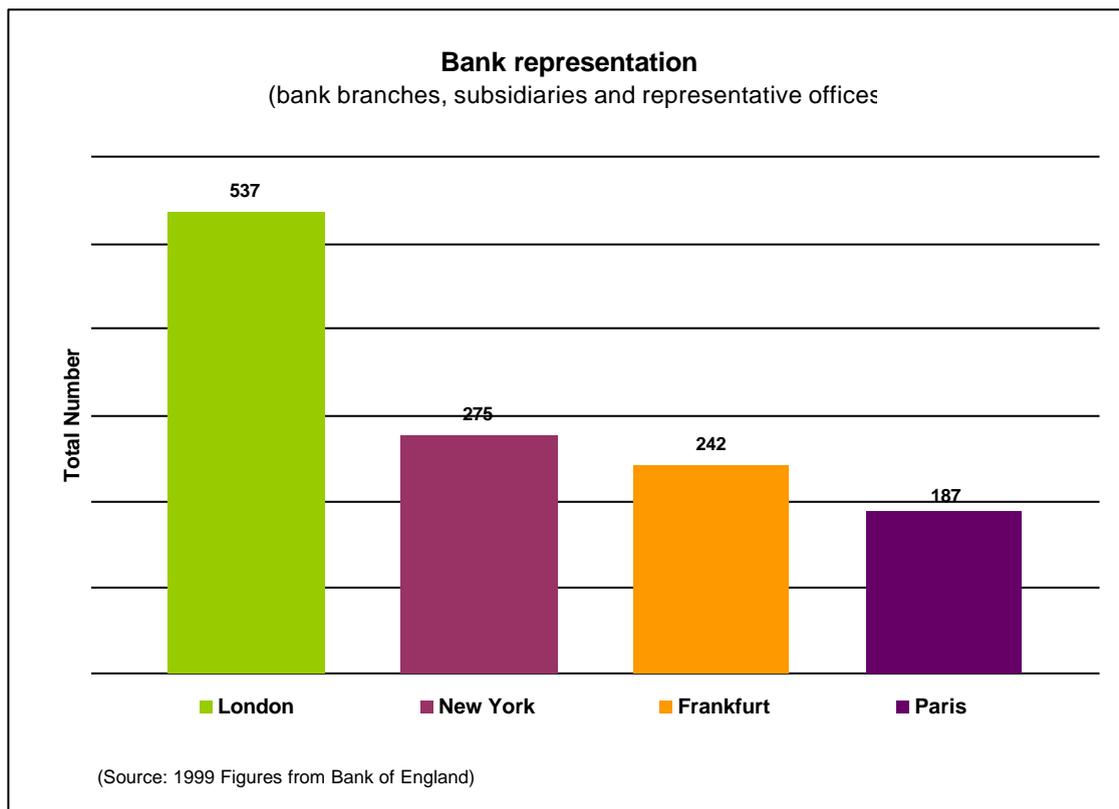
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Despite the depth of financial markets in the UK (see Figures 3.5, 3.6 and 3.7), prior to the launch of the euro concern regarding the City's future prospects centred on:

- The general development of EU capital markets, which have considerable potential for growth, thereby losing market share for the City.
- The Target real time gross settlement system and the lack of full access to non EMU countries.
- The location of the ECB in Frankfurt.

Thus far however neither Target (which the City has access to via Chaps Euro), the ECB or the deepening in Euroland capital markets appears to have had a sizeable impact (see Seifert et al, 2000). Some of the fears were always misplaced. For example, US banks haven't moved to Washington to locate alongside the Federal Reserve. Confidence in the City's future prospects is best summed up by Deutsche Bank's decision to invest around \$500 million in a new international investment banking HQ in London.

Figure 3.6



The Bank of England has reported (*Practical issues arising from the euro*, Bank of England, December 1999) that,

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***“all the available evidence confirms that London has to date fully maintained its position as the main international financial market in the European time zone”.***

The BoE acknowledges that the location of activity in many wholesale financial markets can be hard to pin down, but says that capital market activities, treasury and risk management operations, trading, fund management and research are all concentrating in London.

AT Kearney report (*Financial Times*, 25<sup>th</sup> January 2000) that banks continue to rate the UK as the most attractive place in the world to invest. As a result, there are almost twice as many banks in London as New York, and more banks than in Frankfurt and Paris combined. One voice of concern over the City’s future prospects was Lord Levine, the former Lord Mayor of London. In February 1999 Lord Levine stated that,

***“London’s business would, in time, be eroded if the UK’s entry into EMU is long delayed”.***

However, by the end of 1999 he had revised his views saying that,

***“ [the launch of the euro] has been positive for the UK financial services sector ... the Government would have to look to other parts of the economy to support the case for joining”.***

Two recent reports provide additional confidence. Research produced by the NIESR, for the London Chamber of Commerce, concluded that,

***“the City of London will prosper whether or not the UK joins the single currency”.***

Another report (*LePrix del’Euro*, CSFI, February 1999) concluded that,

***“provided the race is run fairly, being out should be no handicap”.***

The City retains huge strengths as the only true world financial centre. The depth of expertise and agglomeration economies located in the City are enormous – in most areas of the City’s business it has five times the number of employees of Frankfurt or Paris (see Seifert et al, 2000). Moreover, information technology suggests that existing financial centres should be able to serve wider hinterlands in the future. The share of pension assets in GDP is massive in the UK, compared with Germany (Frankfurt) and France (Paris).

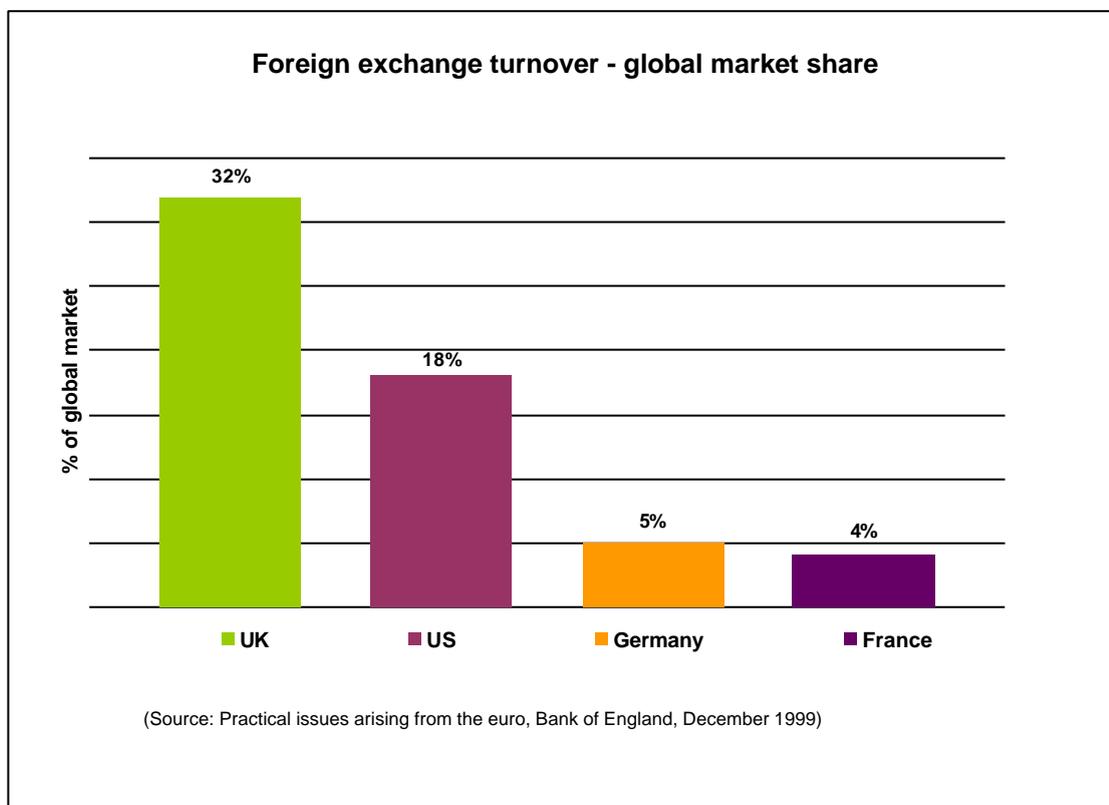
There are very real concerns that participation in the euro might lead to a greater regulatory intensity being imposed on UK financial services. Clearly, the experience of the Withholding Tax illustrates that greater regulatory interference, including taxation in the City is not prevented by staying outside the euro.

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The IoD argues that UK participation in the euro will hasten EU integration and that there must be concern for a future scenario that entails UK participation in a single currency, followed by deepening moves towards a single financial market involving some form of super Euro FSA - such a body could well be established anyway regardless of the UK's participation in the euro.

The risk in euro participation is that it might encourage bolder moves towards a less market orientated regulatory environment. Seifert et al (2000) have pointed out that one of the objectives of the FSA is to protect 'innovation and international competitiveness' in the City, a requirement that has no match in any of the statutes for regulators on the continent.

Figure 3.7



## 4 Political convergence and future fiscal policy

Ultimately EMU is a political project and as yet, as figure 4.1 shows, there is very little political convergence in the UK electorate's support for euro participation, as compared with our EU partners.

Figure 4.2 shows the future income tax rises required to maintain generational balance in the fiscal positions of six EU countries. The tax rises are based on inter-generational accounting estimates produced by L. Kotlikoff and N. Ferguson, published in *Foreign Affairs* (March/April 2000). The estimates suggest that the already large gap - in the share of public expenditure in GDP - between the UK and the rest of the EU will widen further in the future. OECD figures (annex table 29, *OECD Economic Outlook*, No. 67, June 2000) show that taxes accounted for 40% of GDP in the UK and 45% in the EU in 1999.

Consequently, in the future we are likely to see expanding political divergence between the UK and the EU as a result of the fiscal implications of deeper EU integration. In other words, the electorate is likely to connect future monetary and fiscal policy harmonisation - with the former hastening the latter - as the price of euro participation.

Figure 4.1

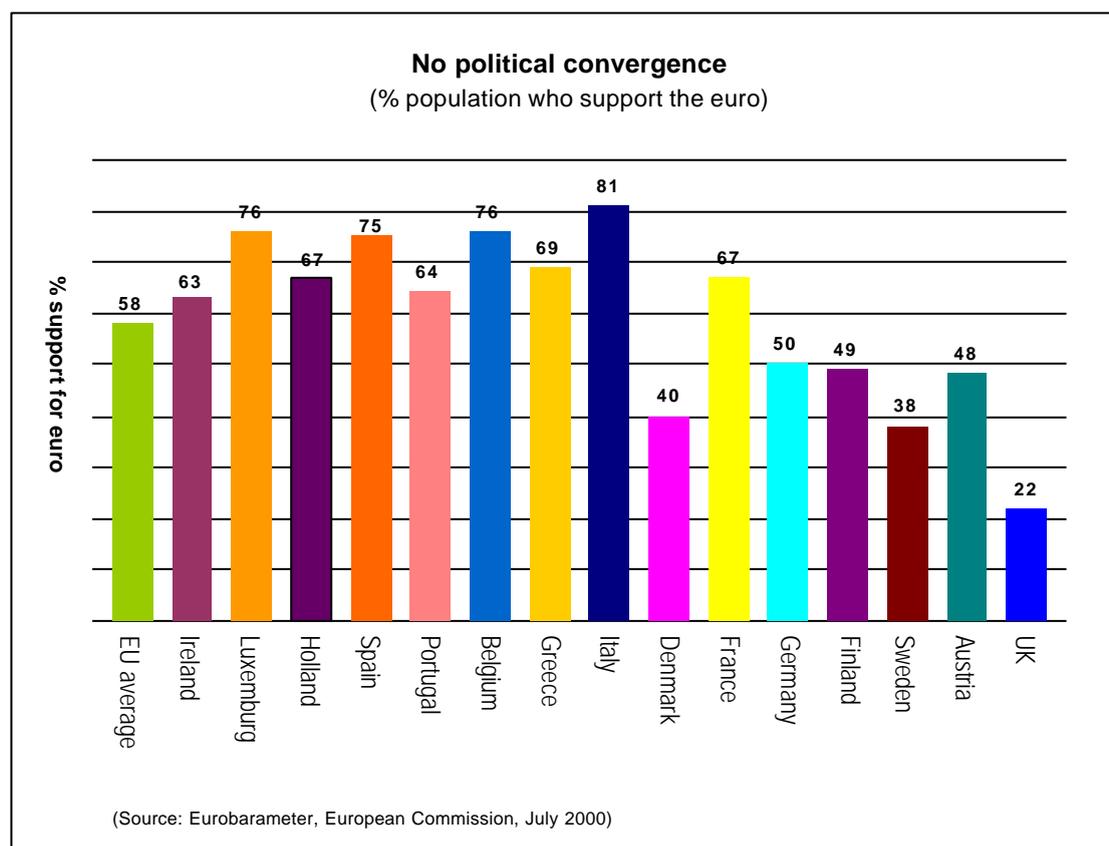
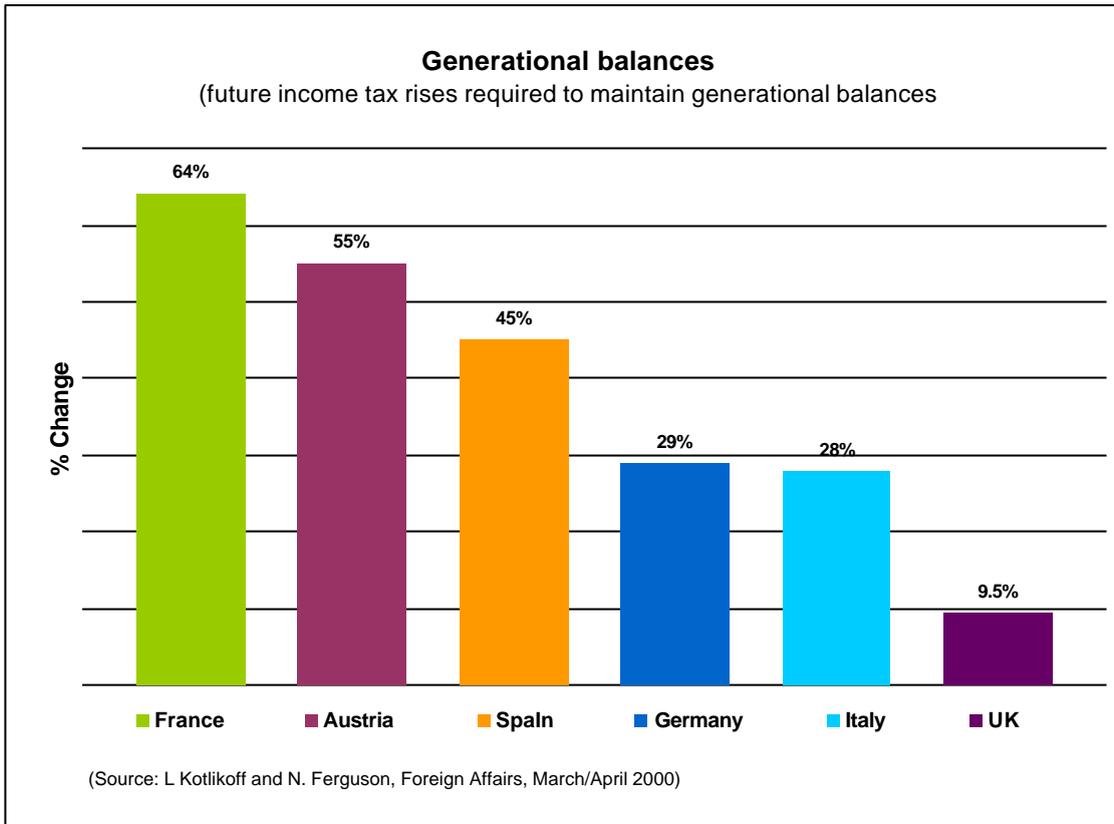


Figure 4.2



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# Annex 1

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## IoD Convergence Contract

In August 1999 the IoD attracted considerable media attention when it published its '**Convergence Contract**' (the contract was 'adopted' by The Sun newspaper!).

The IoD published the contract in order to highlight the structural changes required to provide sustainable convergence with Euroland. Moreover, key elements of the contract stress the need for reform across Euroland and why the UK alone cannot generate sustainable convergence.

The convergence contract shows that the only sensible way the UK economy can converge with Euroland is if Euroland itself changes towards an Anglo-American style system. This is highly unlikely to happen and explains why the IoD says the UK should stay outside the euro for the foreseeable future.

The contract criteria were:

- The GDP correlation coefficient between the UK and Euroland should exceed that with the US for a decade.
- Euroland should account for more than half of total current account earnings for a sustained period.
- The proportion of the UK mortgage stock at fixed rates should converge with Euroland.
- The gap between UK and Euroland unemployment rates, activity rates and employed populations should halve, but without a deterioration in the UK's position.
- The gap between UK and Euroland tax shares should halve, but without a deterioration in the UK's position.