EUROPEAN PARLIAMENT

Task Force on
Economic and Monetary Union

Briefing 1
Third Revision

EMU and the United Kingdom

Briefing prepared by the Directorate-General for Research
Economic Affairs Division

The opinions expressed in this brief are those of the author alone, and do not necessarily represent the view of the European Parliament

The UK will not be one of the founding Member States of monetary union in 1999. Membership is now likely in mid-2002, although there will have to be both a General Election and a referendum beforehand.

Luxembourg, 7th. April 1998 PE 166.059/rev.3

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Introduction

On the 25th March the Commission and the European Monetary Institute published their separate reports on progress towards meeting the convergence criteria for Economic and Monetary Union. In addition, the Commission published its Recommendation on which Member States had qualified to participate in the Single Currency on 1st January 1999. Its assessment was that eleven countries met the criteria: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Denmark and the UK had met the criteria, but had exercised their right to "opt out" for the time being.

This Recommendation now has to be confirmed by the Council of Economic and Finance Ministers (ECOFIN); by the European Parliament; and, for final decision, by the European Council of Heads of State and Government on 2nd May.

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The UK will not now be a founder-member of the Euro area at the beginning of 1999.

Nevertheless, the issue is increasingly "*Not 'If' but 'When'*"[1]. Though the Government has ruled out joining before the next UK General Election, barring "unforeseen economic developments", it is encouraging active preparations for membership shortly afterwards. The financial markets are making a "*working assumption that the British will enter...in early 2002, when the first euro-coins and notes start circulating*..[2]"

Protocol 11 ensures that the UK is under no obligation to join the single currency (the so-called "opt-out"). But it also allows an "opt in". Though the UK has notified its intention not to participate on 1st January 1999, it retains the right "*to change its notification at any time...*"

As forecast in the UK Convergence Programme[3], the UK economy has met all the statistical criteria for the single currency (see Table 1). Sterling, however, is not within the EMS Exchange-Rate Mechanism. Nor, despite the major changes introduced by the incoming Government in mid-1997, will the Bank of England be completely independent, as defined by the Maastricht Treaty.

The main economic obstacle to UK participation, however, is seen to be the UK's position in the economic cycle compared to that of most other potential EMU members. This has led the Bank of England to raise short-term interest rates to 7.25%; whereas the rate set by the European Central Bank in 1999 is likely to be several percentage points lower.

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[1] Headline in the *International Herald Tribune* of September 18th, 1997

[2] *Financial Times*, 1st October, 1997

[3] Published by HM Treasury, September 1997

Compliance with the Criteria

Table 1. UK indicators and the Convergence Criteria

	Inflation (%)	Long-term interest rates	Budget deficit (% of GDP)	Public debt (% of GDP)
1992	3.7	8.00	6.2	41.8
1993	1.6	7.50	7.9	48.5
1994	2.4	8.85	6.8	50.5
1995	3.0	8.30	5.5	53.9
1996	2.5	7.83	4.8	54.7
1997	1.8*	7.0*	1.9	53.4
1998 (forecast)	2.4	6.5	0.6	52.3
1999 (forecast)	1.8		0.3	49.8

Source: EMI Convergence Report, March 1998, UK Convergence programme.
* Reference period Feb.1997 - Jan. 1998

a) Inflation

Despite the current strong growth in retail sales, the UK has easily met the inflation-rate criterion. The European Monetary Institute[4] identified the UK in 1993 as one of the three "best performing" reference countries for the interpretation of Article 1 of Protocol 6.[5] The rates in 1994, 1995 and 1996 have qualified the UK as a "convergent Member State", as has the result for the reference period February 1997 to January 1998.

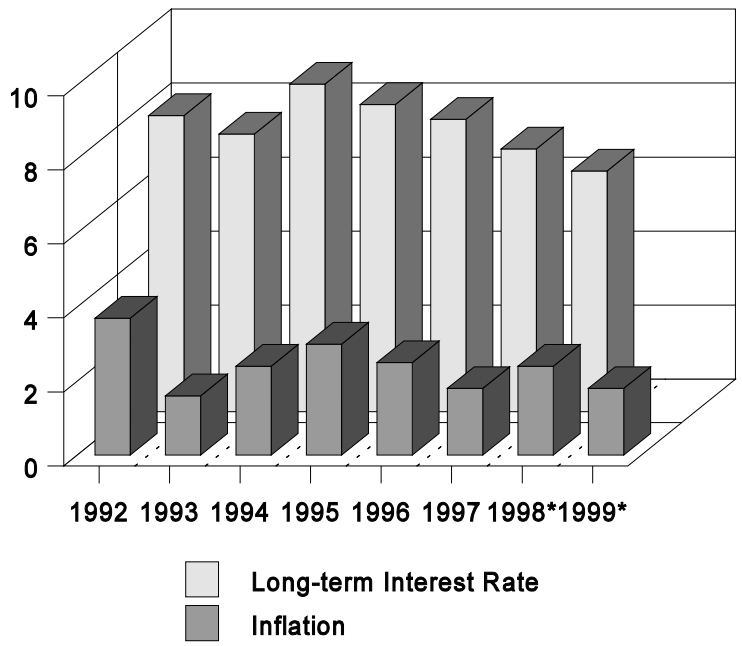
It is worth noting, however, that the precise inflation position is affected by the index used. The normal Retail Price Index (RPI) is strongly influenced by the movement of interest rates, since it includes mortgage interest payments. The Government's current target inflation rate of 2.5% has been set, however, on the basis of the "RPI ex MIPs" index: i.e. the Retail Price Index *excluding* mortgage payments. This has been moving between 2.5 - 3.5% over the last three years.

The decisions on EMU membership have been taken using the Harmonised Index of Consumer Prices (HICP), which also excludes interest and other payments. On this basis, the UK inflation rate is exactly on the Community average of 1.8%.

[4] Annual Report for 1994

[5] A Member State must have a price performance that *"does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability"*.

Chart 1: UK inflation and long-term interest rates, 1992-99



**=forecast*
Source: EMI Convergence report, March 1998

b) Long-term interest rates

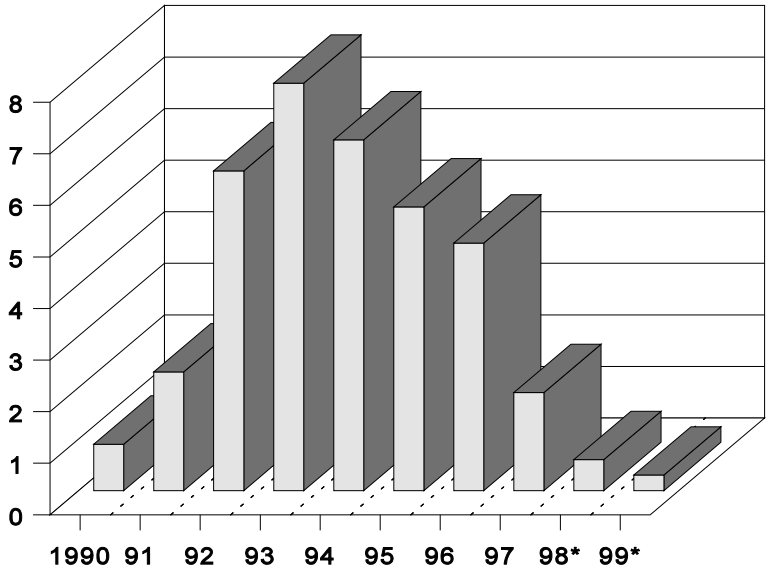
Like the inflation criterion, that for long-term interest rates is calculated by reference to the three best-performing Member States in terms of price stability, though the margin in this case is 2 percentage points. The relevant yield is that of "benchmark" ten-year government bonds.

For most of the last few years, the UK's long-term interest rates have fluctuated around the relatively high figure of 8%, nevertheless falling within the Maastricht limit. In May 1997, however, the rate fell to around 7%; and during the month of September fell again to below 6.5%. The level during the reference period of February 1997 to January 1998 was 7%, meeting the convergence criterion.

c) General government borrowing as a percentage of GDP

In the period 1987-89, the UK ran an average budget *surplus* of 0.2% of GDP. With the onset of the recession, a PSBR (Public Sector Borrowing Requirement) appeared, and grew rapidly to a peak of nearly 8% in 1993. It has since been falling steadily. The figure in 1997 was 1.9%, well below the 3% Maastricht reference limit.

Chart 2. UK budget deficits as a % of GDP, 1990-1999



** = forecast*
Sources: EMI Convergence Report, March 1998

In order for the UK to join the Single Currency at a date later than January 1999, it will of course be necessary to meet the fiscal convergence criteria (and *after* participation, too, under the Stability and Growth Pact).

In the **short term,** forecasts for 1998 indicate that this will present no problem. The Commission predicts a deficit of only 1.4% of GDP, and the figure is expected to be even lower in 1999.

In the **medium term**, much will depend upon the cyclical behaviour of the UK economy. An economic slow-down could produce rising deficits as through the operation of the "automatic stabilisers". However, the Government's policy, outlined in the Convergence Programme, is to maintain a *current* budget position which is either in balance or in surplus. Fiscal policy will be guided by the "golden rule":

> "*over the economic cycle the Government will only borrow to invest and not to fund current expenditure*".

The current account, in deficit by 2.75% of GDP in 1996-97, should be in surplus by 1998-99. The Convergence Programme outlines three sets of projections for the following years, based on varying growth paths.

> *"In every case the Government's fiscal objectives are achieved. However, it should be emphasised that these projections are subject to considerable uncertainty".*

In the **long term**, the UK has one major advantage over many other EU Member States: a far lower level of unfunded state pensions. Demographic factors will therefore strain the UK's budget comparatively little in the early decades of the next century.

Table 2: Projections of public pensions costs (as % of GDP)

	BE	*DK*	*DE*	*ES*	*FR*	*IE*	*IT*	*NL*	*PT*	*Fl*	*SE*	***UK***
2000	9.7	6.4	11.5	9.8	9.8	2.9	12.6	5.7	6.9	9.5	11.1	**4.5**
2040	15	11.6	18.4	16.8	14.3	2.9	21.4	12.1	15.2	18	14.9	**5**

Source: EMI

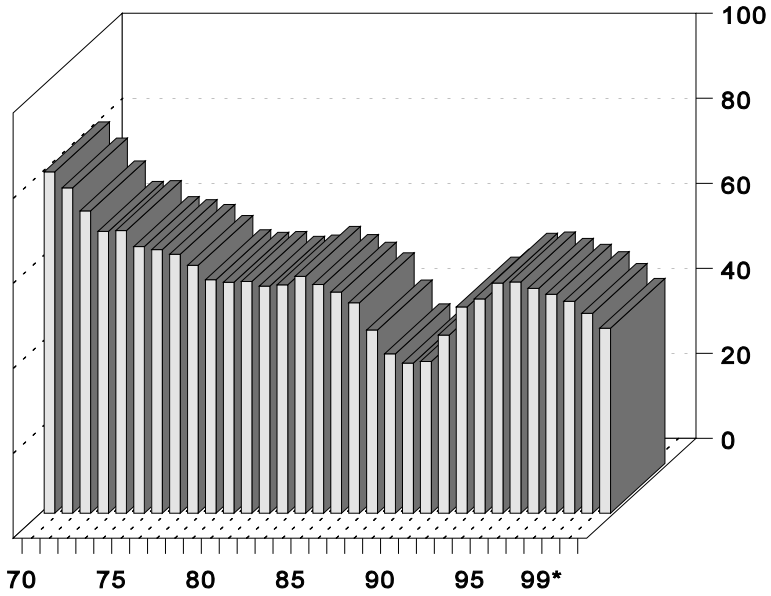
d) Public debt as a percentage of GDP

Though the substantial reductions in UK Gross General Government Debt made during the late 1980s were in some measure reversed during the early 1990s, the total peaked at well below the Maastricht reference figure of 60% of GDP, and is now falling. The level in 1997 was 53.4% of GDP, and is likely to be at 52.3% in 1998 and 51.5% in 1999. The projections for 2002 given in the Convergence Programme show a level of debt at between 42% and 45.1% of GDP.

The total amount of debt comes to just under £410 billion, forecast to rise to just over £425 billion in 1998-99.

Central Government debt (as opposed to all public sector debt) totals around £300 billion, equal to 44% of GDP. Interest payments on this debt come to about 8.5% of all public expenditure. Details of this debt's structure (in terms, for example, of its maturity and marketability) can be found in the Debt Management Report published in March each year.

Chart 3: UK public debt as a % of GDP, 1970-2002



** forecasts*
Sources: Intrastat. EMI Connvergence Report March 1998. UK Convergence Programme.

e) Normal ERM fluctuation margins

Since it left the narrow-band ERM in 1992, there have been no moves for Sterling to rejoin the mechanism. Doing so was explicitly ruled out by the former Conservative Government, and the present Labour Government has made no moves in that direction.

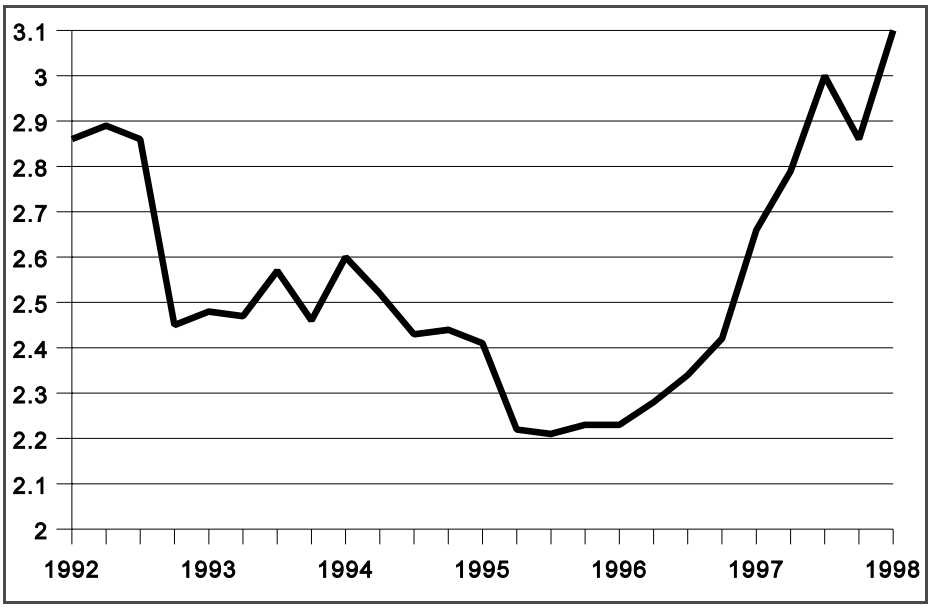
Whether this is an insuperable legal obstacle to early UK membership of monetary union is a matter of interpretation. Article 109j of the Treaty requires Member States, not specifically to join the mechanism, but to achieve"*a high degree of sustainable convergence"* through:

> "*the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State".*

At the time of the Maastricht Treaty, the "normal" margins were 2.25% either side of the central rates. Since mid-1993, however, they have been 15% on either side. This has led to a widespread assumption that the provision is out of date. The Governor of the Bank of England, Eddie George, is reported to have said that "*it would be completely dotty to exclude a country whose currency had been stable just because it had not had a formal two-year membership of the ERM*".

In recent years, Sterling has experienced periods of stability; but also others of some volatility.

Chart 4: Value of the £ Sterling in D-Marks, 1992-1998



Following its very sharp fall after "black Wednesday" in September 1992, the Pound was relatively stable for two years. In 1995 it again fell by about 5% against ERM currencies[6], but

[6] The 1995 fall was strongly affected by the depreciation of the Dollar against the D-Mark. The Commission, indeed, attributed the general exchange-rate volatility in Europe at that time to this Dollar factor (see *Report on Convergence in the European Union 1995).*

during 1996 began to recover. Then, during the first half of 1997, it rose rapidly, more than regaining its pre-September 1992 ERM parity of 2.85 D-Marks. In late 1997 it once again fell back to something like this level; but during the early months of 1998 once again rose sharply, reaching a peak of 3.10 D-Marks in late March.

From January 1999, the current EMS exchange rate mechanism will be replaced by "ERM2", intended to link those EU currencies still outside the monetary union directly to the Euro itself [7]. Whether this can be considered the mechanism referred to in Article 109j is a matter of legal interpretation. In any case, like Sweden, the UK has so far given no commitment to join.

In or out, however, it is clear that the £/Euro exchange rate will need to be stable for two years as a condition of entering the monetary union.

f) Independence of the Bank of England

During Stage Two of EMU, under Article 109e, each Member State should have been starting a process "*leading to the independence of its central bank*". No participating central bank

> "*when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ECSB.....shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body*" (Article 107).

Though the Bank of England is still in public ownership, its status has moved substantially in this direction over recent years. Under the former Conservative Government, the Bank acquired independent powers to comment on public policy - notably through the quarterly Inflation Reports; and considerable operational independence. The Governors of EEC Central Banks, in their annual report for 1992, observed that "*the main instrument of monetary policy is the short-term interest rate, which the Bank influences through its operations in the money markets."*

More substantial changes were immediately made in mid-1997 by the incoming Labour Government. The key power to determine short-term interest rates was transferred fully from the Chancellor of the Exchequer to the Bank, and an independent group of experts appointed to assist in interest-rate decisions. At the same time, however, the Bank lost its functions of prudential supervision over the UK's banking and financial system.

Whether these changes have been sufficient for the Bank to qualify as "independent" under the Maastricht definition will be a matter of interpretation.

g) Growth and Unemployment

The decision on EMU membership in 1998 will also take into account the degree of convergence that has taken place in "economic performance": i.e. growth and unemployment.

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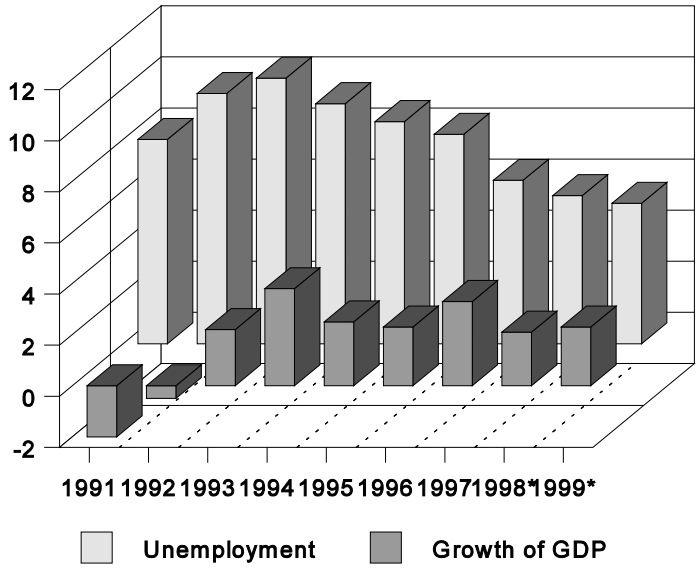
[7] See Briefing 29, "*Exchange Rate Policy under EMU"*

In this respect, the UK will be among the highest achievers. The UK's real GDP grew by 3.3% in 1997 - as against an EU average of 2.6%. A slight slow-down in UK growth, to 2.1%, is forecast for 1998. The Convergence Programme predicts that it will then return to "*its trend rate of 2.25%*".[8]

The same is true of unemployment rates. The UK rate is now below 6%[9], as compared to an EU average rate of 10.3%.

Chart 5. UK economic performance: growth and unemployment



* = *forecast*

Source: Commission Communication (COM(1998) 103 final of 25.02.1998

Part of the explanation, however, could be that the UK's economic cycle is out of alignment with that of most other Member States. This is indeed the main argument advanced by the Government for not joining the Single Currency in 1999.

Real GDP was falling in the UK in both 1991 and 1992: a period during which the German economy grew by 5% and 2.2%, and the French economy by 0.8% and 0.2%. Since then the UK

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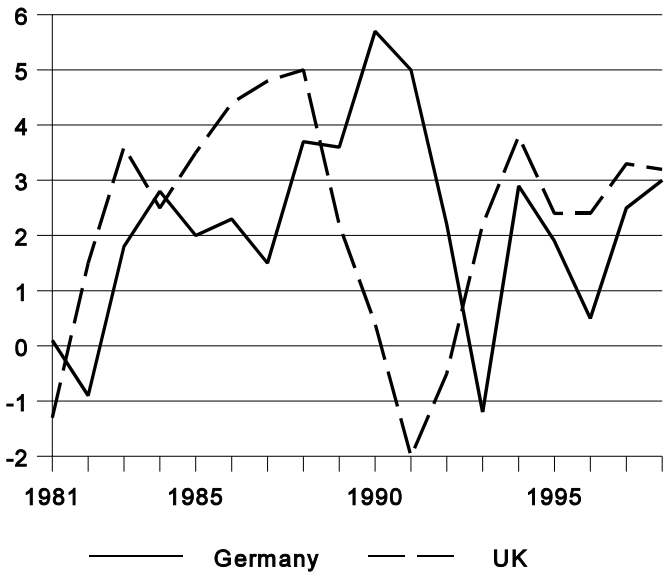
[8] Growth rates sustained above this level can create inflationary pressures. The Convergence Report explains that the trend rate of growth "*can be broken down into three components: (i) trends in the labour force; (ii) changes in the underlying unemployment rate; and (iii) the trend in productivity*." Of these, the most important was productivity, which "*grew at around 1.75 - 2 per cent a year over the last economic cycle*". The Report considers it plausible that non-inflationary growth of between 2 and 2.75% a year "*might be sustained over the medium term*". A "*more prudent estimate of the trend growth rate would be 2.25%, which is also broadly in line with the post-War average and the average over the last full cycle (between the estimated on-trend points in early 1986 and early 1997).*

[9] Unemployment figures are calculated either on the basis of social security claims (which give a 1997 rate of only 5.5%) or of the Labour Force Survey (LFS), which gives a rate of 7%. The published figure is a composite.

economy has enjoyed a sustained economic upswing, combined with falling unemployment, while other European economies have been in recession.

Chart 6: German and UK growth rates, 1981-97



Source: "European Economy": 1996 Broad Economic Guidelines

On the other hand, the latest figures and forecasts show a marked recovery in both the German and other Continental economies, while the UK continues to enjoy steady growth. Unless there is a dramatic slowdown in the UK economy in the near future, the cycles may therefore be moving into alignment.

Even during the recession period of 1991-2, however, UK unemployment levels were at or below the EU average. From the start of 1993 - when both the EU average and the UK level were just above 10% - the gap has steadily widened.

One explanation advanced for this situation is the relative flexibility of the UK labour market. In this respect the UK economy has certain common features with that of the United States, where unemployment levels and growth rates are following a similar pattern.

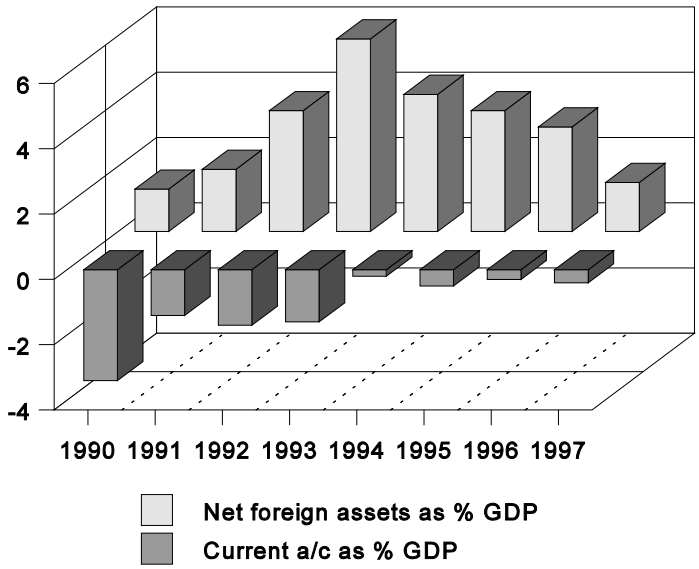
h) Trade and the balance of payments

The UK has during the 1990s been running regular annual trade and current account deficits. Capital investment flows, however, are of far greater importance to the UK economy than is the case with other EU Member States. The UK economy has attracted substantial inward investment over recent years. It nevertheless has a substantial and growing net external assets position.

The recent rise in Sterling has led to fears that British exports will be priced out of foreign markets, so leading to a sharp deterioration in the balance of trade. Though reports from

manufacturers indeed show a sharp fall in export order-books, the overall figures have so far shown no massive deterioration in the balance of payments. There is a general view, however, that such a deterioration will take place if Sterling remains at a level significantly above D-Marks 3.

Chart 7: UK capital and current accounts as a percentage of GDP



Source: EMI Convergence Report, March 1998.

Note: The current account is now described as the "current account plus new capital account". The EMI observes that this is in accordance with the 5th edition of the IMF Balance of Payments Manual, which is "conceptually the equivalent of the current account in previous editions of the manual". The net foreign assets are defined as the international investment position (IIP) as defined by the IMF, or the closest possible substitute.

The political background

Public opinion in the United Kingdom remains hostile to joining the Single Currency - most polls[10] show around 60% to be against. This is despite the positive attitude of the Blair Government; and the fact that the Confederation of British Industry (CBI), the trade unions (TUC), the Liberal Democrat Party, most of the Labour Party and an influential section of the Conservative Party are broadly in favour.

Until recently, there was also a widespread belief that the Single Currency would be delayed until after 1st. January 1999, giving the UK an extended period to "wait and see". It is now realised that EMU will be starting on time,[11] and that there will be major consequences for the UK .

a) The Government

A year before the May 1997 General Election, the then Shadow Chancellor of the Exchequer, Gordon Brown, told a meeting in Bonn[12] that Labour had no "arguments of principle" against joining the Single Currency, but believed that a series of "practical problems" had to be solved. He outlined a number of "British economic tests" for membership:

- *would EMU create a better climate for investment ?*
- *how would it affect UK financial services?*
- *were the business cycles of the UK and continental Europe compatible?*
- *would EMU be flexible enough to deal with cyclical and other economic problems?*
- *would EMU promote economic growth, stability and lasting employment?*

These were elaborated in a detailed document following the election of the Labour Government in 1997.[13] This emphasised, in particular, that the UK economic cycle had hitherto been closer to that of the US than that of Germany or of France, reflecting the UK pattern of trade.

In the event, the policy on which the new Government was elected turned out substantially the same as that of its outgoing Conservative predecessor: participation in the Single Currency was neither "ruled in" nor "ruled out". To this was added the pledge to hold a referendum before committing the UK to membership, a policy common to all the main political parties.

The UK was under an obligation to state before the end of 1997 whether it intended to join the Single Currency at the beginning of 1999. The Government clarified its position in a statement to Parliament on Monday 28th October.

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[10] The Annual British Social Attitudes Survey conducted by Social and Community Planning Research gives a figure of 61% (see *Financial Times* of October 6th 1997). The Gallup poll gives 57% "in favour of retaining the Pound" (see *Daily Telegraph* of 26th September 1997)

[11] This has come as a considerable surprise to some. "*How could the EMU-sceptics (myself included) have been so wrong?"* wrote *Times* correspondent Anatole Kaletsky on March 3rd. 1998.

[12] Reported by the *Financial Times* on Wednesday, May 8th. 1996.

[13] "UK Membership of the Single Currency: an Assessment of the Five Economic Tests" *(HM Treasury, October 1997).*

- The UK would not exercise its right to take part in EMU Stage 3 on 1st January 1999.
- Though membership before the next General Election was not renounced *"legally, formally or politically*", it was not a realistic prospect.
- If economic tests were met, membership would take place "*early in the next Parliament*".
- Active preparations for membership would in any case begin.

Certain steps have indeed already been taken to prepare the general public for a referendum on the issue. The government has already circulated 17,000 copies of a pamphlet by Prof. David Currie of the London Business School on the pros and cons of EMU membership. Some 35,000 practical guides for business have been distributed. Reversing a decision by the previous government, the UK is taking up its share of the EU's information budget for promoting EMU.

The Treasury has also established a special EMU advisory group to investigate the practical implications for the UK of joining the Single Currency, which will report at the end of 1997. The Chancellor of the Exchequer also told the CBI Conference on 10th November 1997 that companies might even be able to file accounts, issue shares and pay taxes in Euros before the UK fully joined the monetary union.[14]

b) The Bank of England

The current Governor of the Bank of England is on record as being both "*frankly nervous at the prospect of introducing the euro at a time of very high and very different rates of unemployment across Europe"* [15] and wary of early UK participation in EMU Stage 3. Instead, he advocates pursuing, at least for a time, a "parallel" policy of low inflation, low public borrowing and low interest rates - in effect that the UK should qualify for participation, whatever the actual decision[16].

On the other hand, the Bank has itself led a campaign to encourage the City of London to prepare for a single European currency. This reflects a growing general belief in financial circles that the Single Currency will indeed come at the beginning of 1999; and that the City will be obliged to adapt to new competitive conditions, whether the UK joins or not.

c) The Opposition

Though the policy of the Conservative Party at the 1997 election was to keep all options open, its manifesto stated it to be *"unlikely"* that there would be "*sufficient convergence of economic conditions across Europe for a single currency to proceed safely on the target date of January 1st 1999"*. Without such convergence "*a British Conservative Government will not be part of it"*.

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[14] Reported in the *Financial Times* of 11th November, 1997. See also *The Times* of February 25th.: *"Brown will clear way for firms to pay tax in euros"*.

[15] 16th Mais lecture, delivered at the City University Business School, London, on 24th June 1997.

[16] See evidence to the House of Commons Treasury Select Committee at the beginning of May 1996.

Following the election defeat, William Hague replaced John Major as Leader of the Opposition. He stated his policy to be that the UK should not join the Single Currency either "*in this parliament or the next"*: i.e. for possibly ten years. At the 1997 Conservative Party Conference in October, the line appeared to soften: joining was ruled out "*for the foreseeable future".* A later meeting of the Shadow Cabinet, however, confirmed the Hague position as official policy (though there have been recent rumours that the policy may be "toned down" for the 1999 European Parliament elections)[17].

Though the Conservative Party is therefore set to fight the next election on a platform opposing UK membership of EMU, it has been agreed within the Shadow Cabinet that Conservative supporters of the Single Currency will be free to campaign for a "yes" vote in any referendum.

d) The Labour Party

Over the last fifteen years, opinion within the Labour Party has become steadily more favourable towards the European Union. A significant turning point occurred in 1988, when the then Commission President, Jacques Delors, addressed the Trade Union Congress. The trend accelerated under the leadership of John Smith. Finally, with the coming of "New Labour" and the leadership of Tony Blair in 1994, the last official traces of the old anti-Europeanism disappeared.
The attitude of the Party towards the Single Currency has followed the same trend. Though initially critical of the possibly deflationary consequences of the Maastricht criteria and the subsequently negotiated Stability and Growth Pact, party spokesmen have increasingly emphasised the positive aspects of EMU: notably the limitations it will place on currency speculation. The emphasis on job-creation at the Amsterdam Summit is seen as an important positive development.

There remains, however, an element within the Labour Party which continues to be antagonistic towards the EU and EMU. Some 50 Labour MPs in the 1992-97 Parliament formed "A People's Europe" group, which called for a manifesto commitment that the Pound should not join EMU during the lifetime of the next Parliament. Associated with it were prominent life-long opponents of UK membership of the European Community like Tony Benn and Peter Shore.

Though greatly diminished in relative strength by the large numbers of New Labour MPs elected in May, such opposition is particularly strong on - though not exclusive to - the left of the Party. This believes that the "*sado-monetarist blueprint for a single currency.....will institutionalise low growth and high unemployment*".[18]

e) The Conservative Party

Within the 1992-7 Conservative parliamentary party, there was always a group of about 20 MPs resolutely opposed to any UK participation in a Single Currency, which they believed would

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[17] See *The Times* of March 20th., 1998

[18] From an article by Larry Elliott writing in *The Guardian* on April 29th. 1996.

involve an unacceptable sacrifice of national sovereignty. The Conservative whip was temporarily withdrawn from eight of these in 1993 during the passage of the Maastricht Treaty.
As the General Election approached, a general increase in "Euroscepticism" resulted in more widespread opposition to EMU. John Redwood, who challenged John Major for the leadership in 1995, called for British participation in EMU to be ruled out altogether. During the General Election campaign the party found it increasingly difficult to hold the official line of "wait and see".

In the new leadership contest which followed the general election defeat, former Chancellor of the Exchequer, Kenneth Clarke - generally recognised as a supporter of EMU - was defeated by William Hague. This reflected a desire within the parliamentary party[19] for a more Eurosceptic line, and for opposition, in particular, to "the abolition of the Pound".

Significant support for EMU nevertheless exists within the Party. Some leading members of the Party including the then Shadow Agriculture Minister, ex-MEP David Curry, resigned from the Shadow Cabinet in protest at the hardening of the party line against UK participation. Opponents of Euroscepticism have come together within the "Conservative Mainstream" group, under the chairmanship of former Deputy Prime Minister, Michael Heseltine. He has argued strongly that the Conservative Party should not cut itself off from business opinion, and that ruling out membership of the Single Currency for ten years "*is inconsistent with Britain's national interest*".

Meanwhile, former Chancellor of the Exchequer, Kenneth Clarke, has called for an all-party campaign to win a "yes" vote in the EMU referendum.

f) The Liberal Democrats

The Liberal Democrat Party has consistently supported both the principle of Economic and Monetary Union and UK participation. Writing in the *Financial Times* on 6th October 1997, party leader Paddy Ashdown called on the Government for an early "declaration of intent", including "*a clear commitment to join Emu within a defined timescale - say no later then the end of 2001"*. The declaration "*might also include some agreed indicative range within which Britain intends to enter Emu, say DM 2.55 to DM 2.70"*; and should set a date for the referendum.

Although the large Labour majority in the House of Commons has not given the Liberal and Democrat Party the influence it might have enjoyed had the result been closer, it now has some 40 MPs, who form an important pro-EMU bloc there.

g) Scotland and Northern Ireland

Scotland and Northern Ireland are unique within the European Union in that a number of their clearing banks currently issue their own banknotes.[20] They are not legal tender within the UK

[19] According to the National Union of Conservative Associations, however, Kenneth Clarke was the clear favourite in the constituency parties.

[20] The Isle of Man also issues its own Sterling notes and coins. It is not, however, part of the UK, nor of the European Union, though bound by Protocol to certain provisions of the UK Accession Treaty.

(although are generally treated as such), and therefore do not strictly come within the scope of the Maastricht Treaty. Scottish and Northern Irish clearing banks may therefore, in any case, be able to continue with current practices after the introduction of the Euro. Otherwise they would wish arrangements to make the continuation of present practices possible.

The referendum decision in Scotland to set up a separate parliament has lent additional importance to distinctive Scottish opinions on EMU. The **Scottish National Party** itself is positive about the potential benefits of EMU in general, but emphasises the need to take account of the costs in some countries of meeting the convergence criteria. It believes that the ultimate decision on Scottish membership of EMU should be the subject of a separate referendum of the Scottish people.

In Northern Ireland, **Unionist** opinion is generally sceptical about EMU. By contrast, the **SDLP** is broadly favourable.

h) Industry and Commerce

"*Under the Tories"* the *Sunday Times* columnist David Smith wrote on 5th October 1997, "*any businessman who championed the single currency was seen as several pfennigs short of a D-mark. Now it is becoming....the conventional wisdom".*

Business opinion in the UK has in fact been divided on EMU for some years. The Confederation of British Industry, which broadly represents the larger and more established UK firms, together with the National Farmers Union, is generally *in favour* of participation. On the other hand, the Institute of Directors, which tends to represent smaller firms, voted at its 1996 annual conference in April 1996 *against* by a margin of 69.1% to 28.3%. Prominent figures in the business world can be found on both sides of the argument.[21]

A survey of its members by the CBI in mid-1997 found 72% in favour of Single Currency membership "*as soon as economic convergence is in place*". Only 16% disagreed, and there were 11% of "don't knows". The main demand from those in industry and commerce has been for a "time frame" for membership. If the UK is to join, it emphasises, the British Bankers Association has argued, preparations urgently need to be made; but companies are not willing to commit themselves to the necessary expenditure unless eventual membership is assured. A survey by Barclays Bank has found that 75% of UK firms have made no preparations for monetary union.

British business in general, however, is also becoming aware that a Single Currency will have an impact, whether the UK participates or not. Firms which supply to the rest of the EU have "*already been warned by large continental companies to switch price lists from sterling to euros from 1999*"[22]. Many may switch their billing and payment system from sterling to Euros; and the Euro could well, as a result, be "forced down the supply chain". Marks and Spencers has already made a decision to show prices in both Sterling and Euros in 1999. Suggestions have even been made that the Euro should in any case become a "common currency" in the UK after 1999, being

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[21] The main opponents of EMU within the business Community, led by chairman of Dixons Group, Sir Stanley Kalms, wrote an open letter to the *Sunday Times* on 18th.January 1998.

[22] See *Financial Times* of 21st July 1997

accepted as legal tender alongside Sterling.[23]

i) The Trade Unions

Like most of their European counterparts in the European Trade Union Confederation (ETUC), the UK Trade Union Congress (the TUC) strongly supports UK membership of EMU. The TUC General Secretary, John Monks, has campaigned for early entry on the grounds that "*a prolonged absence from the Euro will be harmful to British jobs"*.[24] The general secretary of the AEEU engineering union, Ken Jackson, has even confessed to being "*devastated*" by the possibility that the UK will not join before the next election.[23]

j) The Press

During the early 1990s, the British national press as a whole increasingly adopted a "Eurosceptic" stance. Tabloids, notably *The Sun*, specialised in "Euro-scandal" stories, and in headlines like *"Up Yours, Delors", "Stuff your union Jacques, Santer*", and "*No Way Euro Day*". Much the same attitude was adopted, if less blatantly, by both *The Daily Telegraph* and *The Times* and by *The Sunday Times*. The *Financial Times* and the *Independent*, on the other hand, remained broadly supportive of the EU, with the *Guardian* tending to reflect Labour's position.

Voices within the UK press itself were also themselves aware, however, that the way in which Europe was being handled was not serving the British public well. Writing in the *Sunday Times* on 12 May 1996, Robert Harris observed that "*there is a case to be made against, say, a European currency, which carries less weight when advanced by British diplomats precisely because of the strident background noise*".

Over the last year or so - and particularly since the General Election, when anti-Europeanism did not turn out to be a vote-winner - the tone of the press has changed somewhat. Though editorials in, for example, *The Times* and the *Sunday Times* have warned PM Tony Blair against an "*EMU ambush*" to "*bounce the UK into EMU*"[25], there is an increasing (if in some cases reluctant) belief that *"sterling cannot remain outside a single currency for long after a successful launch*".[26]

There are even signs of a more favourable attitude towards the EU as a whole. For example, in May 1997 two articles in *The Times* by Simon Barnes - one headed "*How Cantona & co beat Alf Garnett*"[27] - drew attention to how "*Continental football idols - Eric, Ruud, Gianfranco and Jürgen - have swept British xenophobia off the field*".

k) The issues

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[23] See, for example, *"A New Proposal On European Currency"* by Dr. Madsen Pirie (Adam Smith Institute, February 1997)

[24] *Financial Times*, 22nd October 1997.

[25] *Times*, September 29th. 1997

[26] Maurice Peston in the *Financial Times* 27th September 1997.

[27] *Times*, 24th May 1997

The possibility of a Single European Currency has been a prominent topic of controversy in the UK for some years now. The arguments have had both an economic and a political dimension.

Economic issues

Proponents of EMU in the UK have rested their case on much the same general arguments as those advanced elsewhere within the European Union: namely that "a Single Market needs a Single Currency". The purpose of EMU is "*to abolish the costs of switching from one currency to another (and) to end uncertainty caused by one currency rising or falling against another*"[28].

The events of 1992, 1993 and 1995 have also drawn attention to the potential role of EMU in ending the vulnerability of European currencies to world-wide speculative attack. More specifically, the emergence of the Euro as a major international currency is seen as providing a stable alternative to the Dollar.

Opponents have maintained:

i) that EMU is itself undesirable: European economic and cultural diversity, and the inflexibility of labour markets, will cause the monetary union to "blow apart".

ii) that, even if EMU is desirable, the Maastricht model is not. This opinion is to found on both the left and right of British politics (compare, for example, the Larry Elliott quotation earlier[29] with the statement by Opposition Trade spokesman John Redwood: "*Preparing for the single currency is destroying jobs and raising taxes across western Europe*"[30]).

iii) that, even if EMU is desirable, the UK should not participate. This opinion is much more widely held than about EMU *per se*. Three factors in particular are cited:

- The apparent non-alignment of the UK's economic cycle with the rest of the EU;
- The supposed greater dependence of the UK economy upon economic links with countries outside the EU than is the case with most Member States: for example, participation in world financial markets.
- The sensitivity of the UK economy to movements in short-term interest rates. This derives, in part, from the extent to which housing is financed by variable-rate mortgages, and the reliance of small businesses on bank overdrafts.

On the other hand, there is also a widespread feeling that if EMU goes ahead as planned, the UK economy - including the London financial markets - would suffer from being left out. Opinion in political, administrative and business circles is aware of the mistakes of the past: i.e. finding it necessary to negotiate an entry after the main "rules of the game" have been established.

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[28] Commissioner Sir Leon Brittan in the *Financial Times*, 16th May 1996

[29] The article quoted was also reporting the publication of a pamphlet, "*There is an Alternative"*, by the Campaign for an Independent Britain, and documents from Ken Coates MEP and former Labour MP Stuart Holland.

[30] also in the *Financial Times*, 16th May 1996.

Political issues

The economic dimension of the debate therefore leads directly to the political question which has been at the centre of the UK's policy towards Europe since the early 1950s: to what extent is it acceptable to "surrender" or "pool" national sovereignty in order to obtain economic benefits and a "seat at the table"? On the political right, the primary objection to EMU is precisely that it is seen as yet another step on the way to "a country called Europe"[31]. They envisage the Bank of England becoming "an outpost of Frankfurt"; and Parliament "*no longer having a say on how much you can borrow, what the mortgage rate should be, whether your business can expand*". This view is shared by opponents of EMU on the political left, where there is strong resistance to the idea of surrendering control of the economy to "unelected central bankers".

.By contrast, removing the money supply from political control is seen as an *advantage* by supporters of EMU, and even by some opponents on the political right. The record of the nationalised Bank of England in maintaining the value of the £ is contrasted unfavourably with the record of the *Bundesbank* in relation to the D-Mark. At the Institute of Directors conference in April 1996, Liberal Democrat deputy leader Alan Beith waved a £5 note issued in 1949 to make the point. It is now worth less than 29p..

l) Possible Scenarios

Given the Government's position as outlined by the Chancellor of the Exchequer on 27th October 1997, and the current state of the UK economy, a number of scenarios are now possible.

♦ *UK membership before the next General Election*

This has not been entirely ruled out by the Government (see earlier). It would depend upon unforeseen economic developments: notably a rapid alignment of the UK and Continental business cycles, and a convergence of short-term interest rates. A number of legal hurdles would also have to be overcome: for example, ERM membership and further changes to the status of the Bank of England. Finally, there would need to be an early referendum, with little time to win over a currently sceptical electorate. Such a scenario is extremely unlikely.

♦ *UK membership in mid-2002*

This is the scenario with the highest probability. It now virtally certain that (apart from the UK) only Greece, Denmark and Sweden will remain outside EMU in 1999, and there will be strong arguments for all these countries to join the Single Currency in 2001 or 2002 - perhaps at the same time as the final changeover to Euro notes and coins in July 2002. (Greece may well now join earlier, given that the Drachma is now within the ERM). Economic cycles may then also be more in alignment. Certainly the financial markets - as measured by bond yield curves, the currency swap markets, etc. - are already predicting UK membership at this time. The timetable

[31] Redwood *op. cit.*

would be:

- A General Election in 2001, with a majority of pro-EMU MPs of all parties being returned.
- An Act of Parliament, establishing an intention to join, and providing for a referendum.
- The referendum itself.
- Legislation on the Bank of England, on notes and coins, and other technical matters.
- A decision by the European Council (following the recommendations of the Commission and the European Central Bank) that the UK still fulfilled the convergence criteria.

Whether, and at what stage, Sterling would join ERM2 is still unclear.

♦ *UK membership at a later date*

Alternatively, the UK could continue outside the Euro area for 5 to 10 years, or even longer. Even if Greece, Denmark and Sweden became EMU members earlier, the UK would in due course be joined outside - but within the EU itself - by Poland, the Czech Republic, Hungary, Estonia, Slovenia and Cyprus, and perhaps by Latvia and Lithuania.

This scenario would be the most likely outcome of the next General Election returning a Conservative Government under current official policy. Critical problems in this case would be:

- the possible marginalising of the UK in decisions on economic policy in general, as recently predicted by French Finance Minister, Dominique Strauss-Kahn; and
- whether or not Sterling would have to be linked to the Euro within ERM2

♦ *No UK membership, and a floating £*

This is the option generally favoured by the "Eurosceptic" right. The £ would, in effect, be linked to the $ rather than the Euro. In this case, however, the UK would have to face the possibility of being partially excluded from the Single Market, as those in the Euro area took steps to counteract any "competitive depreciation" of Sterling. In the long run it might result in the UK retiring from the EU altogether in favour of membership of the European Economic Area.

♦ *EMU does not take place in 1999, or falls apart afterwards.*

These are possibilities in the event of a major international financial crisis before 1999; or if the economies of some EMU participants deteriorate severely afterward, leading to political upheaval and breaches of the Stability and Growth Pact, or even the re-creation of national currencies. In the event of such Doomsday scenarios - predicted by certain economists and economic

correspondents[32] - the UK would have no decision to make. But none of them appear likely.

[32] For example, John Jay in the *Sunday Times* of 2nd November 1997, who predicts "*a level of civil unrest not seen since the 1930s, maybe the kind of conflict seen more recently in Bosnia - or something even worse"!* Similar predictions have recently been made by Professor Martin Feldstein of Harvard University, who points to lessons provided by the American Civil War (in a recent paper, "*Emu and International Conflict"* in *Foreign Affairs*, reported in the *Financial Times* of 19th November 1997 by Richard Lambert: "*Europe's dangerous monetary experiment"*).