

Obstacles Still Ahead for Sterling Entry into EMU

On 9 June, UK Chancellor Gordon Brown delivered his long-awaited assessment of the UK's requirements for entry into EMU. The Chancellor was positive about the long-run benefits of membership of the single currency but, in the short-term, felt that the UK was not ready to join. As in 1997, only one of the five economic tests, whether membership would impact on the UK's financial services industry, has been met. The assessment did, however, point out that the two tests on investment and growth could be met if stable and durable convergence is achieved. This leaves convergence (Test 1) and flexibility (Test 2) as the main stumbling blocks to membership.

On convergence, the report concluded that significant progress had been made since 1997. The UK now exhibits a greater degree of cyclical convergence than some EMU members demonstrated in the run-up to the start of EMU in 1999 and remains more convergent than a number of EMU countries today. However, this convergence is still not sufficient to warrant entry. Remaining structural differences with the euro area pose a significant risk to the UK, not least of which is the housing market. The UK's preference for floating rate mortgages means that interest rate changes could have materially different effects in the UK than the rest of the eurozone.

Flexibility is particularly important in an EMU context as the independence of interest rate policy is removed. The flexibility of the UK economy has improved markedly since 1997, with considerable progress made on labour market reform, product and capital markets. However, more needs to be done to ensure that the UK is resilient to deal with the challenges of EMU membership.

The Chancellor also outlined a number of policy initiatives, two of which are worth noting. First, was the announcement that the government plans to change the measure of inflation targeted by the Bank of England from the current RPIX measure to the eurozone's preferred HICP. The switch is due to take place in November, when the Chancellor delivers his pre-budget report. With the HICP trending below the RPIX (the current HICP annual rate is 1.5% while the RPIX rate is 3.0%) this could have implications for UK interest rate levels.

Secondly, and of particular interest to UK business, were the studies on the equilibrium exchange rate for sterling-euro. The level used by the Treasury in its assessment of the economic tests was Stg0.73p and reflects a \$1.15 rate for dollar-euro and \$1.59 for dollar-sterling. While the government is under no obligation to accept the rate, the favouring of a particular level in its assessment is important nonetheless and will be a focal point for exchange rate markets. Thus, it could help to keep the sterling-euro rate in a reasonably tight range to its current rate of Stg0.71p.

Setting out a programme of reforms, which should in themselves help towards sustainable and durable convergence and flexibility, and drafting legislation to prepare the way for a referendum, the government appears to be accelerating the processes of membership. However, there are still significant obstacles ahead, not least of which is public opinion. The Treasury has said that it may review the 5 economic tests next Spring. However, notwithstanding Tony Blair's desire for membership, we feel that the chances of sterling joining EMU in the lifetime of this parliament are still slim.

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