

House of Commons
Treasury Committee

THE UK AND THE EURO

Sixth Report of Session 2002–03

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Proceedings of the Committee*

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Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by the page number as in 'Ev 12'.

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SIXTH REPORT

SUMMARY

The Committee's inquiry and this Report

The Committee agrees with the Chancellor that the question whether to join the euro is “perhaps the biggest peace time economic decision we as a nation have to make”. This inquiry has examined the operation of the euro, since its beginning in 1999, and the basis for the assessment of the Government’s ‘five economic tests’ for deciding whether Britain should join.

Political issues will form a major part of any referendum debate, but the role of this Report is to examine the economic implications of any decision to join. If the Government’s imminent announcement leads to a referendum, then the Report will inform the referendum discussion. If the assessment is against joining, then it should nevertheless assist the debate for as long as the euro remains an issue.

The workings of the euro so far

The European Central Bank: In the eurozone, interest rates are set by the European Central Bank, with a good record of success in controlling inflation. The ECB’s control of monetary policy would be better with less apparent emphasis on monetary growth and with a ‘symmetrical’ inflation target. There should be changes to increase accountability. In preparation for enlargement, further consideration could be given to setting up a smaller committee—more separate from the national bank governors than the committee currently envisaged—for setting interest rates.

The Stability and Growth Pact: To support eurozone economic stability, limits are placed under the European Treaties on national governments’ freedoms to incur budgetary deficits. The Committee supports the need for medium term fiscal sustainability but emphasises the need for a flexible interpretation that allows an appropriate government response in downturns. It welcomes the reforms in interpretation adopted by the EU so far as a step in the right direction, for example in recognising greater leeway for individual countries to spend on investment and in making more reference to the economic cycle. But the Committee also notes that it is important that the discipline of overall fiscal policy expressed in the Pact remains firm so that breaches of it do not become a way of avoiding the structural reform needed for long term sustainable growth. The Government should make clear how far the reforms meet its own requirements for the Pact.

Performance of the eurozone economies: The eurozone economy has performed sluggishly in the difficult economic environment in 2001 and 2002, after two better initial years 1999 and 2000. There is need for increased structural reform (in particular the reforms set out by EU leaders in the Lisbon objectives in 2000). Germany’s problems are considered partly to be related to the euro and partly to other issues.

The five economic tests

The assessment process: There is a need for a serious and in-depth analysis which will allow the Government to take a properly considered and researched decision on the economic consequences of joining the euro. But an economic analysis is not a mechanistic exercise and there will inevitably be an element of judgement involved. It will be difficult for the results of the assessment to be totally unambiguous. Non-publication of the supporting studies will have reduced the opportunity for informed public debate before the Government becomes committed to a particular judgement.

The 5 tests and supporting studies: The assessment must examine not just the economic effects of joining but also what the effects would be of not joining. The assessment, unlike the previous examination in 1997, will have evidence of the track records both of the euro itself, and of the post-1997 arrangements for control of monetary and fiscal policy in the UK.

The individual tests: The Committee does not form a view as to whether individual tests have been passed (though it notes a greater degree of convergence than in 1997), but identifies a number of issues the tests should be seen to have examined. These include: the implications of the recent imbalances in the economy for achieving convergence; how the UK would react to changes in eurozone interest rates; the effects of any increased volatility versus the dollar; the response to pressures for tax harmonisation; the real significance of current inward investment statistics; the impact of the SGP on public investment; UK influence on EU financial regulation; and the impact of the current ECB reforms. The Committee welcomes the forthcoming examination of the take up in the UK of fixed rate mortgages (which are more common in the eurozone).

Timing and negotiation of entry

The Committee notes a number of issues relating to the process of entry including: the Government's current policy towards keeping within the 3% Treaty limit for the budget deficit; the setting of the entry level for the exchange rate (the Committee notes that a number of witnesses regard the present level as close to what is appropriate); and whether the UK needs to rejoin a form of the Exchange Rate Mechanism. There may currently be a 'window of opportunity' for influencing debate on reforms within the euro system, which may close if the UK decides not to join.

The Committee summarises a range of policy options now facing the Government. There are political implications to each option, but the economic case should be made before any decision to enter is taken.

Engaging the public in the debate

The Committee has examined how the public is to be informed about the issues and encouraged to participate in any referendum. All concerned should be seeking to promote as full a debate as possible. There is a shortage of objective information on the economic issues: the Committee suggests that the Government and the Electoral Commission should address this. The Commission could be given power to provide objective information to each household in the form of a leaflet addressing the main issues of public concern.

The Treasury Committee has agreed to the following Report:

THE UK AND THE EURO

1. INTRODUCTION

The introduction of the Euro

1. The euro was created on 1 January 1999, when the 11 participating EU countries commenced Stage Three of European Economic and Monetary Union. These countries were joined by Greece on the 1 January 2001. This formed the present ‘eurozone’, a common currency area encompassing over 300 million people. The process was completed with the introduction of euro notes and coins, which became legal tender across the eurozone on 1 January 2002. There was a period of dual circulation of the euro alongside the ‘legacy’ currencies, which in most cases lasted for two months, before the legacy currencies were withdrawn.

2. The introduction of the euro came about after many years of debate, culminating in the Treaty on European Union, signed at Maastricht in 1991, where EU leaders agreed firm plans to introduce a single currency by 1 January 1999 at the latest. It was at this point that the UK and also Denmark secured opt-outs from participation.

UK Government policy since 1997

3. United Kingdom membership of the euro has been described by the Chancellor of the Exchequer as “perhaps the biggest peacetime economic decision we as a nation have to make”.¹ The Government’s policy was set out by the Chancellor in a statement to the House on 27 October 1997, in which he announced that the UK would not be seeking to join the euro at that time². It has been restated by the Chancellor and the Prime Minister on many other occasions, and was summarised by the Chancellor in his June 2001 Mansion House speech as “one of pro-euro realism”: there are no overriding constitutional obstacles to joining, and membership of the euro is seen as having potential benefits in terms of trade, currency stability and reduced transaction costs, which if realised could increase the level of economic prosperity in the UK and Europe. The position is stated by the Government as follows:

“In principle, the Government is in favour of UK membership of EMU; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. If it is, there is no constitutional bar to joining.”³

4. The basis as to whether there is a “clear and unambiguous” economic case is the Treasury’s assessment of five economic tests. Should the assessment recommend joining, the process will go through a ‘triple lock’: it would first be subject to approval by the Cabinet, then put to a vote in Parliament and finally to a referendum of the British people. The five economic tests were set out in the Chancellor’s October 1997 statement and in the accompanying Treasury document. The Prime Minister has stated that an assessment of the tests would be delivered within the first two years of the current Parliament, or by June

¹ Mansion House Speech June 2002

² HC Deb, 27 October 1997, col 583

³ HM Treasury website March 2003

2003. The Chancellor announced during his Budget statement that he would be presenting the Government's assessment by the first week in June.⁴

This inquiry

5. We agree with the Chancellor's assessment of the importance of the decision on whether to join the euro. We therefore decided at an early stage in our work⁵ that we would conduct an inquiry into the "UK and the Euro", ahead of the announcement of the Government's decision on the assessment of the five economic tests. The Committee agreed that the terms of reference for its inquiry should be:

"To:

- (i) review the workings of the Economic and Monetary Union since January 1999 with particular reference to the Stability and Growth Pact and the European Central Bank, and examine the implications for United Kingdom membership of the Single Currency; and
- (ii) examine the basis for the Chancellor's current assessment of the five economic tests; with a view to informing the House on these matters."

We agreed also that it should be an important part of the inquiry to examine how debate on the economic issues could be encouraged so as to maximise public understanding of the issues and thus to increase voter interest and informed participation in any referendum.

6. We began taking oral evidence in December 2002, and have held altogether 15 formal evidence sessions with 25 different groups of witnesses. These have included political and economic commentators, academic and other professional economists, business representatives, and representative organisations such as the Institute of Directors, the Trades Union Congress and the No Campaign,⁶ as well as key meetings with the Chancellor of the Exchequer (Rt Hon Gordon Brown MP), the Governor of the Bank of England (Rt Hon Sir Edward George), and the Director General, Economic and Financial Affairs, European Commission (Mr Klaus Regling). A number of British and overseas economists and experts kindly responded to invitations to submit written evidence, and a wide range of other papers were submitted. All this evidence is listed at pages 64–68. We received in addition a large number of submissions from interested members of the public.⁷

7. We also conducted a number of visits within the UK and Europe to discuss attitudes towards the euro and towards the operation—and potential reform—of the Stability and Growth Pact (SGP) and the European Central Bank (ECB), in the light of their operation so far. In November 2002 we went to Frankfurt and Paris, holding meetings with the ECB, the German and French central banks and with the French Finance Minister, as well as other political and economic experts. In February 2003 we visited Edinburgh, Belfast, Newry and Dublin to discuss the views of Scottish and Northern Irish interests on joining the Euro, and the experience of the Irish Republic within the eurozone. In March 2003 four members of the Committee went to Warsaw and Budapest to discuss the perspectives of Poland and Hungary (as two of the largest economies set to accede to the Union—and in due course the eurozone—in the next wave of enlargement) on the process of joining the euro and on reform of the SGP and ECB.

⁴ HC Deb, 9 April 2003, col 284

⁵ Our predecessor Committee had also looked at the euro in 1998 (Fifth Report of Session 1997–98, *The UK and Preparations for Stage Three of Economic and Monetary Union*, HC 503) and 2000 (Eighth Report of Session 1999–2000, *Economic and Monetary Union*, HC 573)

⁶ The pro-euro *Britain in Europe* organisation was invited to attend but declined to do so.

⁷ This followed the inclusion on the *e-politix* website of a statement from the Chairman of the Committee outlining the scope and purpose of the inquiry, with a link inviting the submission of views (which *e-politix* then forwarded to the Committee). We are grateful to *e-politix* for this assistance. A number of submissions were received also following the inclusion of the Committee's e-mail address in an article by Mr William Keegan of *The Observer*, following his oral evidence to the Committee, to whom also we are grateful.

8. We are extremely grateful to all those who have helped during this inquiry, both in the UK and overseas. We are grateful also to the specialist advisers who have helped us.⁸

This Report

9. In this Report we discuss first of all the operation of the euro, and of its institutions and structures (the European Central Bank and the Stability and Growth Pact) since its start at the beginning of 1999. We then look at the Government's five economic tests, before considering a range of particular factors relating to a decision which are specific to the present time and which must therefore be taken into account in the decision. Finally, we turn to the question of how to engage the public in the debate in any referendum.

10. As our terms of reference indicate, the report looks at the economic issues involved in the decision whether to join the euro. But, as many witnesses accepted or emphasised, the issue is by no means a purely economic one. It is also a highly political one, at two-closely interlinked-levels:

C Britain's place within Europe and the future development of the EU: many participants in the debate emphasise the extent to which joining the euro would both symbolise and further Britain's commitment to the EU, and thus increase the UK's general political influence within it, while others argue that joining would represent a further loss of independence and a further step towards statehood for the EU and the effective disappearance of the constituent nation states.

C Economic sovereignty: the debate is not just a technical one about how the economy is best managed but about who holds the economic power; as the Chancellor said in his statement to the House in October 1997 "it must be clearly recognised that to share a common monetary policy with other states represents a major pooling of economic sovereignty"⁹. Given that a government tends to be judged by the electorate on its management of the economy above almost all other issues, the issue of who controls the economy is a highly political one.

In this Report, we do not examine the first of these two issues at all. We try to examine the second only from the point of view of the economic—rather than the political—consequences of the change in the way the levers of economic and monetary policy would be controlled.

11. Many of our witnesses emphasised the extent to which the public's approach to the question would be a political approach rather than an economic one¹⁰. The Prime Minister has said that "the political case for entry is overwhelming"¹¹. Many have argued that there is scope for more debate about this. **We fully recognise that the political issues will clearly form a major part—perhaps even a dominant part—of any referendum debate. But the political issues in themselves are not the subject of this Report.**

12. It must be emphasised also that it is not the purpose of this Report to come to a considered conclusion about whether the five economic tests have been met, or indeed whether the UK should join the euro. Rather, **our intention has been to offer a significant, and balanced, contribution to the debate—so far as possible in relatively simple terms—about the economic implications of a decision to join, or not to join, the**

⁸ Mr Graham Bishop, Professor Tim Congdon, Professor Paul Ormerod and Professor Richard Portes were appointed by the Committee as advisers for the inquiry as a whole on 3 December 2002, and on 10 December Professor Robert Worcester was appointed as an adviser in relation to the aspects of the inquiry dealing with public understanding of the issues ahead in any referendum.

⁹ HC Deb, 27 October 1997, col 583

¹⁰ See for example Q 55 [Dr Diane Coyle, Mr Philip Stephens]

¹¹ New Year Message, 1 January 2003

euro. It follows that the value of the Report should not be seen as being timed solely to influence the imminent assessment by the Government or to influence debate in a referendum this year should there be one. **We hope it will assist the debate for so long as joining the euro remains an issue.**

2. WORKINGS OF THE EURO

The changeover process

13. Eighteen months after their launch, Euro notes and coins have become an integral part of daily life in the eurozone. The completion of the changeover was accomplished at a time of considerable global uncertainty, in the aftermath of the events of September 11th. The Bank of England described the changeover as a “technical success greater than anyone could have anticipated”¹². Mr Mike Rake of KPMG International told us that “contrary to all expectations it was introduced very efficiently and in a very smooth way”¹³. **It is clear that the introduction of euro notes and coins across the eurozone was a logistical success.**

14. There was some concern in the eurozone that traders would exploit the confusion of the changeover to increase prices. Indeed, a public opinion survey conducted by the Commission at the end of January 2003 found that 67% of the public felt that more often than not prices had been rounded upwards. Research by Eurostat¹⁴ found that the contribution to inflation from the changeover process was a maximum of 0.2%¹⁵. One possible explanation suggested was that “shoppers take note mainly of the prices of frequently bought goods; a train ticket, a newspaper, a haircut. It was exactly these small ticket items that became more expensive”¹⁶. The Consumers’ Association told us that “anecdotal evidence collected by consumer organisations in the first wave countries suggested that there have been some significant increases in prices, particularly for personal and leisure services. EU average figures do not of course show sector problems or individual abuses”.¹⁷ The Association also recognised that in the longer term “the greater ability of consumers to make price comparisons may force manufacturers and retailers, over time, to lower prices”. **While rounding up of prices was found to have no significant statistical effect on overall inflation, in a small minority of sectors there was some evidence of retailers taking advantage of the changeover to push up prices.**

The European Central Bank

Strategy and objectives

15. Monetary policy in the eurozone is the responsibility of the European System of Central Banks (ESCB). This consists of the European Central Bank (ECB) and the National Central Banks of each of Member States of the European Union. The ECB is independent of national Governments and the European Commission. The responsibilities of the ECB are to set interest rates for the eurozone, and also to intervene in foreign exchange markets if required. Its primary objective, as defined under the Maastricht Treaty, is to “maintain price stability” in the eurozone.¹⁸ The ECB is able to define what is meant by price stability, which has led the Bank to set its own objective for inflation in the eurozone. Without prejudice to the primary objective, the ECB shall also “support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community”.¹⁹

16. The objectives of the Community are specified in Article 2 of the European Community treaty and include “a high level of employment” and “sustainable

¹² Bank of England, *Practical issues arising from the euro*, May 2002, p6

¹³ Q 114

¹⁴ Eurostat is the statistical office of the European Commission

¹⁵ Eurostat press release, 16 July

¹⁶ Centre for European Reform, *The euro and prices*, January 2003, p 3

¹⁷ Appendix 6

¹⁸ Treaty on European Union: Protocol on the Statute of the ESCB and of the ECB Article 2

¹⁹ Treaty establishing the European Communities (TEC), Article 105

non-inflationary growth”. Britain in Europe told us that the ECB’s mandate was “broadly similar to the UK system introduced in 1997, where the [Bank of England’s] mandate is to meet its inflation target and ‘subject to that’ to support the policies of HM Government for growth and employment”.²⁰ A recent paper from the Centre for Economic Policy Research (CEPR) pointed out that, while the Treaty gave the ECB a double mandate, “the ECB fulfils its double mandate by reducing it to a single responsibility, a focus on price stability”²¹. Mr Wim Duisenberg, President of the ECB, has said in testimony to the European Parliament that “strictly following this mandate [of maintaining price stability] is the best contribution the ECB can make to supporting sustainable non-inflationary growth and a high level of employment in the euro area”²². The CEPR paper considered that “this view is not just narrow, but mistaken” and that “the practical issue is whether the ECB cannot engage in a more active policy of output stabilisation without endangering price stability”.²³

17. The ECB has chosen to define its mandate of price stability as being “year-on-year increases in the Harmonised Index of Consumer Prices (HICP) for the eurozone of below 2%” over the medium term. This objective was criticised by some witnesses as being unhelpfully low and ‘asymmetrical’ because the ECB attempts to keep inflation under 2%, whereas the Bank of England has a ‘symmetrical’ inflation target in that “deviations below the target are treated in the same way as deviations above the target”²⁴. In regarding an undershooting of the target as being as important as an overshooting, the symmetrical approach guards against deflation as well as inflation, while also helping to “ensure that monetary policy not only delivers price stability but supports growth and employment”²⁵. The TUC believed that the ECB’s inflation objective should be “kept at 2% on HICP but set symmetrically with a range above and below the target. So for example a range of 1%–3% might be set”²⁶. The ECB President has, however, countered accusations of a deflationary bias by stating that the ECB’s overriding objective is maintaining price stability, “avoiding both inflation and deflation”;²⁷ and the actions of the ECB in cutting rates while inflation is above 2% lend some support to this statement (see paragraph 19 below). The UK rate of inflation targeted by the Bank of England is measured by the retail price index RPIX. HICP inflation is around one percentage point lower than an equivalent measurement on RPIX, caused in part by major differences in coverage and in part by technical measurement issues.²⁸ In his Budget 2003 the Chancellor of the Exchequer announced an examination of the implications of adopting the Harmonised Index of Consumer Prices. This would bring the UK into line with all eurozone countries.

18. In order to achieve price stability, the ECB has adopted a ‘two-pillar’ strategy to inform its decisions on setting interest rates for the eurozone. The first pillar refers to money supply growth (M3), for which the ECB has set a reference value for annual growth of 4.5%. The second pillar consists of a broadly based assessment of the outlook for price development and the risks to price stability in the eurozone, which has been likened to an ‘inflation forecast’. There was some criticism from witnesses of the ECB’s monetary pillar. The National Institute of Economic and Social Research told us that “monetary growth continues to exceed the ECB’s target, risking bringing it into disrepute in much the same way as happened to UK monetary targets in the 1980s”²⁹. The CEPR believed that “the

²⁰ Appendix 4

²¹ CEPR *Surviving the Slowdown: Monitoring the ECB 4* 2002 p12

²² Testimony to the European Parliament Committee on Economic and Monetary Affairs, 8 October 2002

²³ CEPR *Surviving the Slowdown: Monitoring the ECB 4* 2002 p 12

²⁴ HM Treasury *Reforming Britain’s Economic and Financial policy* 2002 page 47

²⁵ HM Treasury *Reforming Britain’s Economic and Financial policy* 2002 page 47

²⁶ Ev 55

²⁷ Testimony to European Parliament Committee on Economic and Monetary Affairs, 17 February 2003

²⁸ The main differences are that HICP is calculated using a geometric rather than arithmetic mean and excludes housing costs. For March 2003, inflation measured on RPIX was 3%, compared to 1.6% on HICP.

²⁹ Ev 137, para 27

problem with the first pillar was not that it had greatly contaminated interest rate decisions, but rather that it had clouded the ECB's communication strategy"³⁰. **The money growth pillar has an unwarranted prominence in the ECB's monetary framework, though in practice it appears to be disregarded in setting interest rates. This tends to undermine the overall credibility of its monetary framework.**

19. The charts below show money growth, inflation and interest rates in the eurozone:

Chart 1 : M3 annual growth rate

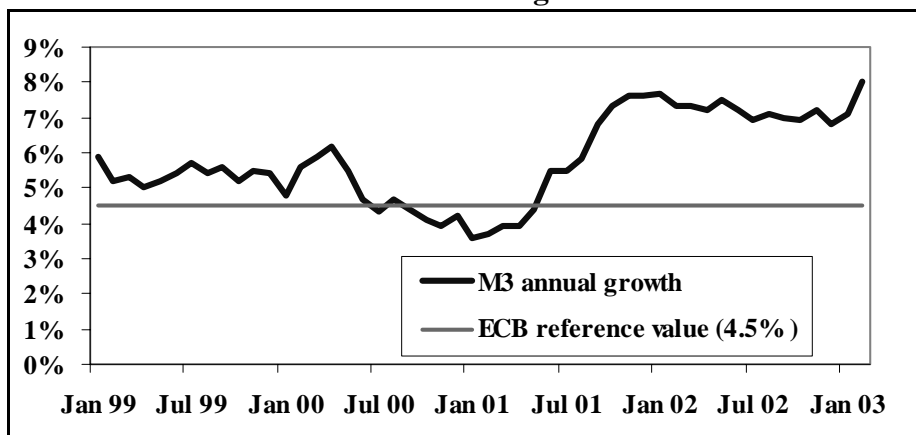


Chart 2 : Eurozone inflation (HICP)

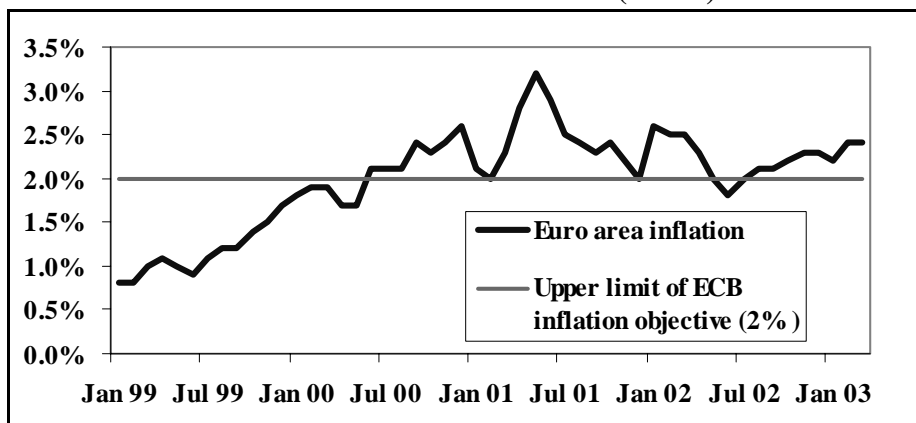
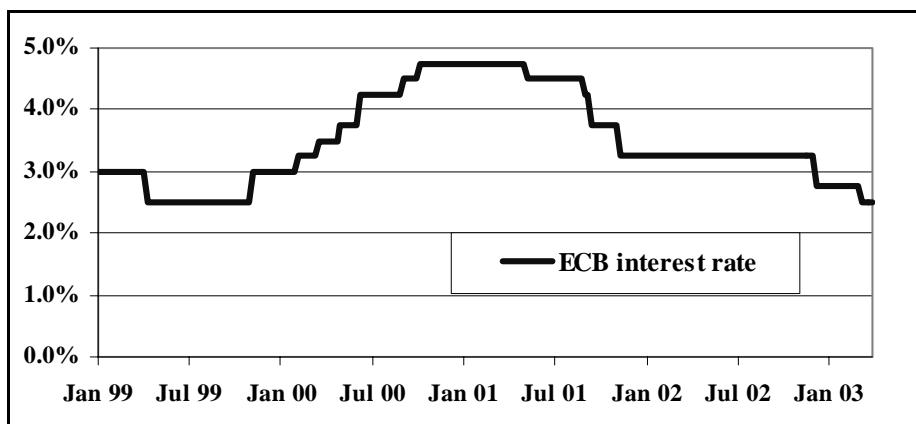


Chart 3 : Key ECB (refinancing) interest rates



³⁰ CEPR *Surviving the Slowdown: Monitoring the ECB* 4 December 2002 p 2

20. The ECB has so far changed its key refinancing interest rate fourteen times, as shown in the above graph. Rates were initially cut in the autumn of 1999 in reaction to the East Asian crisis, and they were then raised during the first half of 2000 as oil and food price rises combined with the depreciation of the euro to push up inflation. As signs of the world economic slowdown began to materialise the ECB cut rates by 0.25% in May and August 2001, followed by a further 0.5% cut after the events of September 11th. The rate was then kept at this level for over a year before a further 0.5% cut in December 2002, and a further 0.25% cut in March 2003. Our witnesses thought that overall the ECB had done an adequate job in controlling inflation although cuts in interest rates in 2001/2 may have come too late in the face of deteriorating economic conditions. Mr Alan Wood, Chief Executive of Siemens in the UK, thought that the ECB had done a “good job of meeting the remit that they were given”³¹. Dr Diane Coyle told us that while the ECB “would almost certainly have done better to cut [rates] faster during 2002, this is a judgement made with the benefit of hindsight. And the core measure of inflation ... averaged 2.6% during the first half of 2002, which also helps explain the slow policy reaction”³². The ECB has continued to cut interest rates although inflation stubbornly remains above 2%, indicating to some that they do take growth into account and that the target is more symmetrical than it appears. There has been some divergence in inflation rates of the individual countries since 1999 and this was seen as making the ECB’s job more difficult. Miss Ruth Lea, of the Institute of Directors, thought the ECB had “done a reasonable job”, but the fact that—on her analysis—there was not proper convergence within the eurozone was making their task “impossible”.

21. The President of the ECB has announced “a serious assessment and evaluation of our monetary strategy” in the course of the first half of 2003. In testimony to the European Parliament he added that “after four years of practice with our monetary policy strategy [... we consider] that it is the appropriate time to take stock of our experience so far and to reflect on the various elements of our strategy”³³. **We welcome the ECB’s review of its monetary policy framework. The framework should be strengthened by the introduction of a symmetrical inflation target. This would not require a great policy change on the part of the ECB, but would provide a better match between its announced strategy and its actions. The ECB would benefit from a less prominent role for the monetary growth pillar, although it should still monitor developments in order to inform its decision making.**

Transparency, openness and accountability

22. Since its inception, the ECB has presented annual reports to the European Parliament, the European Council and the Commission. A monthly report is published and, from December 2000, this has included twice yearly projections of inflation and economic growth in the eurozone. The President of the ECB appears four times a year before the Committee on Economic and Monetary Affairs of the European Parliament. Witnesses felt that the ECB had made some improvements in the area of openness. The Chancellor told us that the ECB was a “far more transparent organisation now than it was a few years ago”.³⁴ Sir Edward George and the Chancellor both contrasted favourably the procedure of the ECB of explaining each decision at a press conference on the same day, with that of the Bank of England, where it is explained two weeks later with the publication of minutes of the MPC’s meeting.

23. One important difference identified by Sir Edward is that the Bank of England publishes the results of the votes at MPC meetings, whereas the ECB “operate by

³¹ Q 414

³² Ev 16

³³ Testimony to the European Parliament Committee on Economic and Monetary Affairs, 17 February 2003

³⁴ Q 1087

consensus and do not publish votes”³⁵. Publication of the voting record of individual MPC members improves accountability, and individual members have to be ready to justify their position (for instance in evidence to this Committee at our regular hearings on the Bank’s Inflation Reports). Members of the ECB Governing Council are mandated to consider the performance of the eurozone as a whole and not national situations when making their interest rate decisions. Some witnesses argued that publication of the votes could invite political pressure on the individual National Central Bankers to vote along national lines rather than considering the appropriate rate for the eurozone as a whole, a view to which Sir Edward George gave some support³⁶. **We welcome the publication of economic projections by the ECB, but believe they should increase the frequency of publication to 4 times per year, as there can be significant change in the outlook over six months. More frequent publication would help the Bank to provide a clearer and more transparent explanation for their decisions.**

24. While it appears that to date formal votes have not been necessary, this may not be possible as the eurozone expands. The ECB should start publishing the voting figures (keeping the votes of individuals confidential), since the figures would indicate changes in policy stance, thereby improving transparency.

25. The TUC also suggested that the interest rate setting process would be improved if the inflation target was set not by the ECB itself but by the European Council.³⁷ Such a move could help to address perceptions that the process lacks any political accountability. **There is a clear opportunity for introducing a mechanism for greater democratic political accountability to the process by which the inflation target is set. We consider that this decision properly rests with ECOFIN.**

Interest rate decision making body

26. Monetary policy decisions are the responsibility of the ECB’s Governing Council, which currently consists of the governors of the 12 eurozone National Central Banks and also the six members of the executive board of the ECB. In our predecessor Committee’s last report on the euro it was noted that reform of the Governing Council could be an “important issue”³⁸ before enlargement of the eurozone took place. Two arguments were put forward in evidence as to why reform was necessary prior to enlargement. First, a decision-making body which, following enlargement, could include up to 30 members was seen as being “too many for efficient decision making”³⁹. Secondly, an enlarged Governing Council run on the principle of ‘one member one vote’ could result in a situation where a coalition of smaller countries could effectively control the monetary policy decisions of the ECB, despite only accounting for little more than 20% of eurozone GDP. The need for reform of the Governing Council was recognised in the Nice Treaty (which paved the way for enlargement of the EU). The Treaty allowed reform of the voting procedures of the ECB to be approved by the European Council on a proposal from either the Commission or the ECB itself.⁴⁰

27. The ECB put forward a recommendation for reform of the voting procedures in the Governing Council on 20th December 2002. In essence, the proposal envisaged that the voting numbers on the Governing Council would not rise above 21, which (with 6 seats taken by the members of the Executive Board) meant that the number of national central bank representatives should not rise above 15. The 15 places would be allotted on a

³⁵ Q 1172

³⁶ Q 1172

³⁷ Ev 55

³⁸ Eighth Report of Session 1999–2000, *Economic and Monetary Union*, HC 573

³⁹ Ev 197

⁴⁰ Treaty of Nice, amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts

rotation system based on three groups of countries ranked according to size. The five largest countries (France, Germany, Italy, Spain United Kingdom) would form the first group and would have 4 seats, meaning that each country's central bank would have a vote for four out of five rotation periods (the length of which has not been decided); the smaller countries in the second and third groups would have correspondingly shorter periods with a vote. Professor Francesco Giavazzi believed that the national central bankers were "simply the wrong group of individuals to propose new voting rules for the ECB" and that it "was inevitable that they would come up with a set of rules that preserves their current rights, rather than proposing the most efficient mechanism for setting interest rates in the eurozone". He went on to say "One of the problems with the current council—which includes 18 members, 12 NCB governors plus the six Executive Board members—is already its size. This has sometimes already produced a status quo bias, that is in the decision to keep interest rates unchanged simply because it proved too difficult to agree on the change".⁴¹ He also identified a number of drawbacks with the scheme in that it capped the number of voting Council members at a level that was far too high, and also violated the principle of ECB statutes, which prescribe that the National Central Bank Governors sit on the Governing Council as individual experts, not as representatives of their own countries. Professor David Begg agreed with this, stating that "one of the good things the ECB has done has been to downplay the nation state, they have mainly focussed on eurozone aggregates in forming their decisions" and that it was "unhelpful" that the rotation system emphasized the nationality as the basis for who had a vote at any one time. Mr Daniel Gros, Director of the Centre for European Policy Studies (CEPS), also pointed out in a recent CEPS paper that "all members of the Governing Council (with and without voting power) will continue to sit at the table and have the right to participate in the discussion. The ECB's proposal thus does not solve the problem of the excessive size of the forum".⁴²

28. Sir Edward George told us that there may be pressure for the ECB to "move to something which is perhaps more efficient over time" but that "The issue is whether now is the right stage at which to exclude national representation on the policy making body". Professor Giavazzi put forward a solution where the "Executive Board should be joined by five independent experts to form the Monetary Committee that makes interest rate decisions, with the Governors bringing important information of local conditions but not making decisions"⁴³. The solution of a small committee was also endorsed by Professor Begg. In its opinion on reform of the voting procedures the European Commission drew attention to the fact that the Nice Treaty "imposes important constraints and limitations which prevented the ECB from considering more comprehensive reform of its Governing structure"⁴⁴. Mr Regling told us that "they were only asked to change Article 10.2 of the ECB protocol which talks about voting procedures" and that the ECB therefore "did not have the mandate" to put forward a more radical proposal. However, the ECB's proposals for reform of its structure on enlargement have now been agreed. **We agree with the Commission that the ECB was prevented from considering alternative proposals for reform of its voting procedures (for example, the introduction of a separate committee based on the Executive Board for setting rates) due to the limitations of the enabling clause in the Nice Treaty. We do not think that the proposals put forward by the ECB are the optimal solution to the problems posed by enlargement. It is regrettable that such an important decision on reform was taken so quickly and with limited debate. We recommend that reform of the Governing Council prior to enlargement needs to be re-considered urgently, under a broader remit allowing changes to the structure of the ECB. We consider such reform important for the credibility and operational**

⁴¹ Ev 198

⁴² *Reforming the composition of the ECB Governing Council in view of enlargement—How not to do it!* Briefing paper for European Parliament Economic and Monetary Affairs Committee, February 2003

⁴³ Q 538

⁴⁴ European Commission press release, 19 February 2003

effectiveness of any enlarged ECB. We think the prospect of UK exclusion from 20% of ECB interest rate votes could prove to be an obstacle to entry.

Stability and Growth Pact

29. Members of the euro have an interest in a stable and orderly monetary union. One possible source of instability is excessive government borrowing by one of the individual countries within the eurozone. Excessive government borrowing in one country could lead to increasing inflation and interest rates, thereby imposing costs on all countries within the zone. In an extreme case a heavily indebted country might default on its debt and impose costs on all eurozone members. It is also argued that reducing government debt and deficits will help member states prepare for the future budgetary costs of aging populations. The Stability and Growth Pact (SGP)⁴⁵ establishes a framework within which members of the European Union have agreed to coordinate their fiscal policies. The Pact requires member states to keep budgets “close to balance or in surplus” over the medium term. Under the Pact countries are also required to observe the two reference values laid down in the Maastricht treaty; these are that government deficits should not exceed 3% of GDP and public debt should not exceed 60% of GDP. The Pact is complemented by the Broad Economic Policy Guidelines (BEPG), which are general guidelines for the conduct of economic policy within the Union, agreed annually by the European Council on the basis of a report from ECOFIN (which acts on the basis of a recommendation from the Commission).⁴⁶

30. The UK Government has also recognised the importance of medium-term fiscal sustainability. It has set two fiscal rules that it will endeavour to meet to ensure that it accomplishes this primary objective. The golden rule states that ‘over the economic cycle, the government will borrow only to invest and not to fund current spending’; the sustainable investment rule states that ‘over the economic cycle, public debt as a proportion of GDP will be held at a stable and prudent level’, which has been defined as a level of net debt below 40% of GDP. The TGWU believed that “the UK’s self imposed ‘golden rule’ is a far more flexible and investment focused fiscal framework”.⁴⁷ Mr Ian Brinkley, of the TUC, pointed out that in some areas the UK’s fiscal framework imposes a tighter regime than the SGP, noting that “the rule on public debt applied by the Chancellor is more rigorous than the one ... applied under the Pact” and that the UK rule implies “roughly 45% on European definitions and the Pact says 60%”.⁴⁸

Implementation of the Pact

31. If a country has a deficit that exceeds the 3% of GDP threshold then the ‘excess deficit procedure’ is launched. The Commission prepares a report. Acting on the Commission’s report the Council decides by qualified majority voting whether an excess deficit exists. If it does then it can recommend that the country take corrective action to bring the situation to an end within a specified period of time. If the Member State concerned persistently fails to put in place the Council’s recommendations, then the Council may decide to apply one of a number of sanctions, ultimately leading to fines for non-compliance lasting at least two years. There is provision under the Treaty for a deficit over 3% not to be regarded as excessive if the deficit is only “exceptional and temporary”.⁴⁹ Countries like the UK that remain outside the eurozone are also subject to the SGP but only ‘endeavour’ to avoid excess deficits and are not subject to sanctions if they fail to do so.

⁴⁵ The Stability and Growth Pact is contained in a European Council Resolution of 17 June 1997 and in Council Regulations 1466/97 and 1467/97: see paper by HM Treasury (Appendix 3).

⁴⁶ TEC Article 99

⁴⁷ Ev 180

⁴⁸ Q 214

⁴⁹ Under the Pact, a deficit is automatically regarded as temporary if output fell by over 2% in the year in question, and may be regarded as temporary if output fell by 0.75–2%

32. Many witnesses referred to the importance of ‘automatic stabilisers’. This is the process through which, during an economic expansion, higher incomes lead to increased income and corporation tax receipts and at the same time lower unemployment leads to reduced social security payments. During an economic slowdown or recession the opposite happens: government tax revenue is reduced and more has to be spent on social security payments. The overall effect reduces the government deficit during a period of high growth and raises the deficit during an economic slowdown. Automatic stabilisers help to reduce the volatility of the economy over the cycle by boosting demand when growth is slow and reducing aggregate demand when the economy is growing quickly.

33. Eight of the twelve eurozone countries achieved the objective of a budget ‘close to balance or in surplus’ by the year 2001. Germany, France, Italy and Portugal failed to reach this objective and have continued to have difficulties since then. To some extent, as some witnesses⁵⁰ and people to whom we spoke during our visit to Frankfurt suggested, countries’ current difficulties in complying with the requirements of the Pact stemmed from a failure to strengthen their fiscal position in earlier years when the economy was performing better. Following the announcement that the budget deficit in Portugal had increased to 4.1% of GDP in 2001, the ECOFIN Council on 5 November 2002 declared that an excess deficit existed in Portugal. The Portuguese Government declared its firm commitment to reducing their deficit below the 3% target in 2002, reducing the deficit to 2.7%. At the ECOFIN Council of 21 January 2003, it was decided that an excessive deficit existed in Germany in 2002, following an outturn figure of 3.6%. An early warning was also sent to France with a view to preventing an excessive deficit occurring in 2003. The Council concluded that the French projection of growth was optimistic and that there was a danger that the deficit would breach the reference value in 2003. The French Government has shown little desire to reduce the deficit for 2003 in the face of weak economic conditions: the Prime Minister, Mr Jean-Pierre Raffarin, was quoted as saying “When growth is uncertain you do not lower spending more than necessary—that would depress the economic climate even further”.⁵¹ Goldman Sachs recently contrasted the fortunes of the three countries that had been subject to the excess deficit procedure: “Germany and France allowed their budget deficits to breach the 3% limit [in 2002]. Portugal by contrast embarked on a hefty fiscal contraction to reduce its deficit below 3%. During the second half of 2002, French and German GDP grew at an annualised rate of 1.25%, Portuguese GDP declined at an annualised rate of 4.5%”.⁵² All three countries illustrate the possible consequences of failure to address significant deficits in good time. However, Portugal, which adhered to the stability and growth pact, suffered more severe economic penalties than Germany and France which did not adhere to it.

34. The TUC believed “that the Pact has put too much emphasis on stability and not enough on growth” and that more flexibility should be allowed in the event of growth of less than 1%⁵³. Professor Begg suggested in respect of reform of the Pact that there is “a need for medium-term fiscal rectitude ... The question is whether there is any way to combine the reaffirmation of that with some operational structure which provides more short-term flexibility”⁵⁴. The Governor of the Bank of England took a similar line, saying that “you obviously have to accept a commitment to fiscal sustainability in the medium and long term but ..., in an environment of weak demand, you must let the fiscal stabilisers operate and not have an artificial cut-off point” and that “applying 3 percent absolutely rigidly would be unwise”.⁵⁵ **We recognise the fact that the countries now exceeding the**

⁵⁰ See for example Q 296 [Mr Martin Weale]

⁵¹ *Financial Times* “France refuses to take steps to curb budget deficit” 25 February 2003

⁵² Goldman Sachs, European Weekly analyst 28 March 2003

⁵³ Ev 53

⁵⁴ Q 301

⁵⁵ Qq 1182, 1195

3% deficit limit of the Stability and Growth Pact would not now be doing so if they had addressed structural fiscal weaknesses before the present downturn. However, tightening fiscal policy at this stage in the cycle could further exacerbate the downturn in the eurozone. We conclude that a Treaty interpretation allowing countries with relatively low overall debt levels to exceed the 3% limit during a cyclical downturn is essential. Governments should, however, take advantage of any increase in economic growth to reduce structural deficits. As growth in the eurozone recovers it is important for those countries with significant structural deficits to achieve an enduring strengthening in the fiscal position. Medium term fiscal sustainability should remain the goal, but if it does not allow flexibility the SGP will lose credibility and jeopardise the ultimate objective. It is important that the discipline of overall fiscal policy expressed in the Stability and Growth Pact remains firm so that breaches of it do not become a way of avoiding the structural reform needed for long term sustainable growth.

Reform of the Pact

35. There have been calls for reform of the Pact from many quarters. We have noted some suggestions in the previous paragraph. Professor Michael Moore, of Queen's University, Belfast, advocated scrapping the Pact with the exception of the target of medium term fiscal sustainability.⁵⁶ Professor Anton Muscatelli, of the University of Glasgow, recognised one criticism of the Pact in that “it gives too much emphasis to deficits and too little emphasis to debt sustainability”.⁵⁷ Some have commented that the Pact is asymmetrical in not establishing any mechanism to encourage governments to improve underlying structural deficits when their cyclical fiscal position is healthy.

36. Recognising some of the growing criticism of the Pact, the Commission put forward a number of proposals to improve its implementation.⁵⁸ Mr Regling described the proposals as intended to make the Pact “a little more sophisticated and more country specific”, by allowing small temporary deviations from the ‘close to balance or in surplus’ rule over the cycle where the deviation is to finance a particular policy initiative with a long-term benefit for the economy, and allowing more permanent deviations from the rule where a country had a long-term healthy financial situation. He thought it possible that “the UK might fall into this category where we would consider more permanent small deviation as appropriate”.⁵⁹ The proposals include measurement of the fiscal balance, for the purpose of assessing adherence to the ‘close to balance or in surplus’ rule, in cyclically adjusted terms. The proposals have no direct effect on the basic 3% limit, because that is set in the Treaty (rather than the Pact) and any change to it would require a Treaty amendment. ECOFIN, in its broad endorsement of the Commission proposals, noted “areas where further improvements could be made or clarification was needed with regard to an effective application of the Stability and Growth Pact. A pragmatic approach seems appropriate which, while abiding by the Pact’s rules, could take reasonable account of specific situations.” The ECOFIN proposals were adopted by the European Council on 20-21 March. **It remains to be seen how far the reforms in the interpretation of the Pact agreed at the March European Council will work in practice, and we believe the promised reforms must be closely monitored to see if they do indeed deliver greater flexibility. We note the principle that there should be more flexibility to take into account the specific situation of individual countries. This could allow higher levels of spending where debt sustainability was not a problem. We note that the Treaty requires classifications to meet the definitions of European integrated economic accounts and that these are monitored by an independent committee convened by**

⁵⁶ Qq 802, 805

⁵⁷ Q 561

⁵⁸ *Strengthening the co-ordination of budgetary policies* European Commission communication, 21 November 2002

⁵⁹ Qq 464-5

Eurostat. It is equally important, however, that individual countries are not allowed to escape the rules of the Pact by artificial reclassification of their accounts or other adjusted accounting.

37. Reforms could go further, for example in the treatment of investment spending. Professor Francesco Giavazzi noted that “There is no attempt [or only a] very mild attempt in the Commission proposal to make the point that current expenditure is very different from investment expenditure and should be treated very differently in the ... accounts”;⁶⁰ he noted also that in the “second part of the 90s, public investment in the euro area has fallen (as a share of GDP)”.⁶¹ The ability to provide for appropriate levels of public investment is important for the UK and other euro countries, and it is particularly important also for the accession countries which need to improve their infrastructure to EU standards. Mr Regling told us that “investment can also be financed through normal tax revenues” and that this does not necessarily “mean higher taxation—it could also mean a restructuring of the budget on the expenditure side; less current expenditure and more investment expenditure”. Though true that must not mean a bias against borrowing for investment if resulting debt levels are sustainable.

38. The UK Government agrees with the principle of a strong SGP founded on sensible fiscal policy coordination. The Government supports a “prudent interpretation of the disciplines of the stability and growth pact [that takes] into account the economic cycle, sustainability of debt and the important role of public investment”.⁶² The Government has also stated that the proposals made by the Commission and adopted at the Council meeting of 21–22 March are “in line with key aspects of the UK’s prudent interpretation of the Stability and Growth Pact”.⁶³ **We support the Government’s view of the need for a prudent interpretation of the Stability and Growth Pact taking account of the economic cycle, sustainability of debt and the important role of public investment. We recommend that the Government should set out at the time of its euro decision its views on exactly how this interpretation could be achieved within the existing framework and how far the Council’s recent reforms are from meeting these requirements.**

⁶⁰ Q 488

⁶¹ Ev 199

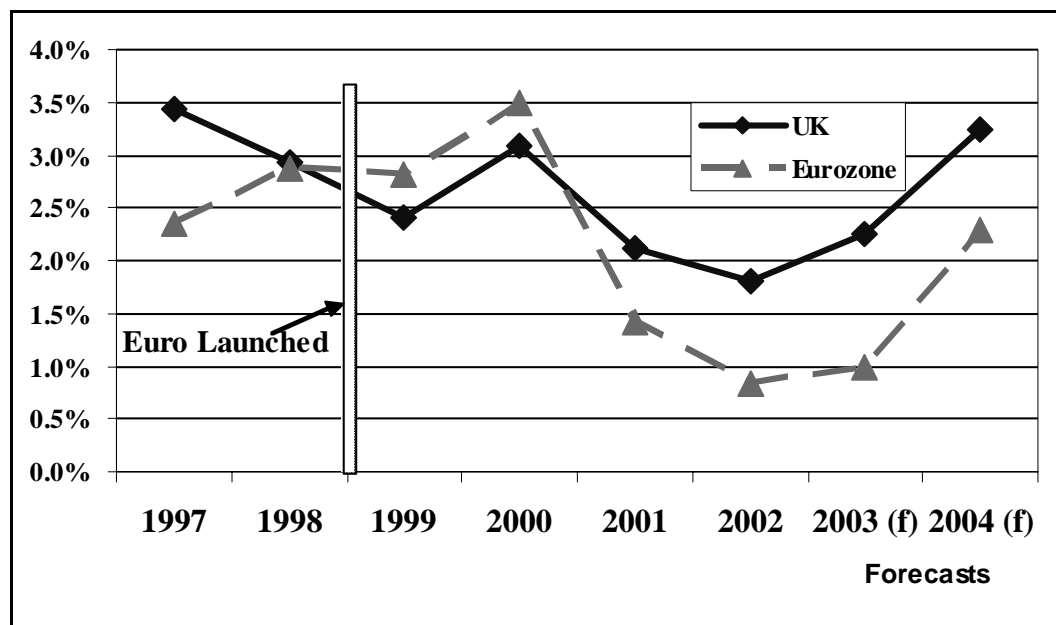
⁶² Appendix 3, para 24

⁶³ HC Deb, 14 March 2003, col 491W

Performance of the eurozone economy

39. The following graph shows the outturn and forecasts for economic growth in the UK and the eurozone for 1997–2004:

Chart 4 : Economic growth in UK and Eurozone



Sources: *HM Treasury*, Budget 2003, chart B5, p226, 2003/2004 midpoint of forecast range; *European Commission*, Spring Economic Forecasts April 2003, table 0.1, p3

40. In the four years since the introduction of the euro, the annual rate of growth of the eurozone economy has averaged 2.2%. This compares with annual growth averaging 2.4% for the UK over the same period. Within the eurozone there were significant divergences in growth rates between countries, with average annual growth performance over the period ranging from 8.8% in Ireland to 1.4% in Germany. Mr Regling told us that “when you look at the period 1999–2002, there were two good years and two bad years but this was also true for many other countries around the world.” However, the downturn of eurozone economic growth during the world slowdown in 2001 and in the aftermath of September 11th was significantly more pronounced than that in the UK. European growth was led by exports, while domestic demand remained weak in the larger countries. In contrast in the UK domestic demand has been the driver of economic growth. Unemployment in the eurozone has fallen from 10.2% in 1998 to 8.5% at the beginning of 2003. The record on employment growth for the eurozone as a whole has been good, particularly amongst the smaller eurozone members.

41. Mr Regling identified one of the benefits of the euro as removing the currency fluctuations between the participating members, thus contributing to stability. He contrasted the experiences since the introduction of the euro with those of 1995, when there were “tremendous intra-European exchange rate variations” and noted that “independent estimates done afterwards that the German economy was affected by about 1% less real growth in the year 1995”.⁶⁴ The TUC drew attention to the higher levels of workplace productivity in the eurozone than in the UK and stated that if “the UK was part of the eurozone it would rank 10th out of 13 in terms of overall economic prosperity (GDP per capita) and workplace productivity levels”⁶⁵. Miss Lea and Mr Martin Taylor suggested that

⁶⁴ Q 461

⁶⁵ Ev 50

UK productivity on an output per head basis was lower primarily because the lower labour costs compared to continental economies made it sensible for businesses to opt for more labour intensity rather than capital intensity,⁶⁶ though clearly greater capital investment would indeed be a boost to productivity.

42. As for the effect on trade between countries, Mr Rake took the view that, by removing the national currency barriers to trade, “the creation of the euro has led to a rapid increase in cross-border trade in the eurozone, while Britain’s trade with Europe has stagnated.” He cited Eurostat figures indicating a 3% average rise in trade within euro countries and a 0.4% fall in UK trade with the EU,⁶⁷ though the No Campaign argued that these figures were misleading since they were based on trade as a percentage of GDP rather than measured by volume.⁶⁸

Structural reform

43. With the advent of the euro structural reform has assumed a greater importance for eurozone members for encouraging economic growth. With internal exchange rates within the eurozone abolished, a greater burden of adjustment falls on product and labour markets, which need to be flexible to facilitate this adjustment. The IMF has noted that “to maximise the benefits from the introduction of the euro, it will be important to move forward with structural reforms”.⁶⁹ At the Lisbon meeting of the European Council in March 2000 Europe’s leaders set out a ten year strategy to make the EU “the world’s most dynamic and competitive economy”. As part of the Lisbon strategy a number of targets and objectives were set covering areas such as labour markets and employment, research and innovation, and further liberalisation of product and financial markets. Mr Regling told us that it is important to recognise that “there had been some progress” towards these targets “but not enough”. He acknowledged that “there is less progress on labour market deregulation, making the labour markets more flexible, particularly in some countries.”⁷⁰ He also stated that the Commission takes the view that “the low growth environment that we have at the moment should not be an excuse not to do the reforms that we consider necessary”.⁷¹

44. The Chancellor regarded the economic reform agenda as “absolutely critical to the future of European Union”⁷². The Government recently published a White Paper on economic reform in Europe and the progress that was being made towards the Lisbon Objectives⁷³. This identified that of the different areas of the Lisbon strategy there had been clear progress in six areas including employment, research and innovation and energy markets, 12 others were listed as work in progress, and there was limited progress in three areas. In a foreword to the paper the Prime Minister wrote that “Many countries have made impressive progress in cutting unemployment. But the EU’s Member States are still not doing enough to tackle the fundamental barriers to job creation”.⁷⁴ **We agree that insufficient progress has been made in the eurozone in making labour markets more flexible.**

45. Miss Lea told us that “it is not just the national governments of the eurozone countries that have to address this problem. I would like to see the Commission itself address the problems of labour market inflexibility”.⁷⁵ Mr Philip Stephens told us that the

⁶⁶ Q 366

⁶⁷ Ev 32

⁶⁸ Ev 73

⁶⁹ IMF *World Economic Outlook*, April 2002, p 25

⁷⁰ Q 474

⁷¹ Q 475

⁷² Q 1139

⁷³ HM Treasury *Meeting the Challenge: Economic Reform in Europe* February 2003

⁷⁴ *ibid* (Foreword)

⁷⁵ Q 387

ECB also has a role to play in encouraging structural reform and that the key thing is that “the bargain is struck between the ECB and Governments that trades flexibility in labour, product and capital markets offered by the Governments in return for lower interest rates”⁷⁶. The Centre for European Reform, which issues a ‘scorecard’ for progress against the Lisbon objectives, suggested in its most recent report that, while Denmark, Sweden and Finland already met most of the Lisbon targets and a second tier of countries (which included the UK) were making “good progress”, the “eurozone’s three largest economies—France, Germany and Italy—have so far made little attempt to fulfil their Lisbon promises, particularly labour market and pension reforms” and that these three countries risked “becoming a drag on the entire EU”.⁷⁷ **Structural reform is vital if the eurozone is to gain the full benefits of the single currency. With the loss of monetary policy independence, reform in individual countries must play an increasing role in stimulating growth and reducing unemployment. We acknowledge that there has been progress in some areas, but are concerned that progress appears to be slow. The current weak economic conditions should not be an excuse for the pace of reform remaining slow. We welcome the contribution of the UK Government towards encouraging structural reform. The ECB, the Commission and the Governments of the Member States should work together to ensure that the promised reforms are actually delivered as quickly as possible.**

Germany

46. The growth and unemployment performance of the German economy has been significantly worse than the eurozone averages. The average growth rate over the years 1999–2002 was 1.4%, compared to a eurozone average of 2.2%. There was some debate as to the reasons for this underperformance. Several witnesses commented on the fact that interest rates were too high for the German economy as a consequence of the ‘one-size fits-all’ monetary policy of the ECB. Mr Geoffrey Dicks, of the Royal Bank of Scotland, recognised that Germany was “going to suffer in terms of growth and rising unemployment from the strictures of the Stability and Growth Pact” as they are forced at a time of cyclical weakness and rising unemployment into a fiscal tightening, while acknowledging along with many other witnesses that Germany would not be facing this problem if it had taken advantage of better times to reduce its budget deficit. Mr William Keegan, of *The Observer*, regarded “a reduction in government spending in Germany ...at a time like this [as] the ‘economics of the madhouse’.”⁷⁸ The TUC believed that “Much of the under-performance of the German economy can be traced back to the economic after-shocks of reunification.” Reunification brought an extra 16 million people, with a highly inadequate economic infrastructure, into a country with a population of around 63 million. Mr Regling quoted an EC report which concluded that of Germany’s underperformance “half the problem comes from reunification and the other half comes from the lack of structural reforms”.⁷⁹

47. Many witnesses thought that Germany had locked itself to the euro at an overvalued exchange rate, which meant that manufacturing costs in Germany were much higher than elsewhere in the European Union. Mr Anatole Kaletsky, of *The Times*, drew attention to figures from the US Bureau for Labour Statistics that manufacturing labour costs in France were “about 30% cheaper” than Germany. Lower inflation was seen as a natural adjustment process. Mr Roger Bootle, of Capital Economics, argued that while “it is by no means the ultimate root of Germany’s problems” there is a sense in which being in the euro “blocks off some of the more comfortable exits”⁸⁰. Many witnesses referred to structural problems

⁷⁶ Q 71

⁷⁷ Centre for European Reform Press Release 10 March 2003

⁷⁸ Q 48

⁷⁹ Q 477

⁸⁰ Q 298

with the German economy, particularly with regard to the flexibility of labour markets, which acted as a barrier to job creation. There was some disagreement as to the effect which the euro would have on solving these problems. Mr Rake of KPMG believed that over time the euro would help “correct these issues”⁸¹ whereas Mr Hamish McRae, of *The Independent*, believed that it “it will be hard for other structural reforms to be put in place in such a tight fiscal and monetary regime”⁸². Mr Keegan drew attention to the higher productivity of the German economy relative to Britain and stated that “In the short run I would not be putting my money on the German economy but in the medium to long run I would not be pessimistic”.⁸³ **Witnesses put forward a number of explanations for the recent under-performance of the German economy and the extent to which they were caused or made worse by the euro. Many stated that the problems of the German economy were long term in nature and related to the after effects of reunification. There was a broad consensus that Germany entered the euro at an overvalued exchange rate—though the current account is now returning to substantial surplus. All witnesses questioned on the subject referred to the fact that structural reforms are necessary if Germany is to correct its underperformance.**

Ireland

48. The smaller eurozone countries have typically outperformed the central countries. This has particularly been true in the case of the Republic of Ireland which has grown at an average annual rate of nearly 9% over the years 1999–2002—over four times the eurozone average. Irish unemployment is now at 4.4%, at a lower level than in the UK, having fallen from 12% in 1995. The lower interest rates available to Ireland as a member of the eurozone were partly responsible for the elimination of this spare capacity within the Irish economy. The economy began to overheat in 1999, which led to increased inflation, initially exacerbated by the fall in the value of the euro, which pushed up import prices due directly to the large proportion of Irish imports that come from outside the eurozone (in particular, around 37% from the UK). Many of those to whom we spoke referred to the potential benefit to the Republic of British membership of the euro, in terms of reduced exchange rate volatility. Inflation has now moderated slightly, falling from 6% in late 2000 to 4.9% in March 2003, although it is still the highest in the eurozone.

49. As part of this inquiry the Committee visited Dublin to examine the performance of the Irish economy. We were particularly interested in the performance of the Irish housing market since this is similar in structure to that of the UK, with a significant proportion of debt at a variable rate. The reduction in interest rates led to rapid growth in house prices in the years leading up to the introduction of the euro, with annual increases peaking at 30% in 1998. However in the years following the introduction of the euro the rate of growth moderated, without leading to substantial falls. This moderation was partly due to the increased supply of housing, with housebuilding activity rising by 50% over the past five years. **The Irish economy has benefited from being part of the eurozone in terms of gaining a credible monetary policy and the elimination of exchange rate fluctuations against other eurozone members. However, excessive inflation could lead to a loss of competitiveness in the longer run if not matched by productivity improvements. There may be a particular danger of this following the appreciation in the value of the euro against sterling and the dollar, especially if the UK remains outside the eurozone.**

⁸¹ Q 114

⁸² Ev 1

⁸³ Q 32

Experience of UK companies so far

50. While the UK remains outside the eurozone, many British firms trading with Europe deal with the single currency on a regular basis. ALSTOM already saw one benefit of the single currency as “reducing the complexity and financial costs ... of transactions throughout the eurozone”.⁸⁴ The Engineering Employers’ Federation told us that of respondents to their survey “over six in ten companies” were conducting some of their invoicing or purchasing in euros.⁸⁵

51. The Committee visited Northern Ireland to examine the UK’s land border with the eurozone. Ms Gault of the Northern Ireland Hotels Federation told us that her members would be “dealing with dual currency all along the border” although she highlighted the problem for marketing hotels in Northern Ireland. The Committee also visited the border town of Newry and witnessed the arrangements for dual circulation of sterling and the euro. The euro was increasingly in use as a currency of invoicing in Newry, a role that the punt did not have previously. Many retailers used the euros they accepted to pay suppliers throughout the eurozone, not only in the Republic but also further afield in Germany and Italy. Some employees were paid in euros.

52. Extensive use is of course also being made of the euro by individuals travelling to eurozone countries. **It is clear that, both at the level of international businesses and at local level, UK businesses and citizens are adjusting comfortably to use of the euro. While UK firms are finding it relatively easy to adopt operational strategies for living with the euro while the UK remains outside the zone, longer term issues affecting location and investment may well be contingent on knowing where government policy is headed. UK companies need to see the analysis of the five tests to provide such clarification.**

⁸⁴ Ev 154, para 10

⁸⁵ Engineering Employers’ Federation: *Manufacturing and the euro—any change?* 2002

3. THE FIVE ECONOMIC TESTS

The assessment process

53. The Government has stated that, even leaving aside the political and constitutional issues involved in the decision, it would recommend joining only if the economic case was “clear and unambiguous”. The assessment of the five economic tests laid down is the process by which the Government will come to a view about whether such a case has been made.

54. As announced in a paper submitted to this Committee in September 2002, examination of the tests is being underpinned by a number of supporting studies (discussed further below—see paragraphs 60–61).⁸⁶ The Chief Economic Adviser to the Treasury, Mr Ed Balls, emphasised the importance of this supporting analytical work in a speech in December 2002, stating that the five tests enabled the decision to be made “on a proper economic assessment of the long run economic case” and the economic consequences to be “fully understood”; he suggested that, arguably, other important economic decisions of the last century had not been made on the basis of a similarly thorough exercise.⁸⁷

55. Some commentators have expressed some scepticism as to how far, in practice, the five tests can be decided along economic rather than political lines, given the political issues involved in, for example, the interaction between the SGP and national fiscal policies and the accountability of the ECB. But several witnesses emphasised the thoroughness of the analysis being attempted⁸⁸. The Governor of the Bank of England told us that he was “absolutely convinced that [the assessment] will be a balanced assessment looking at the potential benefits and the potential disadvantages and it would go across all of [the] issues.”⁸⁹ It will be for political and other observers alike to judge, when the assessment is announced, whether they are satisfied that the assessment has indeed been made on economic grounds. There will also be a question, as many have pointed out, as to whether the economic case for entry can ever be truly “clear and unambiguous”⁹⁰. **But we accept the need for a serious and in-depth analysis which will allow the Government to take a properly considered and researched decision on the economic consequences of joining the euro. At the same time, we recognise that an economic analysis is not a mechanistic exercise and that there will inevitably be an element of judgement involved in assessing the economic case for entry. It will be difficult for the results of the assessment to be totally unambiguous.**

56. We discussed with the Chancellor the process by which the decision on whether to proceed to a referendum will be taken.⁹¹ It will be for the Chancellor in the first instance to make the assessment of the five tests, once the supporting studies have been completed. The Cabinet will then make its decision. The assessment will be announced, and the supporting studies will be published at the time of the assessment, but not before. If the assessment is in favour of joining, a bill will be brought in to provide for a referendum; if the decision is not in favour of joining then an indication will be given as to the Government’s policy in the new situation⁹². The Chancellor told us that in practice the decision rested with the Treasury, rather than the Cabinet or the Prime Minister:

“...the Prime Minister has already said that the economic assessment made by the Treasury will be decisive. In other words, while in constitutional theory the Treasury makes the assessment and the Cabinet will make the decision, the Prime Minister said

⁸⁶ Appendix 1: *The Treasury’s approach to the preliminary and technical work* 6 September 2002

⁸⁷ Cairncross Lecture, 4 December 2002

⁸⁸ For example, Miss Lea (for the Institute of Directors) Q 338

⁸⁹ Q 1208

⁹⁰ See for example Q 74 [Mr Peter Riddell]

⁹¹ Qq 1002–1033; see also Q 66 [Mr Stephens, Mr Riddell]

⁹² Q 1025

that in his view the decision should be made on the basis of whether the assessment recommends yes or no... In practice the Prime Minister has already made it clear that the economic assessment and the Treasury's recommendation will be decisive."⁹³

He added that while the supporting studies were in preparation "Obviously the Prime Minister is involved in this process"⁹⁴ and that "we are drawing on a large range of expert advice and there will be occasions when members of the Number 10 staff have been involved".⁹⁵

57. The decision that the supporting studies should not be published before the assessment is announced has been controversial. The Chancellor told us:

"The studies are intrinsic to the assessment; in other words, they are the technical work that backs up the assessment. Therefore the appropriate time to publish them is on the day and at the time of the assessment, not in advance of the assessment. It would be a mistake to believe that, either for reasons of market sensitivity or for reasons of completeness, we would be adding to the debate by publishing these individual studies in advance of assessment. They are intrinsic to the assessment and will be published at the time of the assessment."⁹⁶

58. Mr Peter Riddell, of *The Times*, argued that this was bringing "both the analysis and the conclusions under the same umbrella of secrecy" and that there was no reason why "the analysis should not be released and discussed at an earlier date... We need an open debate now, before the assessment, not afterwards";⁹⁷ other witnesses took a similar line⁹⁸. Mr John Monks, for the TUC, while not allowing himself to be pinned down specifically to calling for advance publication of the studies, said that the TUC would "certainly be asking for a more open process than the one that there is at the moment"⁹⁹. The Chancellor's suggestion that the studies are market sensitive may not apply, for example, to academic and comparative work on other currency areas. **It seems to us that non-publication of the supporting studies ahead of the announcement will have reduced the opportunity for informed public debate before the Government becomes committed to a particular judgement. It is now too late for the studies to be published before the assessment is made and announced, and we regret this.**

The five tests and the supporting studies

59. The five economic tests which "must be met before any decision to join can be made"¹⁰⁰ are:

- i) Convergence: are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- ii) Flexibility: if problems emerge is there sufficient flexibility to deal with them?
- iii) Investment: would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- iv) Financial services and the City: what impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- v) In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

⁹³ Q 1011

⁹⁴ Q 1026

⁹⁵ Q 1028

⁹⁶ Q 1002

⁹⁷ Ev 15 (para 7); see also Qq 54,73

⁹⁸ Q 73 [Dr Coyle, Mr Stephens]

⁹⁹ Qq 206–207

¹⁰⁰ Appendix 1: *The Treasury's approach to the preliminary and technical work*, 6 September 2002

60. As part of the preliminary and technical work underpinning the assessment, a total of 18 supporting studies examining key issues relating to the tests are being undertaken by the Treasury. 14 studies were announced in the paper sent by the Chancellor to this Committee in September 2002:¹⁰¹

- C The monetary transmission mechanism
- C The housing market
- C National business cycles
- C The exchange rate
- C Labour markets
- C Adjustment mechanisms and how the UK economy responds to shocks
- C Using fiscal policy as a stabiliser
- C The cost of capital
- C Impact of joining the euro on business in the manufacturing and service sectors of the economy
- C Financial services and the City
- C Trade
- C The experience of the US as a monetary union
- C Fiscal and monetary policy in the eurozone, including the Stability and Growth Pact
- C Price differentials

61. Four additional studies were announced later:¹⁰²

- C The transition to the euro
- C The exchange rate and macroeconomic adjustment
- C A selection of specially commissioned papers by international academics on aspects of British membership of the euro
- C The overall framework for the assessment of the five economic tests.

62. The tests seek to determine whether UK membership of the euro is in the national economic interest. The fifth test indicates that the Treasury will define this as whether joining the euro will “promote higher growth, stability and a lasting increase in jobs”. The Treasury memorandum indicated that the five tests will judge the decision on UK membership of the euro “against the Government’s central objective to raise the economy’s sustainable rate of growth, and achieve rising prosperity through creating economic and employment opportunities for all”.¹⁰³

63. Joining the euro would have both advantages and disadvantages for the UK economy and the tests seek to examine these. The potential benefits have been described by the Chancellor as being “in terms of trade, transparency, costs and currency stability—and could help us create the conditions for higher and more productive investment and greater trade and business in Europe”.¹⁰⁴ The 1997 assessment describes potential benefits in terms of reducing the structural level of unemployment, through increased competition, reduced volatility and increased market reform, and of increasing growth and investment, through increased intra-European trade, increased stability and greater price transparency.¹⁰⁵ The tests covering the effect on investment and on growth and jobs will seek to estimate the extent to which these benefits could be realised.

64. Balanced against these potential benefits is the fact that the single interest rate (referred to by some commentators as the ‘one-size-fits-all’ interest rate) set by the ECB might not be appropriate for the UK economy at all times. The first two tests, covering convergence and flexibility, examine whether this could pose problems for the UK

¹⁰¹ *ibid*

¹⁰² Q 999

¹⁰³ Appendix 1: *The Treasury’s approach to the preliminary and technical work* 6 September 2002

¹⁰⁴ *ibid*

¹⁰⁵ HM Treasury: *UK membership of the single currency – An assessment of the five economic tests* (October 1997)

economy. Countries adopting a common currency require a single interest rate, and the European Central Bank sets the interest rate for the eurozone on the basis of the overall performance of the economies in the eurozone. Without proper convergence and sufficient flexibility, inappropriate interest rates set by the ECB could increase the instability of the UK economy and outweigh any benefits to investment and growth from currency stability with the eurozone. A single interest rate is not always appropriate for each individual economy within the eurozone at all times. In some economies interest rates may be too low, leading to excesses of inflation, whereas in other economies interest rates may be too high leading to increased unemployment. However, some witnesses referred to the fact that the interest rates set by the MPC for the UK economy did not suit all sectors and regions within the UK.

The ‘counterfactual’ question - the consequences of remaining outside

65. The purpose of the five tests is to compare two different futures for the UK economy, one within and one outside the euro. Many witnesses stressed the importance of the assessment being forward-looking. Dr Diane Coyle told us that “there is an important omission from the framework. The tests look at the possible effects of euro entry. Yet there’s no explicit recognition in the Treasury’s statement that there will be a need to assess the counterfactual: what will happen if Britain stays out?”¹⁰⁶ Possible consequences from staying out include loss of foreign direct investment (FDI) and increased currency instability¹⁰⁷ and also loss of influence in design of the eurozone rules. The status quo may alter substantially. Many witnesses referred to the importance of assessing the tests in this way. The Chancellor confirmed that the consequences of not joining the euro would be taken into account in the assessment.¹⁰⁸ **We note the importance of assessing the consequences of not joining the euro. One set of issues arises if the decision is taken to join. A different set of issues arises if the decision is taken not to join in the foreseeable future. Both scenarios bring new challenges to the UK economy. We therefore welcome the confirmation that this point is being taken into account in the Treasury’s assessment.**

Two routes to stability

66. In one respect there has been a change of emphasis since the Treasury’s 1997 assessment, reflecting the fact that the UK now has a number of years of experience of the post-1997 arrangements for setting monetary policy. The Chancellor observed that “there are two routes to stability, one from domestic monetary and fiscal arrangement and one from joining the ECB”.¹⁰⁹ The No Campaign believed that, insofar as the new arrangements had already delivered (since 1997) lower long-term interest rates, this undermined the arguments that the UK still suffered from an inflation premium and that the increased credibility of the ECB could potentially allow lower interest rates without leading to higher inflation.¹¹⁰ Professor Begg told us that he would never advocate “joining monetary union to get a better monetary policy” but that people making the case for entry considered that there were other benefits that could be obtained to offset the sharing of sovereignty and that the UK “might also be able to throw our weight behind improving the arrangements that currently exist” in the eurozone.¹¹¹ Some witnesses also cautioned that it would be wrong

¹⁰⁶ Ev 17

¹⁰⁷ Q 78

¹⁰⁸ Qq 1046, 1058ff.

¹⁰⁹ Q 1045

¹¹⁰ Ev 71, 103

¹¹¹ Q 298

to be complacent about the superior performance of the UK's economic policy frameworks.¹¹²

67. Just as there is now evidence which was not available in 1997 about the domestic “route to stability”, so also there is now evidence about the ECB “route”. When the Treasury undertook its first assessment of the five economic tests in October 1997, there was still considerable speculation as to whether the euro would actually be introduced. The European Central Bank had yet to be established and the Stability and Growth Pact had only been introduced several months previously. The euro has now been in existence for over four years and the body of evidence of the effect of its introduction, while not yet substantial, is increasing. Many of the issues covered under the five tests can and should be supplemented by examining the experience of the eurozone so far. For example, to what extent is the euro promoting trade and investment amongst the countries in the eurozone? How are adjustment mechanisms operating in the eurozone in the face of a single interest rate set by the ECB? Are they allowing economies to regain their competitiveness and avoid sustained periods of low growth or high inflation? The extent to which convergence can occur between economies *after* joining the eurozone should also be examined. The Chancellor told us that “part of our assessment will include a view of what has happened since 1997” and that “there is quite a debate taking place in the EU about why the inflation rates in different countries have been diverging [and about] the level of growth overall”.¹¹³ Several witnesses thought that the assessment should also examine the reasons for the eurozone's recent poor performance in the face of the global slowdown and the extent to which the euro had contributed to these problems.

68. When the tests were constructed in 1997 evidence concerning the present UK monetary arrangements and the eurozone (as a monetary union) was not available. We welcome the Treasury's examination of the experience of the eurozone so far as part of a number of the supporting studies. The eurozone countries now provide 12 case studies as to the effects of entering monetary union and we believe these provide important lessons for the UK. Equally, given six successful years of the new UK monetary framework, supporters of entry will have to demonstrate that entering the monetary union will be at least as beneficial as the UK framework that is to be abandoned.

Convergence test

“Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?”

69. Convergence is one of the most significant of the five tests. The Treasury stated, at the time of the first assessment, that “we need to demonstrate sustainable and durable convergence, before we can be sure that British membership of EMU would be good for growth and jobs”.¹¹⁴ As already stated, if the UK joins the euro, responsibility for fixing interest rates for the UK economy will pass to the European Central Bank, which sets rates according to the economic conditions in the eurozone as a whole. Although the UK would account for around 20% of the eurozone economy and would have some input into the determination of the rate through a seat on the Governing Council of the ECB,¹¹⁵ if the UK economy has not converged with the economies of the eurozone then the interest rates set might be inappropriate for the UK. This could lead to instability in the economy, and in the

¹¹² In our Report on the 2002 Pre-Budget Report we noted that while the Monetary Policy Committee's record of achieving its inflation targets since 1997 was good, it was possible that this could be associated with continuing sectoral imbalances, and we recommended that the Treasury and the Bank of England should undertake a joint review of the process (Second Report of Session 2002–03, *The 2002 Pre-Budget Report*, HC 159, para 30)

¹¹³ Q 1044

¹¹⁴ HM Treasury: *UK membership of the single currency—An assessment of the five economic tests* October 1997 p 8

¹¹⁵ Subject to the eventual impact of a rotation system following enlargement, discussed above.

short term to excessive inflation if interest rates were too low or increased unemployment if interest rates were too high, threatening a return to ‘boom and bust’. What does convergence mean in practice? The test divides convergence into two main issues which seek to determine both whether the UK is currently converged with the eurozone and also whether the convergence is capable of being sustained. The first issue is whether the UK is at a similar point in the economic business cycle to the eurozone economies—this is known as ‘cyclical’ convergence. The second issue is whether the convergence is capable of being sustained, which will involve analysing whether there is ‘structural convergence’—i.e. whether the structures of the UK and eurozone economies are similar. This will establish if there are particular features of the UK economy that could lead it to react differently to changes in eurozone interest rates or to other types of economic shock.

70. In a recent paper, HSBC examined the extent of convergence between the UK and the eurozone economies. They concluded that since the Treasury’s 1997 assessment “the UK has become more convergent” but that “part of this convergence results from the pursuit of independent policies”.¹¹⁶ Goldman Sachs in recent research pointed out that “the key test is whether the cycles would have been so well correlated if interest rates [in the UK and the eurozone] had been held at the same level and the exchange rate had been fixed”.¹¹⁷ HSBC also compared the performance of the UK economy with that of the 11 eurozone countries if Germany is removed from the figures: they concluded that “the UK is convergent not so much with the eurozone as a whole but with the eurozone excluding Germany”.¹¹⁸

71. The recent imbalances that have developed in the UK economy were seen as having implications for the convergence test. UBS Warburg recently pointed out that while “the growth rate of the UK economy has on average been similar” to that of the eurozone “growth in UK consumer spending has remained well above that” in the eurozone.¹¹⁹ Goldman Sachs, in a recent paper, made a comparison with the ERM period, suggesting that “declining imbalances and a depreciation in the real exchange rate go hand-in-hand. Inside the euro, the real exchange rate could only fall if prices in the UK rise less rapidly than the eurozone—this is only likely if the UK grows more slowly than other eurozone countries for a prolonged period”.¹²⁰ Mr Bootle told us that that he would be much more convinced that convergence had been achieved if it was still in place following a correction of the imbalances.¹²¹

72. There was broad agreement amongst witnesses that there had been some convergence between the UK and eurozone since the Treasury’s previous assessment in 1997. Mr Weale told us that the economies were “much more converged than in 1997”.¹²² At the time of the previous assessment there was a difference of around 4 percentage points in UK and eurozone interest rates and the difference is currently 1.25 percentage points. Mr Taylor believed that “we are more convergent, the question is whether we are convergent enough”.¹²³ Structural obstacles to sustainable convergence such as labour markets, the housing sector, and trade linkages were identified, although the importance of these was disputed by Britain in Europe. Some witnesses believed that the act of joining the euro could increase convergence. Professor Moore believed that “convergence is a feature of countries that are already in monetary union, it is not something that takes place beforehand”.¹²⁴ **There has been substantial convergence between the UK and the**

¹¹⁶ *The UK’s Euro Challenge*, HSBC, January 2003

¹¹⁷ *Can the UK achieve a smooth transition to EMU?* Goldman Sachs, February 2003

¹¹⁸ *The UK’s Euro Challenge*, HSBC, January 2003

¹¹⁹ *Preparations for EMU*, UBS Warburg, October 2002

¹²⁰ *Can the UK achieve a smooth transition to EMU?* Goldman Sachs, February 2003

¹²¹ Q 315

¹²² Q 315

¹²³ Q 374

¹²⁴ Q 800

eurozone economies since 1997. In some respects the level of convergence is greater than that between some of the eurozone members themselves before 1999. However, the Treasury assessment must include examination of whether convergence to date is cyclical or structural. It must also examine the implications of the recent imbalances in the economy for achieving sustainable and durable convergence and whether these imbalances would have arisen had the UK been in the eurozone from the outset.

The monetary transmission mechanism

73. The monetary transmission mechanism—the means through which changes in interest rates affect the wider economy—is the subject of one of the supporting studies. Oxford Economic Forecasting submitted a study concluding that “the UK is four times more sensitive to interest rate changes than the Eurozone and the different structure of its housing market and mortgage markets are an important component in that sensitivity”.¹²⁵ In contrast, a recent study by the NIESR found that “the eurozone countries and the UK are similar to each other in terms of their overall interest rate sensitivity”.¹²⁶ The European Commission economic paper found that following changes in interest rates “consumption in the UK was more affected than elsewhere but the impact on investment was smaller”.¹²⁷ **How the UK reacts to changes in eurozone interest rates is an important area for the Treasury to have examined during the assessment; this should include an assessment of the effect of interest rate changes on investment and consumption in the UK as well as in aggregate.**

The exchange rate

74. The Treasury’s 1997 assessment made little reference to the importance of the exchange rate. As part of the technical work for the forthcoming assessment a supporting study will be completed “Analysing different approaches to the sustainable real exchange rate—as this is a key indicator of convergence and of obvious importance to this and all of the tests”.¹²⁸ The exchange rate is of critical importance for convergence: even if there is currently cyclical convergence, entering at an inappropriate exchange rate could cause economic performance to diverge. Locking in at an overvalued rate could create a long process of adjustment by low wage and price growth and higher unemployment. Similarly, going in at an undervalued level could lead to a period of above average inflation, which could damage competitiveness in the medium term. **The essential question is whether the recent fall in the value of sterling against the euro provides an exchange rate that would avoid these difficulties if it were the basis of the UK joining the euro. The Treasury assessment must spell out how a sustainable real exchange rate for entry is to be determined.**

The housing market

75. The housing market is the subject of one of the Treasury’s supporting studies, informing the assessment of the convergence test. The Council of Mortgage Lenders (CML) told us that “the UK housing market is quite different from the rest of the eurozone because it combines a high level of owner occupancy, a high level of debt and a high proportion of variable rate mortgage finance”.¹²⁹ UK mortgage rates and the level of mortgage payments therefore respond quickly to changes in interest rates, in contrast to the

¹²⁵ No Campaign Press Release 2 March 2003, reporting on paper by Oxford Economic Forecasting *The housing market and the monetary transmission mechanism in the UK, in and out of EMU*, February 2003.

¹²⁶ NIESR: *Designing and choosing macroeconomic frameworks: the position of the UK after 4 years of the Euro* (Ray Barrell and Martin Weale) November 2002

¹²⁷ European Commission: *European Economic Papers No. 178* October 2002

¹²⁸ Appendix 1: *The Treasury’s approach to the preliminary and technical work*, 6 September 2002.

¹²⁹ Appendix 7, para 4

eurozone where a higher proportion of loans are taken out at fixed rates. Changes in interest rates affect both the disposable incomes of the homeowner (through a change in mortgage payments) and also the price of housing by making it more or less affordable. Miss Lea explained that changes in the eurozone interest rate would therefore have a “big impact on the housing market in this country and on personal consumption ... whereas this would not be the case in Germany”.¹³⁰ The CML told us that “a switch from variable to fixed rates could protect borrowers against changes in interest rates” and “the take-up of fixed-rate mortgages can change quite dramatically over relatively short periods of time”.¹³¹ Figures supplied by the CML show the proportion of new loans at fixed rates has fallen from a high of around 50% in 1998 to 24% in 2002; this compares with around 57% in the EU in 1999. The Chancellor announced in the 2003 Budget a review of the factors underlying the low take-up of fixed rate mortgages in the UK.¹³² An interim report is due by autumn 2003, and a comprehensive report with recommendations due by the time of Budget 2004.

76. The housing market in the UK has recently been through a period of high growth in prices. The Permanent Secretary to the Treasury has previously described the rate of growth in house prices as “unsustainable”,¹³³ although the Treasury have argued that “there may well be structural reasons why house prices have increased permanently” meaning that actual price levels may be sustainable¹³⁴. The Treasury have also previously acknowledged with regard to house price inflation that “although a slowing must come at some point, the longer it is delayed the greater the risk of a sharp correction”.¹³⁵ The CML cautioned that lower interest rates stemming from euro entry could lead to further unsustainable rises in house prices, “this may increase the chances of an asset bubble developing and the potential for a sharp correction”. However, the risk of a bubble developing and being followed by a sharp fall in house prices will depend, in part, on the economic outlook at the time that interest rates converge with lower European levels. Mr Weale drew attention to how different the situation in the housing market is from the 1980s when the large fall in house prices was caused by very high interest rates for a very long time and suggested that “no one is expecting that at the moment either inside or outside the eurozone”.¹³⁶ The Republic of Ireland’s housing market experienced similar buoyant conditions in the run up to their entrance to the euro but so far had managed to avoid a subsequent crash. Part of the reason for this is that price rises were moderated in the medium term due to a large rise in house building. There is a question as to whether the planning system could accommodate such an increase in housebuilding in the UK.

77. We welcome the research announced in the Budget into factors influencing the take up of fixed rate mortgages, but regret that it will be too late to inform the assessment of the tests due to take place by June 2003.

The degree of convergence required for entry

78. Present members of EMU joined on the basis of satisfying broad convergence parameters set out in the Maastricht Treaty covering price stability; sustainability of government finances; long term interest rates and exchange rate stability (discussed further at paragraphs 97–98 below). For some years the UK has satisfied the Maastricht criteria, except membership of the ERM. The question now is how much further convergence there needs to be before normal economic forces, by a process of adaptation and adjustment, can be relied on to bring about sufficient convergence without jeopardy to growth and stability. To demand total convergence before joining EMU is likely to be an impossible condition

¹³⁰ Q 379

¹³¹ Appendix 7

¹³² Budget 2003, HC (2002–03) 500, para 2.79

¹³³ Q 71 in evidence to this Committee’s Second Report of Session 2002–03, HC 159

¹³⁴ Pre-Budget Report 2002, Cm 5664 (para A70)

¹³⁵ Appendix 7, para 15

¹³⁶ Q 316

to fulfil and indeed not all present EMU members fulfil it. The judgement of whether the present degree of convergence is enough for any adverse consequences of post entry adjustment to be outweighed by the benefits of membership is more political than economic.

Flexibility test

“If problems emerge is there sufficient flexibility to deal with them?”

79. Even if there is a high degree of convergence between the UK and eurozone economies, they may still react differently to future economic events. This test examines the mechanisms by which individual economies can adjust to mitigate the effects of an economic shock in the absence of changes in interest and exchange rates. The Chancellor drew attention to the experience of the United States where there are three mechanisms through which individual states adjust to shocks. These were “a very big central budget” which adjusts expenditure towards poorly performing regions; labour mobility where “people will move from one part of the single currency area to another, so if there are less jobs in Massachusetts they may move to California and the other way round”; and “the way labour markets work, particularly in terms of wages, and it is undoubtedly the case that in a single currency area you need greater flexibility for that single currency to work”.¹³⁷ The Chancellor told us that the adjustment mechanism of a central budget was “not available for the European Union” and that US-type labour mobility did not happen in the EU.¹³⁸

80. In practice labour market flexibility covers a range of questions. How rapidly do prices and wages adjust to a shock to demand? Can firms respond to changes in demand for their products by recruiting workers or making cutbacks? Are workers’ skills flexible enough to enable them to change jobs and move to new industries? Also, are workers able to access training opportunities to improve their skills and productivity? Is there sufficient labour mobility—are people able to travel or move house to find jobs? Are there incentives that make work more attractive than remaining on benefits? Capital market flexibility is also important—can firms invest in areas of high unemployment, and are the workers productive and skilled enough to make such investment worthwhile?

81. We asked our witnesses what types of flexibility it was important for the UK to have if it was to join the euro. Mr Bootle interpreted the test as being “mainly about labour market flexibility” and “the ability of [the] wage and price structure to adjust”.¹³⁹ To the TUC flexibility meant workers “being agile, ...capable of change, ...well rewarded, well trained and well educated and ...able to adjust without their wages being adjusted downwards rapidly or their hours being chopped and cut around”.¹⁴⁰ Mr Dicks regarded this as a symmetrical test requiring flexibility both for the UK and the eurozone.¹⁴¹ The Chancellor confirmed this saying that the “test looks at whether there is sufficient flexibility to enable us to withstand shocks. In other words, it is movement in achieving greater flexibility that we have been looking for both in the UK economy and in the euro area.”¹⁴² **Labour market flexibility is important for the UK economy, if it is to respond efficiently to shocks. We ask the Treasury to clarify and define the ways in which there has to be flexibility amongst the eurozone countries and the UK for this test to be passed. We note the Chancellor’s statement in Budget 2003 in respect of achieving greater labour cost flexibility in the regions of the UK. We hope the Treasury assessment will say more about the context for this reform.**

¹³⁷ Qq 1136–1137

¹³⁸ Qq 1136–1137

¹³⁹ Q 317

¹⁴⁰ Q 188

¹⁴¹ Q 317

¹⁴² Q 1139

82. With the loss of an independent monetary policy, a greater burden will be placed on fiscal policy to stabilise the economy and prevent swings in output in response to a shock. The No Campaign identified a number of drawbacks to using fiscal policy to stabilise output, including the speed with which discretionary fiscal policy can be used and whether the use of fiscal policy could interfere with long term priorities in promoting efficiency and welfare; Ms Janet Bush believed that there would be pressure for the EU to enlarge the central budget and to make transfers through the tax system between Member States.¹⁴³ Mr Taylor also thought that the eurozone might increase the pressures for tax harmonisation.¹⁴⁴ The Chancellor told us that he disagreed with those who said “that a successful single currency requires tax harmonisation or federal tax and spending arrangements”¹⁴⁵ and stated that the government opposed “tax harmonisation and ... qualified majority voting on taxes”.¹⁴⁶ We note that taxes remain unharmonised in the highly integrated federal United States economy.¹⁴⁷ **The Treasury assessment needs to set out clearly the Government’s thinking on the relationship between monetary union and member state fiscal policy regimes and how it will deal with the extra pressure in a single currency for tax harmonisation and for an enlarged EU budget.**

Investment test

“Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?”

83. Encouraging investment to raise the long-term growth and productivity performance of the UK is a key part of the Government’s objectives. This test examines “how EMU membership will affect public and private investment in general and foreign direct investment in particular”.¹⁴⁸ If the UK joins the eurozone then some firms may be encouraged to increase their investment because they want to sell into the European markets and the absence of exchange rate risk enhances the attractiveness of locating in the UK. The degree of convergence and flexibility assessed in the UK will have a bearing on whether the overall effect on investment is positive.

84. ALSTOM told us about a number of possible benefits of eurozone membership including greater price and cost transparency and a removal of currency risk. Mr Paul Barron, Alstom’s UK President, stated that for the UK part of the business “unlike all our European partners selling into the eurozone, we still have the currency fluctuation to deal with”.¹⁴⁹ Unilever told us that “some investment decisions had already been influenced by the euro—and while it remains one factor among several, the uncertainty of the currency value equation will undoubtedly be a major influence in the future. In the long term, the continuing UK position outside the euro is likely to have a negative effect on Unilever’s investment and employment levels in the UK”.¹⁵⁰

85. While the fact that reduced currency volatility with the eurozone would benefit trade and investment was not disputed, Miss Lea claimed that if the UK joined the euro our currency would be “more volatile” against the dollar than if we kept sterling,¹⁵¹ although the significance of this effect was disputed by Britain in Europe.¹⁵² Professor Rowthorn

¹⁴³ Qq 252– 255

¹⁴⁴ Qq 374–375

¹⁴⁵ Q 999

¹⁴⁶ Q 1041

¹⁴⁷ See also paper on fiscal transfer payments in the USA by Professor H Scobie (Appendix 8)

¹⁴⁸ Appendix 1 *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁴⁹ Q 369

¹⁵⁰ Appendix 22

¹⁵¹ Q 345; see also evidence from Professor Minford Q 490

¹⁵² Britain in Europe further memorandum (see List of Memoranda p 68)

told us that “in terms of exchange rate stability ... the balance of advantage would depend in large measure on the relative importance of our trade with eurozone and non eurozone countries”.¹⁵³

86. The Treasury has said that “Evidence suggests that foreign direct investment into the UK can raise the productivity of UK firms through technology and skills spillovers. The preliminary and technical work is considering how EMU would affect FDI inflows to the UK”.¹⁵⁴ The UK has a well established track record of attracting much higher levels of foreign direct investment than other countries in the EU. Several different sources of statistics were presented to us including those from Eurostat, Ernst & Young and the UN.¹⁵⁵ Dr Coyle told us that “it is impossible to draw strong conclusions about FDI flows given that they have suffered globally and that much UK inward investment has come from the US in the past. Nevertheless the UK’s share of EU inward FDI has fallen”.¹⁵⁶ Mr Bootle cautioned that that FDI is “imagined as being some foreign company moving to a greenfield site and building a car factory” whereas it is sometimes “essentially a financial transaction where a company is taking over another company’s shares”.¹⁵⁷ Ms Lea believed that swings in FDI had a lot to do with mergers and acquisitions and that figures could be distorted by big takeovers such as Vodafone’s takeover of Mannesman¹⁵⁸ (which was a factor in the large increase in Germany’s share of intra European FDI to over 30% in 2000, from 10% in 1999). Dr Coyle believed that there will be a clearer picture of whether the UK’s share of FDI has declined as a result of being outside the eurozone when global investment flows start to increase.

87. Membership of the single currency is likely to provide the conditions for more and better investment if there has been sufficient convergence between the UK and the eurozone and sufficient flexibility exists. In this way the third test is to some extent a consequence of whether the first two tests have been satisfied. We received evidence from a number of firms that over time investment decisions would increasingly favour the eurozone at the expense of the UK. The assessment must cover the extent to which volatility against the dollar could be increased if the UK joined the eurozone and what effect this could have on inward investment to the eurozone from the US. The accuracy and significance of the large volume of inward investment statistics needs to be assessed, if possible with the effects of mergers and acquisitions identified and separated out.

Public Investment

88. The Treasury’s paper to the Committee indicated that, under the heading of the investment test, the assessment will be examining the “potential impact ... on public sector investment” of the UK joining the euro.¹⁵⁹ As discussed in paragraph 30, the UK governs public expenditure through the Chancellor’s fiscal rules, while also being subject to the Stability and Growth Pact (but not to its penalties). The No Campaign told us that “The golden rule distinguishes between capital (investment) and current (short-term) spending. It ... lets the Government borrow to invest”.¹⁶⁰ The TGWU were concerned that “the imposition of the rigid Pact on the UK economy during this Parliament would place severe downward pressure on the promised investment in public services”.¹⁶¹ The Chancellor referred to the ongoing debate over reform of the Pact and told us that people were coming

¹⁵³ Appendix 24

¹⁵⁴ Appendix 1 *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁵⁵ See for example Ev 16 (Dr Coyle), Ev 45 (Mr Rake), Ev 63 (No Campaign), Appendix 4 (Britain in Europe)

¹⁵⁶ Ev 16

¹⁵⁷ Q 318

¹⁵⁸ Q 409

¹⁵⁹ Appendix 1: *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁶⁰ Ev 106

¹⁶¹ Ev 174

to accept the importance of debt levels being taken into account and of investment being distinct from consumption.¹⁶² **We welcome the examination within the assessment of whether the Stability and Growth Pact would place any constraints on the level of public investment in excess of those of the Government's fiscal rules. While the recent proposals allow a temporary deviation in the short term from the close to balance requirement to fund public investment, it is important to estimate whether investment projections in Budget 2003 could be constrained because overall deficits would breach the 3% limit of the Stability and Growth Pact.**

City and financial services test

“What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?”

89. The Treasury has stated that “given the importance of the financial sector to the UK both in terms of employment and indivisible earnings, it is vital that the decision on whether to join the single currency does not damage the sector's competitiveness”.¹⁶³ The assessment of the five tests in 1997 concluded that “EMU offers benefits to the UK financial sector whether the UK is in or out. But the benefits and the opportunities from the single currency will probably be easier to tap from within the eurozone”.¹⁶⁴ Mr Lascelles of the Centre for the Study of Financial Innovation told us that “non-membership of the eurozone has not damaged the City in any way” and that “fears at the time of the euro launch that the City would lose out to continental centres, particularly Frankfurt, ... have not materialised.”¹⁶⁵ Mr Rake believed that the threat to the City from the UK being outside the eurozone was “long-term rather than short-term” but that in the “increasingly competitive environment, remaining outside the euro risks putting the City at a unique disadvantage to its European competitors”.¹⁶⁶

90. Sir Martin Jacomb stated that “whether we join the euro or not is not the major threat to the City of London” and that more important was the threat of “over-regulation ... [and] over-taxation”.¹⁶⁷ A recent survey commissioned by the Corporation of London was surprised to find the “low ranking of the euro-membership issue as a factor affecting the potential location of banking activity in London. There are several strategic concerns relating to London as a centre of financial activity, but UK Eurozone membership is way down the list”.¹⁶⁸ Mr Rake believed that outside the eurozone the City could face a disadvantage from a lack of influence over financial regulation. However, Mr Lascelles believed that it was unlikely that eurozone members would pass any regulation that would discriminate against the City as this would violate the principles of the single market. The London Stock Exchange told us that “Stamp duty levied on UK equities harms the competitive position of the City of London. A combination of euro entry together with stamp duty would further disadvantage London...” and that “the Government needs to begin the process of phasing out the tax...before possible euro entry”.¹⁶⁹ **Many witnesses stated that the financial services sector had not yet been adversely affected by being outside the eurozone, but that it would wrong to be complacent about the position of the City as Europe's dominant financial centre. We believe that as well as assessing the recent performance of the financial services industry the test also needs to reflect a forward looking approach examining both potential opportunities and threats. It**

¹⁶² Q 1086

¹⁶³ Appendix 1: *The Treasury's approach to the preliminary and technical work*, 6 September 2002

¹⁶⁴ HM Treasury: *UK membership of the single currency – An assessment of the five economic tests* October 1997, p 35

¹⁶⁵ Appendix 5

¹⁶⁶ Ev 45–46

¹⁶⁷ Q 116

¹⁶⁸ *The Impact on the City of UK Eurozone Membership: The Banking Industry* – press release 2, December 2002

¹⁶⁹ Appendix 13, paras 6.1– 6.2

is also important to examine any possible effect on the UK's influence on European financial regulation from being outside the eurozone.

91. The National Changeover Plan envisaged 4 months between a Government decision to join and a referendum, and then a further transition period of 24 to 30 months following the referendum. The Governor of the Bank of England felt that the City and the Bank “were as well prepared as we can be at this point”.¹⁷⁰ Standard Life’s experience of the euro conversion in Ireland led them to believe that they would “need three years to prepare for converting our UK data”.¹⁷¹ Mr Paul Richards from the Bank stated that most banks “would start to implement their preparations on a government decision to recommend entry and not wait until a referendum”.¹⁷² **Witnesses from the financial services sector told us that they needed at least three years to prepare their UK operations for any changeover to the euro. We note that under the current National Changeover Plan this would mean they would have to begin preparations immediately following a Government decision to recommend entry and not wait until the result of any referendum.**

Growth, stability and jobs test

“In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?”

92. This, the final and most fundamental test, will draw on all the preceding analysis to assess whether joining the euro would overall be good for growth and jobs. The technical analysis “is—as in 1997—analysing the potential benefits of EMU for the longer term performance of the economy. The assessment will compare these against the potential costs of joining”.¹⁷³ As noted above, we believe it is important to recognise that remaining outside the euro has costs as well as benefits and that this test should be assessed against a scenario of the possible future performance of the UK economy outside the eurozone.

93. Britain in Europe told us that “the creation of the euro has led to a rapid increase in cross-border trade in the eurozone, while Britain’s trade with Europe has stagnated”; they drew attention to figures from Eurostat, showing that between 1998 and 2001 EU trade as a proportion of GDP increased for France and Germany, while it declined for the UK. The No Campaign preferred measures looking at the volume of trade, which they claimed showed “British exports to the eurozone have grown faster than the euro members’ exports to each other”.¹⁷⁴ The relative merits of empirical studies covering the effect of monetary unions on trade between member countries were discussed.¹⁷⁵ Britain in Europe referred to a recent paper from the Inter-American Development Bank which estimated that the impact on trade amongst eurozone member countries was 5%–10%.¹⁷⁶ Mr Bootle believed that while “there was no doubt that being in a monetary union should boost trade” there remain questions about the magnitude of these effects.¹⁷⁷ As part of the assessment the Treasury plans to undertake a supporting study assessing the likely impact of UK membership of the euro on “UK external trade with the euro area and the rest of the world” and to “consider the range of estimates for the influence of monetary union on trade and assess the econometric studies that suggest the effects on trade could be very large”. **As the Treasury itself admits, this crucial fifth test rests on judgements about long term**

¹⁷⁰ Q 1151

¹⁷¹ See List of Memoranda p 68

¹⁷² Q 1152

¹⁷³ Appendix 1: *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁷⁴ Ev 118

¹⁷⁵ Q 319, Ev 123–124

¹⁷⁶ Appendix 4

¹⁷⁷ Q 319

effects. They cannot be known with certainty in advance. The assessment is therefore a judgement and the balance of evidence which informs it needs to be clearly set out.

The experience of the US & Canada

94. The US economy is of a similar size to the eurozone economy and has long been operating as a monetary union. The Treasury plans to examine “what lessons can be learned from the experience of the US as a monetary union”, including “how different regions respond to asymmetric shocks with the same interest rate and the role of relative price changes, factor mobility and fiscal policy in resolving regional divergences”.¹⁷⁸ Sir Martin Jacomb suggested that there may also be a parallel between the positions of the UK and Canada, both existing on the edge of large monetary unions.¹⁷⁹ Professor Begg made reference to a study examining the effect on trade of the Canadian border,¹⁸⁰ and the relative merits and demerits of this study were discussed in submissions from Britain in Europe and the No Campaign. Professor Laidler from the University of Toronto submitted two papers on the subject of Canada joining in a monetary union with the US. Both papers stressed the importance of the political element in any decision about international monetary integration, particularly those appertaining to the political accountability of the monetary authorities including the capacity to influence “the goals of monetary policy and the means whereby the relevant authorities pursue those goals”. We welcome the examination of the experience of the US as a monetary union. There may also be something to be learned from the experience of Canada.

The Stability and Growth Pact and the European Central Bank

95. If the UK joins the eurozone then, as previously discussed, the European Central Bank will be responsible for setting the interest rates applicable for the UK. Similarly fiscal policy will become subject to the Stability and Growth Pact. An important part of the assessment of the effect of euro entry on the UK economy will be how these frameworks operate and comparing them with the monetary and fiscal frameworks currently in place in the UK. One of the Treasury’s supporting studies will examine “the current arrangements for fiscal policy, monetary policy, and policy coordination in eurozone - how they deal with shocks, and how they contribute to the credibility and conduct of economic policy”.¹⁸¹ Since the Treasury announced this study, there have been changes to the Stability and Growth Pact, and the announcement of a review by the European Central Bank of its monetary policy framework. The Chancellor, during his appearance before the Committee on 27 February, told us that he expected to be clear “about the next steps that the ECB are taking in the conduct of monetary policy and what they are proposing as a result of the review in the next few weeks”.¹⁸² **We recognise that, while much of the current round of reforms is largely agreed, there is a need for continuing evolution in the reform process and any assessment of the European Central Bank and the Stability and Growth Pact will be in essence ‘aiming at a moving target’. If the assessment of the five economic tests is announced prior to the completion of the review of its monetary policy framework by the ECB, then the Treasury should publish a supplementary study examining any significant changes made.**

¹⁷⁸ Appendix 1: *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁷⁹ Q 154 (see also Q 330 [Mr Weale])

¹⁸⁰ Q 330

¹⁸¹ Appendix 1: *The Treasury’s approach to the preliminary and technical work*, 6 September 2002

¹⁸² Q 1126

4. TIMING AND NEGOTIATION OF ENTRY

96. The possible transition to membership of the euro was not analysed in the 1997 assessment of the economic tests. In a recent lecture¹⁸³ the Chief Economic Adviser to the Treasury highlighted previous decisions on exchange rate policy, including the return to the Gold Standard in 1925 and the devaluations of 1947 and 1964 as well as the experience of sterling in the ERM in 1990. One of his lessons from the 1925 decision in particular was that the then Government “did not undertake a full economic analysis of the economic consequences including any short-term transitional issues so that the economic consequences were fully understood”. He went on to say that the opinion at the time was that “the actual exchange rate chosen did not matter, for in the long run the system would adjust and adjust successfully. No one really attempted to point out how long and difficult the short run might be”. The Chancellor announced in February the addition of a further supporting study covering “the transition to the euro”.¹⁸⁴ In his evidence to the Committee he gave further details, saying there was a “need to understand what might be the implications of a transition to EMU as part of the requirements of sustainable and durable convergence”. We examine below some of the possible implications of how the transition might be accomplished.

Maastricht criteria

97. The process of joining monetary union is that the Commission and the ECB prepare a report to ECOFIN on whether the Member State has achieved the “high degree of sustainable convergence” necessary to join the eurozone. Taking account of this report the Council then makes the decision as to whether the country can join.¹⁸⁵ The criteria used to judge convergence were established in the Treaty of the European Union, and have become commonly known as the Maastricht criteria. These criteria are:

- Price stability: an average inflation rate within 1.5% of the three EU countries with the lowest inflation
- Sustainability of the government financial position: measured as the planned or actual government deficit being less than 3% of GDP and government debt being less than 60% of GDP, unless these figures are exceeded for temporary and exceptional reasons or the deficit has declined continuously and substantially and comes close to 3% of GDP.
- Long-term interest rates: the durability of convergence, measured by an average nominal long-term interest rate not more than 2% above that of the three eurozone members with the lowest inflation rate.
- Exchange rate stability: the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism (ERM) for at least two years, without devaluations at the candidate’s own initiative.

98. Whether these criteria are still in every respect appropriate, for the UK or other applicants, as a means of assessing fitness for membership, is now a subject of some debate. The UK easily meets the criteria on interest and inflation rates. On the Harmonised Index of Consumer Prices measure, which allows cross-country comparisons, the UK has one of the lowest inflation rates in the EU and has had so for several years. Long term interest rates are also close to those in the eurozone. The Budget 2003 projections of the public finances comfortably meet the criteria for debt, with debt forecast to remain close to 40% up to 2007/8, and the fiscal deficit projected to be 2.3% of GDP in 2002/03, rising slightly in 2003/04 to 2.4% of GDP and 2.1% in 2004/05, before falling below 2% for the remainder of the forecast period. Mr Regling told us that “if a country has a deficit of above 3% and applies for [euro] membership, that would not make sense really because it is one

¹⁸³ Cairncross Lecture 4 December 2002

¹⁸⁴ See Q 999

¹⁸⁵ TEC Article 122

of the convergence criteria that is taken very seriously and was taken very seriously in 1998 when it was decided which countries would join”; he also believed that today’s “euro area members would not be willing to accept a country that, at the time when the country applies” for membership has a deficit above 3%.¹⁸⁶ **We recommend that the Government should clarify whether they regard it as their policy to keep the deficit within the 3% limit required by the Maastricht treaty. We note that any deficit exceeding 3% on the treaty definition may preclude the UK from applying for membership of the euro.** The relevant UK financial year would be 2003-04, for an application during the latter part of 2004.

Exchange rate

99. The exchange rate is of critical importance to the assessment of the five tests. This has been recognised by the Treasury, which has commissioned a study to analyse “different approaches to the sustainable real exchange rate”. As the Chief Economic Adviser acknowledged, entering at an inappropriate rate imposes short term costs on the economy as prices and wages adjust to regain competitiveness.¹⁸⁷ The entry rate is important for all the tests—for example entering at an exchange rate that is too far away from the current value could cause divergence between the UK and eurozone economies (although this will depend on economic conditions at the time of entry). Entering at an overvalued rate would cause a loss of competitiveness for UK industry and could jeopardise investment and lead to a period of slower growth and fewer jobs. We asked our witnesses what methods were available to estimate the sustainable real exchange rate. Various methods were put forward including purchasing power parity (PPP), which provides an estimate of the exchange rate that equalises the prices of a similar basket of goods. Other witnesses advocated an exchange rate that would lead to equilibrium on the balance of payments. The Governor told us that estimating the rate would be “a real art” and that you have “to get the views of people who are actually exposed to the euro exchange rate” and “do an awful lot of academic work”.¹⁸⁸ Several employers’ organisations, including the Engineering Employers’ Federation and the British Chambers of Commerce, also submitted survey evidence.¹⁸⁹

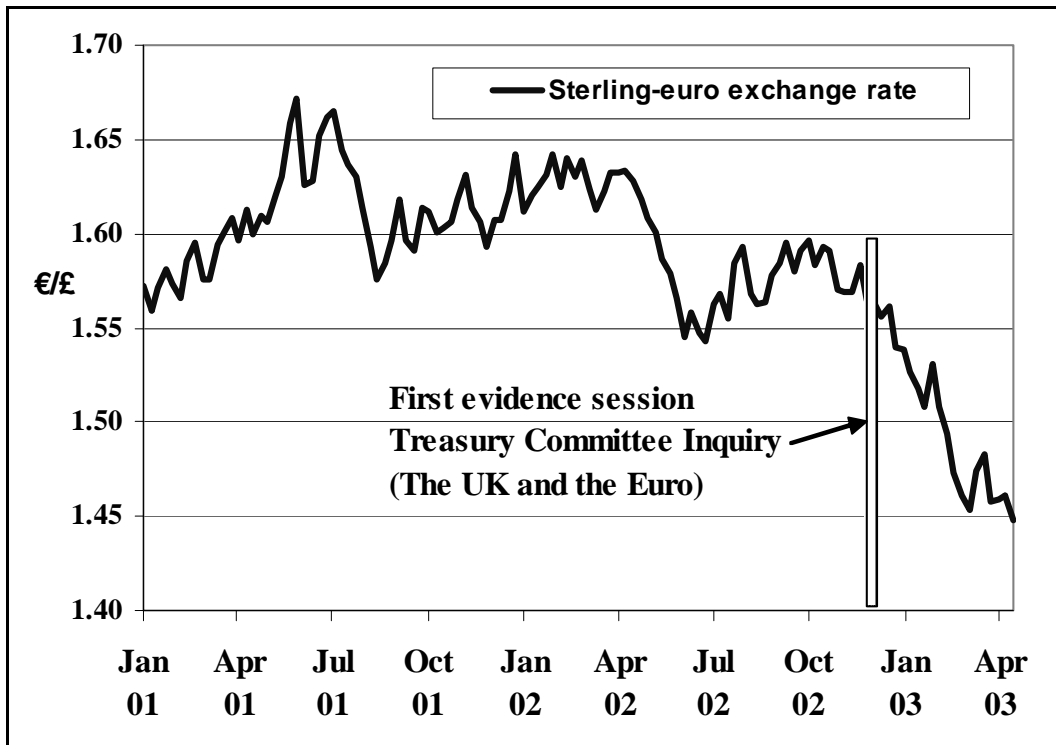
¹⁸⁶ Q 467

¹⁸⁷ Cairncross Lecture 4 December 2002

¹⁸⁸ Qq 1201–1203

¹⁸⁹ *Manufacturing and the euro—any change?* EEF Europe Survey 2002; *Single Currency Survey*, BCC January 2003.

Chart 5 : Sterling/Euro Exchange rate



100. We asked a number of our witnesses how far they thought the current exchange rate was from a sustainable rate. As shown in the graph above, since we started our inquiry in August and during our evidence sessions in January and February sterling has fallen against the euro by around 10%. Mr Weale thought that a feasible entry rate was “1.48 to 1.50...so now we are pretty close”.¹⁹⁰ Mr Bootle believed that “we are pretty close to a feasible rate, but ... some way away from a desirable rate”, referring to the imbalances in the economy. “We are going to need the external part of our economy to be pretty competitive”.¹⁹¹ The Governor told us that “a year or so ago the sterling/euro exchange rate was an immediate obstacle to entry”¹⁹² but following the recent fall in the exchange rate that obstacle is certainly reduced. Mr Stephens drew attention to the fact that “the glide path towards what the Treasury regards as a sustainable rate is probably the most awkward thing in all this”.¹⁹³ The Chancellor told us that as part of the assessment the Treasury were undertaking “two very detailed studies, one on the approaches to the sustainable real exchange rate, and one looking at the exchange rate in its macroeconomic context” but would not speculate on what kind of conclusions they would reach and if they would indicate the Government’s view of what was a sustainable rate.¹⁹⁴ **It is of fundamental importance that entry to the euro, should this take place, is at a viable and appropriate exchange rate. Although there is no unanimity on what the precise appropriate rate would be, we note that a number of expert witnesses are now of the view that the exchange rate is close to such a rate.**

¹⁹⁰ Q 328

¹⁹¹ *ibid*

¹⁹² Q 1203

¹⁹³ Q 80

¹⁹⁴ Q 1082

101. The process by which the UK would fix the entry rate against the euro provoked some discussions amongst witnesses, both on when the rate should be determined and the process for doing so. Mr Regling, referring to the Maastricht criteria, told us that “the treaty is very clear in this respect. One of the five criteria relates to the exchange rate and it says very clearly...that a country that wants to join the euro area has to be a member for two years in the Exchange Rate Mechanism”.¹⁹⁵ The Chancellor disagreed with this, telling us that “the ERM...described in the Maastricht treaty no longer exists” and stating that “we would not rejoin the ERM and have no intention of doing so”. He also drew attention to the fact that if the UK were to apply to join the euro it would “be a matter for the Council to decide”.¹⁹⁶ Professor Giavazzi told us that “asking a country to be in a system for two years that has proved very unstable would be very dangerous...not only thinking about the UK...but also the countries of central and Eastern Europe that are thinking of joining”.¹⁹⁷ The Governor drew attention to the wider 15% bands of ERM2 compared to the earlier years of the ERM, noting “That is a pretty wide margin for error”.¹⁹⁸ **We recognise the potential drawbacks of a process of entry involving a two year membership of ERM2. There is potential for the UK to provide leadership on this issue and to set out its preferred method of joining. Whatever the exact process were to be, it is important that the electorate knows, at least in approximate terms, the Government’s view of an appropriate exchange rate range before they are asked to vote in a referendum.**

Influence of UK on reform

102. The influence that the UK would have on the process of reform of the Stability and Growth Pact and the announced review of the European Central Bank’s monetary policy framework and the voting procedures was discussed by a number of witnesses. Professor Giavazzi believed that “an important window for reform—in monetary policy, financial regulation and fiscal design—is now opening” and “it will be of finite duration”.¹⁹⁹

103. Opinion was divided on this point. Some witnesses suggested that the UK would in a sense gain by waiting to see if the reforms change in an optimal manner. On the other hand, Dr Coyle cautioned that if the UK says that it is “going to wait to join” until reforms have been resolved satisfactorily then the UK may be less likely to secure a satisfactory outcome.²⁰⁰ The example of the Common Agricultural Policy was put forward by both sides: as a demonstration of doubts about the grounds for assuming the UK would be able to secure reform from the inside, and as a demonstration of the fact that a country outside when something was originally negotiated would find it being structured in a disadvantageous and inferior way. John Monks of the TUC believed that there was the opportunity for the UK to “provide the catalyst...for some necessary changes in the Stability and Growth Pact”.²⁰¹ The Chancellor told us, regarding the Pact, that “there is a growing recognition that you cannot simply look at fiscal policy on an annual basis, but you have to look at it over the economic cycle” and that “people are coming to accept...the view that we have consistently put forward about the importance of debt being taken into account and the importance of investment being distinct from consumption”.²⁰² The Governor told us that the Bank had a technical relationship with the ECB which he thought likely to continue regardless of the near-term decision, although he confirmed to us that there had been no Bank of England input into the review of the ECB’s monetary policy strategy.²⁰³

¹⁹⁵ Q 478

¹⁹⁶ Qq 1075–1077; TEC Article 122

¹⁹⁷ Q 503

¹⁹⁸ Q 1219

¹⁹⁹ Ev 196

²⁰⁰ Q 70

²⁰¹ Q 171

²⁰² Q 1086

²⁰³ Qq 1158–1161

104. In this period, when the eurozone's monetary policy and institutions are bedding in, there is clearly a greater 'window of opportunity' for British influence in negotiating reforms within the system, than would be the case later if there is a decision not to join the euro in the foreseeable future. The Government should continue to play an active role in the debate over reform of monetary and fiscal policy and structural reform. The analysis of the five tests and the accompanying studies will be of value to the eurozone states in this respect. Encouraging reform which improves the performance of the eurozone economy will also help to improve the performance of the UK's main export markets, whether or not the UK joins the euro.

The present options

105. This section of the Report has shown that the issue of timing—like so much in the debate over the euro—is not just an economic issue about whether or not there has been sufficient convergence. There are also politico-economic issues relating to whether the current moment is particularly opportune in relation to possible reform of the supporting institutions and structures of the single currency, not to mention the political impact that seeking to join might have on Britain's influence in the discussions inside and outside the Convention on the future structure and treaty base for the EU.

106. Government (and then Parliament) now face a range of options. These might be summarised as follows:

- *To conclude that the time is right to apply now to join the euro*
- *To conclude that the economic case is made for joining, not immediately but at some fixed date in the near future*

107. The implication of these options is that the economy would have been judged to be ready to move into the euro in the near future. For those convinced by the economic case for joining, the envisaged economic benefits of membership of the eurozone would then flow, but if the judgement proved premature there would be adverse economic consequences. The focus would move to the referendum campaign. The benefits of joining in terms of taking advantage of the 'window of opportunity' discussed above would be maximised by the first option rather than the second, but any wider political benefits could result from either option. A 'delayed' entry option would presumably involve a delayed referendum (leading in practice to a longer campaign), rather than the holding of an early referendum on the principle but delaying the actual projected time for entry; in such a case there would be an onus on the Government to explain why the delay was appropriate.

- *To conclude that the economic case has been made for joining provided certain conditions are met*
- *To conclude that the economic case for joining has not yet been established but that it would be right to re-examine the issue within a certain timeframe*

108. These two options would both involve a judgement that there were circumstances in which the economic case had been made. Future freedom of action would be maximised, but whether any hoped-for political benefits in terms of British influence within the Union would be realised could depend on the way in which the decision was presented—i.e. whether the Government gave positive or negative signals about the likelihood of a later decision to seek to join, and whether any 'conditions' set down or the timescale for future re-consideration appeared reasonable. On the basis that there is indeed a 'window of opportunity' for maximising the benefits of joining in the near future, this might be lost. There is also the possibility that the Government might want to preserve for itself maximum flexibility and announce, in the event of a negative assessment by this June, that it reserves the right to re-run the assessment of the five tests at some indeterminate time or times in the future. For understandable reasons the Chancellor

declined to speculate on this point when asked, but such a rolling re-run of the five tests could lead to uncertainty in the British economy.

- To conclude that there is no prospect of it being appropriate for the UK to join the euro, and to make no plans for revisiting the decision at a later date.

109. This option would promote certainty in policy making by ruling out one option and, in the opinion of those who are not convinced by the economic case for joining, would bring with it long term economic benefits. However, it would represent a dramatic change in declared government policy and could thus create considerable uncertainty. It might also carry some of the most immediate risks, in respect of a loss of confidence (more specifically a possible loss of enthusiasm for investment) in the British economy amongst those who consider Britain's economic future to lie within the euro. It would of course also have significant political implications in respect of Britain's influence both within economic policy making in Europe and more generally over the future direction of the EU.

110. We do not judge between these options, but we have sought in this Report to provide additional analysis and information on the implications of each option. The point we would emphasise is that while there are indeed political implications to each option (to which we have referred throughout this Report) it is of fundamental importance that the economic case for entry is met first of all if the UK is to enter the euro.

5. ENGAGING THE PUBLIC IN THE DEBATE

The challenge

111. As already stated, we agree with the Chancellor that the question of whether to join the Euro is one of the most significant issues faced by Parliament and the nation. If the Government and Parliament decide in favour of moving forward towards membership, then it is the people—in the form of the electorate—who will be faced with the final choice. But how will the public respond to being asked to make such a choice? Will people be sufficiently interested to participate in the debate and the referendum process? Or does recent evidence of voter disengagement mean that there will be only a low turnout? Alternatively, even if sufficiently interested, how confident will individual voters be in making a choice of such importance? Will they feel they understand enough about the issues to make the choice? And will they feel able to balance the political and the economic issues?

112. These questions are important. **It should be the objective of the Government—and of other organisations and institutions involved, including the political parties and Parliament itself—to promote as full and as well informed a debate as possible ahead of any referendum. We should be seeking to maximise the level of participation in a referendum and to maximise the extent to which voters feel they have been given the information necessary to cast their vote, based on their knowledge of the issues involved.**

113. In order to examine this issue, we included in our programme of oral evidence a range of journalists and commentators, together with witnesses from the BBC and from the Electoral Commission. We also had the benefit, as outlined earlier, of electronic submissions from members of the public,²⁰⁴ which—although self-selecting—helped to supplement our own experience from constituents and others as to the issues which were of principal concern to the public.

Public interest and increasing public understanding

114. The baseline for current views on whether the UK should join the Euro appears to be that—of those already fairly decided in their view—there is a majority against joining over those in favour. However there is a large proportion who are either undecided or who profess themselves capable of being persuaded either way. These results appear to be fairly consistent across different polls using different ways of putting the question.²⁰⁵

115. We note evidence given to us by MORI: “But from the outset, the British public has been opposed to British membership of the European single currency. Tracking the level of support and opposition to Britain’s membership...bi-monthly over the past five years shows that while early on there was about a near 20 point gap between opponents and supporters, that gap has widened to a steady two to one opposition.”²⁰⁶ That trend has been consolidated since the introduction of the euro at the start of 2002.

116. Witnesses were reasonably bullish about likely levels of interest and participation in a referendum. Although the low turnout (59%) at the 2001 General Election was widely acknowledged to be a matter of concern and to indicate at least in part some disaffection with the political process, it was felt that the circumstances of a referendum on the Euro

²⁰⁴ See footnote 7 above; about 90 e-mails were received

²⁰⁵ Ev 325 and 345

²⁰⁶ Ev 323

would be different²⁰⁷. For example, Mr Kaletsky, of *The Times*, told us “I think when the referendum comes there will be far more interest and the public will be pretty fully engaged, or more engaged and involved than they have been in any of the other European countries.”²⁰⁸ It was noted, however, that political circles, opinion formers and the media had an important role to play. Dr Coyle, of Enlightenment Economics, suggested “It does depend on the rhetoric... If everyone who is talking about it says that this is the most important decision our nation has ever taken, then the public is more likely to pay attention.”²⁰⁹ Mr Kavanagh, of *The Sun*, took the view that in the lead up to a referendum “there will be no shortage of coverage for and against the argument”.²¹⁰

117. The Electoral Commission noted that recent opinion polls suggested that people’s propensity to vote in a euro referendum was similar to that for a general election²¹¹. Mr Sam Younger, the Chairman of the Commission, indicated that if the trials of initiatives to increase electoral turnout generally went favourably then they could in principle be applicable for a euro referendum, though in respect of all-postal voting he said that “My own gut feeling would be that it would be a step too far to go into that for a major UK-wide vote at the moment”²¹². The Commission also noted “that there would appear to be significant gaps in public knowledge and understanding” of the issue”,²¹³ adding that its existing research and experience suggested that “...information provision is a key factor influencing electors’ decisions about whether to ‘turn out’. Information provision (and especially the absence of information) appears to be especially important to non-voters.”²¹⁴ Existing legislation does not give the Electoral Commission a power to promote participation in a referendum; specific provision is however being included for this in the enabling legislation for the referendums for English regional assemblies and the Commission stated that it “would expect the Government to make similar provision in any future referendum legislation”.²¹⁵ **We recommend that, were there to be a referendum on the euro, provision for the Electoral Commission to encourage voter participation, and—as we discuss below—to provide objective information, should be included in the enabling legislation.**

118. Other witnesses made a range of comments on the extent of knowledge and understanding of voters about the issues involved. In some ways, it was thought that the UK electorate was reasonably well placed. Mr McRae, of *The Independent*, told us that “I am not too worried about the level of debate and the level of understanding in this country about the issues... if you look at the overall level of economic competence we are remarkably high.”²¹⁶ Mr Kavanagh thought that “at the end of a referendum campaign [people’s] knowledge about the issues will have grown enormously”²¹⁷. For the BBC, Mr Damazer suggested that surveys “indicate that the level of understanding of the British public about the mechanics and simple issues surrounding the euro is not as high as we

²⁰⁷ The fact that the vote would come at the end of a high profile campaign could also mean that—unlike in an opinion poll—the exact wording of the question may make relatively little difference to the outcome. Professor Worcester argued that “At the end of a three- or four- week campaign people know what is at issue, and the people who cast their vote have thought something about it. It is not sprung on them.” (Ev 322; Q1228) Nonetheless, the Electoral Commission, who are required by statute to consider the wording of referendum questions, told us it regarded “the intelligibility of a referendum question as critical to engaging voters”; it has issued a number of guidelines designed to ensure that the wording of the question (on any referendum) is as clear and as neutral as possible. (Ev 361 para 17 and Annex B). We note the Commission’s evidence that it is important that the question be short and clear; if there is a need to place other information before the voter on the face of the voting paper then this should be in a preamble to the question (though in such a case extreme care would have to be taken that the preambular material was impartial) (Q 1313 ff.).

²⁰⁸ Q 3

²⁰⁹ Q 108

²¹⁰ Q 1254

²¹¹ Ev 360 (para 11); see also Q 1330

²¹² Qq 1331, 1334 ff.

²¹³ Ev 360 (para 11)

²¹⁴ Ev 360 (para 12)

²¹⁵ Ev 360 (paras 9–10)

²¹⁶ Q 3; see also Mr Kaletsky (Q 3)

²¹⁷ Q 1278

would like it to be”, but that “during the course of any referendum campaign, that level of understanding would dramatically increase”²¹⁸. At the same time, it was suggested that there was a wide desire for greater knowledge. Mr Riddell, of *The Times*, told us “...the most striking thing of all the focus groups and polling evidence I have seen is the degree of ‘We want to know more about the issue’. That is absolutely clear cut.”²¹⁹

119. Mr Sparrow, of ICM Research, was more cautious however. He suggested that:

“...you only have to scratch the surface to realise that people’s actual understanding of what it means to change our currency is very shallow indeed.. I think that is a real problem with engaging the public, a broad mass of people, in this issue about the euro; it is simply too difficult a subject for them to understand.”²²⁰

He also thought that “It would be wrong... to take at face value the demand by most voters to be informed and imagine they are likely to engage in a real debate in advance of a real campaign” because in many cases such a response will have been made to excuse current ignorance²²¹. It must also be recognised, as we have stated throughout this Report, that people’s response in a referendum will be as much a response to the politics as to the economics of the debate and that this is likely to be the case however well informed they are about the economic issues.

120. Nonetheless, while we fully accept that a real readiness to learn more about the issues will be far from universal, **we conclude overall that there is a need and a desire among the public for a balanced source of information on the economic issues involved in a decision on whether to join the euro, ahead of any referendum. We recommend that the Government and the Electoral Commission give specific attention to examining ways of providing such information.**

121. How is this to be achieved? Obviously, the lead role in the debate will be taken by the political parties and the other protagonists for each side. The Electoral Commission will have the duty of registering as ‘permitted participants’ (these are any bodies, including political parties, intending to spend over £10,000) and for selecting ‘designated organisations’ (these are existing or specially established organisations, one for each side of the debate, who will be eligible for assistance such as free mailings and referendum broadcasts, and higher spending limits, under the provisions of Part VII of the Political Parties, Elections and Referendums Act 2000). Their campaigns will be widely reported through the media as for any other issue, and the press will be pushing their own views at the same time. Professor Worcester argued that “an important factor in any referendum campaign will be press coverage of the issue”,²²² because such coverage was the more significant the lower the salience of an issue in the public mind²²³. Asked whether *The Sun*’s coverage would be “educative or campaigning”, Mr Kavanagh replied “I hope it will be both”, though he was unsure “how much one newspaper can affect the settled view of the public”.²²⁴

122. But while these campaigns will serve to increase public awareness of the importance of the issue at stake (and thus promote turnout), the public may find them unconvincing as a means of promoting understanding of the issues, since these sources are not those from which they seek reliable, balanced information. Professor Worcester noted that:

²¹⁸ Q 1349; see also Qq 1359–1360

²¹⁹ Q 107; we note also that the motion on the euro passed by the TUC on 15 September 2002 called for factual information on a range of issues relating to the euro and eurozone be put before each Congress prior to any referendum.

²²⁰ Q 1228

²²¹ Ev 344; Q1228

²²² See Ev 359–361 and Q 1343 ff; the issue of spending limits for the various organisations and campaigns has itself been an issue of controversy, but is not a matter for this Report

²²³ Ev 329

²²⁴ Qq 1255, 1276

“There is little systematic and objective information in any structured way available to policy makers and the citizenry. Nor is there any real forum for people’s views to be aired, and little open debate not led by either the protagonists or the antagonists, no objective and trusted ‘middleman’ leading the debate.”²²⁵

Mr Sparrow was sceptical, however, as to whether it would be possible to find independent figures who could significantly influence the public’s understanding of the issues, suggesting that “...there will be a very limited number of facts, impressions and attitudes that will, in the end, determine it. It comes out of that political debate with the two sides willing to argue either case passionately on both sides...”²²⁶

123. Among those cited as sources in which the public would place more trust—perhaps because they are seen, in the words of Mr Whittam-Smith, as “not particularly typecast as having one view or another”—were broadcasters, business leaders and economists²²⁷. It is possible that distrust of Government announcements might be ameliorated by the knowledge that their arguments for joining had been buttressed by a serious in-depth analysis (ie the 5 tests and the supporting studies); however, witnesses thought this was unlikely, partly because the tests did not really mean much to the wider public in the first place²²⁸. Dr Coyle suggested that the contribution of economists (and economic issues) to the debate might in practice be weakened by the fact that opinion amongst economists on the issue was so divided.²²⁹

124. An extra premium is thus placed on the role played by the broadcast media in promoting objective debate in an informative way. The Deputy Head of News for the BBC, Mr Mark Damazer, suggested that, while it was not the BBC’s role to increase turnout as such, their hope was that their coverage would encourage people to exercise their civic responsibility and would increase knowledge of the issues²³⁰. He recognised the potential importance of the BBC’s role, accepting that “were there to be a referendum, it would be one of the supreme challenges for public service broadcasting, indeed for any broadcaster” and that it would:

“take a great deal of imagination, air time and resource during the course of the referendum campaign to ensure that all the BBC’s many audiences are as well informed as they would hope to be from the BBC about the issues that are at stake.”²³¹

He observed that “we have to place and schedule these programmes across all our various networks in a way that gives the audience a chance to find them”²³². Economists and leading figures from business, to whose explanations and expertise people may be more responsive than to those of politicians and political commentators, might have a particular role to play²³³. The BBC already had webpages dedicated to the euro debate²³⁴. An overriding issue for the BBC was that their coverage should be impartial.²³⁵

125. We consider that the role of the broadcast media in promoting informed and educative debate on the issues relating to the euro will be of particular importance during a referendum campaign. We have every confidence that broadcasters will

²²⁵ Ev 320

²²⁶ Qq 1240–1241 and 1248; see also Q 1242 [Mr Kellner]

²²⁷ See for example Q 6 [Mr Whittam-Smith], Q 107 [Mr Riddell]

²²⁸ Q 1251 and Ev 344 [Nick Sparrow, ICM]

²²⁹ Q 55

²³⁰ Qq 1353–1356

²³¹ Q 1349

²³² Q 1387; one witness suggested that including references to the issues in non-factual programmes, such as soaps and game shows might increase awareness (Q 1252), though another thought that this would “simply turn people right off” (Q 1282).

²³³ Q 1388

²³⁴ Q 1389 ff.

²³⁵ Q 1361 ff.

recognise the significance of their treatment of the issue and will live up to their responsibilities. The BBC and other websites could play an invaluable role.²³⁶

126. We considered whether there were further specific measures which might be taken to promote knowledge and understanding. There may be a case for taking more direct steps to promote the distribution of information, perhaps through the preparation, and distribution to each household, of a public information document setting out some basic information on the key issues on which the public wanted to know more. Dr Coyle told us that she “would like to see a leaflet sent to each household listing a wide range of sources of information”.²³⁷

127. One possibility for preparing such a leaflet might be the Electoral Commission itself. The Chairman of the Commission, Mr Younger, told us that while there was “a role for an organisation such as ours... I think I need to be very careful about what it is we do. What we would hope to do in the context of a referendum on the euro is be able to leave the substance of the arguments ... to those designated organisations and others, to those who are particularly engaged in the issue.”²³⁸ However, the Commission explained that, in connection with the English regional assembly referendums, legislative provision was being made for allowing the Commission to provide voter information itself in the event that no designated organisations had been selected. Although the situation we envisage—where any such information would be in addition to information provided by campaigning bodies—would be different, it does suggest that the principle of a neutral body supplying information might be workable²³⁹. Another possibility might be a document based on this Report²⁴⁰.

128. We are under no illusions about the difficulty of finding a means by which an information document could be prepared which would command universal (or near-universal) consent as to content which would not at the same time be so bland as to be almost worthless. It might not be necessary to satisfy absolutely everyone that the document is sufficiently neutral to justify its distribution at public expense, but it would ideally have to satisfy both designated groups and the main political parties, and the process must be safe against legal challenge. Specific provision for such an exercise would have to be made in the legislation establishing the referendum.

129. We accordingly recommend that, as part of their response to the recommendation in paragraph 120 above, the Government and the Electoral Commission, in consultation with the British political parties represented at Westminster and in the European Parliament, should examine ways in which a public information leaflet could be prepared and distributed to each household ahead of a referendum. The leaflet should include summary information on the key issues. It should also include website addresses for a range of other documentation and organisations. We note that, as the legislation currently stands, the issuing of any such document by a public body in the last 28 days of a campaign would be unlawful,²⁴¹ and that accordingly the enabling legislation for the referendum would have to remove this obstacle.

²³⁶ Mr Riddell drew particular attention to the potential value of the internet in informing the euro debate (Q 108).

²³⁷ Ev 17

²³⁸ Q 1340

²³⁹ Ev 362 Annex A

²⁴⁰ Mr Andreas Whittam-Smith, former Editor of *The Independent*, noted that “Parliament itself might be the body which would publish something that would be something people would trust as being a fair analysis of the two sides of the argument” Q 2

²⁴¹ Political Parties, Elections and Referendums Act 2000 section 125.

130. In making this recommendation, we are under no illusion either that it will necessarily have a dramatic effect. We recognise that—as Mr Sparrow suggested to us²⁴²—many people would not read any document, however simply it set the issues out. Nevertheless, if it reached and was found useful by only a relatively small proportion of those genuinely seeking extra information, it would have had some value. Professor Worcester noted evidence from polls that there was a group of very nearly 20% of the electorate who were both open to persuasion by either side on the issue of euro membership and who read no newspaper regularly²⁴³.

Issues of concern to the public

131. What is it that the public might want or need to know more about? It would clearly be naïve to imagine that there is a great demand for the kind of detailed economic analysis of the kind we have received in the written and oral evidence in this inquiry. Nor would there be great purpose in attempting to supply such analyses. But there are certain core issues which feature again and again in the wider submissions we have received²⁴⁴.

132. For those broadly in favour of the euro, the principal concerns were:

Political: the need for the UK to show more commitment to the whole EU process if it was not to lose influence

Economic:

- C the ability to influence the development of the eurozone institutions and policies
- C the advantages for business of reduced foreign exchange risks/costs, and hence
- C the prospect of greater foreign investment and better prospects for jobs, in particular manufacturing jobs

133. For those broadly against joining the euro, the principal concerns were:

Political: fears that entry involved a significant diminution in political autonomy and was another step towards a single European state

Economic:

- C the imposition of inappropriate monetary and economic policy on the UK: concerns about the ‘one-size-fits-all’ interest rate and lack of convergence
- C the extent to which the current problems facing Germany are attributable to the euro
- C the abandonment of the current successful UK model for monetary/economic governance in favour of less successful and less accountable ones.

134. Most (though not all) responses expressed concerns only from their own side of the argument. Some issues did however receive frequent mentions from both camps (as well as from the uncommitted):

- C *the extent to which the decision is as much (or even more) a political decision as an economic one*

²⁴² Q 1249

²⁴³ Ev 330; BBC research also pointed to a significant group who neither voted nor watched BBC political programmes (Q 1350)

²⁴⁴ Overall, the e-mail responses received broke down roughly 35% in favour of the euro, 45% against and 20% not clearly decided.

- C *the importance of the level at which sterling would enter the euro*: opinion on all sides of the debate noted the significance of getting the entry rate right, with almost all seeking a lowering of the current sterling rate²⁴⁵
- C *a need for more, or more balanced, information to be made available to help voters to decide*: in making this point, a number of responses suggested that currently the debate was in effect a dialogue of the deaf conducted in superficial terms.

Issues which were mentioned but not with great frequency included whether joining was in some sense inevitable,²⁴⁶ and issues to do with changeover (such as possible inflationary effects). There was relatively little awareness in the responses about what has been called (as discussed earlier in this Report) the ‘counterfactual’ issue in the event of not joining—i.e. the need to consider, in assessing the UK’s economic prospects, not the economy’s position compared to the eurozone now but what the situation would be after a few years once it had been decided that the UK was not to join.

135. These concerns tally very closely with those suggested by our witnesses as being those in which the public were likely to be most interested. These included: suspicion that continental Europeans are in some way taking over²⁴⁷ or that joining the Euro means entering a United Europe, essentially a single state;²⁴⁸ not joining the Euro means being left out of something it is worth being in;²⁴⁹ the long-term interaction between politics and economics and the losing of control over interest rates and monetary policy;²⁵⁰ economic policy—who is going to decide our taxes?;²⁵¹ jobs;²⁵² foreign investment;²⁵³ how well the eurozone is performing relative to the UK²⁵⁴ and the current problem being faced by some eurozone economies, particularly Germany;²⁵⁵ benefits for business, especially multinationals;²⁵⁶ use of the changeover as an excuse or opportunity for price rises.²⁵⁷

136. As the earlier discussion in this report has shown, these are indeed important issues. On some of them, it may be that some of the fears—on either side of the debate—can be shown to be largely misplaced. On others, there is clearly room for differing views. It is worth noting that these concerns straddle the political and economic angles to the issue.²⁵⁸

137. The public information leaflet we have proposed will need to include information addressing the issues listed in paragraphs 132–134 above, if it is to be effective in responding to voters’ concerns for information.

²⁴⁵ Though it should be noted that many of these responses were submitted at a time when the pound stood at a higher rate than the current rate (see Chart p 5, page 42 above, for change in rate over recent months); we note also the observation by Mr Sparrow that the general public’s response to seeing the pound rise against foreign currencies is that “means something good” Q 1244

²⁴⁶ Mr Sparrow suggested that if there were a deep sense of “inevitability” about the euro then this might have been expected to show through in opinion poll results and there was no evidence that it was doing so (Q 1238)

²⁴⁷ Q 1235

²⁴⁸ Ev 343

²⁴⁹ Ev 343

²⁵⁰ Qq 1247, 1264 and Ev 344

²⁵¹ Q 4

²⁵² Qq 55, 1237

²⁵³ Q 105

²⁵⁴ Q 4 [Mr McCrae]

²⁵⁵ Qq 4, Q 1243

²⁵⁶ Ev 344

²⁵⁷ Ev 343

²⁵⁸ We note that in one of their surveys on opinion on the Euro, MORI asked half its sample about “Britain’s economic interests” and half simply about “Britain’s interests” and found no statistical difference between the responses (Q 1227)

LIST OF RECOMMENDATIONS AND CONCLUSIONS

This Report

- (a) **We fully recognise that the political issues will clearly form a major part—perhaps even a dominant part—of any referendum debate. But the political issues in themselves are not the subject of this report (paragraph 11).**
- (b) **Our intention has been to offer a significant, and balanced, contribution to the debate—so far as possible in relatively simple terms—about the economic implications of a decision to join, or not to join, the euro... We hope it will assist the debate for so long as joining the euro remains an issue (paragraph 12).**

The changeover process

- (c) **It is clear that the introduction of euro notes and coins across the eurozone was a logistical success (paragraph 13).**
- (d) **While rounding up of prices was found to have no significant statistical effect on overall inflation, in a small minority of sectors there was some evidence of retailers taking advantage of the changeover to push up prices. (paragraph 14).**

European Central Bank

- (e) **The money growth pillar has an unwarranted prominence in the ECB's monetary framework, though in practice it appears to be disregarded in setting interest rates. This tends to undermine the overall credibility of its monetary framework (paragraph 18).**
- (f) **We welcome the ECB's review of its monetary policy framework. The framework should be strengthened by the introduction of a symmetrical inflation target. This would not require a great policy change on the part of the ECB, but would provide a better match between its announced strategy and its actions. The ECB would benefit from a less prominent role for the monetary growth pillar, although it should still monitor developments in order to inform its decision making (paragraph 21).**
- (g) **We welcome the publication of economic projections by the ECB, but believe they should increase the frequency of publication to 4 times per year, as there can be significant change in the outlook over six months. More frequent publication would help the Bank to provide a clearer and more transparent explanation for their decisions. (paragraph 23).**
- (h) **While it appears that to date formal votes have not been necessary, this may not be possible as the eurozone expands. The ECB should start publishing the voting figures (keeping the votes of individuals confidential), since the figures would indicate changes in policy stance, thereby improving transparency (paragraph 24).**
- (i) **There is a clear opportunity for introducing a mechanism for greater democratic political accountability to the process by which the inflation target is set. We consider that this decision properly rests with ECOFIN (paragraph 25).**
- (j) **We agree with the Commission that the ECB was prevented from considering alternative proposals for reform of its voting procedures (for example, the introduction of a separate committee based on the Executive Board for setting**

rates) due to the limitations of the enabling clause in the Nice Treaty. We do not think that the proposals put forward by the ECB are the optimal solution to the problems posed by enlargement. It is regrettable that such an important decision on reform was taken so quickly and with limited debate. We recommend that reform of the Governing Council prior to enlargement needs to be re-considered urgently, under a broader remit allowing changes to the structure of the ECB. We consider such reform important for the credibility and operational effectiveness of any enlarged ECB. We think the prospect of UK exclusion from 20% of ECB interest rate votes could prove to be an obstacle to entry. (paragraph 28).

Stability and Growth Pact

- (k) **We recognise the fact that the countries now exceeding the 3% deficit limit of the Stability and Growth Pact would not now be doing so if they had addressed structural fiscal weaknesses before the present downturn. However, tightening fiscal policy at this stage in the cycle could further exacerbate the downturn in the eurozone. We conclude that a Treaty interpretation allowing countries with relatively low overall debt levels to exceed the 3% limit during a cyclical downturn is essential. Governments should, however, take advantage of any increase in economic growth to reduce structural deficits. As growth in the eurozone recovers it is important for those countries with significant structural deficits to achieve an enduring strengthening in the fiscal position. Medium term fiscal sustainability should remain the goal, but if it does not allow flexibility the SGP will lose credibility and jeopardise the ultimate objective. It is important that the discipline of overall fiscal policy expressed in the Stability and Growth Pact remains firm so that breaches of it do not become a way of avoiding the structural reform needed for long term sustainable growth (paragraph 34).**
- (l) **It remains to be seen how far the reforms in the interpretation of the Pact agreed at the March European Council will work in practice, and we believe the promised reforms must be closely monitored to see if they do indeed deliver greater flexibility. We note the principle that there should be more flexibility to take into account the specific situation of individual countries. This could allow higher levels of spending where debt sustainability was not a problem. We note that the Treaty requires classifications to meet the definitions of European integrated economic accounts and that these are monitored by an independent committee convened by Eurostat. It is equally important, however, that individual countries are not allowed to escape the rules of the Pact by artificial reclassification of their accounts or other adjusted accounting (paragraph 36).**
- (m) **We support the Government's view of the need for a prudent interpretation of the Stability and Growth Pact taking account of the economic cycle, sustainability of debt and the important role of public investment. We recommend that the Government should set out at the time of its euro decision its views on exactly how this interpretation could be achieved within the existing framework and how far the Council's recent reforms are from meeting these requirements (paragraph 38).**

Performance of the eurozone economy

- (n) **We agree that insufficient progress has been made in the eurozone in making labour markets more flexible (paragraph 44).**
- (o) **Structural reform is vital if the eurozone is to gain the full benefits of the single currency. With the loss of monetary policy independence, reform in**

individual countries must play an increasing role in stimulating growth and reducing unemployment. We acknowledge that there has been progress in some areas, but are concerned that progress appears to be slow. The current weak economic conditions should not be an excuse for the pace of reform remaining slow. We welcome the contribution of the UK Government towards encouraging structural reform. The ECB, the Commission and the Governments of the Member States should work together to ensure that the promised reforms are actually delivered as quickly as possible. (paragraph 45).

- (p) Witnesses put forward a number of explanations for the recent under-performance of the German economy and the extent to which they were caused or made worse by the euro. Many stated that the problems of the German economy were long-term in nature and related to the after effects of reunification. There was a broad consensus that Germany entered the euro at an overvalued exchange rate—though the current account is now returning to substantial surplus. All witnesses questioned on the subject referred to the fact that structural reforms are necessary if Germany is to correct its underperformance (paragraph 47).
- (q) The Irish economy has benefited from being part of the eurozone in terms of gaining a credible monetary policy and the elimination of exchange rate fluctuations against other eurozone members. However, excessive inflation could lead to a loss of competitiveness in the longer run if not matched by productivity improvements. There may be a particular danger of this following the appreciation in the value of the euro against sterling and the dollar, especially if the UK remains outside the eurozone (paragraph 49).

Experiences of UK companies so far

- (r) It is clear that, both at the level of international businesses and at local level, UK businesses and citizens are adjusting comfortably to use of the euro. While UK firms are finding it relatively easy to adopt operational strategies for living with the euro while the UK remains outside the zone, longer term issues affecting location and investment may well be contingent on knowing where government policy is headed. UK companies need to see the analysis of the five tests to provide such clarification (paragraph 52).

The assessment process

- (s) We accept the need for a serious and in-depth analysis which will allow the Government to take a properly considered and researched decision on the economic consequences of joining the euro. At the same time, we recognise that an economic analysis is not a mechanistic exercise and that there will inevitably be an element of judgement involved in assessing the economic case for entry. It will be difficult for the results of the assessment to be totally unambiguous (paragraph 55).
- (t) It seems to us that non-publication of the supporting studies ahead of the announcement will have reduced the opportunity for informed public debate before the Government becomes committed to a particular judgement. It is now too late for the studies to be published before the assessment is made and announced, and we regret this (paragraph 58).

The five tests and the supporting studies

- (u) We note the importance of assessing the consequences of not joining the euro. One set of issues arises if the decision is taken to join. A different set of issues arises if the decision is taken not to join in the foreseeable future. Both

scenarios bring new challenges to the UK economy. We therefore welcome the confirmation that this point is being taken into account in the Treasury's assessment (paragraph 65).

- (v) **When the tests were constructed in 1997 evidence concerning the present UK monetary arrangements and the eurozone (as a monetary union) was not available. We welcome the Treasury's examination of the experience of the eurozone so far as part of a number of the supporting studies. The eurozone countries now provide 12 case studies as to the effects of entering monetary union and we believe these provide important lessons for the UK. Equally, given six successful years of the new UK monetary framework, supporters of entry will have to demonstrate that entering the monetary union will be at least as beneficial as the UK framework that is to be abandoned (paragraph 68).**

Convergence test

- (w) **There has been substantial convergence between the UK and the eurozone economies since 1997. In some respects the level of convergence is greater than that between some of the eurozone members themselves before 1999. However, the Treasury assessment must include examination of whether convergence to date is cyclical or structural. It must also examine the implications of the recent imbalances in the economy for achieving sustainable and durable convergence and whether these imbalances would have arisen had the UK been in the eurozone from the outset (paragraph 72).**
- (x) **How the UK reacts to changes in eurozone interest rates is an important area for the Treasury to have examined during the assessment; this should include an assessment of the effect of interest rate changes on investment and consumption in the UK as well as in aggregate (paragraph 73).**
- (y) **The essential question is whether the recent fall in the value of sterling against the euro provides an exchange rate that would avoid these difficulties if it were the basis of the UK joining the euro. The Treasury assessment must spell out how a sustainable real exchange rate for entry is to be determined (paragraph 74).**
- (z) **We welcome the research announced in the Budget into factors influencing the take up of fixed rate mortgages, but regret that it will be too late to inform the assessment of the tests due to take place by June 2003 (paragraph 77).**

Flexibility test

- (aa) **Labour market flexibility is important for the UK economy, if it is to respond efficiently to shocks. We ask the Treasury to clarify and define the ways in which there has to be flexibility amongst the eurozone countries and the UK for this test to be passed. We note the Chancellor's statement in Budget 2003 in respect of achieving greater labour cost flexibility in the regions of the UK. We hope the Treasury assessment will say more about the context for this reform (paragraph 81).**
- (bb) **The Treasury assessment needs to set out clearly the Government's thinking on the relationship between monetary union and member state fiscal policy regimes and how it will deal with the extra pressure in a single currency for tax harmonisation and for an enlarged EU budget (paragraph 82).**

Investment test

- (cc) **Membership of the single currency is likely to provide the conditions for more and better investment if there has been sufficient convergence between the UK and the eurozone and sufficient flexibility exists. In this way the third test is to some extent a consequence of whether the first two tests have been satisfied. We received evidence from a number of firms that over time investment decisions would increasingly favour the eurozone at the expense of the UK. The assessment must cover the extent to which volatility against the dollar could be increased if the UK joined the eurozone and what effect this could have on inward investment to the eurozone from the US. The accuracy and significance of the large volume of inward investment statistics needs to be assessed, if possible with the effects of mergers and acquisitions identified and separated out (paragraph 87).**
- (dd) **We welcome the examination within the assessment of whether the Stability and Growth Pact would place any constraints on the level of public investment in excess of those of the Government's fiscal rules. While the recent proposals allow a temporary deviation in the short term from the close to balance requirement to fund public investment, it is important to estimate whether investment projections in Budget 2003 could be constrained because overall deficits would breach the 3% limit of the Stability and Growth Pact (paragraph 88).**

City and financial services test

- (ee) **Many witnesses stated that the financial services sector had not yet been adversely affected by being outside the eurozone, but that it would be wrong to be complacent about the position of the City as Europe's dominant financial centre. We believe that as well as assessing the recent performance of the financial services industry the test also needs to reflect a forward looking approach examining both potential opportunities and threats. It is also important to examine any possible effect on the UK's influence on European financial regulation from being outside the eurozone (paragraph 90).**
- (ff) **Witnesses from the financial services sector told us that they needed at least three years to prepare their UK operations for any changeover to the euro. We note that under the current National Changeover Plan this would mean they would have to begin preparations immediately following a Government decision to recommend entry and not wait until the result of any referendum. (paragraph 91).**

Growth, stability and jobs test

- (gg) **As the Treasury itself admits, this crucial fifth test rests on judgements about long term effects. They cannot be known with certainty in advance. The assessment is therefore a judgement and the balance of evidence which informs it needs to be clearly set out (paragraph 93).**
- (hh) **We recognise that, while much of the current round of reforms is largely agreed, there is a need for continuing evolution in the reform process and any assessment of the European Central Bank and the Stability and Growth Pact will be in essence 'aiming at a moving target'. If the assessment of the five economic tests is announced prior to the completion of the review of its monetary policy framework by the ECB, then the Treasury should publish a supplementary study examining any significant changes made (paragraph 95).**

Maastricht criteria for entry

- (ii) **We recommend that the Government should clarify whether they regard it as their policy to keep the deficit within the 3% limit required by the Maastricht treaty. We note that any deficit exceeding 3% on the treaty definition may preclude the UK from applying for membership of the euro (paragraph 98).**

Exchange rate on entry

- (jj) **It is of fundamental importance that entry to the euro, should this take place, is at a viable and appropriate exchange rate. Although there is no unanimity on what the precise appropriate rate would be, we note that a number of expert witnesses are now of the view that the exchange rate is close to such a rate (paragraph 100).**
- (kk) **We recognise the potential drawbacks of a process of entry involving a two year membership of ERM2. There is potential for the UK to provide leadership on this issue and to set out its preferred method of joining. Whatever the exact process were to be, it is important that the electorate knows, at least in approximate terms, the Government's view of an appropriate exchange rate range before they are asked to vote in a referendum (paragraph 101).**

Influence of UK on reform

- (ll) **In this period, when the eurozone's monetary policy and institutions are bedding in, there is clearly a greater 'window of opportunity' for British influence in negotiating reforms within the system, than would be the case later if there is a decision not to join the euro in the foreseeable future. The Government should continue to play an active role in the debate over reform of monetary and fiscal policy and structural reform. The analysis of the five tests and the accompanying studies will be of value to the eurozone states in this respect. Encouraging reform which improves the performance of the eurozone economy will also help to improve the performance of the UK's main export markets, whether or not the UK joins the euro (paragraph 104).**

The present options

- (mm) **Government (and then Parliament) now face a range of options [indicated in paragraphs 107–109]...We do not judge between these options, but we have sought in this Report to provide additional analysis and information on the implications of each option. The point we would emphasise is that while there are indeed political implications to each option (to which we have referred throughout this Report) it is of fundamental importance that the economic case for entry is met first of all if the UK is to enter the euro (paragraph 106 and 110).**

Engaging the public: the challenge

- (nn) **It should be the objective of the Government—and of other organisations and institutions involved, including the political parties and Parliament itself—to promote as full and as well informed a debate as possible ahead of any referendum. We should be seeking to maximise the level of participation in a referendum and to maximise the extent to which voters feel they have been given the information necessary to cast their vote, based on their knowledge of the issues involved (paragraph 112).**

Public interest and increasing public understanding

- (oo) **We recommend that, were there to be a referendum on the euro, provision for the Electoral Commission to encourage voter participation, and—as we**

discuss below—to provide objective information, should be included in the enabling legislation (paragraph 117).

- (pp) **We conclude overall that there is a need and a desire among the public for a balanced source of information on the economic issues involved in a decision on whether to join the euro, ahead of any referendum. We recommend that the Government and the Electoral Commission give specific attention to examining ways of providing such information (paragraph 120).**
- (qq) **We consider that the role of the broadcast media in promoting informed and educative debate on the issues relating to the euro will be of particular importance during a referendum campaign. We have every confidence that broadcasters will recognise the significance of their treatment of the issue and will live up to their responsibilities. The BBC and other websites could play an invaluable role (paragraph 125).**
- (rr) **We accordingly recommend that, as part of their response to the recommendation in paragraph 120 above, the Government and the Electoral Commission, in consultation with the British political parties represented at Westminster and in the European Parliament, should examine ways in which a public information leaflet could be prepared and distributed to each household ahead of a referendum. The leaflet should include summary information on the key issues. It should also include website addresses for a range of other documentation and organisations (paragraph 129).**

Issues of concern to the public

- (ss) **The public information leaflet we have proposed will need to include information addressing the issues listed in paragraphs 132–134 above, if it is to be effective in responding to voters' concerns for information (paragraph 137).**

LIST OF ABBREVIATIONS
(used in the Report or in the evidence)

CEPR	Centre for Economic Policy Research
CEPS	Centre for European Policy Studies
CER	Centre for European Reform
CML	Council of Mortgage Lenders
ECOFIN	Council of Economic and Finance Ministers (of the EU)
ECB	European Central Bank
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
FDI	foreign direct investment
HICP	Harmonised Index of Consumer Prices
MORI	Market Opinion and Research International
MPC	Monetary Policy Committee (of the Bank of England)
NIESR	National Institute of Economic and Social Research
PPERA	Political Parties, Elections and Referendums Act 2000
SGP	Stability and Growth Pact
TEC	Treaty establishing the European Communities (using the revised Article numbers in force following the revisions under the Treaty of Amsterdam)
TEU	Treaty on European Union
TUC	Trades Union Congress

**MINUTES OF PROCEEDINGS OF THE COMMITTEE RELATING TO THE
REPORT**

THURSDAY 24 APRIL 2003

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard
Angela Eagle
Mr Michael Fallon
Norman Lamb

Mr George Mudie
Dr Nick Palmer
Mr James Plaskitt
Mr David Ruffley

Draft Report [The UK and the Euro] proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Ordered, That consideration of the draft Report begin with paragraphs 106 to 132.—(*The Chairman.*)

Paragraph 106 to 109 read and agreed to (now paragraphs 111 to 114).

A paragraph—(*Mr David Ruffley*)—brought up, read the first and second time, and inserted (now paragraph 115).

Paragraphs 110 to 118 read and agreed to (now paragraphs 116 to 124).

Paragraph 119 read, amended and agreed to (now paragraph 125).

Paragraphs 120 to 131 read and agreed to (now paragraphs 126 to 137).

Paragraph 132 read and postponed.

Paragraph 1 read and agreed to.

Paragraph 2 read, amended and agreed to.

Paragraphs 3 to 8 read and agreed to.

Paragraphs 9 and 10 read, amended and agreed to.

Paragraphs 11 to 13 read and agreed to.

Paragraphs 14 to 18 read, amended and agreed to.

Paragraphs 19 and 20 read and agreed to.

Paragraphs 21 and 22 read, amended and agreed to.

Paragraph 23 read, amended, divided and agreed to (now paragraphs 23 to 25).

Paragraph 24 read and agreed to (now paragraph 26).

Paragraphs 25 to 27 read, amended and agreed to (now paragraphs 27 to 29).

Paragraphs 28 to 30 read and agreed to (now paragraphs 30 to 32).

Paragraphs 31 and 32 read, amended and agreed to (now paragraphs 33 and 34).

Paragraph 33 read and agreed to (now paragraph 35).

Paragraphs 34 to 36 read, amended and agreed to (now paragraphs 36 to 38).

Paragraph 37 read and agreed to (now paragraph 39).

Paragraph 38 read, amended and agreed to (now paragraph 40).

Paragraphs 39 and 40 read and agreed to (now paragraphs 41 and 42).

Paragraphs 41 to 43 read, amended and agreed to (now paragraphs 43 to 45).

Paragraph 44 read and agreed to (now paragraph 46).

Paragraphs 45 to 47 read, amended and agreed to (now paragraphs 47 to 49).

Paragraph 48 read, amended, divided and agreed to (now paragraphs 50 and 51).

A paragraph—(*The Chairman*)—brought up, read the first and second time, amended and inserted (now paragraph 52).

Paragraphs 49 and 50 read and agreed to (now paragraphs 53 and 54).

Paragraph 51 read, amended and agreed to (now paragraph 55).

Paragraph 52 and 53 read and agreed to (now paragraphs 56 and 57).

Paragraph 54 read, amended and agreed to (now paragraph 58).

Paragraphs 55 to 59 read and agreed to (now paragraphs 59 to 63).

Paragraphs 60 to 65 read, amended and agreed to (now paragraphs 64 to 69).

Paragraphs 66 to 69 read and agreed to (now paragraphs 70 to 73).

Paragraph 70 read, amended and agreed to (now paragraph 74).

Paragraphs 71 and 72 read and agreed to (now paragraphs 75 and 76).

Paragraph 73 read, amended and agreed to (now paragraph 77).

A paragraph—(*Mr Nigel Beard*)—brought up, read the first and second time, and inserted (now paragraph 78).

Paragraphs 74 and 75 read and agreed to (now paragraphs 79 and 80).

Paragraphs 76 to 78 read, amended and agreed to (now paragraphs 81 to 83).

Paragraph 79 read and agreed to (now paragraph 84).

Paragraphs 80 to 93 read, amended and agreed to (now paragraphs 85 to 98).

Paragraph 94 read and agreed to (now paragraph 99).

Paragraphs 95 and 96 read, amended and agreed to (now paragraphs 100 and 101).

Paragraph 97 read and agreed to (now paragraph 102).

Paragraph 98 read, amended and agreed to (now paragraph 103).

Paragraphs 99 to 102 read and agreed to (now paragraphs 104 to 107).

Paragraphs 103 and 104 read, amended and agreed to (now paragraphs 108 and 109).

Paragraph 105 read and agreed to (now paragraph 110).

Postponed paragraph 132 again read, and disagreed to.

Summary read, amended, and agreed to.

Resolved, That the Report be the Sixth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select committees (reports)) be applied to the Report.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence be reported to the House.—(*The Chairman.*)

Several Memoranda were ordered to be reported to the House.

[Adjourned till Wednesday 30 April at Nine o'clock.]

LIST OF WITNESSES

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LIST OF MEMORANDA INCLUDED IN THE MINUTES OF EVIDENCE

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LIST OF APPENDICES TO THE MINUTES OF EVIDENCE

No.

1. HM Treasury: HM Treasury's Approach to the Preliminary and Technical Work
2. HM Treasury: The European Central Bank
3. HM Treasury: The Stability and Growth Pact
4. Britain in Europe
5. Centre for the Study of Financial Innovation
6. Consumers' Association
7. Council of Mortgage Lenders
8. European Economics and Financial Centre, Professor Scobie
9. Futurus
10. Joint SNP/Plaid Cymru Group
11. Labour Euro Safeguards
12. Professor David Laidler, Bank of Montreal
13. The London Stock Exchange plc

14. The New Economics Foundation
15. Newry and Mourne Euro Committee
16. Northern Ireland in Europe
17. Mr James Robertson
18. Mr Helmut Schlesinger, Former President of the Deutsche Bundesbank
19. The Scottish Executive
20. Mr Christopher Taylor, Visiting Fellow at the NIESR, London
21. UNIFI
22. Unilever UK
23. University of Bradford, European Economies Research Unit
24. University of Cambridge, Mr Ken Coutts and Professor Robert Rowthorn
25. University of Kent, Mr Tony Thirlwall
26. University of Leeds and the Levy Institute, Philip Arestis and Malcolm Sawyer
27. Mr John Keating, Wessex Resins and Adhesives

LIST OF MEMORANDA REPORTED TO THE HOUSE BUT NOT PRINTED

Copies of the Memoranda listed below are deposited in the Library of the House of Commons and the Record Office of the House of Lords. Requests for inspection by the public should be addressed to the Record Office, House of Lords, London SW1A 0PW (Tel; 020 7219 3074). Hours of inspection are from 9.30am to 5.30pm.

Memoranda submitted by:

1. Mr Maurice Fitzpatrick
2. Standard Life
3. The Freedom Association
4. Dr G C Harcourt, Jesus College, Cambridge
5. Global Britain
6. British Retail Consortium
7. Barclays Capital
8. Mr Richard Heller
9. Britain in Europe, (further memorandum: response to the Memorandum from the No-Campaign)
10. Electoral Commission (further memorandum)

**LIST OF RECENT REPORTS PUBLISHED BY THE TREASURY
COMMITTEE**

SESSION 2002-03

First Report: National Statistics: The Classification of Network Rail (HC 154)

Second Report: The 2002 Pre-Budget Report (HC 159)

Third Report: Split Capital Investment Trusts (HC 418)

Fourth Report: The Handling of the Joint Inland Revenue/Customs and Excise STEPS PFI Project

Fifth Report: Annual Report for 2002 (HC 491)

First Special Report: Government Response to the Committee's Seventh Report, Session 2001-02: Parliamentary Accountability of Departments (HC 149)

Second Special Report: Government Response to the Committee's First Report, National Statistics: The Classification of Network Rail (HC 550)

Third Special Report: Government Response to the Committee's Second Report, The 2002 Pre-Budget Report (HC 528)

SESSION 2001-02

First Report: The 2001 Census in England and Wales (HC 310)

Second Report: Budget 2002 (HC 780)

Third Report: The Office of Government Commerce (HC 851)

Fourth Report: Appointment to the Monetary Policy Committee of the Bank of England of Mr Paul Tucker and Ms Marian Bell (HC 880)

Fifth Report: Banking, the Consumer and Small Businesses (HC 818)

Sixth Report: The Financial Regulation of Public Limited Companies (HC 758)

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Ninth Report: Appointment of Sir Andrew Large as a Deputy Governor of the Bank of England and Member of the Monetary Policy Committee (HC 1189)

Special Reports:

First Special Report: Government Response to the Committee's Fifth Report, Session 2000-01: Banking and the Consumer (HC 198)

Second Special Report: Responses by the Government and the Bank of England to the Committee's Ninth Report, Session 2000–01: The Monetary Policy Committee—An end of Term Report (HC 199)

Third Special Report: Government Response to the Committee's Eighth Report, Session 2000–01: The Royal Mint (HC 266)

Fourth Special Report: Government Response to the Committee's Seventh Report, Session 2000–01: The Government Actuary's Department (HC 267)

Fifth Special Report: Government Response to the Committee's Sixth Report, Session 2000–01: HM Customs and Excise (HC 315)

Sixth Special Report: Government Response to the Committee's Tenth Report, Session 2000–01: Equitable Life and the Life Assurance Industry: An Interim Report (HC 316)

Seventh Special Report: Government Response to the Committee's Fourth Report, Session 2000–01: International Monetary Fund: A Blueprint for Parliamentary Accountability (HC 379)

Eighth Special Report: Government Response to the Committee's Third Report, Session 2000–01: HM Treasury (HC 429)

Ninth Special Report: Government Response to the Committee's First Report, Session 2001–02: The 2001 Census in England and Wales (HC 852)

Tenth Special Report: Government Response to the Committee's Second Report, Session 2001–02: Budget 2002

Eleventh Special Report: Government Response to the Committee's Third Report, Session 2001-02: Office of Government Commerce (HC 1217)

Twelfth Special Report: Government Response to the Committee's Fifth Report, Session 2001-02: Banking, Consumers and Small Businesses (HC 1218)

Thirteenth Special Report: Government Response to the Committee's Sixth Report, Session; 2001-02: The Financial Regulation of Public Limited Companies (HC 1219)

Fourteenth Special Report: Government Response to the Committee's Eighth Report, Session 2001-02: Inland Revenue Self Assessment Systems (HC 1220)