

TO JOIN OR NOT TO JOIN? THE OUTCOME OF BROWN'S 5 TESTS

On 9 June, the Chancellor of the Exchequer announced the results of the Treasury's assessment of the five economic tests for sterling's membership of the single European currency. At the same time, he released 18 separate studies that underpinned the analysis of the five tests. Here, we summarise the key points in the studies that will be of most interest to financial directors.

Analysis of European and UK business cycles and shocks

This econometrics-laden study was prepared by Professor Michael Artis of the European University Institute (most others were prepared by Treasury officials). It examines and updates some previously published work on business cycle and shock correlations, and was commissioned to help assess the **first** of the five economic tests. The research found evidence that:

- There is a positive correlation between the UK business cycle and that of other European countries over an extended period of time; the degree of correlation with the EU15-UK (the 12 EMU members, plus Denmark and Sweden, but excluding the UK) is just over 50%, but the correlation with individual member states is typically lower – 39% for Germany, 49% for France.
- The UK's business cycle is strongly correlated with that of the US – about 80% – more so than with those in Europe.

Fluctuations in UK GDP have been sharper than in the major continental economies. No UK region's business cycle is strongly correlated with the European cycle; in this respect, the UK is unique among European economies.

- This adds up to evidence of what is known as the UK idiosyncrasy – the notion that there is 'something different' about the behaviour of the UK business cycle with regard to the rest of Europe.

However, there is no doubt that were the UK to join EMU, its business cycles would change, economic policy would be different and trade with the rest of the eurozone would increase further.

EMU and the cost of capital

The **third** test as to whether Britain should join EMU, economic and monetary union asks, "Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?" Theory suggests that businesses continue to invest as long as the expected returns exceed the cost of the investment. The cost of capital is, therefore, an important part of the decision-making and of the assessment of the third test.

The cost of capital is made up of two components, either of which might potentially fall if the UK joined EMU.

- The risk-free rate (as it is generally known, or the 'credit risk-free rate' as it is described by the Treasury study) may fall if joining EMU reduces

macroeconomic volatility and inflation expectations.

- The market risk premium could fall if financial markets' integration reduces risk for investors in bonds or equities.

The study suggests that in countries where inflation (and inflation expectations) have normally been high, nominal risk-free rates fell in the run-up to joining EMU, but there was no such benefit in large, low-inflation countries such as Germany or France. Rates in Spain and Italy converged on those of Germany and France, largely because of falling inflation expectations.

The risk-free rate would not, therefore, be expected to change much in the UK, which has seen low and stable rates of inflation in recent years.

There is some evidence to suggest that integration in euro-area financial markets has resulted in a market risk premium that is lower than has prevailed in the members' domestic markets, eg:

- Greater corporate bond issuance
 - Mergers between stock exchanges and settlement systems
 - Creation of pan-European bond trading platforms
 - Greater portfolio diversification
 - Lower transaction costs
- This degree of integration creates a larger market, which might be expected to reduce the liquidity risk component (the risk of not finding a buyer/seller at a reasonable price) of the market risk premium, while greater

portfolio diversification might be expected to reduce the credit risk component (the counterparty credit risk).

While UK corporates can access the larger euro market from outside EMU, the study concludes there might be a small reduction in the risk premium (but not in the risk-free rate) of the cost of capital.

EMU and business sectors

This study helps assess the **third** and **fifth** economic tests.

As with much of the EU, manufacturing industry has been in decline in the UK. But services account for a higher proportion of UK trade (partly a result of the UK's financial services industry) and hence the UK's ability to respond to shocks may be different.

UK trade with non-EU countries has fallen markedly over time, as a proportion of total trade, but the UK has historically received, and continues to receive, more foreign direct investment than other EU countries, especially from the US.

Sectors that are highly exchange-rate sensitive will be more affected than those that are not, depending, however, on whether the sensitivity is to the euro or other currencies. EMU would most likely facilitate price convergence in industries where prices are higher (or lower) than in major EU economies, provided such industries do not have strong national regulations or tastes; for example, cars and domestic appliances.

Sectors where acquisition potential is high would likely be highly affected. Larger companies will tend to get larger absolute benefits, but greater proportionate benefits would be felt by smaller and medium-size businesses (but probably not micro-enterprises), so makers of car components

might derive more benefit than major car manufacturers.

Businesses that make much use of capital markets would likely benefit from EMU and its impact on capital market integration and competition.

To the extent that a loss of an independent monetary policy will result in greater volatility of demand, the most cyclical industries (for example, consumer durables and commodity chemicals) will see greater impact from EMU.

EMU and trade

This study is designed to help assess the **fifth** economic test. Currency transaction costs and exchange rate volatility act as a barrier to trade and increase the uncertainty that overseas transactions will be profitable, so a single currency would be expected to increase trade within member states. Price transparency also increases competition.

However, there is doubt as to whether these are very serious problems; for example, currency transaction costs amount to less than 0.5% of GDP. Moreover, there is no strong evidence that exchange rate volatility adversely affects trade. On the contrary, there is some evidence that it increases trade: volatility presents not only a risk it also offers an opportunity, particularly since businesses do not have to export overseas but can choose to do so when the level of profit looks attractive.

The eurozone accounts for about half of Britain's trade in goods and services (the US and Asia each account for less than one-fifth), but trade with the eurozone amounts to less than 30% of GDP, less than for other large EU countries, suggesting perhaps that the UK is a "less

natural candidate" for EMU.

The potential increase in trade with the eurozone could be anywhere between 5-50% (without any diversion of trade from the non-EMU area). Experience within the eurozone so far is at the *bottom* end of that range. Other evidence says that countries within a currency union trade three times more with each other than do countries with separate currencies, in which case the long-term impact may be toward the higher end of the 5-50% range.

Each 1% increase in the trade-to-GDP ratio increases real GDP per head by at least 0.33% in the long run.

Prices and EMU

Greater price transparency arising from the introduction of the euro ought to benefit consumers through greater market efficiency and competition, resulting in cheaper prices, better quality and/or greater choice. This study looks at the likely impact on UK prices were sterling to join the euro, and at what the eurozone experience has been. This issue is particularly relevant for the **second** and **fifth** tests. The research found that:

- There is much more price discrepancy within the EU (and between the EU and the UK) for similar goods and services than there is within the US – a more mature currency union.
- EMU should reduce – but not eliminate – the extent of price divergence, which will continue to be affected by transportation costs, and local variations in taxes and wages.
- There is no European country that is uniformly cheap or expensive. For example, the Netherlands was the cheapest country for a particular type of IKEA mirror, costing less than half

the price of the same mirror in Germany; but the Netherlands was much more expensive than many other countries for other types of IKEA mirrors. However, UK prices tend to be "at the high end" for a number of products.

- Some barriers to trade will remain and will prevent price convergence. For example, the mere existence of a border appears to prevent price convergence: the evidence for this is that price variations between countries can easily be 20% or more, many times the regional price variations within a country which are typically less than 4-5%.

- Price convergence "is likely to take some time, occurring over many years". Studies in the US suggest that it can take nine years just to halve a regional price difference for particular products.

Andrew Sawers

A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- All the studies are available at www.hm-treasury.gov.uk

The other Treasury reports

The five tests framework
Estimates of equilibrium exchange rates for sterling against the euro
Housing, consumption and EMU
EMU and the monetary transmission mechanism
Modelling the transition to EMU
Modelling shocks and adjustment mechanisms in EMU
EMU and labour market flexibility
The exchange rate and macroeconomic adjustment
The location of financial activity and the euro
The United States as a monetary union
Policy frameworks in the UK and EMU
Submissions on EMU from leading academics
Fiscal stabilisation and EMU

See also

UK membership of the single currency: An assessment of the five economic tests
National Changeover Plan

The five economic tests

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