

# City analysts are in convergence with Chancellor

**Lea Paterson**, Economics Editor, considers the Treasury's verdict on Gordon Brown's famous five tests and solicits a range of independent views

## TEST ONE

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

**Treasury view:** In the 1997 assessment, this test was seen as the most important of the five, and it continues to be central to the economics of the euro. Although there has been progress on convergence since 1997, there remain problematic structural differences.

The Treasury concluded: "We cannot yet be confident that UK business cycles are sufficiently compatible with those of the euro area. While the extent of convergence with the euro area has significantly increased, the convergence test is not yet met."

The housing market is singled out as an area where there needs to be considerable structural change. The high levels of mortgage debt in Britain and the prevalence of variable-rate mortgages mean that it is more sensitive to short-term changes in interest rates than many other euro-zone countries. This could pose problems inside the euro.

The assessment sets out a number of policy measures that ought to increase convergence between Britain and the eurozone. These include the intention to set the Bank of England's inflation target with reference to the eurozone measure of inflation, known as the Harmonised Index of Consumer Prices, rather than the UK Retail Prices Index. Also important will be the studies commissioned on fixed-rate mortgages and housing supply.

**Independent views:** Virtually all economists agree with the Chancellor that, since 1997, Britain has moved closer to the economics of the eurozone. Interest rates and inflation are much nearer to euro-

## A driven man

It became the most famous taxi ride in new Labour history (David Charter writes). On February 19, 1997, Gordon Brown, then Shadow Chancellor, was in New York to meet members of the Clinton Administration.

He was under pressure to produce a firm statement on Labour's attitude towards the euro after an apparent hardening of the Conservative Government's approach.

Although not written on the back of an envelope, as some have claimed, a series of five "British economic tests" were hastily devised between Mr Brown and his adviser, Ed Balls.

Their most important discussion came during a New York cab ride and the five tests were unveiled by Mr Brown the next day in Washington.

zone levels than six years ago.

"Since the last assessment of the tests, there has been evidence of cyclical convergence between the UK and the eurozone," Roger Bootle, who heads the consultancy Capital Economics, said.

Annual growth rates of GDP have moved much more closely together than in recent years. Where there is less agreement, however, is on structural convergence. Most, but not all, analysts agree with the Treasury that the housing market presents a real problem for euro membership. But there are disagreements about whether the housing market

difficulties can be overcome.

Michael Dicks, of Lehman Brothers, said: "In the Budget in April, the Chancellor announced reviews into housing supply and into encouraging fixed-rate loans, which, if followed up, should bring Britain and euro-area housing markets more closely into line." Others, however, are much more sceptical about the ability of Mr Brown's reviews to change the housing market.

## TEST TWO

"If problems arise, is there sufficient flexibility to deal with them?"

**Treasury view:** There has been some progress here since 1997, particularly in the British labour market, but more needs to be done. On the plus side, there have been large falls in long-term unemployment, and an increase in flexible employment practices, such as part-time working. On the minus side, there are still skill shortages and too little mobility of labour. The inflexibility of labour markets in the eurozone presents difficulties for British membership of the euro.

The Treasury concluded: "At the present time, we cannot be confident that UK flexibility, while improved, is sufficient. The less flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK."

Policy measures likely to help Britain to become flexible include regional variations in public-sector pay and moves to improve workforce skills.

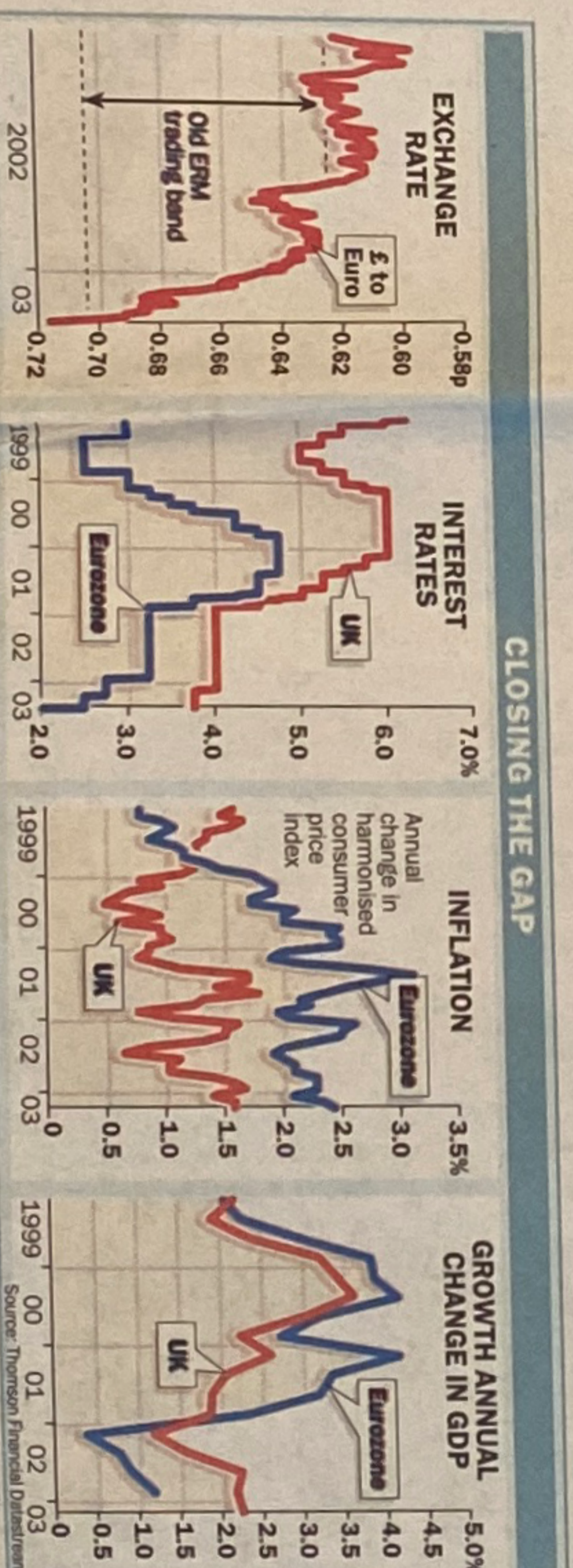
**Independent views:** There is a broad consensus with the Treasury view that, although there have been improvements in flexibility, problems remain. Most analysts are also critical about progress on flexibility in the eurozone. "Structural rigidities in the euro area still present a flexibility problem, making it difficult realistically to claim

## EURO VERDICT

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Euro Academy 11 DOWNING STREET LONDON SW1			
Test	Comments	Mark	
ONE Convergence	Some improvement, but more work needs to be done. Going forward, more attention must be paid to the problems of the housing market if a satisfactory mark is to be achieved	30/100	Fail
TWO Flexibility	Again, better than in 1997, but gaps remain. Skills of the labour force are a weak spot. Unsatisfactory performance by others in the class - particularly Germany - have helped to drag down the score	40/100	Fail
THREE Investment	Has potential, but let down by weaknesses elsewhere in the assessment. If more progress is made on convergence (Test One), then a good pass here is well within the candidate's ability	42/100	Fail
FOUR The City	Satisfactory, but an unexceptional performance. As in 1997, a clear pass, but little seems to have changed in the last six years	60/100	Pass
FIVE Jobs and growth	Persistent under-achievement, in part because of weaknesses elsewhere. There is huge potential here, but the candidate needs to get to grips with Test One before real progress can be made	32/100	Fail
<b>OVERALL</b> Some progress over the last six years, but still a long way short of potential. To make the grade, the candidate needs to get back to basics and focus on economic fundamentals			

*Carla Bru*  
HEADMASTER



that the flexibility conditions have yet been met," Mr Dicks said.

Where analysts take issue with the Treasury is over the phrasing of test two, which most believe is open to inter-

pretation. Many in the City think that this will allow the Treasury to declare the test met once the Cabinet believes the political environment to be right. Mr Bootle, of Capital Economics, said: "This is the vaguest of the five tests and therefore, in theory, the easiest to judge passed."

## TEST THREE

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

**Treasury view:** This test would certainly be passed if tests one and two were satisfied. Joining the euro could boost investment flows from

overseas and make it cheaper for British businesses to raise money on the financial markets. But this all depends, crucially, on Britain achieving durable and sustainable convergence with the eurozone.

"If sustainable and durable convergence is achieved, then we can be confident that the quantity and quality of investment would increase, ensuring that the investment test would be met."

**Independent views:** Statistics have been contradictory. Some figures have shown that Britain has lost out to the eurozone in the battle for overseas investment. However, other data

have suggested that Britain has maintained its position as the most attractive EU location for overseas investment.

With the statistics failing to point to a clear conclusion, most analysts agree with the Treasury that the outcome of test three depends on tests one and two. Claran Barr, of Deutsche Bank, said: "Membership of EMU would most likely provide better conditions for investment into and out of the UK... the caveat is that tests one and two need to be met first."

## TEST FOUR

"What impact would entry into EMU have on the competi-

"The euro would provide better conditions for investment but tests one and two must be met first"

itive position of the UK's financial services industry, particularly the City's wholesale markets?"

**Treasury view:** This test is passed, as it was in 1997. There is little evidence that the City has suffered from Britain being outside of the euro. But if Britain were to join the single currency, this would make it easier for the financial services industry to tap into new markets.

"EMU entry should enhance the already strong position of the UK's wholesale financial services sector by offering some additional benefits. Overall, the financial services test is met."

**Independent views:** There is broad agreement that test four has been satisfied, but many believe that the Treasury has overstated its importance.

In some respects, this test is not even valid as the currency is not the key issue to the success of the City," Gerard Lyons, of Standard Chartered Bank, said. "The City is Europe's leading financial centre, and will remain so whether Britain joins the euro or not."

## TEST FIVE

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

**Treasury view:** There are large potential benefits to euro membership. Trade with the eurozone could rise by up to 50 per cent, retail prices could fall significantly and, overall, growth could be around a quarter of a percentage point higher every year. But to realise these gains in full, there needs to be durable and sustainable convergence with the eurozone.

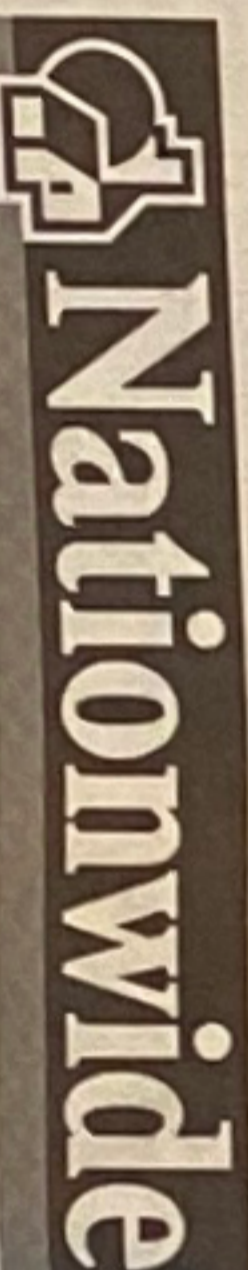
The Treasury concludes: "EMU membership could significantly raise UK output and lead to a lasting increase in jobs in the long term. We can be confident that the growth, stability and employment test would be met once sustainable and durable convergence has been achieved."

The Treasury assessment also emphasises the need for flexibility from both the European Central Bank and Brussels rules on tax and spending — known as the Stability and Growth Pact — if the gains from euro membership are to be realised in full.

**Independent views:** The Treasury's assessment of the potential impact on trade and prices of euro membership drew broad agreement from the City.

Mr Dicks said: "Academic research strongly supports the Treasury's claim [that trade with the Continent would increase if Britain joined the euro]."

## MORTGAGES



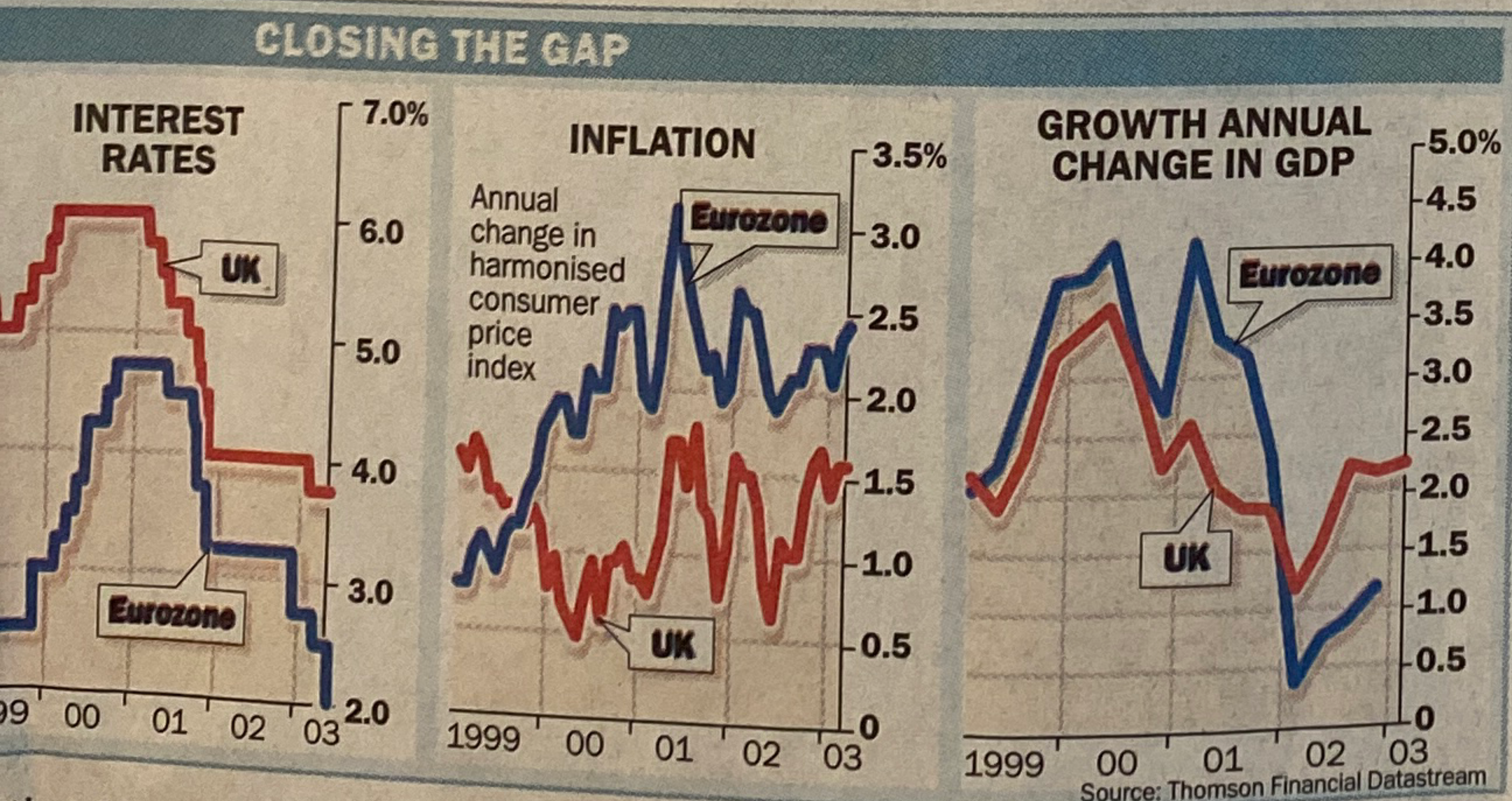
This could

The deal

# Euro Academy

LONDON SW1

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Some improvement, but more work needs to be done. Going forward, more attention must be paid to the problems of the housing market if a satisfactory mark is to be achieved	Fail 30/100
Gain, better than in 1997, but gaps remain. Skills of the labour force are a weak spot. Unsatisfactory performance by others in the class - particularly Germany - have helped to drag down the score	Fail 40/100
Good potential, but let down by weaknesses elsewhere in the assessment. If more progress is made on convergence (Test One), then a good pass here is well within the candidate's ability	Fail 42/100
Good factory, but an unexceptional performance. As in the last six years, a clear pass, but little seems to have changed in	Pass 60/100
Good under-achievement, in part because of weaknesses elsewhere. There is huge potential here, but the candidate needs to get to grips with Test One	Fail 32/100
Good over the last six years, but not of potential. To make the needs to get back to economic fundamentals	



Many in the City think that this will allow the Treasury to declare the test once the Cabinet believes the political environment to be sound. Mr Bootle, of Capital Economics, said: "This is the best of the five tests and, before, in theory, the easiest to judge passed."

**TEST THREE**

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

**Treasury view:** This test is likely to be passed if one and two were satisfied. Joining the euro could increase investment flows from

overseas and make it cheaper for British businesses to raise money on the financial markets. But this all depends, crucially, on Britain achieving durable and sustainable convergence with the eurozone.

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## Housing market

# Brown back

long-term mortgages and new homes will prepare Britain for the euro, says Anne Spackman

SIGNIFICANT reforms to the mortgage, planning and house-building systems will be introduced within the next 12 months as essential measures to prepare Britain for euro entry.

Mortgages must be built and more borrowers must be persuaded to take out long-term loans if the housing markets to escape from its characteristic boom and bust cycles, the Chancellor said.

He singled out the housing markets as an important obstacle to euro entry and a chief cause of Britain's volatile economy in the past. "Most stop-go problems that Britain has suffered in the last 50 years have been led or influenced by the housing market," he said.

New powers to allow regions to enforce high levels of house-building are being considered in areas like south-east England, where demand for property outstrips supply. Low levels of house-building were cited by the Treasury in its review of the five economic tests as a key factor in forcing up house prices.

Britain tops the European house price inflation league, with prices rising 25 per cent last year, compared with 17 per cent in the second-highest performer, Spain.

At the same time, Britain has one of the highest levels of mortgage debt compared with income in the industrialised world.

High house prices, coupled with high levels of debt at variable rates, made the housing market far more sensitive to interest rate movements, the Chancellor said.

He reiterated his determination, announced in the Budget, to persuade British home-owners to switch to long-term, fixed-rate mortgages, which are less risky, but more costly to the consumer, in order to reduce volatility.

Only per cent of British borrowers are currently on long-term fixed rates, compared with the majority of borrowers in the US and some EU countries such as Germany.

The British mortgage market, like that of Scandinavian countries, is also far more sophisticated, making it easier for homeowners to access

their housing wealth through mortgage equity withdrawal.

Mortgage lenders supported the development of a long-term, fixed-rate mortgage but questioned whether borrowers would change their behaviour. "Flexible mortgages bring a good degree of independence for individual borrowers," Philip Hansford, mortgage manager at the Halifax, said. "It is only when borrowers see a clear benefit in long-term, fixed-rate products that they will take these significant numbers."

A survey published last day by the accountancy firm KPMG found that the UK was keen to borrow over the long term to reduce risk, only if they were offered at competitive rates.

David Miles, Professor of Finance at Imperial College London, is currently investigating fixed-rate mortgages for the Government. Barker, a member of the Bank of England's monetary committee, is charged with studying under-supply in the housing market.

Gordon Brown said he would report back in time to further proposals to be announced in the pre-statement in November.

With the European setting interest rates for the euro area as a whole, a policy that did not suit the economy would have enormous economic implications because of the housing market, the report went on.

The risks to property of inappropriate interest rates were also highlighted by the Royal Institution of Chartered Surveyors. In a report last day, the RICS said that the euro would lead to a mini-boom followed by a bust. "By 2006 prices could be between 15 per cent and 20 per cent higher as lower rates fed through to demand," the report said. "A price boom could start before action is taken to the euro, if speculation started to bid up house prices."

"However, following a housing boom on entry, there is likely to be a sharp slowdown post-2006 as unsustainable price levels which could be exacted by an interest-rate policy set

## High street

# Shoppers welcome retailers' return

By Valeri Elliott

THE switch to the euro would immediately drive up retail prices in Britain as firms pass on the costs of new cash machines and labels showing prices in both euros and sterling, according to the Treasury

country are based on a range of factors, including the labour, national and taxes, transport and fuel, and different mark-up policies for wholesalers and other outlets.

On the plus side, the

Brown shows his power of veto