



## **Background brief on how Britain can join the euro**

### **British membership of the euro has been on the back burner**

British membership of the euro has been formally an objective of government policy since 1997 but in practice there has been little serious interest in it for some years. Gordon Brown, when he was Chancellor of the Exchequer, was widely seen to be a brake on British moves to join the euro. His elevation to the post of prime minister is unlikely in itself to bring about change.

This long period of neglect cannot be overcome straightaway. There is a period of time needed for preparation for euro membership, affecting both economic policy and other aspects of political strategy. That preparation should start now.

### **The euro is back on the agenda**

The recent collapse in the financial markets is a catalyst for change. The value of sterling is a useful barometer of what the rest of the world thinks about the sustainability of the United Kingdom's economic policies.

The magnitude of the 23 per cent decline against a broad basket of currencies since summer 2007 is the largest since the dramatic 30 per cent devaluation against the US dollar in the late 1940s after the Second World War. Going even further back, it has exceeded the crash in sterling in the aftermath of the First World War and rivals the decline when Britain left the Gold Standard in the 1930s. So the foreign holders of sterling are sending us a message with a force that has only been witnessed a handful of times in the last 100 years.

If the experience of the financial crash means anything, it should lead us to rethink the basics of our economic policy. And one of those basics is membership of the euro.

### **Two ways in which the world economy has changed since the euro was last debated**

The world is very different now from when this issue was last debated.

#### **1. The euro has been a success**

The euro itself has become established. The euro is now the world's second reserve currency. Dollar dominates the foreign exchange market, but the euro has overtaken the dollar in the bond market.

Compared with the US and the eurozone, the UK is now a rather small player.

	United States	Eurozone	UK
Population	302 m	320m	65m
GDP - € trn, PPP	11.9	8.9	1.5

## **2. Growth in Asian economies**

There has been astonishing growth in the Asian economies. The balance of power in the global economy is shifting dramatically at an unprecedented rate. Asia makes up a quarter of world GDP, but this is an increase from one fifth 10 years ago. Asia generates more than half of all world economic growth.

### **Four out-dated arguments against joining the euro**

Not only has the world changed in the last 10 years, but Britain has changed. Arguments were made against joining the euro then are much weaker now.

#### **1. Housing market and mortgage finance**

It was argued that the UK housing market was very different from the rest of Europe. The UK housing market is set to change dramatically now.

#### **2. Pensions**

It was argued that Britain had funded pensions, as opposed to the unfunded pension liabilities elsewhere in Europe. These days, UK unfunded public sector pension liabilities are between £600 billion and £1 trillion, according to different methods of estimation.

#### **3. Importance of the financial services industry**

It was argued that UK economic strategy should be built around the purported needs of the financial services industry. The whole strategy of UK financial services needs to be rethought now.

#### **4. The UK's dependence on oil**

It was argued that the UK's dependence on oil production made it economically different from the rest of the EU. However, UK oil production peaked in 1999 and has almost halved since then.

The reasons that people advanced against joining the euro then: they weren't very strong at the time, but are even less strong now.

## **Three reasons why Britain can't join the euro quickly**

### **1. The recession**

The Maastricht convergence criteria require public debt to be below 60 per cent of GDP and a deficit below 3 per cent of GDP. The recession will increase both of these.

Assuming the government's projections on the depth and duration of the recession are accurate, we will just about stay within the debt rule but will not meet the deficit rule until 2013 at the earliest. And many observers think that the government's projections are over-optimistic

### **2. Uncertainty in the currency markets**

Joining the euro depends on establishing a fixed and permanent exchange rate. To do this, a prospective member of the euro must spend at least 2 years in the ERM. Economic policy must then have as an objective exchange rate stability, to be achieved progressively over time. (British membership of the ERM failed in 1992 because the then government was not willing to work for exchange rate stability but assumed that it happened automatically – the system was of fixed but adjustable exchange rate bands, but John Major's government treated them as fixed.)

### **3. Public opinion**

The two parties that currently support British membership of the euro say that it should be approved by a referendum. That means communicating with public opinion about Europe and the euro in a more grown-up manner than we have had in the past. The groundwork needs to start now if there is to be a referendum in the medium term.

## **Joining the euro is not a policy but a strategy**

Joining the euro is not a policy but a strategy. It is not simply business as usual but with a different name for the currency. Many things will change as a result. It's not a short-term fix but a medium-term programme to deliver long-term benefits.

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