Putting Gordon's 'Famous Five' to the test

In the first a series of articles Anthony Scholefield assesses whether the British economy is likely to pass the Government's five tests. He also considers the relevance and implications of the tests themselves.

The role of Gordon Brown's famous five tests has recently been disparaged by those who say that the Government will make its mind up on the basis of purely political criteria. Nevertheless, the Chancellor solemnly reiterates his belief in their importance on all occasions.

What follows is an attempt to understand what the tests tells us about the Government's policy on the euro, and whether or nor Britain is likely to pass them.

The first test is: **Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?**

This is really two tests, not one, because it attempts to assess two distinct phenomena:

- Sustainable and durable convergence of the business cycle
- Sustainable and durable convergence of the economic structure

The Business Cycle

There are certain general problems with the concept of convergence as outlined in the 1997Treasury Assessment in relation to the business cycle:

- Is the idea of convergence of business cycles of all the major European economies a good one?
- Why should Britain do the converging? The Treasury Assessment defines success as when Britain has converged with Europe (The reference to 'Europe' rather than the EU is typical of the lack of precision displayed by the Treasury document throughout).
- If Britain has a more robust business cycle with lower unemployment and interest rates, and higher growth wouldn't it be better for eurozone countries to attempt convergence with Britain?
- Equally, it can be argued that there is no need for this test; no other euro entrant has set itself such a challenge.
- Why is Britain trying to converge *before* entry when the Maastricht Treaty specifically states that a single currency will encourage the convergence of 'economic performance' *after* countries join?
- Have the euro countries converged and in what respects? Has convergence taken place in respect of economic structure, business cycle, or economic performance?
- What is the point of converging with the euro zone when 12 other countries that will not have to pass the Brown convergence tests will shortly be joining the EU?

Mistaken Goal

Some of these questions are, of course, unanswerable. But it is worth considering the general proposition that it is a good idea for British economic performance to converge with that of the eurozone. The Treasury Assessment states that "sustainable and durable convergence" is the touchstone and this is the criteria used in *Britain in Europe's* campaign. Its position is that we should wait until sterling reaches a rate that reflects substantial convergence (though with exactly what is not defined). *Britain in Europe's* Council will determine when this has occurred.

Many observers, including this writer, think the goal of convergence between business cycles is a mistaken one; that its pursuit will lead to accentuating boom and busts; that a varied pattern of economic development is safer and will lead to better prospects for long-term growth.

And, indeed the Treasury Assessment half agrees:

"It is, of course, the case that not every country's economic cycle needs to be in line all of the time. Indeed, that could cause difficulties of its own. But successful convergence requires being confident about staying within tolerable limits."

So the Treasury's view seems to be that convergence is the Holy Grail, but not too much of it, please! And what, pray, are "tolerable limits?"

The Assessment also states:

"Participation in a monetary union does not require that all Member States are perfectly in line.. There may be, in fact, some advantages to cycles being slightly out of phase, in that if one country is growing rapidly while another is growing sluggishly, they may help to stabilise each other."

You do not need the analytical powers of Milton Friedman to realise that economies undergoing "rapid growth" may be more than a little out of line with those experiencing "sluggish growth" and that they are scarcely the same thing as "convergence..

Such vague terminology and sloppy analysis seems all the more remarkable given that the members of the eurozone and the European Central Bank could not care less about "sustainable and durable convergence." All they are interested in is monetary convergence as laid down in the Maastricht Treaty and only in the period leading up to entry.

The Treasury Assessment on convergence gives some statistical analysis although without any sources quoted. This concludes:

Extraordinary Idea

"The U.K. became increasingly out of step with Germany during the 1980's, while the U.S. and U.K. cycles have been relatively synchronised."

This raises another question not dealt with in the Treasury Assessment. There is a great difference between the U.K. selecting the euro zone to converge on at a moment when it was not in convergence with another economic area and what is now proposed. This is that the U.K. should forcibly remove itself from "relatively synchronised cycles with the U.S." and realign itself with the euro zone. In fact, I would suggest that it is an extraordinary idea to even contemplate uncoupling from the world's biggest

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and most dynamic economy with a population shortly about to overtake that of the EU (less the U.K.) in a bid to achieve convergence with another economic zone. Yet, according to Tony Blair and Gordon Brown, it is precisely this kind of economic 'heart transplant' that is being contemplated.

The Treasury has used as its tests of cyclical convergence the following:

- interest rates
- output gaps
- growth rates
- inflation

Although opinion on this subject is not universal the evidence is clear that in 2002, both output gaps and growth rates differed significantly from those in the euro zone and that the UK cycle has remained linked closely to the US since 1997.

To show that the test of cyclical convergence had been passed the Treasury would have to demonstrate that the synchronisation and correlation with the US, which it found existed in 1997, no longer existed and that the UK was synchronising and correlating with the euro zone. I conclude that it will be unable to do so.

Economic Structures

The Treasury Assessment identified certain structural differences between the U.K. and euro zone economies.

The most important of these is that the UK's proportion of trade with the other EU states is much below the EU average. This has not changed. What has to be taken on board more seriously is the impact of future population loss in most of the EU (except France and Ireland), which means the EU will inevitably become a smaller market in the future.

Nor have there been any significant changes in the other areas identified by the Treasury: house ownership patterns, household holding of shares, corporate borrowing and the U.K. oil sector.

So there has been no sign of convergence of economic structures between Britain and the euro zone countries since 1997 and indications of considerable future divergence. One of the failures of the Treasury Assessment lies in its inability to acknowledge the dynamic nature of all economies. The EU is not an unchanging or fixed entity. Its principal future characteristic is likely to be population loss on such a scale that in all of the EU countric except Britain, France and Ireland, there will be increasing difficulties to maintain GDP at current levels

Reduced Irish support for the EU

One of the most obvious outcomes of the Irish General Election held on 16th May was that the anti-Nice Treaty parties did well while the most vocal pro-Treaty party - Fine Gael - lost half of its seats, including those of several ministers. Among the casualties was a former leader of Fine Gael, Mr Alan Dukes, the best known europhile after Dr Garrett Fitzgerald. Mr Dukes was the principal spokesman for the European Movement in the Republic's referendum on Nice in June and is expecting to be a leading campaigner when a second referendum is held in October, but will now be handicapped by the loss of his parliamentary seat.

The two small EU-critical parties in the Dail - the Greens and Sinn Fein - both achieved major gains, the former increasing its representation from two to six, and the latter from one to five. Both parties stressed their opposition to the Treaty.

A statement from the eurosceptic *National Platform* said: "*These results show that popular dissatisfaction with the mainstream parties of the europhile centre-right and centre-left, which has manifested itself lately in several European countries is now growing in Ireland, too.*"

Growing anti-EU sentiment is also demonstrated in the most recent opinion poll on support for the Nice Treaty. This has shown marked drift towards the 'No' side since January, according to the *Irish Times* on 20th May. Some 32 per cent would vote for the Treaty, down eight points; 32 per cent would vote against, up three points; 32 per cent do not know, up 10 points.

According to Mark Brennock, the newspaper's political corresponder the Irish Government, which itseli includes known critics of the Treaty, will face a major challenge in persuading the electorate to vote 'Yes' in the autumn rerun of the referendum. In June 2001 the Treaty was rejected by 53.9 per cent to 56.1 per cent.

The euro is a jobs killer, says union

In its first anti-euro leaflet, UNISON alleges that entry to the single currency would have an adverse impact on jobs, growth and public services. Britain's biggest union with 1.3 million members will send the publication to all of the union's 1,250 branches. It says that as result of the EU Growth and Stability Pact public spending would have to be cut by £10 billion, while pointing out that the National Institute for Economic and Social Research has suggested that such cuts could be as much as £22 billion. UNISON General Secretary Dave Prentis said: "It would be a disaster for our public services if we had to cut public spending by such large amounts when the Chancellor has only just pumped in huge investment to rebuild our hospitals and schools."