EMU ENLARGEMENT: WILL GREAT BRITAIN JOIN?

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Abstract

At this moment in time, from all the 27 European Union member states only 13 are involved in the 3rd stage of EMU: the 11 „ founding members" which begun to use the euro from 1999, Greece which has joined the euro zone from 2001, and Slovenia starting 2007. From the group of the 14 countries which are outside the euro zone, only Great Britain and Denmark have a permanent derogation (the opt-out clause) which means that they will join the euro zone only when they decide to (and of course if the nominal convergence criteria will be met). In the exposed context, the present paper makes a synthetic analysis of Great Britain's perspectives of joining the euro zone, relying on the stages and conditions established in Maastricht and also by analyzing the specific British tests and governmental plans.

1. The euro launch – stages and conditions

Signed on the 7th of February 1992, the Maastricht Treaty establishes the implementation of EMU, based on two aspects. Firstly, there have been decided the stages that the member countries should follow in order to accede to the Economic and Monetary Union, and secondly, a series of criteria for the participants. Following the Delors Report proposal, the Treaty reiterates the three stages to fundament the EMU, but it also indicates a compelling calendar for achieving the Union and establishes two dates for introducing the single currency : the earliest on the 1st of January 1997 and the latest, on the 1st of January 1999.

EMU stages

As we know the first stage consisted of capital flows liberalization, which has been finalized at the end of 1993.

The second stage started in November 1993 and ended in December 1998. It established the European Monetary Institute, which had the task of monitoring the efforts of the EU Member States to meet the convergence criteria and was responsible for preparation for the creation of European Central Bank. During this stage, the Member States made significant progress towards policy coordination and towards meeting the criteria for EMU accession. At the end of the second stage, in 1998, the ECB was created, EMU was officially launched and the participating Member States selected for the final stage.

The third Stage (Stage three), which means the birth of euro and completion of EMU, started at 1 January 1999, following Madrid scenario. This stage was based on Council decision in May 1998 which settled the participating countries, following the convergence procedure that used the reports of the Commission and EMI. As the Commission recommended, the Council decided that 11 EU countries will participate in the final stage. From the fifteen members of EU, Greece didn't meet the criteria, UK and Denmark used their „opt-out" clauses, and Sweden used some criteria to remain outside EMU.

Following the calendar, the Euro has circulated as a scriptural currency until the 1st of January 2002, the enterprises and the people beginning to use it according to the *„no*

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obligation, no interdiction" rule. From this date on, euro banknotes and coins have been launched into circulation, which have coexisted alongside the national currencies for maximum period of two months. From the last day of this period (28th of February 2002) the national currencies have no longer been accepted as a mean of payment. [1]

The settlement of the euro irrevocable exchange rates by the EU Council has been made in accordance with the Commission's proposals and only after consulting the European Central Bank, on the 31st of December 1998; these have been used and applied from the 1st of January 1999[2]. It must also be mentioned that all the ministers, the central bank's governors, the European Commission and the European Monetary Institute have released two press statements regarding the implementation of the irrevocable euro exchange rates beginning with the 3rd of May and 26th of September. After establishing the final and official rates, the Euro has become the single currency of the 11 countries, the national currencies being considered as its subdivisions.

The convergence criteria

EU member states are evaluated using the following criteria, as Maastricht Treaty asks:

1. **Price stability**: "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability"; this mean that inflation rate will not exceed by more than 1,5 pp the average of inflation rates of the three best performing states. (the index is the annual average of HICP)
2. **Interest rate convergence**: "the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System is being reflected in the long-term interest-rate levels;" the long term interest rate (ten years maturity) will not exceed by more than 2 pp the average of long term interest rates of the three countries from the previous criterion;
3. **Exchange rate stability**: "the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State";
4. **Sound fiscal position**: "the sustainability of the government financial position"; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6); The excessive deficit situation is evaluated using two reference values: budget deficit/GDP ratio less maximum 3%, and public debt/GDP ratio max. 60%;

Another condition for stage three of EMU is the legislative criterion meaning that the national legislation concerning central bank has to comply with the Treaty provisions (Articles 108 and 109) and ESCB status.

As a result, since 1st January 1999, eleven countries from the EU have adopted the euro as their currency, on the base of irrevocable rates settled by Council decision, and since 1st January 2001, after meeting convergence criteria, Greece joined the euro zone as well.

[1] The dual circulation period has been shortened from 6 to 2 months.
[2] Practically speaking, the first day of euro was 4th January.

BOX 1 LAUNCHING THE SINGLE CURRENCY

1st of January 1999

- Euro becomes the national currency of the 11 EMU member states (Germany, France, Belgium, Italy, Luxemburg, Holland, Ireland, Spain, Austria, Portugal and Finland)
- The national currencies become nondecimal euro subdivisions; the exchange rates between the two are pronunced irrevocable.
- Euro still remains just in a scriptural form (there are no euro coins and banknotes).
- The common monetary policy is applied.
- The legislative aspects concerning the single currency come into force.
- The financial markets begin to use the euro (valutary markets, bonds and shares markets)

01.01.1999- 31.12.2001

- The tranzit period and the „no obligation, no interdiction"principle.

- **19.06.2000**
- The Council's decision (427/2000) for Greece to adopt the single currency. The Councul's reglementation no.1478/2000 establishes the exchange rates for the two currencies as 340,750 drahmas for 1 euro.

1st of January 2001

- Greece adopts the single currency (The Council's Decision from 19.06.2000).

During 2001

- Informative campaign regarding the security elements of the euro banknotes).
- **At the end of 2001, the banks and the** most important retailers receive euro banknotes and coins.

1st of January 2002

- Begins the circulation of the euro banknotes and coins.
- The national banknotes and coins begin to be withdrawn from circulation: the period of double monetary circulation).
- All the scriptural transactions must contain the sum in euro.

- **28th of February 2002**

The national banknotes and coins are completely withdrawn of circulation, so the double circulation period comes to an end. After this date, for a short period of time the remaining coins and banknotes could be exchanged by the commercial banks and onwards the exchange was made only by the central banks (the deadlines were decided by each country).

2. Stages and conditions for EMU enlargement

If previously I have mentioned the EMU's stages and criteria, I will continue by naming the specific features of the monetary union enlargement process, in the case of the 14 member states that are outside the euro zone. Consequently we can classify those states in two: the three EU- 15 states which are outside the euro zone and the new members of the Union, on the other hand.

The first stage of the EMU was achieved by the EU – 15 countries once with the capital flows liberalization, and by the new members, at the moment when they acceded to the Union.

At present, all the EU countries outside the euro zone participate to the EMU's second phase, are implementing *convergence programmes,* and are coordinating their economic politics in accordance to the Commission's recommendations. Depending on the their strategy, the countries will join the ERM 2, an intermediary phase of the monetary integration which implies connecting the national currency to the euro and the obligation to maintain the exchange rate evolution in certain limits. After the accession, the resolution regarding the MRS 2 must be applied and also for the national central banks it is necessary to sign an agreement with ECB . Even if the Treaty provides the participation to the MRS 2 with two years before the accession to the EMU, the situation remains debatable. The Council's Decision to allow Italy and Finland to take part to the EMU final stage without them participating two full years to the EMS consists an example in this case

At the moment, only 7 EU member states are taking part to this mechanism: Denmark (from the 1st of January 1999, the only country which has chosen a +/-2,25% fluctuation scale), Estonia and Lithuania (from the 28th of June 2004), Cyprus, Latvia and Malta (from the 2nd of May 2005) and Slovakia (beginning with the 28th of November 2005). The Czech Republic, Poland and Hungary, countries with sustainable economy policies are currently outside the MRS 2. [1] It is important to mention that the main reason for a country be participate in MRS 2 is due in order to meet the convergence criteria. Still in the second integration stage the states are constantly bending every effort to obtain the nominal convergence and implicitly the "entry ticket" for the euro zone.

All in all, the participation to the second phase of the EMU implies meeting and maintaining the convergence criteria, and, at the moment of joining the stage three, giving up to the monetary policy independence and also to the exchange rates used for adjusting the economic unbalance. Once part of the EMU, the member states will establish stability programmes.

It is important to emphasize that the unilateral euro adoption *(„euroisation")* by the member or candidate countries is considered to be inconsistent with the EMU framework and not acceptable by the EU. All the countries are bound to follow all the three stages stipulated in the Treaty.

Here we have to mention a very important event, the first euro zone extension towards East, the accession of Slovenia, on the 1st of January 2007.

Once with achieving important progress concerning the nominal convergence,

[1] http://ec.europa.eu/economy_finance/euro/world/euro_world_6_en.htm

Slovenia has requested for convergence reports. In May 2006, the European Commission and the ECB have released the results of the reports and has recommended the country's accession to the euro zone, based on the compliance with the convergence criteria. On the 16 of May, the Commission released a statement saying that Slovenia has reached high levels of sustainable convergence and that it is prepared to use the single currency. Based on the convergence report, the Commission has proposed the Council for Slovenia to join the euro zone starting the beginning of 2007.

After Parliament consulting and discussions held inside the European Council, on the 11th of July 2006, ECOFIN has agreed for Slovenia to take part in the final EMU stage from the 1st of January and has also established the irrevocable exchange rate between Slovenia's tolars and the euro: 239,64 tolars for 1 euro.

Lithuania also requested the Commission's evaluation concerning its compliance with the convergence criteria, but the European institutions have ruled against and have released a negative result. Consequently, Slovenia's experience definitely represents an example for all the other EU members which are preparing for the single currency.

Concerning the entry conditions I will have one comment for now, referring at "price stability" criterion. The Commission is using a reference based on the inflation in three best performing EU member states. At the moment of the first evaluation this procedure was the right one. But we have to remember that EU member states had their own currency and independent monetary policy at that time. I believe that in the present, the criterion should be used from a different point of view, because there is a monetary union and an unique monetary policy for twelve countries. One could say that using the inflation values from three countries means a great importance for regional indicators, instead of euro zone indicators. Moreover, the criterion is based on three countries from EU, which could not be members of euro zone. Considering the EU enlargement, the reference value could be influenced by inflation rate from small and unrepresentative countries. We can imagine that UK will join EMU, on the base of inflation from countries that are not in EMU (maybe Lithuania and Malta)! To conclude, the economy of the country that wants to enter euro zone has to be convergent with the euro area, not with three countries from EU but outside euro area. Using the euro inflation, it eliminates even the possibility to use one country deflation rate for reference value.

3. Great Britain on the road to euro

Great Britain represents a particular case concerning the changeover to euro. The country's officials have stated that Great Britain will join the EMU only when this step will be in accordance with the national interest.

It is well known the special status of the British people, and the European accession process emphasizes this situation at both politic and population level. It is known that Great Britain has ratified the Maastricht Treaty only after obtaining derogation (the opt-out clause) regarding the participation to the third and final stage of the Economic and Monetary Union. It is appropriate to mention a similar situation back in 1971, when the monetary changes had a different aspect (replacement of the metallic coins), Britain was reluctant to the change. Then, Great Britain changed to the decimals subdivisions, because the existing system was growing difficult the transactions (see box no.2)

Box 2 The British monetary systems-until 1971-named „LSD”

Changing to the decimal monetary system took place on the 15th of February 1971, and stated that 1 pound could be divided in 100 units.

Until that moment, the divisions were the following :
1 Pound = 20 Shillings
1 shilling = 12 pennies

So, the sums were written after the template: ***£4 15s. 6d.*** *(= 4 pounds, 15 shillings and 6 pence).*

The British people were not very satisfied with the introducing the „new money” process, one of the most frequent question being: „how much this is expressed in old money?”.
Even back then, the British conservatism was obvious. An example in this sense is represented by the launch on the 1 pound coin in 1983, which was not welcomed by the population. The reason for such a behavior was that a coin couldn't possibly have the same worth as a banknote.

This could represent the justification for the British population's reluctance to the euro introducing, and possible positive effects that this could have.

Even since 1997, the British government has announced that they are not against the euro introduction, but this will happen only when certain advantages for the nation will be clearly known.

After 6 years, there still exist uncertainties concerning the governmental plans for the future monetary policy. On the 9th of June, the British government, through de Chancellor of the Exchequer, Gordon Brown announced that UK „is not prepared” for the single currency and that Britain will take this step only when the nation will acquire positive results.

In the case of Great Britain the decision will definitely be based on the specific tests carried out by the Treasury.

The British tests and the government's plans

A costs-benefits type analysis for determining a country's possibility to join the euro zone is a very complex process. In order to establish whether for Great Britain this will represent a successful step, there is carried out a series of five economic tests. These tests were applied in 1997 and 2003. In 2003, once with the public release of the tests' results, there have also been edited a set of 18 support studies which sum up a total of 1900 pages!

The five tests measure the economic implications, taking into consideration: *(1) the economic convergence, (2) flexibility (3) the impact on foreign direct investments, (4) the impact on financial services and on London-as a financial center, (5) the impact on economic stability, growth and employment.* A decision regarding the EMU accession will be made in accordance with the tests' results and also with the referendum results. The tests were launched back in 1997 at the Finance Minister's – Gordon Brown initiative. [1]

Concerning the economic cycles' convergence, during the last years, Great Britain has been very close to the euro zone level, fact which emphasizes the intensification of the accession process. At present, Britain has obtained even a better convergence rate of the economic cycles than some of the euro zone country members in the period before starting to use the single currency. Britain has also proved that it meets all the convergence criteria stated by the Maastricht Treaty. Still, there have been determined certain structure differences comparing to the euro zone which are estimated as potential risks. So, even if the convergence rate is close to its level in the euro zone, it was considered that the test is not yet passed.

Referring to the next test, the results show that that the labor market flexibility has increased in comparison the middle 90's; the reduction of unemployment has transformed Great Britain into one of the countries with the higher employment rate, with better results even than USA. The test's results indicate that even if the flexibility level has risen, it is not prepared to face any asymmetrical shocks caused by possible structural divergences. In conclusion, neither this test has been passed.

Concerning the investments test, to reinforce the advantages of becoming a member of the euro zone, we can mention the reduction of capital costs for the English companies in the case when the long term interest rates of the euro zone will continue to reduce and as a consequence the participation in a large financial market will reduce the financing costs. These costs could diminish especially for the small and medium enterprises, as long as the EMU membership provides the elimination of the hurdles that these companies encounter on the financial market of the euro zone. The Treasury Report shows that an effect of participating to the euro zone could be increasing the direct investments level. Statistics indicate that Great Britain's share of EU investments has decreased after launching the EMU; and this could be a sign that the longer the monetary integration is postponed, the higher the opportunity costs shall be. The conclusion is that only under certain circumstances (eg: ensuring the sustainable convergence), the level of FDI will increase, and the test could be passed.

Regarding the financial service problem and the supremacy of the City, the euro zone accession will not have negative effects. On the contrary, the participation to the EMU will strengthen Britain's competitiveness by offering the financial services important advantages. Therefore, EMU's membership could offer Great Britain the possibility to from the high level of integration and efforts to create the single market. This test was considered as passed.

The last test refers to Britain's possibility to increase its productiveness and

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[1] The questions for each test are the following:

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

employment level as a direct consequence of EMU member status. The trade could double in the next 30 years, whereas the national revenues could increase by 5-9%. The main concerns about the accession to the EMU are related to the use of fiscal policies as adjustment instruments within the Growth and Stability Pact, and also joining a zone where the inflation rate is limited to 2%, factors which could lead to a decrease of the stability level, and productivity and employment rates. Moreover, the convergence with the euro zone could not be sustainable and the flexibility level of British economy couldn't face any possible shocks which would affect the euro zone. This test could be considered passed only when the convergence with the euro zone would be sustainable.

Hence, the final decision whether or not to join is complicated for the government, especially taking into account the pessimistic public opinion. This issue is difficult to tackle as long as the citizens' opinion seems to be divided in a perfect balance between participation and staying outside the euro zone.

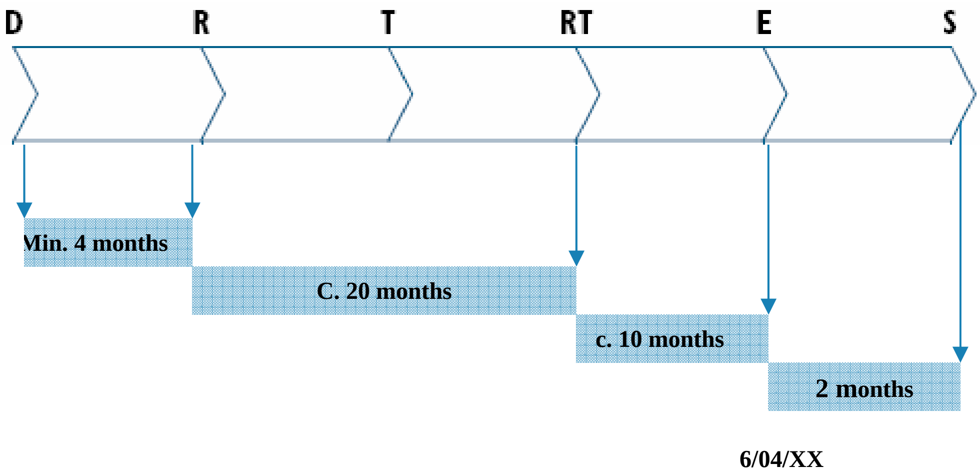
The stages of adopting the euro for Great Britain

Leaving aside the debates concerning the effects of adopting the euro, we have to praise the British authorities' efforts for preparing the transition to the single currency. It was stated that the country will begin the EMU joining process the moment the Government, the Parliament and the population (via referendum) decide it is convenient. Starting 1997, the Government designs plans in order to switch to the single currency.

There have been prepared three national plans for the accession, strategies and situation reports. Moreover, for each semester, The Bank of England is editing informative publications and leaflets containing the implications of euro using in order for the financial sector to be prepared. All these measures are considered necessary legal (Britain has to comply with the *acquis communitaire*) and also procedure (the technical switch must be successful) steps.

At present, Great Britain continues to participate in the second phase of EMU, and is preparing for the third and final stage. Now, we will present the calendar of the euro adopting process established by Britain.

The third *National Changeover Plan* announced by the Government, contains the phases of this complex process. Taking into account the positive experience of the 12 countries and also the negotiations carried out for the management process, in July 2006 the Government announced the reduction of the time period for the two currencies to circulate simultaneously from 6 to 2 months. Therefore, the EMU joining process has the following stages:



Graphic no. 1 – Changeover to euro plan – Great Britain

In the first graphic, the information have the following signification:

• **D**: *Decision* –The Government's decision to join the EMU;

• **R**: *Referendum* – the British electorate officially expresses its interest in the monetary union;

• **T**: *Time of entry and start of transition*. Great Britain joins the EMU. The euro – pound exchange rate is irrevocably settled;

• **RT**: *Retail Transition*. Beginning of the retail transition phase. There will be available retail financial services denominated in euro;

• **E:** *Euro* – the cash begins to circulate and the transition period is over. All non-cash transactions will be denominated in euro. The planned date for achieving this stage is considered the 6th of April (while for the other 12 candidate states it is the 1st of January)

• **S**: *Sterling* – The pound is no longer a legal mean of payment. The end of the double circulation period.

We can see now that the main problem is considered to be the government's decision. It is obvious that a positive decision will be taken once having the guarantee of the advantages that Great Britain will obtain. The correct timing is a key factor for the process success.

Under these circumstances, the only issue remaining is obtaining the *"entry ticket"* from the European institutions after examining the convergence criteria. It is well known that even from 1998, Great Britain had complied with the Treaty criteria. Nowadays, Great Britain has to elaborate the Convergence Programmes, and for example the December 2005 Programme shows that the member state has important potential to fulfill all the convergence requirements: price and interest rate stability as well as the fiscal criteria. It shall be decided the moment when the pound will undertake ERM 2 (*Exchange Rate Mechanism 2*).

Conclusion

I consider that Great Britain will not be able to remain much longer outside the euro zone, especially that the single currency has proven its viability. The problem is not whether Britain will join or not EMU, but when it will happen. The referendum date and the promotion campaigns results will be decisive. For the people, business environment and for the British financial institutions it is crucial to be strongly prepared in order to face the transformation and to reduce the negative effects to a minimum.

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