Name the day:
the business case for joining the euro

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Tony Blair's presentation to the House of Commons of a national changeover plan for the adoption of the euro, last February, will come to be seen as a defining moment in Britain's path towards economic and monetary union (EMU). It moved the debate forward and put EMU firmly at the forefront of national economic strategy. Government funds have now been earmarked for the conversion of public sector computer systems and processes. A possible scenario is for a referendum to be held in the second half of 2001, following a general election in May of that year. That could mean the UK entering EMU as early as 2002. But this is only rumour and speculation. Although the changeover plan has mapped out the timeframe for the transition process, the problem for business remains that nobody knows when this process will come into effect. There is still no clear indication of a target date for entry.

Consequently, whereas their competitors within the euro-zone have long had a firm timeframe and deadlines against which to plan their transition to the euro, British companies still cannot take either the timing of future UK membership or, for that matter, accession itself for granted. This makes it that much more difficult for British companies to take the decisions and actions required to put their businesses in the best possible shape for successful growth and development, at the least possible cost and disruption to their operations.

The government would help UK companies to succeed in Europe's new business environment if it set a starting date as early as possible. Although the whole issue of UK entry remains subject to positive votes by the Cabinet, by Parliament and then by the British people in a referendum—and also requires favourable verdicts from the European Commission and the Council of Ministers—the government must take a clear and firm stance. Of course, companies will still have to have fallback strategies for a "no" vote, but a clear statement of government intent would allow them to focus on the most likely outcome and make plans accordingly.

The benefits to British businesses of the UK joining the euro are potentially very substantial. As well as removing the burdens of foreign exchange risk and transaction costs for exporters, it would make it possible for any British company to target euro-zone business opportunities more effectively. Such opportunities include market development, pricing, funding, corporate restructuring and purchasing as well as the location of investment, plants and facilities. For the first time, it would be possible to make decisions without the distortion of exchange-rate risk and the attendant costs of currency hedging. Where capital is committed on an extended timescale, as for example in setting up a new plant or distribution centre, these risks are multiplied and the benefits of EMU are commensurately greater. However, the benefits do not flow automatically. They have to be targeted and realised. Therefore appropriate strategies need to be put in place well in advance.

At the same time, there are substantial costs associated with a company getting ready for the euro. A recent KPMG survey shows that for the average large pan-European business with more than 5,000 employees, compliance costs will amount to around £13.5 million. This figure does not include any of the indirect costs arising from the changes that a business needs to make in order to maximise its competitiveness in the new euro-zone environment, estimated at a further £18.5 million. Since these figures apply to pan-European companies, they do not capture the fact that UK businesses, particularly smaller ones, may face two separate strikes to their bottom lines: first, to deal with the euro as a parallel currency and second, to make the transition to the euro as the domestic currency.

The first cost stems from a process described as "eurocreep": a large number of businesses are expected to adopt the euro early and will incur costs as a result, regardless of when the UK joins. These include the local subsidiaries of foreign-owned multinationals, those UK-based companies that generate a large part of their revenue from the euro-zone and suppliers to major pan-European companies. For these types of firms, the initial costs of preparing for euro payments and receipts cannot realistically be delayed or avoided, even if the companies concerned trade only on the domestic UK market.

The second and larger cost of adopting the euro as the base accounting or functional currency, may be delayed but not avoided if we are to join EMU in the foreseeable future. The point here is that, unless and until there is more certainty regarding both the commitment to join and the timing of entry itself, for most businesses it will be inappropriate or even irresponsible to incur the full costs of transferring to the euro. But unfortunately, the total bill for piecemeal conversion is likely to be substantially higher.

Early entry is therefore desirable because it would make the benefits available sooner and, for many businesses, reduce the overall costs of transition. Yet there are a number of major hurdles to be overcome before the government can make a commitment to the principle of entering.

In October 1997 Gordon Brown, the British Chancellor of the Exchequer, set out five economic tests against which the government would seek to measure the attractions of UK entry:

★ Has the UK economy achieved sustainable convergence with the economies of the single currency?

★ Is there sufficient flexibility in the UK economy to deal with any problems that might emerge?

★ Would joining make for better conditions for businesses to make long-term decisions to invest in the UK?

★ What impact would it have on the UK financial services industry?

★ Will it be good for employment?

The answers to these questions are clearly subject to some latitude of interpretation and to the exercise of informed judgement. The first criterion is the one that really matters. It also happens to be the one most capable of quantification, on the basis of some pertinent economic indicators, such as trends in GDP, inflation, employment and interest rates.

There is already evidence pointing to a significant degree of convergence. Figure 1 shows that in the year 2000, French and German economic growth rates are expected to be around 2.6 per cent, with the UK only slightly behind at around 1.9 per cent. Inflation rates are also coming more closely into line, with euro-zone inflation at around 1 per cent and underlying UK inflation around 1.5 per cent, as measured by the EU harmonised index of consumer prices. The important point is that these trends reflect recent and prospective developments in the real economy, including those arising from an acceleration in cross-border investment and mergers and acquisitions. It would not be unreasonable to say that business is already making convergence a reality.

One of the reasons for this relative optimism is a belief that there is a great deal of potential for productivity growth across Europe. Greater convergence is being driven by faster-than-expected harmonisation of the economic framework, not least the regulatory and taxation provisions, and by deregulation and privatisation.

In the medium-term UK growth is expected to come fully line with the euro-zone. Figures published in 1998 by the NIESR, for example, show that over the period 2001-05, there is little to distinguish the UK, France and Germany, in terms of their growth outlook. Whereas this is partly due to the inescapable tendency for economic forecasts to converge as the time horizon is extended, it is also undoubtedly a reflection of real underlying convergence.

There is also growing evidence of convergence of British interest rates with the euro-zone. UK long-term bond yields have already converged significantly:

FIGURE 1: EUROPEAN GROWTH RATES (%)

	1997	*1998*	*1999 (forecasts)*	*2000 (forecasts)*
Austria	2.5	3.0	2.1	2.3
Belgium	2.9	3.0	2.0	2.2
Denmark	3.1	2.6	1.6	1.9
Finland	6.0	5.0	2.7	2.8
France	2.3	3.2	2.3	2.6
Germany	2.3	2.5	1.7	2.6
Greece	3.2	3.2	3.0	3.1
Ireland	9.8	9.0	6.8	5.7
Italy	1.5	1.4	1.7	2.4
Netherlands	3.6	3.7	2.4	2.2
Portugal	3.5	3.9	3.1	2.7
Spain	3.5	3.8	3.4	2.9
Sweden	1.8	2.8	1.9	2.4
UK	3.5	2.3	0.6	1.9
EU	**2.6**	**2.8**	**1.9**	**2.5**
Euro-11	2.5	2.8	2.1	2.6

SOURCE: CONSENSUS FORECASTS (MARCH 1999)

the 5-year yield spread against German government bonds is already less than 1 per cent. Short-term rates continue to reflect the difference in base rates: at the time of writing, they were 5.25 per cent in the UK and 2.5 per cent per cent in Germany and the rest of the euro-zone. However, significant convergence of short-term interest rates has already taken place. As recently as October 1998, the UK base rate was 7.25 per cent compared to a synthesised euro rate of 3.75 per cent.

It is worth noting that, in the case of Spain and Italy, short-term interest rate convergence really only happened when it had become quite clear that these countries would join in the first wave, and the markets began to discount accordingly. As long as UK monetary policy continues to be exercised independently of the rest of Europe, differences in interest rates will persist. Although market expectations will drive the outcome, they themselves reflect the government's stance and level of real commitment to euro membership.

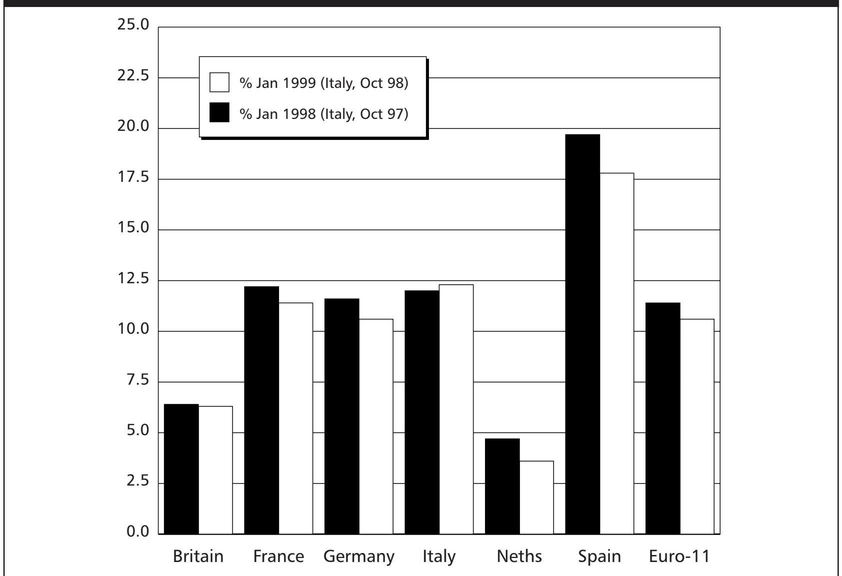
Unemployment in the euro-zone has fallen consistently since the mid-1990s although it is still unacceptably high, at around 10 per cent. The difference compared to the much lower average levels in the UK can be explained by the inflexibility of the major continental European labour markets. This has yet to be satisfactorily addressed although there has been significant progress recently, particularly in France.

The greatest contribution that the UK can make to European economic prosperity is to show, by example, the advantages that flexible, responsive labour markets can deliver, in a business environment in which change will be the only constant.

Within the euro-zone, there will continue to be significant differences in employment, as Figure 2 shows. However, this is partly due to statistical inconsistencies. Spanish unemployment, for example, is thought to be overstated in the official statistics by up to 7 per cent.

Undoubtedly there are still structural differences between the UK and the euro-zone economics. The fact is that whilst these differences are real they are not insurmountable, and they are likely to become less significant over time. Already there is progress in areas such as fixed and variable interest rates: an increasing proportion of UK domestic and commercial mortgages are now

FIGURE 2: EUROPE'S UNEMPLOYMENT LEVELS (%)



SOURCE: THE ECONOMIST

taken out on fixed-rate terms and, equally, more continental European debt is now at variable rates.

It is also the case that the timing of the business cycles in the UK and major continental economies is still asynchronous. However, this is also becoming less of an issue. The EU economy is becoming more integrated, not least through the activities of business. Since the mid 1980s, intra-EU trade has increased, on average, from around 50 per cent of member-states' external trade to over 60 per cent. Whilst the UK figure is somewhat lower, around the mid fifties, it started from a lower base and the trend of integration is no less marked.

More fundamentally, there has also been a substantial restructuring of the corporate base in Europe. European Commission figures show that intra-EU cross border investment rose more than five-fold between 1985 and 1993. Merger and acquisition activity rose by a factor of more than three between 1986 and 1995. In this respect the UK's acquisitive corporate culture has been employed to good effect, with UK-based companies well to the fore. Today, there are few UK companies of any significant size that are not represented by local subsidiaries and operations in many of the key euro-zone markets. Since parts of their groups are already within the euro-zone, such companies will have to prepare for the euro on the same basis as indigenous companies. As a result they will incur substantially the same cost penalties, but without the full benefits until such time as the UK joins.

The other economic tests laid out by the Chancellor are less substantive. They are "judgement calls" on which first the Treasury and then the Cabinet will have to take a view. In reality the need to fulfil these remaining criteria is unlikely to delay a decision unduly. EMU has been successfully launched and is being established as a stable currency on the foreign exchange markets. As long as the ECB succeeds in managing the euro-zone economy as a low inflation, stable interest rate environment, and there is no adverse reaction in employment markets, then all the tests can arguably be said to have been met.

Political hurdles represent an important uncertainty, and it will be necessary to ensure that the public is fully aware of all the issues, benefits and disadvantages, before it is asked to decide. The government is now committed to an information campaign led by the public sector; this should ensure that, when the referendum takes place, the electorate is in a position to cast its votes on an informed basis.

But the options for UK entry cannot be assumed to be open-ended. The Maastricht treaty does not specify time limits, but after around 2003, entry may become more difficult. The EU is expected to get larger following the accession of a number of new member-states around this time. Poland, Hungary, the Czech Republic, Slovenia and Estonia are expected to join the club in a first wave, with another five East European countries waiting in the wings.

Inevitably, this will re-focus attention on the need to reform the European institutions to accommodate a larger EU. On top of that, it will become increasingly urgent to modernise the Common Agricultural Policy and re-focus the regional funds to benefit Eastern Europe. As 2005 approaches, the EU's energies and institutions will be increasingly focused on making these changes happen, and on putting in place the necessary frameworks and processes.

Consequently, there might then be little enthusiasm for accommodating the entry of a major additional currency like sterling, with all the necessary political negotiations, administrative preparations and disruption. The late entry of a major currency, at a time when a successful *modus vivendi* will have already formed between the ECB and existing euro-zone members, will be difficult to accommodate without considerable dislocation. EMU will have been to all intents and purposes done and dusted by then, at least as far as the larger countries are concerned.

So a pertinent question is, what are the implications of joining early, before say 2003? Some clear economic advantages are likely to flow from early entry:

Stable conversion rates. Fixing the euro conversion rate early would give industry the benefit of stable conversion rates for the major part of the UK's export trade immediately. Companies would be able to plan their activities without exchange–rate risk and without having to allow for hedging and transactions costs. This should bring down the costs of exporting and make British goods and services more competitive. The crucial issue would be the exchange rate. Based on current market rates, it would require a realignment of around 10 per cent to hit the DM 2.60 (€1.33) target which industry would prefer.

More stable international exchange rates. The damaging exchange-rate developments of 1996-98 have been a major concern for UK companies, particularly those in manufacturing industries. It is now becoming clear that the effect on exporters of the 30 per cent or so rise in the value of sterling against other European currencies, although lagged, has been very significant, leading to a marked deterioration in the UK's current account balance and falling manufacturing output. As well as eliminating damaging exchange rate movements against European currencies, the adoption of the euro should also lead to a more stable exchange rate with the other major international currencies.

The removal of dollar exposure. As the euro becomes established as a major world trading currency to rival the US dollar, a significant proportion of UK trade with non-European countries will start to take place in euros. At present, much of our trade with the Far East is dollar–denominated and there is no reason why much of this should not be switched to the euro. British business will not share the benefits whilst we remain outside. Some sectors, such as the aerospace industry, stand to benefit particularly. Partly for traditional reasons, much of the business of aerospace companies, even inside Europe, has been dollar denominated. Airbus has already announced that it will seek to trade in euros. So long as the UK remains outside, there will be little exchange-rate benefit to UK suppliers from trading in euro. But were the UK to enter all this trade would effectively become denominated in the domestic currency.

The avoidance of domestic exchange-rate exposure. It is already clear that a number of the largest companies in the UK will be early adopters of the euro, even if we stay out. The following sectors will face increasing pressure to adopt the euro:

★ financial markets

★ importers to, and exporters from, the euro-zone

★ UK subsidiaries of large multi-nationals

★ UK suppliers to multi-nationals

★ retail and services sectors, such as tourist centres, international airports and ports

★ providers of travel and tourist services.

For these companies, and for their suppliers and other business partners, early entry will remove the exchange rate risk and any other disadvantages of using the euro as a base currency. Equally, suppliers exposed to exchange rate risk within the domestic market, through having to deal an in what is still a foreign currency in the UK, would benefit from early entry removing this exposure.

Easier access to the euro capital market. The transition to the euro will lead to deeper and more liquid euro-denominated capital markets, providing an important source of cheap funding for UK companies. These new markets can provide the competitive finance that firms will need if they are to be amongst the winners in the large-scale corporate restructuring that is likely to follow the launch of the euro. All major players in the EU market will be looking to consolidate and reinforce their positions in the wider euro marketplace. UK corporates will find their access to cheap euro-denominated finance constrained by exchange-rate fluctuations for as long as Britain remains outside the single currency.

Ensuring we are not left on the margins. Despite the denials of politicians, there is some real concern that the euro-zone may become more and more inward-looking. Although 18 per cent of European cross-border trade is external to the EU, there is growing evidence that the business environment is becoming more internally-focused. Apart from the sharp growth in intra-EU trade, consolidation and concentration will drive further economic integration. Many companies are building pan-European structures and supply chains, closing existing loopholes in their operations. The incentive to look outside the euro-zone, with all the options available within it, may well diminish. For the UK, that means if we are not in, we may well lose out.

It is also salutary to consider what the economic position might be for the UK if it remains outside for an extended period. Firstly, there must be some concern as to how sterling might perform against the euro. Received wisdom had it that the sharp, unstoppable appreciation of sterling over the year-and-a-half preceding the formal confirmation in May 1998 of the commencement of EMU on 1 January 1999, was partly a reaction of the financial markets against the uncertainties afflicting the main first–wave currencies, in particular the D-mark. But of course the problem did not end there. Sterling will inevitably remain somewhat volatile against the euro for a number of reasons, whilst it remains outside.

These reasons include the underlying potential for volatility of the euro. The euro and its management by the ECB will remain for some time an unknown quantity with the financial markets. They are likely to continue to test the resolve of the ECB, both to defend the value of the currency and to maintain a stable, non-inflationary economic environment. However, given the clear mandate of the ECB and the independence of the central bankers who run it, it is likely that, once the markets are comfortable with prevailing euro exchange rates, a stable policy stance can be maintained.

The second source of potential instability is the outlook for sterling itself. The Bank of England is expected to continue managing UK monetary policy on a similar basis to the ECB, by adopting broadly the same policy framework as would apply within EMU. But in practice this might prove difficult if there are significant pressures on the exchange rate. Sterling will still be affected by the euro even if we stay outside it, but it will be affected in an unpredictable way. There could be knock-on effects on sterling from the progress of the euro. Sterling will be affected by the euro's strength or weakness. It will be affected by the euro's perceived success or otherwise in delivering the objectives set for EMU. And it will be affected by any lingering doubts as to the euro's sustainability.

As long as the current uncertainty about UK membership remains, every ministerial speech could have the potential to unbalance sterling and cause attacks on the currency. At the same time, the markets will be discounting the likelihood of second wave or subsequent entry on a rolling basis. If or when it is perceived that we have missed the boat on second wave entry, this may well have an important, negative effect on confidence and sentiment.

Finally, if we do in the end opt to stay out indefinitely, sterling could become increasingly vulnerable to speculative activity, leading to further uncertainty and volatility. Should the pound fall significantly, rising inflation would not be far behind, and we could be back in the viciously circular economic environment of the 1970s and 1980s that decimated our industrial and commercial base. It does not have to happen, and it is to be fervently hoped that the structural changes in the UK economy in recent years would limit the downside, but the dangers are clear.

The corollary of these scenarios would be a monetary policy stance that is less than ideal for the delivery of stable economic growth. Volatility in exchange and interest rates is highly damaging to confidence, investment and growth, particularly in a open economy like the UK. Coupled with a likely substantial decline in inward investment from staying outside the euro, the consequences could be dire. It is one thing being on the inside, with the rest of the euro-zone facing the same economic pressures, but quite another being exposed on all sides; euro, dollar, yen and everything else.

For these reasons, therefore, I urge the UK government to commit as early as possible to second–wave entry to EMU, barring unforeseen circumstances or developments, and thereby set a clear timeframe for business. This would mean that sterling would be irrevocably locked to the euro at an early date, preferably on 1 January 2002 or even during 2001, but certainly no later than 2003, in order to avoid any potential clash with EU enlargement.

By that time, euro trading will, for many businesses, already be commonplace. The national changeover plan has already addressed the concerns of other companies that need more time to make extensive preparations—such as those in the retail and banking sectors. To ensure that the national changeover plan is are taken seriously and acted upon, however, the government needs to commit to a date of entry.

Business managers dislike uncertainty above all else, because it forces them to gamble with the future of their companies and their shareholders' funds, on the basis of inadequate information. Typically, businesses plan on the basis of one-, three- and five-year strategic planning horizons, driven by the annual and three-year budget cycle. Planning scenarios are based on detailed financial models and projections, encompassing all prospective costs and revenues under alternative assumptions and possible courses of action. The present uncertainty about the UK's position means that several key elements are currently unknown, including the size of the costs associated with joining the euro, and when they need to be provided for. Equally, the potential benefits of euro-zone membership cannot be ascertained until they are researched, analysed and planned for. A clear commitment to joining on a certain date would remove these uncertainties.

Managers are currently being forced to make assumptions about events over which they have no control, which are outside their normal frames of reference and which are beyond their experience and knowledge of their own industry and markets. The outcome cannot but be something of a lottery. In such circumstances some individual companies may win, but the economy as a whole will be the likely loser.

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