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FILE TITLE: SINGLE CURRENCY	SERIES
Annex1: Practical issues arising from the Euro.	EUROPEAN POLICY
	PART: 2
PART BEGINS: 23 November 2001	PART ENDS: 27th FEBRUARY 2002	CAB ONE:

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PART

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DATE CLOSED	

Series : **EUROPEAN POLICY**

File Title : **SINGLE CURRENCY**

Part : **2**

Date	From	To	Subject	Class	Secret
23/11/2001		PM	From Didier Reynders : Set Of Euro Coins	U	0
27/11/2001	pd(rl)	Ch.Staff	Polling on the Euro quesiton	U	
27/11/2001	HMT		Preliminary and Technical work to prepare for the assessment of the t	R	
29/11/2001	FCO	FA/APS	MINECOR 3 December 2001	R	0
04/12/2001			PA News, Blair Can Woo Britain over the Euro - Mandelson	U	
10/12/2001	MS/FCO	FA/APS	MINECOR on Euro Notes and Coins: 3 December: Record	U	
14/12/2001	Cab Off	France/HME	France and EMU: Tel No 880	U	
18/12/2001	EST	LP	PMB: Euro Sterling (Dual Choice)	U	
19/12/2001	PM		To Didier Reynders : Thanks for Euro Coins	U	0
20/12/2001	PD(DS)	PM	Imbalances in the UK and Euroland	C	0
20/12/2001	EU/PS	PM	EMU: Timetables and Strategy	S	228
21/12/2001	Ch.Staff	PM	Euro: Politics	S	233
05/01/2002	Ch.Staff	PM	The Euro	C	
09/01/2002	Cab Off	Ch.Staff	Euro Poll	U	0
11/01/2002	Ch.Staff	PM	EURO organisation	C	
23/01/2002	Ch.Staff	PM	Barclays Capital - Euro Convergence Monitor - In with the in Crowd?	U	
24/01/2002	PPS	PM	EMU Strategy Meeting with GB	C	
24/01/2002	PPS	PM	EMU	C	
31/01/2002	PD(JN)	PPS	Net Present Value of Changeover to Euro	R	0
01/02/2002			Convergence Test	U	
04/02/2002		PM	From DM - Euro - politics and economics	C	
15/02/2002	HMT	CH/EX	Survey of external estimates of sterling's possible entry rate	C	
25/02/2002	PPS	PM	EMU Brief	U	
27/02/2002			Euro changeover costs Bank of Italy 258 million euros	C	

file

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cc SJH
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WPE30185
R ECO R61 UUUU
EURO CHANGEOVER COST BANK OF ITALY 258 MLN EUROS

(ANSA) - Rome, February 27 - The changeover from the lira to the euro has cost the Bank of Italy about 258 million euros, roughly five euros per Italian citizen, the central bank estimated today.

Costs were already riding at around 200 million euros at the end of November and subsequent distribution operations along with overtime paid to staff have added the rest, officials said.

The bill for the Italian credit system as a whole was put at 650 million euros. At present some 1.6 billion euro banknotes are in circulation, with a total value of 48.6 billion euros, or 93 trillion lire.

According to Bank of Italy data, bank ATM cash machines were used 50% more than usual in January and credit card use went up by 20%.

Asked to comment on the growing irritation felt by many Italians over the tiny one and two-eurocent coins, Bank of Italy Deputy General Manager Antonio Finocchiaro said the market would "decide by itself" whether they should be withdrawn.

PEM

NNNN

1. cc by fax

Katharine Morgan, HMT
Simon Gray, BoE
Richard Crabtree, CO
Neil Wigan, FCO

2. file: Euro impact.

JB 4/3

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R CRO R61 UUUU
SORDI AND MARINI TO TOSS 'OUTGOING' LIRA INTO TREVI FOUNTAIN

(ANSA) - Rome, February 25 - Veteran actor Alberto Sordi and blonde bombshell Valeria Marini will wish the lira goodbye by throwing their remaining coins into the Trevi fountain, organizers of the event said today.

The two actors will also be appointed ambassadors of the lira during a ceremony at the 18th century Rome fountain on Thursday, when the Italian currency ceases to be legal tender.

Throwing coins in the fountain is a traditional gesture for travellers to Rome because legend has it that whoever does so is sure to return to the eternal city.

City officials said that money swept out of the fountain will be donated to the Red Cross. Hundreds of schoolchildren will also be on hand for the lira farewell ceremony and will be tasked with the release of red, green and white ballons as a police band plays the national anthem.

Sordi, 82, is considered the country's leading comic actor.

In many of his most famous films he depicts an endearing average Italian dimwit who always get caught in the wrong place, at the wrong time, but manages to weasel out through a combination of native cunning,simplistic logic and luck.

For many years he dominated the stage of the Commedia all'Italiana genre, and his good-natured poking fun at the shortcomings of the petit bourgeois established him as the comic conscience of the Italian people.

Marini is a popular television showgirl and comic actress who starred in Sordi's last film.

MIE

NNNN

cc Katherine Morgan, HMT
Simon Gray, BoE
Neil Wigan, EuD(1)
Andrew Jackson.

I haven't heard of either of them!

JB.
26/2

From: Jeremy Heywood
Date: 25 February 2002

PRIME MINISTER

cc: Jonathan Powell
Alastair Campbell
Peter Hyman
Robert Hill
Sally Morgan
Stephen Wall

EMU BRIEF

As discussed at the office meeting this morning, here is the current Treasury core script and brief on EMU. The main problem in my view is that it is so long. But do you want to add or change anything? Or shall we just recirculate after Cabinet?

Jer

JEREMY HEYWOOD

5 TESTS – KEY MESSAGES (ALL TAKEN FROM EMU CORE BRIEF)

In principle, the Government is in favour of UK membership of EMU; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

As the Chancellor said in his October 1997 statement, the Five Economic Tests will define whether a clear and unambiguous case can be made. The assessment will be comprehensive and rigorous. Once the assessment is complete, the Government will publish the conclusions and the report.

Once the Treasury has completed the Five Tests assessment, a recommendation will be made to Cabinet. The Government will then make a decision on UK membership of EMU. If the Government recommends UK entry, it will be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

Aren't the five tests just a smokescreen for a political decision?

The Chancellor and the Prime Minister have repeatedly stressed that the Five Tests must be met before any Government decision to enter the single currency can be made.

The Five Tests are:

- sustainable convergence between Britain and the economies of a single currency;
- whether there is sufficient flexibility to cope with economic change;
- the effect on investment;
- the impact on our financial services industry; and
- whether it is good for employment.

In its 2001 Article IV Report on the UK economy published on 28 February 2001, the IMF states that the Five Tests are: "consistent with the economic considerations that would be important for the decision to join a monetary union."

[NB: In his interview with the Financial Times on 25 May 2001, the Prime Minister said: "the tests have got to be genuinely met. The economics have never been political camouflage."]

The Government will 'fudge' the Five Tests? Matter of judgement?

The Government will not fudge the Five Tests. The Chancellor and the Prime Minister have repeatedly stressed that the Five Tests must be met before any Government decision to enter the single currency can be made. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

The assessment will be comprehensive and rigorous; all relevant economic issues will be dealt with as part of the assessment. Once the assessment is complete, the Government will publish the conclusions and the report.

[NB: In his Mansion House speech on 18 June 2001, the Chancellor said: "To short-cut or fudge the assessment, and to join in the wrong way or on the wrong basis without rigorously ensuring the five tests are met would not be in the national economic interest. Because the Government is determined that we will make the right long-term decisions for Britain, we will not take risks with Britain's hard-won stability."]

Can a clear and unambiguous case be made?

The Government will only take a decision to recommend UK membership if a clear and unambiguous case can be made. As the Chancellor said in October 1997, the Five Tests will define whether a clear and unambiguous case can be made.

The Chancellor and the Prime Minister have repeatedly stressed that the Five Tests – which define whether a clear and unambiguous case can be made – must be met before any Government decision to enter the single currency can be made.

What is the procedure for making the Five Tests? Who will make the assessment? Does the Treasury have a veto on the Five Tests?

The Government has said that the Treasury will complete an assessment of the Five Tests within two years of the start of this Parliament.

Once the Treasury has completed the Five Tests assessment, the Chancellor will make a recommendation to Cabinet. The Government will then make a decision on UK membership of EMU. If the

Government recommends UK entry, it will be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

[NB: The Chancellor said at his Mansion House speech of 15 June 2000: “The tests, for which this Government and this Treasury is the guardian, are real”.]

[NB: The Chancellor said to the Treasury Select Committee in July 2000: “It is a matter for the Treasury to make an assessment but [the decision] is a matter for the Government as a whole.”]

[The Prime Minister confirmed in a Times interview on June 1 2001 that: “The Treasury will recommend but it [will be]…a collective decision”.]

[In an interview with the FT published on 25 May 2001 the Prime Minister said: “The Treasury are absolutely right to stress that they are the guardians of the tests in the sense that the tests have got to be genuinely met.”]

Have we met any of the Five Tests? Are we near to meeting any of the Five Tests?

The Government will not give a running commentary on the Five Tests. The Government has said it will complete the assessment within two years of the start of this Parliament. Once the assessment is complete, the Government will publish the conclusions and the report.

Is a referendum inevitable?

A referendum is not inevitable. The referendum would only occur if the Five Tests were met, so that there was a clear and unambiguous case for joining, and the Government had made a decision to recommend joining.

Is EMU membership inevitable? Is it possible to run a parallel currency in the UK now that the euro is a reality?

EMU membership is not inevitable.

The Government will only take a decision to recommend UK membership if a clear and unambiguous case can be made. As the Chancellor said in October 1997, the Five Tests will define whether a clear and unambiguous case can be made.

The Chancellor and the Prime Minister have repeatedly stressed that the Five Tests – which define whether a clear and unambiguous case can be made – must be met before any Government decision to enter the single currency can be made.

Newspapers report that Gus O'Donnell said UK membership is ultimately a political decision?

The Treasury has made clear that Mr O'Donnell has no recollection of saying that membership is ultimately a political decision. Any Government decision on the euro will be based on a thorough and rigorous assessment of the Five Economic Tests. The economic case must be clear and unambiguous before the Government will recommend membership.

EMU CORE BRIEF

INDEX

HEADLINE MESSAGE

The Government's policy on membership of the single currency is unchanged. It remains as set out by the Chancellor of the Exchequer in October 1997, and restated on numerous occasions including in the Labour Party manifesto.

The Chancellor and Prime Minister have made clear that they will not 'bounce' people into a referendum on the back of the general election.

In principle, the Government is in favour of UK membership of EMU; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. If it is, there is no constitutional bar to joining.

As the Chancellor said in his October 1997 statement, the Five Economic Tests will define whether a clear and unambiguous case can be made. All relevant economic issues will be dealt with as part of the Five Tests assessment. The Five Tests are:

- sustainable convergence between Britain and the economies of a single currency;
- whether there is sufficient flexibility to cope with economic change;
- the effect on investment;
- the impact on our financial services industry; and
- whether it is good for employment.

The Government has said that the Treasury will complete an assessment of the Five Tests within two years of the start of this Parliament.

The assessment has not yet started, but the necessary preliminary analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised – is underway.

Since 1997 the strategy has been to prepare and decide. This has involved the publication of the draft national changeover plans and the work of the standing committee with business. To prepare and decide is the approach the Government will continue to pursue.

Once the Treasury has completed the Five Tests assessment, a recommendation will be made to Cabinet. The Government will then make a decision on UK membership of EMU. If the Government recommends UK entry, it will be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

PRELIMINARY AND TECHNICAL WORK

Has the assessment started?

The assessment has not yet started, but the necessary preliminary analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised – is underway.

What's new – the Chancellor announced you'd be doing this preliminary work in his Mansion House speech in June?

The Government's policy on membership of the single currency is unchanged. It remains as set out by the Chancellor of the Exchequer in October 1997, and restated on numerous occasions including in the Labour Party manifesto.

The Treasury has issued a note which addresses the issues of content and timing of the preliminary and technical work to prepare for the assessment of the Five Tests for UK membership of the single currency.

The Government has said that it will complete another assessment of the Five Tests within two years of the start of this Parliament. The assessment has not yet started, but the necessary preliminary analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised – is underway.

What does the preliminary work involve?

The scope of the necessary preliminary and technical work was set out in the original October 1997 assessment. Although there have been new developments since the 1997 assessment, the underlying issues to be analysed remain the same and the five tests themselves remain unchanged. Now the preliminary and technical work is updating the analysis on:

- the cyclical behaviour of the UK economy relative to the euro area and their relative responses to economic shocks;
- the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;
- the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;
- the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the euro area since 1997; and
- the impact of the single currency on trade, competition and productivity.

This is by no means an exhaustive list as the preliminary work continues to evolve to take account of the latest technical research and analysis. More detail is given in the Treasury note which addresses the issues of content and timing of the preliminary and technical work.

What does the preliminary and technical work on [x], described in the Treasury note, involve?

Not going into any more detail than set out in the Treasury note which addresses the issues of content and timing of the preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency.

How does the preliminary work differ from the assessment?

This is preliminary work covering the necessary technical issues that will need to be addressed. When the assessment of the five tests is made, it will bring all these elements together in a comprehensive and rigorous manner.

When does the preliminary work finish and the assessment begin?

The preliminary work will not be rushed. We need to ensure the assessment is comprehensive, rigorous and thorough. We have said repeatedly that the assessment will be made within the first two years of this Parliament.

What are the findings of the preliminary and technical work so far?

Work on the preliminary and technical work is ongoing. The results of the preliminary and technical work will feed into the assessment, which has not yet started.

Will there be an announcement of the assessment's start date?

We are committed to making the assessment within the first two years of this Parliament, to publishing the assessment and to ensure the assessment is rigorous and thorough.

Will outsiders be involved in this preliminary work / the assessment?

We will, or course, continue to monitor all of the analysis by outside economists. The Treasury is in regular contact with outside economists on a whole range of issues, including aspects of the preliminary work. But is clear that the assessment will be a Government assessment and the work will be undertaken by the Treasury. There is no intention to contract out any part of the assessment to outsiders.

Are you involving other departments / the Bank of England in the preliminary work / the assessment?

The Treasury is in regular contact with other departments / the Bank, on a whole range of issues, including aspects of the preliminary work. Not going to go into specifics. But is clear that the assessment will be a Government assessment and the work will be undertaken by the Treasury.

Are you commissioning work for the preliminary work / the assessment from academics?

The Treasury is in regular contact with academics on a whole range of issues, including aspects of the preliminary work. Not going to go into specifics. But is clear that the assessment will be a Government assessment and the work will be undertaken by the Treasury. There is no intention to contract out any part of the assessment to outsiders.

How many officials are involved in the preliminary and technical work?

A wide range of officials are contributing.

Why have you said that the assessment has not started when preliminary work has been underway for sometime?

The assessment has not started. The preliminary work will inform the assessment, which has not yet started.

Why have you decided to publish information on the nature of the preliminary work?

We thought it would be helpful to provide more information, given the level of interest in the debate [including by the Treasury Select Committee.]

Will the preliminary work be published?

The preliminary work will inform the assessment. The assessment will be rigorous and comprehensive. It will be published and will of course then be a subject for debate.

KEY QUESTIONS ON EMU DECISION AND PROCESS

When will the assessment of the Five Tests be made?

The Government has said that it will complete another assessment of the Five Tests within two years of the start of this Parliament.

How long will the assessment take? / What form will it take?

Work on the assessment will take at least several months to complete. The assessment will be comprehensive and rigorous; all relevant economic issues will be dealt with as part of the assessment.

Once the assessment is complete, the Government will publish the conclusions and the report.

[NB: The FT on 7th June 2001 quotes the Chancellor: "These tests will be applied rigorously, the work will be done in detail, the conclusions and the report will be published."]

[At Treasury Questions on 14 December 2000, the Chancellor said: "Precisely because we have to look at all issues related to this matter, we have our five economic tests."]

What is the procedure for making the Five Tests? Who will make the assessment? Does the Treasury have a veto on the Five Tests?

The Government has said that the Treasury will complete an assessment of the Five Tests within two years of the start of this Parliament. Work on the assessment has not yet started; it will take at least several months to complete.

Once the Treasury has completed the Five Tests assessment, the Chancellor will make a recommendation to Cabinet. The Government will then make a decision on UK membership of EMU. If the Government recommends UK entry, it will be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

[NB: The Chancellor said at his Mansion House speech of 15 June 2000: "The tests, for which this Government and this Treasury is the guardian, are real".]

[NB: The Chancellor said to the Treasury Select Committee in July 2000: "It is a matter for the Treasury to make an assessment but [the decision] is a matter for the Government as a whole."]

[The Prime Minister confirmed in a Times interview on June 1 2001 that: "The Treasury will recommend but it [will be]...a collective decision".]

[In an interview with the FT published on 25 May 2001 the Prime Minister said: "The Treasury are absolutely right to stress that they are the guardians of the tests in the sense that the tests have got to be genuinely met."]

Isn't this a politically motivated timetable?

The Government has repeatedly said that the determining factor underpinning any Government recommendation to join the single currency will be the national economic interest. The Government has said that the assessment will be completed within two years of the start of this Parliament.

The Government will 'fudge' the Five Tests?

The Government will not fudge the Five Tests. The Chancellor and the Prime Minister have repeatedly stressed that the Five Tests must be met before any Government decision to enter the single currency can be made.

The assessment will be comprehensive and rigorous; all relevant economic issues will be dealt with as part of the assessment. Once the assessment is complete, the Government will publish the conclusions and the report.

[NB: The FT on 7th June 2001 quotes the Chancellor: "These tests will be applied rigorously, the work will be done in detail, the conclusions and the report will be published."]

[NB: In his interview with the Financial Times on 25 May 2001 the Prime Minister said: "the tests have got to be genuinely met. The economics have never been political camouflage".]

No one believes the Five Tests are credible — aren't they just a smokescreen?

In its 2001 Article IV Report on the UK economy published on 28 February 2001, the IMF states that the Five Tests are: "consistent with the economic considerations that would be important for the decision to join a monetary union".

How can you carry out an assessment of the Five Tests without knowing the terms of UK entry, e.g. the sterling entry rate?

The assessment will be comprehensive and rigorous; all relevant economic issues will be dealt with as part of the assessment. The subject of the exchange rate will be addressed in the assessment of the Five Tests.

[NB: The FT of 30 May 2001 reports: "Mr Brown said the subject of the exchange rate would be addressed in the assessment of the five economic tests when the Treasury measures whether "settled and durable convergence" has been achieved".]

Why not get an independent body like the Bank of England or the OECD to do the Five Tests assessment?

This will be a Government assessment. It will be a comprehensive and rigorous assessment.

Have we met any of the Five Tests? Are we near to meeting any of the Five Tests?

The Government will not give a running commentary on the Five Tests. The Government has said it will complete the assessment within two years of the start of this Parliament. Once the assessment is complete, the Government will publish the conclusions and the report.

The Prime Minister said in December 2000 that he would say "No" if asked in an opinion poll whether we should join the euro. What's changed since then?

The Prime Minister's comment was entirely consistent with the Government's policy on EMU, ie that economic conditions were not right for the UK to join EMU with the 'first wave' at the beginning of 1999. The Government has said that another assessment of the Five Tests will be completed within two years of the start of this Parliament.

What would be the entry rate for sterling? Is the exchange rate a sixth test for UK membership?

The Government has said that the rate at which sterling would enter the single currency would need to be consistent with economic fundamentals in the UK and compatible with sustainable convergence between the UK and other euro area economies.

There is no sixth test. The Chancellor has said that the subject of the exchange rate will be addressed in the assessment of the Five Tests.

[NB: The FT of 30 May 2001 reports: "Mr Brown said the subject of the exchange rate would be addressed in the assessment of the five economic tests when the Treasury measures whether "settled and durable convergence" has been achieved".]

Will the Government take steps to lower the value of the pound ahead of possible UK entry to the single currency?

Previous UK experience has shown that an artificial exchange rate target can be counter-productive, and lead to less not more stability.

The Government believes in a stable and competitive exchange rate for the medium term. The exchange rate will, over time, reflect the fundamentals.

The Government has said that the rate at which sterling would enter the single currency would need to be consistent with economic fundamentals in the UK and compatible with sustainable convergence between the UK and other euro-area economies.

[NB: In his James Meade speech in May 2000 the Chancellor stated that: "such a euro-sterling exchange rate cannot be justified by any view of long-term economic fundamentals." At this time the euro was trading at around US$0.90 and £0.60.]

[NB: In May 2000 the Eurogroup stated: "we share a common concern about the present level of the euro which does not reflect the strong economic fundamentals in the euro area." At this time the euro was trading at around US$0.90 and £0.60.]

[NB: In his June 2000 Mansion House speech, the Chancellor stated: "the policies which [we are] sometimes asked to follow to bring the exchange rate down or even set an exchange rate target alongside the inflation rate target would today risk ... a return to stop-go." At this time the euro was trading at US$0.95 and £0.63.]

[NB: On 23 September 2000 following intervention to support the euro the G7 stated that they: "shared concern...about the potential implications of recent movements in the euro for the world economy". At the time of the G7 intervention, the euro was trading at around US$0.85 and £0.60.]

[NB: The FT of 30 May 2001 quotes the Chancellor: "we want a stable and competitive exchange rate for the medium term. The exchange rate will, over time, reflect the fundamentals."]

[NB: The FT of 30 May 2001 quotes the Prime Minister: "we should not take any risks with economic stability. There should be no artificial devaluation of our currency."]

When would the Government negotiate an entry rate for sterling? Would the entry rate be known in advance of a referendum?

These are important issues which would have to be considered in the event that the Government made a decision to join EMU.

In these circumstances the Maastricht Treaty and the UK Protocol set out the formal position that if the UK were to reverse its opt-out "the Council shall, acting with the unanimity of the Member States without a derogation and the Member

State concerned…adopt the rate at which the [euro] shall be substituted for the currency of the Member State concerned".

Is a referendum inevitable?

A referendum is not inevitable. The referendum would only occur if the Five Tests were met and the Government had made a decision to recommend joining.

What will happen if the Government does not recommend membership of the single currency following the Treasury's assessment? Will there be another assessment?

The Government is not going to speculate on the outcome of the assessment, which will be completed within two years of the start of this Parliament.

[NB: On Question Time of 30 May 2001 the Prime Minister said "if you make a decision within the first two years that its not on then it becomes less likely that you will do it in the Parliament."]

Opinion polls suggest that the public is strongly opposed to joining the single currency. Surely the Government would never risk losing a referendum?

The Government has repeatedly said that the determining factor underpinning any Government recommendation to join the single currency will be the national economic interest.

[NB: The FT of 26 May 2001 quotes the Chancellor as stating: "if the economic tests are met, and we have put the recommendation that is accepted by Parliament, we believe we can win the case in the country. It is the economic benefits of the single currency that would be important to people if there were a referendum".]

What is the time assumed between the election and a referendum? Won't you try and 'bounce' the electorate into a referendum?

The Government has said that the Five Tests assessment will be completed within two years of the start of this Parliament.

The Chancellor and Prime Minister have made clear that they will not 'bounce' people into a referendum on the back of a general election.

First there must be an assessment of the Five Tests. The tests would have to be met. Cabinet would have to agree. Parliament would have to agree. There would have to be legislation for a referendum. The Electoral Commission would have to give its view on the question.

If, on the basis of the Treasury's assessment, the Government made a decision to join, the National Changeover plan estimates that at least four months would be needed to put the necessary practical arrangements in place for a referendum.

[NB: In an article in the Sun on 30 May 2001 the Prime Minister wrote: "First there has to be an assessment. The economic tests would have to be met. Cabinet would have to agree. Parliament would have to agree. There would have to be legislation for a referendum. The Electoral Commission would have to give its view on the question".]

How would the wording for the referendum be set?

The wording will be a matter for Parliament to decide. The question to be asked in any referendum will need to be considered as part of the legislation needed for a referendum to be held. It would then have to be certified by the independent Electoral Commission.

[NB: On Question Time of 30 May 2001 the Prime Minister said: "the question will be decided by Parliament and certified by the independent Electoral Commission."]

[NB: The FT of May 29 2001 reports the Chancellor as saying: "The nature of the question is still for discussion. It is not fruitful…to speculate what the question should be until we have made the assessment"]

What are the constitutional implications of EMU?

The October 1997 statement acknowledged that to share a common monetary policy with other States represents a major pooling of economic sovereignty. It also stated that if the economic benefits are clear and unambiguous, there is no constitutional bar to British membership of EMU.

The Government believes - as a matter of principle - that, if a decision to recommend joining is taken by Government, it should be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

Do you want to complete the entry process during the course of the Parliament?

The Government has said that the determining factor underpinning any Government recommendation to join the single currency will be the national economic interest.

Could you leave EMU if you joined?

The Government has always made clear the importance of the EMU decision. The Government believes that, if a decision to recommend joining is taken by Government, it should be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree

It is also because of the importance of the decision that the determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

Is the ECB's lack of clarity, accountability and transparency an obstacle to UK membership of EMU? Is it a sixth test for entry?

The Government's policy on EMU membership is clear: the key factor is whether the economic benefits of joining are clear and unambiguous. There is no sixth test related to the ECB.

We believe that high levels of transparency and accountability are very important. Openness and transparency are key to ensuring the ECB gains the trust of the European public and financial markets. Ultimately they will help to provide the credibility needed for a more effective monetary policy. This was a key feature of the Government's new monetary policy framework.

[NB: The FT of 24 May 2001 quotes the Chancellor as stating that the eurozone has "the ECB and its fiscal and monetary rules. We have our own fiscal and monetary rules. All this has to be taken into account when we look at the Five Tests."]

"A successful single currency": is this a sixth test for UK membership?

As the Chancellor said to the Treasury Select Committee in July 2000, "the success of the euro is implicit in the five domestic tests that we are applying."

As the Chancellor made clear: "There is not a sixth test."

What do you mean by a successful single currency?

A successful single currency will act as a complement to the Single Market, reducing transaction costs and exchange rate uncertainty on trade within the euro zone. It will make prices more transparent, boosting competition and providing new opportunities for trade and investment.

A successful single currency will also deliver a zone of macroeconomic stability as a foundation for sustainable, non-inflationary growth. It will reduce the damaging effects of volatility on investment, employment and, ultimately, economic prosperity.

What do you mean by convergence?

As the Chancellor said in his October 1997 statement, the most critical test is convergence; whether we can "be confident that the UK business cycle has converged with that of other European countries so that the British economy can have stability and prosperity with a common European monetary policy".

As the Chancellor also made clear, "that convergence must be capable of being sustained and likely to be sustained – in other words, we must demonstrate a settled period of convergence."

Independent estimates suggest the cost of entry to the euro could be as much as £36 billion? Why has the Government not made its own estimate of the costs of entry?

There are no reliable estimates of cost. Producing estimates would distract from real planning work and could not be done without placing an unnecessary burden on business.

ECONOMICS

Why join EMU with the UK economy doing so well?

The Government has said it will only recommend joining a successful single currency if it is in our national economic interest and the economic case for the UK joining is clear and unambiguous.

As the Chancellor said in his Mansion House speech of June 2001, "In principle British membership of a successful single currency offers us obvious benefits - in terms of trade, transparency, costs and currency stability" and "could help us create the conditions for higher and more productive investment and greater trade and business in Europe". Half of our total trade is with Europe – with almost three million jobs affected.

What are the potential benefits to the UK of EMU membership?

As the Chancellor said in his Mansion House speech of June 2001, "In principle British membership of a successful single currency offers us obvious benefits - in terms of trade, transparency, costs and currency stability" and "could help us create the conditions for higher and more productive investment and greater trade and business in Europe". Half of our total trade is with Europe – with almost three million jobs affected.

However, as the Chancellor also said in his Mansion House speech, "to join in the wrong way or on the wrong basis without rigorously ensuring the tests are met, would not be in the national interest. Such a course would risk repeating past failures, would prejudice our stability and would be damaging for investment, business and jobs generally."

What are the economic implications of Britain's membership of the EU?

To be part of Europe is in our national interest:

Europe is fundamental to the UK economy. Around 3 million jobs are directly and indirectly affected by our economic ties with Europe. Over 50% of our total trade is with the EU - the EU is an extremely important trade and investment partner.

Economic reform is crucial to Europe's future success. The Government is determined to play a positive and constructive role within Europe, helping to deliver that reform. All member states now recognise the importance of reform.

Britain is stronger with the US because of our relationship with Europe.

How many UK jobs are dependent on UK membership of the European Union?

It is estimated that around 3 million jobs in the UK are linked, directly and indirectly, to the exports of goods and services to the European Union from the UK.

BEPGS

Does the Government support the BEPGs process?

The BEPGs are at the centre of the economic policy coordination process in the EU, incorporating the budgetary policy within the framework of the Stability and Growth Pact and Structural Reforms.

The BEPGs are centred upon, and give operational content to, the conclusions of the Lisbon and Stockholm Special European Councils.

We welcome the focus on the medium and long-term implications of structural policies and on reforms aimed at promoting economic growth potential, employment and social cohesion, as well as on the transition towards a knowledge based economy and policies for sustainable development.

UK welcomes the BEPGs approach to structural reforms. Positive and important contribution to take forward EU economic reform agenda started at Lisbon. Must keep up momentum if EU is to match its aspiration of being "....the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth and more and better jobs and greater social cohesion".

So especially welcome overall focus on invigorating EU labour markets, where clearly more needs to be done - Government strongly believes that a job is the best safeguard against social exclusion. Also, agree with emphasis on completing the Single Market and raising EU R&D and innovation performance.

What is the Government's view of the 2001 BEPGs?

The Government is content with the BEPGs as agreed by European Council at Göteborg and adopted by ECOFIN. Now adopted, the BEPGs provide the reference text for the Commission and Council to monitor economic developments within the EU and Member States.

The BEPGs are non-binding on Member States. Article (189) of the Treaty states that 'recommendations and opinions shall have no binding force'.

On **parliamentary involvement**, The Government remains fully committed to the scrutiny process. As such, we have fulfilled our commitments to Parliament over the last year.

On the **Budgetary recommendations**, as part of the ongoing debate the Chancellor has called for an intelligent interpretation of the SGP which recognises the contribution of public investment to growth and employment.

Government's two fiscal rules, the Golden rule and the Sustainable Investment rule are the most appropriate for the UK, ensuring sound and sustainable public finances while enabling increased investment in priority public services. UK has one of the lowest levels of debt in the EU - it is right to borrow modestly to fund much needed capital spending on public infrastructure.

The UK has made it clear that the Commission had exceeded its remit in proposing a UK-specific guideline that the expected ratio of UK public sector current expenditure to GDP should not exceed 37.3 per cent. This guideline was subsequently removed from the final BEPGs adopted by the Council. Decisions on the level of public spending are for member states, and the Government's fiscal rules ensure sound and sustainable public finances while enabling increased investment in priority public services.

The Council Opinion on the 2000 UK Convergence Programme confirms that the UK is meeting its obligations under the Stability and Growth Pact and has delivered a sound, stable, macroeconomic performance.

The move into deficit in the medium term entirely results from a more than doubling of net investment over the next three years, in schools, hospitals and law and order, to redress long standing under investment in key public services.

The Government, by increasing investment as a share of GDP for a transitional period, is acting firmly in accordance with the current Broad Economic Policy Guidelines (BEPGs).

On **economic reform recommendations** UK broadly accepts own key issues identified by Commission. Pleased that Commission recognises that UK's labour market is among the strongest in the EU, that liberalisation of our markets is well advanced, and that our financial markets remain the most developed in the EU.

But Government not complacent and recognises more can be done. As identified by the Commission, accepts that productivity performance still lags our leading competitors, and that social exclusion persists in some areas.

Committed to meeting these challenges and taking forward economic reforms that will raise the employment and productive potential of the economy. Will therefore continue to implement policies to raise employment, combat social exclusion, and raise productivity.

The BEPGs criticise the Government's fiscal policy?

UK has a strong fiscal position which is delivering economic stability.

Public finances in strong surplus; Budget 2001 shows net lending £16bn for 2000-01 (up £6 billion on convergence programme estimate), and Govt remains on track to meet its strict fiscal rules over the cycle. The current budget is projected to remain in surplus over the next five years and net debt will be held at a stable and prudent level.

Projections do show a move into deficit in medium term. This is only because net investment is more than doubling over the next three years to redress long standing under investment in key public services. Some borrowing for investment is sensible given years of neglect on this score.

The Government, by increasing investment as a share of GDP for a transitional period, is acting firmly in accordance with the current BEPGs.

Projections are still consistent with the terms of the Stability and Growth Pact.

Government debt is well within the Treaty reference value and is one of the lowest in all Member States. Government deficit is also under the 3% reference value, remaining close to balance throughout the projection period.

Income tax will have to rise by 2p, or spending will have to be cut if the UK joins EMU?

The Government has said it will only recommend joining a successful single currency if it is in our national economic interest to do so, and if the economic case for the UK joining is clear and unambiguous.

REFERENDUM AND CONSTITUTIONAL ISSUES

What are the constitutional implications of EMU?

The October 1997 statement acknowledged that to share a common monetary policy with other States represents a major pooling of economic sovereignty. It also stated that if the economic benefits are clear and unambiguous, there is no constitutional bar to British membership of EMU.

The Government believes - as a matter of principle - that, if a decision to recommend joining is taken by Government, it should be put to a vote in Parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

Why not hold a referendum on membership now?

Such a fundamental question can only be asked on the basis of the facts and circumstances that prevail at the time at which the people are asked to decide. To hold a referendum now would mean asking the British people to speculate on future economic conditions. Any significant gap between a referendum and joining the single currency would undermine the conclusions of that referendum.

Why join EMU when opinion polls show it is so unpopular with the public in both Europe and the UK?

The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. The Government believes that, if a decision to recommend joining is taken by Government, it should be put to a vote in Parliament and then to a referendum of the British people.

How would the wording for a referendum be set?

The wording should be a matter for Parliament to decide. The question to be asked in any referendum will need to be considered as part of the legislation needed for a referendum to be held. It would then have to be certified by the independent Electoral Commission.

What happens if there is a positive referendum result?

This is a hypothetical question. However, the National Changeover Plan sets out the procedures which would have to be followed in the event of a positive referendum result.

First, the Government would be required to make a formal application to join EMU. Article 121 (ex 109j) of the Treaty would then require the ECB and the Commission to undertake convergence assessments of the UK economy and submit these to the EU Council. The Commission would also submit a recommendation on whether the UK fulfils the necessary conditions for adoption of the euro.

The Council, in the form of Heads of State and Government, would then assess, on the basis of these reports, whether the UK fulfilled the criteria for entry. The European Parliament would also be consulted. ECOFIN Ministers would then meet to make the final decision.

What happens if the result of a referendum is No?

The Government is not going to speculate on the outcome of the assessment, which will be completed within two years of the start of this Parliament.

How does the UK have a special status with respect to EMU?

UK has a special status agreed by all Member States (Protocol No.11 to the EC Treaty), referred to as an ‘opt-out’. This recognises that “the United Kingdom shall not be obliged or committed to move to the third stage of economic and monetary union without a separate decision to do so by its Government and Parliament”.

The present Government has exercised this opt-out, and so was not assessed against the conditions for EMU membership in the ‘first wave’ in May 1998, nor in the ‘second wave’ in May 2000.

Unless the UK Government notifies the Council of its intention to join the single currency, the UK is under no obligation to do so.

CONVERGENCE TEST

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

The UK is not sufficiently converged with the euro zone?

The Government will not give a running commentary on the Five Tests. The Government has said it will complete the assessment within two years of the start of this Parliament. Once the assessment is complete, the Government will publish the conclusions and the report.

The original 5 tests assessment recognised that the UK is not in line with many other European economies, and concluded that, joining the single currency in the first wave would mean accepting an interest rate that would not be appropriate for UK domestic circumstances.

The 5 tests assessment concluded that the UK needs a period of economic stability to demonstrate that convergence is sustainable. Our priority has been to put an end to the boom and bust instability of the past with sound macroeconomic policies.

How will you know that convergence is settled and sustainable?

As the Chancellor said in his October 1997 statement, the most critical test is convergence; whether we can "be confident that the UK business cycle has converged with that of other European countries so that the British economy can have stability and prosperity with a common European monetary policy."

As the Chancellor also made clear, "that convergence must be capable of being sustained and likely to be sustained – in other words, we must demonstrate a settled period of convergence."

Doesn't the example of Ireland show that a 'one-size fits all' monetary policy is doomed to fail?

The Government will only recommend joining the single currency if the economic case is clear and unambiguous.

FLEXIBILITY TEST

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

Is economic reform in Europe a sixth test for UK membership?

Not a sixth test. We have always underlined the importance of economic reform. As the October 1997 statement said: " To be successful in a monetary union, countries will need even more flexibility to adjust to change and to unexpected economic events once the ability of countries to vary their interest rates and exchange rates has gone and the euro and a single European interest rate are in place. "

The October 1997 statement also said: "Other European countries need to tackle unemployment and inflexibility to make sure Europe as a whole is able to withstand any shocks that arise. The Government will continue to argue that employability, flexibility and stronger competition must be a top priority so that monetary union can be successful. "

Government has said it will only recommend joining a successful single currency if it is in our national economic interest to do so.

Has EMU delivered benefits to participating Member States?

EMU has the potential to deliver significant benefits to its member countries by creating a zone of economic stability and acting as a complement to the Single Market.

In Britain's interest that EMU succeeds. Almost 50 per cent of our total trade is with the euro-area; the UK and the euro-area are extremely important trade and investment partners.

Euro is not a successful currency?

EMU has the potential to deliver significant benefits to its member countries by creating a zone of economic stability and acting as a complement to the Single Market.

In Britain's interests that the single currency succeeds. Almost 50 per cent of our total trade is with the euro area; the UK and the euro area are extremely important trade and investment partners.

INVESTMENT TEST

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

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

As the Chancellor said in his June 2001 Mansion House speech, "membership of a successful single currency could help us to create the conditions for higher and more productive investment in Britain."

But the worst case for investment would be for Britain to enter EMU without proper preparations and without sufficient convergence, and with all the uncertainty that would entail.

Not joining EMU means overseas investors will go elsewhere?

The UK remains Europe's premier investment location.

What matters for inward investment is stability. Inward investors understand that to join EMU without the necessary convergence would be a recipe for less stability not more.

The Government will take into account inward investment in deciding whether to recommend membership. Investment is one of the 5 economic tests.

Recent job losses in multinationals (e.g, Vauxhall, Fujitsu) show foreign investment drying up?

Appreciate these job losses are unwelcome. But they must be seen in context of UK's continued success in attracting FDI. 1999-00 was an all-time record for the number of UK inward investment success stories and in total these created or safeguarded over 132,000 jobs.

FINANCIAL SERVICES TEST

"What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?"

The City of London is prospering even though the UK is not in EMU, so why risk joining?

The City of London has performed well since the euro was launched. We strongly welcome this; it reflects the hard work and intense preparation carried out across the City before the launch of the euro with the support of the Bank of England.

We have never doubted the City's ability to prepare well and compete effectively. As the Chancellor said in his October 1997 statement: " We can now be confident that the industry has the potential to thrive whether the UK is in or out of EMU".

The strength of our financial services industry is vital to our economy. And the dynamic nature of the financial services industry means there can be no room for complacency. So it is right that we should include it as one of our five economic tests for EMU.

City will perform better outside EMU on account of less regulation and lower taxes?

In or out of EMU, fiscal policy and financial services regulation remain the responsibility of individual Member States.

The benefits that the City currently offers will ensure it is well placed to benefit from the euro whether or not the UK joins. But as the 5 tests assessment recognised, the benefits and new opportunities from the single currency may be easier to tap from within the euro area.

London will lose out as euro financial business gravitates to euro zone?

The Government recognises the importance of the financial services sector to the UK. The 5 economic tests included an assessment of the impact of the single currency on the competitiveness of the City. The City enjoys a host of advantages, such as large and liquid markets, which will help to ensure it thrives on the euro whether or not the UK joins. London is already in an excellent position to compete for euro business.

EMPLOYMENT AND GROWTH TEST

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

Joining EMU would mean unemployment rising to European levels?

The Government has said it will only recommend joining a successful single currency if it is in our national economic interest to do so. The impact of membership on employment is one the Chancellor's 5 economic tests.

In addition to introducing a wide range of employment-creating measures in the UK, including New Deals and reforms to the tax and benefit system, the Government is committed to promoting further economic reform of Europe's labour markets to boost job creation in the EU. All Member States are now signed up to the importance of economic reform.

"Britain In Europe" estimate that 66,000 jobs were lost in the UK in 2000 due to currency volatility – isn't this an argument for joining the euro?

Unemployment in the UK is at its lowest level for around 20 years. The Government has said it will only recommend joining a successful single currency if it is in our national economic interest to do so. The impact of membership on employment is one of the 5 economic tests.

EXCHANGE RATES

Despite its recent rebound, the euro is a fundamentally weak currency?

Not appropriate for the Government to comment on day-to-day developments in the foreign exchange market.

Why spend taxpayer's money on supporting the euro?

The first Euro intervention of September 2000 was a co-ordinated move by the G7 authorities.

As a G7 member, the UK shared in the concern about the potential implications of the euro exchange rate for the world economy.

A stable global financial system is important for the health of the UK economy.

Recent intervention shows that the UK is planning to join EMU?

The G7 co-ordinated intervention has no bearing on the Government's policy on membership of EMU.

Government policy on membership of the single currency remains as set out by the Chancellor in his October 1997 statement.

The determining factor underpinning any Government decision is whether the economic case for the UK joining is clear and unambiguous.

Will there be further intervention?

Not appropriate for the Government to comment on exchange-rate intervention.

What would be the entry rate for sterling? Is the exchange rate a sixth test for UK membership?

The Government has said that the rate at which sterling would enter the single currency would need to be consistent with economic fundamentals in the UK and compatible with sustainable convergence between the UK and other euro area economies.

There is no sixth test. The Chancellor has said that the subject of the exchange rate will be addressed in the assessment of the Five Tests.

[NB: The FT of 30 May 2001 reports: “Mr Brown said the subject of the exchange rate would be addressed in the assessment of the five economic tests when the Treasury measures whether “settled and durable convergence” has been achieved.]

Will the Government take steps to lower the value of the pound ahead of possible entry to the single currency?

Previous UK experience has shown that an artificial exchange rate target can be counter-productive, and lead to less not more stability.

The Government believes in a stable and competitive exchange rate for the medium term. The exchange rate will, over time, reflect the fundamentals.

The Government has said that the rate at which sterling would enter the single currency would need to be consistent with economic fundamentals in the UK and compatible with sustainable convergence between the UK and other euro-area economies.

[NB: In his James Meade speech in May 2000 the Chancellor stated that: “such a euro-sterling exchange rate cannot be justified by any view of long-term economic fundamentals.” At this time the euro was trading at around US$0.90 and £0.60.]

[NB: In May 2000 the Eurogroup stated: “we share a common concern about the present level of the euro which does not reflect the strong economic fundamentals in the euro area.” At this time the euro was trading at around US$0.90 and £0.60.]

[NB: In his June 2000 Mansion House speech, the Chancellor stated: “the policies which [we are] sometimes asked to follow to bring the exchange rate down or even set an exchange rate target alongside the inflation rate target would today risk … a return to stop-go.” At this time the euro was trading at US$0.95 and £0.63.]

[NB: On 23 September 2000 following intervention to support the euro the G7 stated that they: “shared concern … about the potential implications of recent movements in the euro for the world economy.” At the time of the G7 intervention, the euro was trading at around US$0.85 and £0.60.]

[NB: The FT of 30 May 2001 quotes the Chancellor: “we want a stable and competitive exchange rate for the medium term. The exchange rate will, over time, reflect the fundamentals.”]

[NB: The FT of 30 May 2001 quotes the Prime Minister: “we should not take any risks with economic stability. There should be no real artificial devaluation of our currency.]

When would the Government negotiate an entry rate for sterling? Would the entry rate be known in advance of a referendum?

These are important issues which would have to be considered in the event that the Government made a decision to join EMU.

In these circumstances the Maastricht Treaty and the UK Protocol set out the formal position that if the UK were to reverse its opt-out "the Council shall, acting with the unanimity of the Member States without a derogation and the Member State concerned ... adopt the rate at which the [euro] shall be substituted for the currency of the Member State concerned."

How does the euro's value affect your decision to join?

The Government has said it will only recommend joining a successful single if it is in the national economic interest and if the economic benefits to the UK, from joining, are clear and unambiguous.

Turn-around in the value of the euro provides an opportunity for the UK to join?

The Government has said it will only recommend joining a successful single currency if the economic benefits to the UK, from joining, are clear and unambiguous.

How will you decide at what rate sterling should enter?

The Government has said that the rate at which sterling would enter the single currency would need to be consistent with economic fundamentals in the UK and compatible with sustainable convergence between the UK and other euro-area economies.

The UK will have to join the ERM2 to join EMU?

The Government has no intention of rejoining the ERM.

The Government accepts that exchange rate stability is one of the Treaty criteria for assessing membership of EMU. The Government believes that, as recognised by several European Councils, what matters for exchange rate stability is sound economic fundamentals. As the Luxembourg European Council stated on 13 December 1997 "in general exchange rates should be seen as the outcome of all other economic policies". The best way to achieve this is through the monetary and fiscal frameworks we have put in place.

- ***Sweden has not qualified for EMU because of non-membership of the ERM?***

The May 1997 European Council decided that Sweden did not qualify for EMU EMU membership. This decision reflected a range of factors used to assess the case for membership, including the exchange-rate criterion, and incompatibility of national legislation – including the statutes of the central bank – with the Treaty requirements.

Danish and Greek participation in ERM2 shows that you will have to join too?

The Government has no intention of rejoining the ERM. Our EU partners understand this. Amsterdam European Council resolution on the ERM2 stated very clearly that "participation in the exchange rate mechanism will be voluntary for the Member States outside the euro-area."

How will you achieve exchange rate stability now that Bank is independent and working to a domestic monetary policy target?

The Government's policy is for a stable and competitive pound over the medium term. Sound fundamentals are what matters for exchange rate stability. Our new fiscal and monetary policy frameworks will help deliver the macroeconomic stability which is vital for a stable exchange rate.

When would the Government negotiate an entry rate for sterling? Would the entry rate be known in advance of a referendum?

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In these circumstances the Maastricht Treaty and the UK Protocol set out the formal position that if the UK were to reverse its opt-out "the Council shall, acting with the unanimity of the Member States without a derogation and the Member State concerned ... adopt the rate at which the [euro] shall be substituted for the currency of the Member State concerned."

Is ERM membership a precondition for EMU?

The Government accepts that exchange rate stability is one of the Treaty criteria for assessment of EMU membership.

The Government believes that exchange rate stability can only be achieved on the basis of sound economic fundamentals, in particular low and stable inflation, steady and sustainable growth and sound public finances. The exchange rate should therefore been seen as the outcome of all other economic policies.

- The Government has never believed that the Treaty provisions on the ERM could be applied mechanically, given the changes that have occurred since the Treaty was agreed in 1991.

EURO-GROUP

Is the Euro-Group an example of the UK losing influence?

We have always recognised that 'Ins' will want to meet from time to time to discuss certain issues to do with sharing a currency. The Luxembourg European Council agreed this; we have no problems with it.

But important to remember that ECOFIN is the sole decision making body on economic policy co-ordination and that, whenever matters of common interest are discussed by the Euro-Group, all Member States will be present. The Luxembourg European Council made this quite clear.

The UK is already playing an active role in helping to shape the European agenda. The leading part played by UK at the Special European Council in Lisbon is a case in point. Government's positive approach to Europe means we are able to play a full part in shaping EU policies.

What do you think of Commission plans to develop the role of Euro-Group?

We stand by the 1997 Luxembourg Council inter-governmental deal on appropriate areas of work for the Eurogroup, and would resist any attempt to re-open it. This Commission Communication has to be seen in the context of the way Eurogroup has evolved to date: inter-governmental and informal.

To the extent that developments in the Eurogroup are about better informal organisation, and about better visibility - including better communications between Eurogroup, the ECB and the markets - we are very much in favour.

But it is quite clear that the Treaty assigns the central role in economic policy co-ordination to ECOFIN.

We will remain very vigilant and resist anything that threatens ECOFIN's status and lead decision-making role. Important that ECOFIN and the Euro Group should work well together.

What issues will the 'Ins' discuss without us ?

The Luxembourg Council conclusions are quite clear on this: participating Member States will only discuss issues connected with shared specific responsibilities for the single currency.

What is the remaining role for the Council of Ministers given Euro Group's growing status?

ECOFIN remains the sole decision making body on EU economic policies. As the Luxembourg Agreement of December 1997 states, "Under the terms of the Treaty, the ECOFIN Council is the centre for the coordination of Member States' economic policies and is empowered to act in the relevant areas."

The Nice Council conclusions made clear that all work of the Euro Group must be undertaken "with due regard to the Luxembourg Conclusions".

ECOFIN's responsibility for the EU's Broad Economic Policy Guidelines (BEPGs) is a clear example of ECOFIN's continuing status at the centre of economic policy making in the EU.

Eurogroup discussing more and more issues outside of their specific responsibilities; focus on fiscal policy coordination a clear example of this?

The Luxembourg Council Conclusions are quite clear on areas of Eurogroup responsibilities: participating Member States will only discuss issues connected with shared responsibilities for the single currency.

What do you think of Nice Conclusions for Eurogroup to discuss structural issues?

UK welcomes the Euro Group focussing on structural policies. Structural reforms are a key element of a successful single currency, and therefore right that euro area Ministers discuss them.

But we will remain very vigilant and resist anything that threatens ECOFIN's status and lead decision-making role. Important that ECOFIN and the Euro Group should work well together.

SECOND WAVE

Did the UK agree that Greece was a suitable candidate for EMU?

The UK welcomes the achievement by Greece of the conditions necessary for the adoption of the single currency on 1 January 2001. The decision on Greek membership was taken by the ECOFIN Council of EU Finance Ministers in the margins of the Feira European Council in June 2000.

Why has Sweden not qualified for EMU?

The May 1997 European Council decided that Sweden did not qualify for EMU EMU membership. This decision reflected a range of factors used to assess the case for membership, including the exchange-rate criterion, and incompatibility of national legislation – including the statutes of the central bank – with the Treaty requirements.

How does the Danish result affect the Government's policy on EMU?

Danish membership of EMU a matter for the Danish people. The outcome has no bearing on the Government's policy towards UK membership of the single currency.

Does the Danish "No" vote make UK membership less likely?

The Government will only recommend membership if it is in the national economic interest and the economic case for the UK joining is clear and unambiguous.

If Denmark can succeed outside of euroland, then so can Britain?

The Government will only recommend membership if it is in the national economic interest and the economic case for the UK joining is clear and unambiguous.

Not for the Government to comment on the Danish vote. The decision on Danish membership is a matter for the Danish people.

How does the UK's opt-out position compare to the positions of Sweden and Denmark?

Denmark also has a special status defined under the Maastricht Treaty. But Denmark's Protocol provides for a more limited opt-out than that of the UK.

Sweden does not have an opt-out, but instead has a derogation. Derogations are temporary and presuppose that the Member State will join the single currency at a future point in time, when the Council assesses the conditions for membership have been fulfilled.

EUROPEAN CENTRAL BANK

Is the ECB's lack of clarity, accountability and transparency an obstacle to UK membership of EMU? Is it a sixth test for entry?

The Government's policy on EMU membership is clear: the key factor is whether the economic case for joining is clear and unambiguous. There is no sixth test related to the ECB.

We believe that high levels of transparency and accountability are very important. Openness and transparency are key to ensuring the ECB gains the trust of the European public and financial markets. Ultimately they will help provide the credibility needed for a more effective monetary policy. This was a key feature of the Government's new monetary policy framework.

What is the Government's view of performance of the ECB so far?

We share the ECB's primary objective of ensuring price stability as a platform for high and stable levels of growth and employment.

We agree that the ECB must ensure that decisions are as transparent as possible and we welcome the efforts the ECB has made so far.

We welcome the ECB's approach to openness and transparency - with press releases, monthly bulletins, staff projections etc - which is more open than some of the euro zone central banks used to be. We recognise the ECB has already gone further than people expected when the Treaty was signed.

We believe that high levels of transparency and accountability are very important. Openness and transparency key to ensuring the ECB gains the trust of the European public and financial markets. Ultimately will help provide the credibility needed to deliver a more effective monetary policy. This was a key feature of Government's new monetary policy framework.

Recognise that no one single approach suits all circumstances. ECB framework takes into account the requirement to co-ordinate monetary policy over a number of member states.

Should the structure of the ECB Governing Council be adjusted in advance of enlargement of the EU?

The future of the ECB Governing Council post-enlargement is an important issue. The Nice Treaty proposes changes to the ECB's Statute to allow the composition of the ECB's Governing Council to be amended by the Council, acting unanimously. Previously, a separate IGC was needed for any changes to the statutes. Any such change would, though, still need to be ratified by all Member States; in the UK this would involve the national Parliaments.

FISCAL AND TAX ISSUES

The UK will have to pay for other countries' unfunded pension liabilities?

British taxpayers will not make payments to the Community or to other member states to pay for other countries' pension liabilities, whether or not we join EMU. The Treaty guarantees this.

Rules on excessive deficits and the Stability and Growth Pact mean that participating Member States will not be able to finance their pension liabilities through excessive borrowing. They will have to cut spending or raise contributions.

Why did you agree to QMV on Article 100 of the EC Treaty at Nice? This article could be used as the base for an EMU bail out fund.

There is no question of Article 100 being used for an EMU bail-out fund. Article 103 of the EC Treaty explicitly rules out bail outs of this nature. The UK ensured that an explicit commitment was added to the Nice proposal on Article 100, which makes clear that any decision taken under Article 100 will not lead to an increase in EU spending.

History shows that monetary unions will always lead to fiscal unions?

No reason why EMU should lead to a fiscal authority in Europe. Idea of a fiscal authority or centralised system of fiscal transfers not on the agenda and no Member State arguing that it should be.

In EMU, fiscal policy remains the responsibility of individual governments, subject to the avoidance of excessive deficits. Member States retain considerable flexibility to operate national fiscal policies to balance their economies.

Is the EU Stability and Growth Pact binding on the UK?

Not being a member of the single currency, the Stability and Growth Pact does not place any new legal obligations on the conduct of UK economic policy. For as long as the UK is outside EMU, we will not be *obliged* to avoid excessive deficits (NB but we should *endeavour* to avoid excessive deficits).

But the UK plays a full part in the Stability and Growth Pact's peer review process and the Government's fiscal policy is fully consistent with the Pact.

- ***EMU inevitably means tax harmonisation?***

Nonsense. Tax policy will remain responsibility of Member States. US has a single currency, but no harmonisation of sales, corporation or income tax rates.

In EMU, fiscal policy remains the responsibility of individual governments, subject to the avoidance of excessive deficits. A centralised system of fiscal transfers in EMU is not on the agenda, and no member state is arguing that it should be.

Any changes to this position would require the unanimous agreement of all member states. There is no question of the UK giving up its ability to make decisions on tax and spending. These will remain matters for UK Budgets and spending reviews.

European Commission report says that European Union states have reached broad agreement on common rules governing national tax cuts?

Tax policy remains the responsibility of Member States. Any changes to this position would require the unanimous agreement of all Member States. No question of the UK giving up its ability to make decisions on tax and spending.

The Government welcomes the Commission paper on public finances, which is wholly consistent with out own fiscal policy framework. Paper is a technical document, which is non-binding on Member States.

What happens if participating Member States countries harmonise taxes and make harmonisation a condition of UK entry to EMU ? (Flexibility articles agreed at Amsterdam allow EMU 'Ins' to harmonise taxes. UK will have to follow suit if we join EMU?)

The conditions required to join EMU are set out in the Treaty. To change them requires unanimity.

The Treaty makes no distinction between initial and later participants regarding the conditions necessary to join the single currency. Harmonisation of taxes was not considered to be a necessary condition for membership in the first wave.

GOLD SALES

Recent decision to sell Gold shows Government preparing for EMU?

The recent restructuring of the UK's reserves is a prudent decision to reduce the share of gold and increase the share in interest-bearing foreign currency assests. Lowering the proportion of the UK's net reserves which is held in gold should achieve a better balance in the portfolio.

The UK has not transferred any foreign exchange or gold reserves to the ECB and would not be required to do so unless and until we joined the single currency. If the UK enters EMU, the Bank of England would contribute to the foreign currency and gold reserves of the ECB. But in return it would receive a claim on the ECB equivalent to this contribution. There is nothing to prevent EMU countries from continuing to hold gold if they have more than they need to make their ECB contribution.

Would the adoption of the euro in the UK involve the physical movement of any proportion of UK gold reserves to the European Central Bank?

In accordance with the Treaty, if the UK joined EMU, the Bank of England would be required to contribute to the foreign reserve assets of the ECB, including gold.

The Bank of England would be credited by the ECB with a claim equivalent to its contribution, which would be renumerated. The ECB has the right to hold and manage the foreign reserve assets that are transferred to it, but physical movement is not necessary for these purposes.

EURO PREPARATIONS

What is the Government doing to help business prepare for the euro as a new international currency?

Important that all firms consider the impact of the euro on their business, whether we are in or out of the single currency. The euro is now a reality in Europe.

The Government is committed to helping UK businesses, particularly SMEs, adjust to the reality of the euro in the first wave. Around three quarters of a million small firms have links with Europe and all of them could be affected by the euro.

The Government is helping business to consider the impact of the euro by:

- **Providing business with essential information** - This includes dealing with requests for 400,000 sets of factsheets and distributing 1½ million leaflets. Business to business case studies have been published across a range of sectors, from machine tools to retail.

- **Ensuring the public sector is able to respond to business** use of the euro - firms can pay taxes, file accounts, issue and redenominate shares, have the option to receive certain agricultural grants and grants under Regional Selective Assistance (RSA), aimed at internationally mobile projects, in euro. Customs have a programme to ensure they can deal with enquiries and deliver services in euro to the business community.

- **Taking forward activity at a local level** - through 12 regional Euro Forums across the UK. Chaired by prominent local business people, they are providing local support and advice to help businesses prepare for the euro.

What is the Government doing to prepare for possible UK membership of the single currency?

Need to prepare now to have a genuine choice early in the next Parliament.

The Government has coordinated two Outline National Changeover Plans in close consultation with the business community and the wider public sector. They set out how the UK is preparing for the possibility of joining the single currency. They provide a framework for the private, public and voluntary sector organizations involved in planning.

The second Outline National Changeover Plan, published in March 2000, showed that through making targeted preparations, the UK has maintained the option to make a decision to join a successful single currency early in the next Parliament.

- Close attention is also being paid to the lessons and experiences of countries in the euro area.

The public sector is making targeted investments to build in euro compatibility as part of the ongoing modernisation of public sector systems. In particular legislation has been passed to allow Inland Revenue, HM Customs and Excise and DSS to spend up to £20m in 2000-01.

This is targeted investment to ensure that the UK could make a transition in a smooth and cost-effective manner, should a decision to join be taken.

Neither edition of the National Changeover Plan adequately addresses the issue of the cost of a changeover to the single currency. Independent estimates suggest the cost could be as much as £36 billion.

The first and second Outline National Changeover Plans are aimed at exploring the practical steps that would need to be taken were the UK to decide to join the single currency. They are not intended to be a cost benefit analysis of UK membership.

This planning work is based squarely on a consideration of what factors would contribute to a cost-effective changeover.

There are no reliable estimates of cost. Producing estimates would distract from real planning work and could not be done without placing an unnecessary burden on business.

NOTES AND COINS

If we joined EMU, Scottish and Northern Irish banks would not be able to continue issuing notes as they do now?

The Treaty makes clear that the issue of euro banknotes is subject to approval of the ECB Governing Council. This would include any banknotes issues by Scottish and Northern Irish banks.

The Government is aware of the importance the Scottish and Northern Irish banking associations attach to this issue. This would be an issue for negotiations were the UK to join EMU.

Large quantities of counterfeit euro notes and coins will enter circulation around the time of the euro changeover, while the public is unfamiliar with the authentic design?

The UK has been working along with all EU Member States to ensure that euro notes and coins are effectively protected from the threat of counterfeiting. ECOFIN has reached agreement on measures to protect the euro from counterfeiting.

The euro notes and coins feature a number of technical security features.

Joining the euro would mean losing the Queen's head from our notes and coins?

The design of the UK's euro notes and coins would be a matter for negotiation if we were to join EMU. Currently, each participating Member State has a national symbol on one side of its euro coins.

F

CONVERGENCE TEST

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

Preliminary and technical work[1] is:

- Updating evidence (from 1997 assessment) on cyclical behaviour of UK economy relative to that of euro area countries, and their relative responses to different shocks. Including collecting information on indicators like:
  - the output gap;
  - inflation;
  - interest rates;
  - the real effective exchange rate;
  - as well as updating and extending the analysis on issues of convergence.

- Considering the evidence on the sustainability and durability of convergence, including studying key structural features of the UK and euro area economies that might be a source of asymmetric cyclical responses in the future. Including:

  - Analysis of trade and investment linkages;
  - Behaviour of housing markets;
  - Sectoral composition of output;

---

[1] All taken from 4 November Treasury paper on 'Preliminary and technical work to prepare for the assessment of the five tests'

- Analysis of financial structures and of studies of the monetary transmission mechanisms of the UK and euro area economies.

- Considering the strength of arguments that closer convergence will develop over time, such as through the operation of a common monetary policy, or through stronger trade and investment linkages.

FLEXIBILITY TEST

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

<u>Preliminary and technical work</u> is:

- Focussed on compiling evidence on evaluating the mechanisms by which product, labour and capital markets adjust.

- Looking at how well and how quickly product, labour and capital markets work.

- Looking at the behaviour of the labour market including the degree of wage and employment flexibility.

- Looking again at the evidence for market flexibility in the UK economy as well as the position in other European countries following the drive to make progress on economic reform.

INVESTMENT TEST

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

The preliminary and technical work is:

- Considering the general impact both on investment and on foreign direct investment, including analysing the impact of the single currency on:
    - The cost and availability of capital;
    - Macroeconomic stability;
    - The stability of the real effective exchange rate;
    - The location, quantity and quality of private and public investment.

FINANCIAL SERVICES TEST

What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?

The preliminary and technical work is:

- Updating the analysis in the 1997 assessment, acknowledging that EMU will affect the financial services industry more immediately and more profoundly than other sectors of the economy;

- Making a detailed analysis of the changes that have already occurred in this sector in the UK and the euro area since the start of the single currency in 1999.

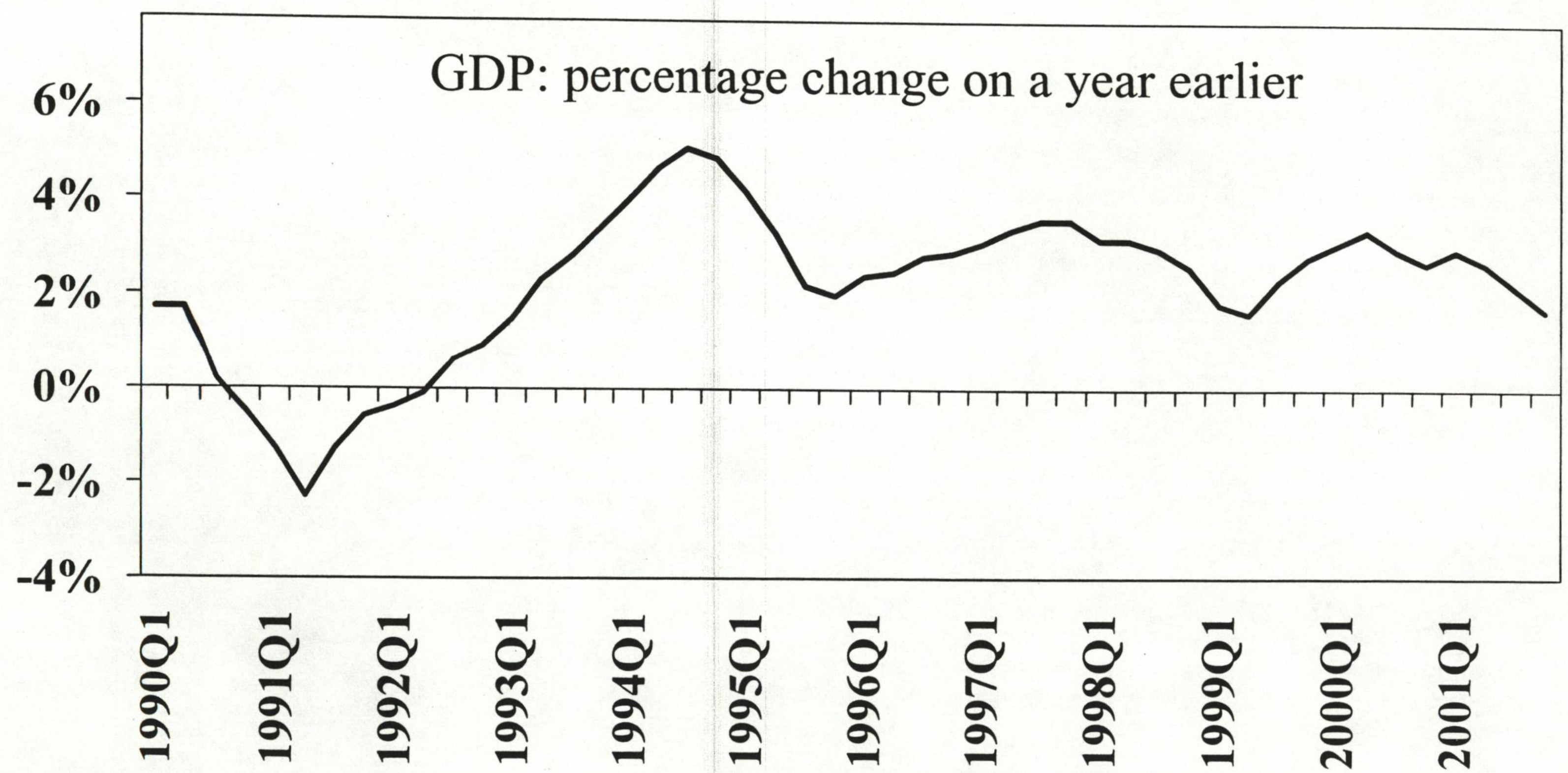
EMPLOYMENT TEST

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

The <u>preliminary and technical work</u> is:

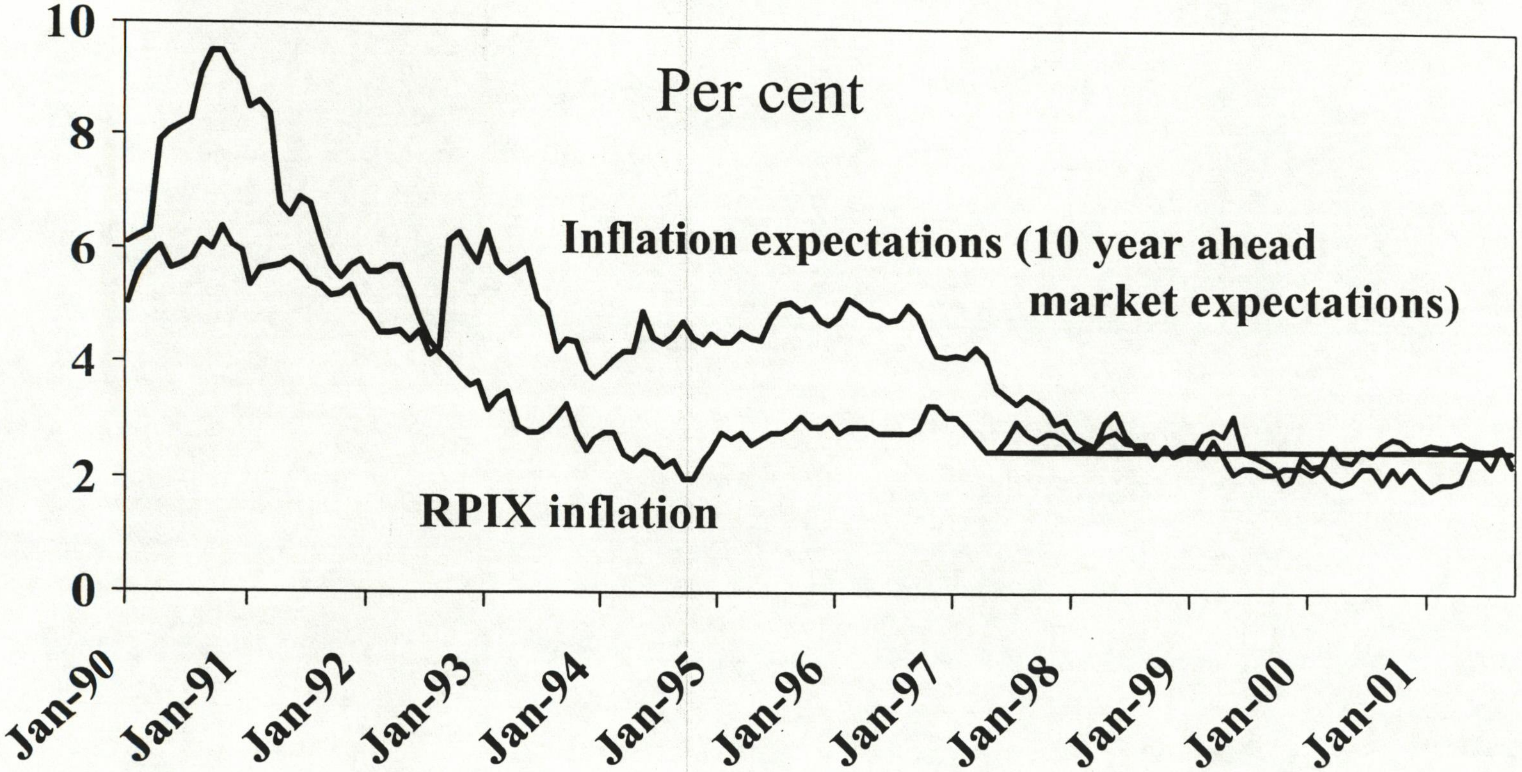
- Analysing the potential benefits of EMU for the longer-term performance of the economy. This includes:
  - An update of the analysis of the potential impact of the single currency on trade;
  - An update of the analysis of the potential impact of the single currency on competition;
  - An update of the analysis of the potential impact of the single currency on productivity;
  - A consideration of its potential sectoral and regional impact.

UK GDP Growth



Source: Office for National Statistics, February 2002

Inflation and inflation expectations

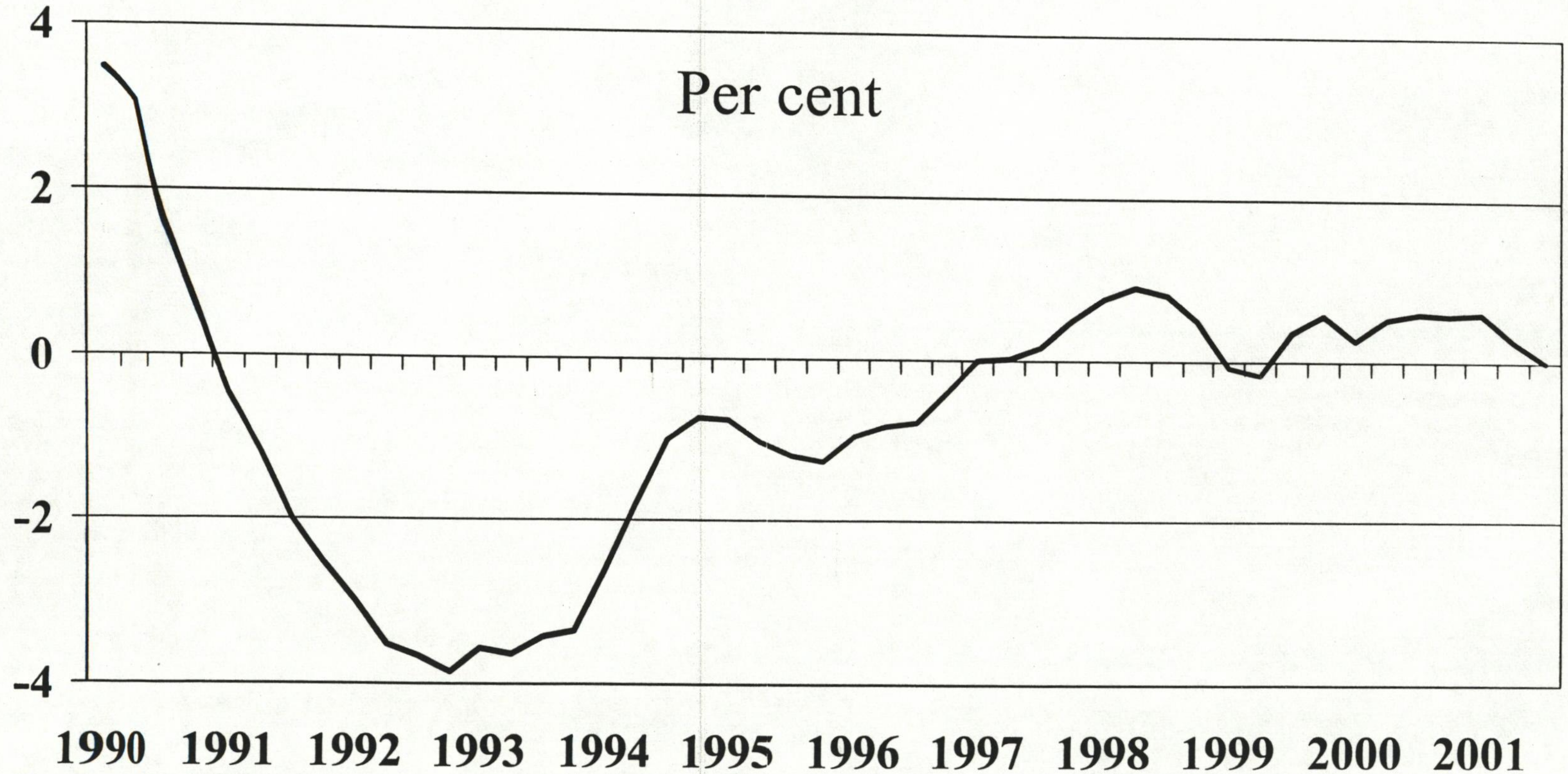


Source: Pre-Budget Report, November 2001

International comparisons

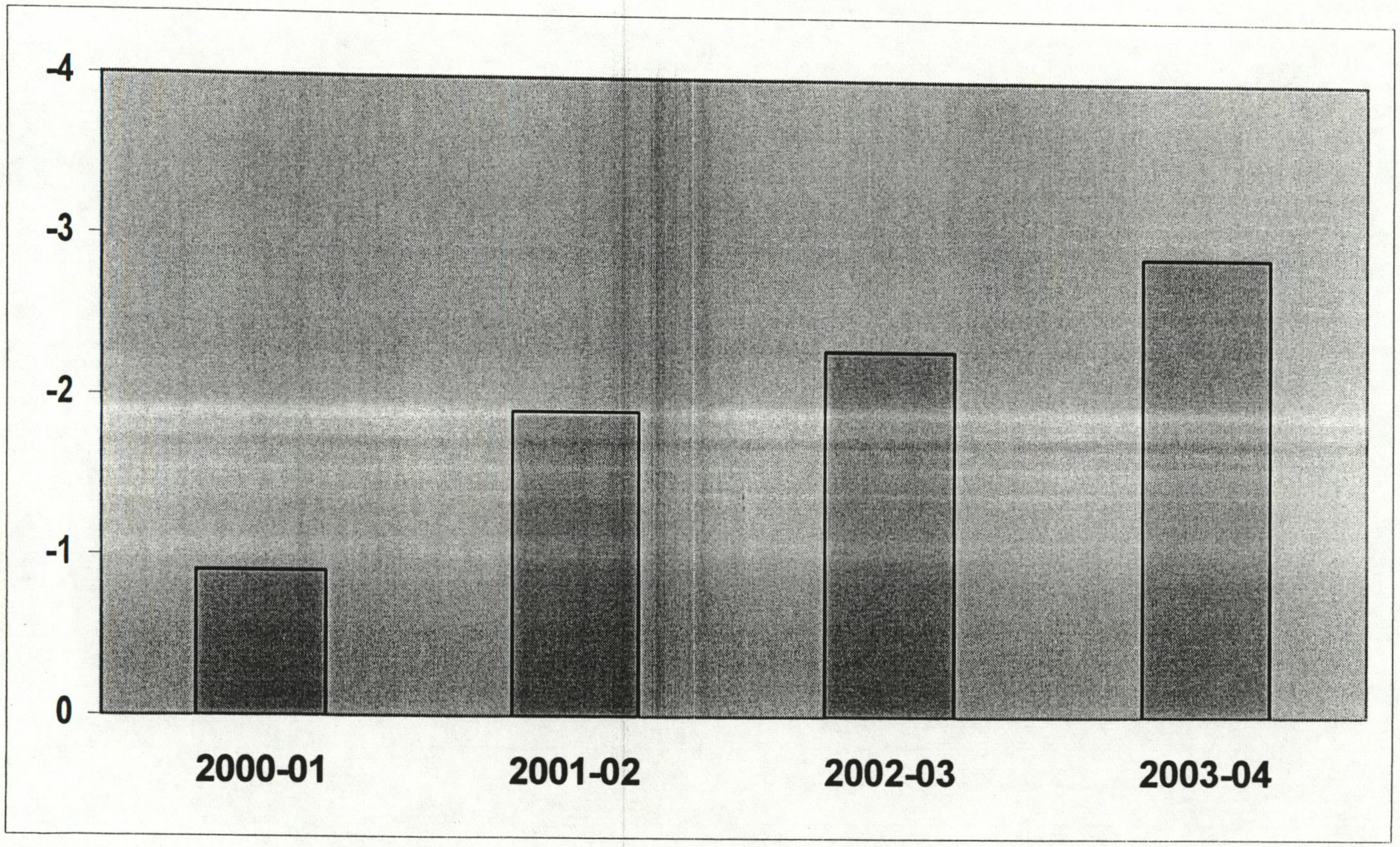
- UK was the **fastest-growing** G7 economy in 2001.
- UK **unemployment rate** is the lowest in the G7 – and significantly below the EU average.
- UK **inflation** is the lowest in the EU.
- UK **long-term interest rates** about level with those in Europe.

The output gap

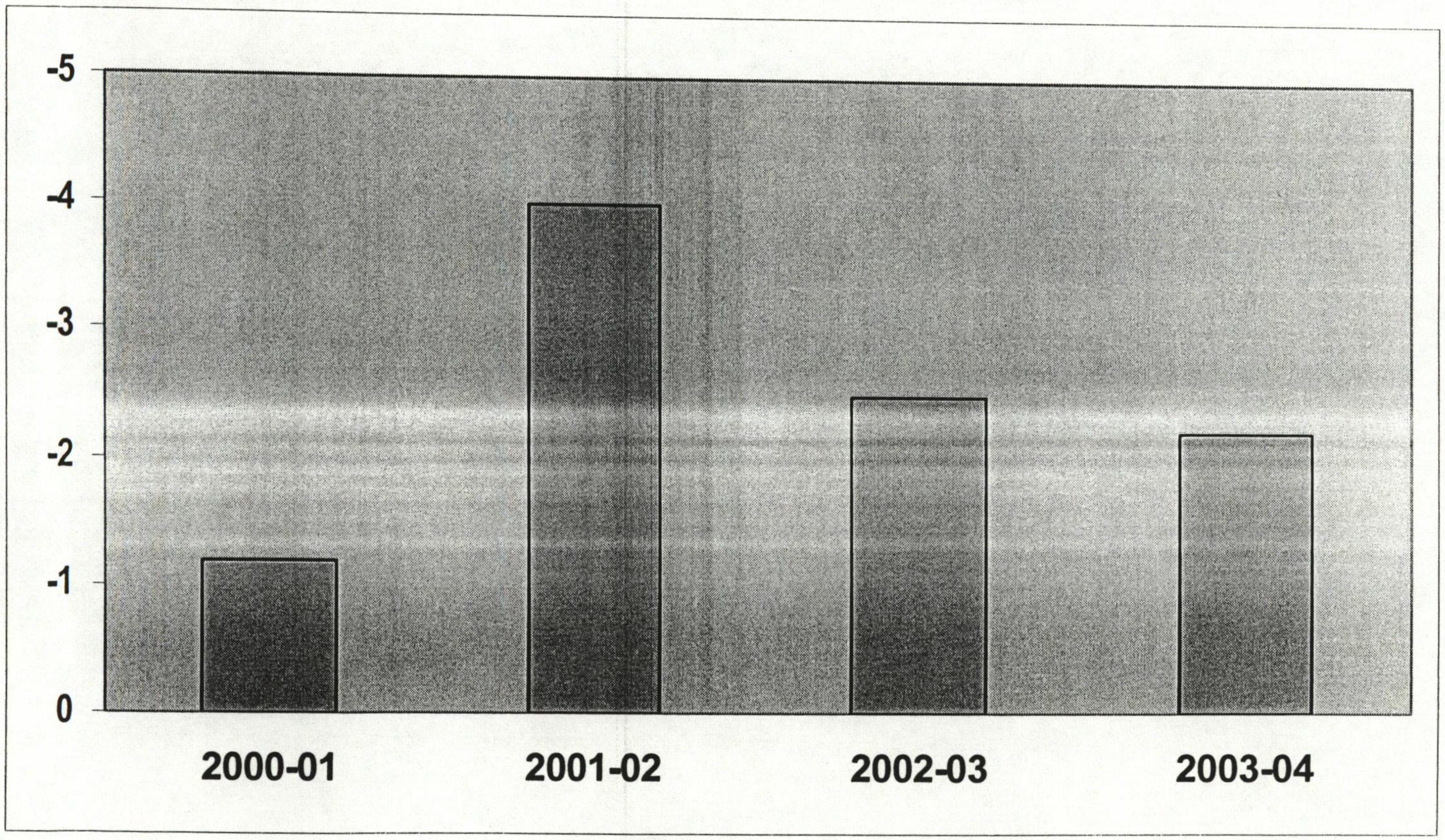


Source: Pre-Budget Report, November 2001

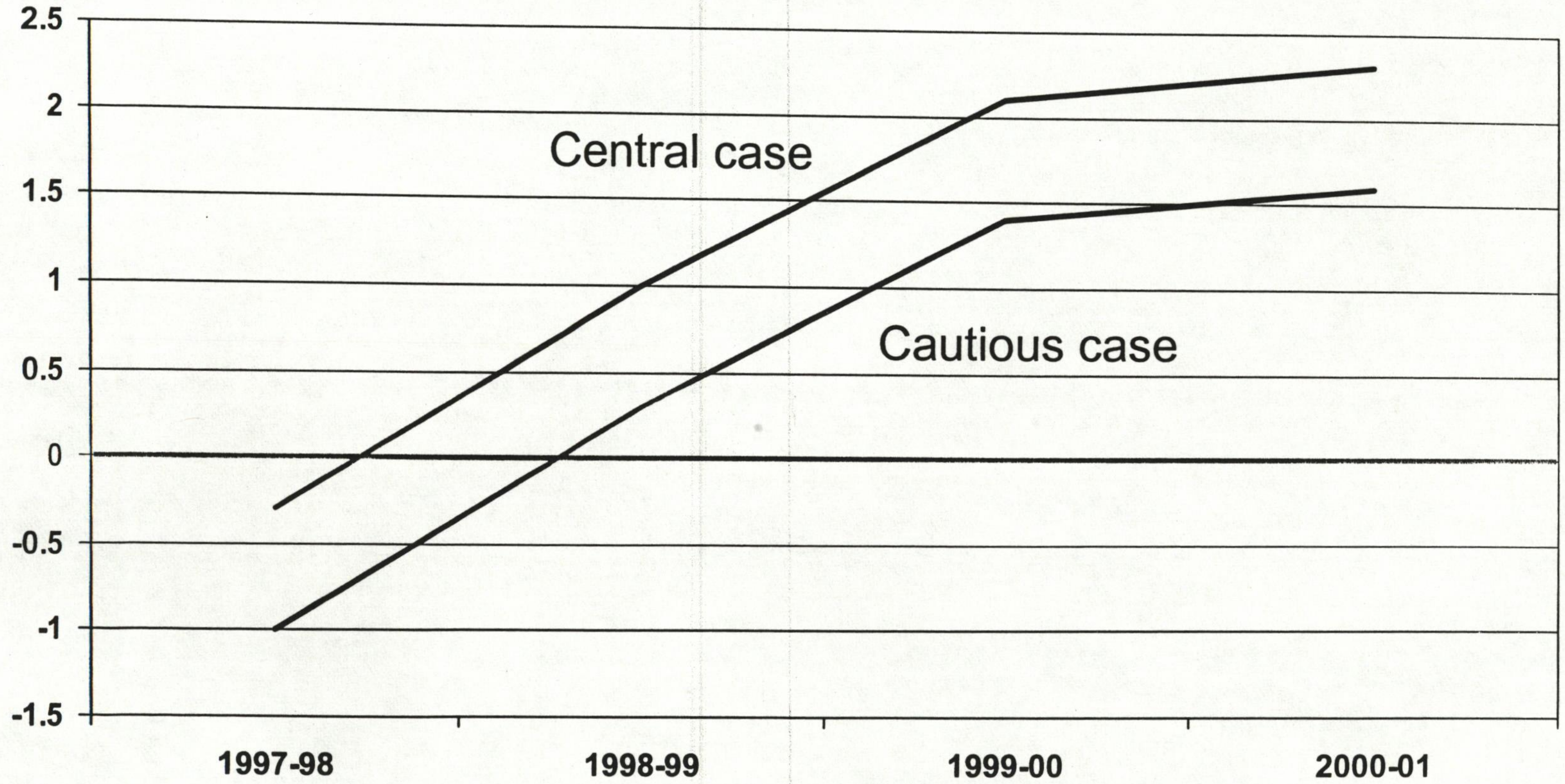
Unemployment: Savings
(£ billion)



Debt Interest: Savings
(£ billion)

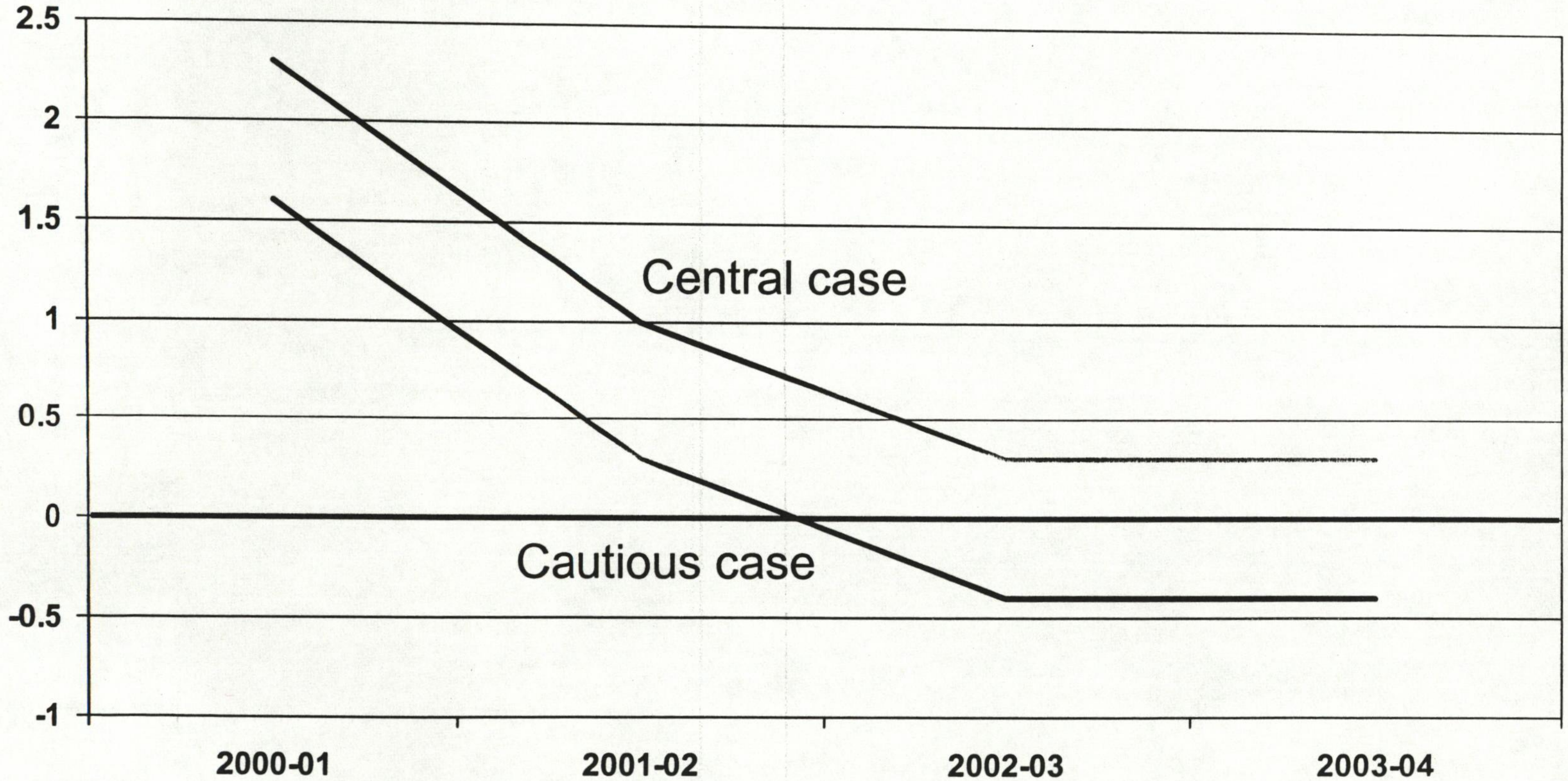


Golden Rule: 97-98 to present



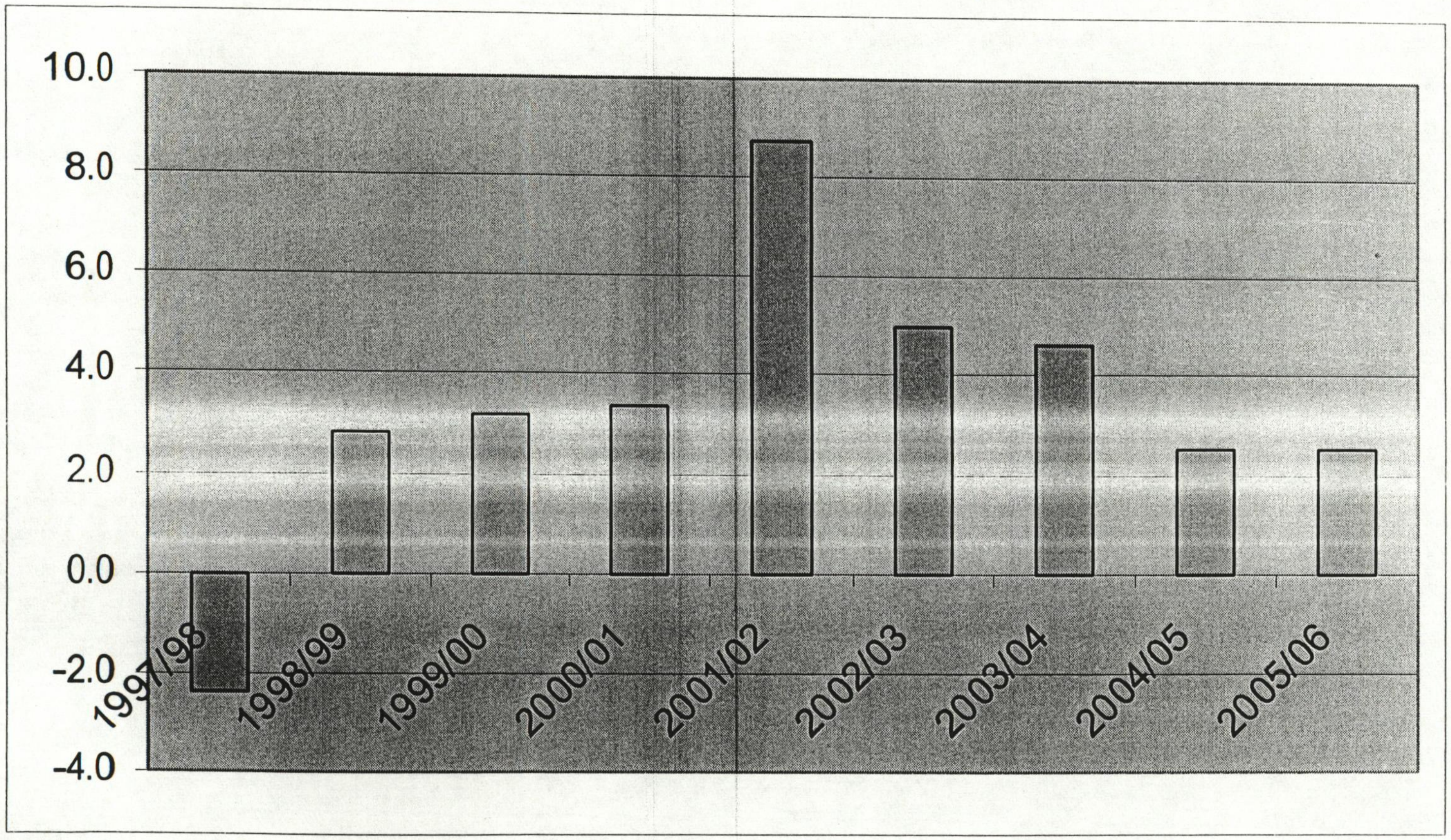
Cyclically-adjusted surplus on current budget – per cent of GDP

Golden Rule: present to 03-04

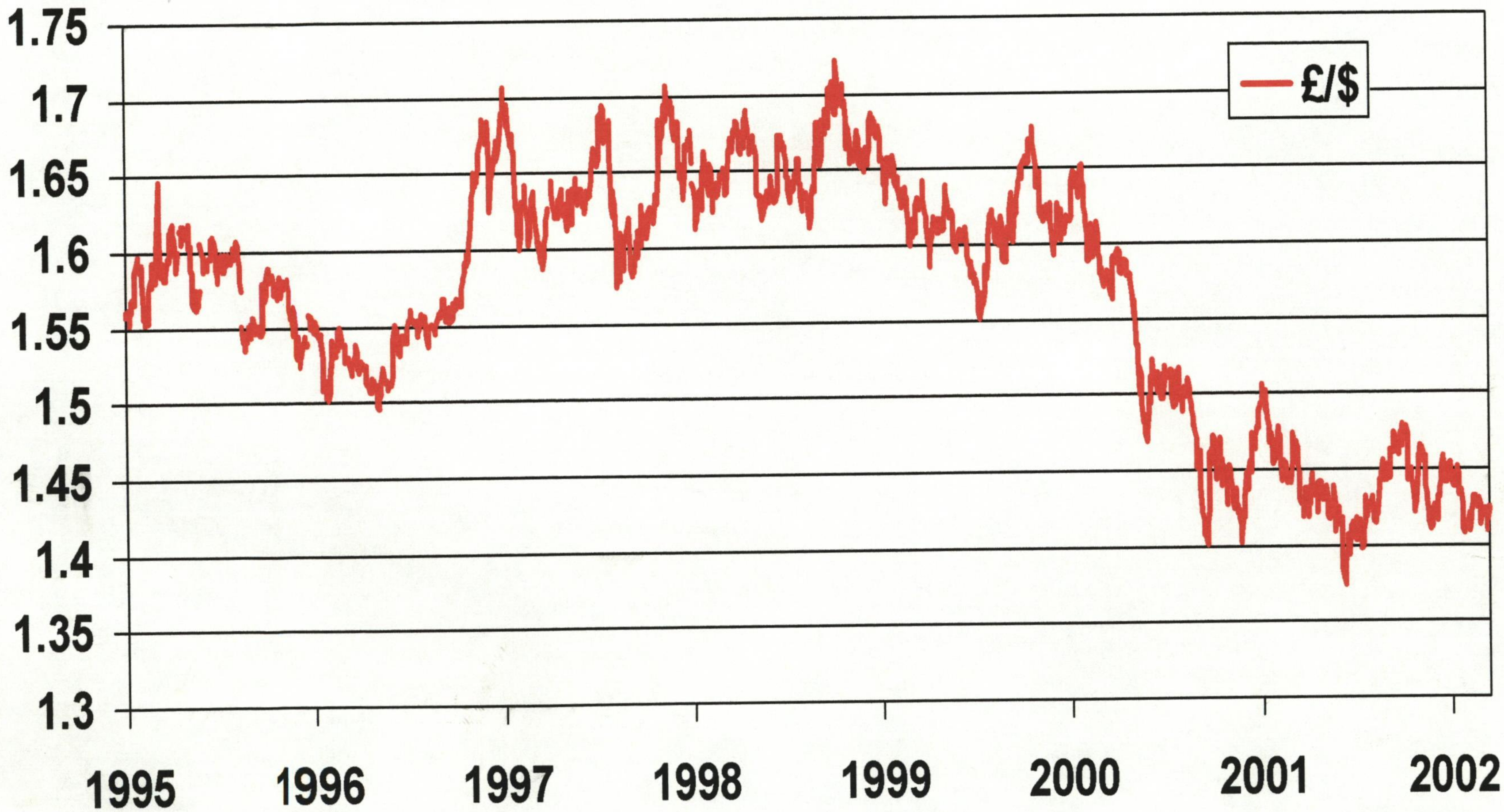


Cyclically-adjusted surplus on current budget – per cent of GDP

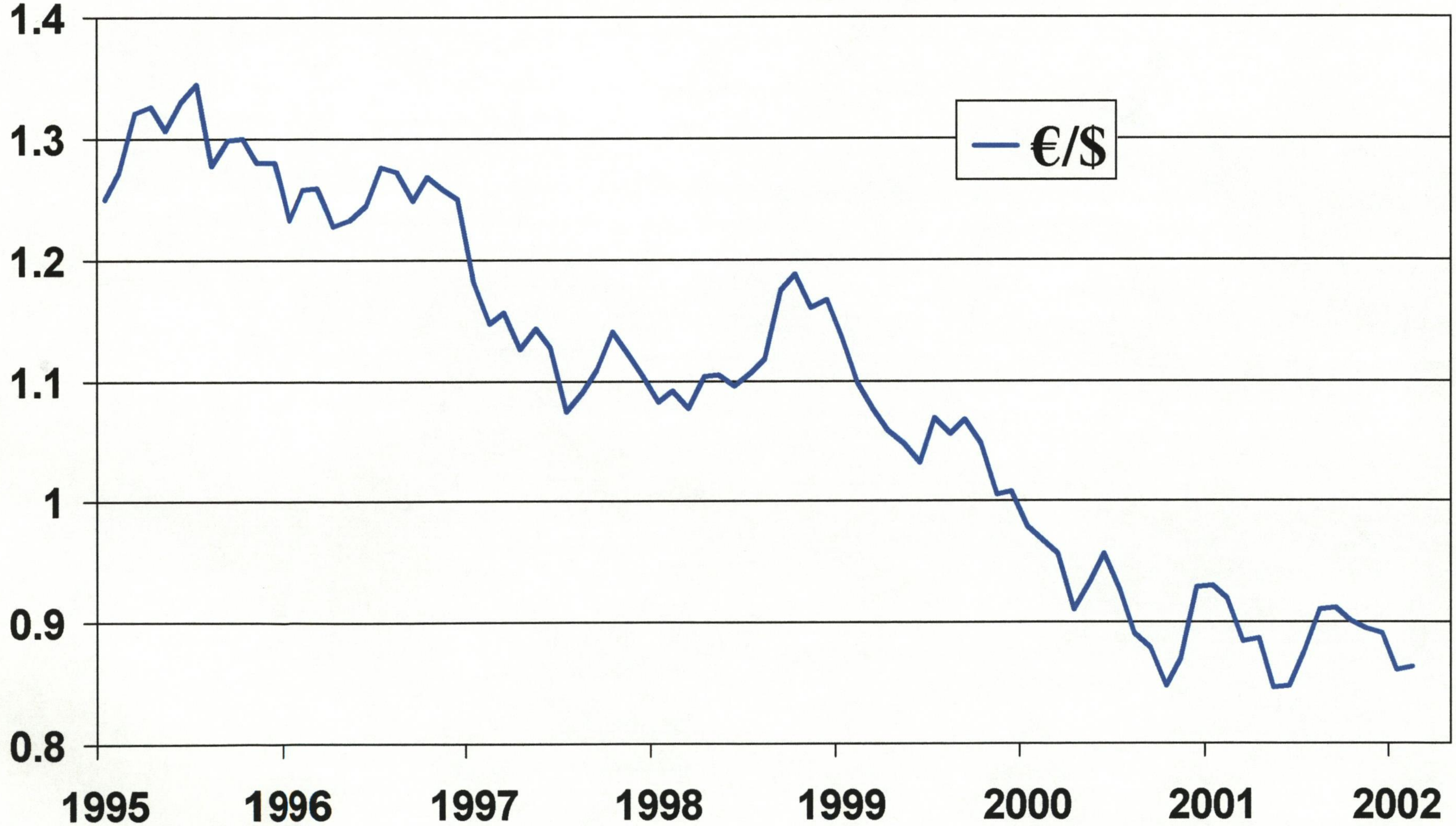
% year on year growth in DEL, real terms 1997-98 – 2005-06



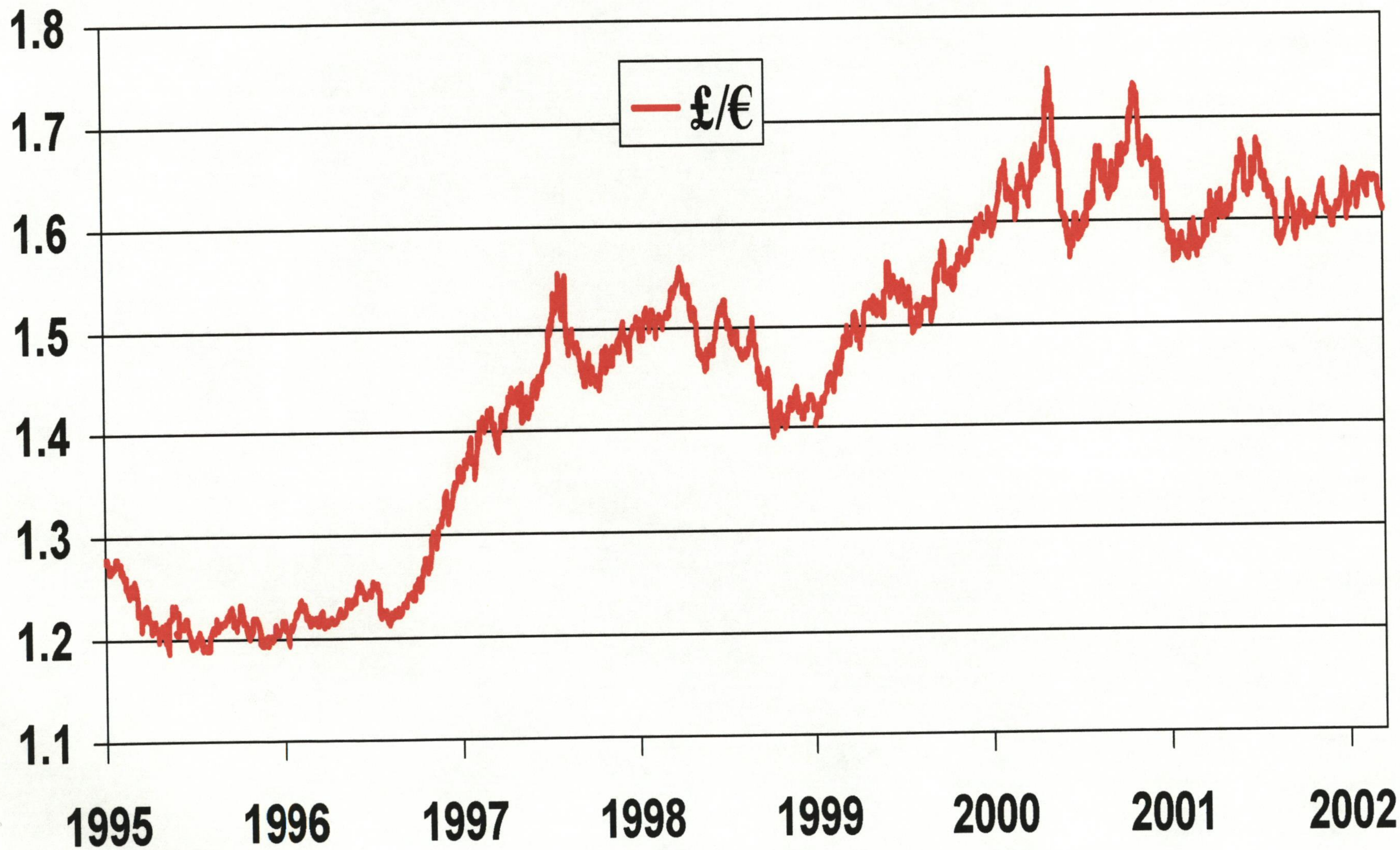
GB Pound / US Dollar Nominal Exchange Rate
(close daily)



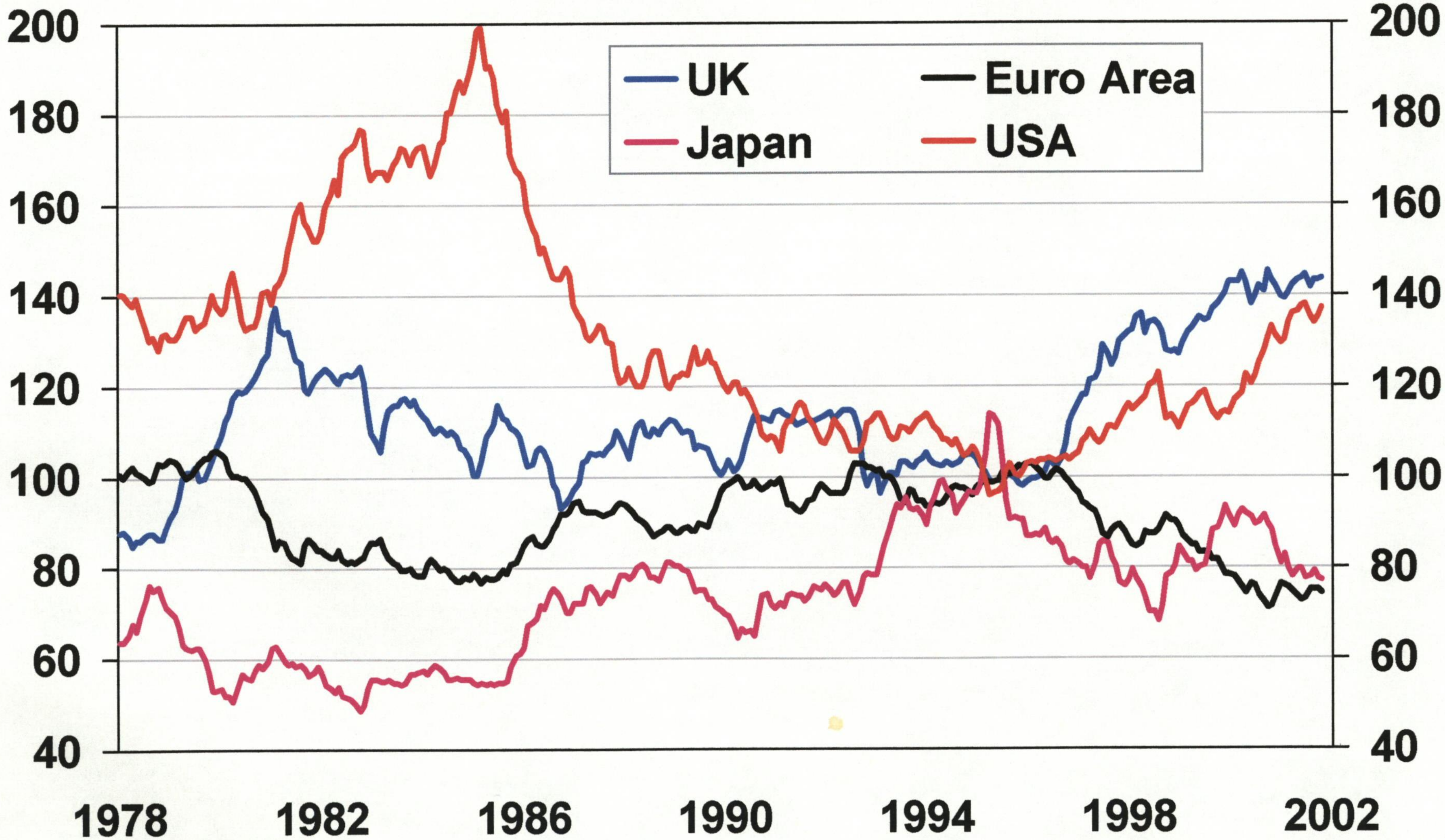
Euro / US Dollar Nominal Exchange Rate
(monthly)



GB Pound/ Euro (ECU pre 1999) Nominal Exchange Rate (close daily)



G3 and UK Real effective exchange rates (1995 =100)



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① cc SM, MD
A useful summary of views on the sustainable exchange range for sterling. Please do not reveal you have seen this. Suggests a slow increase in what is seen as such a level over time.
Richard 5/v

From: Tom Josephs
Date: 15 February 2002
Extn: 4329
Room: 93/3

CHANCELLOR

cc: Sir Andrew Turnbull, Ed Balls, Gus O'Donnell, Simon Brooks, Dave Ramsden, Chris Kelly, Vanessa Morgan, Andrew Gurney, Stewart Wood

SURVEY OF EXTERNAL ESTIMATES OF STERLING'S POSSIBLE ENTRY RATE

Gus O'Donnell suggested we send you a brief summary of the external estimates we have collected of sterling's equilibrium exchange rate, or acceptable EMU entry rate, against the euro. At the time of writing the spot rate was 0.61 £/€ (equivalent to 3.21 DM/£).

2. Diagram 1 presents the estimates by date of publication.

- The average estimate has stayed fairly constant at around 0.70 £/€ (2.79 DM/£) since the start of 2000. There is a wider range of estimates on the downside of this average, while on the upside the highest point estimate was 0.63 £/€ (3.10 DM/£) in mid-2000. The range of estimates seems to have narrowed over the latter half of 2001 and into 2002.

- The FT and Reuters both carried out surveys of leading economists in January 2002. The FT survey of 20 economists produced an average estimate of 0.68 £/€ (2.88 DM/£). Estimates in the Reuters survey ranged from 0.63-0.75 £/€ (3.10–2.61 DM/£).

- The CBI surveyed its members in late 2000; on the basis of this they report an acceptable entry range of 0.67-0.70 £/€ (2.92–2.79 DM/£). This compares to a similar survey in late 1999 where the range was 0.72-0.74 £/€ (2.72-2.64 DM/£).

Jeremy Heywood to see
(Personal)

CONFIDENTIAL - POLICY

Restricted - Personal

~~CONFIDENTIAL~~ - POLICY

J. Heywood

J. Powell No 10

The old DM 2.80 - 3.00 region remains the most popular - 65-70 pence per Euro. But the continued wide range of estimates is perhaps the most interesting element - there will never be agreement on a single 'correct' rate.

MD 8/5

① cc SW, MD

A useful summary of views on the sustainable exchange range for sterling. Please do not reveal you have seen this. Suggests a slow increase in what is seen as such a level over time.

Richard 5/v

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We believe the CBI will be undertaking a further survey this year. A recent poll by the Engineering Employer's Federation found the majority of exporters would be happy with a rate between 0.65 and 0.72 £/€ (3.01 – 2.72 DM/£).

- The TUC were reported in the FT in January this year as advocating entry at 0.67-0.77 £/€ (2.92 – 2.54 DM/£).

3. Diagram 2 presents the same estimates grouped by methodology. EER-type refers to techniques which model the equilibrium exchange rate as the exchange rate which is consistent with internal and external balance, i.e. with growth at trend and a sustainable current account. PPP refers to purchasing power parity models, which assume the exchange rate moves to equate the price of goods across countries. Estimates produced using both these techniques are highly sensitive to methodology and underlying assumptions.

- In the past, EER-type estimates have produced some very low equilibrium values, down to around 0.80–0.85 £/€ (2.44–2.30 DM/£). However, some more recent estimates of this type have produced higher rates of around 0.70 £/€ (2.79 DM/£).
- Estimates based on the concept of purchasing power parity (PPP) have tended to produce lower values for sterling. However, most evidence suggests that exchange rates deviate significantly from PPP in the short and medium run, and that it is at best a weak attractor for the exchange rate in the long run.

4. As part of our preliminary and technical work programme we have engaged Simon Wren-Lewis of Exeter University, a leading expert on equilibrium exchange rates, to review the external work in this field. We will send you a copy of his report once we have received it, along with a fuller discussion of our approach to these issues.

Tom Josephs
EMU team

Diagram 1: Estimates of sterling-euro equilibrium/entry exchange rate, by date

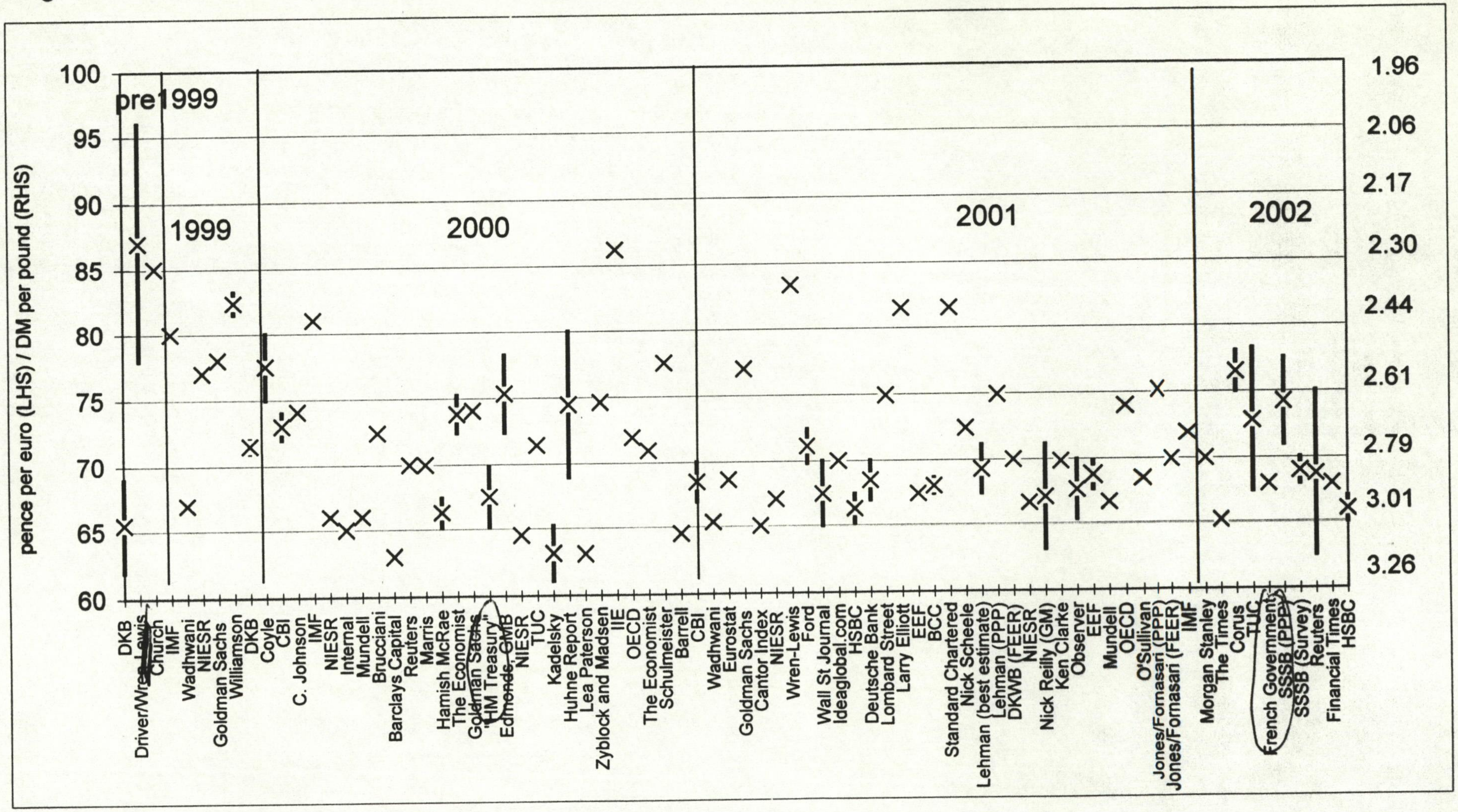
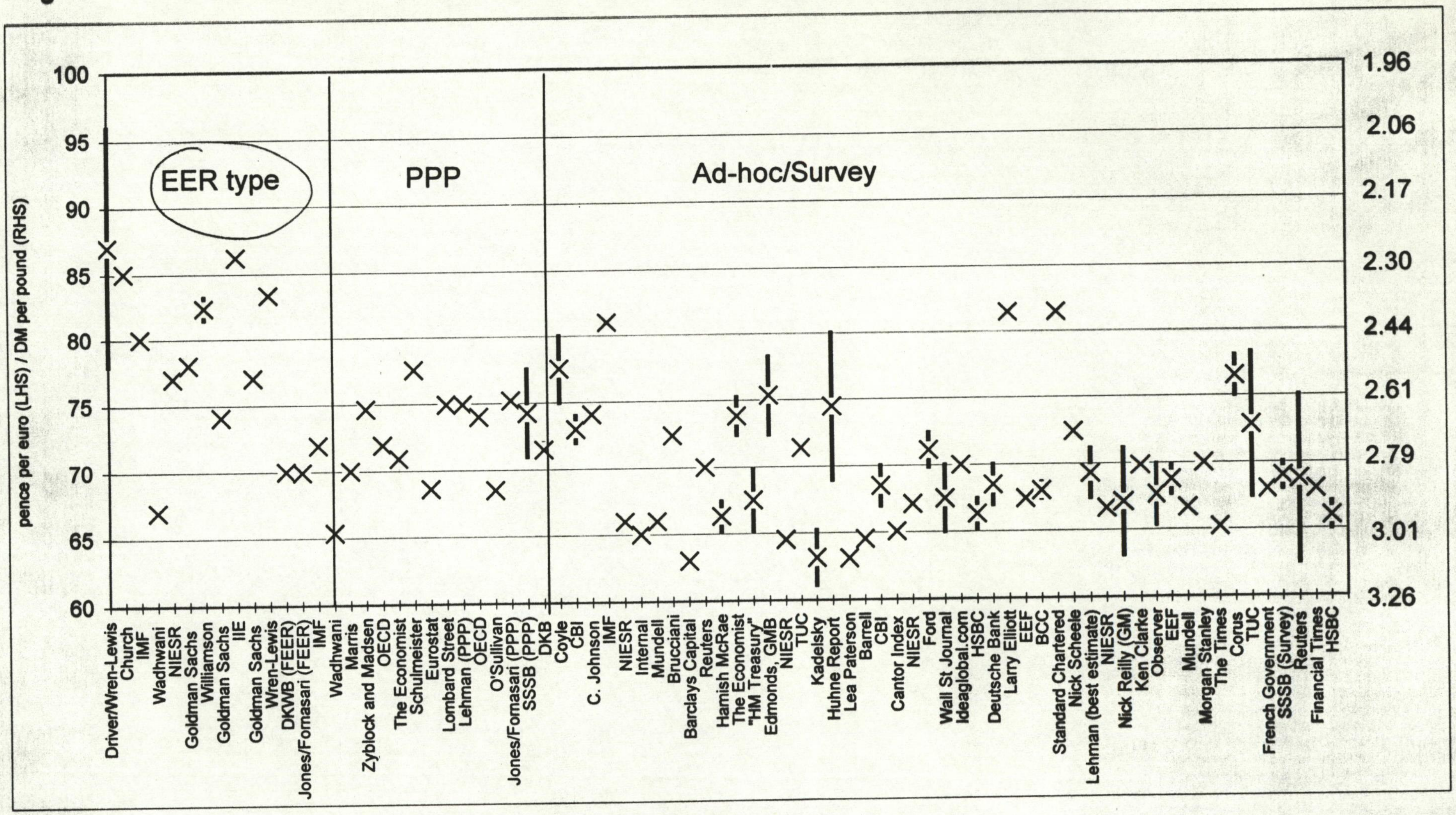


Diagram 2: Estimates of sterling-euro equilibrium/entry exchange rate, <u>by methodology</u>



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PM

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Euro: Politics and Economics

The politics and economics of the Euro are obviously closely related, but I have always believed that the economics are, contrary to the general view, tougher than the politics. The economic stakes are huge, the margin for error limited, and the room for principled disagreement immense. Recent economic developments, and second thoughts about the politics, have persuaded me that some of our assumptions about how to fight the Euro campaign are misguided. My proposal below tries to square the economic and political circle.

1. My assumption has always been that in the run-up to the completion of the examination of the economic tests, we would negotiate with the key governments and authorities over the key questions of our entry – not just our exchange rate etc, but our concerns about reforms to the management of the ECB. I have always assumed that this was the key moment to cash in our credits with Schroeder. Then, hey presto, as we announced that the tests had been met, we would also set out how we planned to enter

2. From the outside, this now seems far-fetched. The negotiations will be very tough; even the question of who we negotiate with and whether Schroeder can deliver for us is open; and the ECB seems disinclined to help any politician produce a neat outcome. Where does this leave us? I think there are three steps.

3. The Question. There is a huge difference between asking people to endorse a specific regime of Euro entry, and getting their permission to negotiate entry. The former seems like the way to fight a campaign on the 'clear and unambiguous' economics. But in the real world the latter now seems much preferable to me. The danger for the referendum campaign is that we get stuffed on two counts: patriotic symbolism played against us, and economic nitpicking over every conceivable aspect of ECB/Euro construction. Asking for permission to negotiate the right terms of entry at least means that we can bat back every complaint about the Euro regime by saying we shall be seeking to overcome them in the negotiations. This is a course with plenty of pitfalls, not least in the negotiations themselves (see below), but it offers a plausible political strategy. After all, we have passed seven years committed to a 'stable and competitive' exchange rate without ever saying what that means.

4. The Negotiations. The obvious argument for opening up negotiations in advance of a Referendum is that this is the moment of maximum leverage for us with EU colleagues: accede to our demands or we will lose the Referendum. But how realistic is this? I now think we will have more clout as a clear 'pre-in' rather than as a 'maybe-in', ie negotiating the terms of entry after a successful Referendum result. If you and GB win a referendum, especially on a commitment to achieve necessary reforms before entering, you will be in a strong position to get a majority of member states with you in pressuring the ECB to agree change. At the moment there is lack of political leadership at European level on economics; after a British Referendum GB could provide it. And up your sleeve you have the

added flexibility that comes from being able to say we are committed to join but we will not do so on the wrong terms.

5. Timing. There is a lot of discussion about Referendum timing, but I am more interested in timing of entry to the fixed rate regime, and the circulation of notes and coins. Up to now, it has always been argued that notes and coins must be circulating before the next election. I favour a referendum sooner rather than later, but I wonder if we shouldn't hold our powder dry on exactly when and how we enter. There are two arguments – economic and political:

   i) Economic. The Euro zone is in a bit of a mess, and will be until Germany sorts itself out. We don't know when this will be, or in what fashion it will do so. Therefore this is not a good time to be making irrevocable decisions. We should wait to see how the land lies in our own time, with a positive Referendum vote safely pocketed.

   ii) Political. Conventional wisdom has always been that we need to get notes and coins circulating before the 2005 General Election because we don't want the Tories to turn the election into a referendum on the Euro. But how frightening is this prospect given the pitiful reaction of the British people last time? The downside, obviously, is that the Tories try to mobilise the NO vote which will be bigger than their core vote; but won't we have a strong argument that they are fighting the last war, and should accept the will of the people?

So I am moving to a position where we capitalise on our economic credibility with a 'Trust Us' mandate to negotiate entry, with the exact economic terms of entry negotiated after the Referendum, with a flexible timetable for the final locking of the currency and circulation of notes and coins. In this way I think we maximise our chances of success in short and long term, squaring the circle between the political demands of a Referendum soon and the legitimate economic point that if it takes until 2006 or 2007 to get successful economic integration then it is worth waiting.

There are many things left out of this analysis, but I think it is worth thinking about.

DM
4/ii

P

cc JoP
PM

very important note. 9/2

From: Jacob Nell
Date: 31 January 2002

JEREMY HEYWOOD

cc: Andrew Adonis
Roger Liddle
Geoffrey Norris
Derek Scott
Simon Virley

NET PRESENT VALUE OF CHANGEOVER TO EURO

You asked for a note on seignorage and an estimate of the financial costs and benefits of the changeover to the euro.

<u>What is seignorage?</u>
Seignorage is the financial return on the sovereign power to issue money. Central banks have the monopoly power of money issue in their jurisdiction. The return they make on this power is the difference between the cost of production of notes and coins (in the UK in 2000/01 a fairly small £51 mn) and the return on the assets, mainly bonds, the purchase of which is financed by issuing the notes and coins (in the UK in 2000/01 amounting to £1.6 bn).

Another way of thinking about it is to look at the balance sheet of a central bank. which basically consist of liabilities of notes and coins - which are liabilities of the central bank to their bearers - and some commercial bank deposits held at the central bank, balanced by assets of government bonds and forex. The central bank does not have to pay any interest on its note and coin liabilities, but it receives interest on its bonds and deposits. To illustrate I attach the balance sheet of the Issue Department of the Bank of England as Appendix 1 (for historical reasons in the UK the central bank balance sheet is divided into a Banking Department and an Issue Department).

The actual transactions by which seignorage is realised can be various. But one obvious route would be for a commerical bank such as NatWest to purchase a vanload of cash by selling some of its gilts to the Bank of England. The BoE would then have financed its purchase of the gilts for the price of producing the notes and coins.

How will our seignorage income change under the euro?
Basically Brits (and the French) hold less money as a proportion of their income in cash than the EU average, mainly because the Germans and Spaniards hold more money as a proportion of their income in cash than the EU average. Consequently although we account - at current exchange rates of 61p to the euro - for 15% of the GDP of the euro 11 plus UK area, we only account for 9% of the currency in circulation in the euro 11 plus UK area. But, if we enter the euro then, once the transitional arrangements for distributing seignorage have been fully implemented in 2008, our share of euro area seignorage will be in line with our share of euroland GDP, i.e. 15%, and not in line with our share of euroland note issue, i.e. 9%.

Seignorage income is best calculated as cash in circulation (i.e the financing for the assets on the central bank's balance sheet) multiplied by the bank rate (i.e a floor rate of return on financial assets suitable for a prudent investor such as a central bank). Assuming that euro 11 plus UK cash in circulation is at the current level of 432 beuro, then the benefit to the UK will vary from 800 mn to 1.6 beuro per annum depending upon the interest rate. At the current interest rate of 3.25%, we would be 900 mn euro per annum better off. But if the interest rate is higher then the return on assets will be higher, so assuming that a neutral interest rate is a higher 5%, we would be 1.4 bn euro better off per annum. (I attach a spreadsheet for the eurozone plus UK, based upon one I developed several years ago and updated on a private basis by former colleagues at the Central Banking journal.)

Other costs and benefits of changeover
Clearly introducing the euro will be a substantial cost, with a huge information campaign, the cost of printing and coining the new currency and associated changeover costs. We may be able to reduce the cost of switching notes and coins following the troublefree introduction of the euro this year in the eurozone. But it is still likely to be a substantial cost. One estimate is that it might cost up to £2 bn.

However there is likely to be a large offsetting hidden gain. Not all the notes and coins will be exchanged. Judging from the experience in other eurozone countires, as much as 5% of the currency issue may not be exchanged, perhaps since it is lost or in cash abroad. Once the legacy currency notes and coins cease to be legal tender, they can be written off and the assets they financed become proft and available for distribution from the central bank to the finance ministry.

For instance in the UK we have a note issue of £27 bn. If 5% is not handed in, then that is a benefit of £1.4 bn.

Net present value of changeover to euro

On the basis of these assumptions - changeover costs of £2 bn in 2004, legacy currency windfall gain of £1.4 bn in 2005 and a stream of increased siegnorage returns rising to £0.9 bn (1.4 beuro) in the future - I calculate as a rough and ready estimate that at a 6% discount rate, the net present value to the UK of joining the euro would be £11 bn. This calculation does not take into account that UK long term interest rates if we stayed outside the euro might be higher, which would tend to reduce the net present value of entry to the euro.

Jacob Nell

JACOB NELL

Appendix 1

Issue Department

Account for the year ended 28 February 2001

	Notes	2001 £m	*2000 £m*
Income and profits:			
Securities of, or guaranteed by, the British Government		776	*791*
Other securities and assets		859	*591*
Other income		–	*1*
		1,635	***1,383***
Expenses:	2		
Cost of production of Bank notes		33	*41*
Cost of issue, custody and payment of Bank notes		13	*18*
Other expenses		5	*7*
		51	***66***
Payable to HM Treasury		**1,584**	***1,317***

Statement of balances: 28 February 2001

	Notes	2001 £m	*2000 £m*
Assets			
Securities of, or guaranteed by, the British Government	3	13,500	*3,763*
Other securities and assets including those acquired under reverse repurchase agreements	4	13,700	*21,377*
Total assets		**27,200**	***25,140***
Liabilities			
Notes issued:			
In circulation	5	27,195	*25,135*
In Banking Department		5	*5*
Total liabilities		**27,200**	***25,140***

E A J George	Governor
D C Clementi	Deputy Governor
Noakes	Director
G Midgley	Finance Director

Appendix 2: Redistribution of seignorage income: gains and losses from the euro

	Currency in circulation (million euro, end 2000)	Proportion of currency in circulation in eurosystem	Imputed annual seigniorage earnings at 3.25% interest (euro millions)	ECB capital shareholding (for 12 "in" countries) +UK	Proportion of captial share for the 12 "in" countries +UK	Share of monetary income (euro millions) under 2008 terms (no phasing) by capital share	Gains/losses from pooling (million euro)
UK	38,672	9.0%	1,934	734,055,000	15.3%	3,315	1,381.11
France	49,187	11.4%	2,459	841,685,000	17.6%	3,801	1,341.38
Greece	3,097	0.7%	155	102,820,000	2.1%	464	309.45
Finland	3,336	0.8%	167	69,850,000	1.5%	315	148.62
Portugal	6,530	1.5%	327	96,160,000	2.0%	434	107.72
Netherlands	18,730	4.3%	937	213,900,000	4.5%	966	29.39
Luxembourg	661	0.2%	33	7,460,000	0.2%	34	0.64
Belgium	13,503	3.1%	675	143,290,000	3.0%	647	-28.11
Ireland	5,368	1.2%	268	42,480,000	0.9%	192	-76.58
Austria	14,540	3.4%	727	117,970,000	2.5%	533	-194.29
Italy	76,420	17.7%	3,821	744,750,000	15.6%	3,363	-457.99
Spain	59,790	13.8%	2,990	444,675,000	9.3%	2,008	-981.51
Germany	142,200	32.9%	7,110	1,224,675,000	25.6%	5,530	-1,579.83
	432,034	**100%**	**21,602**	**4,783,770,000**	**100%**	**21601.71**	**0.00**

Interest rate:	5.00
/£	0.61

JJH

10 DOWNING STREET

PM

We've scheduled 1 hour for you and GB to discuss EMU strategy next week.

—

After that I hope we can move into the detailed list of "technical" meetings.

—

Previous papers below.

JP

TOPICS FOR DISCUSSION

February: Overall political strategy (GB/TB only)

19 March: ECB

- performance so far
- impact of enlargement
- other changes needed
- leadership
- seignourage

23 April: EU Fiscal regime

- current operation
- changes needed
- pressure for tax harmonisation

14 May: Institutional timetable

- timetable set out in the Treaty
- legislative implications
- other domestic/logistical issues
- timing of negotiations
- EU context

18 June Exchange rate

- what is the right rate?
- Transition issues

23 July Five tests

- timetable for assessment
- progress to date

Attendance: TB/GB/JH/SW/EB/GO

From: Jeremy Heywood
Date: 24 January 2002

PRIME MINISTER

cc: Jonathan Powell
Stephen Wall
Sally Morgan

EMU

Stephen and I had a useful session with Ed Balls and Gus O'Donnell yesterday to discuss the way forward on EMU. We agreed that it would be sensible to have a series of "technical" No 10/HMT meetings on Euro-related issues over the coming months – see the attached schedule (NB: not agreed with GB; and **knowledge of these meetings should be held very tightly in No 10**). However, Ed said that before getting into this GB would like a prior discussion with you on the overall political strategy. Ed said that:

- GB was in no doubt that we could win a referendum;

- but in the period before announcing the Government's decision on the Five Tests (date unspecified) it remained GB's view that no-one in Government should say anything that devalues the importance of the economic tests or implies that there is anything inevitable about joining EMU. The Treasury clearly believe that No 10 is happy to see CC, PH etc front-running on all this. They believe that this is completely misguided;

- for GB the real issue, according to Ed, is what would happen to the UK economy in the first few years of our membership – ie how uncomfortable would EMU actually be for us, politically and economically?

TOPICS FOR DISCUSSION

28 January: overall political strategy (GB/TB only)

19 February: ECB

- performance so far
- impact of enlargement
- other changes needed
- leadership
- seignourage

19 March: EU Fiscal regime

- current operation
- changes needed
- pressure for tax harmonisation

23 April: Institutional timetable

- timetable set out in the Treaty
- legislative implications
- other domestic/logistical issues
- timing of negotiations
- EU context

14 May: Exchange rate

- what is the right rate?
- transition issues

18 June: Five tests

- timetable for assessment
- progress to date

Attendance: TB/GB/JH/SW/EB/GO

From: Jonathan Powell
Date: 21 December 2001

S /01

PRIME MINISTER

EURO: POLITICS

Stephen has produced an excellent note for you on the technicalities of entry to the Euro. Over the break you need to think too about the politics - both British and European - in a systematic way and decide what preparatory work we now need to put in hand. There are wider problems than just how we deal with Gordon.

Firstly the date of the referendum. If you go for June 2003 (and I do not think you could go later because of holidays) you will be going just one month after local elections and Scottish, Welsh and Northern Irish elections. There will be pressure on you to go on the same day or possibly move the elections to the same date as the referendum (I do not know if this is technically possible). We need to think hard about the dynamic of this juxtaposition. Also worth bearing in mind it is during the Greek Presidency (just when things are getting difficult on Cyprus and enlargement).

Secondly the starting gun. People will start speculating on whether or not there will be a Referendum Bill in the Queen's Speech in November 2002. We can ride that out. But I assume you will want to announce the outcome of our assessment of the tests and the introduction of a referendum bill at the same time (and not have a consultation period on the former). If you want a six-month campaign you really want to launch these both in the first week of January 2003 with the maximum degree of surprise. I suppose you would call a Cabinet meeting and put the assessment to them and then make an immediate statement to Parliament coupled with introducing the bill. We would need a strong campaign in place to withstand the backlash we would immediately face.

Thirdly, warming up. So far we have got away fairly successfully with a feint and withdraw strategy. We need something a bit more planned over the next year. And if our aim is to bring the exchange rate down gradually (which will make the eventual negotiation on the final exchange rate much easier) we need a series of planned steps indicating that the decision is getting closer – a combination of speeches, indications that one of the tests have been met, publication of opinion polls showing that opinion is shifting etc. In January you should detail some people off to plan this.

Fourth making the political case. As you say this will have to be fought on the political case even more than the economic. The opposition is easy: giving up sovereignty, facing tax harmonisation and a federal state, loss of Queen's face etc. All visceral. Our arguments appeal more to the intellect: Britain has lost out by joining late at every step of the way, we will lose influence in Europe unless we join, threat of others moving ahead without us. We have to think of a way of making our arguments less high falutin' and more down to earth. As you say we need to appeal to the adventurous and bold aspect of the British nature while they will appeal to all that is timid and conservative. It is terribly important that we get some early work done on how we present the case and on our rebuttal, eg on tax harmonisation.

Fifth, machinery. Britain in Europe is weak. We need to beef it up financially and in terms of leadership. Is this a role for Peter or is that too dangerous? And we need strong government machinery in the FCO and the Cabinet Office. If we leave it to the last minute we will spend the 6 months of the campaign struggling to get it into place. In this as in other areas we have to balance the threat of giving the game away by making preparations that become public against the threat of not being prepared when the time comes. And what are we going to do about Eddie George? His successor will need to be chosen at the beginning of 2002, and he will presumably feel even freer to make his personal opinions known.

Sixth, the media. We will be fighting against an overwhelmingly hostile press. Is there anything we can do to reduce the odds by picking off certain papers? And how do we stop TV using the excuse of impartiality to skew the race to the advantage of the antis? We should discuss with Alastair and Peter what can be done.

Seventh, European politics. We think Schroder still owes us a big favour. He has probably forgotten. The French are fairly well disposed at the moment but may become more hostile by 2003. We are going to need the help of both of them if we are going to overcome the hurdles in our way – e.g. the exchange rate negotiation - and stop new hurdles being erected. That argues for taking at least Schroder into you confidence fairly early in the New Year. We should also work on the Commission. How do we stop our partners, or Prodi, saying incredibly unhelpful things in the course of the campaign?

<u>Finally, the demands we should make of Europe as a quid pro quo for joining.</u> The problem, as Stephen's note demonstrates, is that we are unlikely to achieve any of these before we join. So it is important not to make them conditions for joining. EG we can say that we will be arguing for an asymmetric inflation target when we join and aim to agree the necessary treaty change at the IGC in 2004. And we need to work out what other things we want to demand at the IGC to demonstrate the political gains we have made in joining the Euro. I think we should make an elected President of the Council rather than an elected President of the Commission a demand, at least of the Germans. I also like your idea of Elysee Treaty arrangements with French and Germans, although there are diminishing returns as the French and Germans have discovered in too much bureaucracy. What we really want is the threesome of UK, France and Germany able to meet, speak on the phone and decide things amongst ourselves. But that will be hard to force down the throats of the others.

We also need to work out what our strategy is on the exchange rate - both a technical and political issue. The idea of a secret negotiation with a series of European governments and the Commission fills me with horror. It is certain to leak. On the other hand we have to know what the exchange rate would be when we call the referendum. The best answer in my view is to work gradually to get it down to the level we want in the intervening period so the last jump is relatively easy. This is something to discuss at the meeting with GB in January.

JONATHAN POWELL

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228

FROM: Stephen Wall
DATE: 20 December 2001

PRIME MINISTER

cc: Jonathan Powell
Sally Morgan
Jeremy Heywood

EMU: TIMETABLES AND STRATEGY

I attach two notes setting out some initial thoughts on the points that came up at Tuesday's meeting. The first sets out some of the issues we will need to address in firming up the timetable for a possible referendum. The second looks at some of the reforms we might use the opportunity of negotiations on UK entry to advance, though I do not think our partners are <u>so</u> keen to have us that they will be making concessions in our direction.

I also attach a revised version of the second timeline from my earlier note, assuming a June 2003 rather than a February 2003 referendum.

Stephen

STEPHEN WALL

We obviously must discuss this & with HMT. (a) E.G. is going to be difficult (b) we need an exch rate deal <u>before</u> the ref. & (c) I wdn't give up on some reform to the ECB.

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EMU TIMETABLE: TIMELINE ISSUES

This note sets out the main issues on the critical path that you will need to address in order to hold a referendum in June 2003 and to introduce euro notes and coins by spring 2005. This timetable involves the passing of responsibility for UK monetary policy from the Bank of England to the ECB in Spring 2004.

The note complements and provides a commentary on key aspects of the revised timeline (attached) which sets out in summary form the key dates for decisions assuming a June 2003 referendum. At this stage we have not attempted to reach conclusions on how best to deal with the issues in this note, but merely to flag them up and provide some background.

The main points in this note apply broadly unchanged should you decide to hold a referendum a few weeks earlier in May 2003 alongside the English local government elections and the elections to the National Assembly for Wales and the Scottish Executive.

Once we have made the decision to join and held a referendum all the key decisions are made at EU level. The Treaty sets out formally the key stages of the process. It is complex. But in summary:

a. At the UK's request, the Commission and the European Central Bank (ECB) report to the Council (ECOFIN) on "the progress made by [the United Kingdom] in the fulfilment of [its] obligation regarding the achievement of economic and monetary union": are we convergent and otherwise up to scratch?

b. The Council decides, by a qualified majority, whether the United Kingdom "fulfils the necessary conditions". This is a complicated procedure involving a Commission proposal, consultation with the European Parliament and decision in ECOFIN. (*Mutatis mutandis*, this corresponds to the events at and around the EMU meeting of Heads of State and Government in May 1998).

c. The Bank of England pays its subscription to the ECB, contributes to the ECB reserves and transfers foreign exchange reserves.

d. The Council fixes the exchange rate between sterling and the euro (by unanimity of euro participants and the UK, on a proposal from the Commission and after consulting the ECB). (For the first wave this happened formally on 31 December 1998, though political agreement was reached on the rate in May).

why does this need to happen only after a referendum

The issues that require consideration can be divided up into three main categories:

(i) those that need to be addressed before the Council makes its formal decision to admit the UK to EMU (ie up to around February 2004);
(ii) those that can be largely deferred until after the Council decision but which need to be addressed before the introduction of notes and coins (ie from around February 2004 to around Spring 2005). The formal locking of rates will happen during this period, probably around July 2004. **This marks the point at which the Bank of England will cease to be responsible for setting UK interest rates and responsibility for UK monetary policy passes to the ECB;**
(iii) the exchange rate (which is an issue spanning both periods up to the formal locking of rates around summer 2004).
(iv) Developments in the external environment.

Issues before the Council takes its decision on principle of UK membership

(i) Timing of completion of the five tests assessment

Under the June 2003 scenario we will need to make a final decision on whether to call a referendum very early in 2003 and preferably not later than the end of 2002.

There are three approaches to completing the assessment. HMT could either publish a draft assessment, invite comments from academics, business and others and then work up the final assessment to be submitted to you before the referendum decision is made. Or we could move straight to submission to you without a consultative stage. In both cases the final assessment would only be published alongside announcement of the decision to hold a referendum. An intermediate option would be for the Bank of England to be involved in agreeing at least some parts of the assessment. The Governor has, in any event, already indicated that the Bank will publish their views on the five tests. So it would be useful to bind them into the process in this way. We understand HMT have also been considering this issue of how best to approach the Governor.

this is essential

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There ought to be no difficulty for HMT to work up the comprehensive assessment they will want to produce on this timescale. But to put out a consultative document will be slightly more difficult. To allow sufficient time for informed responses before the final assessment and referendum bill this would need to issue early in autumn 2002. If we went down this road we would need to build it into the timetable fairly soon so that work on the assessments could be speeded up slightly.

On the face of it, the slow burn scenario is rather unattractive. All those economists ("who know 100 different ways of making love but don't know any women", as Geoffrey Howe used to say) will be tugging this way and that. There will be a lively debate. On the other hand, to some extent, you could allow the debate to exhaust itself and then come in with a clear and unambiguous judgement at the end. That <u>might</u> be easier than having to announce the assessment and fire the referendum starting gun at the same time. But the politics of this are complex, I recognise. No!

(ii) Legislation

Why before?

As the timeline sets out, we will need to pass at least three separate pieces of primary legislation, before the Commission and ECB can send their completed assessment of whether the UK meets the convergence criteria to the Council for the decision on UK membership.

Very difficult to have a referendum without knowing the likely exch rate.

The **Euro Referendum Bill** will need to be passed at least six weeks before the referendum is held. This means it has to receive Royal Assent by April 2003. The extent to which it will be possible to manage opposition to the Bill in the Lords, in the absence of formal guillotine or programming powers, will be the key constraint in determining how early the Bill needs to be introduced.

The **EC (Amendment) Bill** will be needed to alter the terms on which Parliament signed up to the Maastricht Treaty and the UK's EMU opt-out. This would need to be passed before we can formally notify the Commission and ECB of our decision to seek to join EMU. It therefore needs to be on the statute book by the end of the 2002-03 legislative session and, ideally, before the summer recess.

Finally, the **Bank of England (Amendment) Bill** will be required to ensure that the UK meets the requirements of the Treaty. The major components include:

- abolishing the Government's overdraft with the Bank of England;

- creating a new foreign exchange reserves regime and taking powers to allow the Bank to transfer reserves to the ECB and pay up its subscriptions;
- Minor changes to guarantee the full independence of the monetary policy side of the Bank of England.

Our working assumption is that so long as this Bill has received Commons Second Reading before the Commission/ECB start their assessment this will be sufficient to demonstrate a firm intention to comply. This would point to introduction in the Commons at the very beginning of the 2003-04 Parliamentary session at the very latest.

What if the Lords block it?

None of these Bills need be especially long or complex, though the extent to which we include non-essential elements in the Bank Bill is, we gather, being considered carefully by HMT. But of course the sensitive nature of their content may mean that they demand significant time being discussed on the floor of both Houses.

One of the points we have been keen to stress is the Parliamentary lock over the decision to join. This is guaranteed in two parts: without agreement to the Referendum Bill the question cannot be put to the people. And without Parliament passing the EC (Amendment) Bill we cannot notify our intention to end the opt-out.

There may also be pressure from the Commission and ECB to ensure that Gibraltar law is consistent with the Treaty before the Council can give a positive decision that the UK meets the convergence criteria. If the GoG is unable or unwilling to do this in the time available through local legislation we may need to pass Orders in Council to override their local laws before February 2004. (We may, ultimately, need to do this anyway, albeit on a slower timescale). The read-across to the Brussels process negotiations between Spain and the UK over Gibraltar's future status will need to be carefully considered here.

Issues before the introduction of notes and coins

(i) Speed of preparations for euro notes and coins

The revised timeline looks to secure the introduction of euro notes and coins in April 2005 and the end of a short dual running period by June 2005. This allows 22 months for preparation by business and the public sector after the referendum result is known. This timescale is extremely tight. HMT's Changeover Plan suggests that between 24-30 months will be needed. Given that advance preparations have already started in those parts of the public sector where the lead times are longest (the tax and social security agencies) the public sector is not likely to be a binding constraint on the earliest date for the introduction of notes and coins. But the shorter the time scale for the changeover the greater the extent to which the attentions of the public sector will be diverted away from delivering other public service priorities during this period.

The physical minting and printing of coins and notes will not be a material constraint provided that we are willing to outsource production.

it can't be right!

HMT have not said anything publicly about the costs of the changeover. Private estimates vary wildly but the Commons Treasury Select Committee has suggested the may be of the order of £30bn. Most of this will fall to the private sector, though a significant minority of the costs will fall to the public sector, particularly the tax and social security departments, the Post Office and public transport operators.

(ii) Legislation

Legislation is less of a constraint than in the period before the Council's decision on UK membership. But we will still need to ensure the Bank of England Act reaches the statute book before it can pay its subscription to the ECB and transfer a portion of the UK's foreign exchange reserves. This needs to happen shortly after the Council's decision. Which points to the Bank Bill completing its passage by around March/April 2004.

Before euro notes and coins are introduced a further **Euro (Conversion) Bill** will need to be passed to change references to sterling in legislation to euros and update one or two other parts of the statute book. This could be done late in the 2003-04 Parliamentary session.

(iii) Other issues

There is a whole host of important, if second order, issues that will need to be resolved in the period between the formal Council decision and the introduction of euro notes and coins. Many of them have the potential to raise the political temperature.

In particular, between around February 2004 and February 2005 we will need to reach rapidly final decisions and then seek to negotiate them with the Commission/ECB/Council on subjects including:

- Future monetary arrangements for Gibraltar (insofar as we aren't forced to determine and agree that before February 2004);

- Future monetary arrangements for the Isle of Man, Channel Islands and the Overseas Territories outside the EU which use sterling;
- Decisions on the continuation of note issuance by the Northern Irish and Scottish commercial banks;

The more preparatory work on these issues is taken forward before the formal Council in February 2004 the better. It is important not to under-estimate the complexity of some of these points and the disproportionate amount of time likely to be needed to resolve them with our partners. But so long as we start thinking about these issues early after a positive referendum result they ought not to cause us too many problems in the EMU negotiation. They will of course be extremely sensitive as far as relations between the UK, Gibraltar, Isle of Man, Channel Islands and the Overseas Territories.

The exchange rate

Developing an exchange rate strategy is the biggest single issue which will need to be addressed in order to secure a successful glidepath into EMU. It impacts on virtually everything else.

There are a number of issues to consider and real tensions between different objectives. In considering the questions set out below you need to bare in mind at all times the distinction between:

(i) a political deal on the exchange rate – which we might want to be pursuing as early as the first half of 2003 - and
(ii) the legal locking of rates – which will not happen until spring 2004.

The first question is **whether we can complete the assessment and fight a credible referendum campaign without making, at minimum, some broad assumption about the entry rate.** This looks very difficult. Aside from then political pressures to say something on this issue it is difficult to complete sensibly, let alone publish, the five tests assessment without knowing roughly what the entry exchange rate will be.

If we accept that analysis the second question is **how can we reach such an understanding**. Simply stating unilaterally that we will aim to negotiate an entry rate within a particular band with our partners looks may prove difficult to defend in a referendum campaign. This points to seeking to reach a private deal with the other key players in the form of a political agreement with (at minimum) the Commission, ECB and France/Germany on the entry exchange rate. This need not be a precise figure for the entry rate. Instead negotiating agreement to an entry range or something like "around [say] DM

2.95" which could be incorporated into a one line "core script" that all parties would stick to during the referendum campaign and honour when it came to the formal business of legally setting the entry rate might well suffice politically and prove easier to negotiate. The thing is to ensure the key players (and ideally all EU Governments) are sending out the same message on the entry rate during the referendum campaign.

Reaching such a deal will not be a straightforward process. The Treaty is clear that the Council decision on the formal locking of exchange rates takes place after the Council decision on whether the UK meets the convergence criteria. But of the eleven original EMU members, all of them reached political agreement on the entry rate at the May 1998 European Council alongside the decision to admit them to EMU. Ten of them agreed that their entry to the euro-zone should be fixed at their ERM central parity. The exception, Ireland, reached political agreement on a small revaluation (revaluations are always easier to secure than devaluations). None of this came as much of a surprise – nobody had seriously suggested the central rates should be extensively re-aligned in the months leading up to May 1998.

However, because we are not members of the ERM, we therefore have no central rate acting as the focal point for the expected entry rate. Reaching a deal on the entry rate, or even an entry range, will therefore be much more difficult for us than for the other euro-zone members.

There are various options for choreographing such a deal. But they come down to two basic options, with variants on the precise timing. Not all may be negotiable.

- **Seeking to negotiate secretly the sterling entry exchange rate/range/core script for use by partners during the campaign.** This could either be done very rapidly after the decision to hold a referendum was announced - and revealed either during the passage of the Referendum Bill or very early in the referendum campaign. Or we could try and do the deal earlier, in advance of the decision on whether to hold a referendum so that it could inform the five tests assessment as well as the referendum campaign. The expected entry rate could be announced alongside the decision to hold a referendum was made public. We would have to make clear (or would run the risk that others would do so for us) that this political agreement was "without prejudice" to the prerogatives of the Commission, ECB and Council in judging whether the UK met the convergence criteria and the subsequent legally binding Council decision on the entry rate.

- Negotiate to join ERM II for the period up to the formal fixing of the exchange rate immediately. As with the first wavers this would create a more or less explicit expectation that the central ERM rate would also be the rate at which the sterling/euro rate was irrevocably fixed. But that would explicitly only be a political expectation. There would be no suggestion that the ECB/Commissions' prerogatives were being called into question. Such a deal could be negotiated either immediately after a referendum is called, or alternatively just before - so that the rate can be factored into final judgements on the five tests.

Worth noting that the point of rejoining the ERM would simply be to send a strong signal on the likely entry rate into EMU itself. Given that the permitted fluctuation bands are now +/- 15% they are unlikely to act as binding constraints on the exchange rate in practice. We think the French share this view.

Fairly reliable institutional machinery for confidential negotiations on exchange rate issues already exists in the form of the Economic and Financial Committee (made up of senior Finance Ministry and Central Bank officials plus Commission). Its predecessor, the Monetary Committee, prided itself on the fact that its deliberations never leaked and, where necessary, they could reach difficult decisions quickly. But to maximise the prospects that this process runs smoothly we would need to sound out key players (Commission, ECB, Germany, France, and perhaps the (Greek) Presidency) on both the EFC and No 10 nets informally in advance of any such secret negotiation.

The third question relates to **how we manage the process of getting sterling to a sustainable entry rate**. Can we say anything to influence this before we start looking to make deals? Or is it possible to look for a deal on an entry rate below the market rate? And how do we go about achieving a depreciation?

On **timing**, there may be tactical advantage in ensuring that the process of getting the pound down to a sustainable level was finalised well before any secret negotiations were underway. It ought to increase the prospects of achieving an acceptable outcome in such talks if the "target" rate is close to the market rate.

On **tactics**, the forex markets are heavily influenced by latest expectations of prospects for the UK joining the euro. Other things equal, every time you give a speech which is positive about euro entry the pound/euro rate declines in the expectation that the market rates that have been prevailing throughout the last year are unsustainably high. So a concerted and sustained set of positive messages from the Government on the prospects for euro membership ought to help here. In other words, if you and the Chancellor are saying the same thing (and not being spun to the press as meaning different things) the exchange rate could be managed downward.

But we do need to be subtle to avoid talking down the pound to such an extent that we "undershoot" a sustainable exchange rate. If we do, the MPC will respond by increasing interest rates, damaging the convergence process and creating an unhelpful backdrop for a referendum. In contrast, the impact on forecast inflation, and therefore interest rates, of a depreciation of the order necessary to bring the pound down to (say) DM 2.95 should not be material.

Fourthly, **what is the right entry rate**? On the one hand the Treaty convergence criteria require exchange rate stability (and even if this is not interpreted in the strict sense of requiring two years membership of ERM II the ECB and Commission at least will focus on the issue closely mindful of creating precedents for Poland etc).

But against there is a consensus amongst economists (or as near as they will ever get) on the need for <u>some</u> depreciation of sterling against the euro before we can lock rates. The precise scale of the over-valuation is a hotly debated point with estimates varying from as little as 2% (down to 3.10 equivalent against the DM) to as much as 20%. (around 2.50 DM). The Treasury appears to think that around 2.95 DM, the old ERM central rate parity, might be a sustainable entry rate. We think the French share this view (and might even be prepared to go a little lower). This implies a devaluation of 6.7%. Since the ERM II fluctuation bands are now +/- 15% we ought to be able to argue that a depreciation on this scale was not inconsistent with broad exchange rate stability.

In conclusion, you and the Chancellor will need to reach an early judgement on how to handle the exchange rate issue. If you favour secret pre-negotiations before the five tests assessment is completed decisions will be needed by the end of 2002 at the very latest. If you are content to leave such negotiations until after a referendum has been won decisions can be deferred until spring 2003.

Other developments in the EU

A number of other factors, whilst not requiring decisions by the Government, need to be taken into account in considering the timetable:

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(i) Legislative and Presidential elections in France in spring/summer 2002 and the German federal elections in Autumn 2002.

(ii) The Presidency of the EU and the Euro-X group will be held by Greece in the first half of 2003. The Italians take over in July 2003.

(iii) If Persson is re-elected in Autumn 2002 the Swedes plan to hold their referendum on euro membership in Spring 2003.

Major negotiations that will be ongoing during the run up to a June 2003 referendum and beyond include:

- Future of Europe. The Convention is due to report by spring 2003. We will be pressing to ensure that there is a decent firebreak before the IGC proper starts.
- Tax package. Final decisions due by the end of 2002 so ought to be out of the way by June 2003. However, all the signs are that discussions at Copenhagen in December 2002 will be exceptionally difficult. So we cannot rule out that the debate will drag on into the first part of 2003.
- Enlargement. Agreement to the first wave of enlargement looks likely by the end of 2002 so the ratification process will be taking place in 2003.
- Agenda 2007. Some suggestions that parts of the Commission favour publication of future financing proposals as early as 2003. But Prodi's people seem clear that this will not emerge until at least spring 2004.

CABINET OFFICE
DECEMBER 20 2001

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SCENARIO 3: REFERENDUM IN JUNE 2003

January 2003	Assessment of five tests completed; **Cabinet takes decision** on whether to notify intention to move to Stage III if Parliament and people agree
January to April 2003	**Referendum Bill** in Parliament. RA by Easter recess.
April 2003	Establishment of umbrella campaign bodies; decisions on financing of "yes" and "no" groups
May 2003	Formal Referendum campaign
June 2003	**Referendum day**
June to August 2003	**Bank of England and EC (Amendment) Bills** introduced to Parliament [EC(A)B needs to pass before formal notification; BoEB before transfer of forex reserves etc to ECB] Amendments to Gibraltar monetary legislation published
August 2003	**Formal notification** to Council/Commission/ECB of intention to move to Stage III
September to November 2003	**Assessment** by Commission and ECB of whether UK meets the convergence criteria
December 2003	**Decision (by QMV) by Council (meeting in composition of Heads of Government and State) of whether UK meets criteria to move to Stage III.** [Accompanied by political agreement on entry exchange rate?]
January 2004	Bank pays subscription to ECB and transfers forex reserves
January 2004 onwards	[Negotiation of entry exchange rate if political agreement not reached previously]. Negotiations on other arrangements for UK entry (eg arrangements for Gibraltar, Crown Deps, rights of NI/S Banks to issue own notes; national symbol on notes)
By Spring 2004	**Formal decision by Council (unanimity) on entry exchange rate** on basis of Commission proposal Decision by Council on other arrangements for UK entry
By Spring 2004	ECB decisions on notes (national symbols; Scottish and NI issuers) National decisions on coin specification needed; manufacturing of coins starts [but will still need to outsource much production]
July 1 2004	**UK moves to Stage III; currencies irrevocably locked. ECB sets UK interest rates from this date**
Late 2004	Bill to amend references to sterling in legislation
April 2005	**Euro notes and coins introduced**
June 2005	Sterling notes and coins withdrawn

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EMU: POSSIBLE LINKAGES TO DECISIONS ON OTHER ECONOMIC ISSUES

This note sets out some of the macroeconomic and institutional issues on which we might seek to make progress as part of the process of negotiating to join EMU. It is based on our understanding of the Treasury's main concerns about the current euro-zone fiscal and monetary framework.

We have not sought to assess in detail the prospects for being able to negotiate these changes with other Member States, the Commission and ECB. But it is probably fair to say that at least some of our partners will be looking for concessions from us in return for their agreement to UK participation in EMU at a sustainable exchange rate.

Changes requiring Treaty change could only be effected in the 2004 IGC at the earliest and would take around two years to come into force. The Germans are likely to be highly resistant. But most of the suggested changes set out in this note do not require Treaty change. However, changes in the way the ECB interprets its Treaty objectives will be particularly sensitive. Rather than seek to make any formal linkage with the negotiations on UK entry they are probably best pursued in a low key way once inside EMU.

➢ ECB reform

Some specific reform ideas are outlined below. But the key point is the desired direction of the reforms we would support. They can be grouped into three main areas:

The ECB's targets

The Treaty gives the ECB **full operational independence** and, unlike the Bank of England, a **considerable degree of target independence**, within the Treaty requirement of ensuring price stability. If we wished to change this arrangement, so that, as in the UK, politicians set the target and the central bank is then charged with delivering it, this would require Treaty change. Such a change would be extremely difficult to negotiate. It could have an adverse effect on the dynamics of our whole entry negotiation. The Germans in particular would fear it was an attempt to undermine the ECB's independence.

But there are other changes which would not require Treaty change and go some way in this general direction.

The ECB has chosen to interpret price stability as inflation of 2% or less (on the "HICP" measure, on which UK inflation tends to come out lower than on our own RPI based measures). Put another way, the ECB has an incentive to maintain a slightly tighter than optimal monetary policy because the costs to its reputation of overshooting the 2% ceiling ("failure") are greater than the costs of inflation coming in significantly below 2% ("still within target").

This **asymmetry** in the inflation target has raised concerns that the ECB may take an unnecessarily cautious view in setting interest rates, to the detriment of growth and employment. A symmetrical inflation target or, failing that, a greater readiness to explain how growth and inflation prospects are balanced when setting interest rates, especially in conditions where inflation does not threaten the 2% target, would provide reassurance that there is no systematic bias in favour of reducing already low levels of inflation over following policies supportive of growth. This would not, in itself, require Treaty change. But without it such a change will only happen if and when the ECB are won round to the merits of symmetrical inflation targets.

An alternative approach to address the fears of a systematic bias to a tight monetary policy would be to amend the Treaty to make more explicit the ECB's existing secondary target of supporting the general economic objectives of the EU. These are already referred to in somewhat obscure and inaccessible language and include promoting a high level of employment and raising the standard of living.

Such a change might be largely cosmetic but could be attractive in terms of changing perceptions. However, the Germans and the ECB would both be nervous about the motivation behind such a change. Was the real intention to water down the commitment to stable prices?

Enhancing Transparency and openness

The ECB is widely seen as one of the least open central banks in the world. It has not yet been able to develop good mutual understanding with the markets who often see its pronouncements as opaque and confused. This can damage the effectiveness of monetary policy. While there is a debate to be had about the desirability of publishing voting records (greater openness but at the price of greater attention to national interests?) other, relatively modest, reforms may go a long way to improve understanding of its actions and therefore the effectiveness of monetary policy. These include **early publication of the minutes** of meetings, including the **results** of any **votes** and publication of an **ECB quarterly economic forecast**. None of these changes require Treaty change.

Increasing Accountability and consultation

While the ECB President and Executive Board members regularly appear before the European Parliament's Monetary Affairs Committee it is not formally held to account by any body for its performance. And although the ECB President and Vice President regularly attend Ecofin discussions the quality of dialogue between the EU's central bankers and politicians remains weak. The trick is to improve **communication** and **accountability** without impinging on the ECB's **independence**. More systematic **dialogue** between Ecofin and the ECB would help here. For example, the ECB has a valuable insight into the structural reforms necessary to deliver the EU's Lisbon target and could play a useful role in such discussions. The ECB might also be asked to make a regular presentation to Ecofin outlining its views on current economic conditions and the implications for monetary policy. In turn Ecofin/euro-x could provide its latest assessments of fiscal prospects on a more structured and timely basis.

At Member State level, accountability could be facilitated by ECB Governing Council members testifying before **national Parliaments** (in the same way MPC members regularly appear before Commons and Lords Committees). The Governor of each national "in" central bank might have a special role here.

None of these reforms require Treaty change. But because they are solely within the ECB's competence neither can Ecofin or the European Council give instructions to the ECB. In any event ex cathedra statements by politicians on the issue are likely to make the ECB more defensive. So whilst we should not be afraid to continue to indicate the nature of the reforms we favour, and to step up our activity in this area after a positive referendum result, we need to pursue carefully. A first step might be opening discussions with key Member States, notably France and Germany, on these issues. Contact with the ECB will need to be handled particularly sensitively. These issues are probably best pursued from inside EMU, ideally with a UK member on the ECB's six person Executive Board.

Reforming the decision taking process and dealing with enlargement

At present key decisions at the ECB are taken by **the Governing Council**. This includes the President, Vice President, the four other members of the Executive Board and the Governors of the twelve national "in" central banks. Each has an equal vote. Eighteen members is already at the large end for an effective decision making body. And giving equal votes to all national bank governors, regardless of the size of their national economy, creates a danger that the **"periphery"** has a relatively stronger influence over policy than the **"core"**.

There is no evidence that these concerns have, in practice, damaged the functioning of the ECB. But in an enlarged EU there is a strong case for giving relatively greater power to the six person **Executive Board**. Over time the members of the Executive Board are in any case likely to grow in influence as the Governing Council becomes unwieldy. Worth noting that when the Nice Treaty comes into force it will be possible for the rules governing voting arrangements in the Governing Council could be amended by unanimous agreement in the (Ecofin) Council, rather than requiring Treaty change, as now.

➢ Macro-economic co-ordination in the euro-zone

It is too early to reach definitive judgements on the effectiveness of the euro zone's economic governance arrangements. The key issue is probably the extent to which the **euro-x** group can successfully co-ordinate fiscal policy across the euro-zone under the framework of the **Stability and Growth Pact** (SGP) and convey clear and timely information to the ECB on the euro-zone fiscal stance. There are two aspects to this:

- The **effectiveness of co-ordination** in euro-x. After a rather lack lustre start the quality of these meetings has been improving of late, with proper preparation in the EFC (at 15). But there are still issues surrounding the timeliness of assessments of national budgetary programmes, which are invariably assessed at different times, only after they have been published (and therefore unamendable), often only just before the fiscal year to which they relate commences. Consequently it is not always easy for the ECB to build up a coherent picture of the cumulative effect of budgetary decisions across the eurozone. While there is a limit to the extent to which national procedures can be pre-empted, if the right macro policy mix is to be followed it is important that the ECB is able to take account of expected changes in fiscal stance in setting interest rates. This suggests further improvements to the functioning of the euro-x group (while respecting Ecofin's decision taking role);

- The **interpretation of the SGP**. The medium term objective for fiscal policy enshrined in the SGP is budgets "in, or close to, balance." The ECB have generally argued that where euro members public finances have not reached this position (eg France, Italy and Germany) it is inappropriate to allow the so-called automatic stabilisers (changes in revenues and spending induced by the economic cycle rather than discretionary policy action) to work in full. To do so would run the risk that the 3% limit on deficits might be breached and would worry the markets that the disciplines of the SGP are being relaxed at their first test. Further fiscal restraint is necessary.

  However, the Chancellor, supported by most other Member States, including France, has publicly argued for a more liberal interpretation. Schroeder has even gone as far as to argue for an EU wide fiscal stimulus package (others have thus far reacted coolly). In the Chancellor's view we should be pushing for a more flexible view of the SGP text. This would give much greater weight to factors such as the existing stock of public sector debt, the cyclically adjusted deficit and the level of capital spending in total public spending in determining how far deficit targets can be revised upwards to take account of falling growth - while remaining within the terms of the Pact. And thus avoiding potential fines. This would make the SGP framework closer to the UK fiscal framework, with its emphasis on the golden rule and sustainable debt levels.

➢ **UK member of the Executive Board**

Under the transitional arrangements in May 1998 one member of the existing Executive Board will retire every July between 2002 and 2006. Once we have made a positive decision to join EMU and have secured a yes vote in a referendum we will want to secure a UK member of the Board as soon as possible. This is partly for presentational reasons, but will be critical if we are to ensure that the case for ECB reform outlined above is pursued vigorously in Frankfurt.

Ideally therefore if a referendum is held in June 2003 we would want to secure the replacement seat for the Finnish member retiring that July. This might be difficult to secure, given the tight timing and the reluctance of the "smalls" to see another member of a large euro-zone member on the Board. So the rotation in July 2004 may be a more realistic goal.

Two other points are relevant here:

(i) The outcome of the Duisenberg succession. Both the timing of his departure and whether Trichet is cleared of fraud allegations - and is therefore able to take up his anointed position as successor – are uncertainties. As is how the French will react if, as seems likely, Duisenberg stays on beyond June 2002 when the French Vice President of the ECB, Noyer, is due to be replaced.

(ii) Convention dictates that we would probably appoint a senior serving or former central banker to the Executive Board. So decisions on whether the existing Governor and Deputy Governors of the Bank of England are re-appointed need to be considered. Eddie George's term ends on 30 June 2003 while Deputy Governor King's term expires on 1 June 2003. Deputy Governor Clementi's term ends on 1 September 2002. So, in principle, by July 2003 there may have been significant changes in the senior team at the Bank.

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P

From: Jeremy Heywood
Date: 24 January 2002

PRIME MINISTER

interesting

cc: Jonathan Powell
Stephen Wall
Sally Morgan

EMU

Stephen and I had a useful session with Ed Balls and Gus O'Donnell yesterday to discuss the way forward on EMU. We agreed that it would be sensible to have a series of "technical" No 10/HMT meetings on Euro-related issues over the coming months - see the attached schedule (NB: not agreed with GB; and **knowledge of these meetings should be held very tightly in No 10**). However, Ed said that before getting into this GB would like a prior discussion with you on the overall political strategy. Ed said that:

- GB was in no doubt that we could win a referendum;

- but in the period before announcing the Government's decision on the Five Tests (date unspecified) it remained GB's view that no-one in Government should say anything that devalues the importance of the economic tests or implies that there is anything inevitable about joining EMU. The Treasury clearly believe that No 10 is happy to see CC, PH etc front-running on all this. They believe that this is completely misguided;

- for GB the real issue, according to Ed, is what would happen to the UK economy in the first few years of our membership - ie how uncomfortable would EMU actually be for us, politically and economically?

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TOPICS FOR DISCUSSION

28 January: overall political strategy (GB/TB only)

19 February: ECB

- performance so far
- impact of enlargement
- other changes needed
- leadership
- seignourage

19 March: EU Fiscal regime

- current operation
- changes needed
- pressure for tax harmonisation

23 April: Institutional timetable

- timetable set out in the Treaty
- legislative implications
- other domestic/logistical issues
- timing of negotiations
- EU context

14 May: Exchange rate

- what is the right rate?
- transition issues

18 June: Five tests

- timetable for assessment
- progress to date

Attendance: TB/GB/JH/SW/EB/GO

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Obviously these are issues that you will need to go through with GB in your discussions. But I hope we can then move on to some of the economic and technical issues.

One other point may be worth mentioning. Ed reported that the Governor has made it clear that the Bank of England will not get involved in the question of whether the Five Tests are met. When the time comes they will argue that this is a matter for the Government. If this holds, it is probably sensible; but I doubt it will!

J.

JEREMY HEYWOOD

PM (red box)
Worth reading
JLZ

Barclays Capital

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23 January, 2002

The latest Eurotrack Survey shows that a majority would vote in favour of joining the euro if the Government says that the five economic tests for membership have been passed and recommends that we should join. Although the majority is small (1%), this is the first time that this result has been recorded in an independent survey. Other surveys have suggested that a Government recommendation to join the single currency would do no more than reduce the majority in favour of staying out of the euro.

The Eurotrack results suggest that a Government recommendation based on the Treasury saying that the five tests had been passed is 'worth' around 28% of the votes. This is a far larger impact than most market participants would have expected.

As important, the Survey reveals that there has been a reduction in the earliest time that the public would vote to join the euro. A referendum could now achieve a majority in favour of joining the single currency in between two and five years' time. Previous surveys have suggested that this could only be achieved in between five and ten years' time.

Almost half of all voters (47%) say that the earliest they would vote to replace the pound with the euro is within the next two years. This is a ten-point increase on the percentage recorded in December, and a fourteen-point rise on the percentage recorded in November.

In our view, there are sound economic reasons why the five tests should not be passed during this Parliament. Delaying a positive assessment of the tests until early in the next Parliament might also make sense politically as it would prevent the introduction of euro notes and coins clashing with the next general election. Given that, our central view is that a successful referendum on the single currency will be held in mid-2006 with the exchange rate irrevocably fixed against the euro by June 2007.

However, the results of this Survey suggest that the Government might be tempted to push ahead with a referendum by the autumn of 2003. Under this scenario, the introduction of euro notes and coins could be driven through on a shortened timeframe ahead of a general election in June 2006 (the latest possible date). Irrevocable fixing of the exchange rate would probably take place sometime in the autumn of 2004. Before the January Eurotrack Survey we would have said that there was only a 25% chance of this happening. This has now risen to 45%. In other words, UK membership of the single currency just got a whole lot closer.

As far as strategy is concerned, the economic consensus suggests the market is pricing-in too little sterling weakness ahead of EMU entry, i.e. there is no meaningful improvement in the pound's competitiveness against the euro. In bonds and swaps, the five-year area of the sterling curve appears to be the 'sweet spot'. Short yields might rise in response to worries about rate tightening to offset sterling weakness, while yields beyond five years appear too low, when forward rates are considered. Gilt swap spreads should also fall, particularly in shorts and mediums.

Contents	*Page*

BARCLAYS

Barclays Capital's Eurotrack Survey

Our latest Eurotrack poll shows that the wording of survey questions is vital if you want to obtain the results that matter. This time round, the Survey includes what we think is the most unambiguous question that can be asked with respect to the UK joining the single currency, i.e.

'If the Government said that the UK had passed the five economic tests for membership of the single currency, and recommended that we should join, would you accept this recommendation and vote to join the euro in a referendum, or not?'

Forty percent of the respondents said that they would vote to join the euro, while 39% said they would not. In other words, a small net balance of 1% said that they would vote in favour of the Government's recommendation.

Eurotrack Survey, Special Question: If the Government said that the UK had passed the five economic tests for membership of the single currency, and recommended that we should join, would you accept this recommendation and vote to join the euro in a referendum, or not? % of respondents

	2002 Jan
Yes	40
No	39
Would not vote	7
Do not know	15
Memo item:	
Net balance ('yes' minus 'no')	1

Source: NOP and Barclays Capital.

As far as we are aware, this is the first time that a question of this type has produced a majority in favour of euro membership. A similar question was asked shortly after the general election in the British Election Study. Responses showed that a Government recommendation to join the euro had a large impact on the way Labour supporters would vote in a referendum on the single currency. Indeed, Government support for the euro was shown to reduce the balance of Labour supporters in favour of staying out of the single currency by 17% (to only 5%).

Overall support for staying out of the single currency was also reduced by a Government recommendation to join. Nonetheless, the balance in favour of staying out of the euro was still as high as 27% (see December 2001's Euro Convergence Monitor).

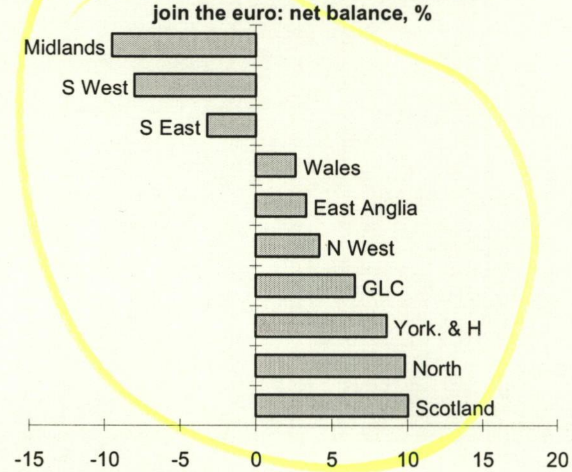
The impact of a Government recommendation to join the single currency (based on the five tests being passed) can be seen most clearly by looking at our regular Eurotrack question on how people would vote if a referendum on the single currency was held today.

The balance in favour of staying out of the euro fell four points between January and December (eight points between January and November). Nonetheless, there were still 27% more respondents who said that they would vote against joining the single currency than those who said that they would vote to join the euro (see the table at the top of next page).

In other words, the Eurotrack Survey suggests that a Government recommendation based on the UK passing the five economic tests is 'worth' around 28% of the votes - the difference between the net 27% who said they were against membership when the Survey question did not include a Government recommendation, and the 1% who said they were in favour of joining the single currency when the question did include a Government recommendation. This is a very large effect. Indeed, it is probably far larger than even the most pro-euro of market participants would have expected.

The Eurotrack results also show that a Government recommendation to join the single currency has a positive impact in almost all regions of the country. Respondents who would accept the Government's recommendation outnumber those who would not in all but three of the regions. Surprisingly, these are the Midlands, the South West and the South East.

Would accept a Govt. recommendation to join the euro: net balance, %



Source: NOP and Barclays Capital.

Eurotrack Survey, Q2: If a referendum on the single European currency were held today, would you vote for or against replacing the pound with the euro? % of respondents

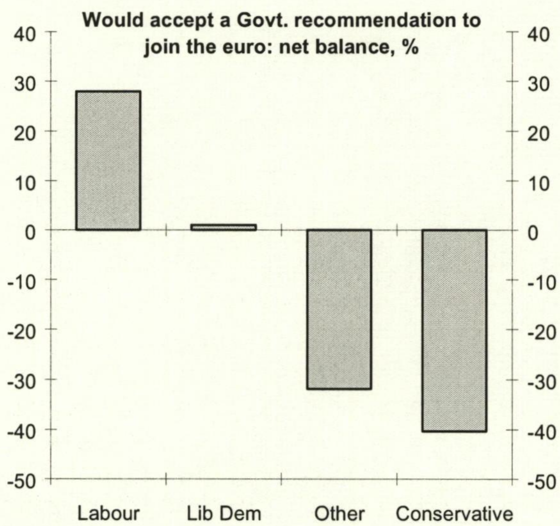
	2001		2002
	Nov	Dec	Jan
For	25	26	29
Against	60	57	56
Would not vote	4	5	3
Do not know	10	13	12
Memo item:			
Net balance ('for' minus 'against')	-35	-31	-27

Source: NOP and Barclays Capital.

The reluctance of voters in the Midlands to join the single currency is surprising given the area's strong reliance on manufacturing. Most pro-euro commentators have suggested that the strength of the pound outside the Eurozone has been responsible for manufacturing's recent decline.

In the South West, support for the Liberal Democrats, who are pro-euro, is relatively firm. As for the South East, it is strange that the balance of voters is negative - not least because the balance in London (GLC) is positive.

One explanation could be that support for the anti-euro Conservatives is strong in the South East. Indeed, a net 40% of all Conservative supporters say that they would not vote to join the euro even if the Government recommended joining on the basis that the five economic tests had been passed (see the chart below).



Source: NOP and Barclays Capital.

We will come back to voting splits by party support later. In the meantime, the key point to note is that a Government recommendation to join the single currency on the basis that the five economic tests had been passed would produce a majority in favour of entry in seven of the UK's ten regions. The majorities range from 3% in Wales to 10% in Scotland.

The Eurotrack Survey also reveals that there has been a reduction in the earliest time that the public would vote to join the euro. Previous Surveys have suggested that somewhere between five years' and ten years' time was the earliest respondents would vote to join the euro.

The December Survey showed, for example, that a cumulative 51% of respondents would vote to replace the pound with the euro within five years, a cumulative 54% within ten years. In the January Survey 60% of respondents said that they would vote to join within five years. More important, 47% said that they would vote to join within two years. This is a ten-point increase on December, and a fourteen-point rise on November. If this trend continues, then a majority of voters will soon be in favour of joining the euro within two years (see the table at the top of the next page).

Unsurprisingly, the breakdown of the responses to this timing question reveals that the largest support for early membership comes from Labour supporters. Fifty-seven percent of the respondents who would vote Labour tomorrow say that they would vote to join the single currency within two years. Sixty-eight percent say they would vote to join within five years. These numbers are up fairly sharply from November when they were 40% and 57% respectively (see the charts in the middle of the next page).

More important, 47% of the respondents who plan to vote Conservative said that they would vote to join the single currency within five years. This is up fifteen points from November. In other words, almost half of those supporting the

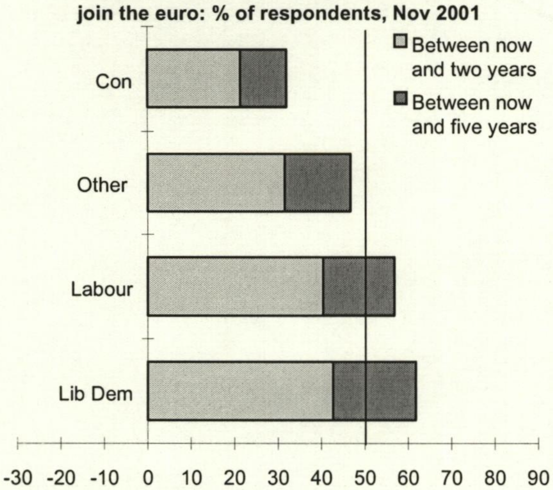
Barclays Capital's Eurotrack Survey

Eurotrack Survey, Q6: Regardless of when there may be a referendum on the euro, when is the earliest you would vote to replace the pound with the euro? % of respondents

	2001		2002
	Nov	Dec	Jan
Now	9	12	14
Within the next year	11	11	16
Within the next two years	13	14	17
Within five years	15	14	13
Within ten years	4	3	3
After more than ten years	3	3	2
Never	34	30	26
Do not know	12	13	10
Memo items:			
Between now and within two years, cumulative %	33	37	47
Between now and within five years, cumulative %	48	51	60
Between now and within ten years, cumulative %	52	54	63

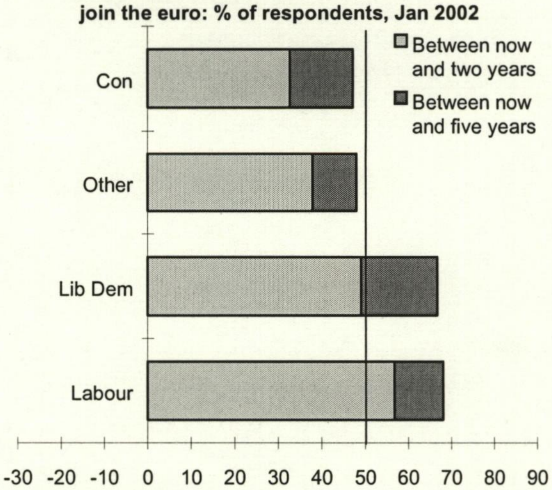
Source: NOP and Barclays Capital.

When is the earliest that you would vote to join the euro: % of respondents, Nov 2001



Source: NOP and Barclays Capital.

When is the earliest that you would vote to join the euro: % of respondents, Jan 2002



Source: NOP and Barclays Capital.

When is the earliest that you would vote to join the euro: % of respondents, Nov 2001

Source: NOP and Barclays Capital.

When is the earliest that you would vote to join the euro: % of respondents, Jan 2002

Source: NOP and Barclays Capital.

anti-euro Conservatives say that they would vote to join the single currency within the next five years (see the charts on the previous page).

A further breakdown of the timing question shows that all regions would vote to join the euro within five years. Majorities range from 4% in Wales to 19% in the South West (the latter figure makes the South West's reluctance to accept a Government recommendation to join the euro even harder to understand). Only two regions - East Anglia and the North West - would vote to join within two years, but others are fairly close.

This, again, suggests a large move toward earlier acceptance of the single currency compared to the situation in November. Back then, only two regions (East Anglia and the North) had a majority in favour of joining within five years. None had a majority in favour of joining within two years (see the charts at the bottom of the previous page).

Put all of this together, and the situation is fairly clear. Without much effort at all, the Government finds itself in a situation where it could obtain a majority in a referendum on the euro if it said that the UK passed the five economic tests and recommended entry. As important, voters now say that the earliest they would vote to join the euro is somewhere between two and five years, rather than the five to ten years that previous Eurotrack Surveys have suggested. This, fairly obviously, means that the chance of a referendum being held during the current Parliament, and of it being won by the Government, has increased fairly substantially.

The increase in pro-euro sentiment probably has something to do with the publicity surrounding the successful introduction of the euro - so we will have to watch how the Survey results change over the next few months. However, having suggested that the introduction of the euro wouldn't have much of an impact on our numbers, and been wrong, we are now reluctant to say that the trends highlighted by the January poll will unwind as coverage of the euro declines. This, of course, is where it pays to be running a regular monthly survey on attitudes to the euro - it means, after all, that we will know fairly rapidly just how important the introduction of euro notes and coins has been.

The other thing to point out is that a Government recommendation to join the single currency once the five tests have been passed only produces a significant majority in favour of entry among Eurotrack respondents planning to vote Labour - the Liberal Democrat majority is less than 1% (see the chart on page three). With Labour so far ahead in the polls, this might not seem very important. But the Eurotrack Survey continues to suggest that voters would prefer the Government to prioritise public services rather than the euro (see the table below). To the extent that voters are disappointed on this front, support for Labour and, therefore, the euro could decline - even with a recommendation to join from the Government.

Eurotrack Survey, Q1: Firstly which of these should the Government give priority to?

	2001		2002
	Nov	Dec	Jan
Health	42	51	47
Education	24	22	21
Law and order	12	10	13
Public transport	1	2	4
Economy (ex the euro)	3	3	3
Unemployment	3	3	3
Terrorism	7	3	3
The environment	2	2	2
Don't know/none of these	2	1	1
Social Security	1	1	1
Taxation	2	1	1
Joining the euro	1	1	1
Northern Ireland	0	0	1

Source: NOP and Barclays Capital.

This, though, is not really the key issue. In our view, what really matters is how easy the Government would find it to convince the 15% of the Eurotrack respondents who say that even if the Government recommended joining the euro (following a positive assessment of the five economic tests), they do not know how they would vote in a referendum.

Cross-matching respondents' answers to the questions on how they would vote both with and without a Government recommendation on joining the euro suggests that persuading this group might be slightly difficult. That's because the majority of the respondents who say that they do not know how they would vote with a Government recommendation are those who say that they would vote against joining the euro if a referendum was held today (162 out of 316 - see the first table at the top of the next page). That suggests to us that the assessment of the five

Cross-matching of responses to Eurotrack question two and this month's special question

		If the Government said the five economic tests were passed and recommended joining the euro, would you vote to join? Yes	No	Don't know	Wouldn't vote	Total
Referendum on euro today: how would you vote?	For	546	23	24	13	606
	Against	181	742	162	75	1160
	Wouldn't vote	12	10	21	26	69
	Don't know	82	31	109	30	252
	Total	821	806	316	144	2087

Source: NOP and Barclays Capital.

Key points: A Government recommendation to join the euro, based on a positive assessment of the five tests, convinces 181 of those who say they would vote against joining the single currency today to change their minds. Eighty-two respondents who do not know how they would vote today also change their minds. Somewhat bizarrely, twenty-three respondents who say that they would vote to join the euro today, say that a Government recommendation to join would make them vote against joining! More important, a postive Government recommendation makes 162 of the respondents who say that they would vote against the euro today, say that they do not know how they would vote. That means that those starting with a negative attitude toward the euro make up the majority of voters who say that they do not know how they would vote if the Government recommended entry. As this is the key swing group, this, in our view, makes increasing the majority in favour of entry on the back of a Government recommendation slightly harder.

Cross-matching of responses to Eurotrack question three and this month's special question

		If the Government said the five economic tests were passed and recommended joining the euro, would you vote to join? Yes	No	Don't know	Wouldn't vote	Total
How might don't knows in Q2 vote?	Probably for	31	10	10	4	55
	Probably against	3	5	7	5	20
	Really don't know	48	16	92	21	177
	Total	82	31	109	30	252

Source: NOP and Barclays Capital.

economic tests for membership of the single currency will have to be as clear and unambiguous as the Treasury says it should be.

In our view, this is supported by the fact that the next largest group who say that they do not know how they would respond to a positive recommendation by the Government are those who also say that they do not know how they would vote if a referendum on the single currency was held today (109 out of 316).

Breaking these responses down further reveals that most of this group (92 out of 109 - see the second table above) really don't know how they would vote if a referendum on the euro was held today (see the second table above).

The degree of uncertainty shown by this group suggests to us that it will be far more likely to accept a Government recommendation if the assessment of the five economic tests is clear and unambiguous.

The necessity for a clear and unambiguous assessment of the tests is also highlighted by the response to another of our Eurotrack Survey questions. This asks those who say that they would, or probably would, vote to replace the pound with the euro to indicate factors that might make them change their minds. Twenty-four percent of the respondents to this question said that they might change their minds if independent economists thought that the five economic tests for joining the euro had not been passed (see the table at the top of the next page).

Regular readers will know that we think the economic tests cannot be passed during this Parliament. We will not run through the reasons for this in any depth here - interested readers can **click on this link** to go to our analysis of the tests or visit the Barclays Capital website at www.barcap.com. Suffice it to say that we do not think the UK economy has converged with the Eurozone. Linked to that, the greater flexibility of

Factors that could change the minds of those who would/probably would vote to replace the pound	%
A concern that UK business would be hurt by the level of the euro if we adopted the single currency.	29
An expectation that prices would tend to be higher if the UK started using the euro.	27
If it became clear that economic growth was weaker in the Eurozone than in the UK.	26
Nothing would persuade me to change my mind.	26
A concern that the UK might join the euro at the wrong exchange rate.	25
Independent economists saying that the five economic tests for joining the euro had not been passed.	24
An expectation that interest rates would tend to be higher if the UK started using the euro.	21
An expectation that joining the euro would mean your terms/conditions of employment would get worse.	18
If it became clear that the UK was not losing political influence in the EU by being outside the Eurozone.	13
The Eurozone not introducing changes that would make it more like the UK economically and politically.	10
Other countries voting to stay out of the euro.	8
A strong case against the euro, presented by the media.	8
A strong case against the euro, presented by the main opposition party.	7
Don't know.	5
A strong case against the euro, presented by your employer.	5
A strong case against the euro, presented by the 'No' campaign.	4
Other.	2

Source: NOP and Barclays Capital.

our product and labour markets, the different structure of our housing market, different composition of our exports etc. etc. mean that the UK responds far more sharply to changes in interest rates than the Eurozone. Both factors suggest that it would be inappropriate and costly for the UK to adopt the Eurozone's one-size-fits-all interest rate policy.

If we are right about the tests, the Government should not make a recommendation to join the euro based on a positive assessment of them during this Parliament (the last possible date for the next general election is June 2006). However, anyone who follows economics closely knows that if you ask two economists to give you a view on something you usually end up with at least three, possibly four, answers.

Given that, there is a high probability that the Treasury could say that it thinks the tests are passed during this Parliament. The latest date for the assessment of the tests is June 2003, and the Treasury is currently engaged in preliminary analysis that will enable it to judge the tests, so we are not too far off a judgment.

We have argued above that the results of the Eurotrack Survey suggest that the more unambiguous the assessment of the tests is, the more likely the Government is to obtain a large majority at a referendum on the single currency - so a positive assessment of the tests by June 2003 might lead to only a slim majority in a referendum (not least because independent economists like us will be saying loud and often that the tests have not been passed).

But what if the Government is not really concerned about that? What if it is interested only in winning a referendum during this Parliament with whatever majority it can get to enable it to meet a political ambition of joining the single currency as soon as possible?

In our view, this would clearly be a high-risk strategy in terms of the sustainability of the UK's position within the single currency. It is also risky from a political point of view. The reason for that is as follows. The ideal 'window' for a referendum on the single currency is the summer-autumn of 2003. Last month's Euro Convergence Monitor outlines a detailed time-line of the events that would make a referendum before then difficult. These are largely political events, but there is also an economic justification for this.

This, of course, is the fact that most economists expect the UK to outperform the Eurozone over the next year or so. The Treasury clearly has some degree of leeway as far as persuading the public is concerned because the Government has successfully managed the economy over the last five years. But it would still be hard-pressed to convince the public that the economic tests had been passed when divergence in economic performance would be clear for all to see (Eurozone growth falling at a time when UK growth was rising, for example).

If the summer-autumn of 2003 is the best time for a euro referendum, then it will be difficult/ impossible for euro notes and coins to be in circulation before the next general election. This is especially true if Labour follows the usual format of holding the election a year before it has to, i.e. in June 2005 (governments typically do not like to hang on until the very last minute as it makes them look weak).

This would give the anti-euro Conservatives the chance to fight the next general election on the basis that it would stop the formal introduction of euro notes and coins if elected. It is true that Iain Duncan Smith said at the weekend that the Conservatives would not seek to reverse what the public had decided in a referendum on the euro. But would this be the case if a referendum had been won with only a very small majority? In our view, probably not.

This adds a clear political angle to the need to secure a large majority if a referendum is to be held during this Parliament. In other words, the Government needs to have a large majority behind the decision to join the euro, not least so that this can be maintained between the referendum and the next general election in order to prevent an anti-euro backlash that results in it losing power. This, in our view, can only be achieved if the assessment of the economic tests is clear and unambiguous. Such an assessment would say that the tests were not passed during this Parliament.

Put all of this together, and, in our view, it makes sense for a positive assessment of the five tests to be delayed until early in the next Parliament. Politically, this will mean that the maintenance of a large majority in favour of the euro between the referendum and the introduction of euro notes and coins is not so important (because a general election will not be looming).

Economically, the cyclical divergence that is expected between the UK and Eurozone over the next year or so should have disappeared. There is also a good chance that the UK and Eurozone will have become more structurally aligned (though this, unfortunately, might be through the UK becoming less flexible rather than the Eurozone becoming more flexible).

Finally, to the extent that cyclical and structural convergence has improved, the issue of how we get the exchange rate down to a level that is sustainable for manufacturing in the long run, and at the same time get interest rates down to the Eurozone level without unleashing an inflationary boom should also be less of an issue.

This then, is our central case. A positive assessment of the five economic tests by March 2006. A successful referendum, with a reasonably large majority in favour of the euro, by June 2006. An irrevocable fixing of the exchange rate against the euro by June 2007, with the introduction of euro notes and coins by December 2008.

The risk to this scenario is that the Government holds a referendum on the single currency sometime between the summer-autumn of 2002 and summer-autumn of 2003, delays the next general election until the last possible date (June 2006) and then tries to force the introduction of euro notes and coins through in a shortened timeframe (less than the two and a half to three years outlined in the national changeover plan). In doing so, it would prevent the next general election from being held before euro notes and coins had been introduced and, therefore, from this being a key election issue. Under this scenario, the exchange rate would probably be irrevocably fixed against the euro sometime between June and October 2004.

Before the January Eurotrack survey we would have said that there was only a twenty-five percent chance of this happening. This has now risen to forty-five percent. In other words, in an area of political economy where there is more uncertainty than most, one thing has suddenly become a little clearer - UK membership of the single currency just got a whole lot closer.

Full Eurotrack Survey results can be obtained by clicking here, or by visiting the Barclays Capital website, at www.barcap.com.

The Eurotrack Survey was carried out by NOP between the 10th and 15th of January 2002. The survey reports the responses of 2,087 adults aged eighteen and over. To visit NOP's website, go to www.nopworld.com.

Readers should note that Barclays PLC has a neutral position on whether entry to EMU is good or bad for the UK.

CONFIDENTIAL - PERSONAL

PTL

I think you are getting ahead of the game here. A lot of these questions should be answered informally now but v. confidentially & we need a proper discussion on it

From: Jonathan Powell
Date: 11 January 2002

PRIME MINISTER

cc: Stephen Wall
Jeremy Heywood
Peter Hyman
Sally Morgan
Alastair Campbell

EURO: ORGANISATION

Even if we take no further political steps in the next six months there are a series of organisational questions on which we need to start making decisions now. If we fail to address them we will not be able to get a campaign up and running when we need to. We should work back from what we want to happen during the campaign itself. The following strike us as the key questions.

1. How long a campaign do we want?

Under the legislation the campaign period must be at least 28 max days. The restrictions on budgets etc kick in however as soon as the referendum bill is introduced into Parliament if it has the date of the referendum on the face of the bill. I assume we want to go for as short a campaign as possible, not least since the government and civil service enter purdah as soon as the campaign period starts. But if limits on expenditure start with the bill, that would argue for introducing the referendum bill as late as possible. On the other hand we cannot be sure how long the Lords will delay the bill, so we cannot afford to introduce the bill too late. Stephen suggested introducing the bill this autumn without a date. That would allow us to get the bill through Parliament and only later set the date of the referendum, keeping the campaign as short as possible and giving us flexibility. But there are obvious political problems in firing the starting gun so early, leaving aside the damage it would do to the rest of the already hard pressed legislative programme. **What is your thinking on the length of the campaign?**

2. Umbrella Organisation.

The legislation allows the Electoral Commission to designate one umbrella organisation on each side. Its expenditure is limited to £5 million and the EC can give it a grant of up to £600,000. It is this body that has the right to TV time, free mail shots etc. Before introducing the referendum bill we must decide if we intend to make BiE that umbrella organisation or whether we should set up another body more directly under our control. If we do the latter how do we engage the pro-European Tories and the Liberals? If we intend to do anything other than use BiE we need to put plans in hand now to create such an organisation. **What is your thinking on an umbrella organisation?** It will be cross-party.

3. The Role of Government.

Up until the campaign proper (at least 28 days before the poll) the government machine is allowed to promote the government's view of the issue. That means that even after the referendum bill is introduced, when limits on expenditure by campaigning organisations begin, the government can spend money and campaign. We need to decide what government should do and when it should start doing it. What extra staff should we recruit and where should they go? To Stephen's empire in the Cabinet Office, the FCO, the press office? When do we start putting them in place? What advertising should the government do? Purely informational or campaigning? When should it start? How do we recruit an agency? Whose budget does it go on? The FCO is already doing polling, but it is made public so it is fairly useless (and conducted by the Tories' pollsters ICM). Should some other part of government be polling? If so, which? And if the government does it we will have to tender which means we cannot be sure what organisation we will end up with. Who in government should be leading on all this - presumably a combination of Stephen, Peter Hain, Peter Hyman and others? When we get to the purdah period 28 days before the poll, government campaigning will have to stop. Do we want special advisers, e.g. Alastair and Peter, to resign then and go and work for the Party or for the umbrella organisation? How will we fund continued ministerial campaigning?

3. **Campaigning Organisations**

We have managed to stabilise Britain in Europe financially but it has not proved itself to be the most competent organisation. Do we want to encourage it to become a "Yes" campaign now? Or do we want to set up an alternative organisation as a "Yes" campaign to take on Business for Sterling? Or would that just dilute resources? How do we get Labour Party people who want to be involved into the act? Do they need a separate vehicle, such as a Labour for Europe organisation, to commission the polling and devise the strategy we do not want to share with the Liberals and Tories in BiE? Is there a problem with people closely associated with you starting to work for a "Yes" campaign already? Do we want Philip working with Stan to do this or should he bring in someone new like Mark Penn? What do we want Charles Clarke and the party to be doing at this stage? They will be able to spend £5 million during the designated period. Should they be drawing up plans and considering how to raise the money? What should we be telling the European Commission it can and cannot do during the run up to a referendum?

4. **Political Leadership**

The campaign will need a political brain guiding it when it starts. Peter M would be the obvious person but there are fairly significant downsides. Who else is there? How do we set up a political campaign organisation involving HMT and us? Do we want to bring in others like Douglas Alexander?

5. **The Opposition**

We have very little information about Business for Sterling, the other anti organisations, what the Tories are doing etc. We ought to commission the Party to do some work on this.

Peter Hyman is producing a longer note next week that looks at a number of these issues in more depth. Richard Wilson will propose to you on Monday establishing a committee with him, Hayden Phillips and Stephen to consider the legal and constitutional implications of a referendum. I recommend you agree to this as long as he can satisfy you that this will not become public. I think you then need an internal on the Euro in the light of Peter's note on the politics and Stephen's earlier note on the economics in the next few weeks. **Agree?**

Jonathan Powell

JONATHAN POWELL

Jonathan Powell

From: MMU [mmu@cabinet-office.x.gsi.gov.uk]
Sent: 09 January 2002 12:19
To: FCO (Generic); 'kara.owen@fco.gov.uk'; 'newsdepartment@fco.gov.uk'; 'cicuk@cicuk.fco.gov.uk'; 'james.paver@fco.gov.uk'; Coffman Hilary - No. 10 -; Conabeare Harriet - No. 10 -; Braithwaite, Julian - No. 10 -; McNeil Lucie - No. 10 -; Sheehan Martin - No. 10 -; Khan Saeed - No. 10 -; Rizwi Sameena - No.10 -; Joseph Tanya - No. 10 -; Kelly Tom - No. 10 -; Livesey Tim - No 10 -; 'ashevas@no10.x.gsi.gov.uk'; Wilson Ben - No 10 -; 'cmcshane@no10.x.gsi.gov.uk'; 'cshoben@no10.x.gsi.gov.uk'; 'gerard.russell@fco.gov.uk'; 'gsmith@no10.x.gsi.gov.uk'; 'hmason@no10.x.gsi.gov.uk'; 'ri@no10.x.gsi.gov.uk'; Powell Jonathan - No. 10 -; Wall Stephen - No 10 -; Hyman Peter - No. 10 -; Campbell Alastair - No. 10 -; hain.general@fco.gov.uk
Subject: NOP Euro poll

PM / JP

Euro poll NOP/Powerhouse poll: If there was a ref tomorrow, how wld you vote? Yes 42% [32% last Feb], No 52% [62% last Feb]; How wld you vote if was a ref in a yr or two, & Govt & business backed it? Yes 51% [42% last Feb], No 43% [50% last Feb] (Poll conducted 4-6 Jan)
Anti-euro Bf£'s George Eustice: Probs with methodology of this poll .. wasn't a standard yes/no poll, & does give a distorted response .. people far less deferential than if '75 .. PM's are not to be followed, but judged (Powerhouse i/v)

From: Jonathan Powell
Date: 5 January 2002

PRIME MINISTER

cc: Stephen Wall
Alastair Campbell
Jeremy Heywood (o/r)

THE EURO

As you requested I have spoken to Ed Balls and asked him to provide lines to take on Gus O'Donnell and the Euro. I will forward these to you when they are prepared but I would not hold your breath. Hopefully these will be rather more durable and convincing than those provided by the Treasury yesterday.

This does not appear to be an immediate media problem, although it will be revived with Robin Cook on Frost on Sunday and - presumably - at PMQs on Wednesday.

The problem is, as you said yesterday, a longer term one. We need to have an intellectually defensible line. I think the problem is not so much the economic tests themselves. Their credibility has already been badly undermined. The problem is more the belief that we will propose entering the Euro for political reasons even if it is against British economic interests to do so. We therefore need to reassert that we will propose entry <u>only</u> if it is clearly and unambiguously in Britain's economic interest in addition to the political arguments for entry. I think the distinction intellectually is between the decision on whether or not to hold the referendum which is self-evidently a political decision and the assessment of whether or not it is in our economic interests where we will be guided by the assessment made by the Treasury economists of the economic tests. That means our line should be something like:

> "Self-evidently any decision to call a referendum on entry to the Euro will be a political decision taken by the Prime Minister, the Chancellor and the Cabinet. The final decision will rest with the British people in the referendum.
>
> But as we made clear in 1997, and this remains true, we will only recommend joining if it is clearly and unambiguously in British's economic interests to do so. The Treasury economists will assess the five economic tests and we will make our decision on the basis of their assessment. As a government we must be guided by the best available technical advice. That is what we will do."

Liz Lambert

pp **JONATHAN POWELL**

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1. cc: SW
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From: Jonathan Powell
Date: 21 December 2001 JP

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Lcc + SM

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PRIME MINISTER

EURO: POLITICS

Stephen has produced an excellent note for you on the technicalities of entry to the Euro. Over the break you need to think too about the politics - both British and European - in a systematic way and decide what preparatory work we now need to put in hand. There are wider problems than just how we deal with Gordon.

Firstly the date of the referendum. If you go for June 2003 (and I do not think you could go later because of holidays) you will be going just one month after local elections and Scottish, Welsh and Northern Irish elections. There will be pressure on you to go on the same day or possibly move the elections to the same date as the referendum (I do not know if this is technically possible). We need to think hard about the dynamic of this juxtaposition. Also worth bearing in mind it is during the Greek Presidency (just when things are getting difficult on Cyprus and enlargement).

Secondly the starting gun. People will start speculating on whether or not there will be a Referendum Bill in the Queen's Speech in November 2002. We can ride that out. But I assume you will want to announce the outcome of our assessment of the tests and the introduction of a referendum bill at the same time (and not have a consultation period on the former). If you want a six-month campaign you really want to launch these both in the first week of January 2003 with the maximum degree of surprise. I suppose you would call a Cabinet meeting and put the assessment to them and then make an immediate statement to Parliament coupled with introducing the bill. We would need a strong campaign in place to withstand the backlash we would immediately face.

Thirdly, warming up. So far we have got away fairly successfully with a feint and withdraw strategy. We need something a bit more planned over the next year. And if our aim is to bring the exchange rate down gradually (which will make the eventual negotiation on the final exchange rate much easier) we need a series of planned steps indicating that the decision is getting closer - a combination of speeches, indications that one of the tests have been met, publication of opinion polls showing that opinion is shifting etc. In January you should detail some people off to plan this.

Fourth making the political case. As you say this will have to be fought on the political case even more than the economic. The opposition is easy: giving up sovereignty, facing tax harmonisation and a federal state, loss of Queen's face etc. All visceral. Our arguments appeal more to the intellect: Britain has lost out by joining late at every step of the way, we will lose influence in Europe unless we join, threat of others moving ahead without us. We have to think of a way of making our arguments less high falutin' and more down to earth. As you say we need to appeal to the adventurous and bold aspect of the British nature while they will appeal to all that is timid and conservative. It is terribly important that we get some early work done on how we present the case and on our rebuttal, eg on tax harmonisation.

Fifth, machinery. Britain in Europe is weak. We need to beef it up financially and in terms of leadership. Is this a role for Peter or is that too dangerous? And we need strong government machinery in the FCO and the Cabinet Office. If we leave it to the last minute we will spend the 6 months of the campaign struggling to get it into place. In this as in other areas we have to balance the threat of giving the game away by making preparations that become public against the threat of not being prepared when the time comes. And what are we going to do about Eddie George? His successor will need to be chosen at the beginning of 2002, and he will presumably feel even freer to make his personal opinions known.

Sixth, the media. We will be fighting against an overwhelmingly hostile press. Is there anything we can do to reduce the odds by picking off certain papers? And how do we stop TV using the excuse of impartiality to skew the race to the advantage of the antis? We should discuss with Alastair and Peter what can be done.

Seventh, European politics. We think Schroder still owes us a big favour. He has probably forgotten. The French are fairly well disposed at the moment but may become more hostile by 2003. We are going to need the help of both of them if we are going to overcome the hurdles in our way – e.g. the exchange rate negotiation - and stop new hurdles being erected. That argues for taking at least Schroder into you confidence fairly early in the New Year. We should also work on the Commission. How do we stop our partners, or Prodi, saying incredibly unhelpful things in the course of the campaign?

Finally, the demands we should make of Europe as a quid pro quo for joining. The problem, as Stephen's note demonstrates, is that we are unlikely to achieve any of these before we join. So it is important not to make them conditions for joining. EG we can say that we will be arguing for an asymmetric inflation target when we join and aim to agree the necessary treaty change at the IGC in 2004. And we need to work out what other things we want to demand at the IGC to demonstrate the political gains we have made in joining the Euro. I think we should make an elected President of the Council rather than an elected President of the Commission a demand, at least of the Germans. I also like your idea of Elysee Treaty arrangements with French and Germans, although there are diminishing returns as the French and Germans have discovered in too much bureaucracy. What we really want is the threesome of UK, France and Germany able to meet, speak on the phone and decide things amongst ourselves. But that will be hard to force down the throats of the others.

We also need to work out what our strategy is on the exchange rate - both a technical and political issue. The idea of a secret negotiation with a series of European governments and the Commission fills me with horror. It is certain to leak. On the other hand we have to know what the exchange rate would be when we call the referendum. The best answer in my view is to work gradually to get it down to the level we want in the intervening period so the last jump is relatively easy. This is something to discuss at the meeting with GB in January.

JONATHAN POWELL

10 DOWNING STREET

PM

We have pencilled in a

meeting with GB, EB, GO

at Chequers in mid-Feb to

discuss the BoE and how it

should be reformed. I understand

that HMT have done quite

a lot of work on this.

You also need to give some

thought to the Governorship of

the Bank. Eddie is going to

become more and more difficult to

control as he moves towards

10 DOWNING STREET

Retirement in June 2003. You will need a pro-euro successor named well before the end of 2002 to reduce EG's relevance. I suspect GB will want to go for someone less enthusiastic about the euro! This could come to a head soon.

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228

FROM: **Stephen Wall**
DATE: **20 December 2001**

PRIME MINISTER

cc: **Jonathan Powell**
Sally Morgan
Jeremy Heywood

EMU: TIMETABLES AND STRATEGY

I attach two notes setting out some initial thoughts on the points that came up at Tuesday's meeting. The first sets out some of the issues we will need to address in firming up the timetable for a possible referendum. The second looks at some of the reforms we might use the opportunity of negotiations on UK entry to advance, though I do not think our partners are <u>so</u> keen to have us that they will be making concessions in our direction.

I also attach a revised version of the second timeline from my earlier note, assuming a June 2003 rather than a February 2003 referendum.

Stephen

STEPHEN WALL

We obviously must discuss this with HMT. (a) E.G. is going to be difficult (b) we need an exch rate deal <u>before</u> the ref. + (c) I wouldn't give up on some reform to the ECB.

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EMU TIMETABLE: TIMELINE ISSUES

This note sets out the main issues on the critical path that you will need to address in order to hold a referendum in June 2003 and to introduce euro notes and coins by spring 2005. This timetable involves the passing of responsibility for UK monetary policy from the Bank of England to the ECB in Spring 2004.

The note complements and provides a commentary on key aspects of the revised timeline (attached) which sets out in summary form the key dates for decisions assuming a June 2003 referendum. At this stage we have not attempted to reach conclusions on how best to deal with the issues in this note, but merely to flag them up and provide some background.

The main points in this note apply broadly unchanged should you decide to hold a referendum a few weeks earlier in May 2003 alongside the English local government elections and the elections to the National Assembly for Wales and the Scottish Executive.

Once we have made the decision to join and held a referendum all the key decisions are made at EU level. The Treaty sets out formally the key stages of the process. It is complex. But in summary:

a. At the UK's request, the Commission and the European Central Bank (ECB) report to the Council (ECOFIN) on "the progress made by [the United Kingdom] in the fulfilment of [its] obligation regarding the achievement of economic and monetary union": are we convergent and otherwise up to scratch?

b. The Council decides, by a qualified majority, whether the United Kingdom "fulfils the necessary conditions". This is a complicated procedure involving a Commission proposal, consultation with the European Parliament and decision in ECOFIN. (*Mutatis mutandis*, this corresponds to the events at and around the EMU meeting of Heads of State and Government in May 1998).

c. The Bank of England pays its subscription to the ECB, contributes to the ECB reserves and transfers foreign exchange reserves.

d. The Council fixes the exchange rate between sterling and the euro (by unanimity of euro participants and the UK, on a proposal from the Commission and after consulting the ECB). (For the first wave this happened formally on 31 December 1998, though political agreement was reached on the rate in May).

why does this need to happen only after a referendum

The issues that require consideration can be divided up into three main categories:

(i) those that need to be addressed before the Council makes its formal decision to admit the UK to EMU (ie up to around February 2004);
(ii) those that can be largely deferred until after the Council decision but which need to be addressed before the introduction of notes and coins (ie from around February 2004 to around Spring 2005). The formal locking of rates will happen during this period, probably around July 2004. **This marks the point at which the Bank of England will cease to be responsible for setting UK interest rates and responsibility for UK monetary policy passes to the ECB**;
(iii) the exchange rate (which is an issue spanning both periods up to the formal locking of rates around summer 2004).
(iv) Developments in the external environment.

Issues before the Council takes its decision on principle of UK membership

(i) Timing of completion of the five tests assessment

Under the June 2003 scenario we will need to make a final decision on whether to call a referendum very early in 2003 and preferably not later than the end of 2002.

There are three approaches to completing the assessment. HMT could either publish a draft assessment, invite comments from academics, business and others and then work up the final assessment to be submitted to you before the referendum decision is made. Or we could move straight to submission to you without a consultative stage. In both cases the final assessment would only be published alongside announcement of the decision to hold a referendum. An intermediate option would be for the Bank of England to be involved in agreeing at least some parts of the assessment. The Governor has, in any event, already indicated that the Bank will publish their views on the five tests. So it would be useful to bind them into the process in this way. We understand HMT have also been considering this issue of how best to approach the Governor.

this is essential

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There ought to be no difficulty for HMT to work up the comprehensive assessment they will want to produce on this timescale. But to put out a consultative document will be slightly more difficult. To allow sufficient time for informed responses before the final assessment and referendum bill this would need to issue early in autumn 2002. If we went down this road we would need to build it into the timetable fairly soon so that work on the assessments could be speeded up slightly.

On the face of it, the slow burn scenario is rather unattractive. All those economists ("who know 100 different ways of making love but don't know any women", as Geoffrey Howe used to say) will be tugging this way and that. There will be a lively debate. On the other hand, to some extent, you could allow the debate to exhaust itself and then come in with a clear and unambiguous judgement at the end. That might be easier than having to announce the assessment and fire the referendum starting gun at the same time. But the politics of this are complex, I recognise.

No!

(ii) Legislation

As the timeline sets out, we will need to pass at least three separate pieces of primary legislation, before the Commission and ECB can send their completed assessment of whether the UK meets the convergence criteria to the Council for the decision on UK membership.

Why before?

Esp. difficult to have a referendum without knowing the likely exch rate.

The **Euro Referendum Bill** will need to be passed at least six weeks before the referendum is held. This means it has to receive Royal Assent by April 2003. The extent to which it will be possible to manage opposition to the Bill in the Lords, in the absence of formal guillotine or programming powers, will be the key constraint in determining how early the Bill needs to be introduced.

The **EC (Amendment) Bill** will be needed to alter the terms on which Parliament signed up to the Maastricht Treaty and the UK's EMU opt-out. This would need to be passed before we can formally notify the Commission and ECB of our decision to seek to join EMU. It therefore needs to be on the statute book by the end of the 2002-03 legislative session and, ideally, before the summer recess.

Finally, the **Bank of England (Amendment) Bill** will be required to ensure that the UK meets the requirements of the Treaty. The major components include:

- abolishing the Government's overdraft with the Bank of England;

- creating a new foreign exchange reserves regime and taking powers to allow the Bank to transfer reserves to the ECB and pay up its subscriptions;
- Minor changes to guarantee the full independence of the monetary policy side of the Bank of England.

Our working assumption is that so long as this Bill has received Commons Second Reading before the Commission/ECB start their assessment this will be sufficient to demonstrate a firm intention to comply. This would point to introduction in the Commons at the very beginning of the 2003-04 Parliamentary session at the very latest.

What if the Lords block it?

None of these Bills need be especially long or complex, though the extent to which we include non-essential elements in the Bank Bill is, we gather, being considered carefully by HMT. But of course the sensitive nature of their content may mean that they demand significant time being discussed on the floor of both Houses.

One of the points we have been keen to stress is the Parliamentary lock over the decision to join. This is guaranteed in two parts: without agreement to the Referendum Bill the question cannot be put to the people. And without Parliament passing the EC (Amendment) Bill we cannot notify our intention to end the opt-out.

There may also be pressure from the Commission and ECB to ensure that Gibraltar law is consistent with the Treaty before the Council can give a positive decision that the UK meets the convergence criteria. If the GoG is unable or unwilling to do this in the time available through local legislation we may need to pass Orders in Council to override their local laws before February 2004. (We may, ultimately, need to do this anyway, albeit on a slower timescale). The read-across to the Brussels process negotiations between Spain and the UK over Gibraltar's future status will need to be carefully considered here.

Issues before the introduction of notes and coins

(i) Speed of preparations for euro notes and coins

The revised timeline looks to secure the introduction of euro notes and coins in April 2005 and the end of a short dual running period by June 2005. This allows 22 months for preparation by business and the public sector after the referendum result is known. This timescale is extremely tight. HMT's Changeover Plan suggests that between 24-30 months will be needed. Given that advance preparations have already started in those parts of the public sector where the lead times are longest (the tax and social security agencies) the public sector is not likely to be a binding constraint on the earliest date for the introduction of notes and coins. But the shorter the time scale for the changeover the greater the extent to which the attentions of the public sector will be diverted away from delivering other public service priorities during this period.

The physical minting and printing of coins and notes will not be a material constraint provided that we are willing to outsource production.

that can't be right!

HMT have not said anything publicly about the costs of the changeover. Private estimates vary wildly but the Commons Treasury Select Committee has suggested the may be of the order of £30bn. Most of this will fall to the private sector, though a significant minority of the costs will fall to the public sector, particularly the tax and social security departments, the Post Office and public transport operators.

(ii) Legislation

Legislation is less of a constraint than in the period before the Council's decision on UK membership. But we will still need to ensure the Bank of England Act reaches the statute book before it can pay its subscription to the ECB and transfer a portion of the UK's foreign exchange reserves. This needs to happen shortly after the Council's decision. Which points to the Bank Bill completing its passage by around March/April 2004.

Before euro notes and coins are introduced a further **Euro (Conversion) Bill** will need to be passed to change references to sterling in legislation to euros and update one or two other parts of the statute book. This could be done late in the 2003-04 Parliamentary session.

(iii) Other issues

There is a whole host of important, if second order, issues that will need to be resolved in the period between the formal Council decision and the introduction of euro notes and coins. Many of them have the potential to raise the political temperature.

In particular, between around February 2004 and February 2005 we will need to reach rapidly final decisions and then seek to negotiate them with the Commission/ECB/Council on subjects including:

- Future monetary arrangements for Gibraltar (insofar as we aren't forced to determine and agree that before February 2004);

- Future monetary arrangements for the Isle of Man, Channel Islands and the Overseas Territories outside the EU which use sterling;
- Decisions on the continuation of note issuance by the Northern Irish and Scottish commercial banks;

The more preparatory work on these issues is taken forward before the formal Council in February 2004 the better. It is important not to under-estimate the complexity of some of these points and the disproportionate amount of time likely to be needed to resolve them with our partners. But so long as we start thinking about these issues early after a positive referendum result they ought not to cause us too many problems in the EMU negotiation. They will of course be extremely sensitive as far as relations between the UK, Gibraltar, Isle of Man, Channel Islands and the Overseas Territories.

The exchange rate

Developing an exchange rate strategy is the biggest single issue which will need to be addressed in order to secure a successful glidepath into EMU. It impacts on virtually everything else.

There are a number of issues to consider and real tensions between different objectives. In considering the questions set out below you need to bare in mind at all times the distinction between:

(i) a political deal on the exchange rate – which we might want to be pursuing as early as the first half of 2003 - and
(ii) the legal locking of rates – which will not happen until spring 2004.

The first question is **whether we can complete the assessment and fight a credible referendum campaign without making, at minimum, some broad assumption about the entry rate.** This looks very difficult. Aside from then political pressures to say something on this issue it is difficult to complete sensibly, let alone publish, the five tests assessment without knowing roughly what the entry exchange rate will be.

If we accept that analysis the second question is **how can we reach such an understanding**. Simply stating unilaterally that we will aim to negotiate an entry rate within a particular band with our partners looks may prove difficult to defend in a referendum campaign. This points to seeking to reach a private deal with the other key players in the form of a political agreement with (at minimum) the Commission, ECB and France/Germany on the entry exchange rate. This need not be a precise figure for the entry rate. Instead negotiating agreement to an entry range or something like "around [say] DM

2.95" which could be incorporated into a one line "core script" that all parties would stick to during the referendum campaign and honour when it came to the formal business of legally setting the entry rate might well suffice politically and prove easier to negotiate. The thing is to ensure the key players (and ideally all EU Governments) are sending out the same message on the entry rate during the referendum campaign.

Reaching such a deal will not be a straightforward process. The Treaty is clear that the Council decision on the formal locking of exchange rates takes place after the Council decision on whether the UK meets the convergence criteria. But of the eleven original EMU members, all of them reached political agreement on the entry rate at the May 1998 European Council alongside the decision to admit them to EMU. Ten of them agreed that their entry to the euro-zone should be fixed at their ERM central parity. The exception, Ireland, reached political agreement on a small revaluation (revaluations are always easier to secure than devaluations). None of this came as much of a surprise – nobody had seriously suggested the central rates should be extensively re-aligned in the months leading up to May 1998.

However, because we are not members of the ERM, we therefore have no central rate acting as the focal point for the expected entry rate. Reaching a deal on the entry rate, or even an entry range, will therefore be much more difficult for us than for the other euro-zone members.

There are various options for choreographing such a deal. But they come down to two basic options, with variants on the precise timing. Not all may be negotiable.

- **Seeking to negotiate secretly the sterling entry exchange rate/range/core script for use by partners during the campaign**. This could either be done very rapidly after the decision to hold a referendum was announced - and revealed either during the passage of the Referendum Bill or very early in the referendum campaign. Or we could try and do the deal earlier, in advance of the decision on whether to hold a referendum so that it could inform the five tests assessment as well as the referendum campaign. The expected entry rate could be announced alongside the decision to hold a referendum was made public. We would have to make clear (or would run the risk that others would do so for us) that this political agreement was "without prejudice" to the prerogatives of the Commission, ECB and Council in judging whether the UK met the convergence criteria and the subsequent legally binding Council decision on the entry rate.

- Negotiate to join ERM II for the period up to the formal fixing of the exchange rate immediately. As with the first wavers this would create a more or less explicit expectation that the central ERM rate would also be the rate at which the sterling/euro rate was irrevocably fixed. But that would explicitly only be a political expectation. There would be no suggestion that the ECB/Commissions' prerogatives were being called into question. Such a deal could be negotiated either immediately after a referendum is called, or alternatively just before - so that the rate can be factored into final judgements on the five tests.

Worth noting that the point of rejoining the ERM would simply be to send a strong signal on the likely entry rate into EMU itself. Given that the permitted fluctuation bands are now +/- 15% they are unlikely to act as binding constraints on the exchange rate in practice. We think the French share this view.

Fairly reliable institutional machinery for confidential negotiations on exchange rate issues already exists in the form of the Economic and Financial Committee (made up of senior Finance Ministry and Central Bank officials plus Commission). Its predecessor, the Monetary Committee, prided itself on the fact that its deliberations never leaked and, where necessary, they could reach difficult decisions quickly. But to maximise the prospects that this process runs smoothly we would need to sound out key players (Commission, ECB, Germany, France, and perhaps the (Greek) Presidency) on both the EFC and No 10 nets informally in advance of any such secret negotiation.

The third question relates to **how we manage the process of getting sterling to a sustainable entry rate**. Can we say anything to influence this before we start looking to make deals? Or is it possible to look for a deal on an entry rate below the market rate? And how do we go about achieving a depreciation?

On **timing**, there may be tactical advantage in ensuring that the process of getting the pound down to a sustainable level was finalised well before any secret negotiations were underway. It ought to increase the prospects of achieving an acceptable outcome in such talks if the "target" rate is close to the market rate.

On **tactics**, the forex markets are heavily influenced by latest expectations of prospects for the UK joining the euro. Other things equal, every time you give a speech which is positive about euro entry the pound/euro rate declines in the expectation that the market rates that have been prevailing throughout the last year are unsustainably high. So a concerted and sustained set of positive messages from the Government on the prospects for euro membership ought to help here. In other words, if you and the Chancellor are saying the same thing (and not being spun to the press as meaning different things) the exchange rate could be managed downward.

But we do need to be subtle to avoid talking down the pound to such an extent that we "undershoot" a sustainable exchange rate. If we do, the MPC will respond by increasing interest rates, damaging the convergence process and creating an unhelpful backdrop for a referendum. In contrast, the impact on forecast inflation, and therefore interest rates, of a depreciation of the order necessary to bring the pound down to (say) DM 2.95 should not be material.

Fourthly, **what is the right entry rate**? On the one hand the Treaty convergence criteria require exchange rate stability (and even if this is not interpreted in the strict sense of requiring two years membership of ERM II the ECB and Commission at least will focus on the issue closely mindful of creating precedents for Poland etc).

But against there is a consensus amongst economists (or as near as they will ever get) on the need for <u>some</u> depreciation of sterling against the euro before we can lock rates. The precise scale of the over-valuation is a hotly debated point with estimates varying from as little as 2% (down to 3.10 equivalent against the DM) to as much as 20%. (around 2.50 DM). The Treasury appears to think that around 2.95 DM, the old ERM central rate parity, might be a sustainable entry rate. We think the French share this view (and might even be prepared to go a little lower). This implies a devaluation of 6.7%. Since the ERM II fluctuation bands are now +/- 15% we ought to be able to argue that a depreciation on this scale was not inconsistent with broad exchange rate stability.

In conclusion, you and the Chancellor will need to reach an early judgement on how to handle the exchange rate issue. If you favour secret pre-negotiations before the five tests assessment is completed decisions will be needed by the end of 2002 at the very latest. If you are content to leave such negotiations until after a referendum has been won decisions can be deferred until spring 2003.

Other developments in the EU

A number of other factors, whilst not requiring decisions by the Government, need to be taken into account in considering the timetable:

(i) Legislative and Presidential elections in France in spring/summer 2002 and the German federal elections in Autumn 2002.

(ii) The Presidency of the EU and the Euro-X group will be held by Greece in the first half of 2003. The Italians take over in July 2003.

(iii) If Persson is re-elected in Autumn 2002 the Swedes plan to hold their referendum on euro membership in Spring 2003.

Major negotiations that will be ongoing during the run up to a June 2003 referendum and beyond include:

- Future of Europe. The Convention is due to report by spring 2003. We will be pressing to ensure that there is a decent firebreak before the IGC proper starts.
- Tax package. Final decisions due by the end of 2002 so ought to be out of the way by June 2003. However, all the signs are that discussions at Copenhagen in December 2002 will be exceptionally difficult. So we cannot rule out that the debate will drag on into the first part of 2003.
- Enlargement. Agreement to the first wave of enlargement looks likely by the end of 2002 so the ratification process will be taking place in 2003.
- Agenda 2007. Some suggestions that parts of the Commission favour publication of future financing proposals as early as 2003. But Prodi's people seem clear that this will not emerge until at least spring 2004.

CABINET OFFICE
DECEMBER 20 2001

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SCENARIO 3: REFERENDUM IN JUNE 2003

January 2003	Assessment of five tests completed; **Cabinet takes decision** on whether to notify intention to move to Stage III if Parliament and people agree
January to April 2003	**Referendum Bill** in Parliament. RA by Easter recess.
April 2003	Establishment of umbrella campaign bodies; decisions on financing of "yes" and "no" groups
May 2003	Formal Referendum campaign
June 2003	**Referendum day**
June to August 2003	**Bank of England and EC (Amendment) Bills** introduced to Parliament [EC(A)B needs to pass before formal notification; BoEB before transfer of forex reserves etc to ECB] Amendments to Gibraltar monetary legislation published
August 2003	**Formal notification** to Council/Commission/ECB of intention to move to Stage III
September to November 2003	**Assessment** by Commission and ECB of whether UK meets the convergence criteria
December 2003	**Decision (by QMV) by Council (meeting in composition of Heads of Government and State) of whether UK meets criteria to move to Stage III**. [Accompanied by political agreement on entry exchange rate?]
January 2004	Bank pays subscription to ECB and transfers forex reserves
January 2004 onwards	[Negotiation of entry exchange rate if political agreement not reached previously]. Negotiations on other arrangements for UK entry (eg arrangements for Gibraltar, Crown Deps, rights of NI/S Banks to issue own notes; national symbol on notes)
By Spring 2004	**Formal decision by Council (unanimity) on entry exchange rate** on basis of Commission proposal Decision by Council on other arrangements for UK entry
By Spring 2004	ECB decisions on notes (national symbols; Scottish and NI issuers) National decisions on coin specification needed; manufacturing of coins starts [but will still need to outsource much production]
July 1 2004	**UK moves to Stage III; currencies irrevocably locked. ECB sets UK interest rates from this date**
Late 2004	Bill to amend references to sterling in legislation
April 2005	**Euro notes and coins introduced**
June 2005	Sterling notes and coins withdrawn

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EMU: POSSIBLE LINKAGES TO DECISIONS ON OTHER ECONOMIC ISSUES

This note sets out some of the macroeconomic and institutional issues on which we might seek to make progress as part of the process of negotiating to join EMU. It is based on our understanding of the Treasury's main concerns about the current euro-zone fiscal and monetary framework.

We have not sought to assess in detail the prospects for being able to negotiate these changes with other Member States, the Commission and ECB. But it is probably fair to say that at least some of our partners will be looking for concessions from us in return for their agreement to UK participation in EMU at a sustainable exchange rate.

Changes requiring Treaty change could only be effected in the 2004 IGC at the earliest and would take around two years to come into force. The Germans are likely to be highly resistant. But most of the suggested changes set out in this note do not require Treaty change. However, changes in the way the ECB interprets its Treaty objectives will be particularly sensitive. Rather than seek to make any formal linkage with the negotiations on UK entry they are probably best pursued in a low key way once inside EMU.

➢ ECB reform

Some specific reform ideas are outlined below. But the key point is the desired direction of the reforms we would support. They can be grouped into three main areas:

The ECB's targets

The Treaty gives the ECB **full operational independence** and, unlike the Bank of England, a **considerable degree of target independence**, within the Treaty requirement of ensuring price stability. If we wished to change this arrangement, so that, as in the UK, politicians set the target and the central bank is then charged with delivering it, this would require Treaty change. Such a change would be extremely difficult to negotiate. It could have an adverse effect on the dynamics of our whole entry negotiation. The Germans in particular would fear it was an attempt to undermine the ECB's independence.

But there are other changes which would not require Treaty change and go some way in this general direction.

The ECB has chosen to interpret price stability as inflation of 2% or less (on the "HICP" measure, on which UK inflation tends to come out lower than on our own RPI based measures). Put another way, the ECB has an incentive to maintain a slightly tighter than optimal monetary policy because the costs to its reputation of overshooting the 2% ceiling ("failure") are greater than the costs of inflation coming in significantly below 2% ("still within target").

This **asymmetry** in the inflation target has raised concerns that the ECB may take an unnecessarily cautious view in setting interest rates, to the detriment of growth and employment. A symmetrical inflation target or, failing that, a greater readiness to explain how growth and inflation prospects are balanced when setting interest rates, especially in conditions where inflation does not threaten the 2% target, would provide reassurance that there is no systematic bias in favour of reducing already low levels of inflation over following policies supportive of growth. This would not, in itself, require Treaty change. But without it such a change will only happen if and when the ECB are won round to the merits of symmetrical inflation targets.

An alternative approach to address the fears of a systematic bias to a tight monetary policy would be to amend the Treaty to make more explicit the ECB's existing secondary target of supporting the general economic objectives of the EU. These are already referred to in somewhat obscure and inaccessible language and include promoting a high level of employment and raising the standard of living.

Such a change might be largely cosmetic but could be attractive in terms of changing perceptions. However, the Germans and the ECB would both be nervous about the motivation behind such a change. Was the real intention to water down the commitment to stable prices?

Enhancing Transparency and openness

The ECB is widely seen as one of the least open central banks in the world. It has not yet been able to develop good mutual understanding with the markets who often see its pronouncements as opaque and confused. This can damage the effectiveness of monetary policy. While there is a debate to be had about the desirability of publishing voting records (greater openness but at the price of greater attention to national interests?) other, relatively modest, reforms may go a long way to improve understanding of its actions and therefore the effectiveness of monetary policy. These include **early publication of the minutes** of meetings, including the **results** of any **votes** and publication of an **ECB quarterly economic forecast**. None of these changes require Treaty change.

Increasing Accountability and consultation

While the ECB President and Executive Board members regularly appear before the European Parliament's Monetary Affairs Committee it is not formally held to account by any body for its performance. And although the ECB President and Vice President regularly attend Ecofin discussions the quality of dialogue between the EU's central bankers and politicians remains weak. The trick is to improve **communication** and **accountability** without impinging on the ECB's **independence**. More systematic **dialogue** between Ecofin and the ECB would help here. For example, the ECB has a valuable insight into the structural reforms necessary to deliver the EU's Lisbon target and could play a useful role in such discussions. The ECB might also be asked to make a regular presentation to Ecofin outlining its views on current economic conditions and the implications for monetary policy. In turn Ecofin/euro-x could provide its latest assessments of fiscal prospects on a more structured and timely basis.

At Member State level, accountability could be facilitated by ECB Governing Council members testifying before **national Parliaments** (in the same way MPC members regularly appear before Commons and Lords Committees). The Governor of each national "in" central bank might have a special role here.

None of these reforms require Treaty change. But because they are solely within the ECB's competence neither can Ecofin or the European Council give instructions to the ECB. In any event ex cathedra statements by politicians on the issue are likely to make the ECB more defensive. So whilst we should not be afraid to continue to indicate the nature of the reforms we favour, and to step up our activity in this area after a positive referendum result, we need to pursue carefully. A first step might be opening discussions with key Member States, notably France and Germany, on these issues. Contact with the ECB will need to be handled particularly sensitively. These issues are probably best pursued from inside EMU, ideally with a UK member on the ECB's six person Executive Board.

Reforming the decision taking process and dealing with enlargement

At present key decisions at the ECB are taken by **the Governing Council**. This includes the President, Vice President, the four other members of the Executive Board and the Governors of the twelve national "in" central banks. Each has an equal vote. Eighteen members is already at the large end for an effective decision making body. And giving equal votes to all national bank governors, regardless of the size of their national economy, creates a danger that the "**periphery**" has a relatively stronger influence over policy than the "**core**".

There is no evidence that these concerns have, in practice, damaged the functioning of the ECB. But in an enlarged EU there is a strong case for giving relatively greater power to the six person **Executive Board**. Over time the members of the Executive Board are in any case likely to grow in influence as the Governing Council becomes unwieldy. Worth noting that when the Nice Treaty comes into force it will be possible for the rules governing voting arrangements in the Governing Council could be amended by unanimous agreement in the (Ecofin) Council, rather than requiring Treaty change, as now.

➢ **Macro-economic co-ordination in the euro-zone**

It is too early to reach definitive judgements on the effectiveness of the euro zone's economic governance arrangements. The key issue is probably the extent to which the **euro-x** group can successfully co-ordinate fiscal policy across the euro-zone under the framework of the **Stability and Growth Pact** (SGP) and convey clear and timely information to the ECB on the euro-zone fiscal stance. There are two aspects to this:

- The **effectiveness of co-ordination** in euro-x. After a rather lack lustre start the quality of these meetings has been improving of late, with proper preparation in the EFC (at 15). But there are still issues surrounding the timeliness of assessments of national budgetary programmes, which are invariably assessed at different times, only after they have been published (and therefore unamendable), often only just before the fiscal year to which they relate commences. Consequently it is not always easy for the ECB to build up a coherent picture of the cumulative effect of budgetary decisions across the eurozone. While there is a limit to the extent to which national procedures can be pre-empted, if the right macro policy mix is to be followed it is important that the ECB is able to take account of expected changes in fiscal stance in setting interest rates. This suggests further improvements to the functioning of the euro-x group (while respecting Ecofin's decision taking role);

- The **interpretation of the SGP**. The medium term objective for fiscal policy enshrined in the SGP is budgets "in, or close to, balance." The ECB have generally argued that where euro members public finances have not reached this position (eg France, Italy and Germany) it is inappropriate to allow the so-called automatic stabilisers (changes in revenues and spending induced by the economic cycle rather than discretionary policy action) to work in full. To do so would run the risk that the 3% limit on deficits might be breached and would worry the markets that the disciplines of the SGP are being relaxed at their first test. Further fiscal restraint is necessary.

  However, the Chancellor, supported by most other Member States, including France, has publicly argued for a more liberal interpretation. Schroeder has even gone as far as to argue for an EU wide fiscal stimulus package (others have thus far reacted coolly). In the Chancellor's view we should be pushing for a more flexible view of the SGP text. This would give much greater weight to factors such as the existing stock of public sector debt, the cyclically adjusted deficit and the level of capital spending in total public spending in determining how far deficit targets can be revised upwards to take account of falling growth - while remaining within the terms of the Pact. And thus avoiding potential fines. This would make the SGP framework closer to the UK fiscal framework, with its emphasis on the golden rule and sustainable debt levels.

➢ **UK member of the Executive Board**

Under the transitional arrangements in May 1998 one member of the existing Executive Board will retire every July between 2002 and 2006. Once we have made a positive decision to join EMU and have secured a yes vote in a referendum we will want to secure a UK member of the Board as soon as possible. This is partly for presentational reasons, but will be critical if we are to ensure that the case for ECB reform outlined above is pursued vigorously in Frankfurt.

Ideally therefore if a referendum is held in June 2003 we would want to secure the replacement seat for the Finnish member retiring that July. This might be difficult to secure, given the tight timing and the reluctance of the "smalls" to see another member of a large euro-zone member on the Board. So the rotation in July 2004 may be a more realistic goal.

Two other points are relevant here:

(i) The outcome of the Duisenberg succession. Both the timing of his departure and whether Trichet is cleared of fraud allegations - and is therefore able to take up his anointed position as successor – are uncertainties. As is how the French will react if, as seems likely, Duisenberg stays on beyond June 2002 when the French Vice President of the ECB, Noyer, is due to be replaced.

(ii) Convention dictates that we would probably appoint a senior serving or former central banker to the Executive Board. So decisions on whether the existing Governor and Deputy Governors of the Bank of England are re-appointed need to be considered. Eddie George's term ends on 30 June 2003 while Deputy Governor King's term expires on 1 June 2003. Deputy Governor Clementi's term ends on 1 September 2002. So, in principle, by July 2003 there may have been significant changes in the senior team at the Bank.

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There are clearly the problems of a single currency area. But there are answers that I will return to in a note!

From: **Derek Scott**
Date: **20 December 2001**

PRIME MINISTER

cc: **Jeremy Heywood**
Andrew Adonis
Jonathan Powell
Stephen Wall

"Imbalances" in the UK and Euroland

In recent years the outstanding feature of the UK economy has been its overall stability. One of the reasons for this is that the MPC has the responsibility to set interest rates on domestic criteria and the exchange rate is free to perform its stabilising function.

One of the benefits of EMU is supposed to be that it leads to more "stability". But if the UK had been in EMU we would have bought greater stability of the pound with the rest of Euroland at the cost of greater instability of output and inflation.

The same is true of existing participants. Much commentary is in terms of Euroland. But there is no such thing as a Euroland economy, only the economies of participating countries. In a number of countries EMU has brought about increased instability and more volatile economic cycles.

The attached note looks as Holland and Ireland, but Portugal and Greece are in similar difficulties.

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Policy makers will always make mistakes from time to time. There is no guarantee that the MPC, the Fed or the BOJ will always get it right, but that is different from a monetary policy framework that by its very design will increase economic instability for its participating members.

This essentially results from the fact that EMU reinforces both the upswing and the downswing of the economic cycle for a particular group of countries, which may vary from time to time, because it accentuates the cycle of real interest rates. This might be reinforced by another aspect of the enterprise.

The euro is expected to introduce greater transparency of prices. Over time, the price levels of the different countries will converge. Since there is no opportunity for the necessary rise in the real exchange rate to be brought about by a rise in the nominal rates, this means that in the low price level countries the rate of price increases will be greater than in the high price level countries. In other words there will be divergent rates of inflation. Since there is only one nominal interest rate in Euroland, this means that there will be divergent real rates of interest with consequent impact on economic cycles.

The thought behind this note was triggered by an editorial that appeared a few weeks ago in the FT.The editorial included two remarkable sentences.

"Higher inflation last year in Ireland was a natural adjustment to different economic conditions in a currency union. It showed the euro was working rather than failing".

These two sentences are true and false at the same time. The first sentence is true, but begs the question was to whether the outcome is a good or bad thing or might otherwise be avoided. The second sentence is also true, in that higher inflation in Ireland is the natural outcome of the punt's participation in the euro, but it is an odd definition of success.

Others must judge the politics of all this, but in my view the economics are going to get very difficult in the next few years.

1. For seven or eight years the UK economy has been one of the most stable economies in the world in terms of growth and inflation. The main reasons are pretty clear: the supply side reforms of the 1980s, the fiscal consolidation initiated by Lamont and completed by us in 1997, and Bank of England independence.

2. Step changes like these provide a momentum that can carry an economy forward for a considerable period of time. In the past few years we have reaped the benefits. It is less easy to judge the effects of our micro-measures. Some may bear fruit, but we have complicated the tax system and added grit into the wheels of labour markets. Too much of our economic/industrial policy is prescriptive and tinkering.

3. It is sometimes difficult to appreciate the length of time it can often take for policies to take effect, for good or ill. When the good times roll the harmful effects of measures that slowly impair the functioning of markets are hidden. No individual step is a disaster, but there is a cumulative loss of edge.

4. However, whatever the absolute GDP growth rates, the UK is set to outperform other countries in the G7. If we could guarantee to achieve the lower end of the Treasury's projection for next year, 2% GDP growth, I'd pocket it now. And for reasons set out in a previous note (mainly because of my views on the strength and timing of US recovery) I'd be a bit more cautious about the 2.75%-3.25% estimate for GDP growth in 2003. But a lot can happen before 2003 and the Treasury's predictions are certainly not "off the wall".

5. There has been much comment, also addressed in earlier notes, about the UK's so-called "imbalances" or "two-speed economy" reflecting the difference between the buoyancy of domestic demand and the weakness of external demand. This is symbolised to some extent in recent data. Retail sales were up just under 6.5% in the last three months on the same period a year ago, while manufacturing output was down nearly 4.0% over a similar period.

6. The deteriorating current account reflects the fact that some of the UK's domestic demand is transferred to external supply. However, it is not the strength of demand that causes inflation, but the interplay between demand and supply capacity. As long as inflation remains low and growth prospects in the UK relatively good a large current account deficit should be manageable.

7. The "imbalances" explain why total output and employment has held up so well and they are better than the alternative: an economy in better "balance" at lower output and reduced employment. Of course, at some stage, when external demand picks-up, domestic demand and in particular household spending in the UK, will have to be reined in. This may not be smooth, but it is part of a normal adjustment in a properly functioning market economy.

8. Of course, in some general sense it would probably be desirable if interest rates were a bit higher and the currency a bit lower. But that is not on offer. The MPC could certainly get sterling lower if it wanted to by cutting interest rates and announcing that is favoured a lower pound. But such a policy would increase both domestic demand and external demand, put pressure on supply capacity and in the end bring higher inflation and greater instability.

9. The imbalances have been made necessary by the weakness of the euro. There is not much evidence that sterling is overvalued against the US$ and over the past twelve months sterling has weakened against the dollar. The problem is the weakness if the euro and there is nothing that the Bank of England, the Fed or anyone outside "Euroland" can do about it.

10. And there are some structural features associated with EMU that suggest that euro weakness may persist. This is not to say that the euro will not go up from time to time, reflecting developments elsewhere, but it is more difficult to see how the euro can be a "strong" currency in terms of attracting mobile capital in search of higher anticipated rates of return. Why?

11. The basic problem is that although the ECB is responsible for running monetary policy for the whole area, there is no such thing as the Euroland economy, only several participating economies. What this means in practice is that the ECB has to focus its attention on the weakest since it cannot let any individual country, however small, go "bust". The speed with which any problems are addressed will vary with the size and political clout of the countries concerned. A big country can demand attention, smaller ones may have to wait, perhaps until several are in similar predicament.

12. Up until now the focus has been Germany, later next year a collection of peripheral countries may be clamouring for attention.

13. When the euro got underway Germany was still burdened with the costs of unification and was locked-in at a very uncompetitive exchange rate against its trading partners. The economic position required either a nominal depreciation of the "DM" against the exchange rate of Germany's major trading partners or a supply side revolution that raised the rates of return on investment. The former is not possible within EMU. There is no sign of the latter before or after the election.

14. The only alternative policy within monetary union has been adopted. Germany's competitive position has been partially restored by higher inflation in other euro countries, or in other words their real exchange rates have appreciated against that of Germany. This has occurred because the ECB has set interest rates that have been more favourable to Germany than for the rest of Euroland. A side effect has been to keep the euro weak and that also helps Germany a bit given that the option of depreciating the "DM" is not available.

15. We are now in a position were practically every country in Euroland needs lower interest rates, but the damage has been done and the policy framework will accentuate the downturn as it did the upturn. The result is amore unstable economic cycle in several countries.

16. Within EMU monetary policy cannot be appropriate for every country. One effect of this is that the euro will be at a lower level than the component economies pursued independent monetary policies geared to domestic criteria. The other effect is to increase the amplitude of economic cycles within Euroland.

17. During the upswing phase of the economic cycle, those countries where interest rates are too low will experience a pick-up in relative inflation. And the process will be self re-enforcing since the very fact that inflation is going up means that real (inflation adjusted) interest rates are lower in these particular countries at precisely the time they should be higher than elsewhere in Euroland.

18. In the downturn the opposite will happen. The decline in domestic demand is exacerbated by the loss of competitiveness produced by higher inflation. The decline in the rate of inflation will be faster in those countries with high relative inflation so this will mean that real interest rates are higher than in the rest of Euroland – even if the ECB is cutting nominal rates - at the very time these should be lower.

19. At both stages in the cycle interest rates will be inappropriate and their inappropriateness reinforced by the very framework of EMU. The profile of the cycle will be exaggerated. Far from bringing more stability, the operation of monetary policy creates more instability. And of course this problem is made much worse within Euroland for particularly dynamic economies. They really do run the risk of "boom and bust".

20. It may be worth looking briefly at the examples of Holland and Ireland, both in their different ways seen as examples of successful economies. This week the Dutch finance minister (Zalm) acknowledged the possibility of negative GDP growth next year.

21. The unification of Germany produced a demand boom in Germany. One result, which was appropriate, was an appreciation of the real exchange rate of Germany in the short run. But by transforming the DM's monetary domain into one which the low-productivity former east Germany was now a part, unification depreciated the long-run equilibrium real exchange rate for the DM.

22. For the Netherlands, while some of the initial German boom leaked into the Dutch economy, the resulting appreciation of the DM and the high level of interest rates necessary in Germany meant that monetary conditions became tight, as the guilder and Dutch interest rates were locked to the DM and German interest rates

23. The Dutch were determined not to devalue within the ERM, so the authorities embarked on what was in effect a "social contract" strategy. The centralised Dutch wage-bargaining system made this possible and the government contracted to cut wage taxes in return for wage moderation.

24. The deal appeared to work and during the 1990s the Netherlands made considerable gains in unit labour costs competitiveness with Germany. Moreover, although at the time of re-unification the guilder was dragged up, via the DM link, above its long run equilibrium level, at least that long run equilibrium level, unlike the DM, did not decline since the Netherlands did not find itself lumbered with East Germany.

25. This meant that the required real depreciation of the guilder in the period following the initial spike in the currency following re-unification, was smaller than that required by the DM. However, the success of the "social contract" meant that the real depreciation actually achieved by the guilder was considerably greater than that achieved by the DM.

26. Thus, by the second half of the decade, with first the Bundesbank and then the ECB in effect targeting Germany's needs, the increasingly favourable competitiveness position of the Netherlands with Germany meant that the Netherlands experienced strong growth that, by the end of the decade, was turning to overheating.

27. From the birth of the euro, ECB monetary policy was definitely too loose from a Dutch perspective. Dutch inflation rose sharply, significantly above the Euroland average and at one stage this year was over 4.5% higher than Germany. This must have been a psychological blow to the Nederlandsche Bank, which had the reputation as the most determined inflation-fighter among countries that chose to join the euro. But it also created the classic boom-bust. The bust is now on us. Manufacturing output in Holland is currently 6% down on a year ago.

28. Over the three year period 2000-2002, the Netherlands is likely to have lost 10 percentage points in unit labour cost competitiveness against its biggest trading partner, Germany, wiping out the gains of the 1990s. And, in the open Dutch economy, the negative effect of eroding competitiveness has, when combined with the world demand slowdown, rather quickly offset the impact of falling real interest rates as inflation carried on accelerating.

29. Now as output and employment turn down, inflation will decelerate rapidly, pushing real interest rates up in the way described in paragraph 18. The same is true in Ireland.

30. It is sometimes suggested that the Irish economy's performance in recent years can be attributed to transfers from Brussels. But these transfers have existed for a long time and this did not stop Ireland's economy performing badly. Slow economic growth (given its relative opportunity for "catch-up), high inflation, large budget deficits and high unemployment. This was transformed with the exit from the erm and the adoption market oriented policies.

31. Since 1992 Ireland's economic record has been spectacular, strong GDP and employment growth, low inflation and large budget surpluses, underpinned by large inflow of capital attracted by high anticipated rate of return. The Celtic Tiger. However, problems have been building up in the past year or so because entry to the euro has mean that interest rates have been too low. The boom is now turning to bust. House prices have fallen for three successive months and at the top end of the Dublin market are 8% down from the beginning of the year. After 11% GDP growth last year Ireland may struggle to get to 3% in 2001 and next year will be worse.

Derek Scott

DEREK SCOTT

> DCO

file

10 DOWNING STREET
LONDON SW1A 2AA

19 December 2001

THE PRIME MINISTER

Dear Didier,

Thank you for your letter of 23 November and for kindly sending me a set of euro coins. I am delighted to have them and do congratulate you on the way you have handled what, apart from its historic significance, is a huge logistical operation, managed with great professionalism.

Yours sincerely

Tony Blair

M. Didier Reynders

file

Top: PD(CS)
cc CoS
PPS
EU/PS
Qs

ECONOMIC SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, London, SW1P 3AG

Rt Hon Robin Cook MP
Leader of the House of Commons
& President of the Council
2 Carlton Gardens
London SW1Y 5AA

18 December 2001

Dear Robin

PRIVATE MEMBERS' BILL: EURO STERLING (DUAL CHOICE)

Graham Allen (Labour, Nottingham North) has introduced a Bill to permit the use of euro as well as sterling as legal tender in the UK for transactions exceeding £1,000.

The Bill is No.5 on the list of Private Members' Bills on 11 January 2002. I am writing to seek the agreement of LP Committee to oppose the Bill and for it to be blocked at Second Reading.

The Bill has yet to be printed. However, I understand that the intention of the Bill is that in the settlement of any debt and the satisfaction of any obligation under contract of an amount equal to or greater than an amount determined in the Act (£1,000), payment in euros of the sterling equivalent of the amount due shall have the same effect as if it were made in sterling.

The Bill would have the effect of permitting the use of the euro as well as the pound sterling in the performance of financial obligations at or above a certain value (£1,000), and for connected purposes. As drafted, the Bill merely states what already may and does happen now, namely that traders may accept payment in any currency, not necessarily in sterling. No Bill is necessary to enable this factual position to continue. The intention of Mr Allen would appear to be (though clause 1 of his Bill is not expressed in these terms) to make the euro legal tender in the UK alongside sterling. This objective, if appropriately worded, would:

- Not be consistent with Government policy on membership of the single currency. In principle, the Government is in favour of UK membership of the single currency; in practice, the economic conditions must be right. The Government has set out five economic tests which must be met before any decision can be made. On the basis of the assessment, the Government will take a decision on whether the five tests have been made. If a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people;

SKP 21/12/01

ECONOMIC SECRETARY TO THE TREASURY

- Increase costs to business by obliging UK businesses and other organisations to accept euro in settlement of contract, as opposed to the present position where firms may choose whether or not to accept euro. Trading in multiple currencies represents a cost to business;

- Introduce unnecessary exchange rate risk into domestic transactions. As sterling is not fixed against the euro, any payments that were made in euro would expose the recipient to exchange rate risk. This would include payments made to the Government. Borrowers in sterling would also be given a free option to repay in the weaker currency, so increasing interest rates that lenders would have to charge to hedge themselves; and

- Give rise to costs to the Government from loss of seignorage revenue that accrues for the issuing authority. For every £1bn of sterling displaced, an estimated £39m a year of seignorage would be lost on notes and £880m in total on coins.

Those in favour of the UK's early membership of the single currency may support the Bill but the Opposition should oppose it, in line with their policy on the single currency. Nevertheless, it provides an opportunity to restate Government policy on membership of the single currency and to set out the Government's commitment to working with business to secure the right level of euro preparations in the UK for working with the euro now and the practical steps that the Government has taken to support UK business.

In conclusion, I ask for agreement from LP Committee to oppose the Bill and for it to be blocked at Second Reading as it would impose extra costs on business, extra costs to Government, introduce unnecessary exchange rate risk into domestic transactions and not be consistent with Government policy on membership of the single currency.

I am copying this letter to the Prime Minister, Members of LP Committee, Members of EP Committee, Sir Richard Wilson and first Parliamentary Counsel.

Yours

Ruth

Ruth Kelly MP

Enc

DRAFT LETTER FROM LEADER OF THE HOUSE AND PRESIDENT OF THE COUNCIL TO MR GRAHAM ALLEN MP

YOUR PRIVATE MEMBERS' BILL ON EURO STERLING (DUAL CHOICE)

I would like to explain briefly why the Government will not be supporting your Private Members' Bill.

Government policy on membership of the single currency remains as set out by the Chancellor of the Exchequer in October 1997, and restated by the Prime Minister in February 1999. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. The Government has said that an assessment of these tests will be produced within two years of the start of this Parliament. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. The Government believes that, if a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people. Your Bill would effectively impose the euro on the British people before they have had the opportunity to register their preference in a referendum.

Meanwhile, the Bill would increase costs to the UK economy by obliging individuals, businesses and other organisations to accept euro in settlement of contract. At present, firms may choose whether or not to use the euro. The intention behind your Bill would appear to be not to allow businesses that choice. As sterling is not fixed against the euro, any payments that were made in euro would expose the recipient to exchange rate risk. This would include payments made to the Government. Displacement of sterling notes and coins would also result in a loss of seignorage income to the Exchequer.

The Government is committed to working with business to secure the right level of euro preparations in the UK for working with the euro now. The Government has taken practical action to support UK business, including writing to some 1.5 million small businesses in the UK to provide details of the introduction of the euro in the euro area and materials to allow firms to assess the impact this will have on them.

I realise that you will be disappointed. But the Government's policy on the single currency is clear: the Government will only recommend membership of the euro if the economic case is clear and unambiguous, based on an assessment of the five economic tests. The assessment has not yet started, but the necessary preliminary analysis – the technical work that is necessary to allow us to undertake the assessment within two years as promised – is underway.

ROBIN COOK

RL
JJH
DS
JSW
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FC
JB

CABINET OFFICE

70 Whitehall London SW1A 2AS
Telephone 020 7270 0177 Facsimile 020 7270 0112
e-mail: Martin.Donnelly@cabinet-office.x.gsi.gov.uk

Martin Donnelly
European Secretariat

David Frost
British Embassy
Paris

14 December, 2001

Dear David

FRANCE AND EMU: TEL NO 880

I found your telegram setting out the effects of EMU on the French economy very helpful. You provide a lot of relevant information and some stimulating conclusions about policy.

Perhaps I could offer a few comments in return.

I wonder if the first sentence of paragraph 8 is a little compressed. The suggestion is that the French "believe" EMU has protected them from a rerun of the turbulence of 92-93. There is evidence to support this view. You will recall that in 1995 the devaluation of the Lira within the ERM caused a shoe factory in Chirac's Correze constituency to close because (it was claimed) of cheap Italian competition, and almost led to French protectionist measures at the Italian frontier. In the end this was dealt with through a demand for a Commission report on the competitiveness impact of the devaluation, which pushed it into the long grass. But the message was clear. Sooner or later pressures on the ERM would lead to currency movements which would be politically unacceptable to some governments in terms of their competitiveness impact. Hence the French conclusion that the single market required a single currency – and rapidly.

The French (and many others) would argue that it was only the imminence of EMU which prevented the Asian crisis in 1998 from leading to the usual ERM tensions with the DM rising and other currencies weakening. Most banks had simply removed their ERM currency dealers so there was literally no market in pre-EMU currencies. The events of September this year would no doubt have produced similar tensions in a pre-1999 world.

So French Euro supporters have a pretty strong case in arguing that its removal of exchange rate tensions has increased welfare by removing a range of protectionist temptations. You recognise the investment stability point in paragraph 12.

I agree with your judgement in paragraph 21 that the UK and EMU is a second order issue for France. We underestimate French focus on Germany at our peril. It has both a political and an economic rationale. We can be a helpful support to French pressure on German policy. But we are not in an equilateral triangle.

We do need to explore further with the French how far we agree on what they like to define as “economic government”. I see little evidence that the French want to change their domestic policies for European reasons. They would of course like greater influence on others’ budgetary (and tax) policies, but I am not sure they really expect to achieve this.

There is as you point out a strong French desire to do something to show that economic as opposed to monetary policy cooperation in Europe is a reality. Hence interest in the Tobin tax; a more assertive role for the Euro group; and a single IMF seat – for which no doubt the French would have many excellent candidates to offer. If Strauss Kahn returns we can expect to hear more of the IMF representation issue.

I strongly agree that the French - Trichet and the Tresor - feel happier with a UK model in which central bank independence is more tactical than strategic. But they are also fully aware of the German constraints on formal policy change. This is an area where we should be able to work effectively together, particularly if and when Trichet becomes ECB President.

Overall therefore I would argue that France has become significantly less protectionist through EMU. It is forced to think outside the hexagon, and to begin to work out a coherent strategy for the Euro zone as a whole rather than simply Franco-German relations.

Over the medium term there are some grounds for optimism about further French structural change, to balance the well-known factors on the other side. And in both manufacturing and services they start from a strong position. They will never use the rhetoric we want. But, as their infrastructure and energy investments and modernisation of the government debt market in the 1980s (some years ahead of the UK) show, in specific policy areas they can be focused and effective. I would expect to see some movement on pensions and more encouragement to equity markets over the next five years. And France successfully made the transition to low inflation in the 1990s.

A final question. Do you, or HMT, consider that current French labour laws actually make it difficult for firms to lay workers off in an economic downturn? The anecdotal evidence I have heard suggests a deal whereby the politicians are allowed to suggest that this is the case, but in practice firms that need to lay off workers can do so. Is that right? How much slower and more costly is it for a retailer to close a store in France compared with the UK?

I am copying this letter to Gus O'Donnell and Ivan Rogers (HMT), Roger Liddle and Derek Scott (No 10).

yours

Martin

MARTIN DONNELLY

The Rt Hon Peter Hain MP
Minister For Europe

cc: SSW (sap copy attached)
XC
Prem
JB

Foreign & Commonwealth Office
London SW1A 2AH

Roger Liddle
Policy Unit
No10 Downing Street
London
SW1A 2AA

10 December 2001

Dear Roger,

MINECOR ON EURO NOTES AND COINS: 3 DECEMBER: RECORD

1. I was grateful to Ruth Kelly for leading our discussion of the presentational aspects of the Euro changeover at MINECOR on 3 December.

2. I think we all agreed that the introduction of notes and coins in the Eurozone will affect the Euro debate in this country. The list of businesses willing to accept Euro in this country grows longer as the changeover approaches. It includes major names such as Waitrose and Sainsbury, and even businesses run by Eurosceptics (such as Dixons). Kitty Usher (DTI Special Adviser) agreed to forward a list of all to the MINECOR secretariat (Steven.Fisher@fco.gov.uk). As far as our message is concerned, the guide is in the excellent HMT core script which was circulated at the meeting.

3. Roger Liddle mentioned the Irish calculator project (a calculator for each citizen to convert Irish pounds to Euro at the push of a button). On reflection, I fear that this is an idea which we have hit upon too late. In any case it would have been more difficult for us to have produced such a device for both practical (variable sterling/Euro exchange rate) and political reasons.

4. We discussed giving old coins of "legacy" currencies to charity, and that some high street banks had pledged to match any contributions. Ruth had publicised the scheme at a school launch in her constituency. We agreed it would be useful if Ruth's press release for this event could be circulated via the Party to all Labour MPs so that they could follow suit. Perhaps Rachel Cowburn could get the message to Labour MEPs too.

5. Denis Haughey pointed out that the introduction of the Euro in the Republic of Ireland will tip the terms of trade still further in favour of the Republic as against Northern Ireland. Northern Irish businesses selling to Europe might relocate (as the haulage industry has largely already done in order to take advantage of lower fuel taxes). There were no easy answers to this.

Citizens' Summaries

6. I reminded colleagues of my suggestion that we post "citizens' summaries" of EC Directives on the FCO web-site. I gather that DTI lawyers think this is problematic, and that other colleagues are concerned over resource implications. Our Legal advisers have done a first draft of a disclaimer which would be included with the summaries. We would be interested in any comments your lawyers might have on the draft, which reads as follows:

"*This summary has been produced for illustrative purposes and does not have any legal effect. Her majesty's Government does not accept liability for loss or damage arising in respect of any statement it contains.*"

7. As for resource implications, colleagues will need to make their own decisions on how far to push this. I hope that we can at least get all new Directives posted, and as many key Directives from the past as possible. I am publishing a 300 word plain English summary of the EU Treaties which I think shows what is possible.

Other business

8. Colleagues may be interested to read the attached summary of an ICM poll on attitudes to Europe commissioned by the FCO. We published the ICM polling on 5 December to the House. The attached summary is an unpublished internal analysis.

9. At the last MINECOR I undertook to provide figures for asylum claims from the current candidate states and on European migration patterns following earlier enlargements. FCO research analysts are compiling this data, with the help of Home Office colleagues. We will circulate it as soon as we have it.

Next meeting

10. The next meeting will take place on 17 January and will be on Barcelona and economic reform. It will take place at 14.00 in the Locarno Conference Room. I hope that we will have a speaker from the private sector. I look forward to seeing you there.

Peter Hain

WHAT THE BRITISH THINK

ABOUT EUROPE

RESULTS OF AN ICM SURVEY

FOR THE FOREIGN OFFICE

ANALYSIS BY PETER KELLNER

CONTENTS

A . EXECUTIVE SUMMARY

ICM interviewed 2,182 electors throughout Great Britain between 9 and 18 October, 2001. This is an unusually large sample. This fact, and the length and depth of the questionnaire, make this probably the most detailed quantitative study that has been conducted in recent years on British attitudes towards the European Union.

This report should be read in conjunction with ICM's analysis of cluster groups

Key findings

- A majority of two-to-one think the UK's membership of the EU is "a good thing for Britain" rather than "a bad thing".

- Clear majorities agree that the EU "promotes peace and security in Europe" and that "it is good for British jobs and trade"

- The people's priorities for the future work of the EU are: maintaining peace and security, fighting poverty, fighting unemployment and fighting crime

- Lowest priorities are: enlargement and reforming EU institutions.

- Similarly, when people are asked what they would like to hear more about, far more people say: *euro, local impact of EU activities, citizen's rights, tackling crime, consumer benefits, defence & security,* and *jobs,* than: *treaties, enlargement* and *how EU institutions work.*

- Attitudes to British membership of the single currency suggest the issue is wide open. "Join as soon as possible": 7%; "join when the Government says the conditions are right": 29% (**total pro: 36%**); "not for the foreseeable future": 24%; "never join: 23% **(total anti: 47%)**. Don't knows: 17%.

- These figures suggest a closer race than that depicted by conventional polls asking "how would you vote if a referendum were held now". This is because many who think we should join "when conditions are right" are likely to say "against" when asked how they would vote "now".

- 65% think it "very" or "fairly" important to teach more facts about the EU to primary school children; the figure rises to 88% when asked about secondary schools and 91% when asked about sixth-forms.

BUT….

Most people also agree that

- " the EU is full of red tape and bureaucracy"
- "Britain's national identity is being lost"
- "Britain is pushed around by other countries, like France and Germany"

NOTE ALSO:

- Most people acknowledge that they know relatively little about the EU.

- More people know that Germany is a member of the EU than Britain.

- The survey reveals a very significant gender gap on some key questions. For example, men are evenly divided on whether to join the euro (44% in favour, either ASAP or when govt says time is right; 46% against); but women divide 48-30% *against*.

- An open-ended question, what's good about being in the EU?, shows that men are far more likely than women to give instrumental answers (above all *trade*, but also *jobs*), while women more likely than men to give idealistic answers (*co-operation, neighbourliness*)

- Other answers also suggest that many women are put off by "male" agenda of much of the discussion about Europe.

- There are also some significant class differences. ABs divide 3-2 in favour of joining the euro; DEs 2-1 against. 61% of ABs, but only 36% of DEs think membership of the EU is good for Britain. These figures reinforce the need for the debate to be less remote, less elitist, and less obsessed with institutional arrangements, if people outside the professional and managerial classes are to be engaged.

- Television is (not surprisingly) the main way people find out, and want to hear more, about Europe. Television news is also the *most trusted* source of news by the population as a whole; although broadsheet newspaper readers trust their own paper even more. Few readers of red top paper readers trust their own paper, though it makes little difference whether they are readers of the Mirror (pro-euro) or Sun (anti).

- There are only minor differences by age. Over 55s slightly more hostile to EU and the euro than other age groups; but it is NOT true that the young are "pro" and the elderly "anti".

- People living in the Midlands and northern England are slightly more hostile than GB average to joining the euro; people living in the south slightly more favourable.

B. HOW WELL INFORMED ARE THE BRITISH?

The short answer is: not very, and they know it.

ICM asked people two sets of questions: some **subjective** – how informed do they feel about European issues? – and some **objective** – what do they know about the membership of the EU and Britain's biggest trading partner?

Subjective questions

How well informed do you feel about…

a) ***the European Union?***

b) ***the single European currency, the euro?***

c) ***the current British Government's policy on the European Union?***

Give a mark out of 10, 1 indicating that you know nothing, 10 that you know a great deal.

	EU	*Euro*	*British policy*
% saying 6-10	*29*	*33*	*27*
% saying 4-5	*25*	*25*	*33*
% saying 1-3	*44*	*39*	*45*
Average score	*4.1*	*4.4*	*4.1*

As those figures show, a third of the public, at most, claim to be reasonably well informed (scoring six or more); significantly larger minorities are willing to acknowledge that they know little or nothing (scoring three or fewer).

Objective questions

Which of the following countries are members of the European Union?

	Yes %	*No %*	*Don't know %*
Germany	***82***	*4*	*14*
Britain	***76***	*12*	*14*
USA	*7*	***75***	*18*
Russia	*4*	***73***	*23*
Ireland	***65***	*14*	*21*
Greece	***54***	*19*	*27*
Poland	*20*	***47***	*33*
Norway	*36*	***31***	*32*

The table shows the responses in rank order of correct responses (shown in bold). Note that more people know Germany is a member of the EU than know Britain is a member. Note also the significant number of don't knows, even for Britain and Germany. 14% of all adults is equivalent to six million electors.

It may be that some of the 24% who fail to give the right answer for Britain are confused about the term "European Union". Perhaps a higher "yes" score would have resulted had we referred to "Common Market" or "European Community". But whatever the reason, there is plainly widespread lack of knowledge of the most basic fact of Britain's membership of the EU.

Similarly, fewer than half the public know that Britain does more trade with the rest of the EU than with the United States or the Commonwealth:

Which one of the following do you think Britain does most trade with…?

Other countries in the European Union	*44%*
USA	*23*
The Commonwealth	*13*
Don't know	*20*

The answers to the knowledge questions have been combined to produce a score out of ten for each respondent. One mark is given for every correct answer about the eight countries listed above, and two for giving the correct answer about Britain's trading links. This is how the sample divided:

Super-knowledgeable – 10 out of 10	*6%*
Very knowledgeable – 8 or 9 out of 10	*28*
Fairly knowledgeable – 6 or 7 out of 10	*28*
Not very knowledgeable – 4 or 5 out of 10	*19*
Not at all knowledgeable – 1-3 out of 10	*19*

There is a clear correlation between the subjective and objective levels of knowledge. In particular, more than 80% of people who score 5 points or fewer on the objective-knowledge scale also score 5 points or fewer on the subjective-knowledge scale.

C. WHAT DO THE BRITISH THINK ABOUT THE EU?

First, ICM asked a general question about British membership of the EU:

Generally speaking, do you think that the UK's membership of the European Union is ...			
- *a very good thing for Britain*	*13%*		
- *a fairly good thing for Britain*	*34*	*TOTAL "GOOD":*	*47%*
- *a fairly bad thing for Britain*	*13*		
- *a very bad thing for Britain*	*12*	*TOTAL "BAD":*	*25%*
- *Don't know*	*29*		

Although almost twice as many people say "good" as say "bad", the proportion of "don't knows" is unusually high for an important political topic. Among those who are "not very" or "not at all" knowledgeable – well over one third of the population – the proportion of "don't knows" climbs to almost 50%.

Later in the survey, ICM also asked about the single currency:

What is your view about Britain joining the European single currency, the euro?			
join as soon as possible	*7%*		
join when the Government says the economic conditions are right	*29*	*TOTAL JOIN:*	*36%*
not join for the foreseeable future	*24*		
never join	*23*	*TOTAL NOT JOIN:*	*47%*
Don't know	*17*		

These figures suggest a closer race than that depicted by conventional polls asking "how would you vote if a referendum were held now". This is because many who think we should join "when conditions are right" are likely to say "against" when asked how they would vote "now".

The following two pages show how people respond to the EU membership and single currency questions by different subgroups. They show that, on the impact of EU membership, people saying "good" outnumber those saying "bad" *in every group*. However, on the single currency more people are "against" than "for" *in most groups.*

That said, when subgroups are compared with each other, clear similarities emerge. Groups that are most positive about Britain's membership of the euro are also keenest to join the single currency. And groups that are least enthusiastic about membership of the EU are most hostile to joining the euro.

ATTITUDES TO EUROPE AND THE EURO

Group	British membership of EU				For or against joining euro			
	Good	Bad	**Net good**	DK	For	Against	Net for	DK
	%	%		%	%	%		%
All	**47**	**25**	**22**	**28**	**36**	**47**	**-11**	17
Gender								
Men	55	25	**30**	20	44	46	**-2**	10
Women	41	24	**17**	35	30	48	**-18**	22
Class								
AB	61	19	**42**	20	52	36	**16**	12
C1	53	24	**29**	23	38	49	**-11**	13
C2	41	25	**16**	34	32	49	**-17**	19
DE	36	28	**8**	36	26	52	**-26**	22
Class / gender								
ABC1 Men	60	22	**38**	18	49	42	**7**	9
ABC1 Women	52	22	**30**	26	39	44	**-5**	17
C2DE Men	45	28	**17**	27	37	49	**-12**	14
C2DE Women	29	25	**4**	46	20	52	**-32**	28
Age								
18-24	45	19	**26**	36	35	43	**-8**	22
25-34	48	17	**31**	35	40	41	**-1**	19
35-44	49	20	**29**	31	36	45	**-9**	19
45-54	50	25	**25**	25	40	47	**-7**	13
55-64	45	28	**17**	27	34	51	**-17**	15
65+	43	35	**8**	22	34	54	**-20**	12
Age/gender								
18-34 Men	54	17	**37**	29	44	42	**2**	14
18-34 Women	40	18	**22**	42	32	42	**-10**	26
35-54 Men	56	27	**29**	17	44	47	**-3**	9
35-54 Women	44	19	**25**	37	32	46	**-14**	22
55+ Men	50	30	**20**	20	42	50	**-8**	8
55+ Women	38	33	**5**	29	25	56	**-31**	19

Group	British membership of EU				For or against joining euro			
	Good	Bad	**Net good**	DK	For	Against	Net for	DK
	%	%		%	%	%		%
All	**47**	**25**	**22**	**28**	**36**	**47**	**-11**	17
Region								
Scotland	47	18	**29**	35	38	39	**-1**	23
Northern England	42	22	**20**	36	33	46	**-13**	21
Midlands	46	26	**20**	28	30	55	**-25**	15
Wales	48	23	**25**	29	41	47	**-6**	12
London	45	24	**21**	31	39	45	**-6**	16
Rest of South	53	26	**27**	21	44	44	**0**	12
Newspaper readership								
Pro-euro broadsheet	70	14	**56**	16	60	35	**25**	5
Anti-euro broadsheet	71	19	**52**	10	58	36	**22**	6
Mail	49	30	**19**	21	35	55	**-20**	10
Sun	35	28	**7**	37	25	54	**-29**	21
Mirror/Record	42	25	**17**	33	32	49	**-17**	19
Any red top	36	25	**11**	39	28	52	**-24**	20
Something else *	52	24	**28**	24	41	44	**-3**	15
No newspaper	41	25	**16**	34	31	46	**-15**	23
Visits to EU in past 12 months								
None	40	27	**13**	33	30	50	**-20**	20
One	53	23	**30**	24	35	50	**-15**	15
Two or more	59	22	**37**	19	51	40	**11**	9
Degree of knowledge								
Super knowledgeable	78	17	**61**	5	56	39	**17**	5
Very knowledgeable	60	24	**36**	16	47	45	**2**	8
Fairly knowledgeable	49	28	**21**	23	36	51	**-15**	13
Not very knowledgeable	41	25	**16**	34	31	54	**-23**	15
Not at all knowledgeable	20	19	**1**	61	19	39	**-20**	42

* "Something else" = local/regional daily/evening paper

Groups that are most "pro-European":
AB social class (professional and managerial workers)
Middle class men (ABC1)
Men aged 18-34
Readers of broadsheet newspapers
People who have visited other EU countries at least twice during the past year
People with a high knowledge of the EU

Groups that are most "anti-European"
DE social class (semi- and unskilled workers and people living on state benefits)
Working-class women (C2DE)
People who remember the Second World War (i.e., aged 65+)
Women aged 55+
Readers of red-top tabloids
People who have not visited any other EU country in past year
People with very low knowledge of the EU

NB (1): these groups overlap to a large extent. AB people are more likely to read broadsheet newspapers, to know about the EU and to travel frequently; DE people are more likely to red red-top tabloids, to know less about the EU and to travel abroad less frequently.

NB (2): There is no significant difference between the views of those who read pro-Euro and anti-Euro broadsheets; the differences between Sun and Mirror readers *are* statistically significant, but not huge. This suggests that the impact of the editorial stance of particular papers is fairly small.

If we combine the answers to the two questions analysed in the tables on the previous two pages, then the GB electorate divides into the following groups:

a) Committed pro-Europeans (UK membership good; for joining the euro): 30%
b) "In Europe, not run by Europe" (membership good; against joining euro): 14%
c) Anti-Europeans (membership bad; against joining the euro): 21%
d) Oddballs (membership bad; for joining the euro): 2%

The remaining 33% replied "don't know" to one or both of the two questions:
e) UK membership good, DK on single currency: 4%
f) UK membership bad, DK on single currency: 1%
g) DK on membership, for joining single currency: 5%
h) DK on membership, against joining single currency: 12%
i) DK on both questions: 12%

Groups b, d, e, f, g – highlighted in bold – hold the key to a referendum on the single currency. They comprise 26% of the electorate. A clear majority needs to be persuaded to vote "yes" to joining the euro. Above all, this means confronting the "in Europe, not run by Europe" argument. William Hague's mantra may have appealed to only one in seven electors; but they are likely to be the people who, in a close contest, will decide the outcome.

The link between knowledge and attitude is highly significant. To a large extent, the more people know about the EU, the more they like it. Just 8% of the electorate comprise "very" or "super" knowledgeable people who consider membership of the EU to be bad for Britain. Only 7% are knowledgeable people who think Britain should never join the Euro.

D. WHAT DRIVES PEOPLES' VIEWS ON THE EUROPEAN UNION?

ICM first sought to find out what people would say, unprompted:

What is the single most important reason you can think of for why membership of the European Union is a good thing for Britain?
(base: those who think membership is a good thing – 986 respondents)

Good for trade	*34%*
Work together / co-operation / not isolated	*14*
UK too small to survive / can't afford to be left behind	*7*
Stronger militarily / war less likely / better chance of peace	*7*
Good for jobs	*5*
Good for the economy (unspecified)	*5*
Easy travel / free movement / no passports	*4*
We are part of Europe / they are our neighbours	*4*

Analysis of the data shows that men are more likely than women to give instrumental answers (above all *trade*, but also *jobs*), while women more likely than men to give idealistic answers (*co-operation, neighbourliness*)

What is the single most important reason you can think of for why membership of the European Union is a bad thing for Britain
(base: those who think membership is a bad thing - 518 respondents)

Lose our independence / inability to make our own decisions / ruled by EU	*25%*
Were alright before / Don't need EU / should never have joined	*13*
Costs us too much / pay more to EU than we get back	*11*
Lose our identity / lose our culture / lose our heritage	*9*
Against single currency / keep the pound	*8*
EU no benefit to us	*5*
Expensive / costly / prices are higher	*5*
Don't trust French / Germans	*4*
We're dictated to / pushed around / told what we can do	*4*

The two tables above omit reasons given by 3% or fewer. By and large, people who think membership is a **good** thing have tangible reasons for their view, mostly to do with the economy; on the other hand, people who think membership is a **bad** thing have "mood" reasons to do with the general virtues of independence, and a belief in Britain's separate history and culture. Only around one in five of the 25% who think membership has been a bad thing – that is, 5% of the total sample – say, unprompted, that their main objection to membership of the EU is that it is doing economic damage to Britain.

All this suggests that the more the debate about Europe is couched in tangible terms to do with the economy and the practical benefits of membership, the more readily the public will embrace the pro-European cause. However, the more the debate concerns such matters as sovereignty and independence, the more likely is the public to embrace the arguments of the Eurosceptics.

Next, ICM tested views on a number of European issues by asking people whether they agreed or disagreed with a series of statements. The table below ranks the statements in order of percentage agreeing

Here are some things people have said about the European Union. For each, can you say whether you agree or disagree?

	Agree %	*Disagree* %	*Don't know* %
The European Union is full of red tape and bureaucracy	*67*	*12*	*21*
Britain is losing the ability to make its own decisions	*61*	*26*	*14*
It promotes peace and security in Europe	*60*	*22*	*18*
It is good for British jobs and trade	*59*	*21*	*19*
Britain's national identity is being lost	*58*	*30*	*12*
Britain is pushed around by other countries, like France and Germany	*57*	*30*	*13*
It makes it easier to live or work in other European Union countries	*56*	*15*	*20*
Britain pays in more to the European Union than it takes out	*51*	*14*	*34*
Britain has more influence as part of the European Union	*46*	*31*	*22*
The European Union makes decisions in an undemocratic way	*44*	*25*	*31*
It helps to give Europe a cleaner environment	*39*	*26*	*34*
It means lower prices e.g. air travel, gas/electricity bills and cars	*34*	*37*	*29*

Three clear messages stand out:

- The pro-Europeans have the upper hand in the debates about a) peace and security, and b) jobs and trade.

- However, the Euro-sceptics have the upper hand in the argument about influence, impotence and independence. Whereas 61% think "Britain is losing the ability to make its own decisions", 58% think we are losing our national identity, and 57% think we are "pushed around" by other EU countries, only 46% think we have more influence as part of the EU.

- Fewer than four out of ten agree that EU is good for the environment and the consumer. It's not that most people disagree – rather that large numbers of people are "don't knows".

These findings suggest the importance of reclaiming both the agenda and the language of the debate. They reinforce and augment the lessons from the open-ended questions. The best topics for debate for the pro-Europeans are **economy, peace, influence** and **day-to-day benefits.**

With **economy** and **peace**, the need is to reinforce, and make more relevant, views already held by most people.

With **influence** and **day-to-day benefits**, the need is to mount and win arguments on which millions of people have yet to form a clear opinion. Indeed, on both points, among ICM's "groups to address" – i.e. the 45% of the electorate who are not firmly in the pro- or anti-EU camps – the proportions who say "don't know" are more than two in five.

We can go further on the **day-to-day impact** of the EU on people's lives:

Do you think British membership of the European Union affects your own daily life for the better, for the worse, or does it not make much difference either way?

Better	*15%*
Worse	*13*
Not much difference	*50*
Don't know	*22*

In other words, barely one person in four has a view either way. Not surprisingly, committed pro- and anti- Europeans hold the strongest feelings. Among "groups to address", just 9% say "better" and only 6% say "worse". Fully 85% say either "no difference" (53%) or "don't know" (32%). Even among groups classified by ICM as "xenophobes" and "informed xenosceptics" (which together amount to 24% of the electorate), just one in three says British membership of the EU affects their daily life for the worse.

Among the minority that does feel there is an impact, there is no consensus on what matters most. When ICM asked people to say, unprompted, *What is the single most important way the European Union affects your daily life?*, the issue that achieved the highest score was metrication (or allied topics such as "weights and measures"), mentioned by just 5%. Nothing else scored above 3%.

There is clearly huge potential here for those who believe that membership of the EU (and, in future, the single currency) has benefits in terms of daily life. Their opportunity is

a) to increase **awareness** of the practical benefits of membership

b) to increase the **saliency** of those benefits – that is, seek to make day-to-day issues matter more than they do today, and "theological" issues (for example to do with sovereignty) to matter less

E. THE PEOPLE'S AGENDA

Is there any reason to suppose that anyone would pay any attention to arguments and information about the EU and everyday issues? ICM tested this in two ways – by asking what people thought the EU's priorities should be, and also what particular issues people would most like to hear more about.

Which three or four of the following should be a priority for the European Union to undertake in the future?	
Maintaining peace and security in Europe	*47%*
Fighting poverty	*46*
Fighting crime	*40*
Fighting unemployment	*40*
Develop a common approach to asylum and immigration	*31*
Developing and protecting the rights of citizens	*30*
Protecting the environment	*28*
Protecting consumers	*18*
Reforming the way the institutions of the European Union work	*13*
Welcoming new countries to join the European Union	*8*

Which three or four of the following would you most like to know more about?	
The euro	*40%*
The impact of the European Union in your local area	*32*
The European Union's work on tackling crime	*28*
The European Union's work on security and defence	*27*
How the European Union helps British trade and job market	*27*
Your rights as an European Union citizen	*26*
Benefits to the consumer	*25*
The European Union's work on the environment	*24*
Work and study opportunities in the European Union	*20*
Your MEPs, and what work they do	*13*
How the institutions of the European Union work	*10*
The European Union's plans to enlarge to include more countries	*9*
European Union treaties	*6*

There is plainly a widespread appetite to hear more about the Euro. Otherwise, the two questions convey much the same message:

- the high importance that people place on peace & security, jobs and fighting crime;
- the moderate importance of the environment, consumer issues and citizen's rights;
- the low importance of treaties, enlargement and the institutions of the EU

There are relatively modest differences in the agendas of "pro-Europeans", "anti-Europeans" and "groups to address". By the same token, demographic differences are fairly small. However, women are even more turned off than men by issues to do with the institutions of the EU and prospects for enlargement.

ICM also tested perceptions of life in Britain, compared with life on the continent:

a) What do you think public services such as health, education and transport are like in other major European Union countries compared to Britain?

b) What do you think the standard of living is in other major European Union countries compared to Britain?

	Public services	*Standard of living*
	%	*%*
Better	*42*	*34*
Much the same	*25*	*35*
Worse	*10*	*9*
Don't know	*23*	*22*

As can be seen, very few people think Britons are better off, or enjoy better public services, than in the rest of the continent. Pro-Europeans are more likely than anti-Europeans (whether judged by attitudes to membership or the Euro) to regard conditions as better across the Channel; but even among the strongest anti-Europeans, far more people say conditions are better in the rest of the EU than in Britain.

This suggests that, if a causal link can be demonstrated between improving living conditions and greater involvement in the EU, then this could be one way to reach out to sceptical, but not downright hostile, members of the public.

F. SOURCES OF INFORMATION

On a scale of 1 to 10, (1 being not at all, 10 being completely), how much do you trust the following to tell the truth about the European Union?

	6-10 %	4-5 %	1-3 %
Your own paper (broadsheet readers)	*43*	*30*	*24*
Television and radio news	*34*	*32*	*30*
Your own paper (Mail readers)	*33*	*33*	*32*
Your own paper (Mirror/Record readers)	*29*	*31*	*34*
Government	*28*	*30*	*38*
Your own paper (Sun readers)	*27*	*31*	*39*
Trade unions	*27*	*31*	*30*
Businessmen	*26*	*32*	*34*

The most trusted source of information is broadsheet newspapers by their readers. There are too few respondents for each title for these to be analysed individually; however, taken together, ICM's figures show that trust for broadsheet papers (like attitudes towards Europe) do NOT correlate with whether the paper is pro- or anti- EU/Euro.

Three other points stand out.

- Very few people trust any source of information a lot (8 or more out of ten). These are the figures: Broadsheet papers: 13%; TV and radio news: 13%; Government: 11%; Mirror/Record: 9%; Trade unions: 9%; Daily Mail: 8%; Sun: 8%; Businessmen: 8%.

- Compared with a similar (but not identical) question asked at the time of the general election, the media are less trusted on Europe than on domestic politics. There seems to be a widespread scepticism about anything anybody says on the EU.

- Broadsheet papers apart, the figures for the remaining sources of information are fairly similar. All are low.

Where do you get your information on the European Union currently?

Television	*74%*
Newspaper	*51*
Friends / family	*8*
Government publications	*4*
Internet	*3*
Radio	*3*
Local events	*1*

As those figures show, television and the press dominate all other sources of information. Among readers of broadsheet papers, newspaper (70%) is mentioned as often as television (68%).

However, among ICM' "groups to address", television (69%) heavily outscored newspapers (39%).

These figures reflect what happens now. They may not reflect what people *would like* to happen. So our questionnaire explored this further:

How would you most like to receive information about Europe?

Television	*56%*
Newspaper	*39*
Leaflets	*30*
Radio	*21*
Talks / debates	*14*
Internet	*9*
Magazine	*9*
Would not want information	*8*
From MEPs	*7*
In speeches / articles by politicians	*6*
Celebrities / well known speakers	*4*

Where would you like to find the information?

From television / radio news	*59%*
In post offices	*23*
In libraries	*19*
In supermarkets	*17*
Local EU events / talks / debates	*9*
In schools	*7*
From television / radio soaps	*6*
In universities / colleges	*5*

Again, television comes top, but less dominantly so. Leaflets and radio (as well as, once again, newspapers) also score heavily as *sources* of information, and post offices, libraries and supermarkets as *locations*.

Politicians don't!

(The figure for the internet is low, but represents around one in five of people with access to the internet; as internet access increases, this figure is also likely to rise.)

In the context of this poll, people are likely to have answered these questions in terms of the politics of Britain's relations with the EU. The results should not be used to deter more imaginative ways (such as via celebrities and TV soaps) to enhance knowledge of the everyday benefits of EU membership. Indeed, there may well be advantages in a media strategy that includes the imparting of information at times, and in ways, in which people do not think they are being "told about Europe": as we have seen, most people are sceptical of almost all sources of information "about Europe". However, these figures DO suggest that there would be widespread resistance to using celebrities, soaps etc in an overtly propagandist way.

What about existing organisations and initiatives that are concerned with European issues?

Which, if any, of the following information initiatives on Europe have you or heard of?

Britain in Europe	*15%*
The debate on the Future of Europe	*8*
Business for Sterling	*7*
The UK Government's website on Europe	*7*
European Public Information Centres (EPICs) in libraries	*5*
Your Britain Your Europe (YBYE)	*4*
None of them / don't know	*72*

Among "groups to address", the none/don't know figure climbs to 80%!

If anything, these figures actually exaggerate the knowledge of institutions and initiatives, as people were not tested on whether their claimed familiarity was based on real understanding. For example, some people who said they had heard of "Britain in Europe" may have been referring to the general concept, rather than the organisation itself.

ICM also tested attitudes to informing the next generation of British citizens.

How important do you think it is for children to be taught more of the facts about the European Union in….

	Very important %	*Quite important %*	*Not very important %*	*Not at all important %*
Primary schools	*34*	*31*	*18*	*13*
Secondary schools	*49*	*39*	*5*	*4*
Sixth forms	*61*	*30*	*3*	*2*

It is clearly significant that two-thirds of the electorate think it is "very" or "quite" important to teach children about the EU, even at primary school. At secondary level, the figure climbs to nine out of ten. These findings cannot be used to settle a dispute about the *content* of an EU-oriented curriculum, but they should help to rebut any criticism of the *basic principle* of teaching children about the EU.

Peter Kellner
2 November 2001

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1 POLITICS Mandelson
BLAIR C[illegible] WOO BRITAIN OVER THE EURO _ MANDELSON<
By James Lyons, Political Correspondent, PA News<
Tony Blair can win a referendum on joining the euro, even if public opinion is against entry when the campaign begins, Peter Mandelson was saying tonight.<
The former Northern Ireland Secretary told BBC's Hard Talk he was confident the Prime Minister can convince voters to join the single currency whenever the ballot takes place.<
Mr Mandelson, a key adviser to Mr Blair, was seen as a leading euro-enthusiast during his time in the Cabinet.<
He says he cannot predict when the economic conditions for the UK's euro entry will be right.<
However, a referendum will be held and possibly before the general election, according to Mr Mandelson.<
``I believe that referendum can and will be won," he told Hard Talk, in an interview screened tonight.<
``We probably won't go into a referendum with the opinion polls saying we are going to win it," he says.<
And Mr Mandelson adds: ``I expect that at the beginning of a campaign more people will be sceptical and against than persuaded but then that is the point of a campaign."<
His comments echo Tony Blair who told this year's Labour Party conference the government should have the courage to go to a vote if the economic conditions were right.<
Mr Mandelson also denied any bitterness over being forced to resign in the Hinduja passport affair.<
He was forced to resign from the Government for a second time earlier this year amid claims he helped one of the controversial brothers apply for a UK passport.<
No wrong doing was found by the Hammond inquiry into the affair but Mr Mandelson insists he does not feel bitter.<
The Hartlepool MP admits anger over the ``flimsy allegations" made by the media.<
But he argues the allegations left Mr Blair little alternative but to demand his resignation.<
``Our friendship and my commitment to him never missed a beat," Mr Mandelson said.<
The former minister, who has just landed a column for men's lifestyle magazine GQ, added that he does not expect to return to government.<
The interview was being screened on BBC News 24 at 10.30pm today.<
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MINECOR

3 December 2001
11.00 – 12.00
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Foreign and Commonwealth Office

Agenda

1. Chair's opening comments/welcome

2. "Euro notes and coins"

   Ruth Kelly
   Economic Secretary

   Ed Balls
   Special Adviser to the Chancellor

3. Discussion

4. Next meeting: timing, topic

5. AOB

<u>Distributed Papers</u>

Euro notes and coins headline messages

Euro press cuttings

Euro notes and coins leaflet

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APPROVED LINES

Headline messages

- We are witnessing a historic event. The euro is about to become a reality in the pockets and purses of 300 million Europeans.
- This is an unprecedented logistical challenge, and further challenges lie ahead. A process of this magnitude is never likely to run without hitches.
- The Government is very pleased to hear euro area countries and the European Commission say that they expect a broadly smooth changeover.
- The Government wants to see a successful changeover in the euro area, not least because half our total trade is with Europe – with around 3 million jobs affected. The UK therefore wishes the participating member states well with their efforts.
- The Government recognises the practical implications for the UK – greater price transparency, more effective competition, easier access to European markets. That is why the Government is making targeted help available to British business and citizens to help them prepare.
- The Government's policy on membership of the single currency is unchanged. It remains as set out by the Chancellor of the Exchequer in October 1997, and as restated by the Prime Minister in February 1999. In principle, the Government is in favour of joining; in practice, the economic conditions must be right.

Lines to take

1. **What does all this mean for UK Government policy on the euro?**

Government policy on the euro remains as set out by the Chancellor in October 1997 and as restated by the Prime Minister in February 1999. In principle, the Government is in favour of joining; in practice, the economic conditions must be right.

2. **Is the euro area ready for the changeover?**

- This is an unprecedented logistical challenge, and further challenges lie ahead. A process of this magnitude is never likely to run without hitches.
- The Government is very pleased to hear euro area countries and the European Commission say that they expect a broadly smooth changeover.

3. **Which country is best prepared, which country is least prepared?**

Not willing to be drawn into that sort of comparison. Key fact is that euro area countries and the European Commission say that they expect a broadly smooth changeover. For further background you might want to look at the country factsheets at www.euro.gov.uk.

4. **Will the changeover lead to price rises/inflation in the euro area?**

- The Commission and participating member states recognise that this is a concern. But they have worked hard to maintain consumer confidence – voluntary agreements by retailers to price stability over the changeover period, dual pricing, raising public awareness and close monitoring of prices.
- Europe is a competitive market. Any retailers that rip their customers off today will pay for it tomorrow. Customers will simply exercise their choice to go elsewhere.

5. **What is being done to stop euro related fraud/ money laundering/ counterfeiting?**

The relevant authorities are aware of the fraud/money laundering/ counterfeiting issues raised by the introduction of the euro and are acting upon them, both in the UK (National Criminal Intelligence Service) and across the euro area (Europol).

6. **Will Greece make it in time? French have recalled 3 million starter kits – shows changeover will be a fiasco?**

Spanish SMEs won't be ready? Queues at Amsterdam railway station?

- This is an unprecedented logistical challenge, and further challenges lie ahead. A process of this magnitude is never likely to run without hitches.
- The Government is very pleased to hear **ALL** euro area countries and the European Commission say that they expect a broadly smooth changeover.

Practical questions

1. What should tourists visiting the euro area do

- Tourists should take existing currencies for visits to the euro area in 2001. This advice applies even if they intend to stay in the euro area into the New Year period, as it will still be possible to use those currencies in January. For visits beginning in 2002, tourists should take euro.

2. Where can UK tourists get more information?

- Travel agents and banks are providing leaflets and giving advice. Information can also be found on the Treasury, FCO and DTI websites.
- The information that the Government is providing is factual, and is designed to assist UK travellers visiting the euro area during the early period of the cash changeover.

3. Will people be able to use euro cash in the UK?

Euro notes and coin are not legal tender in the UK though some shops in major tourist areas have expressed an interest in accepting the euro just as some accept other foreign currencies today.

4. What do UK consumers do with old franc, Deutschmark etc notes?

- In the UK most banks will exchange legacy currency notes for sterling early in 2002. In the euro area, legacy currency can be exchanged for euro at most banks for some months

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after the end of the dual circulation period. Thereafter, legacy currency may be exchanged for euro at National Central Banks.

- If you have legacy notes and coins and are not planning to travel to travel to the euro area before the end of this year, you should exchange notes for sterling now or, if you prefer, for euro at your bank in the early months of 2002. UK banks will not exchange legacy currency coin but some have joined up with charities to collect unused/unwanted coin in their branches.

5. **What does a UK business have to do to prepare for the change to the euro on 1 January 2002?**

- That depends on the firm. Around half of all SMEs say they have trading links with Europe. These firms need to be aware of, and prepare for, a range of issues including the effects of increased competition; marketing and pricing; methods of raising finance; price transparency, and market changes generally.
- HM Treasury's euro website (www.euro.gov.uk) contains a simple self-test tool which will enable firms to evaluate whether they are likely to be affected, and gives indications of what they need to do to prepare for the euro changeover in the euro area.
- The self-test described will enable firms to evaluate what they need to do to prepare for the euro changeover in the euro area. This will direct firms to relevant advice including factsheets and case studies.

Key facts

1. Austria, Belgium, Finland, France, Germany, Greece, the Republic of Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain will use euro cash from 1 January 2002.

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2. Euro coins will also be used by Andorra, Monaco, San Marino, and Vatican City, and the euro will be legal tender in these countries. In addition several overseas territories of the 12 euro area countries will also be using the euro. These include the Canaries, Madeira, the Azores, and the French Outre-Mer territories (Guyana, Martinique, Guadeloupe, Reunion and the collective territories of Mayotte and St Pierre and Miquelon).

3. The euro will not be legal tender in the UK. However, several major retailers have said that they are prepared to accept euro cash, just as they accept other major foreign currencies such as the dollar.

4. The euro will be divided into 100 cents. There will be seven banknotes: 5,10,20,50, 100, 200 and 500. There will be eight coins: 1, 2, 5, 10, 20, 50 cents, and 1 and 2 euro. Each country in the euro area will produce their own coins, with one common side and one national side, but can be used in any of the euro area countries. Euro notes will be identical for all countries and usable throughout the euro area.

5. All countries have a time limited dual circulation period during which both euro and legacy currencies will have legal tender status. Official legal tender status of legacy currencies has to be withdrawn by the end of February, though the withdrawal date is a matter for individual governments. Most allow the full two months, with France, Ireland and the Netherlands choosing shorter periods.[1]

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[1] Germany officially withdraws the Deutschmark's legal tender status on 1 January 2002, but it will continue to be accepted in practice. Although legacy cash will fall out of use within the first few weeks, citizens throughout the EU will still be able to get value for their legacy currency holdings from central banks after the dual circulation period has ended.

P

PRELIMINARY AND TECHNICAL WORK TO PREPARE FOR THE ASSESSMENT OF THE FIVE TESTS FOR UK MEMBERSHIP OF THE SINGLE CURRENCY

1. This short paper restates Government policy on EMU and addresses issues of content and timing of the preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency.

Policy

2. In the Chancellor's Mansion House speech of 20 June 2001 he restated the Government's policy on membership of the single currency. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous. The Government recognizes the constitutional issue as a factor in the decision, but the Government does not consider it a bar to entry if there is clear and unambiguous evidence of the economic benefits of joining, and if the people have the final say in a referendum.

Content

3. The five tests define whether a clear and unambiguous case can be made. In the Mansion House speech in June the Chancellor repeated the five economic tests set out in his October 1997 statement. The tests were set out in full in the document accompanying the statement made in October 1997[1]. They are:

> (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?

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[1] HM Treasury (1997) "UK Membership of the Single Currency: An Assessment of the Five Economic Tests".

(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?

4. The tests are the necessary economic pre-requisites for membership of a successful single currency. Indeed, the IMF[2] have commented recently that the five tests are:

> "…consistent with the economic considerations that would be important for the decision to join a monetary union."

5. In the Mansion House speech in June the Chancellor explained that before the assessment of the tests was started, the Treasury would:

> "…continue to do the necessary preliminary work for our analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised."

This makes clear that the preliminary work will inform the assessment.

6. The Chancellor has made clear that the Government will publish the assessment and ensure that it is rigorous and comprehensive. It is on this basis, taking account of all relevant information that the Government will decide whether to recommend membership to Parliament and then to the British people. The assessment has not yet started but the preliminary and technical analysis is underway.

7. The scope of the necessary preliminary and technical work was set out in the original October 1997 assessment. Although there have been new developments since the 1997 assessment, the underlying issues to be analysed remain the same and the five tests themselves remain unchanged. Some of the key parts of the preliminary and technical work are set out below although this is by no means an exhaustive list as the preliminary work continues to evolve to take account of the latest technical research and analysis.

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[2] IMF Article IV Report on the UK economy (28 February 2001).

- Under the **convergence test** the preliminary and technical work will update the evidence presented in the 1997 assessment on the cyclical behaviour of the UK economy relative to that of the euro area countries and their relative responses to different shocks. The preliminary work will include collecting information on indicators like the output gap, inflation, interest rates and the real effective exchange rate, and will update and extend the analysis on issues of convergence.

  As in the 1997 assessment, the preliminary and technical work will also consider the evidence on the sustainability and durability of convergence. As set out in the executive summary of the 1997 assessment,

  > "…sustainable and durable convergence is the touchstone and without it we cannot reap the benefits of a successful EMU."

  The executive summary went on to spell out that sustainable convergence means that the British economy:

  - has converged with Europe;
  - can demonstrably be shown to have converged;
  - that this convergence is capable of being sustained; and
  - that there is sufficient flexibility to adapt to change and unexpected economic events.

  As in the 1997 assessment, in order to judge whether convergence is sustainable and durable, the preliminary work is studying key structural features of the UK and euro area economies that might be a source of asymmetric cyclical responses in the future. These include: analysis of trade and investment linkages; the behaviour of housing markets; and the sectoral composition of output; as well as analysis of financial structures of the studies of the monetary transmission mechanisms of the UK and euro area economies.

  A forward looking-assessment of convergence also needs to consider the strength of the arguments that closer convergence will develop over time, such as through the operation of a common monetary policy, or through stronger trade and financial linkages. Background analysis of these issues is included as part of the technical and preliminary work.

- The second test concerns the **degree of flexibility** in the UK and euro area economies, and as the 1997 assessment made clear, it is closely related to the convergence test. The preliminary work is focussed on compiling evidence on evaluating the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work. A key area, as reflected in the 1997 assessment, is the behaviour of the labour market, including the degree of wage and employment flexibility. The work is looking again at the evidence for market flexibility in the UK economy as well as the position in other European countries following the drive to make progress on economic reform. The 1997 assessment also noted the importance of macro-economic policy alongside micro policies to achieving flexibility.

- As in the 1997 assessment, the preliminary work on the **investment** test considers both the general impact on investment and the impact on foreign direct investment. Key issues for analysis include the impact of the single currency on: the cost and availability of capital; macroeconomic stability and the stability of the real effective exchange rate; and the location, quantity and quality of private and public investment.

- As with the preliminary work for the other tests, the work on **financial services** will update the analysis in the 1997 assessment on this key sector to the UK economy. The 1997 assessment noted that EMU will affect the financial services industry more immediately and more profoundly than other sectors of the economy. As recognised in the 1997 assessment, the preliminary and technical work for the next assessment will have to include a detailed analysis of the changes that have already occurred in this sector in the UK and the euro area since the start of the single currency in 1999.

- As defined in the 1997 assessment the fifth test on **employment** will cover whether EMU will "promote higher growth, stability and a lasting increase in jobs." The preliminary and technical analysis being undertaken for this test will, as in the 1997 assessment, analyse the potential benefits of EMU for the longer-term performance of the economy. This includes an update of the analysis of the potential impact of the single currency on trade, competition and productivity, and also its potential sectoral and regional impact.

Timing

8. The Budget 2001[3] document set out the details on the timing of the assessment process. The Government has said that it will produce the assessment within two years of the start of the Parliament. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. The Government believes that, if a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people. The referendum would only occur if the five tests were met and the Government had made a decision to recommend joining.

HM Treasury, November 2001

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[3] HM Treasury 'Budget 2001' (March 2001) see box 2.2 on 'EMU and EMU preparations' on page 23.

AS I SET OUT AT THE LORD MAYOR'S BANQUET EARLIER THIS YEAR, OUR APPROACH IS - AND WILL CONTINUE TO BE - CONSIDERED AND CAUTIOUS: ONE OF PRO-EURO REALISM. PRO-EURO BECAUSE, AS WE SAID IN 1997,

> WE BELIEVE THAT --- IN PRINCIPLE --- MEMBERSHIP OF THE EURO CAN BRING BENEFITS TO BRITAIN.
>
> OR
>
> A SUCCESSFUL EURO IS IN OUR NATIONAL INTEREST AND PROVIDED THE ECONOMIC CONDITIONS ARE MET, IT IS RIGHT THAT BRITAIN JOINS.

REALIST BECAUSE TO SHORT-CUT OR FUDGE THE ASSESSMENT, AND TO JOIN IN THE WRONG WAY OR ON THE WRONG BASIS WITHOUT RIGOROUSLY ENSURING THE TESTS ARE MET, WOULD NOT BE IN THE NATIONAL ECONOMIC INTEREST.

A SINGLE EUROPEAN CURRENCY – WITH A FULLY DEVELOPED SINGLE MARKET – COULD IN PRINCIPLE INCREASE TRADE AND COMPETITION THROUGH THE ELIMINATION OF EXCHANGE RATE RISK AND THROUGH MORE TRANSPARENT PRICES; REDUCE TRANSACTION COSTS, AGAIN INCREASING TRADE AND INVESTMENT, AND BENEFITING EVERYONE TRAVELLING IN EUROPE; AND LOWER LONG-TERM INTEREST RATES, AGAIN

GOOD FOR INVESTMENT AND SO GOOD FOR GROWTH AND JOBS.

BECAUSE THE GOVERNMENT IS DETERMINED THAT WE WILL MAKE THE RIGHT LONG TERM DECISIONS FOR BRITAIN, WE WILL NOT TAKE RISKS WITH BRITAIN'S HARD WON STABILITY.

SO THE ASSESSMENT AS TO WHETHER IT IS IN THE BRITISH NATIONAL ECONOMIC INTEREST OR NOT WILL BE COMPREHENSIVE AND RIGOROUS. IT IS ONLY ON THIS BASIS --- TAKING INTO ACCOUNT ALL RELEVANT ECONOMIC INFORMATION --- THAT THE CABINET WILL DECIDE WHETHER TO RECOMMEND MEMBERSHIP TO PARLIAMENT AND THEN TO THE BRITISH PEOPLE.

WHILE THE ASSESSMENT HAS NOT YET STARTED, THE NECESSARY PRELIMINARY ANALYSIS -- TECHNICAL WORK THAT IS NECESSARY TO ALLOW US TO UNDERTAKE THE ASSESSMENT WITHIN TWO YEARS AS WE PROMISED --- IS UNDERWAY.

THE SCOPE OF THE TECHNICAL AND PRELIMINARY WORK FOR THE NEXT ASSESSMENT OF THE FIVE TESTS IS AS SET OUT IN THE ORIGINAL OCTOBER 1997 ASSESSMENT. ALTHOUGH THERE HAVE BEEN NEW DEVELOPMENTS SINCE THE 1997

ASSESSMENT, THE UNDERLYING ISSUES TO BE ANALYSED REMAIN THE SAME.

THE 1997 STATEMENT DETAILED FIVE ECONOMIC TESTS:

- FIRST, SUSTAINABLE CONVERGENCE BETWEEN BRITAIN AND THE ECONOMIES OF A SINGLE CURRENCY;

- SECOND, WHETHER THERE IS SUFFICIENT FLEXIBILITY TO COPE WITH ECONOMIC CHANGE;

- THIRD, THE EFFECT ON INVESTMENT;

- FOURTH, THE IMPACT ON OUR FINANCIAL SERVICES INDUSTRY; AND

- FIFTH, WHETHER IT IS GOOD FOR EMPLOYMENT.

NOW THE PRELIMINARY AND TECHNICAL WORK IS UPDATING THE ANALYSIS ON:

- THE CYCLICAL BEHAVIOUR OF THE UK ECONOMY RELATIVE TO THE EURO AREA AND THEIR RELATIVE RESPONSES TO ECONOMIC SHOCKS;

- THE MECHANISMS BY WHICH PRODUCT, LABOUR AND CAPITAL MARKETS ADJUST AND HOW WELL AND HOW QUICKLY THEY WORK;

- THE IMPACT OF THE SINGLE CURRENCY ON THE COST AND AVAILABILITY OF CAPITAL, MACROECONOMIC STABILITY, THE STABILITY OF THE REAL EFFECTIVE EXCHANGE RATE AND THE LOCATION, QUALITY AND QUANTITY OF INVESTMENT;

- THE EFFECT OF THE SINGLE CURRENCY ON FINANCIAL SERVICES, INCLUDING THE CHANGES THAT HAVE OCCURRED IN THIS SECTOR IN THE UK AND THE EURO AREA SINCE 1997; AND

- THE IMPACT OF THE SINGLE CURRENCY ON TRADE, COMPETITION AND PRODUCTIVITY.

OUR COMMITMENT IS TO COMPLETE A FULL ASSESSMENT OF THE FIVE TESTS WITHIN TWO YEARS OF THE START OF THIS PARLIAMENT.

AND I CAN TELL THE DINNER THIS EVENING THAT OUR COMMITMENT "TO PREPARE AND DECIDE" IS BEING

MAINTAINED WITH THE PUBLICATION OF THE LATEST EURO PREPARATIONS STUDY TODAY.

WE HAVE ALWAYS SAID THAT WE MUST PREPARE TOGETHER – NOT ONE OR TWO BUSINESSES, BUT GOVERNMENT AND BUSINESS WORKING TOGETHER.

THE GOVERNMENTS STANDING COMMITTEE ON EURO PREPARATIONS - WITH MEMBERSHIP DRAWN FROM THE PUBLIC AND PRIVATE SECTORS, INCLUDING THE PRESIDENT AND DIGBY JONES - MET AGAIN LAST MONDAY AS A KEY PART OF OUR CONSULTATION.

AND WE ARE TODAY PUBLISHING OUR LATEST PROGRESS REPORT ON EURO PREPARATIONS. IN JUST A FEW WEEKS' TIME, EURO CASH WILL DISPLACE EXISTING CURRENCIES IN THE EURO AREA. THIS WILL HAVE AN IMPACT ON MANY UK BUSINESSES AND ALSO ON CITIZENS IN THEIR CAPACITY AS TOURISTS. GOVERNMENT AND PARTNER ORGANISATIONS LIKE THE CBI ARE WORKING TOGETHER TO GIVE ADVICE TO BUSINESSES - INDEED THE NEXT PHASE OF OUR INFORMATION CAMPAIGN STARTS TODAY, INCLUDING THE DIRECT MAILING OF SAMPLE CASE STUDIES AND AN INFORMATION BOOKLET TO 1.5M SMEs.

IN ADDITION, PLANNING FOR POSSIBLE UK ENTRY CONTINUES UNDER THE NATIONAL CHANGEOVER PLAN. THE GOVERNMENT HAS INVESTED £13M SINCE THE PUBLICATION OF THE LAST REPORT ON EURO PREPARATIONS IN NOVEMBER LAST YEAR, BRINGING THE TOTAL INVESTED ON CHANGEOVER PLANNING TO £23.5MILLION.

THESE ARE THE PREPARATIONS WE ARE MAKING TOGETHER. BECAUSE WE ARE RESOLVED WE WILL NOT LEAVE BRITAIN ECONOMICALLY UNPREPARED.

Roger, I already showed it to him.

Jn

From: Roger Liddle
Date: 27 November 2001

JONATHAN POWELL

cc: Peter Hyman
Julian Braithwaite

The Prime Minister might like to see this polling on the Euro question. The interesting thing is how much Labour support for the Euro improves when there is a clear Government recommendation.

Simon Buckley is arranging for Peter and myself to meet Paul Whiteley.

Roger.

ROGER LIDDLE

RL

Question Wording Experiment in the British Election Study On Public Attitudes to British Membership of the European Monetary Union

By

Professor Paul Whiteley

(University of Essex)

Introduction

The British Election Study is a series of linked surveys conducted during and immediately after the general election of 2001, which investigates voting behaviour in Great Britain. It is based at the University of Essex and is funded by the Economic and Social Research Council. The study focuses on measuring voting intentions, public evaluations of key election issues, perceptions of the party leaders and a variety of other measures which can be used to explain why people vote and why they choose a particular party.

The election study team conducted an experiment in question wording in one of the surveys, relating to the issue of British membership of the European Monetary Union. This survey involved a short telephone interview of a random sample of the electorate, which took place immediately after polling day. It was conducted by Gallup on behalf of the election study team and had an unusually large sample of more than 4,800 respondents.

The experiment involved randomly allocating respondents to four different groups of roughly 1,000 people each. Individuals in each of these groups were then asked a different version of a question about British membership of the European Monetary Union. The experiment was motivated by the idea that attitudes to British membership of EMU are much more likely to be influenced by opinion leaders and by the context in which the question is asked than is true of other issues. This is because few people in the electorate have any direct experience of the EMU issue to draw on when deciding their views. This is in sharp contrast to issues such as the health service, education and transport, where people have a lot of personal experience to draw on when forming a view. As a consequence their attitudes are likely to be strongly influenced by statements of opinion leaders whom they trust and by the way in which the issue is framed.

The Question Wording Experiment

In the light of the above argument it seems likely that electors will be strongly influenced by the position taken on this issue by the British government, and also by the way in which the policy choices are framed. If respondents are Labour supporters then they are likely to be more responsive to an endorsement of EMU by the government than supporters of the other parties. Similarly, if the question is framed in terms of 'giving up the pound', which appears to threaten a familiar and traditional valued object in people's lives, support is likely to be significantly less than if it is framed in terms of joining a new and potentially successful enterprise. Thus the four versions of the question examine the interactions between the effects of endorsement and framing on public attitudes to British membership of the common currency.

Version One

When the referendum on British Membership in the European Monetary Union, the EURO is held will you vote to.....

	Percentages
Give Up the Pound and Join the Euro	**24**
Keep the Pound and Reject the Euro	**62**
Have not Decided Yet	**12**
Don't Know	**2**

Version Two

When the referendum on British Membership in the European Monetary Union the EURO is held will you vote to.....

	Percentages
Join the Euro	**32**
Reject the Euro	**50**
Have not Decided Yet	**16**
Don't Know	**2**

The framing effect can be examined by comparing versions one and two of the experiment. When the phrase 'give up the pound' is removed from the response categories, support for joining increases by nine percentage points and opposition to joining decreases by twelve percentage points. Thus the effects are quite strong.

Version Three

When the referendum on British Membership in the European Monetary Union, the EURO, is held and the British government recommends entry, will you vote to....

	Percentages
Give Up the Pound and Join the Euro	**30**
Keep the Pound and Reject the Euro	**57**
Have not Decided Yet	**12**
Don't Know	**2**

The endorsement effect can be seen by comparing version one with version three of the experiment. When the phrase 'and the British government recommends entry' is added to the question, this has a significant effect on responses. Support for joining increases by six percentage points, and opposition declines by five percentage points.

Version Four

When the referendum on British membership in the European Monetary Union, the EURO is held and the British Government recommends entry, will you vote to .....

	Percentages
Join the Euro	**33**
Reject the Euro	**53**
Have not Decided Yet	**13**
Don't Know	**2**

The effects of both framing and endorsement together can be seen by comparing version one with version four of the experiment. When the phrase 'the British Government recommends entry' is added to the question and the phrase 'give up the pound' is dropped from the response categories, then support for membership increases by nine percentage points and opposition decreases by the same amount.

Finally a comparison of versions three and four of the experiment demonstrates the impact of the framing effect in the presence of the endorsement effect. It can be seen that support increases by three percentage points and opposition decreases by four percentage points.

It was suggested earlier that the endorsement effect should work most effectively on Labour supporters, and this is investigated next. Responses to the questions are broken down by party identification. This is measured by a question which asks 'Generally speaking do you think of yourself as Labour, Conservative, Liberal Democrat or what? The tables below show the responses of different groups of party identifiers.

Attitudes to the Euro by Party Support

Version One

	Percentages		
	Conservatives	**Labour**	**LibDems**
Give up the pound and join the Euro	9	32	30
Keep the pound and reject the Euro	83	53	57
Have not decided yet	7	12	11
Don't Know	1	2	2

Version Two

	Conservatives	**Labour**	**LibDems**
Join the Euro	15	43	39
Reject the Euro	76	34	44
Have not decided yet	9	21	16
Don't Know	1	2	1

Version Three

	Conservatives	Labour	LibDems
Give up the pound and join the Euro	11	39	39
Keep the pound and reject the Euro	82	44	52
Have not decided yet	7	15	7
Don't Know	1	2	2

Version Four

	Conservatives	Labour	LibDems
Join the Euro	10	44	44
Reject the Euro	82	38	45
Have not decided yet	7	16	9
Don't Know	2	2	2

A comparison of versions one and two show that the framing effect influences the opinions of supporters of all three parties, with the greatest effects being associated with Labour identifiers. *A plurality of Labour identifiers change from being opponents to being supporters as a result of the framing effect.* The effect on Conservative identifiers is much more modest but nonetheless significant, increasing their support by six percentage points.

The endorsement effect is also important as can be seen by comparing versions one and three. In this case Labour identifiers increase their support by seven percentage points and Conservatives increase it by a more modest two percentage points. This is entirely consistent with the idea that electors will respond to opinion leaders who they support and trust.

The interaction between the framing and endorsement effects is seen by comparing versions one and four, and it can be seen that Labour identifiers increase their support for EMU by 12 percentage points and Conservatives increase it by one percentage point. The effect on Liberal Democrats is similar to that of Labour.

Implications for the Referendum Campaign

In relation to the referendum on British membership of EMU, this evidence suggests that both framing effects and endorsement effects are important, with the former being particularly important for Labour identifiers. The effects are weak for Conservative identifiers, but they make up less that a third of the electorate. Thus public opinion can be persuaded to support British membership if:

- The referendum campaign stresses the idea of joining with our European neighbours in a new and potentially successful enterprise.
- There is a concerted campaign by the leaderships of both the Labour and Liberal Democrat parties to persuade their supporters of the importance of this for Britain.

MINISTERE DES FINANCES

LE MINISTRE

Brussels, November 23, 2001

Dear Prime Minister,

It is a great honour for me to give you this set of euro coins which will be put in circulation at the beginning of next year.

As I am writing this, I am interested to read your speech of today in Birmingham about Britain and Europe.

Yours sincerely,

Didier Reynders

The Rt. Hon. Tony Blair M.P.
Prime Minister of the United Kingdom

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EUROPEAN POLICY - PART 2 - SINGLE CURRENCY

ANNEX 1. PRACTICAL ISSUES ARISING FROM THE EURO

Published Document

The published document that was enclosed on this file has been removed.

Such items should not be a part of the historical record if they can be readily accessible elsewhere.

https://www.bankofengland.co.uk/-/media/boe/files/archive/practical-issues-arising-from-the-introduction-of-the-euro/december-2001.pdf

Title: Practical issues arising from the euro

Author: The Bank of England

Department: The Bank of England

Date: December 2001

ISSN: 1467-1492

Signed: A.Lajos

Date: 16/11/2022

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