BROWN´S FIVE ECONOMIC TESTS IN THE PERSPECTIVE OF CURRENT DEBATES ABOUT „BREXIT“

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Abstract

In the perspective of current debates about British referendum on leaving the European Union, that will probably take place in 2017, the British relationship with the Eurozone is considered as crucial for the future. However clear seems it now that the UK will not accept the Euro in foreseeable future, the initial discussions during the times of the emerging Eurozone were quite serious concerning this option. Aim of this contribution is to find out how relevant were the so called Brown´s five economic tests in the process of British initial engagement with the Eurozone. The tests are compared with the original Optimum Currency Area theory, as well as confronted with actual development in the following years after the initial assessment, both through literature review and data analysis.

Key words

Brexit, Brown, Five economic tests, Optimal currency area

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Introduction

Roots of Gordon Brown´s European policy has to be seen in New Labour´s ambition to become modern social-democratic party in the 1990´s. These Labourite efforts have had consequences in a specific new kind of British pro-Europeanism - specific in terms of the prevailing “awkward” EU membership. As by many British leaders before Gordon Brown and Tony Blair, the entrance into government started with redefinition of British relationship with the EU through proclamations about strengthening ties with the EU, as well as, for that time, launching common currency in the future. Yet neither the first nor the latter did happen. Although Brown´s approach to accepting common European currency had been quite realistic from the economic point of view, moreover based on real economic theory, nevertheless it seemed in the end that the political arguments won. This has been however motivation both for euro critiques as well as supporters[1].

Aim of this contribution is to find out how relevant were the so called Brown´s five economic tests in the process of British initial engagement with the Eurozone. The tests are compared with the original Optimum Currency Area theory. Further the author confronts the tests with actual development in the following years after the initial assessment, both through literature review and data analysis.

1 The UK as a possible Eurozone member – literature review

However is the British society euro-sceptical and the acceptance of the euro seems to be far from real in 2015[2], academic debate on the issue has been rather divided. According to Mazumder and Pahl (2012: 450), the existing literature that examines whether the UK should introduce the euro is clearly split into those that are “pro-euro supporters and those who are anti-euro sceptics”. The arguments of the first, euro-friendly group, have been based on an assumption that the benefits of unified market can only be fully achieved with a single currency. Another group of arguments build on a pre-crisis evidence about long-term rising

[1] For instance, former Chancellor of the Exchequer in Major´s government Norman Lamont has been continuously criticizing Eurozone from this point of view. On the other hand, Roger Liddle, former Blair´s advisor in European issues, sees politics as obstacle to further economic integration in the EU.

[2] When considering evidence gained from the Eurobarometer, British citizens had found British membership in the EU overall positive since Q3 2004 until Q1 2008. This had changed with the beginning of the economic crisis, and from Q2 2008 until Q2 2011 the British public opinion on the membership had been constantly negative (European Commission 2015).

cyclical convergence, product and labour market mobility, and also enhanced fiscal flexibility. Seen from the point of view of the British households and firms, the single currency could have brought significant reductions in transaction costs given the fact that they interact a lot within the single market. Also exchange rate risks between British and European firms would be eliminated, and that provides better environment for greater trade and capital mobility.

Concerning the second, anti-euro group, their analyses have been based on arguing why the UK cannot create an optimum currency area with the Eurozone (since there is not enough capital and labour mobility, and wage flexibility as well). This group of studies also point out on high investment flows among the UK and the USA or losing sovereign monetary policy. In addition, the issues as possibility of future tax (or moreover fiscal) harmonization has been seen in the UK as a possible threat to its economy (Mazumder, Pahl 2012: 448 - 451).

According to Buscher and Gabrish (2011), a relatively large portion of the studies aimed at overall understanding of welfare gains and losses, including above all growth, employment and inflation. Understandably, there have occurred also studies on particular aspects of the decision whether accept the single currency – for instance aiming at business cycles correlation, convergence within the transmission mechanisms of monetary policy, analysing possible effects of trade diversion or trade creation, investigating investments diversion connected with regional integration, or at price convergence (Begg et al. 2003).

Concerning the official British governmental point of view, there has been two main reports issued by the finance ministry in 1997 and in 2003 (HM Treasury, 1997 and 2003). They basically argued that the weak synchronization of business cycles between the UK and the then monetary union candidates and the weak flexibility of the economy would speak against introducing euro in the UK. The second study, the so called Brown´s five economic tests, will be discussed later in this paper.

Begg et al. (2003) provided a comprehensive study on the issue just few months before the second official HM Treasury´s view has been introduced. Contrary to the official treasury reports, this study aimed on defining consequences of not joining the Eurozone, both from the point of view of “never ever” and “not yet”. The authors have dedicated quite a lot of space to define benefits of delay, which they see in anticipated convergence of interest rates levels of the UK and Eurozone, as well as in longer opportunity for the sterling exchange rate to depreciate.

The logic behind Begg´s study has been as following – the authors first examined cyclical convergence and monetary transmission and found out that significant convergence had taken place already before 2003. The convergence is reflected by trade patterns, geography and policymaking, which all had helped the UK to converge with the Eurozone. Also financial structure had been assessed as converging rapidly in the preceding decade. It had been also assumed that possible EMU membership would strengthen this even more. Changes in housing finance in the UK would according to the authors also lead to strengthen further the convergence trend[3].

Minford (2004), who had examined alleged benefits of joining European Monetary Union (EMU), one year after realising conclusions of the five economic tests, has summed up the key possible benefits of potential membership. It was reduction of transaction costs of currency exchange, as well as eliminating exchange risks, and benefits from increased price transparency in border areas. Broadly speaking, all of the alleged benefits Minford disproved, nevertheless the evidence showed some positive aspects of especially the first issue. Moreover, potential costs were defined as well – above all the loss of independent monetary policy leading into possible instability during crises, the risk of potential need to donate instable members due to their indebtedness, and also possible threats of further harmonising at the single market. There are strong connections with the structure of Brown´s five economic tests in Minford, however, it seems that Brown´s tests are rather focused on the negative aspects, especially anticipation of possible negative shocks.

Pesaran, Smith and Smith (2007) have developed a macroeconomic model which tries to answer the question what would have happened if the UK joined the Eurozone in 1999. The authors have chosen several factors to observe, above all the GDP and the price level. They have come to an estimation that the UK entry to the Eurozone in 1999 at then exchange rates level would probably have reduced the British GDP in the short term and raised

[3] The change concerned a switch from variable-rate mortgages to fixed-rate mortgages. According to up-to-date British mortgage offers, it seems that the majority of mortgages in the UK are now at the fixed-rated (Barclays mortgages, Halifax mortgages, HSBC mortgages, moneysupermarket.com).

it in the medium term. Entry would have probably caused British prices to be lower in the short term, but higher in the long term. However according to the authors these effects would not be very high.

Buscher and Gabrisch (2011) have analysed daily money market rates in order to answer the question, whether the central banks of Sweden, Denmark and above all the UK are able to influence short-term money markets. If so, the banks would lose according to the authors their influence if the country accept for the single currency. The authors aimed especially at specific reactions of money markets during turbulent times. They have come to a conclusion, that the European Central Bank (ECB) has had already a significant impact on the money market rates in the selected countries. This could have led to a conclusion that there would be no specific benefit for these countries to stay outside the Euro area. However, their findings had not been so strong for Sweden and Denmark. What is remarkable from the point of view of this paper, their conclusion for the UK has not been clearly against accepting Euro compared to the latter two countries.

Mazumder and Pahl (2012) tried to project Phillips curves of the British economy presuming that the UK had accepted the euro in 1999. According to their estimations, unemployment would be higher and output lower if the UK would had introduced the single currency back in 1999.

2 OCA Theory

Basic economic theory used for assessing whether it is appropriate for a country to enter monetary union is Optimum Currency Area theory. It defines set of monetary union benefits as well as obstacles, both economic and political. Two major streams of the theory have developed - the first from the 1960s and 1970s tries to find the crucial economic characteristics to determine where and how could be a hypothetical optimal currency area established. Later on, the theory has been focused on possible members of monetary union and their capability to integrate (Horvath, Komárek 2002: 7). This has been vital for British stance when deciding whether join EMU in the early 2000s, when the OCA theory was used as a decision basis.

Concerning the first main stream of the OCA theory, it shows possible benefits and costs arising from creating a monetary union. Among the benefits of currency area belong reducing transaction costs and uncertainty connected with exchange rate risk. Advantage could be also seen in newly established common monetary authority, here the European Central Bank, which is supposed to act in favour of all its members (Baldwin, Wyplosz 2013: 422 – 423). In the case of the UK, due to long tradition of maintaining low interest rates is this issue not as advantageous as it could be for instance for some of the southern member states.

Costs of the common currency area are defined in asymmetrical (as well as symmetrical) economic shocks. These could affect various currency area members variously with uncertain outcome to a group. Even the symmetrical shocks could lead into asymmetrical results due to member states´ different socio-economic structures (which is reality in the EU, especially concerning the UK as an Anglo-Saxon model compared with the continent). Finally, when we add the last possible cost, different political preferences of the members, we could end up with discussion about British "awkwardness" in this regard. Moreover, for instance Frieden (1991) shows that not even states themselves are homogenous in defining their economic preferences and that there could be various interest groups within one state with different aims within the currency area (Šaroch 2004: 17); (Baldwin, Wyplosz 2013: 420 – 428).

Concerning the second stream of the OCA theory, according to Mongelli (2008), during development of the theory, following issues which lead to favourable membership in a monetary union were defined. Fulfilling these criteria by a particular country should lead into advantageous membership in a monetary union both for the country as well as the union itself. In the following section we will confront these criteria with the five economic tests of Gordon Brown.

- Price and wage flexibility
- Mobility of factors of production including labour
- Financial market integration
- The degree of economic openness
- The diversification in production and consumption
- Similarities of inflation rates
- Fiscal integration

- Political integration.

3 Brown´s five economic tests and the OCA theory

The tests were introduced by Gordon Brown, the then Chancellor of the Exchequer, in 2003, i.e. four years after initial Eurozone formation. There were five issues defined that should have had Britain meet in order to join the Eurozone. The 18 supporting studies aimed at setting out benefits of membership and showed, according to Brown´s statement (Brown 2003), that with the achievement of sustainable convergence and flexibility of the UK economy all five tests could be met in the future, after further assessment. However, no such assessment ever took place as a consequence of political development (Baldwin, Wyplosz 2013: 435).

3.1 Convergence

This test aimed at becoming sure, that the economic cycles and structure of the Eurozone members and the UK are compatible and resistant against asymmetrical shocks. According to Brown´s report from 2003, this test had not been fulfilled due to several structural differences, such as at the housing market condition[4].

Concerning the OCA theory, the test number one covers several issues defined by Mongelli (2008), above all diversification in production and consumption, similarities of inflation rates and the degree of economic openness. Also financial and other markets integration should lead to increased economic convergence. Production and consumption diversification of monetary union members and related diversification of imports and exports have a strong potential to dilute possible impact of sectoral shocks within economies. External imbalances can arise also from differences in national inflation rates. Stable and relatively low inflation rates result in fairly stable terms of trade which will foster more equilibrated current account transactions and trade, reducing the need for nominal exchange rate adjustments. Also the degree of economic openness is vital for economic convergence - the higher the degree of openness, the more changes in international prices of tradable goods could

[4] Here it is necessary to point out that the housing market had become critical issue for Ireland, a country with strong trade and economic ties with the UK, during the Eurozone crisis.

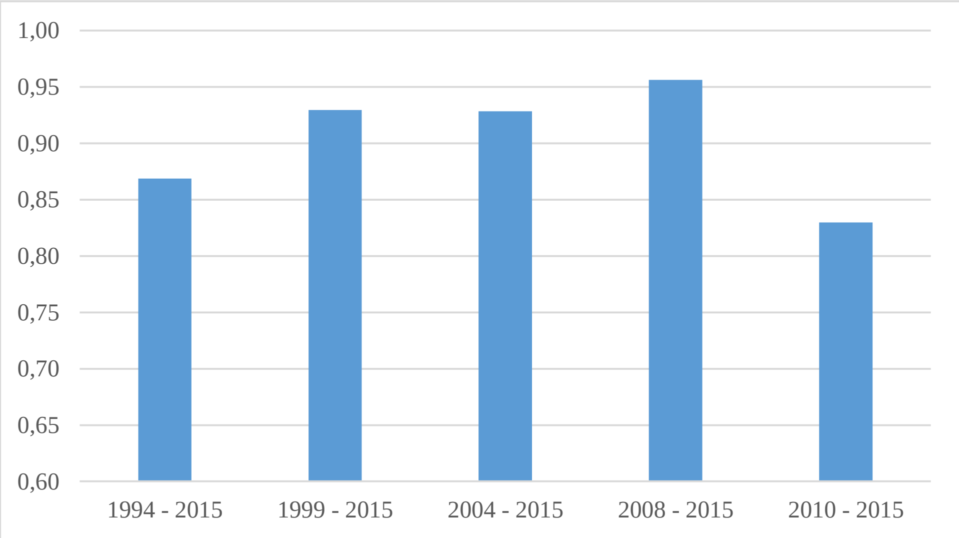
be transmitted to domestic cost of living, which would in turn reduce the potential for money and/or exchange rate illusion by wage earners[5] (Mongelli 2008: 3).

The first test has been structured aiming at covering all possible aspects of economic convergence. In the cyclical convergence section, it had been looked for similarities in economic cycles though analysing development of interest rates, GDP growth and its components´ structure, output gap, inflation and its expectations, labour market conditions and development of the exchange rate. It was found out that although the measures were becoming more convergent, it had not been enough for the UK for entering the Eurozone.

Historical convergence section showed that the UK business cycles have been during EC history much less compatible with the future euro area than the "core" countries as Germany and France. Nevertheless, the first test report showed several improvements in this area, according to conclusion the UK's history of divergence remains a risk factor. Structural convergence has shown itself to be the most critical issue of the first test. Differences in the UK and Eurozone housing markets were, as indicated above, high risk, but also differences in investment linkages and financial structures and sectoral and trade differences were at stake (HM Treasury 2003a).

[5] Economic openness has to be assessed through several dimensions, including the overall openness of a country to trade with the world, as well as the degree of openness to the countries with which the possible member intends to share a single currency, also the share of tradable versus non-tradable goods and services in production and consumption; and a tendency of the country to import (Mongelli 2008: 3).

Graph 1: UK and EU19 interest rates correlation, 1994 – 2015.



Resource: data extracted on 20 Sep 2015 12:44 UTC (GMT) from OECD.Stat, own calculation.

Concerning findings from Begg et al. (2003), where the authors have anticipated the interest rates of the UK and the Eurozone to converge, please see the graph number 1. According to observations of OECD Monthly Monetary and Financial Statistics, particularly quarterly long-term interest rates, correlation between British and Eurozone´s average interest rate had been rising when concerning periods after assessments of the possible UK entry into Eurozone (1994 and 2004 or after actual Eurozone formation in 1999. The correlation rates have been compared to periods of economic and financial crises (since 2008). Nevertheless, the period of 2010–2015 does not comply with Begg´s conclusions. This could be caused by different ways of dealing with the crisis.

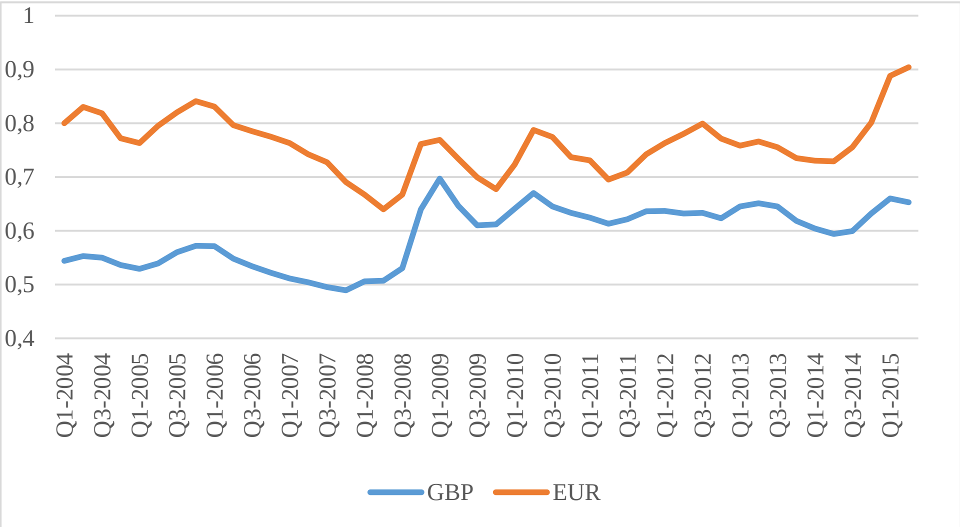
When looking at exchange rates development, which would have had time to become more stable after introducing the Eurozone (according to Begg et al. (2003)), pound sterling had been relatively stable in relation with euro before crisis. Nevertheless, this has changed significantly after 2008. Seen from the perspective of comparing GDP and EUR exchange rates with USD, exchange rates development after 2004 has shown a certain degree of mutual convergence, even at the times of the crisis.

3.2 Flexibility

The second test went further into aspects of possible crisis and Eurozone´s potential to deal with it effectively in order to solve all possible problems of different members. Concerning above described aspects of OCA theory, this test covers price and wage flexibility and mobility of factors of production (above all labour) and fiscal integration[6]. Price and wage flexibility is vital when adjusting to outside economic shocks in the environment of monetary union, as well as is mobility of labour force (Mongelli 2008: 2).

The test aimed at both analysis of the UK´s preparedness to join the Eurozone as well as the state of flexibility within the Eurozone. Also potential for fiscal flexibility had been examined. However, the second test report concluded that flexibility of the UK economy is

Graph 2: Exchange rates GDP/USD and EUR/USD, 2004 - 2015.



Resource: Data retrieved from OECD Stats.

rising, especially compared to the Eurozone, the final conclusion stated that the level of convergence achieved in 2003 was not enough to be prepared to join (HM Treasury 2003b).

3.3 Investments

This test aimed at important source of British economic growth – inward investments. This test had been proven to be met, however with precondition of achieving higher level of economic convergence before entering EMU (HM Treasury 2003c).

[6] This OCA theory condition (based on Kenen) is rather focused on already existing monetary union.

3.4 Financial services

The fourth test had been specifically British due to the special position of financial services in the UK. British financial sector represents the highest contribution of financial sector to country´s GDP among the EU member states. Moreover, the UK is the largest net exporter of financial services and insurance in the world and British trade surplus of financial services is more than double than any other country (Gov.uk 2014: 35). However, this test went through Brown´s assessment as positive, later on is the finance sector becoming rather divisive point in the debates about possible British exit from the whole EU. This arises from strong tensions between the City of London as a successful financial centre of the EU, as well as the main trading centre of Euro-denominated financial assets, and the reality of UK´s position outside the Eurozone. According to Liddle (2014: 212), the success of the City is a success of specialization within the single financial market of the EU, where financial integration proceeded as a result of EU liberalisation. Another aspect of this tensions are British concerns of becoming periphery of the Eurozone, leading into marginalisation of The City.

3.5 Growth, stability and employment

This test focused on a question, whether the Eurozone membership would boost growth, stability and increase of employment. This test had to be fulfilled under condition of fulfilling the first two tests of convergence and flexibility (Baldwin, Wyplosz 2013: 435). Supposed that the UK would enter, the last condition of the OCA theory should be also fulfilled – and thus political integration. As Mongelli (2008: 3) suggests, the political will to integrate is regarded by some as among the most important condition for integrating in a monetary union. “Political will fosters compliance with joint commitments, sustains cooperation on various economic policies, and encourages more institutional linkages”. However positive could be an analysis of economic benefits of joining, political intentions have always capacity to change the state of art very quickly.

Conclusion

This contribution assessed the so called five economic tests of Gordon Brown from 2003 from the perspective of the Optimal Currency Area theory. Assessment of OCA theory aspects has been contextualised with reports on the tests. This paper outlined theoretical aspects analysed in 2003 and thus opened possibilities for further research, especially concerning the convergence test.

Understandably from the point of view of the then Chancellor of the Exchequer, the tests aimed more on defining possible economical threats from joining the Eurozone than emphasising benefits. A questionable aspect has been political criteria, which had not been included, however, it seems that finally just the political criteria decided in the end not to join. The three tests with negative conclusion all ended up with future prospects to change in more positive way in favour of joining – with precondition of further assessment in 2004. Nevertheless, this reassessment did not happen in 2004. The year 2004 had been critical for European integration – the "big bang" enlargement by 10 new members on one hand, but on the other problems with future course of the EU as well as problems of the core Eurozone members, France and Germany, with fulfilling Stability and Growth Pact. In 2004 also was the British public opinion interested much more in ongoing war in Iraq than joining the Eurozone and the political scene lacked interest and discussion about this issue.

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Resources

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