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This pamphlet is dedicated to Roy Jenkins (1920 - 2003)

a great European statesman

How to join the euro

Giles Radice

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Publications

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Foreword

2003 is a critical year for the UK economy. By June of this year the Treasury will have assessed the five economic tests and, if Government and then Parliament agree to recommend EMU entry the, autumn is likely to see a referendum campaign.

This will give the British people the opportunity to take a momentous decision. It is crucial that the issues about the implications for joining the euro and not joining the euro are debated widely, fully and vigorously. The outcome will have a profound effect on the economy, on business and, of course, the people of Britain. At KPMG we have tried to further the economic debate – since our economic success depends upon the future well-being, not just of individual people and business, but the strength of our public services.

Giles Radice brings all his vast experience and expertise to bear on the practical considerations of how we might join the euro. As a business participant in this debate I am struck by a stark sentence in his analysis: *"It is vital that we do not underestimate the costs of a delay."* We have already seen a decline in the UK share of foreign investment into Europe since the launch of the euro, as well as increasing trade within the euro-zone from which the UK is excluded. In addition, I worry about the position of the City of London- the crown jewel of our economy - if the UK is to stay out of the euro or again put off the decision whether to join.

I hope that this learned pamphlet will be widely read, not least by those who say that they want to know more about the arguments and mechanics of the single currency in order to make an informed judgement.

Mike Rake, International Chairman, KPMG

1 Introduction

2003 is the crucial year in which the UK will either decide to join the euro or remain out, at least for the time being. A decision either way will have major consequences for this country.

The reason why 2003 is the key year for Britain and the euro is because the government has said that its judgement of whether there is a strong economic case for entry has to take place by June at the latest. The basis for the government's decision will be the Treasury's assessment of five economic tests, as set out in the Chancellor's statement of October 1997. If the tests are deemed to have been met, then the government has decided that it will not only recommend joining the euro but will also put its decision to both parliament and to a referendum of the British people.

The purpose of this pamphlet is to examine in detail the hurdles facing British entry. It will not only consider the government's five tests and the way in which these should be decided. There are also other important questions that the government needs to address if it is serious about entry. These include satisfying the criteria set out in the Maastricht Treaty governing entry to EMU; the issues associated with the European Stability and Growth Pact; how to deal with the difficult question of the UK exchange rate; what is involved in the UK joining the European Central Bank and the euro group of European finance ministers; the timetable and costs of entry, including the adoption of notes and coins; and the legislation that will be required if the UK is to become a member of the euro.

The underlying argument of the following pages is that the government will need to draw up a strategy for dealing with all these matters as soon as possible. This will help to clear its mind about the way to

decide whether it should join the euro, assist it during the referendum if one is called and make joining easier once the decision is made. Without such a strategy, there is a danger that the decision about entry could be taken without sufficient forethought or botched all together.

This pamphlet is written from the standpoint of someone who is in favour of the UK joining the Economic and Monetary Union (EMU). It is only realistic to recognise that the euro has got off to a good start. Indeed it could be argued the creation of the euro has been one of the biggest economic and political achievements in post-war European history.

For the first time, twelve independent and democratic European nations, representing over three hundred million people, have freely come together to adopt a common currency. As the Bank of England has concluded, the whole complex exercise from the locking together of individual currencies and the introduction of the euro as a unit of account in January 1999 to the launch of euro notes and coins in January 2002, has been conducted with exemplary efficiency. Prior to that, immense efforts were made by member states, particularly the Mediterranean ones, to ensure that their economies were able to meet the Maastricht monetary and fiscal criteria and thus qualify to join Economic and Monetary Union from the start. Now, continental Europeans, from Helsinki in the north to Heraklion in the south, from Leipzig in the east to Limerick in the west, are able to buy and sell, save, spend and invest in the same currency and in the same market, all to their considerable benefit.

At the launch of the euro the UK was a bystander, as the Government had announced in October 1997 that it would not be part of the first wave of EMU membership. However, although Gordon Brown said in the Commons that the UK was not ready to join, he also declared that the government did not believe that there was an over-riding constitutional bar to membership and, proclaiming their support for entry in

principle, said that, "If, in the end, a single currency is successful and the economic case is clear and unambiguous then the government believes Britain should be part of it."

This is not the first time that the UK has initially decided against participating in a major European project. On three previous occasions since World War Two - over the Schuman Plan in 1950, over the Common Market in 1955-57, and over the European Exchange Rate Mechanism (ERM) in the late 1970s and early 1980s - Britain has missed crucial opportunities in Europe. And when they have eventually joined, they have complained, as in the case of the ERM, that they have joined at the wrong time or that the rules have been set against them. This has been particularly damaging to the UK in the sphere of agriculture. The basic rules of the Common Agricultural Policy (CAP), which from the start favoured the less efficient agricultural industries, were well established when the UK joined and have, overall, worked to its disadvantage. In his resignation speech to the House of Commons in November 1990, Geoffrey Howe warned against 'missing the boat' on EMU. "We have paid heavily in the past for the late starts and squandered opportunities in Europe. We dare not let that happen again".

In this context, it is instructive to consider the record of the Treasury. In a recent speech Ed Balls, the Chancellor's Economic Adviser, put the five tests into a historical perspective by convincingly analysing four occasions - the 1925 return to the gold standard, the post-war re-entry to a fixed exchange rate system with the dollar in 1946, the failure to devalue in 1964 and the ERM debacle of the early 1990s - when policymakers failed to pay sufficient attention to economics in making key decisions.

But there is another lesson that could be derived from the Treasury's past - that of excessive caution. In 1950, the Treasury advised strongly against British participation in the Schuman Plan, which Edmund Dell called the "abdication of British leadership in Europe". In the mid-

1950s, the Treasury were - at best - ambivalent about British entry into the Common Market. Even in the early 1970s, when the UK (led by Heath) decided to join the EC, the Treasury dissented. Characteristically, the Treasury advised against the UK joining the ERM when it was first set up and when we could have benefited most from entry. So there is a warning to the Treasury from the past about the costs of delay.

With regard to the euro, the Chancellor has himself acknowledged the benefits of a single currency in terms of ease of transaction, of price transparency across Europe, of the promotion and expansion of trade, and perhaps most important of all, of the economic and monetary stability which comes from the delivery of exchange rate certainty with our main trading partners. It is this stability, which by increasing investment, productivity and economic growth, would help us to improve living standards and assist us in bringing our public services, such as health, education and transport, close to continental standards. It should not be forgotten that, despite the better performance of the UK economy in recent years (in terms of per capita GDP), the UK is still low down in the EU league table, and our productivity remains well behind that of the other two biggest economies, France and Germany. By joining the euro we would become full members of the huge European single market, which takes half our trade, compared with only 16% with the United States. It could also help us achieve the economics of scale and competitiveness that a single currency has made possible in the United States.

The costs of staying out are increasingly apparent. Following the launch of the euro, companies within the eurozone are benefiting from the internal exchange stability while, by contrast, companies in Britain suffer from the continuing risk of exchange rate instability. Already the consequences of this comparative disadvantage are becoming clear. Since 1998, trade in goods between eurozone members has increased markedly, while Britain's trade with the EU has fallen relative to GDP.

Over the same period, the UK's share of foreign direct investment coming into Europe, which has played a key role in helping to modernise our industry, has fallen, while France and Germany have significantly increased their shares.

It is also worth stressing the political cost of staying out. The Prime Minister, Tony Blair, has rightly stressed the need for the United Kingdom to play a leading role in Europe, which is all the more important when the direction and nature of the European Union is under debate. In the medium term, it is difficult to see how the UK's position can be sustained if this country remains outside the euro. In December 2002 the Portuguese Prime Minister warned the UK: "You cannot be in the centre if in the most important enterprise - the euro - you are not there." Outside the euro, Britain's ability to influence the future shape and governance of the enlarged EU will remain seriously limited.

For all these reasons, it is essential that the government draws up an effective strategy for entry which would then enable us to make up for a late start and to take advantage of the opportunities which joining the euro would open up for the UK.

2 The Maastricht criteria

As a way of helping ensure that the economics of the countries joining the euro are sufficiently convergent, the Maastricht Treaty lays down strict economic criteria for entry. These involve a high degree of price stability, sufficient convergence of long-term interest rates, sustainability of the government's fiscal position, exchange rate stability and the independence of the central bank. The achievement of these objectives is both good for individual economies and also essential for the success of the euro. Before joining the euro, the UK would have to satisfy the relevant authorities (namely the European Central Bank, the European Commission and the Council of Ministers) that its economy had met the Maastricht criteria.

This is not a mere formality. Despite unfavourable economic conditions in some of the founding member countries during the 1990s, by a notable feat of political will that was reflected in improved fiscal and monetary management, eleven member states managed to qualify for economic and monetary union. For example, Italy succeeded in reducing its budget deficit from more than 10% of GDP in 1991 to under 3% in 1997, and both Spain and Portugal achieved the necessary transformations in their economy to enable them to qualify for initial membership. Although both Italy and Belgium had debt ratios significantly more than 60% of GDP (the so-called 'reference value' laid down in the Maastricht Treaty), those rates were declining and were therefore deemed to be on the way to meet the debt criteria because they were "approaching the reference value at a satisfactory pace."

There are also other possible candidates for membership, in addition to the UK. These include not only Sweden and Denmark (Greece joined at the beginning of 2001) but also the countries from central and eastern Europe, eight of whom will join the EU in 2004 and several of

whom are already very close to meeting the reference criteria. If the euro is to be successful, the European authorities will need to ensure that the Maastricht criteria for candidate countries are properly enforced.

The UK should have no difficulty in satisfying the criteria on inflation, sustainability of the fiscal position and convergence of the long-term interest rates. On the Harmonised Index of Consumer Prices (HICP) measure, targeted by the European Central Bank and designed to enable cross-country comparisons, UK inflation is currently one of the lowest in the EU, having been the lowest for most of the past two and a half years (Pre-Budget Report November 2002). The sustainability of the government's financial position is measured by reference to whether the planned or actual general government deficit is less than 3 per cent of GDP at market prices, and whether the ratio of government debt to GDP is lower than 60%. In both cases the UK meets the fiscal criteria. Although the government is forecasting an increased deficit for 2002-2003 and 2003-2004, this remains below 3% (on the government's forecast), while the general government debt ratio is projected to remain below 40%, one of the lowest in the EU.

UK short-term interest rates remain higher than those of the eurozone (4% as compared to 2.75%). However the Maastricht interest rate test is concerned with long-term interest rates which must not be more than 2 percentage points higher than the average in, at most, the three best performing member states. British long-term (10-year) bond yields have steadily declined and are now in line with those in the euro area.

Membership of EMU requires that the statutes of a country's central bank are compatible with the Maastricht Treaty and with the statutes of the European System of Central Banks. On 20th May 1997, Gordon Brown announced that the Bank of England would be given operational responsibility for setting interest rates; however the Chancellor would still set the inflation target and retain the right to override the Bank in exceptional circumstances.

BOX A The Maastricht Criteria

Candidates must satisfy the convergence criteria for membership of EMU set out in the Treaty of Maastricht. The Maastricht Treaty lays down five main criteria:

High degree of price stability: An average rate of inflation which does not exceed by more than 1.5% that of, at most, the three EU countries with the most stable prices.

Convergence of long-term interest rates: An average long-term government bond yield, no more than 2% above the average of the relevant interest rates in, at most, the three EU member states with the most stable prices.

Sustainability of government's fiscal position: Annual government budget deficit equal to no more than 3% of GDP and government debt equivalent to maximum of 60% of GDP, unless the ratio is close to the reference value and either has already declined substantially or exceeds the reference value only temporarily.

Exchange rate stability: Participation, without severe strains, in the exchange rate mechanism and observance of the normal fluctuation margin for at least the last two years, without unilateral devaluation of the central rate.

Independence of central bank

As the rules stand at present, to qualify for entry, both the Chancellor's right to set the inflation target and the Treasury's reserve power would have to go, as the Maastricht Treaty makes it clear that neither the ECB nor a national bank can take instructions from a government of a member state.

The criterion which is likely to prove most difficult for the UK is that which says that a candidate country has to participate in the Exchange Rate Mechanism (ERM) for at least two years. The ERM is now very different from the original ERM system; from being a tight arrangement with margin only 2.25% each side of the central rate, it is now much more flexible, allowing wide 15% margins. There is another big difference between the ERM pre-1999 and the ERM post-1999. The former was a grid of bilateral exchange rates between the participants; the latter is for the rates of participating 'outs' and the euro, which increases the flexibility.

However, of the three member states that do not belong to the euro-zone, only Denmark is currently a member of the ERM. Both the UK and Sweden have stayed out (though a referendum on entry is planned in Sweden for September 2003). The Treasury, chary after the ERM debacle of 1992, of accepting any restraints on fluctuations of the exchange rate against other currencies, has stated that the best way to achieve economic stability is "through the monetary and fiscal framework which we have set in place." It may well be that, in the UK's case, our partners would be prepared to accept that the exchange rate requirement would be met provided that the UK could demonstrate a period of relative exchange rate stability before it joins. It certainly seems very unlikely that if the UK declared its wish to join the euro, after a successful referendum, and met all the other criteria, failure to participate in the ERM would constitute an unsurmountable obstacle to entry, especially as both Italy and Finland had not been members of the ERM for the full 2 years at the time of their favourable assessment in the spring of 1998.

3 Stability and Growth Pact

In 1997, EU members agreed to a Stability and Growth Pact (SGP) in order to buttress the fiscal and budgetary provisions of the Maastricht Treaty. The Pact underlines the Maastricht requirement for euro members states to achieve and maintain a medium term objective of a budgetary position of 'close to balance or in surplus'. This is designed to allow flexibility in a cyclical downturn without breaching the 3% deficit level. Participating member states are expected to maintain a deficit of less than 3% of GDP in all but "exceptional circumstances". "Exceptional circumstances" is defined as a fall in real GDP of 2% or more in a year: a fall of less than 0.75% is not considered exceptional.

If a country runs a deficit above 3 per cent, the Commission is required to prepare a report, on the basis of which the Council may declare the deficit excessive. A country that is held to have an excessive deficit is required to take steps to reduce it promptly, on pain of sanctions, which, in theory, may include fines if there were a qualified majority in favour. 'Out' countries are also subject to the SGP but they only have to "endeavour" to keep their deficits below 3% and are not subject to fines if they fail to do so.

In recent months, however, the Pact has been under some strain. The biggest member, Germany, is running a public sector deficit above 3% of GDP. The next two largest members, France and Italy, are only just below the 3% limit and the Commission has already proposed that an "early warning" be sent to France. Romano Prodi, President of the Commission, also helped undermine the Pact's credibility, by calling it "stupid" for its focus on budget deficit limits, regardless of the countries' position in the business cycle. On 27th November 2002, the Commission suggested ways in which the Pact could be modified to make it more suitable for dealing with the circumstances of an economic downturn. The two most

important proposals are that the “close to balance or in surplus” requirement should be judged over the economic cycle and that countries with low debt ratios and with sustainable public finances should be allowed to run modest deficits in order to finance investment in public services and infrastructure projects. These proposals have been generally welcomed though, according to the Commission proposals, countries with excessive budget deficits would be required to cut their underlying deficits by 0.5% of GDP a year which would prove difficult to enforce.

Significantly, in the Pre-Budget Report, the government has gone out of its way to back the principle of a strong Pact. This is what the government said: "The government supports a prudent interpretation of the Stability and Growth Pact which takes into account... the *economic cycle* - allowing automatic stabilisers to operate fully and symmetrically over the cycle will ensure that fiscal policy supports monetary policy in smoothing economic fluctuations... *sustainability* - low debt levels enhance the sustainability of the public finances... *public investment* - against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall public productive potential of the economy."

The Commission's new proposals by implication embrace both the UK Chancellor's 'golden rule' (that, over the economic cycle, the government will borrow only to invest and not to fund current spending) and his 'sustainable investment rule' (that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level). Given that the Commission's new proposals might have been written by the Treasury, it is essential that the UK plays a positive role in ensuring that a reformed Stability and Growth Pact is in line with British interests.

4 The Chancellor's five tests

In his statement to the House of Commons in October 1997, the Chancellor set out five tests by which the decision whether or not to join the euro would be judged. These tests are in addition to the Maastricht criteria and have been devised to ensure that entry is in the British economic interest. In its September 2002 paper to the Treasury Select Committee, the Treasury drew a distinction between the different time scales of the two sets of conditions: "While the Maastricht criteria can judge convergence in the short term, the five tests go to the heart of what is required for the long-term future of the UK economy they are the means of judging the decision on EMU membership against the government's central objectives - full employment and high and sustainable rates of investment and growth."

In his October 1997 statement, Gordon Brown stressed the importance of the first test on convergence: "Can we be confident", he asked, "that the United Kingdom business cycle has converged with that of other European economies, so that the British economy can have stability and prosperity within a common European monetary policy?". He went on: "That convergence must be capable of being sustained and likely to be sustained. In other words, we must demonstrate a settled period of convergence."

In 1997, Britain's economic cycle was out of line with our European partners. Interest rates in the UK were 7%, while in France and Germany they were close to 3%. The output gap in the UK was -0.4 per cent, while the euro area had an output gap of -0.9. However, by 2002 the British economy and that of the eurozone had converged much closer (see Chart A). Inflation rates are now very similar, with the UK marginally below the euro area average. Mainly driven by consumption, the UK growth rate is somewhat faster than that of the eurozone

but both economies are at similar points in the economic cycle. Both have nearly identical long-term interest rates. Whilst short-term interest rates remain higher in the UK than in the eurozone, they are much closer together than they were in 1997.

The question for the Treasury is whether this growing convergence is sustainable. In order to answer this vital question, the Treasury has commissioned detailed work on the output gap, inflation, interest rates and the real exchange rate. It will also assess the behaviour of the UK housing market which has been prone to exaggerated price cycles and has been one of the reasons why British short-term interest rates remain higher than they would otherwise have been. Some leading economists have, however, already been convinced that convergence has been substantially achieved. They also argue that joining the euro would itself provide a guarantee of sustained convergence. In the words of the National Institute Economic Review, "EMU would give more stable interest rates and inflation rates than one would see outside" (Barrell, *National Institute Review*, April 2002).

The second test, which is closely linked to the first, is concerned with the degree of flexibility in the UK and, by implication, in the euro area economies and with the economies can adjust quickly to economic shocks and changes. Here again, the Treasury has commissioned detailed papers on the role of labour markets, adjustment mechanisms and fiscal policy. However, all the indications are that the UK economy has become much more flexible in recent years and should be able to absorb any likely shocks, such as oil price changes or falls in export prices, without prolonged unemployment. There is no reason to believe that the UK is likely to be affected disproportionately by extreme economic shocks, in comparison with other members of the eurozone.

BOX B The Chancellor's five tests

The five tests as set out in the Chancellor's statement to the Commons of 27 October 1997 are:

- 1) Whether there can be sustainable convergence between Britain and the euro area
- 2) Whether there is sufficient flexibility to cope with economic change
- 3) The effect on investment
- 4) The impact on our financial services industry
- 5) Whether it is good for employment

The five tests were set out in full in the Treasury assessment accompanying the statement made by the Chancellor. 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?
- 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?

The continental economies, some of which are just as “open” as that of the UK, are also becoming more flexible. There has been much criticism of the “sclerotic” nature of the German economy, mostly by British eurosceptics. Yet this so-called “basket case” has a far superior productivity and export record to that of the UK, as well as an impressive industrial sector and infrastructure. Germany’s GDP per person is still 6% higher than Britain’s, its public services are for the most part superior, and German workers are nearly 30% more productive than their British counterparts. If there is a weakness in the overall German performance, it lies in the slowness of the political establishment to introduce much needed structural reforms, though these are, in my view, likely to be implemented more quickly in the near future.

Not surprisingly, given long term under-investment in the UK and lower productivity than France or Germany, the Treasury stresses the importance of investment in capital as a key driver of productivity, growth and overall economic performance. The issues surrounding the investment test are whether EMU will provide better conditions for investment and how EMU is affecting the foreign direct investment (FDI) flow into the UK. FDI in the UK has already been hit by the British decision to remain outside the euro. For example, in 1998, Germany received 9.4% FDI into the EU, and Britain 28.3%. In 2002, Germany is set to attract 18.1%, and Britain only 5.1%. A similar pattern is also emerging with France. If the euro area provides a more stable environment for British business, then, in the medium term, membership of the euro would raise investment, capital and the productivity of labour. Equally, we could see a serious shift of investment and capital out of Britain by those international companies who have invested here on the assumption that in due course the UK will join the euro.

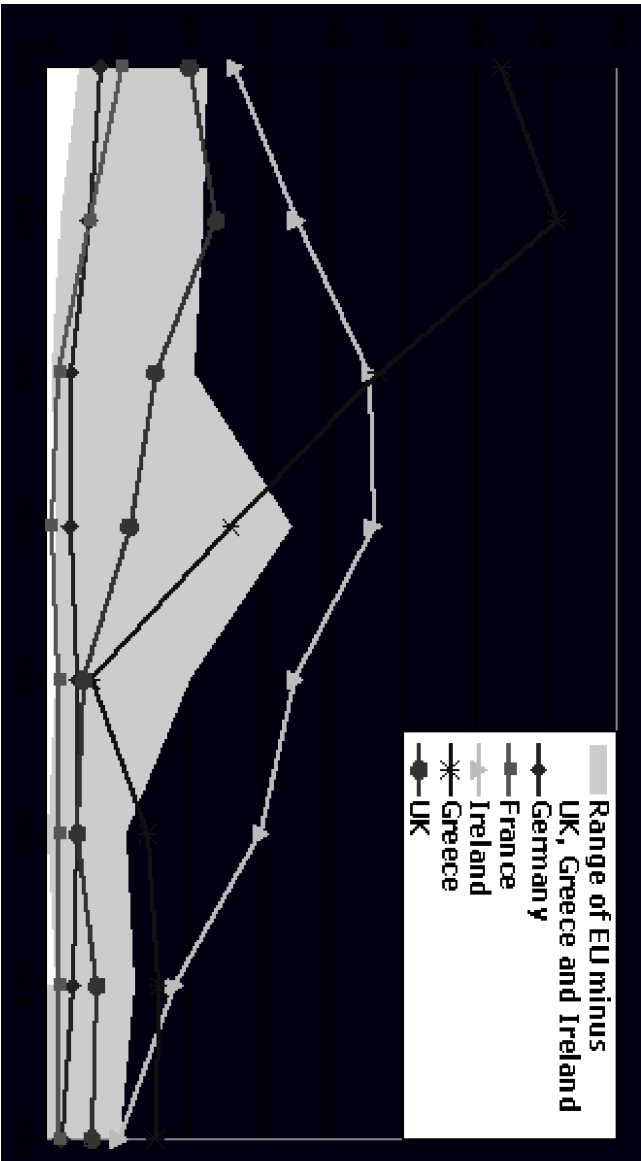
As to the fourth test, the impact of EMU on financial services, the City,

CHART A

Divergence Index Chart

The main indicators of structural and cyclical divergence between the UK and the euro-zone are applied to each EU member versus the aggregate for the euro-zone. The degree of divergence in the UK in 1997 is set at 100. Perfect convergence would equate to the absence of divergence so the index would be zero. The index looks at events since 1997 and forecasts to 2003 and monitors divergence of inflation, output gaps, interest rates and trade orientation.

(Source: www.bankofengland.com)



thanks to comparative advantage and to careful preparation for the launch of the euro, is already acting as the de facto financial centre of the eurozone, even though the UK is not a member. But, as the Treasury concluded in October 1997, "the benefits and the opportunities from the single currency will probably be easier to tap from within the eurozone."

The advent of the euro has had a dramatic effect on the European capital markets. There has been a huge expansion of the corporate bond market, and already substantial progress in terms of consolidation in the banking and financial sector. While the City of London remains the pre-eminent European financial centre, and is able to secure a healthy proportion of the new business, there are signs that its relative position in relation to Frankfurt and Paris is deteriorating, and is likely to weaken further if Britain remains outside the euro.

The fifth test, that of employment, is designed to provide a general assessment of whether EMU will "promote higher growth stability and a lasting increase in jobs." Greater stability and price transparency across Europe should have a significant effect on competition amongst producers and on long-term investment and should raise output, incomes and employment.

The Chancellor has repeatedly stressed the seriousness and irrevocability of the decision on British membership of the single currency. He has rightly set in train a comprehensive and rigorous analysis of the long-term economic case for entry. The Financial Times commentator Martin Wolf wrote, "Never can the British government have made a comparably detailed analysis of any policy decision" (5th November 2002). Some economists have criticised the Chancellor's insistence on the need for a "clear and unambiguous" economic case for entry, on the grounds that nothing in economics or in life is ever "clear and unambiguous". Sir Edward George, Governor of the Bank of England, has explained that the phrase is "a term of art" and is a way of underlining

the thoroughness of the Treasury's assessment. In this context, it should be noted that "clear and unambiguous" refers not so much to the five tests but to the economic case that would be established once the Chancellor's five tests are met.

It is important that the five tests are met but it is also essential, in the making of such an important long-term decision about the British economy, to distinguish the wood from the trees. We must not ignore broader economic questions such as the opportunities that entry would bring with it and the costs of exclusion. Above all it is vital that we do not underestimate the disadvantages of delay. Staying out is not a cost free option. In a world of currency areas, medium sized currencies are likely to experience considerable volatility that will adversely affect their trade and investment. Furthermore, while we stay out, powerful new commercial groups and new trade patterns are emerging on the continent from which we may be excluded. The Chancellor is absolutely right to stress the need to get the economics right. By the same token, he must avoid the mistakes of his predecessors that led to us opting out of the European projects in the 1950s, 1960s and 1970s and then subsequently joining too late.

4 The exchange rate - the sixth test

Going in at a sustainable exchange rate is one of the key short-term issues of entry. Indeed so important is the exchange rate question that it has been called the sixth test. In theory, all rates are sustainable in the long run because relative prices adjust. However there may be costs on the way to equilibrium. If we join and the entry rate is too high, then inflation will be low and growth will be held back for the first few years of membership. If the entry rate is too low, then output will increase but inflation will also rise significantly.

The level at which sterling is locked against the euro is formally for decision by the Council of Ministers. Obviously the market exchange rate is an important indicator but Wim Duisenberg, the President of the European Central Bank, himself said in June 2000 that sterling was overvalued against the euro; he thus implicitly acknowledged that the exchange rate would be an issue for negotiation between the UK and the existing euro members.

Within the UK government's monetary and fiscal framework, the exchange rate is no longer seen as an instrument of policy but rather as the outcome of the interaction of fiscal policy, monetary policy, and the external environment. This policy of benign neglect has been bitterly criticised by British industry which has understandably complained that the high value of the pound, which rose by 25% between 1996 and early 2000, was undermining their competitiveness and leading to loss of jobs. This suggests that the rate at which sterling is locked against the euro ought to be a matter of serious concern for the government, given the probability that, despite the recent strengthening of the euro against the pound, sterling remains overvalued and that the transitional costs of entry at too high a rate that would perpetuate the costs of over-valuation. The policy of allowing the pound to float outside the

euro area has resulted in substantial over-valuation which has contributed to the decline of manufacturing and led to a record trade deficit. Joining the euro at a sensible rate could provide an answer.

It is difficult to be certain what a sustainable exchange rate for entry would be. A recent Engineering Employers Federation survey (October 2000) revealed that almost half of the companies surveyed said that they could live with a rate of 1.54 euros to the pound (close to the rate at the beginning of January 2003). However other estimates, including those based on purchasing power parity, conclude that a depreciation of 10% (or about 1.40 euros to the pound) would be the minimum needed to bring the UK trade deficit (which according to the Pre-Budget report is forecast to widen to over 2% of GDP next year) back into equilibrium.

This suggests that the government needs to take steps to bring about an exchange rate level with which industry might feel more comfortable and which might bring the British economy into better balance. In the past, government intervention in currency markets has usually been ineffective. However, it may well be that immediately following a favourable assessment of the five tests, a firm government statement of its intention to join, combined with a statement from the Chancellor that he considers that sterling is overvalued, might itself influence the market which is already moving in a downwards direction, thus strengthening the British hand in negotiations with our euro partners over a sustainable entry rate. It should be noted that the period between a referendum and the locking of currencies could last for a year or more thus allowing ample time for the market to reach a sensible judgement. The Swedish government have announced that if the country votes for entry in their referendum it will lock currencies at the same time it introduces notes and coins, two and a half years later.

5 Joining the European Central Bank

In EMU, monetary policy is the responsibility of the independent European System which consists of the European Central Bank (ECB) and the twelve independent national central banks. The ECB is responsible for setting interest rates and, if necessary, foreign exchange intervention. Its principal objective is to maintain price stability (under Article 105 of the Treaty) but it is also committed to support overall economic policies in the EU, including sustaining output. The ECB has identified its monetary strategy as resting on two pillars. The first is a reference value for broad money supply growth, inherited from the Bundesbank, which has been set at 4.5 % a year since the start of EMU. The second is a form of inflation targeting which involves keeping consumer price growth below 2% a year with an implicit range of between 0%-2%.

In terms of accountability, the ECB presents annual reports to the European Parliament, the European Council and the Commission. The President of the ECB appears four times a year before the Committee on Economic and Monetary Affairs of the European Parliament. Although the ECB does not publish the minutes of its Governing Council, it currently holds press conferences immediately after the first Governing Council of the month and publishes a monthly bulletin in which it explains its decisions.

Critics of the ECB accuse it both of lacking authority and being excessively deflationary. Yet a recent assessment of the ECB's first three years in action concluded that "the worst fears of the single currency's opponents have not materialised....if anything, the ECB's policy has stimulated economic growth. Nor has the euro's weakness generated a significant rise in inflationary pressure. Against this background, the ECB's monetary policy appears as effective as, if not more so than, the

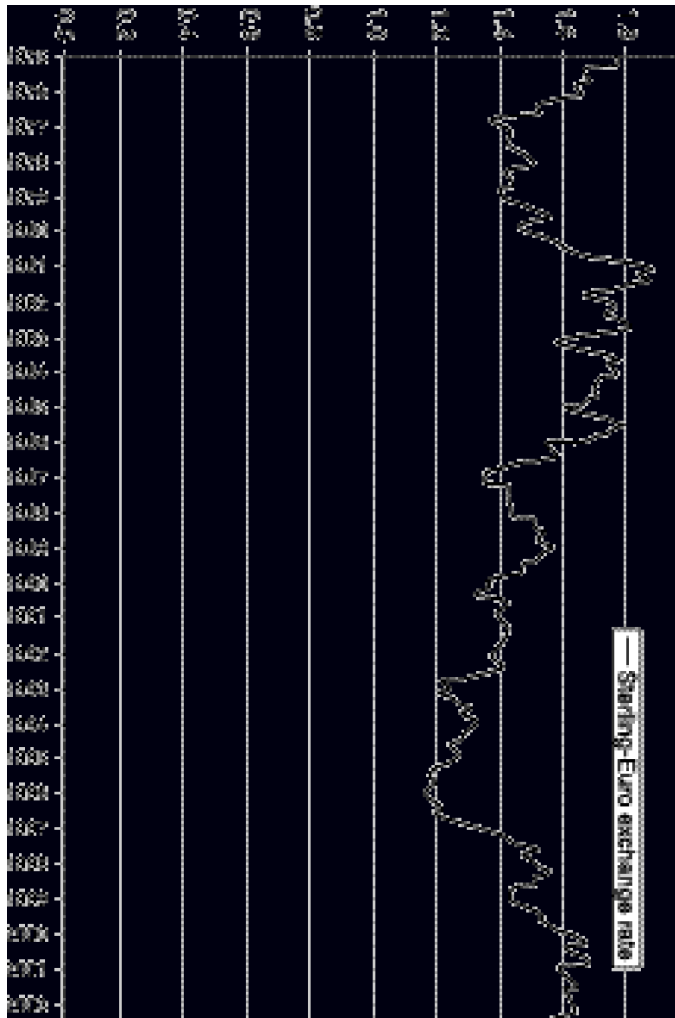


CHART B Sterling - euro exchange rate chart

Pre-1999 euro rates are calculated by averaging the exchange rates of all the constituent currencies, weighted by the size of their economies. (Source: The Bank of England)

monetary policies of the EU's national central banks that preceded it" (Jean-Paul Fitoussi and Jerome Creel *How to reform the European Central Bank*, Centre for European Reform).

There is, of course, a more fundamental critique of the ECB's mission which argues that under its "one interest rate policy fits all" requirement, countries with low inflation, such as Germany, can suffer from relatively high interest rates, whereas countries such as Spain where prices are rising faster could have low real interest rates. But this is both to exaggerate the existing differences between countries (which the Maastricht criteria were designed to minimise) and to underestimate changes stimulated by EMU which should promote greater convergence in the future. It would also be wrong to expect short-term differences in interest rates to compensate for deeper-seated structural problems, as is implied by some critics. The latest down turn in the German economy will be mitigated by the ECB's half per cent in interest rates in December 2002. But it cannot take the place of the structural reforms inside Germany, which both the OECD and the German government believes are needed to invigorate confidence and strengthen growth.

If the UK decides to join the euro, British interest rates will no longer be set by the Bank of England but by the ECB Governing Council (on which the Bank of England governor will sit). The ECB takes account of conditions across the whole euro area, including the UK, which would be one of the euro area's three biggest economies. And, though there are differences in the way the Bank of England and the ECB operate (which are discussed below), we will in effect be moving from one rule governed, independently based system to another, with broadly similar objectives.

The ECB has embarked on a process of reform which could bring it closer to the British regime. In his press conference on 5th December, President Duisenberg announced that the ECB will conduct a thorough

review of its monetary strategy during the first half of 2003. This will give it the opportunity of considering whether it is still worth retaining a special status for broad money supply growth, when it seems increasingly irrelevant, and whether it would be better, as in the case of the UK, to have a specific inflation target. If it were centred on, rather than aiming below 2%, it would be almost identical to the UK's target. Inflation in the euro area has averaged exactly 2% since the start of EMU, so such a change would arguably represent nothing more than a validation of the ECB's actual practice. It might also be possible to attach a summary of the governing body's minutes to the ECB monthly report. However, for the time being, the ECB would be wise to stick to its decision not to publish voting records. The governing body is a collective group acting for the euro area as a whole, not a collection of representatives from nation states.

In response to the 2004 enlargement of the EU as laid down in the Nice Treaty, the ECB has proposed a plan to cap its voting members at 21 (up from 18 at present) in order to prevent the Governing Council's decision-making becoming unwieldy. The six members of the Executive Board will retain permanent voting rights on the Council. However, when their number exceeds 15, the National Central Bank governors will exercise their voting rights on a rotation system, with the rotation frequency determined by the relative size of the country. Once there are 22 euro area members, there will be three groups of National Central Bank governors: one comprising the largest countries, a second group comprising one half of the total number of countries, and a third group comprising the remainder. Although the ECB plan is an imaginative attempt to combine fair representation with effectiveness, it would be unrealistic if permanent voting rights were not reserved for National Bank governors from the largest economies like France, Germany, Italy and, if we join, the UK. The ECB's proposals have to be agreed by the European Council, which will provide an opportunity for amendment by the member states, including the UK.

In this discussion of monetary policy, it would be wrong not to mention the two EU bodies for economic policy co-ordination, Ecofin (the European Council of Finance Ministers) and the informal euro group which comprises twelve members of the eurozone. The UK is represented on the former, but, of course, not on the latter.

Since the start of EMU, the euro group has grown in influence, increasingly becoming the motor force in the development of long-term macro-economic policy. The British Chancellor is not allowed to attend its proceedings which normally take place immediately before the monthly Ecofin meetings. He is thus excluded from a group which is likely to become, de facto, the most important in European economic policy making. Joining this group would, represent, a significant gain for the UK, while remaining outside, especially if Sweden and Denmark join the euro, would relegate the UK to the sidelines of economic policy.

BOX C

THE ECB

The ECB, or to be more precise the European System (i.e. the ECB and the national central banks) is governed by three bodies:

- 1) The Executive Board (EB) composed of six members (including the President) who reside in Frankfurt and are appointed by the European Council (i.e. the Heads of Government of the EU countries).
- 2) The Governing Council (GC) formed by the EB members plus the NCB governors of the countries in the monetary union.
- 3) The General Council formed by the President and Vice President of the ECB and the NCB governors of all EU member countries (including those outside the euro area).

The most important body is the Governing Council, which takes practically all the important decisions e.g. on monetary policy, foreign exchange intervention, personnel issues, and so forth. The Executive Board - whose members are appointed by the European Heads of State and Governments - is responsible for the normal functioning of the ECB, the implementation of the GC decisions, and takes care of documentation, analysis and coordination within the Eurosystem. The GC can delegate some of its powers to the EB. The General Council is not a decision making body, but mostly a talking shop with an advisory role and some limited functions, for example in the area of statistical information and standardising NCB's accounting rules.

The composition of the Governing Council is established by Article 10.1 of the Statute of the European System of Central Banks and of the European Central Bank: "the Governing Council shall comprise the members of the Executive Board of the ECB and the governors of the national central banks (participating in EMU)."

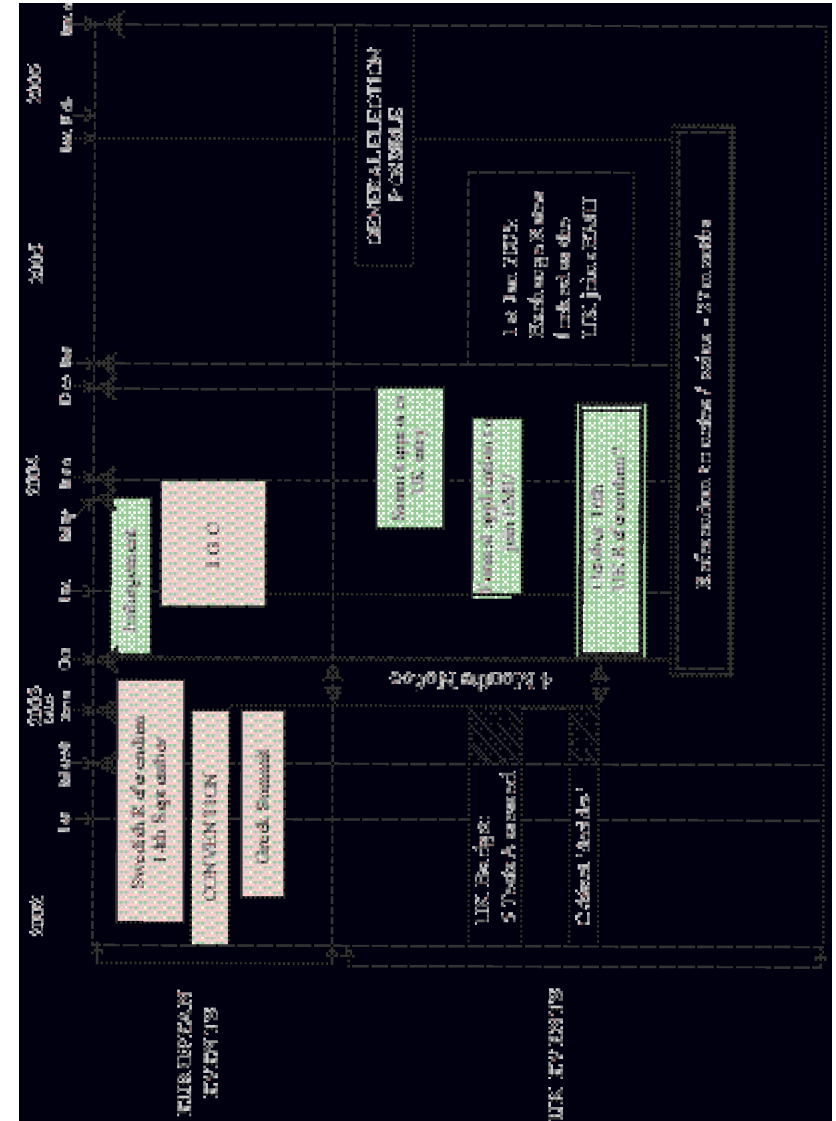
(Source: Goldman Sachs, European Weekly Analyst)

6 Preparations for and timing of the changeover to the euro

If the UK decides to join the euro in the near future, it will have two advantages. First, an outline framework has already been established, so that the UK can be ready for a smooth and cost-effective changeover. Second, we will be able to learn from the experience of the euro area changeover. In his October 1997 statement to the Commons, Gordon Brown announced that he was setting up a Standing Committee on euro preparations to help prepare the UK for entry "so that Britain will be in a position to join a single currency, should we wish to, early in the next Parliament." Since then, two outline "Changeover" plans have been published by HM Treasury, one in 1999 and the other in 2000.

The main task of the first outline plan was to set out a draft timetable for changeover. It concluded that for most sectors of the economy the key period was from the result of the referendum to the introduction of notes and coins and that, provided there was detailed planning, this phase could be completed from 24 to 30 months. The second outline plan confirmed the need for the 24 to 30 months period. However, taking account of the lower than expected use of the euro during the transition period (1999-2002) in the euro area, it suggested that most businesses and consumers would be unlikely to make their changeover to the euro until nearer the introduction of notes and coins. Encouragingly, it also set out how all government departments had produced outline plans, considering what services they would provide during a changeover, how they would convert their systems to the euro and identifying lead times and key planning activities. Legislation had already been passed to allow the revenue departments and the Department of Social Security to invest in preparations for their large

CHART C Countdown to the euro - provisional timetable



and complex IT systems by 2002. The public sector has already spent £30 million on preparations for the euro.

In July 2002, the Sixth Report on Euro Preparations was published by the Treasury, together with a report by UK private sector organisations, setting out lessons for the UK from the changeover in the euro area. These included the need for a clear National Changeover Plan, managed by the government but with full public/private sector co-operation; a phased or managed transition because of the later adoption of the euro by many businesses co-operation between businesses and the development of industry codes of practice; the vital role of banks and insurance companies in an effective changeover; dual pricing for consumers in the period before the introduction of notes and coins; a reduction in the period of dual pricing after the changeover from six to two months; and effective information campaigns.

In view of the fears expressed by small businesses (SMEs) in this country about the euro it is instructive to review the experience of SMEs in the euro changeover. Most did not change their systems until the introduction of euro cash. SMEs sought advice from their banks or accountants who usually provided seminars and training sessions. Issues raised included the time needed for preparation, currency conversion, software and IT structures. With the small business retail sector, the main questions involved dealing with the dual currency period, decimal pricing (where rounding rules could produce significant price increases and decreases), price labelling and book keeping. IT preparation was a big issue for smaller businesses who usually did not have an 'in-house' capability. The UK government may wish to consider allowing SMEs to write off part or whole of the cost of IT upgrading in the period between joining and the adoption of notes and coins.

Timing

The evidence of these reports suggest that, if there is a positive assessment of the five tests by June 2003 and if the referendum takes place in the autumn of 2003 - say in October - then it should be possible to introduce euro notes and coins officially in the UK in the first months of 2006. Important events on the road to the euro include the formal assessments by the EU Commission, the European Central Bank and crucially by the Council of Ministers of whether the UK meets the convergence criteria, and the locking of exchange rates between the pound and the euro. A possible timetable for the adoption of the euro is set out in the chart.

Legislation

Legislation will be required to prepare the UK for entry. First following a positive assessment of the five tests, a bill will be needed to pave the way for a referendum, dealing with the timing, the question to be asked and the details of the polling arrangements. Given the all party support for a referendum, the time needed for the referendum bill should not be protracted. In 1975, the legislation required for the referendum on UK membership of the European Community passed all its stages in five weeks.

If there is a 'yes' referendum and before formal notification of our application for entry, there will have to be an amendment bill to reverse the UK opt out clause negotiated at Maastricht. Here again, as the bill will be little more than a single clause and as the referendum result would have been positive, it should be speedily passed. Technical legislation will also be required to make the Bank of England fully independent, including removing the Chancellor's right to set an inflation target and the reserve power to override the Monetary Policy Committee, to transfer foreign exchange reserves to the ECB and to make provision for the reserves remaining under UK control and for the full UK capital contribution to the ECB.

Cost of changeover

As to the overall cost of the changeover by government, industry and financial services, the official Treasury position is that it is not possible to make an accurate prediction. This has not prevented some extravagant estimates by anti-euro campaigners reaching as high as £36 billion (4% of GDP). It is significant that the 'first wave' members have taken the changeover very much in their stride. A preliminary estimate for the original twelve made by Wim Duisenberg to the European Parliament in May 2001 was no more than 0.5% of GDP, while the Dutch Central Bank estimates that the total cost for the Netherlands will be 0.8% of GDP. The UK will have the great advantage of learning from the experience of existing euro members which should reduce costs. In any case, costs will often represent the bringing forward of existing investment commitments rather than a new category of spending. Above all, the investment in the changeover is a one-off cost, while the savings on transactions continue into the future.

Prices

The March 2002 Eurobarometer survey identified a widespread perception in the euro area that prices had gone up as a result of the changeover to notes and coins. 67% of consumers believed that prices had been rounded up to a higher amount when converted to euros. The President of the ECB, Wim Duisenberg, has himself admitted that retailers, hotels and restaurants, in particular, took advantage of the unfamiliarity of the new currency to push up the prices of some household goods. However EU officials have insisted that the euro's overall inflationary impact has been negligible. A recent study by Eurostat, the EU statistics agency, found that the changeover had contributed to between zero and 0.2 per cent to overall price inflation. The reason for this discrepancy is that the calculation of overall prices includes larger and less frequently purchased goods such as larger electrical goods and motor cars and relatively invisible products, like insurance and other

financial services which have remained stable. In the longer term, the greater transparency and therefore comparability of prices across the eurozone is bound to bear down on prices.

Even so, one lesson for the UK is that, in any changeover, there will need to be careful monitoring not only by consumer groups and organisations but also by government to put pressure on retailers and to retain consumer confidence that the changeover to the euro is not being used for opportunistic rounding up. A clear and simple Consumers Code of Practice will be essential (see Box D).

BOX D**A Draft Consumer Code**

Overall Aim - That consumers can be confident they would be treated fairly, and provided with adequate, targeted and easily understood information to help them throughout the changeover from sterling to euro.

Core Principles - Where an amount was displayed in euro and sterling the two figures should be equivalent in value, and it should be clear which denominations and which methods of payment are accepted.

The official conversion rate should be applied and rounding rules adhered to in all dealings with consumers.

Consumers paying in euro and sterling should be treated equally, although a clearly displayed fee might be charged where euro notes and coins are accepted before their formal introduction in the UK.

Accurate, clear and targeted information should be provided to assist consumers with a changeover from sterling to euro.

Dual currency information in sterling and euros for consumers should be provided, in an appropriate form, for at least the period from euro cash day minus four months until withdrawal of sterling notes and coins is completed.

In the operation of this code, the needs of vulnerable groups, such as older people, the visually impaired and those with learning difficulties, should be taken into account.

Staff dealing with customers shall be well-trained and able to give consumers straightforward and relevant information about the organisation's approach to the euro. (Source: *Second National Changeover Plan*)

8 Conclusion: a strategy for joining the euro

The pamphlet sets out the steps that will be required for the UK joining the euro. The main conclusions are summarised as follows:

- 1) The UK should have no difficulty in satisfying the Maastricht criteria on inflation, sustainability of the fiscal position and convergence of long term interest rates. It will have to legislate to ensure that the Bank of England's statutes are compatible with the Maastricht Treaty. As to the requirement to participate in the exchange rate mechanism (ERM) for at least two years, our partners may be prepared to accept that the requirement is satisfied if the UK can demonstrate a period of relative exchange rate stability before it joins.
- 2) The main modifications in the interpretation of the Stability and Growth Pact suggested by the EU Commission might have been written by the Treasury and deserve UK support, given that the government has announced that it is in favour of a strong Pact.
- 3) The Chancellor set out in October 1997 five economic tests by which the decision whether or not to join the euro should be judged. On the key issue, that of convergence, there can be no doubt that, compared to 1997, the British economy and that of the Eurozone have come much closer together. It is important that the five tests are met, but in the making of such an important long-term decision it is essential to distinguish the wood from the trees and to take account of broader economic questions such as the opportunities that entry would bring with it and the costs of staying out.
- 4) Despite the recent rise in the value of the euro, the policy of floating

has resulted in substantial over-valuation of sterling that has contributed to the decline of manufacturing and led to a record trade deficit. Following a favourable assessment of the five tests, a firm government statement of its intention to join, combined with a statement from the Chancellor that he considers sterling is overvalued, could influence the market in a downwards direction, thus strengthening the British hand in negotiations with our euro partners over a sustainable entry rate.

5) In joining the ECB, the UK would be moving from one rule-governed, independently-based system to another, with broadly similar objectives. The ECB has embarked on a process of reassessment that could bring it closer to the British system, in particular over the inflation target. The UK needs to ensure that any reform of the ECB Governing Council following enlargement reserves permanent voting rights for National Bank Governors from the largest economies. Early membership of the euro group on economic policy, from which we are at present excluded, would represent a significant gain for the UK.

6) In moving towards joining the euro and adopting notes and coins, a National Changeover Plan with a managed and phased timetable will be essential to ensure a smooth and effective changeover.

7) Following the Chancellor's establishment of the Standing Committee on Euro Preparations in 1997, the UK is already in a particularly strong position, especially as it can learn from the experience of the 'first wave' countries, including the vital role of financial institutions in the changeover, the need for dual pricing in the period before euro cash, and for a reduction in the period of dual pricing after the changeover from six to two months.

8) Special attention will need to be paid to smaller businesses (SMEs) who are likely not to change their systems until near the introduction of euro cash. The UK government may wish to consider allowing SMEs to write off part or whole of the cost of IT upgrading in the period between

joining and the adoption of notes and coins.

9) The timetable from a successful referendum to the changeover is likely to be from 24 to 30 months.

10) Legislation will be required to prepare the UK for entry, including paving the way for a referendum, amending the UK opt-out from Maastricht, and making the Bank of England fully independent.

11) As to the eventual overall cost of the changeover by government, industry and financial services, the Treasury has said it is not possible to make an accurate prediction. It is, however, significant that the 'first wave' members have taken the changeover very much in their stride.

12) In view of the 'opportunistic' rounding up of prices by some retailers, hoteliers and restaurant owners in the euro area changeover (which has not, however, affected the overall price level), there will need to be a clear consumer code of practice and effective monitoring by consumer groups and government.

In his New Year's message, Tony Blair said that this year we face, "what may be the single most important decision that faces this political generation - the question of whether to join the euro." He is right. This pamphlet shows that there are a wide range of issues that need to be taken into account in joining the euro that go beyond the five tests, important though these are. If the government is serious about joining the euro, it needs a strategy for entry. There is, therefore, a strong case for the setting up of a Euro Strategy Group - including the Chancellor, the Deputy Prime Minister, the Foreign Secretary, the Secretary of State for Trade and Industry, the Secretary of State for Work and Pensions, the Leader of the House and the Lord Chancellor - to consider these vital matters to be chaired by the Prime Minister himself, who is, after all, First Lord of the Treasury and main arbiter of the national interest.

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