

Sterling Weekly

United Kingdom

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Forecasts	3- month Henc e	12- month Henc e
£/€	0.6 7	0.6 4
US\$/£	1.6 4	1.5 6
Base Rate	4.0 0	5.0 0
10-Year Yield	4.7 5	5.4 5
Spread vs Bunds	30b p	50b p

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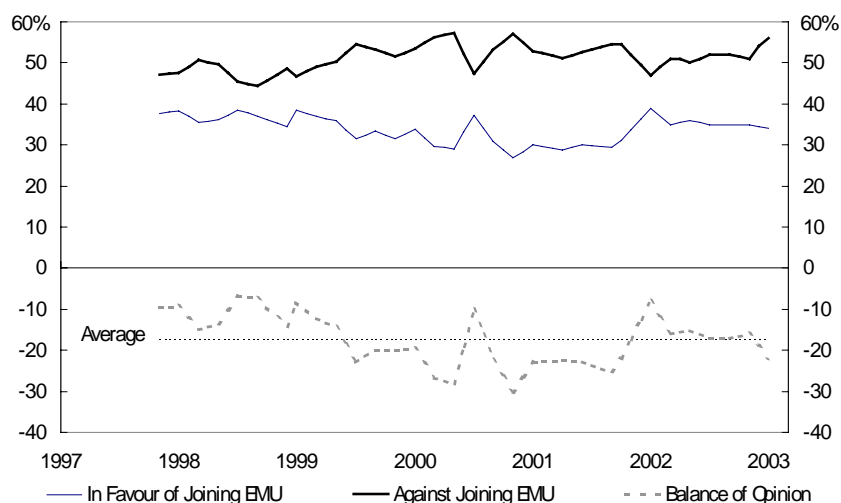
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No to EMU Entry

- With the government only a few months from its 7 June deadline to decide whether or not to join EMU, our latest MORI poll suggests that the balance of opinion against EMU entry has risen further. The balance of opinion against EMU entry is above the average of the past five years.
- Our poll also hints at diminished trust in the government, in that a strong pro-EMU lead from the government would only lift support for EMU entry by 4 percentage points — the lowest impact since we began our polling more than five years ago.
- With these poll readings, plus the contrast between the UK consumer boom and economic weakness in the euro area, the chances of EMU entry in 2003-05 are falling fast. In mid-2002, we put the chance of an EMU referendum in 2003 at about one in three. Now, we put it at less than one in five and sinking. To the extent that the UK short end remains supported by hopes of EMU convergence, we view the probable absence of EMU entry as another reason to be bearish on UK interest rate products.

Figure 1. UK – Public Opinion Over EMU Entry (Using the question "If the government were to strongly urge that Britain should be part of a single European currency, how would you vote?"), Nov 97-Jan 03



Sources: MORI Financial Services and Salomon Schroder Smith Barney.

No EMU Entry For Now

The public debate over EMU entry seems to be settled...

This was meant to be the time when the EMU debate would reach its peak. With the deadline (7 June) for the government to publish its assessment of the five economic tests now only a few months away, the EMU debate should be intense. But, in practice, it appears that the key period in the EMU debate has come and gone. Public opinion is settled, and against EMU entry. We have long argued that the UK will probably not join EMU in 2003-05. Now, **we believe that the chance of EMU entry in 2003-05 is so low — perhaps less than 20% — as to be almost irrelevant.**

...with opinion clearly against EMU entry...

Our latest MORI poll shows that, using the question “*If there were a referendum now on whether Britain should be part of a single European currency, how would you vote?*”, the share in favour of EMU entry is 31% now, the same as last November. The share against EMU entry has risen slightly to 57% from 55% last November. Thus, **the balance against EMU entry is up to 26% from 24% last November and up from 18% a year ago.**

Figure 2. UK – Question 1: “If there were a referendum now on whether Britain should be part of a single European currency, how would you vote?”, Nov 97-Jan 03

	Nov 97- Nov 02	Monthly Surveys By Survey Date							
	Average	Oct 01	Jan 02	Feb/Mar	May 02	Jul 02	Sep 02	Nov 02	Jan 03
In Favour	29%	26%	33%	30%	31%	31%	29%	31%	31%
Against	55	57	51	55	53	55	56	55	57
Don't Know	16	17	15	14	16	14	15	14	11
Balance	-26%	-31%	-18%	-24%	-22%	-24%	-27%	-24%	-26%
Balances Split By Voting Intention									
• Labour	-10%	-19%	-4%	-10%	-5%	-3%	-11%	-7%	-13%
• Conservative	-60	-68	-54	-65	-60	-59	-62	-57	-63
• Liberal Democrat	-15	-24	+4	-3	2	-8	-4	-12	-2

Note: Latest polling during 16-21 January 2003. Sample size 2,057 people for latest, similar for earlier polls.
Sources: MORI Financial Services and Schroder Salomon Smith Barney.

...even if we allow for a strong pro-EMU lead from the government

A strong pro-EMU lead from the government would not alter sentiment much. Using our second question “*If the government were to strongly urge that Britain should be part of a single European currency, how would you vote?*”, the share against EMU entry has leapt to 56% — the highest since late 2000 — from 51% last November. Using this question, the balance of opinion against EMU entry has jumped to 22% from 16% last November and merely 8% a year ago. **The balance against EMU is the highest since late 2001, and well above the 17% average of the past five years.**

Figure 3. UK – Question 2: "If the government were to strongly urge that Britain should be part of a single European currency, how would you vote?" Nov 97-Jan 03

	Nov 1997- Nov 02	Monthly Surveys By Survey Date							
	Average	Oct 01	Jan 02	Feb/Mar 02	May 02	Jul 02	Sep 02	Nov 02	Jan 03
In Favour	34%	31%	39%	35%	36%	35%	35%	35%	34%
Against	51	53	47	51	50	52	52	51	56
Don't Know	14	15	14	13	14	13	13	14	11
Balance	-17%	-22%	-8%	-16%	-15%	-17%	-17%	-16%	-22%
Balances Split By Voting Intention									
• Labour	2%	-3%	+8%	+2%	+7%	+7%	+4%	+6%	-7%
• Conservative	-52	-64	-47	-55	-54	-53	-58	-53	-61
• Liberal Democrat	-8	-20	+9	+4	+7	-7	+1	-5	+3

Latest polling conducted 16-21 January 2003. Sample size 2,057 people for latest, similar for earlier polls.

Sources: MORI Financial Services and Schroder Salomon Smith Barney.

The swing against EMU is broad based...

On both questions, the swing against EMU is broadly based by age group, political opinion and social class (a proxy for income levels). On both questions, more people oppose EMU than support it among *every* age group and in *every* region.

...and seems an insuperable obstacle

Such an opinion poll gap is, in our view, far too big to be closed. For example, the balance of opinion against EMU entry is similar to the opinion poll gap between Labour voters and the Conservatives. Almost no one believes the Conservatives can win the next election, even though the election is probably more than two years away. The chances of a swing in favour of EMU seem similarly low.

The pro-EMU camp face big obstacles:

We doubt that public opinion will change much in coming months. **The pro-EMU lobby face six hurdles, which jointly make entry very unlikely.**

(1) The UK and euro area economies are not convergent

First, **the UK economy is not really convergent enough with the euro area to allow painless entry.** EMU entry would cut short rates to 2.75%, adding fuel to housing and consumer spending — sectors which need restraint rather than stimulus. Inflation could only be subdued if the UK tightens fiscal policy or joins at a painfully high entry rate. The experience of existing members shows that, if convergence is inadequate before EMU, then the result inside EMU will tend to be high inflation (e.g. Ireland, Portugal) or weak growth and very low inflation (e.g. Germany). As the Treasury's Economic Advisor, Ed Balls, recently argued, the government would pay a big long-term political price, by losing its hard-won reputation for economic competence, if the UK joins EMU when the economics are not right¹.

¹ See the 2002 Cairncross Lecture by Ed Balls, 4 December 2002.

(2) Voters do not view EMU entry as a priority for the government

Second, **UK voters no longer believe that EMU entry is a key priority for the UK.** As evidence of the UK's ability to prosper outside EMU has accumulated, the issue of EMU entry and the UK's relations with the EU has plunged to 11th place in the list of voters' concerns, the lowest since 1990. Voters want the government to focus on its stated priorities of health and education, tackle the tricky domestic issues of crime, transport and pensions, and resolve difficult global issues (defence, immigration, nuclear weapons). There also is a slight rise in concern over the economy and jobs. The low priority given to the issue of EMU entry does not mean that voters do not care about the issue. Our poll and others show that voters have a settled and consistent view. Rather, voters do not believe that there is an issue that needs to be resolved: the UK is in the EU but out of EMU, and the government should focus its energies on more urgent issues. Moreover, voters would probably be unwilling to support painful policy measures aimed at promoting EMU convergence.

Figure 4. UK – Voters' Top Concerns, 1993-02

	1993	1994	1995	1996	1997	1998	1999	2000	2001	Q1-Q3 2002	Q4 2002
1.	Jobs	Jobs	Jobs	Jobs	NHS	NHS	NHS	NHS	NHS	NHS	NHS
2.	Economy	NHS	NHS	NHS	Schools	Schools	Schools	Schools	Schools	Crime	Defence
3.	NHS	Crime	Schools	Schools	Jobs	Jobs	Europe/EMU	Europe/EMU	Crime	Schools	Schools
4.	Crime	Economy	Crime	Crime	Europe/EMU	Europe/EMU	Jobs	Crime	Europe/EMU	Immigration	Crime
5.	Schools	Schools	Economy	Europe/EMU	Crime	Economy	Crime	Petrol Price	Defence	Transport	Immigration
6.	Pensions	Housing	Europe/EMU	Economy	Economy	Crime	Economy	Jobs	Immigration	Defence	Pensions
7.	Europe/EMU	Europe/EMU	Housing	Housing	Pensions	Pensions	Pensions	Pensions	Economy	Europe/EMU	Transport
8.	Housing	Pensions	Pensions	Pensions	Poverty	Housing	Defence	Immigration	Jobs	Pensions	Economy
9.	Inflation	Taxes	Taxes	Drug Abuse	Housing	Defence	Housing	Economy	Pensions	Economy	Jobs
10.	Defence	Inflation	Inflation	Taxes	Pollution	Drug Abuse	Drug Abuse	Transport	Transport	Jobs	Nuclear Weapons

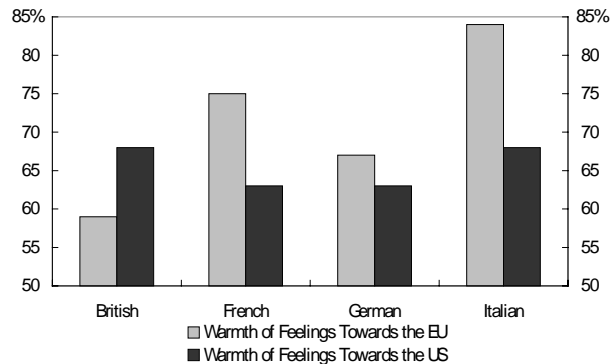
Sources: MORI and Schroder Salomon Smith Barney.

(3) UK voters remain opposed to political integration

Third, **UK voters remain very sceptical about the aim of closer European political integration.** A recent MORI survey found that UK residents have warmer feelings for the US than the EU. The share of UK residents that believe it is important for the EU to exert strong leadership in world affairs (79%) is only a little higher than the share that believe it is important for the US to exert strong leadership (72%)². This is quite striking, given that the UK is a member of the EU but is not a part of the US. By contrast, residents in Germany, France, and Italy view the EU more warmly than the US and, by large majorities, prefer the EU rather than the US to play a global leadership role. Thus, when the economic case for the UK to join EMU is weak (as now), then — unlike most other EU countries — there is no reservoir of public support for closer EU political integration to fall back on.

² See Margaret Nally Memorial Lecture, by Robert Worcester of MORI, 16 January 2003.

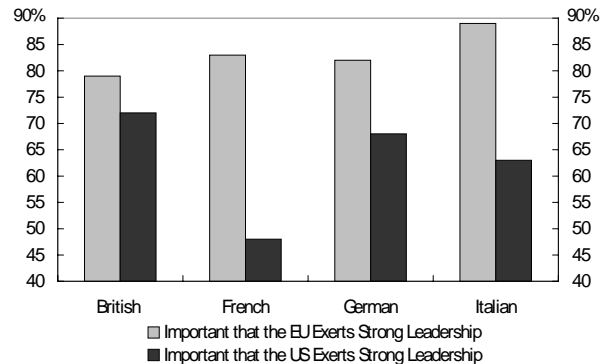
Figure 5. Selected Countries - Warmth of Feelings Towards the US and EU (Nationality of Respondents)



Note: This chart shows responses to the question "I'd like you to rate your feelings towards some countries, with one hundred meaning a very warm, favourable feeling, zero meaning a cold, unfavourable feeling, and fifty meaning not particularly warm or cold. You can use any number from zero to one hundred."

Source: MORI, polling conducted June-July 2002.

Figure 6. Selected Countries - Preference for Global Leadership (Nationality of Respondents)



Note: The chart shows responses to the question "From your point of view, how important is it that the US/European Union exert strong leadership in world affairs?". The chart shows the percentage of people who respond "very desirable" or "somewhat desirable".

(4) Voters may be less willing to trust the government on EMU

Fourth, **our poll hints that voters' trust in the government has fallen.** On average over the past five years, the effect of a strong pro-EMU stance from the government has been to lift support for EMU by 9%. This is the gap between the balance against EMU on questions one and two. But, in our latest poll, this gap is down to just 4%, the lowest since our polls began in late 1997. Voters seem less willing to trust the government's views on EMU — perhaps because they feel the economic case against EMU entry is clear cut, and perhaps because they are simply less willing to take the government's word on any issue.

(5) UK business is unlikely to lobby strongly for EMU entry

Fifth, **UK businesses are unlikely to lobby strongly for early EMU entry.** A recent British Chambers of Commerce survey found that, even if the government says that the five economic tests are met, only 35% of businesses would favour early EMU entry (in 24-30 months). 49% would prefer the government to wait and see how the euro develops for longer; and 13% would still believe the UK should never join³. A regular annual FT survey of CEOs of major UK companies found that — for the first time since the survey began in 1997 — more CEOs oppose the principle of EMU entry than favour it⁴.

³ Source: British Chambers of Commerce, published 8 January 2003.

⁴ See Captains of Industry Survey, by MORI, published in the *Financial Times* on 20 January 2003.

(6) The government is not giving a strong lead

Finally, **no one in the government is giving a strong lead.** In recent weeks, Peter Hain (UK representative on the EU convention) said that there is no rush to join EMU. A recent Treasury paper highlighted the government's worries about the euro-area policy framework, warning that "the government remains very concerned about the Commission's ideas for institutional change on the Stability and Growth Pact"⁵.

It is unlikely that the Iraq crisis will boost support for EMU entry

Some of the pro-EMU lobby have argued that a successful military campaign against Iraq might give Blair the glow of a war leader and allow him to lift public support for EMU. We are dubious. If there is military action, and if it is quickly resolved and if Blair reaps political gains (three big "ifs"), then he will have done so by standing with the US rather than other EU countries. It is hard to see how this could make UK voters suddenly favour closer EU economic and political integration.

If EMU entry in 2003 is ruled out, then 2004 and 2005 also will be ruled out

If the government rules out EMU entry in 2003, then we expect that it also will rule out entry until after the next general election (expected in 2005 or 2006).

The idea (floated by some) that the government will appease other EU countries by keeping open the possibility of an EMU referendum in 2004 or 2005 seems implausible. Having stressed "schools and hospitals first" (in line with public opinion), the government will want to focus on these issues in 2004 and 2005 ahead of a probable general election in 2005. The issue of EMU entry will be even less relevant to the government's political priorities in 2004 and 2005 than now.

The government is looking for an exit strategy on EMU...

We suspect that the government is, rather uncertainly, groping for an exit strategy on the EMU issue. It needs a way of saying to UK voters that the UK will not join EMU in 2003-05, while at the same time reassuring other EU governments that the UK remains pro-European.

...and will want to say "not quite yet" rather than "never"

Recent comments and leaks give a flavour of the message that the government will probably use. The Treasury will say that the UK and euro-area economies have become more convergent than in 1997, but are not quite there yet. To the UK audience, the government will stress its determination to take no risks with the economy. To other EU governments, Blair will stress that "Europe is our destiny", and that it is just a question of timing when the UK joins EMU. The government will hold out the possibility of EMU entry in 2006/07, and probably will accept moves to closer political integration in the EU Convention. But, **these will be fig leaves to soften the underlying decision that the UK will stay out of EMU for a while longer.**

⁵ See Memorandum by HM Treasury to the Treasury Select Committee, 13 January 2003.

*The timing of a decision
on EMU is uncertain*

It is not clear when the government will confirm that EMU entry is not going to occur in 2003. They may wait until the last moment (7 June) or — as reported in the *Daily Telegraph* (January 24) — may close off the issue earlier to prevent it from creating more reports of splits in the government.

*We remain bearish on UK
interest rate products*

Not much is priced into UK markets for EMU convergence, but to the extent that the UK short end retains a premium for the possibility of EMU entry, then we regard these polling results **as an extra reason to be bearish of the UK short end**. With inflation above target, buoyant consumer spending and low unemployment, the chances that short rates fall seem much lower than markets price in.

Economic Indicators

Thu	Personal Borrowing (Dec)	Forecast: £8.7 billion MoM, 13.6% YoY
30 Jan		Previous: £8.8 billion MoM, 13.5% YoY
	Mortgage Lending (Dec)	Forecast: £7.2 billion MoM, 13.3% YoY
		Previous: £7.4 billion MoM, 13.0% YoY
	Consumer Credit (Dec)	Forecast: £1.5 billion MoM, 14.8% YoY
		Previous: £1.4 billion MoM, 15.4% YoY
	Mortgage Commitments (Dec)	Forecast: £21.0 billion MoM, 35.8% YoY
		Previous: £22.4 billion MoM, 44.8% YoY

These data are likely to round off an astonishing year for personal borrowing. A figure in line with our forecast would imply that personal debt rose by £99bn in 2002, a gain of 13.5%, compared to a £72bn rise in 2001 and a £54.8bn rise in 2001. As recently as 1998, personal borrowing rose by just £39bn. In our view, it is a delusion to think that such a massive rise in personal debt, and the resultant credit-driven boom in consumer spending, will not have destabilising effects on the economy. The credit boom already has pushed inflation above target, despite sluggish external growth, and a further rise in inflation probably will oblige the MPC to start to rein in the credit boom during 2003.

Mon	Purchasing Managers' Index (Jan)	Forecast: 50.0
3 Feb		Previous: 49.5

The rise in the US ISM survey in December, plus the improvement in the UK upgrades-downgrades balance for January, suggest that the manufacturing PMI survey edged up in January after slipping in the past couple of months. A figure in line with our forecast would put the index in line with the dismal average of the past five years and hence would not be consistent with great economic weakness, provided that the service sector keeps growing steadily.

Mon	CBI Retail Survey - Balance Reporting Sales Up YoY	Forecast: 35%
3 Feb		Previous: -3%

The weak December CBI retail survey reflected the softer tone of retail sales in the early part of December. We expect this survey to reflect the greater strength of sales in the week ended December 28, and the first couple of weeks in January. Weekly sales data from retailer John Lewis suggest that this more recent period has seen a significant acceleration in consumer spending, and we expect this to be reflected in a jump in the CBI survey for annual sales growth to the highest since April 2002.

Wed	Services PMI (Jan)	Forecast: 54.1
6 Feb		Previous: 53.2

The arguments for a slight rise in this index are essentially the same as those for the manufacturing PMI: the US ISM index rose markedly in December, while the UK upgrades-downgrades ratio improved in both December and January. These indicators are by no means infallible, but have had some value as lead guides to the service sector PMI. The average reading for the service sector PMI over the past five years is 54.8, and thus such a figure would still leave us a little below that - but only a little, and not a significant gap given the acceleration in public spending (which is not fully reflected in this index or the manufacturing PMI).

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2003 - EU30302

Economic Calendar, 20 Jan - 7 Feb 2003

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
	M4 (Dec) Dec 0.9% (6.9%) M4 Lending (Dec) Dec £8.4B (9.1%) CML Gross Mortgage Advances (Dec) Dec £19.5B (45%) PSNB (Dec) Dec02 £4.5B (£21.4B) PSNCR (Dec) Dec02 £11.4B (£23.1B) Retail Prices (Dec) Dec 0.2% (2.9%) RPIX (Dec) Dec 0.1% (2.7%) RPIY (Dec) Dec 0.2% (3.0%)	CBI Industrial Survey (Dec, 11:00) Industrial Nov -19% Dec -19% Output Expectations Nov -1% Dec +2% Order Books (Dec) Nov -32% Dec -25% Price Expectations Nov -12% Dec -12% MPC Minutes (Jan 9)	Retail Sales (Dec) Nov 0.1% (4.1%) Dec 1.1% (6.4%)	GDP (Q4, Q3 0.9% (2.1%) Q4 0.4% (2.2%)
27	28	29	30	31
			Personal Borrowing Nov £8.8B (13.5%) DecE £8.7B (13.6%) Mortgage Lending Nov £7.4B (13.0%) DecE £7.2B (13.3%) Consumer Credit Nov £1.4B (15.4%) DecE £1.5B (14.8%) Mortgage Commitm'ts Nov £22.4B (44.8%) DecE £21.0B (35.8%)	
		FOMC Meeting	FOMC Meeting	
3	4	5	6	7
Purchasing Managers' Index (Jan) Dec 49.5 JanE 50.0 CBI Retail Survey Dec Sales -3% YoY JanE Sales 35% YoY		Services PMI (Jan) Dec 53.2 JanE 54.1 MPC Meeting Starts	MPC Meeting Ends: Outcome at Noon ECB Meeting	Industrial Manuf. Output

E Schroder Salomon Smith Barney estimate. P Provisional. R Revised.

Note: All data are month-to-month percentage changes, except those in parentheses, which are year-to-year changes.

All data are released at 9.30 a.m., except those marked otherwise.