‘The Euro: 10th Anniversary of the Assessment of the Five Economic Tests’

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Introduction and context

It is an honour to be giving the latest in the series of Mile End Group/Treasury talks, on the UK’s decision not to join EMU, EU Economicand Monetary Union, to mark the 10th anniversary of that decision. It is great to see so many people here. Thank you all for coming.

There are three other relevant anniversaries:

The 10th anniversary of the Mile End Group is fast approaching. The fact this is MEG event number 97 is testimony to the vitality of this multidisciplinary group;

2014 will be the 50th birthday of the Government Economic Service, and as head of the GES, my talk follows a path mixing contemporary history and economics trodden much more expertly by the GES’s first head, Sir Alec Cairncross;

Third, as David Marsh, historian and commentator on Germany and the Euro recently reminded me, 2014 will also see the 25th anniversary of the Delors Report2 which in 1989 set out the blueprint for EMU, which began in 1999.

This talk is based on my memories, as I didn’t keep a diary. So it’s a personal view, with all the pitfalls and caveats that implies.

My focus is the Treasury rather than the more often told story of the politics. Primarily the process and how this interacted with the policy and the Five Tests analysis. I also want to revisit the substance of the analysis in the light of developments since.

There is a theme of “Treasury control”, covered more broadly by Nick Macpherson in his Mile End Group/Treasury talk earlier this year4. For today, I am interested in a particular type of control, relating to the stewardship and development of the macroeconomic

framework, comprising the monetary, fiscal and financial policy arrangements. As determined by the currency choice.

The chart shows the chequered history of the dollar-sterling exchange rate since 1900.

The Labour Government's decision not to join the Euro and Gordon Brown's leadership of the issue has been borne out by subsequent events. My conclusion will be that the Treasury contributed to this success because of its increasing control of the decision. But there were issues we missed and the Treasury is continuing to learn the lessons of the post 2003 period.

The lessons from the UK's1925 decision to re-join the Gold Standard and the parallels with the 1948, 1967 and 1990 decisions on currency made by Chancellors Churchill, Dalton, Callaghan and Major was the subject of Ed Balls' December 2002 lecture5, in honour of Alex Cairncross and in particular his 1996 book.

Balls concluded:

"But the reason why the Five Tests are so important is because they ensure that a proper and long term economic assessment of the national economic interest will precede an irreversible decision of great long-term economic and therefore political significance. As Prime Minister Tony Blair has said "they are not window dressing for political appearances…."

In a 1987 interview cited by Peter Hennessy in his definitive history: "Whitehall" John Hunt, the former Cabinet Secretary sets out how far the Treasury had lost control in the post-war period.

"When I joined the Treasury just after the Second World War, the Treasury was virtually all powerful. It was in a different league to other departments, not only as the big economic department but also as a coordinator. Its power was felt very strongly in every

department. And if the Treasury view was known to be so-and-so this tended to get reflected throughout Whitehall. That has changed partly because the coordinating role is divided between the Treasury and the Cabinet Office. I think its also changed because Chancellors of the Exchequer are less able to take big economic decisions on their own, and therefore the power and the awe attached to the Treasury is less. Chancellors are being forced to discuss economic power with their colleagues, and this has stripped some of the mystique of the Treasury."

Hennessy goes on to detail how, in the aftermath of the IMF crisis of 1975, Prime Minister Callaghan institutionalised greater power-sharing on macroeconomic policy through the "Economic Seminar", comprising the PM, Chancellor and officials from No.10, Treasury, Cabinet Office, CPRS, Policy Unit and the Bank of England. There is quite a contrast with the narrow No.10 and HMT attendance at the Five Tests seminars held in early 2003 referred to later.

Process: 1992-2003

The first section of my talk starts as the UK left the ERM in September 1992, an event which shook the Treasury. Speaking in 2002 Terry Burns, Permanent Secretary in 1992, said:

"it was a very difficult period. In that world, there are many times you come across problems, and you think they are going to cause you huge difficulty, but with patience and clever footwork you get your way through them. On that occasion there was no way through. We had to leave and there was no easy way of leaving. So that was not a nice time. But there we were….. my task was to improve management of the Treasury and rebuild economic policy."

The slide shows the scale of the challenge: growth was low, inflation had been high and the exchange rate was falling. In parallel EU developments demanded engagement. The 1989 Delors report set out the next step in EU integration, a single currency area permanently linking together the countries of the EU, so a big advance on the ERM. Plus a single monetary policy, a single interest rate, for the whole area set by a European Central Bank. So implying a ceding of sovereignty over key areas of policy. Politics was a key driver and the Euro was legislated into existence in the Maastricht Treaty in 1991.

Because of the opt-out negotiated by Prime Minister Major in December 1991, the UK did not have to join the Euro, but still created a huge political and policy issue for the UK.

The Government's EMU policy was seen as 'wait and see'. Assuming it went ahead a Euro of even a few members would be the UK's biggest trading partner. Having failed to persuade its partners to go down alternative routes, such as the Hard Ecu, the Treasury worked for a successful EMU. An early example was Ken Clarke's contribution to saving the ERM in 1993. The EU's Monetary Committee chaired at key times by the Treasury's Nigel Wicks, spearheaded the work to establish EMU.

The Treasury couldn't get ahead of the Government. Answers to parliamentary questions could say there were no staff working full time on EMU. Instead the Treasury created X2, a cross-cutting group of staff each working part time on EMU. When X2 met there were enough attendees to fill one of the large conference rooms in the old Parliament St building. X2 considered every policy development and what it might mean for the UK. At Principal/Economic Adviser level, Sam Beckett was an early secretary to X2, supported by Tom Scholar. Melanie Dawes led on economic and policy analysis, and coordinated a major piece of internal work on the economics of EMU, Clive Maxwell led the monetary policy work and Mike Kell and Katy Peters, the fiscal work. I assessed member states readiness for Euro membership and its "one size fits all" monetary policy.

1996 was a busy year. With a view to the upcoming election the Government firmed up its policy in April, by committing to hold a referendum if the Government recommended entry. There was lots of UK parliamentary action to ratify key parts of the EMU architecture.

Anthony Seldon's biography of John Major, describes the Cabinet discussions in late 1996 to further clarify the Government's position. The last Cabinet on 19th December commissioned further Treasury work. Not the last Christmas to be affected by the Euro.

The Treasury paper looked at various possible EMUs, sticking pretty closely to the Maastricht criteria – convergence of inflation, interest rates, deficits, debt and exchanges rates within the ERM – to identify possible membership groups. Following the Cabinet discussion on 23rd January, the Government's press statement said:

"On the basis of information currently available, it is very unlikely but not impossible that the single currency can proceed safely on 1 January 1999, but if it did proceed with unreliable convergence we would not of course be part of it."

"British Economic Tests"

In February 1997 Gordon Brown set out the Labour party's position while on a trip to the US, the first appearance of the five "British Economic Tests". So while the Conservative

party's economic hurdle related more to EMU performance, the Labour party's spelt out that a decision on membership would be conditional on the Five Tests being met.

The folklore became that the Five Tests were invented in the back of a New York taxi, an early example of the "window dressing" charge that dogged the policy.

The Five Tests were actually based on the long established economic literature relating to optimal currency areas, applied to the UK's situation in a pamphlet Balls wrote in December 1992. The Five Tests framed exactly the sort of assessment of the pros, captured by the Investment, City and Job tests, and cons, covered by Convergence and Flexibility, that Cairncross had highlighted in his 1996 work as missing from previous currency episodes. Our internal economic work had been going in the same direction.

The Five Tests were:

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

The flexibility test – If problems emerge is there sufficient flexibility to deal with them?

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

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

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

A crucial advantage of the Five Tests was that while the Maastricht criteria dealt with exclusively nominal variables, the Five Tests dealt with the real economy and the macroeconomic implication of the required adjustments in markets at the microeconomic level.

The UK economy was by now growing steadily. Inflation, the deficit and interest rates were well down from their peaks and sterling was stable. Employment and house prices

were barely back to their pre-recession levels of 1990, but nevertheless Terry Burns, Alan Budd, the Chief Economic Adviser, and the rest of Treasury officialdom had achieved much of what they set out to after exit from the ERM.

The new Labour Government's May 1997 decision to give operational independence to the Bank of England, was designed to entrench macroeconomic stability and credibility. If successful this offered the UK economy a credible, alternative future to Euro membership. At the same time, it was evident that EMU was going to start on the revised date of 1 January 1999, with as many as 11 members.

EMU was a historic project that many in the Labour Government wanted the UK to be part of if the conditions were right, supported by influential private sector voices such as the CBI9. The Treasury did a lot of contingency work and immediately post election the Treasury had in place its first full-time EMU policy team, led by Melanie Dawes. Their priority was to prepare a Five Tests assessment. The Treasury produced the occasional public smoke signal, such as David Currie's report on the "Pros and Cons of EMU", published in July 1997 with a foreword from Gordon Brown.

There was no new policy announcement on EMU from either Prime Minister Blair or Chancellor Brown, creating intense speculation, which ended in October. Gordon Brown gave an interview to the Times, and his press adviser Charlie Whelan reportedly briefed journalists from the Red Lion that the interview indicated the Government was going to decide against early entry to EMU. I was introduced to Whelan as I passed through the Red Lion en route to paternity leave. The EMU decision was announced on Monday 27th October.

The October 1997 Five Tests Assessment document covered all the economic issues in less than forty pages, concluding that:

"Joining EMU undoubtedly has the potential to enhance both growth and employment prospects provided the UK economy is in a state to be able to meet the challenges that membership will bring."

But it also judged that

"neither flexibility nor convergence are sufficient at present to make joining EMU in the near future desirable"

The slide repeats Gordon Brown's statement to Parliament:

“believed that, in principle, British membership of a successful single currency would be beneficial to Britain and to Europe; the key factor is whether the economic benefits of joining for business and industry are clear and unambiguous”

“in order to give ourselves a genuine choice in the future, it is essential that the Government and business prepare intensively during this Parliament, so that Britain will be in a position to join a single currency, should we wish to, early in the next Parliament.”

The policy was “Prepare and Decide”. The outcome wasn’t a surprise. The economics was firmly established as the why of the EMU decision. But the approach was also driving the timing, the when and the next EMU decision wasn’t taken until June 2003, over 5½ years later.

This timing suited those who wanted the Government to focus on other domestic priorities after 18 years in opposition, but created political risks at home and abroad. There was also a risk around the impact on the UK economy, given our role as an economic bridgehead into the EU markets.

EMU’s momentum avoided ‘prepare and decide’ becoming a more drawn out version of ‘wait and see’:

The Euro’s start was formally agreed to under Britain’s EU Presidency in May 1998. The proceedings featured some particularly pro- European speeches by Gordon Brown.

The UK Presidency also set up the Cardiff Process, the first EU wide Member State process to improve the supply side and raise EU potential growth and flexibility.

The Euro began on 1 January 1999 with eleven members, who would introduce Euro notes and coins on 1 January 2002.

And the UK’s first draft National Changeover Plan was released in February 1999, the work of the Treasury’s 20 strong Euro Preparation Unit, headed by Sue Killen and then Mike Glycopantis. There was lots of policy activity alongside this by Michael Ellam and Paul Rankin of the EMU policy team, who I joined in 1999.

The evolution of fiscal policy frameworks was probably the most significant new challenge. The UK had developed its own fiscal rules which took account of the cycle and

which were seen as delivering fiscal sustainability – the UK was by then recording a fiscal surplus – while the EU Stability and Growth Pact was taking shape, with, as we saw it, less economic underpinning. I recall Andrew Turnbull, by then Permanent Secretary, and Gus O'Donnell both commissioning assessments.

By early 2001 the UK economy was performing well with growth up and inflation down, as noted by the IMF in their Article IV statement10. They went on to give the sort of running commentary that we were at pains to avoid:

"Apart from the exchange rate issue, the staff noted that cyclical synchronization had strengthened in 1999-2000".

UK economic officialdom always keeps a close eye on sterling. But public comment is rare. Bill Keegan among others highlights Bank of England Governor Eddie George's unusually overt reference in his June 2001 Mansion House speech:

"Most people agree that sterling's exchange rate on entry to the euro would need to be substantially lower than our present rate, which few would regard as sustainable in the medium and longer term".

The October 1997 EMU policy was unchanged right into 2001. This unusual policy stability reflected political discipline underpinned by the Treasury taking on economic ministry, delivery and coordination functions, increasingly at odds with John Hunt's earlier emphasis.

Again there was pre-election speculation on timing and intentions. Such was the policy stability that when the PM responded to William Hague at PMQs on 7th February 2001, by saying that for the decision on EMU entry "early in the Parliament of course means in two years" it counted as a policy development.

The Chancellor's strategic contribution at the time was to highlight repeatedly that the Five Tests work would be "rigorous and comprehensive" 13, a technocratic signal of the latest possible timing in this two year window. We already had a vision of a 'Budget sized' (250 pages in pre 2010 sizing) Five Tests Assessment with technical supporting material.

There were a sequence of carefully crafted statements which set out the process for doing the EMU work. This quote from Gordon Brown's June 2001 Mansion House speech gives a sense of the relentless internal logic.

"Before any assessment is started we must continue to do the necessary preliminary work for our analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised."

This meant that in answering questions on the timing of the EMU decision we could say that the Assessment couldn't start until the necessary preliminary and technical work was complete.

The preliminary and technical phase served three other important purposes. First, to give us the time to ensure that the analysis really was comprehensive. By the end we had a total of 18 studies, supporting different elements of the Assessment.

Second, ensuring sufficient rigour was difficult because of the unprecedented nature of the exercise we were engaged in. Only Sweden had a similarly comprehensive approach to assessing membership, the responsibility of the Calmfors Commission15, but based on different criteria. There were genuine differences of view amongst economists, as you would expect, but although campaign groups were established there weren't many incentives for research work in this area.

As early as 2000, we had identified issues with Treasury's capacity. The demarcation of the preliminary and technical work covered our engagement with lots of external economists to solve the problem. Many of the more than 50 who helped us would score highly on the new Research Excellence Framework for Impact. I only have space here to mention four: Mike Artis had a multi-year engagement with us which culminated in the Business Cycles study; Chris Pissarides, a future Nobel laureate was a consultant on the Labour Market Flexibility study; and Simon Wren-Lewis produced the sensitive study on estimates of the equilibrium exchange rate between sterling and the euro.

Peter Westaway came on secondment from the Bank of England for 18 months to fill a gap in our modelling capability. He authored two of the most influential studies on the Transition to EMU and Adjustment within it.

The third benefit of the preliminary and technical phase was to enable us to plan and manage the work strategically. EMU related work had been used to pioneer project planning techniques from the 1990s.

The EMU policy team was made up of several branches, on traditional Treasury lines, with Robert Woods, then Andrew Gurney as the lead Economic Adviser working on the Convergence and Jobs tests and coordinating the rest of the team's analysis, with economists on each test – Dave Bailey, Dominic Bryant, Catherine Connolly, Sue Connaughton, Stephen Farrington, Graeme Fisher, Lee Foulger, Joe Perkins and Katherine Townsend to name a few. Economic expertise, supplied by Alison Cottrell and Richard Salt was contracted in from other teams. Vanessa MacDougall led the EMU

strategy and coordination branch, the keepers of the policy faith, assisted by John Battersby and Robert Specterman.

From 2001 we had a programme board, chaired by Gus O'Donnell and then by Jon Cunliffe. Sue Owen returned from Washington to be the Director with management oversight for the whole programme, taking over from Jonathan Taylor.

The Board recognised that logistics and delivery was going to be crucial and resourced accordingly. At the peak of the work 25 people were full time on EMU, plus those on preparations, with more than 100 people involved to some degree. Through 2002 we were developing the 18 studies; planning for the Assessment with issues papers which started as 200 page slide packs for each test; maintaining the policy; and making logistics plans for a Budget- type event with a minimum of five weeks notice. Luckily the Treasury had someone, Ian Walker, who had lots of Budget related experience of this sort of thing, often at short notice in those days. As did Tom Josephs, who also led on the editing, assisted by Helen Griffiths.

To give a taster of the demands this slide reproduces a bit of the 16th December EMU Christmas Reading submission. In parallel we put up early advice on the related domestic policy options.

A Christmas holiday ruined by having to read well over 2000 pages of material. And the end to an unrelenting year:

All this material was submitted to Ed Balls, Mark Bowman, the Chancellor's Principal Private Secretary, and Programme Board members. This reflected Balls' centrality to the work in his role as Chief Economic Adviser. He had been thinking about the issues for ten years, and he linked the team to the Chancellor, with whom we had little need for direct contact.

Meanwhile the economy had continued to grow, with low inflation and sterling was above 3DM on the pre EMU exchange rate.

From the start of 2003 our key "stakeholders" became the Prime Minister and his close officials and advisers, particularly Jeremy Heywood, Stephen Wall and Jonathan Powell.

There had been various discussions between the PM and Chancellor in late 2002. My involvement was through a programme of seminars which were the brainchild of Bowman, liaising with Heywood. Before each seminar the relevant studies were sent over, and the seminar itself started with me presenting the findings and what they meant for the

tests, reinforced by the Chancellor who gave his thoughts on the accompanying policy options.

With the invasion of Iraq becoming ever more likely the seminars didn't always take place on schedule, but they did happen.

The Prime Minister seemed engaged during the seminars and Stephen Wall reports there was a real debate on the issues16. I learnt later third-hand that my approach to the seminars earned me the nickname "The Man in the White Coat".

Five weeks' notice had been given by the Chancellor and we were working towards a Budget day announcement on 9th April, if the political and policy decision was made to do so. It was a draining time for everyone involved.

At the end of March our schedule required we print 2000 copies of the 18 supporting studies, around four million pages in total. The preliminary and technical phase was over and work on the Assessment document had begun. Nick Macpherson played Devil's Advocate, reading an early draft with fresh eyes, and Gus O'Donnell, as Permanent Secretary, signed off on the Treasury's Assessment, which I submitted to the Chancellor on 31st March.

Our conclusion was that the Five Tests had not been met and a clear and unambiguous case for joining EMU had not been made.

I presented our findings to the PM and Chancellor at the last of the seminars on Tuesday 1st April and then returned to the Treasury, where we worked on keeping open the 9th April option. For this we needed finalised Assessment language and movement came at a Heywood-Balls meeting in the Treasury on the evening of Thursday 3rd April. James Bowler, Ed's Private Secretary, and I joined them intermittently. At 1am I headed down to join Ian and Tom at the printers off the Walworth Road for an "all-nighter", to transcribe the agreed changes into the printers proof of the document. The new version was delivered to various addresses at 7.30am.

As Friday went on any remaining hopes of a 9th April launch receded. Objectively this was obvious as Iraq and other issues well above our pay grade intervened. But in our delivery focussed world it came as a shock. The Chancellor told us formally on the Saturday morning that we would have to delay. All the work of the EMU team came to a sudden stop and a few tears were shed. But the 2003 Budget, minus most but not all of the EMU related material still had to be delivered. The 2000 sets of studies were locked up in a large cage at the printers.

The EMU team had a collective breather over Easter. On return we made further changes and updates. During May the Prime Minister and Chancellor agreed the language of the Assessment. A process was agreed and endorsed by Cabinet for the period up to the Parliamentary announcement, set for Monday 9th June. To try and quell talk of divisions on process there was a joint No.10/No.11 press statement on 16th May setting out a united front.

First the studies and then the assessment were shared with members of the Cabinet bilaterally in the second half of May17. There was a meeting of the full Cabinet to agree the policy in the week before the 9th June announcement.

Although lots of progress had been made only one of the Five tests – the City Test – was passed unconditionally. The two key ones, Convergence and Flexibility, were failed, and the Investment and Jobs tests were passed, conditional on passing Convergence and Flexibility. The clearance process left the language quite convoluted in places, but the concluding para, an earlier version of which I had read out at the last No.10 seminar back on 1st April was clear enough.

“Overall the Treasury assessment is that since 1997 the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area. So, despite the risks and costs from delaying the benefits of joining, a clear and unambiguous case for UK membership of EMU has not at the present time been made and a decision to join now would not be in the national economic interest.“

The Assessment and the accompanying Parliamentary statement contained a raft of “policy requirements”, such as the move from RPI-X to an HICP inflation target, which, whatever else it did, saved us and the MPC from embarrassment with the subsequent disclosures about the inadequacies of RPI. These policies made sense in their own right, but also increased the chances that the Five Tests would be assessed to be met in future.

There was a further policy commitment to review annually at Budget time “the reform agenda of concrete and practical steps to address the policy requirements identified by the [Five Tests] assessment”

The extensive analytical and policy contents of the Assessment, 18 studies and the Chancellor's statement provided something for everyone. The slide shows a flavour of the press reporting the day after.

Most agreed it was a weighty contribution, and comparisons were drawn with other recent Government publications, such as the so-called Dodgy Dossier.

We had a major stakeholder engagement plan – the Roadshow – for getting our message across. The domestic side, and much of the work of the EMU team, petered out quickly, but the international part continued.

The slide shows some of the institutions visited. Everyone engaged with us seemed to find the analysis interesting. But my sense was the majority of our EU partners thought it was of limited relevance to them.

Either because it didn't apply to them, as shown by the low level of bond yields and how much they had benefited from EMU. Or because they thought the UK was making a political decision: a version of the window dressing argument.

What did we get right and what did we get wrong?

In the second part of my talk and with the benefit of 10 years of hindsight I want to cover what went well and what went less well. It is an obvious point but subsequent developments do bear out much of the analysis and the UK's decision not to join. Another obvious point worth stressing is that many of these developments in the Euro have been unwelcome.

Starting with the key convergence and flexibility tests I think this is where our analysis was strongest. We built up a clear and rounded picture of the different elements of economic life for a country in EMU, based on a range of analytical approaches and models.

The Assessment noted that a decision to join EMU in the wrong way at the wrong time could have long lasting adverse effects on the economy, and it stressed the risk that insufficient convergence in economic conditions across countries might mean that the common interest rate set by the ECB could prove problematic.

In particular it highlighted that differences in housing markets and the degree of economic development could be exacerbated by a common interest rate. A strong insight from Peter Westaway's analysis was to apply the "Wicksell effect": if inflation is higher, real interest rates are lower and credit growth and related economic activity – such as housing purchase – is stronger, at least in the short term.

Another finding was that adjustment in EMU is different. More specifically “Inside EMU inflation and competitiveness have to take the strain of adjustment previously undertaken outside EMU by an independent monetary policy and the nominal sterling-euro exchange rate”. Related to this the Assessment highlighted that flexibility is crucial in allowing resources to be reallocated more rapidly to mitigate the effects of a shock.

Putting on my metaphorical white coat we applied these insights to modelling the adjustment paths to different shocks including the shock of entry. We then went further and in the Assessment itself modelled the “What If” the UK had joined EMU in 1999.

The charts show for the fictional UK – the dark line in each panel – how joining EMU in 1999 would have meant lower interest rates and a lower exchange rate than actually occurred, the light line. This would have given an initial boost to GDP, which increases inflation, depresses the real interest rate, boosting growth further temporarily until the depressing effects of higher inflation on real incomes and the higher real exchange rate kick in, dampening competitiveness and our earnings from trade (though the jury is still out on the impact of large exchange rate movements on activity).

This cycle in the real economy is only avoidable with a very high degree of flexibility, enabling markets to adjust and resources to be reallocated very quickly. It played out in a number of economies. A 2013 policy brief published by the European Commission echoes the 2003 analysis.

The chart shows that through a combination of lack of convergence of structures, lack of flexibility of markets or both, the competitiveness of Euro members as measured by real unit labour costs diverged, with nearly all economies losing ground relative to Germany which scored well on both.

We didn’t go on to develop this to look at the risks to the balance of payments. The analytical consensus was that within the Euro area current accounts no longer mattered. But even within a single currency area if a country has competitiveness problems this will show up as a current account deficit, reliant on external financing, with capital inflows from other countries including elsewhere in the Euro.

As I have stressed we were focussed on EMU’s fiscal arrangements and what they might imply for Treasury control of UK fiscal policy. The Assessment saw the need for greater fiscal flexibility in EMU, looking at various fiscal stabilisation options, from strengthening the automatic stabilisers through to new instruments such as a consumer credit tax. But

our analysis was very focused on fiscal stabilisation through time within countries, rather than stabilisation between countries.

Since 2003 the UK economy has actually become more cyclically convergent with the Euro area average growth rate, with slightly slower growth – here's a chart updated from the Assessment. But this largely reflects the degree of global convergence in the upswing, and the synchronised subsequent crash.

And the Euro area average masks some divergences between members, reflecting the forces we identified, such as credit.

In terms of the growth and investment tests I think the Assessment was appropriately balanced in emphasising the potential macroeconomic benefits that would come from enhanced microeconomic integration between highly convergent and flexible economies.

In practice the evidence suggests that the UK has seen its trade share with the Euro area decline, although it remains high. If trade has been diverted to other faster growing economies this need not be at the expense of output.

On the investment test we didn't really explore what could happen if the credit channel for monetary policy became and remained impaired. This is something that is being addressed in the UK by the Funding for Lending Scheme, but which still remains apparent in the fragmentation of Euro credit markets.

One of the biggest issues that we didn't do justice to was whether EMU membership was permanent or was an arrangement that a country could leave. This wasn't a failure of imagination, rather it was a conditioning assumption of the whole analytical and policy approach to EMU by the whole EU. And it was informed by the UK's more general stance to the Euro from its first inception, wanting it to be a success. So like everyone else we assumed it was permanent.

A related limitation in our Assessment was the role of fiscal policy and whether EMU implied a fiscal union. The fiscal policy framework in the euro area was and, to a large extent, still is materially different from that of the US which we had studied. In the euro area fiscal policy is largely set at the national level with minimal fiscal transfers between countries. By contrast in the US the federal government can coordinate fiscal transfers between regions.

The European Treaty included specific provisions – the so-called "no bail out" conditions – that underlined that national Governments were fully responsible for ensuring that their

own fiscal positions were sustainable, backed up by the provisions of the Stability and Growth Pact.

There were a range of views about whether this would be sustainable. Some academics submitted evidence to us that inter-regional fiscal transfers were essential to the long term viability of a monetary union.

By contrast our Assessment reached the strong conclusion that a federal fiscal policy was neither necessary nor desirable in EMU, which was much too sanguine. It underestimated the speed with which Governments could lose access to the bond markets – the earlier bond yields chart extended – and hence underestimated the need for last resort financing.

The Treasury has recognised this in its approach to the policy needs for EMU to be a success and also in its analysis of the issues facing Scotland if it were to leave the UK

It would take at least another whole talk to do justice to what we have learnt about the subject of the City Test and the role of the financial sector. We presented an original application of clustering analysis and drew on the historical work of David Kynaston to understand the roots of the UK's strengths. But we didn't foresee the build up in risks in the financial sector – proxied by its increase in size as a share of GDP post 2003.

More importantly we didn't see the risks represented by the increasing size of the financial sector, its balance sheet and the limitations of the UK's financial stability policy framework. We didn't completely ignore the issues but we certainly didn't give them anything like the consideration they deserved, as evidenced by the fact that the Assessment only had one short factual paragraph on financial stability.

The experience of several countries in the Euro periphery – and indeed the UK – has shown the close relationship and risk of an adverse feedback loop between a large financial sector and the sovereign balance sheet and finances.

Another related omission was the failure to focus on balance sheets more generally, and in particular the risks of indebtedness in the private and public sectors. This is surprising given our focus on housing credit. Also given the Maastricht Treaty's early emphasis on public debt.

Underlying all of this we were insufficiently challenging about the resilience of the UK macroeconomic framework.

In light of what I have already said, I can quickly cover the successes of process and how they are reinforced in today's Treasury:

We delivered a major logistical exercise to time. It is one of the myths of Whitehall that the Treasury can't do delivery. In the Treasury of today there are fewer all-nighters, at least of the planned variety, with nearly all the Budget and Autumn Statement texts locked down during the hours of daylight.

And we did this on the basis of a project plan, which followed best practice tenets. Project and Programme management is rightly being prioritised in the current Civil Service Reform agenda and the Treasury takes an increasingly project based approach to policy work, and champions programme management externally, for example through Infrastructure UK.

The Treasury also showed it could invest in its staff, building up a breadth and depth of capability on the euro. We invested in institutional memory and knowledge transfer. And although higher staff turnover has been a problem in recent years, we have retained sufficient capacity to inform our work on the financial crisis and more recently our work on Scotland.

Treasury showed flexibility in its use and deployment of staff, cutting through lines of command and directorate boundaries. The Agile Workforce Report, published yesterday, cites the Treasury's current approach to organising itself, as an example of best practice.

Our degree of engagement with the academic community was unprecedented, and would surprise many given perceptions of the Treasury and the sensitivity of the issues. Simon Wren Lewis recently told me that he gives the EMU work as a best practice example of how Government and academia should interact. In that sense we were years ahead of Civil Service Reform's current emphasis on open and contestable policy making.

A fair challenge is whether we should have involved the rest of Whitehall more? I think we were able to cover all the relevant issues effectively. We did engage with the Bank at some length on the inflation target switch.

Related to this should we have engaged even more with the countries which had joined the Euro to understand more what they were doing and why? If we had, could the Roadshow have got more traction? As it was, Jon Cunliffe and Sue Owen led a pretty full-

on engagement through the EFC and bilaterally. Another “what if” well beyond the scope of this talk, is to consider what might have changed about the performance of EMU and its management if we had been a member from the outset.

The Assessment was the Treasury’s work, but the question is often posed whether we came under political pressure in producing it. Ed Balls was very engaged at every stage, but I never felt under pressure, and Gordon Brown was very careful to keep at one remove throughout. My positive working experience was in line with Andrew Turnbull’s remarks in a speech in 2002.

The Treasury was inherently cautious on currency choices, which aligned our institutional incentives to those of our political leaders. But as I have tried to set out I think officials were open-minded in our analysis with a pluralistic approach. From the mid-1990s internal work stressed EMU should be assessed on its viability, not the optimality of the theory. And the work always covered the Pros as well as the Cons. Peston says it was clear from his contacts with the Treasury in the summer of 2002 that the Five Tests were going to be failed. For me the issues only started to crystallise in February 2003, around the time of the No.10 Flexibility seminar, as our analysis of the challenges of life in a single currency came to the fore.

So I don’t think the Five Tests were “window-dressing”. For me the approach was consistent with the axiom Officials advise: Ministers decide.

Stephen Wall’s and Robert Peston’s conclusions are relevant:

“It has also been argued that, by allowing the Chancellor to set five tests for British entry to the euro, the Prime Minister lost control of the EMU agenda. It is true that the five tests set a framework which gave the economic judgement of the Treasury more importance than if those particular criteria had not been set. But, in political terms, the five tests were no more than a confirmation of the obvious point that the Prime Minister and his Chancellor had to be in complete agreement for there to be any hope of a successful EMU referendum campaign.” (Wall)

“However, the man in the white coat, Ramsden, and the Treasury team were right: this was the wrong moment to participate in monetary union. So it is possible to view the process as a vindication and rehabilitation of the Whitehall machine and the mandarin class: for the only time since 1997, a momentous decision was taken in the old-fashioned way, of civil servants doing a serious piece of work which was subsequently adopted by ministers. Of course, that is an over-simplified view….” (Peston)

Conclusion: Lessons for Treasury.

Peston's conclusion is from early 2005. Events since pose a significant challenge to what the Treasury does and how we do it.

But the approach to the Five Tests still resonates. Rigorous and intensive analysis. Extensive planning. Open engagement with external experts. Cross- cutting teams. Flexible working. These are all fundamental to successful policy making and to a successful Treasury.

Of course, the Treasury has had to deal with even more challenging issues since 2003. And we have sought to learn the lessons of the financial crisis, including building up financial sector expertise and strengthening our approach to handling risk. We have outsourced the economic forecasting function to the OBR, which is much more open and transparent in its work. We have drafted in expertise, on a temporary basis, such as John Llewellyn and John Fingleton and also into the executive team with the recent arrival of Charles Roxburgh from McKinsey. And we have focused our efforts on economic and fiscal scenarios work, to tell stories and to better frame the uncertainties and risks.

Ultimately I think the Treasury did a good job on the UK decision on EMU due to a lot of very hard work by a lot of incredibly committed staff. It's a cliché but true that the Treasury's staff are its main asset and they are highly valued. The Treasury's Executive Management Board is acutely conscious of the need to support them in what they achieve and to safeguard their well- being, including a better work-life balance than we managed with the EMU work.

Currency questions remain of key interest for the Treasury. We are playing a leading role in the cross-Whitehall work to inform the September 2014 referendum of the Scottish people on whether to stay in the UK monetary, fiscal and political Union. The Scotland Analysis work programme which has published three hefty tomes to date on legal, currency and financial sector issues has some similarities to the preliminary and technical work.

As a postscript the negotiations to form the Coalition Government in May 2010 took place as the Greek debt crisis took hold. The Government ruled out joining EMU for the duration of the Parliament to 2015. The role of the Five Tests was over. The Chancellor announced in his June 2010 Budget speech that the last Treasury staff member working on UK Euro preparations was being "redeployed".

Annex

The Treasury's public control of the EMU process was increasingly at odds with Lord Hunt's description and manifested itself in a series of carefully planned and crafted statements, each one referencing back to the last one that brook no alternative world-view of how the work would or should be done.

In the June 2001 Mansion House speech very soon after the election, Gordon Brown reiterated that the Five Tests work would be rigorous and comprehensive, but such was the scale of the work that it would require extensive "preliminary and technical" work.

Then in November 2001, alongside a speech to the CBI in Birmingham, a Treasury paper set out a bit more about the nature of the preliminary and technical work. Here's an example of the relentless, internal logic:

"In the Mansion House speech in June the Chancellor explained that before the assessment of the tests was started, the Treasury would: "…continue to do the necessary preliminary work for our analysis – technical work that is necessary to allow us to undertake the assessment within two years as we promised. This makes clear that the preliminary work will inform the assessment."

Then in the following June's 2002 Mansion House speech the Chancellor announced that there would be at least ten supporting studies, informing the assessment itself.

Then in September, as an input to a somewhat belated Treasury Select Committee inquiry, a Treasury paper on "The Treasury's approach to the preliminary and technical work" stated that the work "continues to evolve to take account of the latest technical research and analysis" announcing four more studies, 14 in total, again assigned to particular tests, including under the fifth jobs test "The robustness of the arrangements for macroeconomic stability – including the Stability and Growth Pact – and their contribution to overall economic performance". A big challenge.

Ed Ball's Cairncross lecture that December, said there would be "at least 14 supporting studies" and three paragraphs later and consistent with the theme of his lecture he said

there would be “a full economic analysis of the economic consequences including any short-term transitional issues”, paving the way for the 15th study.

Notes

1 This talk is dedicated to everyone who worked on and continues to work on the Euro in the Treasury. Particular thanks to my PA Lisa Barrance, who has worked on EMU with me from the early days. Thanks also to Andrew Gurney, Alex Lam, Nick Macpherson, Mario Pisani, Sue Reid and Claire Wakefield for their help with this talk.

2 Report on economic and monetary union in the European Community, Delors Commitee, April 1989.

3 With one exception I haven’t drawn on any unpublished material in putting this together, other than to check dates, twenty years before the relevant files are released. My memories are broadly in line with the two EMU chapters in Brown’s Britain, Robert Peston, January 2005. But they may have been unduly influenced by the book.

4 “The Origins of Treasury Control”, Sir Nicholas Macpherson, 16th January 2013. In his talk, Macpherson quoted Sir Edward Bridges in the Stamp Memorial lecture of 1950: “1941 marks the date when a new theme was introduced to the making of the Budget, namely the inflationary – deflationary scheme, a conscious attempt to use fiscal measures to hold the balance between the money in people’s pockets and what they could buy with it… It is now a well established and important feature of the general aims of Treasury control”

5 “Why the five economics tests?” – Ed Balls, 2002 Cairncross lecture.

6 “Whitehall”, Peter Hennessy, 2001.

7 “Major: a political life”, Anthony Seldon, 1997. Even in the era of Google and Wikipedia, it is very hard to get even this kind of information confirmed from primary on-line sources.

8 “Euro-monetarism: how Britain was ensnared and how it should escape”, Fabian Society pamphlet, 1992.

9 For example see Adair Turner’s CBI conference speech in January 1998.

10 The IMF’s UK Article IV report in February 2001 concluded that “the UK is experiencing the longest period of sustained noninflationary output growth in more than 30 years, partly owing to strengthened macroeconomic and structural policies underpinned by improved monetary and fiscal policy frameworks”.

11 Bill Keegan, “Prudence of Mr Gordon Brown”.
12 Stephen Wall, then the PM’s senior EU adviser suggests it was intended as such. A Stranger In Europe, Stephen Wall, 2008, p170.
13 I can’t track down the first use of the term. However I recall driving out of London on a Saturday morning in January/February 2001 and hearing Gordon Brown use the phrase constantly in a Radio 4 Today Programme interview.
14 In the spirit of being “comprehensive” more are included in the Annex.

15 “EMU: A Swedish Perspective”, Calmfors et al, Klumer Academic Publishers, 1997.

16 “When the detailed research documents which underlay the tests were discussed by the Prime Minister and the Chancellor, there was a real debate between them”, A Stranger In Europe, Stephen Wall, 2008, p170.

17 Some Cabinet members had been sighted earlier on the related policy issues through meetings of the Economic Affairs Committee, chaired by the Chancellor.
18 “UK Membership of the Single Currency: An Assessment of the Five Economic Tests”, Cm 5776, HM Treasury, 2003, page 6.

19 Budget 2004 reported on progress and concluded that “while the Government does not propose a euro assessment be initiated at the time of this Budget the Treasury will again review the situation at Budget time next year”, Budget 2004, HM Treasury, p19. The space devoted to EMU in Budget documents shrank, from a full page text Box in Budget 2004 to only three short paras in a Box tucked away on page 151 of March Budget 2010.

20 “UK Membership of the Single Currency: An Assessment of the Five Economic Tests”, Cm 5776, HM Treasury, 2003, paragraph 54.

21 “A number of Member states joined EMU with well known weaknesses in their adjustment capacity and, until well into the [post 2008] crises, struggled to put in place sufficiently flexible market structures for a smooth functioning in a monetary union. This lack of flexibility substantially increased their exposure to shocks.”

“The Future of EMU” ECFIN Economic Brief, European Commission, 2013, http://ec.europa.eu/economy_finance/publications/economic_briefs/2013/pdf/eb22_en.pdf

22 Making up a large share of the Euro economy ECB policy was relatively well suited to Germany, and flexibility increased markedly through the Hartz reform programme initiated by Chancellor Schroeder in the early 2000s.

23 The convergence between the UK and the Euro area is all the more striking given the context of a widening interest rate differential between the two economies: from August

2004 to August 2005 UK rates were 4.75% while in the Euro area they were 2%.

24 "UK Membership of the Single Currency: An Assessment of the Five Economic Tests", Cm 5776, HM Treasury, 2003, page 13.

25 "Scotland Analysis: Currency and Monetary Policy", HM Government, 2013.

26 http://www.agilefutureforum.co.uk/AgileFutureForumReport/report.html

27 "The special advisers play a much bigger role than in the past, but that's partly because the special advisers are of such a high calibre … the idea that they (the advisers) don't work with Treasury officials is complete bunkum." Andrew Turnbull quoted in Brown's Britain, Robert Peston, 2005.