Introduction

1 This introduction serves two purposes:

- it is a guide to Government policy on EMU and the five economic tests (listed in Box 1) and sets the scene for the assessment. The EMU study *The five tests framework* provides a much fuller account; and
- it highlights the key analytical themes which form the backbone of the assessment, through a detailed exercise re-evaluating the UK decision in 1997 not to join EMU in 1999 and the important lessons that can be drawn from that decision.

GOVERNMENT POLICY ON EMU AND THE FIVE ECONOMIC TESTS

Government policy on EMU…

2 Government policy on EMU was originally set out by the Chancellor of the Exchequer in his statement to Parliament in October 1997 and is updated in the Government statement and decision on EMU membership, based on this assessment of the five economic tests.[1]

3 EMU stands for Economic and Monetary Union. Membership of EMU would mean that the UK would adopt the euro as its currency and UK interest rates would be set by the European Central Bank (ECB), on the basis of economic conditions in the euro area as a whole. The Government's decision on EMU membership reflects what it believes is best for the long-term economic interests of the British people and the performance of the UK economy.

Box 1: The five economic tests

- **Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?**
- **If problems emerge is there sufficient flexibility to deal with them?**
- **Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?**
- **What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?**
- **In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?**

…is founded on four key building blocks

4 When in 1997 the Government committed the UK to the principle of joining the single currency, the Chancellor stated that Government policy towards EMU is founded on four key building blocks:

- first, a successful single currency within a single European market would in principle be of **benefit** to Europe and to the UK: in terms of trade, transparency of costs and currency stability;
- second, the **constitutional** issue is a factor in the UK's decision but it is not an overriding one, so long as membership is in the national interest, the case is clear and unambiguous and there is popular consent;
- third, the basis for the decision as to whether there is a **clear and unambiguous** economic case for membership is the Treasury's comprehensive and rigorous assessment of the five economic tests; and

[1] All available on the HM Treasury website at www.hm-treasury.gov.uk.

- fourth, whenever the decision to enter is taken by the Government, it should be put to a **referendum** of the British people.

EMU in a global setting

5 EMU's development and the Government's policy towards it reflect global trends which are shaping economic policy worldwide. Globalisation is moving the world towards greater integration through increased trade and investment. More and more countries are joining the international trading system, adopting World Trade Organisation free trade principles and looking to secure the benefits of trade free from legal, regulatory and economic obstacles. At the same time, global investment flows have increased significantly in the last 50 years, and particularly in the last decade.

6 Economic theory and evidence show conclusively that increases in trade and investment encourage competition and raise incomes and welfare. This is why the Government strongly supports economic integration at the global, regional and national level through its strong and constructive commitment to the EU.

7 The stronger integration brought by globalisation also brings added uncertainty. Changes in economic circumstances (shocks) in one sector, region or country are now transmitted more rapidly around the world economic system. This puts increased demands on the world's economies and the people and technologies which are the foundation of their success. To be successful in achieving high growth, employment and social inclusion, everyone who plays a role in the economy has to be adaptable both to shorter-term developments and longer-term change.

8 A world characterised by constant economic change and increasing uncertainty would not be good for growth, investment and jobs without the additional safeguard of stability. Stability anchors expectations and allows individuals and companies to plan ahead with confidence. Across the global economic system, there is a growing commitment to policies designed to deliver stability, and increasing evidence and recognition that this is best achieved through frameworks based on clear principles and objectives.

The UK in Europe

9 This is particularly the case across Europe, where there is increasingly a shared commitment to economic stability combined with wide-ranging economic reform designed to achieve full employment, high living standards and social cohesion. With more than half the UK's trade with the EU and increasing integration of product, labour and capital markets, the UK's economic interest is best pursued through a deepening cooperation with other European countries as part of the Government's commitment to a strong EU and a successful EMU. As the Prime Minister said in November 2002:

> *"We should have more self-confidence because we are a leading European power, always have been and always will be."*[2]

The Government's objectives…

10 These global and European trends are mirrored in the Government's central economic objective for the UK to build a stronger, more enterprising economy and a fairer society, extending economic opportunity and supporting those most in need to ensure that rising national prosperity is shared by all.

…and strategy

11 Stability, productivity and employment opportunity are the foundations of the Government's economic strategy. Since 1997, the Government has taken tough decisions and introduced wide-ranging reforms to establish a platform of economic stability and to promote work and enterprise, tackle poverty and deliver sustained investment to modernise public services. The Government's decision on UK membership of the single currency must contribute to these objectives and this strategy.

[2] '*A clear course for Europe*', speech by the Prime Minister, 28 November 2002.

The implications of EMU

12 The key implications of a decision to join EMU are set out in Box 2. EMU membership would mean significant changes to the operation of UK macroeconomic policy. The exchange rate between sterling and the euro would be fixed irrevocably and the euro would become the UK's national currency. The UK would be subject to the single interest rate set by the ECB for the euro area as a whole. And the UK would be required to comply fully with the terms of the EU's Stability and Growth Pact (SGP).

Box 2: The implications of EMU

The 12 Member States of the European Union[a] which have joined EMU have replaced their national currencies with the euro. The key implications for the countries of the euro area are:

- **nominal exchange rates between these countries are fixed irrevocably at the entry rate;**
- **there is a single official short-term interest rate which is set for the euro area as a whole by the ECB; and**
- **fiscal policy remains the responsibility of Member States subject to the requirement to avoid excessive deficits and comply fully with the terms of the SGP.**

If the UK were to join EMU then the key implications would be:

- **sterling would be replaced by the euro as the UK's national currency. The UK would no longer have a floating nominal exchange rate with other members of the euro area. The level of the euro would determine the UK's exchange rate with non-euro area countries, which would continue to move;**
- **official short-term interest rates would be the same in the UK as in the euro area and set by the ECB; and**
- **the UK Government and Parliament would remain responsible for fiscal policy, subject to the full terms of the SGP for EMU members.**

Adoption of the euro as the UK's national currency would therefore entail important economic and institutional changes, both in terms of the frameworks for the operation of monetary and fiscal policy and the coordination of economic policies more generally. This is discussed in detail in the EMU study *Policy frameworks in the UK and EMU*.

It is also important to emphasise that EMU is not static. Sweden will have a referendum on membership in September 2003 and the imminent enlargement of the EU will increase by ten the number of prospective members of EMU.

The E in EMU

EMU stands for Economic and Monetary Union. Many of the potential benefits associated with a common currency depend on well-functioning and integrated product, labour and capital markets. The EU Single Market Programme has been a key driver towards delivering a more dynamic and open Europe and is further advanced by the ten-year European Economic Reform strategy launched at the Lisbon European Council in 2000.[b]

[a] The current 12 members of the euro area are: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Eleven members joined on 1 January 1999 while Greece joined on 1 January 2001.

[b] For an update see *Meeting the Challenge: Economic Reform in Europe*, HM Treasury, February 2003.

A long-term approach

13 The development of the UK economy since 1997 following the introduction of the Government's monetary and fiscal policy frameworks shows how stability has provided a foundation for a long-term improvement in the UK's economic performance.[3] The economy has grown steadily with low and stable inflation and rising levels of employment. This demonstrates why the Government's decision on EMU membership focuses on what is right for the UK economy in the long term. A long-term approach is necessary because of the distinctive nature of the UK economy – a large economy in the EU with a global outlook – and the stop-go nature of the UK's economic history. The EC Treaty convergence criteria, which were the basis for the decisions on membership of other EU Member States, are not a sufficient basis for assessing the case for UK entry. The EC Treaty convergence criteria are a key input into the process at the EU level whereby the Council decides whether countries have met the *'necessary conditions'* to join EMU and are embodied in the assessment of cyclical convergence, as part of the convergence test.

The five economic tests…

14 The Government's five economic tests for UK membership of EMU cover convergence, flexibility, investment, financial services, and growth, stability and employment.

…define whether a clear and unambiguous case can be made

15 The five economic tests define whether a clear and unambiguous case for UK membership of EMU can be made. This sets a demanding standard, reflecting the long-term importance of the decision. The Government believes that to aim lower would fail to take full account of the particular nature and policy history of the UK economy, the irreversible nature of the decision and the constitutional issues which it raises. As the Chancellor said in his 2002 Mansion House speech:[4]

> *"The case for the five economic tests is not just that we must avoid the economic policy mistakes of the past but, when the decision is not just momentous but irreversible, affecting every industry and all people, that the national economic interest – full employment, high and sustainable levels of investment and growth, long term prosperity – is, and should be seen to be, the decisive factor."*

The comprehensive and rigorous approach…

16 To ensure that the assessment can support a decision of this importance, the Chancellor also said in this speech that: *"the assessment will be the most robust, rigorous and comprehensive work the Treasury has ever done"*. To this end, extensive use has been made of the latest analytical modelling techniques and approaches and the latest economic literature, which has been influential in shaping the Treasury's analysis of the key issues. Annex A describes the use of economic models in the assessment. A major development since the 1997 assessment is that it is now possible to examine and analyse the experiences of the countries which have adopted the euro since 1999, enhancing the evidence base and the understanding of the operation of EMU.

…an assessment and 18 studies

17 The assessment of the five economic tests is the work of the Treasury. 18 EMU studies are published alongside the assessment and inform it. Experts from outside the Treasury have produced four of the studies, developing new work in key areas. Other outside experts have assisted the Treasury, in a consultancy capacity, on the studies and provided new insights on previous academic work, as collected together in the EMU study *Submissions on EMU from leading academics*. Annex B lists those outside experts who have assisted in various ways with the preliminary and technical work.

[3] Details are set out in *Reforming Britain's Economic Policy: Towards Greater Economic Stability,* HM Treasury, 2002.

[4] Mansion House Speech by the Chancellor of the Exchequer, 26 June 2002.

Costs and benefits

18 The economic theory underlying the five tests was originated by Professor Robert Mundell, one of the contributors to the EMU study *Submissions on EMU from leading academics*. The basic insight of the theory is that membership of EMU brings potential costs and benefits, or *'pros and cons'* as Professor David Currie described them in his 1997 publication for HM Treasury.[5]

19 These costs and benefits reflect the broader drivers of global economic change:

- the **costs** relate to the loss of monetary policy as a domestic instrument to achieve stability and the loss of the potential adjustment mechanism of the nominal exchange rate to help maintain stability. The means of minimising these costs is through convergence in economic performance – so that interest rates set for the single currency area as a whole are appropriate for individual members – and through having the flexibility to adjust to divergence and to change. These issues are addressed by the convergence and flexibility tests; and
- the gains come from the **benefits** of increased integration, enhancing competition, productivity and growth. The means of maximising these gains is through having a monetary union that covers as large an area as possible, made up of countries which are already close economic partners and which have joined on a sustainable basis. These issues are addressed in the investment, financial services and growth, stability and employment tests. To the extent that the nominal exchange rate can generate instability, then joining EMU would be of benefit, an issue addressed in the convergence test.

Convergence test

20 The convergence test asks: *Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?* The test goes to the heart of what EMU entails. For a single interest rate to be suitable across the whole single currency area, it requires the regions and countries of the area to have economies which are compatible in terms of how they evolve and develop.

21 The structures which make up the different sectors and parts of an economy are always evolving and changing, as economies are hit by shocks and their effects. The convergence test assesses the likelihood that the UK and the euro area will be prone to different shocks or to different responses to common shocks.

22 Shocks can benefit the economy. For example, discoveries of primary products such as oil or sudden advances in technology can improve productive efficiency. Other shocks can have less benign effects, such as a sudden shift in consumer demand away from the output of an industry or a fall in equity markets which reduces demand through its effect on wealth. Any changes in circumstances, particularly if negative, require rapid changes to reallocate resources and maintain high and stable levels of growth and employment across the economy.

23 Economic policies can be a source of shocks, either for the good if they stabilise the economy or improve its performance, or for the bad if they reduce stability or worsen economic performance.

[5] *The pros and cons of EMU*, publication for HM Treasury by Professor David Currie, July 1997.

24 As the Chancellor stressed in his October 1997 statement, convergence must be achieved: *"which is sustainable and settled rather than transitory"*. This means that convergence has to be shown:

- to be *settled* on the basis of an analysis of past history and current conditions, not just at a point in time; and
- to be *sustainable* to ensure the economy can withstand changes or developments which, while uncertain, will inevitably occur in the future.

Flexibility test

25 The flexibility test asks: *If problems emerge is there sufficient flexibility to deal with them?* Flexibility is about the resilience of the economy; its ability to respond to change quickly and at the minimum cost in terms of disruption. So the level of flexibility determines the durability of convergence.

26 Crucially, flexibility focuses on the remaining adjustment mechanisms which exist to deal with any problems that emerge from changing circumstances caused by shocks or the responses to them.[6]

27 In practice there are many different ways that workers and firms can adjust to economic change. For the worker, adjustment may require having to accept a lower wage increase, moving into a different job in the same firm or even changing employer. For firms, adjustment may involve adjusting prices or changing a product line in response to changing market conditions. Flexibility is all about minimising the costs of adjustment.

28 All of these facets of flexibility are being demonstrated all of the time, in response to change in the economy. But because of the loss of the domestic interest rate and of nominal exchange rate flexibility with the euro area, as a consequence of EMU membership, it becomes even more important to be able to adapt to changing economic circumstances in EMU.

Practical tests

29 The convergence and flexibility tests are practical tests to inform the decision on EMU membership:

- the convergence test requires structures and cycles between the UK and the euro area to be *compatible*; and
- the flexibility test asks whether there is *sufficient* flexibility to cope with problems resulting from changes in economic circumstances.

30 It is therefore important to analyse existing monetary unions to gauge the extent of compatibility and sufficiency that is needed. Economic cycles and structures within a monetary union will never be perfectly compatible, as the long histories of the United States (US) and UK show, and as the emerging evidence from the euro area demonstrates. But as the evidence also indicates, and as now recognised throughout the EU, to make a sustained success of EMU requires a high degree of flexibility.

Sustainable and durable convergence…

31 Together the assessment of the convergence and flexibility tests determines whether sustainable and durable convergence has been achieved. The 1997 assessment[7] concluded that:

> *"…we need to demonstrate sustainable and durable convergence before we can be sure that British membership of EMU would be good for growth and jobs. Joining before such convergence is secured would risk harming both."*

[6] See *'The Road to Full Employment: Economic Reforms for a More Flexible and Dynamic Britain and Europe'*, speech by the Chancellor of the Exchequer to the Centre for European Reform, 10 March 2003.

[7] *UK membership of the single currency, an assessment of the five economic tests*, HM Treasury, October 1997.

…is the precondition for successful UK membership of EMU

32 Sustainable and durable convergence is the key precondition[8] for successful UK membership of EMU, to ensure that the potentially significant gains from further integration can be realised.

33 If US states (or UK regions or countries) had separate currencies, overall incomes and output would be lower. Even in a world of increasingly free trade between countries, separate currencies remain a barrier. The euro removes this barrier across an economic area the size of the US and complements the EU Single Market Programme aimed at eliminating the remaining barriers to trade in goods, services and capital. If macroeconomic stability is safeguarded, membership of EMU should:

- stimulate investment through limiting uncertainty, reducing the cost of capital and encouraging cross-border investment;
- boost UK financial services activity; and
- stimulate trade which, with higher cross-border investment, should enhance competition and increase productivity and output.

Investment test

34 The investment test asks: *Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?* Economic theory and empirical evidence both show that investment in capital is a key driver of productivity, growth and overall economic performance. As a result of decades of under-investment, the UK is significantly less capital-intensive than its major competitors, contributing to the productivity gap with them.

35 The Government's strategy for closing the productivity gap has two broad strands: ensuring and safeguarding macroeconomic stability to help businesses and individuals plan for the future; and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently. These microeconomic reforms include encouraging investment to improve the UK's stock of physical capital in every sector and industry.

36 It is important that the EMU decision contributes to the Government's strategy for encouraging investment. The investment test considers the potential impact of EMU on total business investment, including foreign direct investment (FDI) into the UK. FDI plays an important role in the UK economy and could be particularly affected by the EMU decision.

Financial services test

37 The financial services test asks: *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 UK has a significant comparative advantage in wholesale financial services and, on most measures, the City is by some distance the pre-eminent financial centre in Europe.

38 A number of factors make the UK an attractive place for the financial services industry to locate, such as a favourable tax and regulatory environment, a large pool of skilled labour and large and liquid capital markets. Given the importance of the financial services sector to the UK, both in terms of employment and invisible earnings, it is vital that the decision on whether to join the single currency enhances the sector's competitiveness.

39 Reflecting the dynamic nature of the financial services sector, the assessment includes a detailed analysis of the changes which have occurred in the sector since the advent of the euro in 1999.

[8] The 1997 assessment said: *"Sustainable and durable convergence is the touchstone and without it we cannot reap the benefits of a successful EMU."*

Growth, stability and employment test

40 The growth, stability and employment test asks: *In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?* This test considers the critical overall question of whether joining EMU would enhance the prospect of meeting the Government's central economic objective of high and stable levels of growth and employment delivered from a platform of long-term economic stability.

41 Growth, stability and employment are of central importance to the living standards of everyone in the UK. High levels of economic growth foster greater innovation and increase wealth. High levels of employment mean that more of the population is able to share in this wealth. High levels of stability mean that the economy is no longer subject to damaging fluctuations that create uncertainty and hinder long-term planning.

42 The growth, stability and employment test examines the potential impact of EMU on UK trade, competition, productivity and growth. It examines how EMU would affect UK employment both in the short and long term. It also considers how the EMU macroeconomic framework would affect UK economic stability.

Costs and benefits

43 It is important that the decision on whether to join EMU focuses on both the potential costs and benefits of joining at the present time. The potential benefits of membership have to be considered alongside an assessment of whether there is sustainable and durable convergence to enable the potential benefits to be secured.

44 The Treasury's 1997 assessment concluded that the UK was not convergent with the prospective euro area, that flexibility was insufficient and that the lack of sustainable and durable convergence meant that the risks of membership were such that the UK would not be in a position for some time to reap the potential benefits of EMU in terms of higher investment, growth and jobs.

LESSONS FROM THE PAST AND KEY THEMES FOR THE ASSESSMENT

'What if' the UK had joined EMU in 1999?

45 To highlight the key themes which form the analytical backbone of the assessment, a stylised exercise has been conducted re-evaluating the 1997 assessment conclusions and EMU decision by considering 'what if' the UK economy had joined EMU in 1999, at the same time as the 11 'first wave' members (see Box 3).

Box 3: Modelling 'what if' the UK had joined EMU in 1999

The results of this type of modelling exercise require careful interpretation and, as with all 'what if' exercises, should be regarded as indicative rather than exact. Over and above the usual uncertainties, and in the context of the lessons drawn, they do not allow for any offsetting policy action from fiscal policy, nor do they reflect an explicit judgement on the sustainable exchange rate, except to the extent that one is embodied in the adopted forecast baseline. Nor can modelling incorporate the potential benefits from increased trade, competition and employment.

46 Chart 1 illustrates the paths of six key economic and policy variables over the period from 1998 to 2006. Each panel plots two lines; the lighter one shows the actual and projected path of economic and policy variables outside EMU, while the darker line plots the possible evolution of these variables if the UK had joined EMU in 1999 on the terms assumed.[9]

47 Some commentators have suggested that joining EMU in 1999 would have had only limited, and transitory, adverse effects on UK output, inflation and employment. The results of this exercise and the lessons they provide demonstrate that such a view seriously underestimates the important economic issues raised by EMU membership in 1997 and again today. On the assumptions used in the stylised model, reducing UK interest rates by nearly 4 percentage points to euro area levels and fixing the nominal exchange rate at the 1.46 €/£ prevailing on 1 January 1999 would have destabilised UK demand and the wider economy. There would have been significant risks in the short term which could well have persisted into the medium to long term.

48 In the short to medium term, the five years up to the end of 2002, the main effects implied by this exercise are:

- output growth could potentially have been over 2 percentage points higher during 2000, at $5^1/_2$ per cent, particularly benefiting the traded goods and manufacturing sectors. But this would have been followed by growth which was $1^1/_2$ percentage points lower at the end of 2002 ($^3/_4$ per cent compared to $2^1/_4$ per cent) and which remained significantly lower into the medium term;

- inflation would have been predicted to increase, reaching $4^1/_2$ per cent at the end of 2000. Perhaps more realistically, capacity constraints would have prevented growth from rising to the extent shown or the feed-through from consumption to inflation would have been greater. In this case, inflation would have risen by even more, requiring a larger fall in output with the risk of tipping the economy into recession;

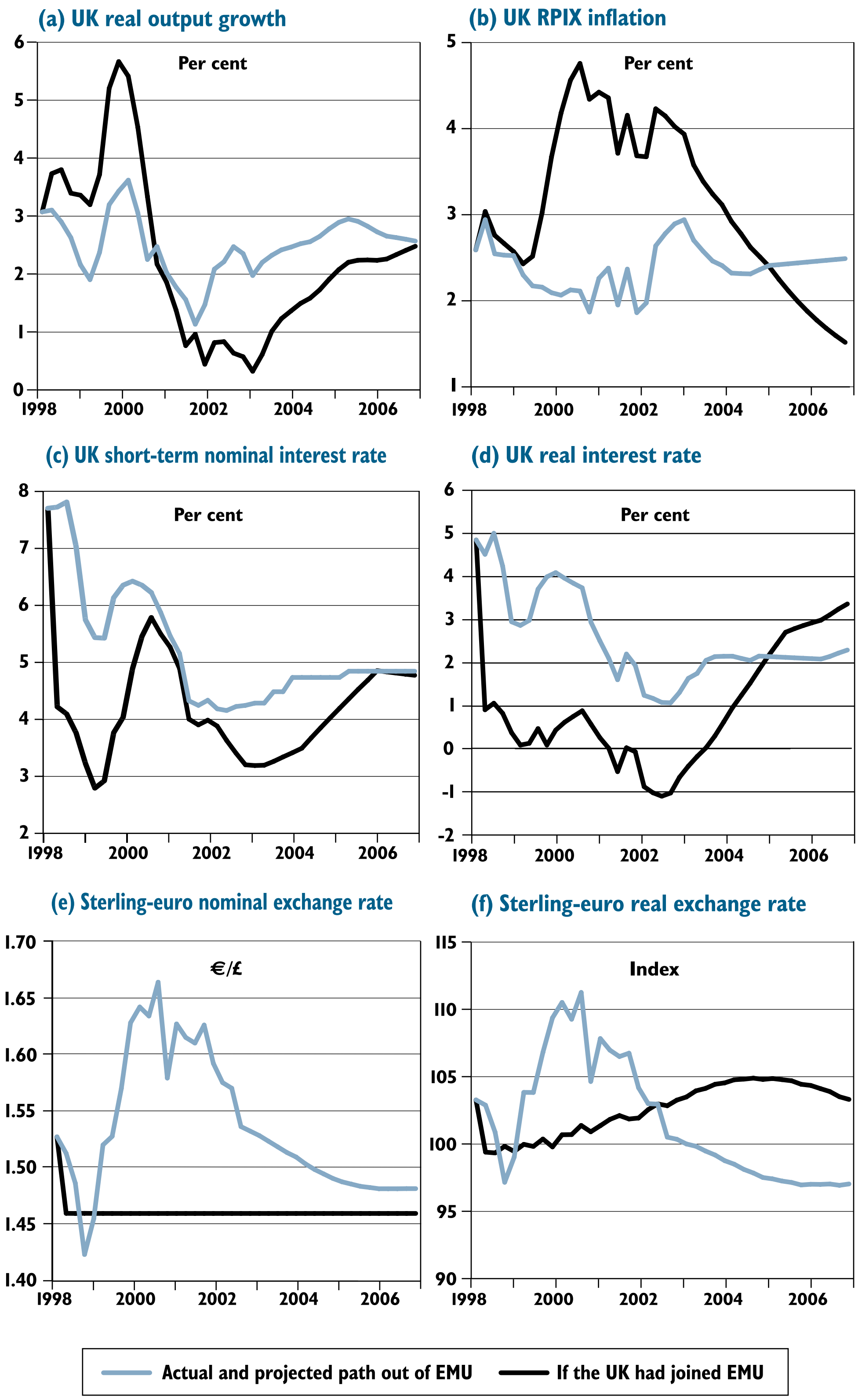
- the rise in inflation would have implied much lower real interest rates than outside EMU, with real interest rates actually turning negative during 2001. This would have provided a further stimulus to the economy at a time when it was already growing strongly and actually requiring higher real interest rates to tighten monetary conditions; and

- with a fixed nominal exchange rate, the real exchange rate – the competitiveness of the economy – would have appreciated more slowly than it actually did.[10] This would have closed off much of the potential dampening effect of the exchange rate appreciation on inflation which actually occurred. Although if inflation had picked up more sharply than predicted by the model, the rate of adjustment would have been quicker.

[9] For the purposes of this modelling exercise, it is assumed that the UK announced on 1 May 1998 that it would join EMU in the first wave at the prevailing exchange rate on 1 January 1999 (1.46 €/£) and with interest rates as set by the ECB (with allowance made for how UK membership might have affected the ECB's actions through the assumed impact on euro area inflation). This exercise has been conducted on the National Institute for Economic and Social Research's NiGEM model, described in Annex A and in more detail in the EMU study *Modelling the transition to EMU*.

[10] The real exchange rate is the nominal exchange rate adjusted for differences in inflation rates at home and abroad. If trade prices are used to convert nominal rates, then the real exchange rate is equivalent to a measure of international or bilateral competitiveness. A rise in inflation at home relative to abroad equates to an appreciation in the real exchange rate which translates into a loss of competitiveness.

Chart 1: What if the UK had joined EMU in 1999: paths of key variables in and out of EMU



Source: EMU study Modelling the transition to EMU.

49 These effects would not have been short-lived and would have continued to have a real impact on growth and jobs in the economy over the longer-term horizon:

- output growth would have continued to fluctuate and only have begun to stabilise a decade after the decision to join (by 2007 in this exercise), with ongoing implications for stability and jobs;
- inflation would still be fluctuating to stabilise the economy, compensating for the absence of other adjustment mechanisms;
- real interest rates would remain more cyclical, staying negative until mid 2003; and
- given the movements in real interest rates, competitiveness – as measured by the real exchange rate – would have to take on more of the adjustment burden, appreciating over the medium term to help curb demand and so squeezing profitability and employment in the traded goods and manufacturing sectors in the long term.

50 As noted, this modelling exercise cannot incorporate the potential benefits from increased trade, competition or employment resulting from EMU membership.

The contrast with what actually happened…

51 Results such as these can seem abstract and unconnected to the real world. But it is very important that the real world consequences are understood. If the UK had joined EMU in 1999, it would not have remained on a path of stability. Instead, it would have repeated the economic policy mistakes of the past and suffered as a result. Instability would have damaged output and job prospects – possibly on a permanent basis – if, for example, long-term unemployment had risen sharply; an example of what is termed hysteresis or path dependency.

52 The results of this stylised simulation can be contrasted with the actual experience of the UK economy since the 1997 assessment. Over the past five and a half years, UK GDP growth has been close to its potential rate, inflation has been close to target and unemployment has fallen substantially. These favourable outcomes have been achieved with UK interest rates remaining consistently higher than those in the euro area and the sterling-euro exchange rate having strengthened significantly from its 1997 level.

…validates the 1997 assessment conclusions…

53 The comparison of the 'what if' findings with the actual path of the UK economy confirms the conclusion of the 1997 assessment that sustainable and durable convergence had not been achieved.[11] As a result of the decision taken then, the UK economy is now in a position of strength from which to assess the five economic tests again.

[11] If the UK had joined EMU in 1999, it would have made the operation of EMU more difficult; in particular, the task of the ECB in setting monetary policy via a single interest rate for the euro area as a whole.

...and provides key lessons for the 2003 assessment

54 As well as validating the 1997 assessment conclusions, this exercise establishes several key general lessons for this assessment of the five economic tests:

- **one-off economic events can have long-lasting economic consequences.** As already emphasised, shocks from outside the economy or the transition effects of a decision to join EMU in the wrong way or at the wrong time can have a long-lasting and potentially permanent adverse effect on the economy;

- **adjustment in EMU is different.** EMU membership puts particular demands on the economy. 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, especially as real interest rate movements can be destabilising inside EMU. These adjustment issues have to be resolved to minimise the impact on output and employment and ensure the economy can move onto the higher potential output path which is the prize of successful EMU membership;

- **flexibility is crucial.** A greater degree of market flexibility allows a faster reallocation of resources to contain and limit the costs of adjustment. Wage and price flexibility is particularly important, but functional flexibility through skills, geographic flexibility through employment mobility and risk sharing through capital markets all play a valuable role. In principle, with perfect flexibility, there would be no adverse effects on jobs and output either in the transition to EMU membership or in the longer term inside EMU. In practice, the degree of flexibility was not sufficient in 1997 and the crucial lesson is that it needs to be high to make a sustained success of EMU membership for the UK;

- **EMU would have distributional consequences.** Joining EMU or maintaining the current position outside EMU would have different distributional consequences. If the UK had joined in 1999, exporters to the euro area would have benefited from nominal exchange rate stability with the euro area in the short term. But they and everyone else in the economy – homeowners, savers and investors – would have had to contend with greater economic instability which would have prevented the potential benefits of membership from being realised in the medium term;

- **whatever the decision on membership, there are policy implications.** For example, encouraging more effective microeconomic market adjustment mechanisms to develop and the potential for an enhanced role for fiscal policy in adjustment at the macroeconomic level. These would serve as additional insurance against the risks inherent in EMU. Since 1997, the Government has undertaken an extensive programme of policy reforms to secure economic stability and increase productivity and employment. Budget 2003 set out the Government's policy reform agenda. A further wide-ranging macroeconomic and microeconomic policy agenda which is in the long-term economic interest of the UK economy is described in the assessment;

- **EMU now means a real choice between policy frameworks.** In 1997, the new UK macroeconomic framework was only just being established and the EMU framework had not been set up, so this was not a practical issue. Now that the UK has established a track record for delivering macroeconomic stability and sound public finances on the basis of a framework which has symmetry at its heart, the choice between the two potential routes to stability open to the UK economy is important;

- **the past may not be a good guide to the future.** These findings are open to the criticism that they are not forward looking. Hence the importance of examining the performance of the euro area in practice and also the experience and operation of long-standing monetary unions such as the US and UK to evaluate how EMU might develop. A particular issue highlighted by many is the possibility of convergence after entry or *endogenous convergence*. This contrasts with convergence prior to entry;[12]

- **uncertainties must be factored in.** The requirement that the case for UK membership must be clear and unambiguous means that uncertainties such as those relating to the sustainable level of the sterling-euro exchange rate must be fully analysed and their implications understood and factored into the assessment. The degree of uncertainty has a particular bearing on the option of joining at a later date, both to allow for the necessary convergence and to learn more about these uncertainties;

- **EMU's performance matters.** While the lessons apply primarily to the UK assessment and decision on EMU, they are also relevant to the countries which have already joined EMU and the different growth and inflation outcomes they have experienced. The emphasis put on the performance of EMU at the time of the 1997 decision still applies; and

- **the importance of the potential benefits of EMU.** As noted, the 'what if' analysis is not designed to capture the potential dynamic benefits of membership of a successful EMU. The experience of EMU to date sheds significant light on these. As Professor Jacques Mélitz stresses in his contribution to the EMU study *Submissions on EMU from leading academics: "both the economic benefits and the economic costs of entry* [are] *higher than they seemed only a while back"*.

The right decision for the UK

55 The assessment draws on these lessons and provides a sound basis for the Government to make the right decision on EMU membership in the UK's long-term economic interests.

[12] Professor Peter Kenen emphasises this distinction in his contribution to the EMU study *Submissions on EMU from leading academics*.