EMU and business sectors

EMU study

HM TREASURY

Executive Summary

Key issue: EMU and business sectors

1 A key consideration in determining whether it would be in the UK's economic interest to join Economic and Monetary Union (EMU) is the impact of membership on UK business sectors. To what extent might EMU entry help, hinder or reshape the UK's industrial performance, and how might this impact be distributed across different UK industries and over different time periods?

2 Entry into EMU would offer UK industry potential opportunities as well as challenges. The removal of the exchange rate between the UK and the euro area would reduce a barrier to doing business across a huge market. As a result, cross-border trade and investment between the UK and the euro area could rise. Over time, the level of competition in EU industry and markets might increase. Strong, competitive business sectors would prosper and find new opportunities to expand; weaker industries, however, would have to adapt to an environment of increased competition.

3 EMU entry would also have important macroeconomic implications for UK industry. The loss of an independent monetary policy and nominal exchange rate flexibility would fundamentally alter the way in which the UK economy adjusts to economic change and unexpected disturbances. Much of this adjustment would take place through changes in the industrial environment.

4 While this study takes into account these macroeconomic issues and their potentially important consequences for business sectors, its focus is on the microeconomic implications of EMU entry for UK business sectors. A standard result of economic theory is that the removal of a barrier to cross-border transactions usually enhances economic welfare. This means that the emphasis of this study is on the potential benefits of EMU. It is, however, important to recognise that these potential benefits would not be realised unless the UK had joined EMU on the basis of sustainable and durable convergence. If this were not achieved because, for example, the transition to membership required a significant change in the exchange rate or the interest rate, or because economic structures in the UK and the euro area were different, then EMU entry could lead to increased macroeconomic instability and, over the longer term, potentially lower output and employment.

5 The study addresses five key questions:

- how do UK and EU industrial structures compare?
- what is the right framework for thinking about the potential microeconomic impact of EMU over the short, medium and long term?
- what has been EMU's impact to date on cross-border sectoral trade and investment; what is the potential effect on foreign direct investment (FDI) in particular, and what does this imply for the medium term?
- is there longer-term evidence that EMU may lead to increased competition or affect specialisation and concentration, and what does this imply for the incidence of shocks?
- in the future, what can be said about the way in which EMU might affect different industries, depending on specific sectoral characteristics?

6 The baseline, or counterfactual, for this study – as for the other EMU studies and for the five tests assessment – is that, outside EMU, the UK would be a full and active member of the EU. This means that UK industry would have full access to the Single Market in goods and services and to EU capital markets, both now and in the future in an enlarged EU.

7 The analysis in this study informs the investment test and the growth, stability and jobs test – the third and fifth of the Government's five economic tests for EMU entry. It also complements the analysis in several of the EMU studies by HM Treasury which focus on the potential microeconomic impact of EMU, such as *EMU and trade, Prices and EMU* and *EMU and the cost of capital*. The potential costs of adjustment in EMU are the subject of the EMU studies *Modelling shocks and adjustment mechanisms in EMU* and *The exchange rate and macroeconomic adjustment*.

The context: UK and EU industry structures

8 When addressing these issues, it is important to understand how the UK's industrial structure compares with that of countries in the euro area:

- the UK displays **similarities** in a number of respects. Manufacturing in both the UK and the rest of the EU has declined in relative importance and services have increased. Germany remains an outlier insofar as its manufacturing sector is still relatively large. UK trade with non-EU regions has fallen markedly over time as a proportion of total trade, and integration in goods trade with the EU is now comparable with Germany and other large EU countries; but

- there remain important **differences**. Services account for a higher proportion of total trade in the UK, due in part to the more prominent UK financial services sector. Although some countries have begun to catch up in recent years, the UK has historically received larger amounts of FDI than other EU countries, especially from the US, and continued to do so in 2001.

9 These similarities and differences would play an important role in determining the impact of EMU on UK business sectors. For example, the UK's relatively large service sector and its high level of service sector trade with non-EU countries may mean the UK has a different response to an EU-wide shock.

EMU's impact in theory

10 The analysis of how the single currency might affect the supply-side conditions faced by UK business sectors is set within a dynamic framework of immediate, short to medium-term and longer-term effects:

- **immediate effects**. The immediate impacts of joining a single currency include the removal of currency conversion costs, reduced exchange rate volatility within the euro area, greater price transparency and the introduction of one-off changeover costs;

- **short to medium-term effects**. Stemming from the entry effects, these are potentially increased cross-border trade, potentially increased investment and changes to the mechanisms for economic adjustment; and

- **longer-term effects**. Over the longer term, EMU could potentially promote competition and influence trends in concentration and specialisation.

The evidence on short to medium-term effects

11 The operation of EMU to date provides a narrow but informative evidence base on the potential short to medium-term effects of EMU on cross-border trade and investment, and in particular on FDI. Positive effects on **cross-border trade** at an aggregate level are broadly confirmed by analysis at a sectoral level. Data on **cross-border investment** seem to suggest significant changes in investment flows in recent years. There is evidence that the UK's share of inward investment from outside the EU has fallen relative to other EU members since the introduction of EMU. This must, however, be considered against a backdrop of factors such as the rapid global increase in FDI over the late 1990s, largely driven by increased merger and acquisition activity, and the sharp fall since 2000, as well as the UK's leading position within Europe in terms of inward investment. It is difficult to detect with any confidence a specific EMU effect.

The evidence on longer-term effects

12 A look back over recent decades leads to the following conclusions about the potential longer-term impact of EMU:

- the Single Market Programme (SMP) and US experience highlight increased **competition** as a key potential long-term implication of EMU. The SMP appears to have promoted price convergence through the 1990s. There is as yet little to indicate an additional EMU effect on competition over and above other effects;
- evidence drawn from the experiences of the US and the EU over recent decades implies that EMU will promote greater **specialisation**. However, as the EU remains less specialised than the US, it should be less vulnerable to asymmetric shocks stemming from industrial structure; and
- the evidence is inconclusive on geographical **concentration**, with manufacturing exhibiting strong sectoral variations. At the level of the overall economy, however, the expansion of the more dispersed services sector exerts a dampening influence on geographical concentration.

Different impacts on different industries

13 The nature and intensity of the effect of EMU on individual sectors and, therefore, on UK business if the UK were to join would vary with a range of different characteristics.

14 Sectors which are highly **open** or **exchange rate sensitive** (for example, tourism) would be more affected by EMU than those which have smaller trading propensities, though the impact would vary depending on whether exposure or sensitivity was primarily to euro area or non-euro area currencies (machinery and equipment, and electrical and optical products are, for example, sensitive to both exchange rate volatility and US dollar-based competition).

15 The impact of EMU membership would be influenced by **pricing behaviour**. EMU would be most likely to facilitate price convergence in sectors where products are differentiated, where prices are outside the range of large euro area members or where markets are not segmented by national preference or regulation. EMU would be unlikely to facilitate price convergence in sectors producing commodity goods (for example, steel), where prices are within the range of large euro area members (for example, food), which are segmented by national preference or regulation (for example, cars), or which have strong branding (for example, sports clothing).

16 Different **market structures** imply different EMU impacts. Sectors where acquisition potential is high, or where customer arbitrage is feasible (for example, travel), would tend to be more affected. Sectors segmented by national tastes (for example, domestic electrical appliances), in which undifferentiated products are sold in a global marketplace (for example, steel) or where sunk costs are determined in part at a firm level (for example, R&D and advertising intensive sectors such as pharmaceuticals) would be less affected.

17 **Firm size** is an important characteristic. While the absolute cost savings generated by EMU would be greater for large firms, the benefits (and the increase in competition) would be relatively pronounced in sectors characterised by smaller firms (for example, the manufacturers of car components rather than finished cars). More integrated product and capital markets may, at the same time, facilitate the development of multinational enterprises.

18 In terms of **finance and ownership,** enhanced capital market competition and integration would have a clear effect on sectors in which firms make extensive use of external funding (for example, telecommunications), operate in relatively new or specialised fields (for example, biotechnology), are able to absorb FDI (for example, machinery and equipment), form strategic alliances (for example, pharmaceuticals) or have separate managerial control and ownership.

19 To the extent that the loss of an independent monetary policy implies greater **volatility of demand**, there may be a greater impact on sectors which have highly cyclical demand (e.g. consumer durables) or which find cyclicality to be particularly damaging (for example, commodity chemicals).

Conclusions

20 A fully quantified cost-benefit analysis of the potential impact of EMU entry on individual UK business sectors is not feasible, for reasons of data availability, reliability and complexity. Nevertheless, a combination of theory, evidence, history and comparison allows an informed judgement to be reached as to the potential dynamic consequences of EMU membership for the UK industrial base, and the possible implications for different industry sectors. The effect of membership of EMU would have to be gauged relative to a changing and evolving EU industrial landscape. The push to complete the Single Market in goods and services and further integration of capital markets are key elements of this change. Against this backdrop, several conclusions can be drawn:

- the potential increase in competitive pressure generated by membership of EMU could occur through both product and capital markets. While open and exchange rate sensitive industries would feel the impact of EMU most directly, all sectors and firms – however domestic their focus – would be affected by improved access to capital which facilitated expansion and restructuring;
- increased competition would be of particular benefit in many service sectors which have, to date, been less exposed to the effects of the Single Market than the goods sector. Greater competition and openness would help to raise productivity (especially important in services which affect business competitiveness such as distribution or business services) and deliver substantial benefits to consumers;
- by removing a currency barrier to trade, and potentially improving access to funding, EMU membership should be of disproportionate benefit to small and medium-sized enterprises (albeit less so to micro-enterprises); and
- at the opposite end of the size spectrum, EMU could also facilitate the development of multinational enterprises. This could help to raise aggregate productivity.

21 The potential increase in competition, trade and cross-border investment facilitated by EMU will help shape the euro area's industrial base and influence in the process the industrial structures of euro area trading partners and competitors. Irrespective of the UK's EMU decision, UK industries cannot avoid being affected by the euro, though the quantitative and qualitative effects and the adjustment costs will clearly differ. Inside or outside of EMU, its existence places an increased premium on the flexibility and resilience of UK firms, business sectors and the economy as a whole.

22 Whether or not the UK joins EMU, the Government is committed to creating the best possible environment for enterprise and investment across all UK regions, sectors and industries. This is important for the Government's long-term economic goal of closing the productivity gap which exists between the UK and its major competitors. In an EU context, the Government is committed to the economic reform strategy agreed by EU Heads of Government or State at Lisbon in March 2000. The Government's vision is of a dynamic, job-creating EU characterised by full employment, high living standards and social cohesion. Challenging reforms of labour, product and capital markets are needed to achieve this goal.[1]

23 The conclusions of this study are based on the assumption that if the UK were to join EMU, it would do so on the basis of sustainable and durable convergence. If this were not the case, UK business sectors would be faced with an environment of greater macroeconomic instability and, over the longer term, potentially lower output and employment than would otherwise be the case. These issues are considered further in the assessment of the five economic tests for EMU entry.

[1] See *Meeting the Challenge: Economic Reform in Europe* (HM Treasury, 2003) for full details.