

# GLOSSARY

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- Adjustment mechanisms** The ways in which an economy responds to changing economic circumstances.
- Asymmetric shock** See **country-specific shock**.
- Automatic stabilisers** Those elements of the tax and spending regime that automatically tend to stabilise the economy. For example, during an upturn, unemployment benefit payments will tend to fall and tax receipts to rise, dampening the economic cycle.
- Basis points** Used to measure differences in rates that are expressed in percentage terms, such as official interest rates. 100 basis points make up 1 percentage point.
- Broad Economic Policy Guidelines (BEPGs)** A document agreed by the **European Council** and formally adopted by **ECOFIN** which contains non-binding recommendations to Member States on both fiscal and structural policies. The BEPGs, provided for under the **EC Treaty**, are the key instrument for economic policy coordination in the EU.
- Business cycle** The fluctuation in the level of national income around its trend. The business cycle is a well-observed economic phenomenon, though it has a variable time span.
- The City** A descriptive rather than geographical term, which includes all financial market activity in Greater London and not just that in the City of London or Square Mile. Used interchangeably with 'London'.
- Coefficient of variation** A measure of the degree of variation in a set of data. The lower its value the closer are the individual data to the overall average of the set.
- Comparative advantage** A country or region has a comparative advantage in the production of those goods and services in which its relative efficiency is greatest. Comparative advantage matters because a country or region can maximise its consumption of goods and services by concentrating its resources in the production of goods and services in which it has a comparative advantage, and trading its surplus production with those countries or regions which specialise in the production of goods and services in which they have a comparative advantage.
- Consolidation** The **merger** of two or more firms into a new company. The new company absorbs the firms' assets and liabilities.
- Constrained discretion** A principle which applies to the situation in which policymakers have some freedom (discretion) to vary policy instruments, such as taxes or interest rates, but within well-defined limits (constraints). A well-designed policy framework gives policymakers sufficient freedom to respond flexibly to **shocks** and sufficient constraints to ensure that they do not exercise their discretion in a way that could undermine the long-term stability of the economy.
- Correlation coefficient** A measurement of the strength of a correlation between two variables. The more correlated variables are, the more they will change together systematically.
- Cost of capital** The cost of the funds used to finance investment. Firms generally raise finance for investment through either internal finance (reinvesting profits) or external finance (issuing debt or equity). The cost of external finance for a firm is given by the weighted average of the firm's costs of debt and equity.
- Country-specific shock** An economic disturbance or '**shock**' whose impact is significantly stronger in one country than in others.

- Credit risk** The risk that a borrower will default on debt repayments.
- Discretionary fiscal policy** Discrete changes in tax and public spending over and above what would result from the impact of the economic cycle through the operation of the **automatic stabilisers**. This can include fiscal measures taken to lower inflation, stabilise the **business cycle** or reduce unemployment.
- Disposable income** The total income of households after tax and benefit payments.
- ECOFIN** The Council of the European Union meeting in the composition of Economic and Finance Ministers. ECOFIN is the legislative body in the field of economic and financial affairs and also coordinates the economic policies of the Member States.
- Economies of scale** Where the average cost of producing a unit of a good falls as the number of units produced increases.
- EC Treaty** Treaty establishing the European Community (first agreed in Rome in 1957 as the ‘Treaty establishing the European Economic Community’, revised in Maastricht in 1992 as the ‘Treaty establishing the European Community’ and revised again in Amsterdam in 1997). It includes the Treaty articles on EMU.
- Effective exchange rate** The exchange rate of a country’s currency measured by reference to a weighted average of the exchange rates of the currencies of the country’s trading partners.
- Endogenous** Describes a variable whose value is determined by other variables within a system.
- Endogenous convergence** In the context of EMU, refers to convergence that occurs as a result of being part of the monetary union. For example, a monetary union may lead to a higher trade between countries than if they had retained separate currencies. Trade increases the extent to which economic conditions in one country or region affects its trading partners, and as a result will tend to increase the convergence of their **business cycles**.
- Equilibrium exchange rate** The exchange rate that would prevail when the economy has fully adjusted to disturbances in the demand for and supply of its goods and services.
- Equity market capitalisation** The total value of all shares listed on a stock exchange. Often expressed as a percentage of the GDP of the country in which the exchange is located.
- Euro area** Collective term for the 12 (11 prior to January 2001) participants of EMU: Austria, Belgium, Finland, France, Germany, Greece (as of January 2001), Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.
- Eurobond** A bond denominated in a currency other than that of the country where it is issued, for example a dollar-denominated bond issued in London. Not to be confused with euro-denominated bonds.
- Eurogroup** An informal meeting of euro area Economic and Finance Ministers promoting information exchange between euro area countries.
- Euromarkets** The money market for borrowing and lending currencies that are held in the form of deposit, such as **Eurobonds**, located outside the country where the currency is issued as legal tender.
- European Central Bank (ECB)** The independent central bank established under the **EC Treaty** to set monetary policy for the euro area as a whole. The ECB’s primary decision-making body is the Governing Council, which comprises the six-member Executive Board and the Governors of the National Central Banks of euro area countries.

- European Council** The European Council brings together the Heads of State or Government of the Member States of the European Union and the President of the European Commission in the form of a ‘European Summit’.
- Eurosystem** The Eurosystem is the **ECB** together with the national central banks of the Member States which have adopted the euro.
- Excessive Deficit Procedure (EDP)** Set out in Article 104 of the **EC Treaty** and clarified in Council Regulation 1467/97, an obligation on euro area Member States to avoid excessive budgetary deficits, defined by a reference value of 3 per cent of GDP, unless the deficit is ‘*exceptional and temporary*’. Article 104 also sets out a procedure to be followed at Community level to identify and counter such excessive deficits, including the possibility of financial sanctions.
- Exchange rate risk** The risk that movements in the exchange rate will affect the domestic currency value of a firm’s foreign currency revenues or assets.
- Financial intermediary** An institution which holds money balances of, or which borrows from, individuals and other institutions in order to make loans or other investments. Hence, financial intermediaries channel funds from lenders to borrowers.
- Fiscal flexibility** Describes the ability of **fiscal policy** to adjust in response to economic **shocks**, and the speed with which that adjustment takes place.
- Fiscal policy** Government economic policy in which changes in taxation, benefit payments, and government expenditure and borrowing are used to influence the economy.
- Foreign direct investment (FDI)** Where a firm based in one country invests in another country. Investment may take the form of establishing production facilities or acquiring a significant share of the ownership of a company operating in another country. Inward FDI describes foreign firms’ investment in the host country and outward FDI describes investment by home country companies in other countries.
- Functional flexibility** Describes the ability of the workforce to perform different tasks and to acquire and apply different skills, enabling employees to perform a wide range of jobs and to adapt readily to technological change.
- Golden rule** One of the UK Government’s two fiscal rules (the other being the **sustainable investment rule**). It states that over the economic cycle, the Government will borrow only to invest and not to fund current spending.
- Gross domestic product (GDP)** A measure of the total flow of goods and services produced by an economy – known as ‘output’ – over a specified time period, normally a year.
- Gross value added (GVA)** The total value of goods and services produced by the economy minus the value of goods and services used to produce the final products.
- Harmonised Index of Consumer Prices (HICP)** A measure of price levels on a comparable basis across EU Member States and the EU and euro area as a whole. The annual increase in the HICP is a measure of the rate of inflation.
- Hedging** Collective term for a range of techniques used to protect against risk, such as foreign exchange fluctuations. Usually involves buying one security and selling another. A perfect hedge produces a risk-free portfolio.
- Home bias** The tendency of investors to invest in their own country’s assets, even when it may be more profitable to invest in foreign assets.

<b>Hysteresis</b>	The failure of macroeconomic variables to return to their original values after a temporary economic disturbance.
<b>Inflation expectations</b>	The views held by individuals as to the future behaviour of the rate of inflation.
<b>Labour market flexibility</b>	Describes the ability of the labour market to adjust to economic <b>shocks</b> and longer-term structural changes achieved through a combination of adjustments in wages, the supply of labour and the demand for labour.
<b>Liquidity</b>	A liquid market allows participants to find a counterparty for a trade at a reasonable price, and to buy and sell with relative ease, with minimum price disturbance. Liquidity risk is the risk of not finding a counterpart for a transaction at a reasonable price.
<b>Lucas critique</b>	In 1976, Robert Lucas argued that economic models built to capture the relationship between variables on the basis of past behaviour could produce unreliable predictions if economic circumstances change. The Lucas critique criticises efforts to predict the impact of a policy in the future according to previous responses.
<b>Marginal cost of capital</b>	The cost of a small increase in productive capacity.
<b>Marginal return to investment</b>	The revenue gain to a firm of a small increase in productive capacity.
<b>Mergers and acquisitions (M&amp;A)</b>	Mergers involve firms combining into one operation on roughly equal terms, whereas acquisitions involve one firm taking over another. M&A is used as a collective term encompassing both of these concepts.
<b>Monetary policy</b>	Policy with respect to the official interest rate and other monetary variables, for example the quantity of money in the economy.
<b>Monetary transmission mechanism</b>	The mechanism through which the operation of <b>monetary policy</b> , such as interest rate changes, affects output and inflation.
<b>Mortgage equity withdrawal</b>	Measure of the part of consumer borrowing from mortgage lenders that is not invested in the housing market.
<b>NAIRU</b>	Non-accelerating inflation rate of unemployment. The rate of unemployment in an economy consistent with a stable rate of inflation. Sometimes referred to as <b>structural unemployment</b> or the natural rate of unemployment.
<b>Nominal exchange rate</b>	The exchange rate as quoted on financial markets, expressed in value terms rather than real (inflation-adjusted) terms.
<b>Nominal interest rate</b>	The interest rate as quoted on financial markets, expressed in value terms rather than real (inflation-adjusted) terms.
<b>Nominal rigidity</b>	Describes the situation where nominal variables (such as wages or prices) do not adjust immediately in response to shocks.
<b>Nominal wage flexibility</b>	Describes the ease with which nominal wages (the pay of an individual before adjusting for changes in the price level) adjust, in particular when this adjustment entails potential wage cuts.
<b>Output gap</b>	The difference between the level of trend or <b>potential output</b> and the actual level of output in an economy.

<b>Portfolio diversification</b>	The holding of a range of assets across firms, sectors, countries or regions in a portfolio in order to diversify risk. Provided that the risks associated with each asset are not strongly positively related, a diversified portfolio will tend to have less overall risk than its individual components.
<b>Potential output</b>	The level of output that is consistent with stable inflation in the long run.
<b>Price dispersion</b>	The difference in the price of a given good between specific locations, regions or countries.
<b>Price transparency</b>	The ability of consumers to compare prices of goods and services in different markets. In relation to EMU, often used with reference to cross-border price comparisons.
<b>Product market flexibility</b>	The ability of product markets to act as an <b>adjustment mechanism</b> to economic <b>shocks</b> and long-term structural changes in the economy. Price flexibility is an example of product market flexibility.
<b>Productivity</b>	The relationship between the output of goods and services and the inputs of resources used to produce them. Higher productivity enables higher output from the same quantity of inputs.
<b>Purchasing power parity (PPP)</b>	An exchange rate between two currencies such that the same basket of goods and services could be bought at the same price in each country if the cost were converted at that exchange rate.
<b>Rate of return</b>	The income from an investment as a proportion of the total amount invested. Can be used in relation to investment in financial assets or to physical investment (see also <b>marginal return to investment</b> ).
<b>Real exchange rate</b>	An exchange rate between two currencies that adjusts the market exchange rate for measures of either price levels or cost levels in each country.
<b>Real interest rate</b>	The <b>nominal interest rate</b> minus the rate of inflation.
<b>Real wage flexibility</b>	Describes how rapidly real wages (the pay of an individual after adjusting for inflation) respond to imbalances between labour demand and labour supply.
<b>Relative wage flexibility</b>	Describes movements in wage differentials across particular segments of the labour market, such as different regions or different occupations.
<b>Retail financial services</b>	Financial services provided to private individuals or small businesses. For example, savings and loans, insurance, mortgages and investment advice.
<b>Retail Prices Index (RPI/RPIX)</b>	The RPI is an index of the retail prices of goods and services, expressed in percentage terms relative to a base year. RPIX is calculated as the RPI excluding mortgage interest payments. The annual increase in the RPI is a measure of the rate of inflation.
<b>Risk sharing</b>	The concept that, by holding a diversified portfolio of financial assets, households can insure themselves, at least in part, against falls in income that arise from downturns in their local (or national) economy.
<b>Securitisation</b>	The substitution of <b>securities</b> , generally bonds, for loans. Banks and other <b>financial intermediaries</b> , for example, have packaged house mortgages in this way so that the interest paid by borrowers is received by the purchaser of the <b>security</b> .
<b>Security</b>	A financial asset, usually shares or bonds, which gives the holder a claim on property or future income (for example, dividends).
<b>Seigniorage</b>	Revenues gained from the issuance of notes and coins by a central bank, where banknotes and coins cost less to produce than their face value or selling price.

- Shock** An event which has an impact on an economy, in either a positive or negative way. Shocks may come from a source inside or outside the economy. The oil price increases of the 1970s and their effects on the UK and global economy have been among the most prominent shocks in recent decades.
- Single Market** The Single European Act, adopted in 1986, defined the internal market as “*an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty of Rome*”.
- Specialisation** Describes the extent to which the activity of a given region occurs in a small number of industries, usually defined relative to other countries or regions.
- Stability and Growth Pact (SGP)** Part of the intergovernmental framework for the coordination of fiscal policies in the EU under which Member States aim to safeguard sound government finances. Adopted at the Amsterdam European Council in June 1997, the SGP is underpinned by the **EC Treaty**, supplemented by a Resolution of the **European Council** and two Council Regulations.
- Structural unemployment** Usually used as a synonym for the **NAIRU**.
- Sustainable investment rule** One of the UK Government’s two fiscal rules (the other being the **golden rule**). It states that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (defined as below 40 per cent of GDP).
- TARGET** Trans-European Automated Real-time Gross settlement Express Transfer system, the **Eurosystem’s** wholesale cross-border payment system.
- Transaction costs** The costs associated with buying and selling, particularly in financial transactions. An example is the fee charged for foreign exchange trades between sterling and euro transactions. These would be removed should the UK join EMU.
- Wholesale financial services** Those financial services activities undertaken on a large scale by professional investors and borrowers either on their own account or on behalf of large-scale, normally corporate or governmental, clients.

## LIST OF ABBREVIATIONS

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BEPGs	Broad Economic Policy Guidelines
BIS	Bank for International Settlements
CBI	Confederation of British Industry
E5	Group of five countries at the geographical centre of the euro area: Belgium, France, Germany, Luxembourg and the Netherlands
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFTA	European Free Trade Association
EIU	Economist Intelligence Unit
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
EU15	The 15 members of the EU. Comprises the 12 members of EMU: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain; plus Denmark, Sweden and the UK
FDI	Foreign direct investment
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
G7	Canada, France, Germany, Italy, Japan, the UK and the US
GDP	Gross domestic product
GVA	Gross value added
HICP	Harmonised Index of Consumer Prices
ICT	Information and communication technology
IFSL	International Financial Services, London
ILO	International Labour Organisation
IMF	International Monetary Fund
IT	Information technology
M&A	Mergers and acquisitions
MIPs	Mortgage interest payments
MIRAS	Mortgage interest relief at source
MPC	Monetary Policy Committee
NAFTA	North American Free Trade Agreement
NAIRU	Non-accelerating inflation rate of unemployment
NIESR	National Institute of Economic and Social Research
NiGEM	National Institute Global Econometric Model

## LIST OF ABBREVIATIONS

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OCA	Optimal currency area
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Cooperation and Development
OEIC	Open-ended investment company
OFT	Office of Fair Trading
ONS	Office for National Statistics
PPP	Purchasing power parity
QMV	Qualified majority voting
R&D	Research and development
RDA	Regional Development Agency
RMS	Root mean squared
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RPL	Relative price level
SGP	Stability and Growth Pact
SMEs	Small and medium-sized enterprises
SVAR	Structural vector auto-regression
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
UIP	Uncovered interest parity
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States
VAT	Value Added Tax
WEO	IMF World Economic Outlook
WTO	World Trade Organisation